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EVALUATION OF SOCIAL MARKETING OBJECTIVES: A CASE STUDY OF THE EFFECTIVENESS OF OPERATION GCIN’AMANZI IN SOWETO, SOUTH AFRICA

Maxwell Agabu Phiri*, Degracia Khumalo**

Abstract

This study was aimed at investigating the effectiveness of the social marketing goal in the implementation of Operation Gcin’amanzi (OGM) in Mofolo North, Soweto, South Africa. The paper is based on a quantitative in nature, although qualitative data was collected to confirm and clarify issues identified in the survey questionnaire. A process-based research approach was pursued in order to measure the impact of social marketing as a phenomenon that has been explored in changing consumer behaviour for the public good. Due to unsuccessful telephone calls to the Johannesburg Water’s communication centre (JW) there is a lack of information from them on specific studies or surveys conducted specifically on OGM since its inception. It is anticipated that the findings from this study will add value to the knowledge in the public sector by elevating the significant role of social marketing in the delivery of basic services projects. These projects are complex in nature as issues of equity, access and the impact on development have to be considered, unlike in traditional marketing approaches where it is the benefit and satisfaction of an individual consumer that is key.

Keywords: Social Marketing, Project Management, Service Delivery

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1 Introduction

The City of Johannesburg, hereafter (CoJ) hosted a spectacular opening and closing ceremonies during the 2010 FIFA World Cup, entrenching its position as the epicenter of Africa. Inspite of being Africa’s second largest economy (McKinsey Global Institute, 2014), there are still remnants of the apartheid legacy especially among previously disadvantaged communities (Statistics South Africa, 2013). Since the commencement of democracy, the CoJ has been challenged by a lack of basic service delivery in water and sanitation within the Johannesburg Metropolitan (Metro) (Gauteng Legislature, 2014) and more specifically to its major townships of Soweto and Orange Farm. In the last seven years, access to water has been a controversial issue in Soweto with the introduction of Operation Gcinamanzi (OGM) in 2003 (Gavin, 2009). The introduction of OGM, which emphasised water demand management through prepaid metering and other strategies, has resulted in confrontations between the CoJ and civil society.

Predominantly white areas, popularly known as the suburbs, were well serviced at the expense of the predominantly black areas, which came to be known as townships. As a result, infrastructure in the townships is inferior, over and above the fact that with the advent of the new government in 1994, maintenance was not prioritised. Therefore, infrastructure has deteriorated rapidly in areas such as Soweto, which is one of the first black townships in South Africa.

2 The research problem statement

Due to the controversy generated by OGM in Soweto resultant of assuming ineffectiveness in achieving the social marketing or non-financial objectives, an integrated social marketing approach has been recommended. The purpose of this article is to discuss some of the issues that are related to the effectiveness of the social marketing in the implementation of OGM in Mofolo North, Soweto. The research objectives of this study were to: 1) investigate the effectiveness of the OGM and save water in the implementation of prepaid metering devices 2) determine the influence of demographics in adopting water saving behaviour, to investigate consumer perceptions, beliefs, and attitudes on the socio-economic impact of OGM 3) investigate consumer satisfaction with the implementation of OGM and 4) determine the positioning of OGM in the minds of the consumers in the CoJ.
3 Literature review

3.1 Theoretical foundation: growth and development of social marketing

There has been a growing interest in social marketing among academics in the 21st century despite its roots dating back to before World War I. Governments are mandated with improving the quality of life for the benefit of society in the delivery of public sector services. In the 21st century, globalisation emphasizes consumer-focused strategies in the delivery of public services. It is as a result of the growing exposure of the citizenry to private sector management techniques and the introduction of public sector reforms, to include cost recovery, that have resulted in people gaining the status of consumers (Allen, et al. 2006; Roch & Poister, 2006).

3.2 The social marketing theoretical framework

Over the last decade, social marketing has gained momentum resultant of the social challenges and limited resources facing the public sector in the public services delivery, especially in developing countries in the provision of basic services (Wiebe, 1951/1952; Wilkie & Moore, 2003, Proctor, 2007).

Public sector services consumers have become global citizens, being able to easily access information and are now demanding that the public sector adopt private sector management techniques to satisfy its mandate to the public and keep citizen dissatisfaction at bay (Baker, 1995; Hastings, 2007; Walsh 1994). Hence, social marketing is a strategic management tool in the application of public sector reforms such as the New Public Management (NPM) which is concerned with inter-alia consumer satisfaction and improved service delivery (Pollit & Bouckaert, 2004).

The strategic emphasis on social marketing is intent on influencing a change in consumer behaviour for the benefit of society. It further forms the backbone for this study and the extrapolation of the theoretical framework from an individual consumer behaviour perspective to sustainable and equitable service delivery for the benefit of society through the development of acceptable group behaviours.

3.4 Change in consumer behaviour

Due to the complexity of social marketing, a change in behaviour is influenced by multiple stakeholders through simultaneous partnership exchanges at the individual, interpersonal, institutional, community and public policy levels (Hastings, 2007; Hunt, 2002). Furthermore, in the public sector consumer behaviour is impacted by various social structures including the influence of ward councillors, ward committees, local government, provincial and national government in the delivery of basic services (Rogers, 1995; Proctor, 2007).

3.5 CoJ’s participation in social marketing

Andreasen (2006) commends the close engagement of society in public services discussions and decisions as a demonstration of the public sector acknowledging the public as critical stakeholders and consumers in the management of limited resources within government.

The outcome of these close engagements where social marketing is employed is that consumers become aware and informed of the consequences of adopting certain behaviours that government is advocating in improving the quality of life for society. In its objectives, the OGM infers that the programme is aimed at the following (Barry, 2007):

- Reducing water losses: 7 billion litres a month
- Encouraging water conservation and responsible use
- Addressing water supply and consumption problems
- Installing approximately 169 000 free pay meters
- Creating a conducive environment for payment of water and sewerage services
- Decommissioning mid blocks

3.6 Competition and positioning of the CoJ

Whilst trying to influence the citizenry to make use of public sector services with consideration for the benefit of society, social marketing objectives are challenged by competition in the internal and external environment of the consumers (Siegel & Donor, 2004; Kotler & Lee, 2006). Internal competition emanates from the current or preferred behaviour, while external competition arises from other factors seeking to position their influence in the minds of the consumers (Grier & Bryant, 2005; Reis & Trout, 2000).

Expanding on the impact of competitive positioning, Hastings (2007) observed that in the effort to adopt new constructive behaviour, a consumer’s cognitive process is challenged by a myriad of competitive factors that include inertia, existing behaviours, alternative behaviours, and competition from commercial marketing and other organizations. For instance, in South Africa, the public sector is challenged by low revenue collection from the delivery of basic services that include water, sanitation and refuse removal due to the high levels of unemployment and poverty, which are estimated at approximately 40% and 27% respectively (Landman, et al., 2003). The CoJ has a 30% indigent rate, that is, households living below the poverty line, and an unemployment rate of 22.6% of the economically
active population (CoI, DEDP, 2008). A major drawback to public sector reforms, like cost recovery as embedded in OGM, is poverty. Consequently, repairing a leaking faucet so that water can be conserved for the benefit of the community becomes of secondary importance like putting bread on the table for survival (Bond, 2002; Fiil-Flynn, 2001; McDonald, 2002).

In circumstances like these, the social diffusion process highlights that the rate of adoption of innovative behaviours is likely to be low due to the social standing and education of community members which affects the levels of awareness, knowledge and interest, and the survival instinct (Rogers, 1995; Bond 2002). However, Johnson (1999) and Fjelstad & Ajam (2004) argue that socio-economic disparities have no influence on the consumer’s behaviour and attitudes towards taking responsibility for maintenance, and consequently the payment of services charges. They are of the opinion that in South Africa, consumers in Soweto and other previously disadvantaged communities have developed a culture of entitlement which leads to irresponsible behaviour that affects the whole community. These arguments are outside the ambit of this literature review, but they highlight important considerations that need to be taken into account in the assessment of the positioning of social marketing in the mind of the consumer. Nonetheless, careful product development that elevates the core benefits of social marketing and the augmented product by adopting a constructive behaviour has the potential to reduce competition.

Hence, the positioning of each of the six characteristics of a successful social marketing programme is critical since it informs the most competitive approaches within target segmentation (Stead, et al., 2007), thereby relying on innovation and creativity to bring value and behavioural change (Urban 2004, Kotler & Lee, 2006, McKenzie-Mohr, 1999). For example, the marketing mix should question the cost-benefit ratio of exchanging specific behaviour for another by looking at the product and price relationship, incentives and penalties, distribution channels and the communications in relation to the competition.

In analysing the marketing mix strategy, a clear unique selling proposition should entice the consumers to take an interest in the benefits of new behaviours that should provide superior value in relation to the old behaviours by creating a distinctive position in the mind (Reis & Trout, 2000; Kotler & Lee, 2009).

3.7 Policies

These are the regulations that guide the public sector. Water delivery in South Africa is guided by the Water Act (No. 36 of 1998) and service delivery is guided by the Constitution, and strategic plans instituted by the government (Department of Water Affairs and Forestry, 1998). The implementation of OGM has focused on the policy aspect in the marketing mix evidenced by the standoff between government and residents. Most arguments have a socio-political angle which questions the legality of the intervention. Yet, the community has become consumers through the introduction of prepaid meters, which recover costs. The quality and effectiveness of the OGM should be measured specifically through consumer satisfaction surveys which should be used to draw lessons learnt for future planning.

3.8 The application of social marketing in the public sector

The literature highlights a strong allegiance towards public health and social services in the implementation of social marketing programmes (Weinreich, 1999). Within the public health and social services, social marketing has been prevalent in programmes relating to nutrition, criminal justice, wellbeing and associated social behaviour (Hastings, et al., 2005; Guindon & Boisclair, 2003; McDermott, et al., 2005).

Mellkote, et al. (2001), Fine (1990) and Fraser & Restrepo-Estrada (1998) observed the successes of the application of the diffusion theory in social marketing programmes relating mostly to public health in developing countries. An example that can be associated with the delivery of public infrastructure is that of Trunnel and White (2005) who also applied the diffusion theory to influence a change in behaviour that resulted in the reduction of infections related to water and sanitation services.

3.9 Services delivery in post-apartheid South Africa

All over the world South Africa is applauded for having one of the most progressive constitutions, recognising diverse human rights which enabled a smooth transition from apartheid to democracy (Mammburu, 2009). The smooth transition raised high expectations from the previously marginalised and disadvantaged communities associated with an opportunity for all South Africans to have a better life irrespective of class, race, or social standing. However, judging by the increasing number of uprisings and riots in recent years, a better quality of life has fast become a distant dream in some communities (Williams, 2007; Mammburu, 2009).

In an effort to make good on the injustices of apartheid, the South African government found itself caught in a dilemma as to how to ensure that every South African had access to basic services. In 1994, approximately 90% of the population did not have infrastructure basic to the wellbeing of society, such as water, sanitation, and electricity (City of Johannesburg, 2014). Furthermore, revenue generation in previously disadvantaged communities
is challenged by high levels of unemployment and the inadequate budgeting practices of capital expenditure of the past. For example, the past regime allocated approximately ZAR 600 per person for infrastructure development in urban areas and ZAR 100 per person in the townships, and much less in rural areas (City of Johannesburg, 2014). This resulted in inferior infrastructure development which is rapidly deteriorating and requires upgrading or replacement. Also, the previously disadvantaged areas, due to other socio-economic conditions such as high levels of unemployment are perpetually dependent on government (City of Johannesburg, 2014).

In responding to this challenge, the government aligned itself with the practices of developed countries who adopted NPM reforms in the public sector. This entailed inviting more participation of the private sector through various funding mechanisms and structures such as Public Private Partnerships (PPPs), corporatisation and privatisation. The current local government dispensation is aligned with all the objectives of the NPM, including active consumer participation in the planning and delivery of infrastructure, and consumer-orientated approaches such as the adoption of ‘Batlo Pele’ principles (Education and Training Unit, 2014), in public services delivery.

The NPM reforms regard the inclusion of the private sector as a critical stakeholder in public services delivery and are viewed by one school of thought as ideal to address the infrastructure backlogs. It is believed that the private sector has the potential to adopt market principles which, in effect, will benefit the poor and the marginalised through economies of scale and efficiencies. According to Savas (2005), the private sector has better financial resources and human capital strengths than the public sector. As a result, PPPs are more politically appropriate and the government encourages them as funding mechanisms to ease the frustration of the basic services backlog. Numerous studies have been conducted on the impact of PPPs in poor communities, and most of them indicate a change in the quality of life for the better (Development Report 142, 2000).

On the other hand, another school of thought views the NPM reforms as a classical case of perpetuating neo-liberalism. According to McDonald, et al. (2002), the poor are likely to be destitute if they cannot afford the services in an environment that perpetuates survival of the fittest. Some studies have been conducted with unsuccessful PPPs; for example, the Mpumalanga Water Concession cost the local government far more than expected and it is inferred that consumers are now carrying the burden until the concession agreement expires (Smith, et al., 2003).

3.10 The CoJ metropolitan mandate

A large portion of basic services delivery has been mandated by the Constitution of 1996 for delivery by local government which includes Metropolitan, District and Local Councils (SALGA, 2011). The Metropolitan, District and Local Councils are differentiated by the functions allocated by the Constitution, S155.1.a and the Municipal Structures Act 1998 (Act 117 of 1998) which expect that a Metropolitan Council should fulfill the functions of both District and Local Councils. Furthermore, the Municipal Structures Act of 1998 implements the expectations of the Constitution to develop Unicities, which implies that Johannesburg, East Rand, Pretoria, Durban, Bloemfontein and Cape Town would incorporate a mix of cities under their jurisdiction to avoid a duplication of functions and multiple service points for citizens (SouthAfrica.info, 2014). The CoJ is one of the six Metropolitan (Metro) Councils, in South Africa. Together with Ekurhuleni (Germiston) and Tshwane (Pretoria) Metropolitans, these cities constitute the Gauteng Province. As a Metro, the CoJ is classified as a Category A municipality, which is expected to be a centre of economic development with strong social and economic linkage (SALGA, 2011). The challenges of national government are cascaded down to local government, and the CoJ had to amalgamate with previously disadvantaged municipalities and came close to insolvency due to the inequitable distribution of wealth, the poor revenue base, and increasing demands on municipal expenditure (SALGA, 2011).

The first strategic plan, iGoli 2002, ended up with a structure that entailed 11 regions, five municipal entities for basic services delivery, five economic development entities, and four support services for planning, emergency services, the metro police and heritage services (City of Johannesburg, 2002). The CoJ also split the core functions of the municipality between the contractor and client function, thereby increasing efficiency and creating good organisation. The municipal manager is the accounting officer appointed to fulfill a role equivalent to the Chief Executive Officer (CEO) and reporting to the Chair of the Board (Executive Mayor) who reports to the Board (Council). The Integrated Development Plan (IDP) guides the services delivery agenda of the CoJ through the interlinking of the various functions in fulfilling the City’s mandate.

3.11 The mandate of Johannesburg Water (JW)

JW is an independent municipal entity that was established following the adoption of the iGoli 2002 plan in 1999 (SALGA, 2011). The CoJ is the sole shareholder of the company which provides services to approximately 3.84 million citizens resident in over 1.69 million households in and around Johannesburg.
(City of Johannesburg, 2014; CIA World Factbook, 2014). Its annual is approximately R 1.6 billion (City of Johannesburg, 2013) and it is managed along private sector management lines which foster customer satisfaction and cost recovery business principles. In the delivery of the water function on behalf of the city, JW has to take cognizance of various legislations such as the Constitution, the Water Services Act (1997), and the National Water Act (1998).

The vision of the JW is to become a world class water utility entity in South Africa and deliver quality water and sanitation services through sustainable, cost effective and affordable delivery (Johannesburg Water, 2013). It is also committed to upgrading services in low income areas and fosters a customer-friendly culture in services delivery. Its performance objectives entail the reduction of water and sanitation backlogs; reviewing metering policy, water and energy losses; and updating the water services development plan. OGM is one of the flagship programmes of the JW and is referred to in this study to determine consumer behaviour and satisfaction.

It has been observed that many problems have been reported since the inception of water metering under the OGM programme (WD-SA, 2009). These problems range from removal of meters, defect infrastructure, communities complaining about total disregard for their properties, complaints about leakages, protests against the programme and detention of anti-privatisation activists (McDonald, et al., 2002).

3.12 Implementation of OGM programme in Soweto

OGM which means ‘Operation Conserve Water’ is a R1 billion plus programme adopted by the CoJ Council in 2003 for implementation by JW to improve services delivery throughout Soweto over a five year period (Johannesburg Water, 2006). According to Johannesburg Water (2006) and Barry (2007) the objectives of OGM are to:

- Reduce the seven billion litres of water lost monthly in Soweto.
- Ensure a reliable and affordable service to every household in the area.
- Address water supply and consumption problems in Soweto.
- Address issues surrounding affordability, wastage, and loss, therefore creating an environment conducive to payment for the services of water and sewerage.
- Provide and implement a free payment metering programme.
- Relocate the reticulation system from the mid blocks to the road reserve, thus decommissioning the former.

Although not very clear in the objectives of the JW, the thrust of this paper on social marketing is based on interrogating the effectiveness of the objectives that aim to encourage water conservation for the benefit of society.

A contentious element of the OGM implementation programme was the introduction of free pay meters. According to the CoJ the free pay meters make it possible for households who use less than 6 000 litres of the free basic water allocation to benefit there from it without having to pay any additional costs. Furthermore, the free pay meters provide a budgeting mechanism for consumers to track their usage and not be surprised by monthly bills (Barry, 2007). However, the installation of free pay meters is seen by anti-metering organisations as prepayment meters which are used to infringe on the rights of communities to access water. It is also viewed as discriminatory as it is implemented only in traditionally black townships (McDonald, et al., 2002).

This resulted in a controversial court case between the residents of Soweto and the CoJ. The Court rules are conflicting, favouring each side on certain elements and resulting in each party claiming victory. In 2008, the Johannesburg High Court ruled that the free pay meters were unconstitutional, together with the minimum water allocation of 6000 litres per household per month which translated to 25 litres per day for a family of eight; this was considered to be a reasonable average for Soweto residents (Southern African Legal Information Institute, 2009). In March 2009, following an appeal by the CoJ, the earlier judgment was upheld with modifications for a recommendation of 42 litres per family member per day, instead of 50 litres that was sanctioned earlier on. The CoJ and Phiri residents both then applied to the Constitutional Court which favoured the city’s position to install prepaid meters and ration water according to the current allocations (Southern African Legal Information Institute, 2009).

3.13 Demographics & socio-economic indicators of Soweto

Soweto is a mega township in the CoJ of which by 2008 inhabited by a population of approximately 1.3 million people and now it has over 3 million 2014 residents spread across 32 formal townships/wards and a number of informal settlements (Chauke, 2013; Siyabona Africa Travel, 2014; Soweto Vibe, 2014). The name Soweto is an acronym for South Western Townships, and has 305 000 formal households with an average of 4.2 family members. The township has approximately 12 800 shacks; 15% of the informal settlements in the CoJ.

Soweto has a high level of unemployment as well as a high level of poverty. Approximately 28% of the households earn about R800 per month, 40% of the total households are unemployed, and the weighted average of household income is about ZAR 3,800 per month, and 70% of the employed...
population work outside of Soweto. The poorest townships include Phiri which was the first pilot site of JW’s OGM roll out programme in February 2004 (Danchin, 2010).

### 3.14 Local economy and the state of infrastructure in Soweto

Currently Soweto contributes about 4% to the CoJ’s Gross Domestic Product (GDP)(City of Johannesburg, 2014). It is estimated that, including social grants, the spending power is about ZAR 3.5 billion per annum, hence the interest in retail and property development. However, the according to Dr. Anthony Turton from the Centre for Environmental Management, the province of Gauteng’s economic development is in jeopardy due to the unreliable water supply and related shortages, which may have adverse repercussions for the major industries in the province contributing to the country’s GDP (Molathwla, 2014). Gauteng, through its industrial and commercial activities, contributes a percentage of 34.7 to the national GDP (Statistics South Africa, 2014 in Alexander, 2014).

The impending water shortages imply that small contributors like Soweto to the GDP of CoJ may experience adverse impacts with the slowing down of infrastructure and development investments and therefore the ability to draw investors into the township to participate in economic development. The Gauteng unicities put together a task team to develop a strategy that will support water management and sustainability (DWAF, 2006).

### 3.15 The state of water infrastructure in Soweto

Soweto is one of the oldest working class townships in South Africa. The water infrastructure linking Soweto and Johannesburg is more than a century old. Approximately 15,000 litres of water are lost daily from the 9,500 kilometres of water infrastructure reticulating Johannesburg which feeds to Soweto (www.igoli.gov.za). The aging infrastructure may be perpetuating the belief that consumers are contributing to the water losses as most households also experience leaking toilets and pipes. One of the key mandates of JW is to reduce the losses through households which comprise at least 15% of the estimated water losses. The rest is allocated to free basic water which is accounted for through the indigent allocations (www.igoli.gov.za).

### 4 Research methodology

According to Creswell (2003), Trochim (2006) and Saunders, et al. (2007), the research approach chosen in a study highlights the epistemology or the philosophical thinking or knowledge of the researcher by providing the scope on the purpose of the study. The epistemology is the underlying influence guiding the research to achieve its objective whilst also taking cognizance of the limitations.

In this study, a quantitative research approach was selected to complement the positivist epistemology in line with the objective to measure consumer behaviour and satisfaction, although in the methodology, a convergence of quantitative and qualitative data collection tools occurred. The study’s approach was supported by Creswell (2003) and Krauss (2005), who state that although researchers have the quantitative or qualitative research approaches to select from, these are merely philosophical and not methodological, hence the emergence of a mixed research philosophy and the convergence of data collection tools.

#### 4.1 Quantitative research approach

The quantitative research approach is aimed at counting and measuring knowledge, attitudes, beliefs and behaviours through numerical data that can be statistically analysed (Cresswell, 2003; Bless & Higson-Smith, 2000). Furthermore, according to Fouche & Delpot (2000) and Collis & Hussey (2003), it has a strong allegiance to the positivist research philosophy that seeks to test the trueness of what is already known through scientific extrapolations. The benefits of a quantitative research approach for this study were; the ability to create generalisations about the influence of OGM on consumer behaviour towards water management in Soweto and the ability to extricate the consumer satisfaction levels through the use of close-ended questions that required specific responses to issues of policy, socio-economics, attitudes and behaviours towards OGM.

#### 4.2 The appropriateness of the data collection instrument

In marketing studies, it has been found that survey questionnaires are the most widely used instruments in soliciting attitudes, behaviours, and perceptions (Rasmusson, 1999). In order to mitigate the disadvantages of the quantitative research approach, the research method entailed the application of a qualitative data collection tool, focus groups, that were aimed at allowing the researcher to make judgments, draw relationships from variables following the application of open-ended questions, and gain insight that is not driven by measurements (Healey & Perry, 2000; Trochim, 2006).

#### 4.3 Research design & process

OGM has been in implementation since 2003, backed by years of prior policy work and theory formulation (Water Services Act, 1997, the Constitution, 1996), hence it was appropriate to follow the process based
research design since it sought to measure the impact on consumer behaviour and satisfaction through quantitative and qualitative data collection methods. According to Hussey & Hussey (1997), there are fundamental steps that each research project must cover, irrespective of the research design, type or approach if it is undertaken under the auspices of a scientific study. Moreover, Punch (2000) advises that in pursuing these fundamental steps, the researcher elaborates on the tools and strategies by which empirical data will be collected and analysed, therefore providing the means to test the thesis statement and satisfy the objectives.

Thereafter, an overview was provided on the services of CoJ including OGM and a profile of Soweto where it was initially piloted. The findings of the literature review guided the selection of the epistemological approach that was pointing towards a quantitative approach and further highlighted that in view of the objective, the study was more suited to the process based research approach.

5 The sampling strategy

5.1 Target population: questionnaire survey

The target population, according to Gorard (2003), consists of all the possible and relevant subjects that are eligible to be selected for participation in the study. The target population for the primary data collection consisted of 1,600 households within the study location; Mofolo North, Soweto. Only the formal households in the area qualified for participation, therefore the informal settlements around the area were excluded, as were businesses and schools, as they were exempt from participating in the OGM programme.

Each household was counted as a single participant, despite the fact that some households had more than one family in the yard, mostly not related to the main family but renting out backrooms or shacks within the formal compound. However, their dependence on the main household infrastructure implied that these households were a homogeneous component of the main household.

5.2 Target population: focus groups

In the second phase of data collection, other stakeholders in the Mofolo North community were included to explore further the responses of the households from various professional and interest groups’ point of view through focus group discussions. Their selection was conducted purposefully due to the interest in their expert opinion and standing in the community.

5.2.1 Group 1: Mofolo Home Based Care (MHBC) Board of Directors

The group consisted of a variety of community members with vast experience in different fields, ranging from business to public health and community welfare. The participants were of a mature age, between 35 and 75 years, and expressed themselves as heads of families and community development activists. The group consisted of seven members with an 80:20 gender representation between females and males.

5.2.2 Group 2: Mofolo Community Workers

A group of nine (two of whom were largely silent) community workers was identified for participation as a result of the practical, day-to-day hands-on experience in the community regarding quality of life. Therefore the group was able to contextualise the socio-economic impact of OGM in the community. The community workers were all female, aged between 22 and 47 years. Four of the community workers resided in the area.

5.2.3 Determining the sample size

The appropriate sample size in relation to the population articulated above was determined to be 310 households, which was appropriate for generalisations to be made to the population at large. The households were surveyed and expected to reveal broad behavioural aspects pertaining to attitudes, beliefs, awareness, and knowledge amongst the population. The sample size was determined in line with the statistical sample tables developed by Krejcie, et al. (1970). However, the study sampled 400 households to increase the generalisation value of the sample, allowing for spoilt responses without necessarily affecting the base sample size.

Numbers were created in an Excel spreadsheet for 1,600 households, cut into single numbers and placed in a container. The container was shaken to thoroughly mix the numbers and the first 400 pulled from the container were recorded for participation.

5.2.4 Data collection methodologies

Data collection facilitates the analysis of raw data into information and therefore requires an approach that is holistic to mitigate prejudice. A survey questionnaire and focus group interviews were selected to enable methodological triangulation (Sekaran & Bougie, 2009). Data was collected monthly in batches of 50 questionnaires, from January 2009 to August 2009, following the dispatch of 400 questionnaires to randomly selected houses in Mofolo North. The questionnaires were personally administered to the respondents and extensive follow up done. Hence it
5.2.5 Focus group discussions

The first focus group with the MHBC Board met the first week of November 2009 in a session that lasted about an hour and a half. The second focus group with the community workers met in October 2010 in a session that lasted approximately an hour. The focus group interviews were manually recorded, with a summary of each response and the whole discussion confirmed by the participants. The facilitator allowed for a measured amount of debate and dialogue, which developed naturally and allowed the participants the opportunity to learn from one another and to understand the different opinions on the subject.

6 Data analysis process

Data analysis was primarily computed through the SPSS 18.0 for the questionnaire survey and manual transcription of the focus group discussions. The process entailed data clean up, coding and capturing.

6.1 Data clean up

A thorough and critical examination of the completed questionnaire is essential to determine compliance with the criteria for collecting data and to act upon deviations (Hardy & Bryman, 2009). For the purposes of this study, data clean up was pursued with a view of examining the questionnaire’s completeness following the editing of data and identification of non-qualifying responses. In data clean up, the objective of the researcher was to process for interpretation the questionnaires that were 90% completed.

7 Discussion and results

Although the unit of analysis is households, it was important to get some demographic data on the representatives to provide background on the ability to complete the questionnaire. The remaining valid questionnaires indicated that approximately 84% of the respondents had high school education or better, hence the ability to complete the questionnaire. Also, education was important in gauging the rate of adoption of innovation. Rogers (1995), in the social diffusion process theory, alludes to the fact that education is important in the adoption of innovation. The early adopters of innovation are often highly educated and therefore able to influence others based on their ability to source the right information about new developments.

The analysis illustrates more female representation (53.3%) on the 212 household responses received in the execution of the questionnaire, which is in line with the gender demographics for the CoJ and South Africa which is in line with 52% females and 48% males representation of the South African community as shown by Stats SA data of 2001 (StatsSA, 2001). It may also indicate an openness of females to participate in surveys. The modal age of the respondents was 29 to 38 years (29%) followed by the 18 to 28 years (27.8%) age group. This might indicate social factors: young people and the youth are likely to be better educated than other age groups following the education opportunities post-democracy and also implying knowledge and awareness about social issues.

The household demographics presented the model number of family members in the five to nine members range 72.5% and followed by smaller families with up to four members 19.9%. Factor analysis of the demographics on the six identified components did not yield any significant differences among the variables. The gender of the respondents did not have any effect on the mean scores of the six components; namely, general satisfaction, knowledge and information, responsible behaviour and understanding, commitment to OGM goals, satisfaction with feedback, responsiveness and household economics.

7.1 Study objective and question analysis

The factor analysis was presented in line with the research questions using descriptive statistical analysis. The factors included the following variables in line with the questionnaire as presented in a in decreasing order of the component strength.

Question 1: Has the community embraced the “save water” philosophy introduced by OGM implementation through water metering?

The study found that overall, consumers have not embraced the “save water” philosophy since five of the six components measuring the behaviour and attitude of water consumers have mean values above 3, which is the midpoint of the 5 scale Likert rating separating the strongly agree (1) and agree (2) responses and the disagree (4) and strongly disagree (5) responses.

7.2 Focus group observations

The focus groups felt that although the objectives of OGM were noble, the manner in which it was implemented was unjust and discriminatory and therefore has failed the community. Currently, the programme is perceived as dysfunctional, inefficient (poor infrastructure quality) and ineffective (billing systems are poor and therefore it is only prepaid metered households that actually pay for water) and does not consider the poor socio-economic dynamics of the area.

For example, in some families it may come down to a choice between buying bread or water once
the free allocation had been exhausted, hence the illegal connections which negate the programme.

Question 2: Did demographics influence consumer behaviour in the adoption of the OGM ‘save water’ objective in the interests of the public good?

The study found that demographics did not have any significant influence in the mean scores of the six components, except for age. An analysis of age indicated a variance in responses between the age groups in response to knowledge and awareness, responsible behaviour, commitment to OGM goals, and financial implications.

It was further observed that although all the varying sources of income were accepting the save water philosophy, the households involved in informal and formal economic activities were more inclined to embrace it (M=2.70, SD=0.829) than the households dependent on other activities as they were on the verge of not buying into the philosophy (M=2.95, SD=0.942). The level of income was also not a deterrent in buying into the philosophy with both categories buying in.

7.3 Focus group interviews

The observations of the focus group discussions highlighted the following:

The area has households living next to each other with one having a prepaid meter and the other with no prepaid meter, resulting in different levels of awareness. In all of the three focus groups there was consensus that the households that have prepaid meters are more conscious of their water utilisation. One member of the focus groups said,

“It hurts me to see my next door neighbour who does not have a meter waste it like that since they know it does not affect their pocket. They don’t mind leaving the tap dripping the whole day.”

Therefore, the comments are in line with the questionnaire findings which indicated that despite the demographics, on average, the community has not embraced the save water philosophy.

Question 3: What are consumer perceptions and attitudes towards the legislation, policies, government plans and intended outcomes of OGM?

The respondents demonstrated a high level of awareness and answered all the questions in the affirmative. The positive response was the same for all demographics tested which included gender, age, number of working family members, source of income and approximate income.

7.4 Focus group observations

Focus group members felt that the rationale behind OGM, from a philosophical perspective, was understood by the community and households to be primarily about saving water. However, there was a general consensus that very few households are committed to the goals beyond awareness and knowledge about the programme.

Focus group one, consisting of community workers who do not necessarily all live in the area (5/9 = 55%), appreciated OGM in Mofolo North because the area does not have burst and unattended water pipes and people are more conscious of their water usage, unlike the areas they come from which do not have the programme. As one member said:

“In my area there’s always water running down the street from the yards or street infrastructure because of a burst pipe and also people are not conscious of their water usage”.

However, the remaining members of the group (4/9 = 45%) resident in the area felt that although OGM is a good initiative it has become an overkill in Mofolo North as on a daily basis there’s water rationing where water is unavailable for certain periods of the day, especially on weekends, denying water to the community and therefore making it hard to commit to the goals of the programme.

8 Recommendations

Based on the research findings, this article makes the following recommendations.

- Social marketing should become an integral part of the OGM delivery planning, implementation and post implementation plans. The Court case between the government and the Soweto residents has tainted the credibility of OGM and therefore an approach that is responsive and engaging is critical in paving an amicable and effective way forward. There is no value in incurring costs such as prepaid meters, especially with the provision of FBW, when communities can be asked to come up with alternatives and achieve the same objectives.

- A social marketing strategy should be developed for Soweto taking cognisance of the social dynamics and the communities through processes similar to those followed in the IDP processes. CoJ should take responsibility for the development of an area-specific plan, considering implementation and post implementation activities.

- The CoJ should consider setting up street water committees consisting of a water representative for each street in the area to undertake infrastructure audits, monitoring, and street campaigns.

- On a monthly basis, the street water committee should engage with the representatives for government, the service provider and community representatives, including civil organisations, to discuss issues of mutual interest; for example, complaints and concerns and action to address these.

- The CoJ and JW should give communities the choice to decide whether they want to participate in the OGM prepaid metering scheme or the monthly billing scheme, but also ensure that the billing systems are effective to boost the morale of the prepaid users.
● Develop incentives for sound water management; for example, if the FBW is not exhausted, it should be carried over to the next month. Communities should access tokens that are immediately credited to the account and be advised on limits as well as the availability of emergency water.
● The water steering committee, together with the representatives of the service providers, should be able to track water losses and the source, and report them in a newsletter.
● The street water committee should report on a monthly basis on the indigent support provided to the pensioners, the disabled and child-headed households to Council and in the newsletter.
● The vendors and sub-contractors should ideally be from the area, within a walking distance, and allow top-up through the cell phone to ensure 24 hour water accessibility.

9 Conclusion

The study confirms the article problem statement that considering the challenges faced by the CoJ in the implementation of OGM since 2003, an integrated social marketing approach in resolving the water crisis in the CoJ is recommended. Although the CoJ reflects elements of the social marketing approach, the results highlight the need to emphasise the non-financial aspects of the programme as much as the financial aspects. The social marketing approach should extend beyond promotion (advertising and media campaigns) and focus on achieving the desired mindset of the water users. There is need for corporate effort of the city management to promote social marketing in educating the community in the use of resources such as water.

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ROLE OF UNIVERSITY ENTREPRENEURSHIP CENTRE IN DEVELOPING SMALL AND FAMILY BUSINESS

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Abstract

The paper examines University Entrepreneurship Centre’s role in developing small and family business. Global economic recession effect led majorly to unemployment and poverty. To revamp the economy, recovery programs were embarked upon to empower the citizenry. University Entrepreneurship Centre collaborated to empower “aspirants,” “established” and “stucked” entrepreneurs gain skill and best business practice strategy revealing university entrepreneurship Centre’s role. The methodology is qualitative and exploratory, textual in design and divided into sections. The paper identified university entrepreneurship Centre’s roles as advisory, innovation, training and synergizing campus entrepreneurship activities and concluded that the economy will geometrically grow when knowledge trapped in the university are shared with business entrepreneurs. By implication, university would have effectively carried out community engagements as core mandate to mankind’s benefits.

Keywords: Entrepreneurship, Small and Family Business, University Entrepreneurship Centre

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1 Introduction

The global economic recession has affected even the greatest economy. The fall out of this development has been high level of unemployment and inequality. In South Africa, for example, the unemployment rate is very high, at more than 25% and the poor have limited access to economic opportunities and basic services. Poverty also remains a major problem.

To address most of this social ills, recovery program is embarked upon by the concerned government to create employment and empowerment for the citizenry and even create enabling environment for the individuals to start a business. One of such measures is the university taking the giant strides to contribute to the development of its economy by supporting entrepreneurship drive in the nation. The drive was supported by the regulatory body demanding that the university should contribute to the environment in which they operate through community engagement which is equally a way of linking the ivory tower to the society. This has been accomplished by some of the universities by operating an entrepreneurship centre or the small business centre to train and empower individuals on the different vocations with the view to generate employment and equally reduce the social ills. This is with the ultimate aim of contributing to the growth of the economy, gross domestic product and human capital development.

The arguments for family businesses have increasingly been attracting more attention in public and policy discussions. The drivers for this enhanced attention are a greater awareness of the contributions family businesses make to economic and social development, increased attention to the issue of business transfer as well as a higher degree of academic interest in the issue. The opinion of Richard Branson underscores the relevance of family businesses in prompting the economy. According to him, the South African economy is dependent on entrepreneurial activity for creating future economic growth and jobs, but the economic contribution to South Africa’s entrepreneurial sector is below the developing country norm. I believe that increasing entrepreneurship in this country is the golden highway to economic democracy.

Despite the mandatory requirements of the university to be involved in community engagements that will have lasting impacts on their community as well as increasing attention of small and family business in public and policy discussions, some of the universities from observations are yet to be associated with lasting intervention in the affairs of the small and family business. This paper focuses on the role expected of the university entrepreneurship centre in developing small and family businesses and equally
determines the need for Entrepreneurship centre. For example, University of South Africa, a foremost open and distance learning institution (ODL). It is apposite at this juncture to examine some concepts relevant to this study: entrepreneurship, small and family business, university centre for small and family business.

2 Literature review

2.1 The concept of entrepreneurship

A small and family business derives from the spirit of entrepreneurship. What is entrepreneurship? Wits centre for entrepreneurship (2007) defines entrepreneurship as a series of creative activities that give expression to a vision through the development of a venture.

Entrepreneurship is attributed with qualities such as creativity, flexibility, ability to find novel solutions, opportunity recognition, proactiveness, value creation and risk taking in literature (Morris et. al., 2004; Knight, 1997). Entrepreneurship refers to the pursuit of creative or novel solutions to challenges confronting the firm, including the development or enhancement of products and services, as well as new administrative techniques and technologies for performing organizational functions (Knight, 1997). Stevenson et al (1989) defined entrepreneurship as “the process of creating value by bringing together a unique package of resources to exploit an opportunity”. The process includes the set of activities necessary to identify an opportunity, define a business concept, assess needed resources, acquire those resources, and manages and harvests the venture (Morris et al., 2004).

The consensus in the strategic management and entrepreneurship literature offers three underlying dimensions of the organizational predisposition to entrepreneurial management processes: innovativeness (that is introducing novel goods, services, or technology, and to develop new markets), risk taking (that is making reasonable decisions when faced with environmental uncertainties, systematically mitigating risk factors) and proactiveness (that is seeking novel ways both to bring an entrepreneurial concept to fruition) (Covin and Slevin, 1991; Miles and Arnold, 1991; Morris et. al., 1993; Barringer and Bluedorn, 1999).

2.2 The nature and concept of small & family business

Family businesses are a traditional way of conducting business within the private sector. A wide range of different definitions have been applied in socio-economic research and also partly in legal regulations. Across Europe, a total of 90 different definitions were identified, which mainly require major family influence on ownership and management control. Other features used to differentiate family business from non-family businesses are the active involvement of family members in the enterprise’s everyday activities. (i.e., the formal or informal employment of family members in non-managerial positions), the enterprise’s contribution to the family’s income generation, and intergenerational considerations (i.e., the intention to ensure the enterprise’s sustainability beyond the entrepreneur’s (professional) lifetime).

Small businesses are defined differently based on where they are and the requirements of that country. For example, the definition of a small business in the United States is not necessarily the same as in South Africa, especially in terms of size. This study will follow the definition of small business as defined by the National Small Business Act of 1996 of South Africa. This is as follows: a separate and distinct business entity, including cooperative enterprises and nongovernmental organizations, managed by one owner or more which, including its branches or subsidiaries, if any, is predominantly carried on in any sector or sub-sector of the economy and which can be classified as a very small, a small, a micro or a medium enterprise (SMME)... The White Paper (1995:10) sub-divides small business as follows:

- **Survivallst enterprises** - These are defined as enterprises that engage in activities carried out by people who are unable to find a paid job or get into an economic sector of their choice. These activities generate income that falls far short of even minimum standards. Little capital is invested and there is virtually no skills training available in the particular field. Only limited opportunities are available for growth into a viable business;

- **Micro-entreprises** - These refer to a very small business, often involving only the owner, some family member(s) and at the most one or two paid employees. These enterprises usually lack “formality” in terms of business licences, value-added tax (VAT) registration, formal business premises, operating permits and accounting procedures. Most of these enterprises have a limited capital base. The operators of micro-enterprises only have rudimentary technical or business skills. However, many micro-enterprise advance into a viable small business;

- **Small enterprises** – These are regarded as the bulk of the established businesses, with employment ranging between five and 50. The enterprises are usually owned by a manager or are directly controlled by the owner-community. These enterprises are likely to operate from business or industrial premises, be tax-registered and meet other formal registration requirements;

- **Medium enterprises** – These are still viewed as basically owner/manager controlled, though the shareholding or community control base could be made more complex. They employ a maximum of 200
employees and have about R5 million worth of capital assets (excluding property).

The common feature of these companies is that of the family dimension, where business and ownership is intertwined. Family businesses can be small, medium sized or large, listed or unlisted. Family businesses in Europe have been widely equated to Small and Medium-Sized Enterprises (SMEs) in public and policy discussions. A firm, of any size, is a family business, if:

- The majority of decision-making rights are in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who has/have acquired the share capital of the firm, or in the possession of their spouses, parents, child or children's direct heirs.
- The majority of decision-making rights are indirect or direct.
- At least one representative of the family or kin is formally involved in the governance of the firm.
- Listed companies meet the definition of family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25% of the decisionmaking rights mandated by their share capital.

In the advanced countries of the world, small and family businesses are attributed with the same features. In Germany, the small and medium-sized family businesses, are often in the hands of the same family for three generations or more, are renowned for a faithful devotion to the long-term growth of the companies they own, much more so than shareholders in America.

In German speaking countries, small and family businesses are called Mittelstand. The nature of the operation of the small and family businesses in Germany is categorized into two:

Family controlled companies: In this definition all companies which are controlled by a limited number of natural individuals are subsumed. Ownership and management does not necessarily need to match. This definition is the most common in public as well as in scientific literature.

Owner-managed companies: According to this definition, such companies are family businesses controlled by a small number of individuals, in which at least one of the owners also handles the management of the company.

In Belgium, Family businesses are a traditional way of conducting business within the private sector. In the past, however, family businesses were often perceived as the weakest link in business life.

### 2.3 Importance and characteristics of small and family businesses

Across Europe, about 70% - 80% of enterprises are family businesses and they account for about 40% - 50% of employment. On the one hand, a large share of European SMEs is family businesses, and some of the largest European companies are also family businesses. On the other hand, similar to the European economy in general, the family business sector is dominated by SMEs, and particularly by micro enterprises with less than 10 employees. Family businesses are active in all sectors of the economy. In some countries, data are available highlighting that family firms are more prevalent in traditional and labour intensive sectors. However, a shift towards more modern industries is taking place. Within family businesses, there is a strong interrelationship between the family and the business. The family is (formally, but also informally) at the centre of the company. This results in two structures encountering each other, namely the family and the business, increasing the potential for conflict which affects both the family and the business sphere.

Family businesses tend to focus on the firm’s long-term sustainability rather than realizing short-term profits and on realizing generational changes in ownership and Management. In line with this, family businesses are on average older than non-family Businesses. When a firm is transferred to the next generation, it is not only financial assets which are passed on, but also social and cultural capital. The latter refers, for example, to the value system, i.e., the importance of honesty, credibility, modesty, respect etc. On the one hand, this has led to particular emphasis being placed on the personal commitment and engagement of family members within the enterprise and, on the other hand, on the firm’s engagement in Corporate Social Responsibility activities.

Another characteristic of family businesses is the dominance of management from within the family. In this context, paternalism and nepotism are also often prevalent in family firms, as is the existence of emotional and informal decision making. The capitalisation of family firms stems from family funds and bank loans. Profits are often reinvested in the company and the owners are more willing to wait for a return on their investment (so called “patient capital”).

Family businesses’ growth trajectories are quite stable and continuous in comparison to non-family businesses, which take more dynamic and volatile routes.

### 2.4 University entrepreneurship centre

The Centre usually is a part of the Business School and usually headed by a director and governed by an advisory board, with composition that facilitates active relationships with the host university, private and public sector. The director oversees entrepreneurship research function at the Centre.

The Centre is to develop an entrepreneurial mindset that encourages people to develop skills to see opportunities. The Centre inculcates culture of entrepreneurship in the citizens through different
trainings that are provided for enterprising action that develops emerging economies and help to supports democratic societies in transition. The Centre provides for various courses that provides entrepreneurial and enterprise skills development.

2.5 Institutional framework for small and family businesses

Owing to the increasing awareness of the importance of family businesses in any economy, in terms of their contribution to both employment and wealth generation, there is a large network of different private and public institutions dealing with the issue of family businesses either by conducting research, providing training or by acting as a lobbying organization for the interest of family businesses. This includes family business specific organization, employers organization, Government, Support service provider and the Universities. These ranges of institutional framework vary from countries to countries.

The universities have expanded the university mission from teaching and research to entrepreneurial activities. The emergence of the entrepreneurial academic model should not be simply understood as a pure higher education reform but rather a fundamental change in the relationships between the state, university and the industrial and business sector. Government all over the world has encouraged Small Business growth by establishment of the entrepreneurship center in the university to assist with training, create financial model for the university.

The government through the ministries responsible for economic and financial affairs and some agencies influence family businesses environment by setting activities to foster and facilitate entrepreneurship in general. The concerns of government have been noticeable in the following areas: Improving economic performance and competitiveness by way to look for ways to reduce tax burden, provide access to finance, business regulation practice, awareness raising research, management and entrepreneurship education as well as business transfer and governance.

2.6 Some existing university entrepreneurship centres

2.6.1 Hamburg Institute of family owned business

Its structure emanates from the Hamburg School of Business Administration. The focus is to carry out research in the field of family owned business. They engaged excellent scientific education of the staff as well as integration in the network of academic community to deliver high output.

It collaborates with government and universities in the area of highest level of output to small family businesses.

2.6.2 Utrecht centre of entrepreneurship

It is an affiliate of Utrecht university of school of Economics. The focus is to stimulate and develop an entrepreneurial attitude, knowledge and skills. The research focus of the centre are on institutions and welfare, sustainability and globalization, business strategy and governance. The centre collaborates with the Ministry of Economic Affairs together with the ministry of education and science. The two ministries awarded grant to facilitate the centre

2.6.3 Wits Centre for Entrepreneurship

Wits Centre for Entrepreneurship was established in 2007 to facilitate research, learning and development, information and support, and advocacy through an application of shared-value creation and self-actualisation of entrepreneurs. The centre aimed also to tackle poverty alleviation, socio-economics rights and most importantly self-leadership of entrepreneurs. It also purpose to transform the economy from extractive to generative, by training and mentoring entrepreneurs through coursework, thought leadership, and creating opportunities to start and scale sustainable businesses. The mission of the centre is to provide the skills, tools, and coaching to facilitate drive within entrepreneurs who think differently. It is located at the Wits Business School’s Parktown Campus. The centre is a bridge between academic knowledge on entrepreneurship and implementation of knowledge into practice by entrepreneurs. The centre identify interventions and focus on asset-building within the early days of business and focus attention on aspirant entrepreneur, established entrepreneur, and the ‘stuck’ entrepreneur. They offer interventions at every level through ‘Generator: Incubator: Accelerator’ approach to creating shared-value within entrepreneurship as a tool for transformation.

3 Methodology

This research undertook qualitative research method and exploratory research design since the notion of University small business Centre’s role in developing small and family business are to be uncovered. The study was a preliminary study for the subsequent researches in this field. The study was essentially textual as numerous literatures were consulted.

4 Role of university entrepreneurship centre

The primary role of any University small Business centre can be categorized into four broad areas as Advisory Services, Training Services, Innovation and Incubation Services as well as synergizing all entrepreneurship activities on campus. These broad functions are specifically implemented as below.
The small business centre in the university consolidate, co-ordinate and syneritize entrepreneurship and innovation activities in the university. The different ventures of the university are coordinated by the centre to avoid duplication of infrastructure on the campus. It is what the centre has that will be used also to promote and facilitate training for the trainees.

The centre develops staff, students and external stakeholders’ knowledge, exposure and interest in entrepreneurship. It is also expected to train staff, students and external stakeholders in acquiring necessary skill on different vocations. The centre raises fund as well as develop sustainable financial model for center and the university. It is expected of the centre through her operations to contribute to the financial position of the university. It helps to develop academic and vocational program in entrepreneurship that identifies with the needs of the nation. The centre is to empower and train majorly both the employed and the unemployed to acquire proficient skill to master any chosen vocations. In furtherance to its role, the centre is to equally develop a research program in entrepreneurship relevant to the needs of the nation and equally assist to drive relevant policy development. The centre is actually a mother of necessity to abate unemployment and foster gross domestic products. It is the centre responsibility to identify areas of the economy that people are lacking in skill and develop new vocations to engage the unemployed in order to assist with the economy. To further promote the achievement of this, the centre collaborate with national and international partners who are active in the area of entrepreneurship and its development.

The centre is to provide the environment with a fellowship of support to new and existing entrepreneurs as well as providing a wide range of advisory services for individuals, business, not-for-profits and community organizations. It also provides training opportunities for business development professionals, for new and existing small business owners, for not for profit organizations, for job seekers and for individuals. University entrepreneurship Centre provides range of courses that equally provides entrepreneurial and enterprise skills development. Some of the courses includes: Opportunity search and evaluation for aspiring entrepreneur, Start your venture, Create your venture, Plan your venture and Grow your venture. The centre among other reasons for existence is to innovate and incubate services to facilitate industry engagement with the University, develop an entrepreneurial economy equipped with the necessary skills, enables job creation, wealth creation and facilitates socio-economic development; develop entrepreneurial mindset that encourages people to develop skills to identify opportunities. Not all the people will become successful entrepreneurs; however all can develop an entrepreneurial mindset that skills people to see opportunities, solutions, creates, and innovate. People who recognize problems see opportunity for solutions and affect change no matter the context. In addition, the university small business centre assist to shape entrepreneurs who want to have positive impact on society with ideas that are scalable and meet a societal need, contribute to the advancement of knowledge and the practice of entrepreneurship. The centre equally promotes the image of the university by creating a momentum that will place the university among the handful business schools known for both research excellence and world class educational experience in entrepreneurship and innovation that combines experiential and research based learning.

5 Is there a need for university entrepreneurship centre?

With the overwhelming contributions of the entrepreneurship centre to the nation or society in which it operates, it will only amount to undermining the effective performance of the university community engagement if the university does not in any way provide for university entrepreneurship centre. For example, it may be highly expedient for UNISA as a frontline Open and distance learning institution to tremendously impact the economy by establishing a university entrepreneurship centre to cater for the aspirant entrepreneur, established entrepreneur and stucked entrepreneur. The centre is not an over statement considering the level of unemployment in South Africa. The jobless youths will be empowered. The University in collaboration with the government at the different tiers will organize the jobless youth for different vocational programs like Barbing, hospitality business, computer engineering and repairs, fabric making and host of other vocations. As the centre addresses the need of the aspirant entrepreneurs, the established entrepreneurs are trained to understand the modern ways of conducting business as well as competitive strategy that will enable them to excel in their chosen vocations or line of business. The category of stucked entrepreneurs are anxiously waiting to get consultation on how to revitalized the ailing business. The University to make impressive impacts in one area of her core mandate which is community engagement should broaden her horizon on setting up an entrepreneurship centre which as pointed out will equally enhance the internally generated revenue of the University while other benefits will accrue to the University.

6 Conclusions

The developed economy of the world are majorly attributed and dominated by small and family businesses that are opportune to benefits from the knowledge of the ivory tower through consultations, visitations and training that is made available to them.
For the third world economy to grow in leaps and bounds, the knowledge that is trapped in the University must be shared with business entrepreneurs whether aspirants, established and stucked entrepreneurs. University in this wise must be committed to entrepreneurship centre to develop skill and contribute to growing the economy through leadership entrepreneurship training and best business practice strategy.

References
FIRM VALUATION, PERFORMANCE AND ORIGIN OF CONTROLLING SHAREHOLDER IN BRAZIL

Pedro Bruno*, Andre Carvalhal**

Abstract

This study analyzes if the origin of the controlling shareholder influences firm value and performance in Brazil. Although there is a vast literature on this topic, the results vary significantly and, in some cases, are even inconclusive. Our analysis of 407 Brazilian companies from 2002 to 2009 provide evidence that firms controlled by families and government have lower valuation. There is no significant relation between origin of control and firm performance.

Keywords: Ownership and Control, Firm Value, Performance, Corporate Governance, Origin of Controlling Shareholder

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1 Introduction

Corporate governance has become increasingly important both in academia and in the professional market. Although corporate governance can be analyzed through many different aspects (executive compensation, board of directors, conflicts of interest, among others), the ownership and control structure is one of the most important factors, because it directly influences the company's direction and therefore the generation of value or not by them.

Shleifer and Vishny (1997) state that the ownership and control structure is, along with legal protection, one of the two determinants of corporate governance. Thomsen and Pedersen (1997) argue that ownership and control structure is important because: a) the concentration of ownership will create greater incentives on large shareholders to better monitor the performance of the firm; b) the separation of control and ownership may cause the expropriation of minority shareholders; c) the identity and the origin of the controlling shareholder may indicate the guidelines and strategies that will be taken by companies; and d) the liquidity position and risk aversion of controlling shareholders may affect behavior of corporate investments.

There are many studies that analyze whether companies that have controlling shareholders should be traded at a premium or discount, since the existence of a major shareholder can be an incentive to monitor managers (by reducing agency costs) but can increase the expropriation of minority shareholders. The combined effect of these factors may be beneficial or harmful to companies.

One important aspect of the ownership and control structure is the origin of the controlling shareholder (families, governments, foreigners and institutional investors). There are many studies that analyze if there is a significant relation between firm valuation and origin of capital, and the results obtained so far vary across countries and periods.

Discussions about family control are broad. There are studies indicating that families may be favorable to shareholders, while others indicate they are unfavorable. On one hand, families may be active shareholders and maximize firm value. On the other hand, families can manage the company seeking to maximize only their own benefit, thus damaging the interests of other minority shareholders.

Holderness and Sheehan (1988) find that family-owned companies have lower Tobin’s Q, while Reeb and Anderson (2003) find opposite results. Villalonga and Amit (2004) relate family control positively to firm value, but only in companies where the company’s founder serves as CEO or is present on the board, highlighting that the benefit of the active presence of the founder overlaps the cost of expropriation of minority shareholders.

Maury (2006) conducts a study with European companies and finds evidence that family control can improve the company’s performance. Sciascia and Mezzola (2008) analyze 620 small Italian firms and do not find a statistically significant relationship between family control and performance. The authors point out some negative aspects of family control, especially the difficulty in assessing the management performance.

There are also many studies on State-owned firms. In general, the results indicate that such companies trade at a discount, because, as the main purpose of the government is to maximize social welfare, this interest can go against the objective of maximizing the company returns.
Tian and Estrin (2005) study Chinese companies and find that government control reduces the value of the company as a result of the effects of existing political interference in these companies. In Indonesia, Yonnedi and Sari (2006) find a negative relationship between ROA, ROE and government control.

Alfaraih, Alanezi and Almujamed (2012) analyze 134 companies in Kuwait and report a negative effect of government presence on the value of the company. In Malaysia, Razak, Ahmad and Aliahmmed (2005) show that companies controlled by the government have lower value but higher performance (ROA).

Foreign-controlled companies are generally more stable and have stronger global presence, efficiency and more technology. Wiwattanakantang (2001) studies Thai companies and find that foreign-controlled firms outperform domestic ones. Choi and Yoo (2005) analyze Korean companies and observe a positive relationship between Tobin’s Q and the presence of a foreign shareholder. Kumar (2004) examine Indian companies and find no evidence correlating foreign control and firm performance.

When the largest shareholder is an institutional investor (pension fund, insurance company, private equity firm, etc), the company benefits are diluted among a large number of investors, decreasing the risk of expropriation of minority shareholders. In addition, some institutional investors have good reputation with respect to management and improved governance. In this case, it is expected that the institutional control increase firm valuation and performance.

In the United States, McConnel and Seraes (1990) conclude that companies controlled by institutional investors tend to outperform. Cornett, Marcus, Saunders and Tehranian (2007) study companies in the S&P100 and find a positive relationship between the presence of institutional investors and firm performance.

Seifert, Gonenc and Wright (2005) study companies in different countries and show that the effects of institutional shareholder in firm performance vary, being positive in the US, negative in Japan and not significant in Germany and the UK. Chen and Chen (2007) show that the presence of the institutional shareholder increases the value of the company in New Zealand. Alfaraih, Alanezi and Almujamed (2012) also find evidence of a positive effect of institutional investors on the value and performance of the company.

Bertin, Iturriaga and Foronga (2009) show that institutional investors that have business relationship with the company, such as banks and insurance companies, do not increase the company’s performance, because they cannot maintain an independent position. Bhattacharya and Graham (2007) find a similar conclusion in Finland.

This paper analyzes if the origin of the controlling shareholder influences the value and performance of Brazilian companies. We classify companies according to the nature of the controlling shareholder (family, government, foreigners and institutional investors) and relate it with firm value (price-to-book) and performance (return on assets - ROA). Our analysis of 407 Brazilian companies from 2002 to 2009 shows that companies controlled by families and governments have lower valuation. With regard to performance, we do not find significant relation between origin of capital and ROA.

2 Data and methodology

Our sample consists of 407 companies listed on BM&FBovespa from 2002 to 2009. For each company, we identify their controlling shareholders and the origin of their capital (family, government, foreign and institutional). The companies are classified as “dispersed capital” if the largest shareholder does not have at least 50% of voting capital.

Because of cross-shareholdings and pyramids, the analysis of the control structure should not be restricted to direct ownership. Therefore, we also analyze who is the ultimate controller of the company. Identification of the final or indirect controlling shareholders helps to better identify the origin of capital. The information on the ownership and structure is obtained from the Brazilian Securities & Exchange Commission (“CVM”).

Firm value and profitability are measured by price to book (“P/B”) and return on assets (“ROA”), respectively. We use several firm’s characteristics as control variables, such as leverage and firm size. All financial variables are obtained from Economatica database.

We estimate several panel models (common, fixed and random effects) to verify the relationship between capital origin, value and performance of Brazilian companies. The models are expressed below:

$$ P/B_{it} = \beta_0 + \beta_1FAM_{it} + \beta_2GOV_{it} + \beta_3FOR_{it} + \beta_4INS_{it} + \beta_5SIZE_{it} + \beta_6LEV_{it} + \epsilon_{it} $$

$$ ROA_{it} = \beta_0 + \beta_1FAM_{it} + \beta_2GOV_{it} + \beta_3FOR_{it} + \beta_4INS_{it} + \beta_5SIZE_{it} + \beta_6LEV_{it} + \epsilon_{it} $$

Where P/B is the price-to-book (market value/equity), ROA is the return on assets (EBITDA/total assets), FAM is a dummy variable that takes the value 1 when the controlling shareholder is a family and 0 otherwise, GOV is a dummy variable that takes the value 1 when the controlling
shareholder is the government and 0 otherwise, FOR is a dummy variable that takes the value 1 the controlling shareholder is a foreign group and 0 otherwise, INS is a variable dummy that takes the value 1 when the controlling shareholder is an institutional investor and 0 otherwise, SIZE is firm size (log of total assets) and LEV is leverage (non-equity liabilities/total assets).

We also use industry dummy variables for each economic sector according to the BM&FBovespa classification: oil and gas, basic materials, industrial goods, construction and transportation, consumer non-cyclical, consumer cyclical, information technology, telecommunications, public utilities, financial and other.

According to the evidence of many international studies (presented in the previous section), we expect the family-controlled firms have lower valuation, because the incentives to expropriate minority shareholders may be higher because these shareholders are no so active in Brazil when compared to developed markets.

3 Results

Table 1 shows the descriptive statistics of the variables used in the study. The results show that the most frequent type of controlling shareholder in the sample is family (42%), followed by foreigners (17%), government (9%) and institutional investors (6%). On average, Brazilian companies have a price-to-book of 2.45, ROA of 3.95% and leverage of 59.8%.

We classify the companies by industry and the most frequent economic sector in our sample (not reported) is basic materials (17%), financial (16%), public utilities (14%) and consumer cyclical (13%). Families are the most frequent controlling shareholder in almost every sector except in telecommunications (foreign and institutional predominance) and public utilities (predominantly government and foreigners). On average, the sectors with the highest P/B are consumer cyclical and non-cyclical (3.36 and 2.77, respectively), whereas the sectors with the highest ROA are industrial goods (5.84%) and public utilities (5.76%).

Table 2 shows the correlation matrix between variables. The variable FAM has negative and statistically significant correlation with P/B and ROA. The variable FOR has positive and statistically significant correlation with ROA. The variable GOV has negative correlation with P/B and ROA, but their values are not statistically significant. The variable INS has negative correlation with P/B and positive correlation with ROA, but their values are not statistically significant.

<table>
<thead>
<tr>
<th>Variables</th>
<th>P/B</th>
<th>ROA</th>
<th>FAM</th>
<th>GOV</th>
<th>FOR</th>
<th>INS</th>
<th>SIZE</th>
<th>LEV</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/B</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>ROA</td>
<td>0.01**</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FAM</td>
<td>-0.10**</td>
<td>-0.07**</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GOV</td>
<td>-0.03</td>
<td>-0.04</td>
<td>-0.26**</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FOR</td>
<td>0.02</td>
<td>0.14**</td>
<td>-0.38**</td>
<td>-0.14**</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>INS</td>
<td>-0.01</td>
<td>0.04</td>
<td>-0.23**</td>
<td>-0.08**</td>
<td>-0.12**</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.02</td>
<td>0.11**</td>
<td>-0.25**</td>
<td>0.22**</td>
<td>0.09**</td>
<td>0.15**</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>LEV</td>
<td>0.21**</td>
<td>-0.31**</td>
<td>-0.03</td>
<td>0.10**</td>
<td>-0.05**</td>
<td>0.03</td>
<td>0.32**</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Note: ** denotes statistical significance at 5%
Regarding the control variables, firm size has positive correlation with ROA, GOV, FOR, INS, LEV and negative correlation with FAM, all with statistical significance at 5%. Leverage has positive correlations with P/B, GOV and SIZE and negative correlation with ROA and FOR, all with statistical significance at 5%.

Table 3 shows the average and median P/B and ROA for companies according to the origin of the capital. We run test of differences in mean and median to verify if companies controlled by the government, foreigners and institutional investors have greater value and performance when compared to family firms.

Table 3. Firm value and performance by capital origin

<table>
<thead>
<tr>
<th>Variables</th>
<th>FAM</th>
<th>GOV</th>
<th>FOR</th>
<th>INS</th>
</tr>
</thead>
<tbody>
<tr>
<td>P/B</td>
<td>1.90</td>
<td>1.93</td>
<td>2.61</td>
<td>2.35</td>
</tr>
<tr>
<td></td>
<td>(1.10)</td>
<td>(1.00)</td>
<td>(1.70)</td>
<td>(1.60)</td>
</tr>
<tr>
<td>ROA</td>
<td>3.11</td>
<td>2.60</td>
<td>7.02</td>
<td>5.43</td>
</tr>
<tr>
<td></td>
<td>(2.90)</td>
<td>(2.45)</td>
<td>(5.80)</td>
<td>(3.80)</td>
</tr>
</tbody>
</table>

Note: Obs: Coefficients of mean and median (in parentheses). ** denotes that the P/B or ROA are significantly higher (at 5% level) than those of family firms.

The results indicate that foreign companies have higher P/B than family firms (mean of 2.61 versus 1.90; and median of 1.70 versus 1.10). Both differences in means and medians are statistically significant at 5%. The companies controlled by institutional investors also have average and median P/B (2.35 and 1.60) superior to family businesses, but only the latter is statistically significant.

Foreign-controlled companies have higher ROA than family firms (mean of 7.02% vs. 3.11% and median of 5.80% versus 2.90%). Both differences in means and medians are statistically significant at 5%. The companies controlled by institutional investors also have average and median ROA (5.43% and 3.80%) higher than family businesses, but only the first is statistically significant.

Overall, the results of Tables 3 indicate that companies controlled by foreigners and institutional investors have higher value (price-to-book) and performance (ROA) than family firms. State-owned companies have value and performance similar to family businesses.

Table 4 shows the results of the panel regressions for P/B. The FAM and GOV coefficients are negative and statistically significant, so we can conclude that family and State-owned firms have lower market value. The FOR and INS variables are not statistically significant, so we cannot conclude that companies controlled by foreigners and institutional investors have higher value. The firm size and leverage have negative and positive coefficients, respectively, both statistically significant, indicating that smaller and more leveraged companies tend to have higher market value when compared with larger and less leveraged firms.

Table 4. Firm value (P/B) regressions on capital origin

<table>
<thead>
<tr>
<th>Variables</th>
<th>Common-Effects</th>
<th>Fixed-Effects</th>
<th>Random- Effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAM</td>
<td>-1.37***</td>
<td>-1.98****</td>
<td>-1.88***</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>GOV</td>
<td>-0.94**</td>
<td>-1.80</td>
<td>-1.59**</td>
</tr>
<tr>
<td></td>
<td>(0.04)</td>
<td>(0.24)</td>
<td>(0.05)</td>
</tr>
<tr>
<td>FOR</td>
<td>-0.08</td>
<td>-0.48</td>
<td>-0.27</td>
</tr>
<tr>
<td></td>
<td>(0.81)</td>
<td>(0.58)</td>
<td>(0.62)</td>
</tr>
<tr>
<td>INS</td>
<td>-0.66</td>
<td>-0.69</td>
<td>-0.97</td>
</tr>
<tr>
<td></td>
<td>(0.18)</td>
<td>(0.54)</td>
<td>(0.21)</td>
</tr>
<tr>
<td>SIZE</td>
<td>-0.63***</td>
<td>-1.57**</td>
<td>-1.30***</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.04)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>LEV</td>
<td>0.06***</td>
<td>0.08***</td>
<td>0.07***</td>
</tr>
<tr>
<td></td>
<td>(0.00)</td>
<td>(0.00)</td>
<td>(0.00)</td>
</tr>
<tr>
<td>Year Dummy</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Industry Dummy</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Adj R²</td>
<td>0.10</td>
<td>0.48</td>
<td>0.08</td>
</tr>
<tr>
<td>Obs</td>
<td>1,858</td>
<td>1,858</td>
<td>1,858</td>
</tr>
</tbody>
</table>

Note: Obs: Coefficients and p-value (in parentheses). ***, ** and * denote statistical significance at 1%, 5% and 10%, respectively
Table 5 shows the panel regression for ROA. In the first model, GOV has negative coefficient, whereas FOR and INS have positive coefficients, all of them with statistical significance. However, in none of the other models, the coefficients are statistically significant, so we do not have strong statistical evidence indicating that there is a correlation between the origin of the control and firm performance. Firm size and leverage have positive and negative coefficients, respectively, indicating that larger and less leveraged companies have superior performance.

Table 5. Firm performance (ROA) regressions on capital origin

<table>
<thead>
<tr>
<th>Variables</th>
<th>Common-Effects</th>
<th>Fixed-Effects</th>
<th>Random- Effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>FAM</td>
<td>-0.11 (0.83)</td>
<td>-0.18 (0.86)</td>
<td>-0.02 (0.98)</td>
</tr>
<tr>
<td>GOV</td>
<td>-1.87** (0.03)</td>
<td>-2.38 (0.43)</td>
<td>-2.06 (0.20)</td>
</tr>
<tr>
<td>FOR</td>
<td>2.81*** (0.00)</td>
<td>-0.67 (0.69)</td>
<td>1.04 (0.20)</td>
</tr>
<tr>
<td>INS</td>
<td>2.15** (0.03)</td>
<td>0.87 (0.69)</td>
<td>1.98 (0.20)</td>
</tr>
<tr>
<td>SIZE</td>
<td>2.69*** (0.00)</td>
<td>3.95*** (0.01)</td>
<td>3.36*** (0.00)</td>
</tr>
<tr>
<td>LEV</td>
<td>-0.16*** (0.00)</td>
<td>-0.23*** (0.00)</td>
<td>-0.20*** (0.00)</td>
</tr>
<tr>
<td>Year Dummy</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Industry Dummy</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Adj R²</td>
<td>0.19</td>
<td>0.55</td>
<td>0.15</td>
</tr>
<tr>
<td>Obs</td>
<td>1,858</td>
<td>1,858</td>
<td>1,858</td>
</tr>
</tbody>
</table>

Note: Obs: Coefficients and p-value (in parentheses). ***, ** and * denote statistical significance at 1%, 5% and 10%, respectively.

4 Conclusion

Although there are several studies on the relation between the origin of capital and firm value and performance, there is no consensus on the conclusions since results vary widely across countries. On one hand, ownership concentration can enhance monitoring and reduce agency costs, but on the other hand it can also generate incentives for expropriation of minority shareholders.

This paper analyzes if the origin of the controlling shareholder influence the value and performance of Brazilian companies. We classify companies according to the nature of the controlling shareholder (family, government, foreigners and institutional investors) and relate it with firm value (price-to-book) and performance (return on assets - ROA).

Our analysis of 407 Brazilian companies from 2002 to 2009 provides evidence that companies controlled by families and governments have lower valuation. These results are in line with international studies that show that families and government can manage the company without maximizing shareholder value (Holderness and Sheehan (1988), Sciascia and Mezzola (2008), Tian and Estrin (2005), Alfaraih, Alanezi and Almujamed (2012)).

With regard to performance, we do not find significant relation between origin of capital and ROA. Therefore, although many international studies cite factors that would indicate better performance of firms controlled by foreign and institutional shareholders, we cannot infer conclusions with respect for our sample.

References

JOB SATISFACTION AND PRODUCTIVITY: AN INTEGRATED MODEL, A CASE OF PUBLIC SECTOR ENTITY IN SOUTH AFRICA

Prof. Ajay K Garg*, Mr. K. Temba*

Abstract

The purpose of the study was to validate an integrated model to capture factors that motivate job satisfaction and to study the relationship between Job Satisfaction and Productivity. A model considering five factors; pay, promotion, communication, co-worker and fringe benefits were developed with job satisfaction and productivity as dependent variables. Data was collected through survey questionnaire, 51 responses were received. The model could not validate the positive relationship between pay, communication and co-worker with job satisfaction. While the relationship between promotion and fringe benefits were found to be positive with job satisfaction. The relationship between job satisfaction and productivity was also found positive and statistically significant**.

Keywords: Job Satisfaction, Productivity, Promotion, Pay, Fringe Benefits, Communication, Co-worker

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** The views expressed here are of our own and not necessarily of the organisation to which author belongs to. We express our sincere gratitude to the anonymous reviewer for improving the quality of this paper. Our thanks are to Mrs. Eunice Mtshali, Information librarian for providing library support.

1 Introduction

Given the critical role that job satisfaction and productivity play in determining the efficiency, effectiveness and sustainability of organisations, it is paramount to understand what motivates them and to what extent they are satisfied by the organisations and other contextual variables. Job satisfaction among organisations is increasingly being recognised as a measure that should be included in quality improvement programmes. Low job satisfaction can result in increased staff turnover and absenteeism, which affects the efficiency of organisations. Knowledge of employees on job satisfaction and productivity and the nature of the relationship between these variables will enhance understanding of the aspects that may influence employee job satisfaction and productivity in workplace.

In view of the above the objectives of the study was to ascertain the level of job satisfaction and productivity of employees and establish the relationship between the two variables in a public sector organisation in South Africa. Further this study developed an integrated model that captured the motivators of job satisfaction and its relation with productivity.

2 Background literature

There is no dearth of literature on job satisfaction, productivity and factors that affects job satisfaction. However, relationship between job satisfaction and job performance was one of the most popular research topics in industrial and organisational psychology; many empirical studies have examined this relationship (Choi & Lee, 2013:577). Although according to Al-Ahmadi (2009:51) job performance was found to be affected with satisfaction with several aspects of work conditions, including working hours, hospital policies, shifts, physical surroundings, and access to supplies and equipment as a significant predictor of job performance. According to Wilson & Frimpong (2004:471) for many decades now, the view that job satisfaction affects employee performance has received much attention in the literature, the general consensus from numerous studies was that employee satisfaction was only mildly, but positively, linked to general measures of performance with the view that satisfied employees will deliver quality service or improved performance. Notably according to Indridason & Wang (2008:78) strong emotional attachment in managing organisations their bonds with the employing organisation, seem to have weakened somewhat; moreover, employee commitment proved to be an effective predictor of citizenship behaviour and job performance; and the nature of the contractual relationship, productivity management and human resource management practices had significant influence on employees’ job performance and the private company’s ability to meet the performance requirements.

Correlation analyses showed that the variable job satisfaction (represented by two distinct measures) was positively related to job performance. Job
satisfaction was positively related to job performance, while working as a production employee might seem unsatisfactory to more educated people, different factors, including employee benefits, camaraderie, job security and possibly others might make this job generally satisfactory (Sarmiento, Beale & Knowles, 2007:922). Literature also suggests that the relationship between Job Satisfaction and Productivity can affect not only motivation at work but also career decisions, personal health, organisational performance and how one relates with others.

Factors influencing job satisfaction and productivity vary in nature as there are personal factors and expectations involved, which tend to generate exceptions, therefore generalisations are risky. The future of organisations work environment poses significant challenges for employers and employees. The implication for managers is that if organisations desire to attract and retain employees, they will need to find ways to cater for intrinsic job satisfaction factors as well as additional benefits.

Literature also indicates that factors like promotion, salary, fringe benefits, communication within the organisation, relationship with co-workers, were the key factors that impact job satisfaction and there are enough academic studies to support this relationship.

However most of the studies are discrete in nature in the sense that they have studied relation between factors that affect job satisfaction in different settings or simply have studied relationship between job satisfaction and performance. There has not been an integrated model that has studied the relationship between factors that affect job satisfaction and its relationship with productivity. This study tries to close this gap in the literature.

3 Research design

The study analysed the relationship of job satisfaction and its influence on productivity, with the objective of identifying factors that affect job satisfaction. The factors for job satisfaction (pay, promotion, co-worker, fringe benefits, and communication) were taken from the previous literature. The model of study is demonstrated below by using the structural equation model in figure 1.

Figure 1. Model for the study

The selected public sector organisation had two hundred and ninety (290) employees. All were contacted and 51 employees responded, which results in 18% response rate. The questionnaire used by Lumley (2011:134), was studied and found to be limited in addressing the objectives of this study, because its emphasis was more on organisational commitment. The questionnaire by Van Dyk (2009:78) was also studied, however was found to be inadequate because it focused mainly on job embeddedness and retention. A modified questionnaire from Ramosodi (2010:25) was used as guide in this study. This questionnaire was more relevant because of the facet approach which can provide a more complete picture of a person’s job satisfaction than a global approach.

The questionnaire designed for this study consisted of a cover page and the questionnaire. The intent of the cover page was to inform the respondents about the purpose of this study and to provide them with the assurance that all information obtained through the questionnaire would be treated as confidential and that the results would only be used for research purposes. In addition, the cover letter provided the respondents with the details and contact information of the researcher.

The questionnaire consisted of three sections: Questions from 1 – 4 focused on personal and
biographical information; Questions 5 – 10 is about Job satisfaction and Productivity scale; and Questions 11 – 25 were Job satisfaction factors.

Questions 1 – 4, the personal and biographical information section, covered the more general questions of the study. It consisted of questions regarding gender, age, years in current position and years with the organisation.

Questions 5 – 10 by Swart (2010:69), the job satisfaction and productivity scale, consisted of 8 statements relating to the job satisfaction and productivity variables that were identified through the literature study. The aim of these questions were to evaluate how employees perceive their level of job satisfaction and its perspective towards organisational productivity in the following areas: company rewards system as regards salaries, promotions and benefits, high performance standards amongst co-workers, working conditions and job satisfaction.

The purpose of Questions 11 – 25 by Ramosodi (2010:54) and Steyn (2010:84), of the questionnaire was to establish the importance of each of the job satisfaction factors, which were identified during the literature study. This included, promotion as a tool to motivate, pay to remunerate performance, fringe benefits to address satisfaction as regards remuneration package, communication as regards organisational motivation and co-worker to ascertain the atmosphere of co-operation between staff and management. Clear instructions were provided to the respondents on how to complete each section of the questionnaire.

The ethical considerations took into account the personal and revealing nature of the study, which required that voluntary, informed consent, using the consent form designed for this study, needed to be obtained from the participants. Prior to administering the questionnaires, the aims and objectives of the study were clearly explained to the participants and written informed consent was obtained. Confidentiality and anonymity were ensured throughout the execution of the study as participants were not required to disclose personal information on the questionnaire. Provisions were made to have participants’ concerns relating to the study addressed and misconceptions corrected. Participants were informed that their participation was voluntary and that they could withdraw from the study at any time if they wished to do so.

4 Data analysis

Data was analysed using Partial least Square (PLS) software. In order to determine item-construct loading, a factor analysis was conducted in PLS using the items and constructs with no relationship between the constructs. The results of the factor analysis are reported in Table 1 below.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Indicator</th>
</tr>
</thead>
<tbody>
<tr>
<td>Job Satisfaction</td>
<td>JS1 I’m satisfied with my working conditions</td>
</tr>
<tr>
<td></td>
<td>JS2 My job is personally satisfying</td>
</tr>
<tr>
<td></td>
<td>JS3 My job is challenging</td>
</tr>
<tr>
<td>Productivity</td>
<td>P1 The company’s value system adds to my productivity</td>
</tr>
<tr>
<td></td>
<td>P2 My manager emphasizes productivity as one of the key objectives of the company</td>
</tr>
<tr>
<td></td>
<td>P3 I am satisfied with my productivity</td>
</tr>
<tr>
<td>Promotion</td>
<td>Pr1 Promotion based on merit will enhance employee job satisfaction</td>
</tr>
<tr>
<td></td>
<td>Pr2 The prospect of promotion is a powerful motivator</td>
</tr>
<tr>
<td></td>
<td>Pr3 The promotion process in the organisation is credible</td>
</tr>
<tr>
<td>Pay</td>
<td>Py1 Employees should be remunerated based on performance</td>
</tr>
<tr>
<td></td>
<td>Py2 Would you regard performance bonuses and notch progressions sufficient to encourage job satisfaction in the organisation</td>
</tr>
<tr>
<td></td>
<td>Py3 My income is a reflection of the work I do</td>
</tr>
<tr>
<td>Co-workers</td>
<td>CoW1 I have a good working relationship with my colleagues</td>
</tr>
<tr>
<td></td>
<td>CoW2 I can depend on my colleagues for support</td>
</tr>
<tr>
<td></td>
<td>CoW3 There is an atmosphere of co-operation between staff &amp; management</td>
</tr>
<tr>
<td>Communication</td>
<td>Com1 There is a clear channel of communication at my workplace</td>
</tr>
<tr>
<td></td>
<td>Com2 Conflicts are handled appropriately through proper communication channels</td>
</tr>
<tr>
<td></td>
<td>Com3 The organisation communication motivates me to meet its goals.</td>
</tr>
<tr>
<td>Fringe Benefits</td>
<td>Fb1 I am satisfied with my remuneration package</td>
</tr>
<tr>
<td></td>
<td>Fb2 I feel that for the amount of work I do, the pay is sufficient</td>
</tr>
<tr>
<td></td>
<td>Fb3 My remuneration package compare well to others in this field</td>
</tr>
</tbody>
</table>

All the indicators in italics (table 1) that did not load during the analysis therefore were excluded in
the study. In order to find multicollinearity factor loading and cross loading of measures for the constructs was obtained and shown in Table 2 below.

### Table 2. Factor loading and cross loading of measures for the constructs

<table>
<thead>
<tr>
<th>Construct</th>
<th>JS1</th>
<th>JS2</th>
<th>JS3</th>
<th>P1</th>
<th>P2</th>
<th>Pr1</th>
<th>Pr2</th>
<th>Py1</th>
<th>Py2</th>
<th>Com1</th>
<th>Com2</th>
<th>Cow1</th>
<th>Cow2</th>
<th>Cow3</th>
<th>Fb1</th>
<th>Fb2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Job Satisf</td>
<td><strong>0.8432</strong></td>
<td>0.4491</td>
<td>0.2129</td>
<td>0.4336</td>
<td>0.2626</td>
<td>0.3084</td>
<td>0.4452</td>
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</tr>
<tr>
<td>Productivity</td>
<td>0.4194</td>
<td><strong>0.8585</strong></td>
<td>0.2458</td>
<td>0.3735</td>
<td>0.2666</td>
<td>0.2908</td>
<td>0.1937</td>
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<tr>
<td>Promotion</td>
<td>0.2472</td>
<td>0.4961</td>
<td><strong>0.6820</strong></td>
<td>0.1659</td>
<td>0.1969</td>
<td>0.3622</td>
<td>0.1767</td>
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<td></td>
</tr>
<tr>
<td>Pay</td>
<td>0.1738</td>
<td>0.3172</td>
<td>0.3936</td>
<td><strong>0.8804</strong></td>
<td>0.2645</td>
<td>0.1660</td>
<td>0.1622</td>
<td>0.0382</td>
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</tr>
<tr>
<td>Communication</td>
<td>0.2762</td>
<td>0.2737</td>
<td>0.8567</td>
<td>0.0255</td>
<td>0.0738</td>
<td>0.1810</td>
<td>0.0806</td>
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<tr>
<td>Co-worker</td>
<td>0.3011</td>
<td><strong>0.9338</strong></td>
<td></td>
<td>0.1042</td>
<td>0.1153</td>
<td>0.0587</td>
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<td></td>
</tr>
<tr>
<td>Fringe benefits</td>
<td>0.3197</td>
<td>0.2874</td>
<td>-0.1004</td>
<td><strong>0.7620</strong></td>
<td>0.1947</td>
<td>0.4163</td>
<td>0.5910</td>
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<tr>
<td>JS</td>
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<td>Prod</td>
<td>0.2919</td>
<td>0.2328</td>
<td>0.2328</td>
<td>0.7044</td>
<td>0.3684</td>
<td>0.0982</td>
<td>0.0301</td>
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<td>Pr1</td>
<td>0.2736</td>
<td>0.3216</td>
<td>0.2276</td>
<td>0.3754</td>
<td>0.8566</td>
<td>0.3809</td>
<td>0.2246</td>
<td></td>
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</tr>
<tr>
<td>Pr2</td>
<td>0.2132</td>
<td>0.2540</td>
<td>0.0907</td>
<td>0.2165</td>
<td><strong>0.7492</strong></td>
<td>0.5270</td>
<td>-0.2964</td>
<td></td>
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<tr>
<td>Py1</td>
<td>0.1700</td>
<td>0.4020</td>
<td>0.0042</td>
<td>0.3231</td>
<td>0.2974</td>
<td><strong>0.6810</strong></td>
<td>0.0395</td>
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<tr>
<td>Py2</td>
<td>0.3678</td>
<td>0.2998</td>
<td>0.1832</td>
<td>0.3421</td>
<td>0.6244</td>
<td><strong>0.8478</strong></td>
<td>0.1440</td>
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<tr>
<td>Com1</td>
<td>0.3456</td>
<td>0.2949</td>
<td>0.0512</td>
<td>0.2183</td>
<td>0.3207</td>
<td>0.8216</td>
<td>0.1346</td>
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</tr>
<tr>
<td>CoW2</td>
<td>0.3227</td>
<td>0.1551</td>
<td>0.0710</td>
<td>0.3569</td>
<td>-0.0627</td>
<td>0.0830</td>
<td><strong>0.8869</strong></td>
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</tr>
<tr>
<td>Cow3</td>
<td>0.2944</td>
<td>0.0883</td>
<td>0.1175</td>
<td>0.4164</td>
<td>0.0607</td>
<td>0.1827</td>
<td><strong>0.8622</strong></td>
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</tr>
</tbody>
</table>

Examination of factor loadings in Table 2 suggested that there was no major multicollinearity between the indicators, as the loading of the indicator with respect to its construct was greater than the other constructs.

To determine internal consistency and discriminant validity, the constructs were joined in the model, and the model was run as a molecular model. The results are shown in Table 3, which shows the correlation matrix for the construct where the diagonal of this matrix is the square root of AVE.

### Table 3. Internal consistency and discriminant validity construct (AVE and squared correlation n=51)

<table>
<thead>
<tr>
<th>Construct</th>
<th>JS</th>
<th>Prod</th>
<th>Prom</th>
<th>Pay</th>
<th>Comm</th>
<th>Cowork</th>
<th>FB</th>
<th>AVE</th>
<th>Fornell</th>
<th>SQRTAVE</th>
</tr>
</thead>
<tbody>
<tr>
<td>JS</td>
<td><strong>0.795</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prod</td>
<td>0.474</td>
<td><strong>0.820</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prom</td>
<td>0.386</td>
<td>0.321</td>
<td><strong>0.895</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pay</td>
<td>0.417</td>
<td>0.356</td>
<td>0.080</td>
<td><strong>0.733</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Comm</td>
<td>0.305</td>
<td>0.361</td>
<td>0.109</td>
<td>0.378</td>
<td><strong>0.803</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cowork</td>
<td>0.399</td>
<td>0.394</td>
<td>0.121</td>
<td>0.360</td>
<td>0.550</td>
<td><strong>0.783</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FB</td>
<td>0.353</td>
<td>0.141</td>
<td>0.106</td>
<td>0.440</td>
<td>-0.004</td>
<td>0.149</td>
<td><strong>0.875</strong></td>
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<td></td>
</tr>
</tbody>
</table>

The results shown in Table 3 below suggest good internal consistency, and convergent and discriminant validity for all the constructs with AVE greater than 0.50 (the decision rule was that AVE should be greater than 0.5, which meant that 50% or more of the variance of indicators should be accounted for. Moreover, the productivity construct shares a high covariance (0.474 in Table 3) with Job Satisfaction.

### Table 4. Constructs and its associated mean values

<table>
<thead>
<tr>
<th>Construct</th>
<th>n = 51</th>
</tr>
</thead>
<tbody>
<tr>
<td>Job Satisfactory</td>
<td>2.39</td>
</tr>
<tr>
<td>Productivity</td>
<td>2.71</td>
</tr>
<tr>
<td>Promotion</td>
<td>2.71</td>
</tr>
<tr>
<td>Pay</td>
<td>2.27</td>
</tr>
<tr>
<td>Fringe benefits</td>
<td>2.00</td>
</tr>
<tr>
<td>Communication</td>
<td>1.87</td>
</tr>
<tr>
<td>Co-worker</td>
<td>2.47</td>
</tr>
</tbody>
</table>
5 Key findings

Section A of the questionnaire solicited data about the demographic segmentation of the target population. Its aim was to see the dynamics of the target population in relation to gender, number of years, level of education and years of service in the organisation.

- **Gender.** Males made up more than half of the sample selected, at 61%, while females made up 39% of the sample. This was a fair representation of the target population, as there were more males than females employed in the NRCS.

- **Level of education.** The observation of the designation of the sampled population indicated that 18% of the sample size represent employees below grade 12, 22% of the sample size represent employees with post graduate degree, 23% of the sample size represent employees with Bachelor degrees and 37% represent employees with a Diploma certificate.

- **Years of service.** The observations of the years of service of the sampled population indicated that 20% of the sample size represent employees with less than three years in the organisation, 20% of the sample size represent employees between four and five years of service in the organisation, 23% of the sample size represented employees between six and eight years of service and whereas 37% represent employees with more than eight years of service in the organisation.

- **Age.** The observations of the age of the sampled population indicated that 7% of the sample size represent employees with less than 29 years in the organisation, 47% of the sample size represent employees between 30 and 39 of age in the organisation, 19% of the sample size represent employees between 40 and 49 years of age and whereas 27% represent employees with more than 50 years of age in the organisation.

The PLS model results and explanation are shown in figure 2 and 3.

![Figure 2. Model for the paths and loadings](image)

Bootstrap re-sampling was performed to examine the statistical significance of path loadings and weights. The results in Table 5 show the results of the analysis. The path loadings and weights suggest the relative importance of each dimension.

### Table 5. The path, loading and t-values for the construct - Perceived Usefulness

<table>
<thead>
<tr>
<th>Paths</th>
<th>Loading</th>
<th>T-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pr→JS</td>
<td>0.314</td>
<td>1.6805*</td>
</tr>
<tr>
<td>Py→JS</td>
<td>0.195</td>
<td>0.6805</td>
</tr>
<tr>
<td>Fb→JS</td>
<td>0.0202</td>
<td>1.5262*</td>
</tr>
<tr>
<td>Com→JS</td>
<td>0.079</td>
<td>0.3609</td>
</tr>
<tr>
<td>Cow→JS</td>
<td>0.217</td>
<td>0.7619</td>
</tr>
<tr>
<td>JS→Pr</td>
<td>0.474</td>
<td>2.8502**</td>
</tr>
</tbody>
</table>

Note: *statistically significant at 90%, **statistically significant at 95%
Table 5 suggests that paths Py→JS, Com→JS, and Cow→JS were not statistically significant while other paths were statistically significant at 90% or more.

**Figure 3.** Model showing the paths weights

The Chi Square test of association showed that there was no significant association (p<0.05) between demographic variables i.e. gender, level of education, age, year of service and variables like job satisfaction, productivity, promotion, pay, fringe benefits, communication and co-worker.

6 Discussions and conclusions

The results showed that job satisfaction has a significant positive association with productivity, while promotion and fringe benefits were positively associated with productivity. The relationship between other factors like pay, communication, co-worker and productivity were not statistically significant. These findings are discussed below per factor.

6.1 Promotion

Carmeli, Shalom and Weisberg (2007:200) found organisations can use a promotion mechanism to motivate employees towards achieving good performance and job satisfaction. Study of Steidle, Gockel and Werth (2013:175) emphasizes that promotion focus should direct an employee’s attention to and increase the perceived importance of aspects in the work environment that offer possibilities to reach aspirations, whereas an employee’s prevention focus should lead to a preference for work-related aspects that offer security. Although according to Okpara, (2006:236) promotions based on merit and performance evaluations will be perceived by workers as fair and equitable and would encourage performance, resulting in a greater degree of job satisfaction and ultimately higher productivity. The proposed approach was applied in a public sector organisation of a developing country, were the findings of the paper hold that independent variables such as job satisfaction, organisational commitment and job promotion have positive and significant relationships to dependent variables, i.e. employee career commitment (Shah, 2011:534).

Literature suggested that organisations can use a promotion mechanism to motivate employees towards achieving good performance. The finding of this study on the relationship between promotion and job satisfaction are in line with the findings in the literature.

6.2 Pay

According to Kara, Uysal and Magnini (2012:1061) fairness and equity in salary and wages are the basic tools that can be used to maintain and increase job satisfaction levels of both male and female employees. Qualitative insights indicate that pay fairness is important, and those who perceived pay was not fair generally made comparisons with others or felt that pay did not reflect their effort. Incentive pay has a positive effect on the mean job satisfaction of very high-paid workers only. A potential explanation for this pattern could be that for lower-
paid employees perceived to be controlling, whereas higher-paid employees derive a utility benefit from what they perceive as supportive reward schemes (McCausland, Pouliakas & Theodossiou, 2005:653). Salimäki, Hakonen and Heneman (2009:161) indicated that both knowledge and meanings of pay mediate the effects of goal setting on pay satisfaction. A potential explanation for lower-paid employees performance related pay was perceived to be controlling, whereas higher-paid workers derive a utility benefit from what they view as supportive reward schemes (McCausland, Pouliakas & Theodossiou, 2005:636). Although according to Okpara (2006:235) salary differential does exist between male and female, male managers were more satisfied with their salary than their female colleagues.

Literature supports positive associations between pay and job satisfaction, however the findings of this study does not validate a statistically significant relationship between pay and job satisfaction amongst the respondents. One of the possible explanations could be the permanent nature of job characterised by fixed salaries in public sector, which does not make pay as motivator.

6.3 Fringe benefits

Fringe benefits stand as an important component of worker compensation. Fringe benefits were significant and positive determinants of job satisfaction (Artz, 2010:626) while cheaper benefits should increase worker job satisfaction (Artz, 2010:627). Kasper, Muehlbacher, Kodydek & Zhang (2012:172) found that fringe benefits were significant motivators for employees and were regarded as attractive by them. However, studies by Kasper, Muehlbacher, Kodydek & Zhang, (2012:172); O’Halloran (2012:657) etc indicated that fringe benefits had a stronger negative impact on the labour turnover rate. The lack of personal attention paid to employees may have the adverse impact on their retention (Min 2007:375).

The finding of this study, fringe benefits have positive relationship with job satisfaction is in line with the previous literature.

6.4 Communication

Brunetto and Farr-Wharton (2004:582) concluded that managing the communication feedback processes is fundamental to achieve both perceived and real organisational communication effectiveness. Further studies by Awad & Alhashemi (2012:134); Goris (2007:739) etc support the fact that implementing effective and efficient communication practices in organisation was vital to create and maintain relationships as well as the ability to communicate effectively (Awad & Alhashemi, 2012:135). Dasgupta, Suar and Singh (2013:173) indicated that satisfaction with communication fostered a strong emotional bond with organisations and the emotional bond with organisations reduces employees’ absenteeism. Carrie’re and Bourque (2009:29) concluded that personnel operate under pressure and communication practices that were ineffective and inefficient can increase their frustration with the organisation. Further they indicated that an organisation’s internal communication practices consist of the full spectrum of communication activities, both formal and informal, undertaken by its members for the purpose of disseminating information to one or more audiences within the organisation. However according to Jusoh, Simun and Choy Chong (2011:516) achieving positive outcomes from the contributions of motivated employees was an important goal in today’s organisational environment.

Literature suggests that communication today has become the lifeblood of every organisation and was necessary to perpetuate the health of the organisation. However the finding of this study does not validate the fact that communication was positively related to the job satisfaction. This could be due to that fact that employees do not perceive communication in the organisation as an important aspect of their job satisfaction.

6.5 Co-workers

Studies by Moyes, Williams and Koch (2006:537); Poon (2006:526); Forret and Love (2008:25); Auh and Menguc (2013:1333) etc support the positive role of co-worker and job satisfaction. The literature indicated that when employees were provided with an environment that fostered high co-worker relationship quality and consensual knowledge sharing norms, the motivational loss resulting from the incongruence between pay-for-performance and knowledge sharing behaviour was mitigated Auh and Menguc (2013:1333). However the fining of this study did not validate this relationship. The issue needs further exploration.

6.6 Relationship between job satisfaction and productivity

The average scores of job satisfaction 2.39 and productivity at 2.27 suggest that respondents believed that they were satisfied with the job and they company systems were adding to their productivity and it was one of the key objectives of the company. The positive and statistically significant relationship between job satisfaction and productivity is in line with previous studies and the integrated model explains 22.4% of variance in productivity, while 38.5% variance in job satisfaction was explained by the factors considered in this study.

In conclusion this consolidated model provides way forwards for other researchers to study various factors of motivation, job satisfaction and productivity in an integrated way.

7 Limitations of the study

Since the study was limited to a public sector in South Africa, the findings may not be generalised to whole
of South Africa, more samples from various other public sector entity is required before the results can be generalised.

References

ETHICS AND AUDITING: SETTING THE BAR TOO LOW

Keith Hooper*, Jenny Wang*

Abstract

Purpose - from a philosophical and empirical perspective this paper seeks to show how the big audit firms have managed to set the bar low so that they offer only opinions on whether financial statements meet accounting standards. It is argued that while the concepts of virtue ethics have now largely disappeared, ethical legitimacy has moved beyond consequential ethics to a form of social Darwinism. It is a Social Darwinism that is legalistic and technical as evidenced by the audit firms' widespread use of the Bannerman clause attached to their opinions. Design - to illustrate the shift of ethical positions, the paper is informed illustrations of a failure to discharge a duty of care to the public. Findings – the shift in underlying social values contributes to what the Economist Journal describes as a steady decline in professional ethics. This arguable conclusion is supported by various illustrations and cites the shift in combinations of cognitive, moral and pragmatic legitimacy as drivers employed by accounting firms. Research Limitations – the paper uses secondary and documentary data and is informed by conceptual analysis which necessarily in the realm of ethics may be contentious. Originality – the paper seeks to link the changing social values with changes in legitimisation and to show shifts in accounting practices like the recent practice of issuing disclaimers.

Keywords: Ethics, Disclaimers, Kant, Unilateralism, Social Darwinism, Values

*Department of Accounting, Unitec Institute of Technology, Auckland, New Zealand

1 Introduction

The paper is concerned with ethical trends in the accounting profession. There have been an increasing number of accounting scandals in recent years (The Economist 2009). The trend is also revealed in the very recent global financial crisis, which – while possibly involving some unethical business practices in the banking and finance industry – may also reflect serious ethical issues in the accounting profession, as banks enjoyed the benefits of unqualified opinions from their auditors prior to the collapse (Sikka, 2008). In contrast to the global trend of increasing accounting scandals, the volume of content of the New Zealand Professional Code of Ethics (COE) has grown from six pages to more than 120 pages. However, the longer COE does not seem to have had a positive impact on accounting ethics. Most ethical codes are built on the moral traditions of their respective societies. In this way, Accounting ethics reflect and adapt to societal values. The New Zealand code, it can be argued, broadly reflects the moral inheritance of Europe, which has been refined by philosophers like Kant, Bentham and Mill, and Spencer (Stackhouse, 2004). Different ethical positions are always contentious but can be useful to focus thinking on the role of ethics in Accounting. This paper attempts to reveal ethical trends in the accounting profession in New Zealand through an analysis of the changes in underlying ethical philosophies as reflected in the profession’s COE: arguably derived from Kantian principles of virtue ethics, to a more legalistic and technical rhetoric reflective of Utilitarianism and Social Darwinism.

The accounting profession has over one hundred years of history and has been growing in importance to business communities and society (Backof & Martin, 1991). The New Zealand Society of Accountants was founded in 1908 and is now called the New Zealand Institute of Chartered Accountants (NZICA). The accounting professions in Commonwealth countries are self-regulating, with members’ behaviours being guided by their profession’s ethics, regulations, or COE. In New Zealand, professional ethics regulations were first issued by the Society of Accountants in 1927. The most recent version of the COE became effective in 2003 and was subsequently amended in 2006. This paper argues with Abbott (1998) that the changes from 1927 to 2006 in the COE reflect a shift from the personal qualities of accountants to legitimacy of technique. The 2003 COE adopts a more teleological approach with emphasis on legitimising the accounting profession. Preston et al (1995) observe that originally accounting like medicine and law was to be regarded as an occupation more heavily influenced by the service motive than entirely by the profit motive. As suggested by Higgins & Olson (1972), accounting involves judgement and the acceptance of responsibility to others. Putting, originally, a focus on character means as Preston et al (1995) observe that the profession’s foundations rest
on moral schema and code of ethics rather than standardisation and regulation. The paper attempts to show how the NZ COE has shifted from a focus on character to a more functionalist model which protects clients by delivering expert services. While such a question cannot be resolved by discussion or by empirical surveys, explanations can be offered for discussion that may illuminate how ethics codes could be derived and developed.

The plan of the paper is first to consider the concept of legitimacy and its link with moral and pragmatic philosophies in respect of COE. Following the discussion of legitimacy, the paper considers some of the elements of Kantian ethics and consequentialist thinking (Utilitarianism, and Social Darwinism) that have relevance to the paper. The object is to briefly outline the differences between these philosophical approaches to ethical problems as is necessary to explain moral and pragmatic legitimacy. With these differences in mind, the paper next compares the COE of 1927 and 2003, being respectively the first and latest COE promulgated by the accounting profession in New Zealand. The discussion which follows draws out concepts embodied in these COE with the overall purpose of showing how the focus has moved from the character of the accountant to the character of accounting. The process is informed by a shift from a more deontological position to a more consequentialist position. We illustrate this latter consequentialist position with a case study which has had considerable media attention in New Zealand – that of Hanover Finance. Like the Graham case (Baskerville-Morley, 2004), the Hanover Finance case illustrates the shift in ethics as reflected in practice. The accounts, reports and audit of Hanover Finance were in a minimalist sense just within the existing legal boundaries but there was widespread loss when the finance company suddenly collapsed – a not uncommon story. Anecdotal evidence has it that from the beginning of the company’s short history that the audit engagement was not much sought after because of the risk involved. Before the conclusion, a discussion is advanced to draw together three themes: values philosophy, COE, and how the shift in values reflected in the two COE can be shown in a recent company collapse.

2 Legitimacy

The paper sets out, first, to outline the concept of legitimacy which, it is argued, underpins many professional codes of ethics. As Aldrich & Fiol (1994) observe such a concept may be driven by (1) a concept of legitimacy to meet pragmatic assessments of stakeholder relations (2) a more normative response to what is considered morally appropriate or (3) legitimacy grounded on cognitive appropriateness. So what is legitimacy? Suchman (1995) defines it as, “a generalised perception or assumption that the actions of an entity are desirable, proper and appropriate within some socially constructed system of norms, values, beliefs and definitions” (p. 574). The appeal for legitimacy is to a social group as a whole notwithstanding individual reservations. It is argued in this paper that COE are the means to establish social legitimacy and the underlying philosophical positions they reflect are designed to be congruent with current social values and beliefs.

What is legitimacy overlaps with what is legitimacy for in that legitimacy cements congruence between an organisation and its cultural environment. The emphasis being not so much what is desirable as is recognisable and understandable such that would explain and justify an organisation’s existence (Meyer & Scott, 1983) (Meyer & Scott, 1983). Suchman (1995) points out that the concept of legitimacy seems to divide academic studies into two distinct groups: strategic or institutional. The strategic studies emphasise a management perspective which manipulates and use effective symbols to gain societal support (Ashforth & Gibs, 1990; Dowling & Pfeffer, 1975). By contrast, the institutional studies emphasise cultural pressures which transcend any organisation’s control (DiMaggio & Powell, 1983; Meyer & Rowan, 1991).

While the divisions between strategic and institutional legitimacy are an important consideration, it is the concept of legitimacy being driven by pragmatic, moral or cognitive considerations that arguably helps to explain why COE may be expected to change to meet changing social values.

Pragmatic legitimacy rests on the self-interested calculations of an organisation’s most immediate audiences according to Suchman (1995). Aldrich & Fiol (1994) point out that for pragmatic reasons organisations may emphasise image and support such an image by advertising. Moreover, image advertising may foster generalised attributions of good disposition. Whether such calculations are driven strategically or institutionally as a result of cultural expectations is not resolved but what is motivating is a desire to build and maintain a reputation for competence and reliability. When pragmatic strategies of legitimacy are preferred it follows that COE will be designed to include consequentialist values and beliefs.

By contrast, moral legitimacy is harder to achieve. Ashforth & Gibbs (1990) conclude that for organisations their best hope is to accumulate a record of technical success. They observe that within the contemporary rationalist order, technical performance not only establishes consequential legitimacy but it also exerts spillover effects on moral dynamics to provide a lasting validation for procedures, and structures (Suchman & Eyre, 1992). Moral legitimisation comes with a warning from Selznich (1949) that it carries with a substantial likelihood of unanticipated goal displacement and possibly public cynicism.
Suchmann (1995) argues that to further cognitive legitimacy, gatekeepers may be employed to grant certification to label institutions and grant preferred definitions such as employed by the professions to privilege members and provide them with certified recognition. Finally, while pragmatic and moral legitimacy can be arrived at by cost-benefit appraisals or ethical judgements by way of public discussion cognitive legitimacy implies unspoken assumptions as to professional legitimacy. Some defensive endeavours taken by professional organisations may have the wrong effect and imperil taken for granted assumptions. On the other hand, pragmatic legitimacy relies on audience self-interest that it the right organisation for the job, whereas moral and cognitive legitimacy do not.

These observations from the literature explain from the point of view of legitimacy, why professions need a COE and why such a COE may combine element of pragmatic and moral philosophies. This is not to say that any one kind of legitimacy is dominant in COE but rather that all three – pragmatic, moral and cognitive - are combined. However, what is argued is that there has been a shift within this combination. A shift to reflect changing values not necessarily from a strategic design but from institutional reflexes to cultural change. The paper seeks now to briefly outline features of ethical philosophies, which are sources of legitimacy drawn on by professional monopolies to underpin their COE.

3 From Kant to Social Darwinism

The principles reflected in the COE have an ethical inheritance, which generally reflects the moral values and ethical philosophies of the society in which they are embedded. This section provides an overview of principles of ethical philosophies that are reflected in the COE, namely Kantian and Mintz’s virtue ethics, Utilitarianism and Social Darwinism. To explain such a reflection, the paper attempts to link elements of these philosophies with the COE. The position reflected in the paper is that ethics is about choices of principles that may right or wrong, while morality is about good or bad, though the latter is not under discussion.

Ethics is necessary because people’s actions may conflict and most people are more interested in their own welfare than in that of others. Such egoistic actions are frequently involved in social conflicts. Ethics has a twofold purpose: first, to find criteria by which to distinguish right and wrong actions; second, by means of praise and blame, to promote right actions and discourage wrong ones (Russell, 1947, p. 807). To ameliorate social conflicts, the moral inheritance generally shared by Europeans, which is also shared in New Zealand, has been developed by philosophers like Kant or modified by philosophers like Bentham into utilitarianism. For the purpose of this paper, the deontological arguments employed are drawn primarily from Immanuel Kant. It is acknowledged that there are other major deontological contributors, but this paper is necessary limited in its content.

Immanuel Kant (1724-1804) argues that a fundamental principle of morality is a rational will and such rationality of will must be regarded as independent and self-governing. He calls these moral principles ‘Categorical Imperatives’ (CI) (Kant’s Moral Philosophy, 2008). He believes that “The highest good was the good will” (Frederick, 1999, p. 3). Because humans have free will and are rational, they are capable of reasoning what constitutes right actions. CI are formulated so that rational beings should abide by the maxim, “Act only on that maxim through which you can [...] will that it should become a universal law [for all rational beings] (Kant, 1993, p. 30)”. In other words, according to Russell, Kant maintains an ethical position of “Do as you would be done by” (as cited in Russell, 1947, p. 737). The second formulation of CI is to “Act in such a way that you treat humanity, whether in your own person or in the person of any other, never merely as a means to an end, but always at the same time as an end” (Kant, 1993, p. 36). Kant argues that certain actions or behaviour cannot be justified as moral based on the outcomes from such actions. For example, a businessman is honest because he knows that it will attract more customers and increase profits. He is not genuinely moral because his intention to be honest is to increase profits under Kantian ethics. Kant’s ethics are non-consequentialist. It is a deontological approach, which focuses on duties rather than consequences. The third formulation of CI is that, “So act as if you were a member of an ideal kingdom of ends in which you were both subject and sovereign at the same time” (Frederick, 1999, p. 4). This means that people should abide by the maxim all of the time, without exception. The maxim is thus a law which applies to everyone. No one should exempt himself from the maxim but expect others to abide by it. In other words, Kant’s deontological approach emphasised a sense of duty.

However, this focus on duty is not the same as a focus on character, except that, as Aristotle observes, “We are what we repeatedly do” (Gough, 1998). In this vein, according to virtue ethics theory, virtues characterise the decision maker: “Possession and exercise of virtues tend to increase the decision maker’s propensity to exercise sound ethical judgements” (Armstrong, Ketz, & Owsen, 2003, p. 3). This combines Kant’s view of rational cognitive acts, recognising moral issues and thinking them through, with an intention to act morally, and the ethical character to bring that intention to fruition (Armstrong et al, 2003). From Kant comes the element of reason necessary to understand issues, think, and arrive at an ethical judgement, while virtues add ethical motivation, allowing individuals to place the interest of others before themselves. For Pincoff (1986),
virtues are those attributes of character that describe an individual’s direct concern for others, which contrasts with Adam Smith’s view that people act in their own self-interest, egoism, and that they are rational but greedy. Mintz (1995) believes that virtues in accounting are linked to the requirements of professional codes: trustworthiness, benevolence, altruism, honesty, integrity, impartiality, open-mindedness, reliability, dependability and faithfulness. Thus, what are for Kant elements of an over-riding concept of “duty”, become virtues in practice and characteristics of accountants.

In contrast to Kant’s deontological perspective, Jeremy Bentham (1748 – 1832) developed utilitarianism. In essence, his teleological approach advocates identifying the aggregate of pleasure and pain that would best advance “the greatest happiness” of all of those whose interest is in question. Bentham holds not only that the good is happiness in general but also that each individual always pursues what he believes to be in his own happiness. He rejects Kant’s subjectivism of what ought to be for everyone else as merely an expression of Kant’s moral feelings.

“If each man in fact and inevitably pursues his own pleasure, there is no point saying he ought to do something else. Kant urged that “you ought” implies “you can”; conversely if you cannot, it is futile to say you ought” (Russell, 1947, p. 806).

Bentham seeks a more scientific approach in terms of utility and consequences and by such terms arrives at a deterministic account of mental occurrences (Pope, 2004). Utilitarianism introduces the idea that whether an action is ethical is based on the outcomes resulting from that action. Using the same example as above, the businessman is honest because he knows that is the way to increase profits. Because the consequence is to increase profits and acting honestly is a way to achieve this consequence, the businessman is considered to be morally right. In contrast to Kantian ethics, the intention of being honest is irrelevant as long as it achieves the ends.

Mill (1861) declares: “Utility, or the Greatest Happiness Principle holds that actions are right in proportion as they tend to promote happiness, wrong as they tend to produce the reverse of happiness ” (p. 257). If the outcomes of action or behaviour lead to greatest happiness, which is calculated as the sum of the happiness of all affected people in a given situation, that action or behaviour is ethical. This rejects Kant’s ethics where the ethical values of people are absolute and autonomous. Under utilitarianism, consequences can justify the means. For example, according to utilitarian ethics, stealing can be justified if more people benefit from this action than suffer losses. So where a person steals from his wealthy neighbour’s household of four people and gives the proceeds to an orphanage with fifteen orphans, the stealing is an ethically permissible action because the happiness of the fifteen orphans is greater than the happiness of the neighbour’s household.

One of the drawbacks of utilitarianism is the difficulty of quantifying happiness and a calculation of happiness (Preuss, 1998). Other flaws also exist. The concept of utilitarianism relies on legislators, who prescribe sanctions, knowing what is in the community’s interests while ignoring their own interests or desire for pleasure. If, however, as Adam Smith argues, every man always pursues his own pleasure, how are we to ensure that the legislator will pursue the pleasure of mankind in general? (Russell, 1947) Thus, the ideal that all pain and happiness can be brought into calculation is, for some, flawed. For example, those framing accounting standards must ignore the interests of lobby groups or their own paymasters to pursue a community’s interest, which presupposes that they know what such interests are and they know which side of a social conflict they support (Tinker, 1991).

Herbert Spencer (1820-1903), a liberal utilitarian, first enunciated the concepts of Social Darwinism, drawn from the theory of natural selection known as Lamarckism, in which acquired characteristics are inherited. In nature, living things can modify new traits gradually in response to needs created by their environments and pass them on to their offspring (Stent, Sydney, & Jeffrey, 2001). Spencer applies this argument, with irresistible evolutionary logic, that it is natural and proper for the strong to survive at the expense of the weak (Spencer, 1897):

...every type that is best adapted to its conditions, which on the average means every higher type, has a rate of multiplication that insures a tendency to predominate. Survival of the fittest, acting alone, is ever replacing inferior species by superior species. (Spencer, 1882, 2:478 cited in Weikart, 2009, p. 24)

This paper adopts Mike Hawkins definition of Social Darwinism as “the attempt to justify or promote human competition for scarce resources as a necessary, natural phenomenon fostering biological progress” (Weikart, 2009, p. 21). It has two central assumptions. First, it suggests that there are underlying and irresistible forces acting in societies, which are like natural forces that operate in the animal and plant kingdoms. Second, these social forces are of a kind to produce evolutionary progress through natural conflict between social groups. The best adapted and most successful groups survive these conflicts (Abercrombie, Hill, & Turner, 1994). Indeed, to support those unfit to survive can be argued to be morally incorrect, but that does not mean that the opportunity for self-improvement should be denied (Hawkins, 1997). For example, the American capitalist, Andrew Carnegie, was an overt Social Darwinist, using his vast fortune to establish libraries and other educational institutions so that the so-called weak might have the opportunity for self-improvement (Hawkins, 1997). Social Darwinism introduces a laissez-faire approach to business
(Weikart, 2009). “The business of business is business” is a quote attributed to Milton Friedman, an advocate of laissez-faire economics. Taking this observation as the hallmark of Social Darwinism, the relevance of this philosophy to the latest COE is found in the espoused qualities of competence and technical efficiency. More broadly, Social Darwinism mainly holds that it is good to be successful and that eliminating weaker competition facilitates evolutionary progress. It justifies ruthless competition and argues that it is both natural and proper to exploit the weak (Bergman, 2001). Echoes of Social Darwinism arguably resound whenever the concept of “the business of business is business” is used to reject suggestions of business social responsibility and may be applied to audit firms who justify disclaimers to exploit perceived of fairness in (Weikart, 2009). Some blending of these opposing philosophical positions (Kant, Utilitarianism and Social Darwinism) is the basis and justification for most modern business interpretations of ethics and for various professional COE (Stackhouse, 2004). In the next section, the paper shows how these three philosophical positions are reflected in the accounting professions COE in New Zealand. Through the analysis, the paper demonstrates the inclination and the trend of prevailing philosophies reflected in COE. To achieve this, the paper compares the New Zealand accounting profession’s first COE in NZ, issued in 1927, with the current one, issued in 2003.

4 New Zealand's Code of Ethics (COE)

This section identifies differences in the content of the 1927 and the 2003 COE. By analysing these changes, this section attempts to demonstrate the shift that has occurred in their underlying ethical philosophies.

The New Zealand Society of Accountants adopted its first Professional Ethics code in 1927. This consists of 17 clauses and is six pages in length (attached as Appendices A). The 17 clauses cover a range of requirements, including: the overall characteristics of professional accountants (clause 1-2), confidentiality (clause 3), disclosure of conflict of interests (clause 4), relationship with other accountants and the profession (clause 5-9), advertising (clause 10), obligation to stakeholders (clause 11), unbiased judgement (clause 12), no commission dealing (clause 13), obligations to the profession and the Society (clause 14-17). As Preston et al (1995) found in the 1917 American Association of Public Accountants code of ethics there were similar prohibitions against encroachment and advertising. According to Preston et al (1995) the term independence was not used until 1964, rather the emphasis is “replete with exhortations of duty, responsibility and loyalty” (p. 513). They argue such ethics reflect contemporary conceptualisations of morality and societal culture to legitimise the profession within a wider public domain. The insistence is on good character. Preston et al (1995) suggest that the focus was on forming oneself as an ethical subject and being of good character was the basis for legitimising the activities on accountants. This focus on duty, responsibility and loyalty ties in with the concepts virtue ethics.

The first paragraph of the 1927 Professional Ethics, which has disappeared from the current COE, reads:

Every member of the Society in the practice of his profession or in the course of his service to his employer should give such service with absolute fidelity and should be actuated by a spirit of fairness to client and employer, considerate to the fellow practitioners, loyalty to his country, and devotion to high ideals of courtesy and honour (p.1).

The stated virtues of professional members include “absolute fidelity”, “a spirit of fairness”, being “considerate to the fellow practitioners”, “loyalty to his country”, and “high ideals of courtesy and honour”. These virtues are also reflected in subsequent clauses. For example, clause 5 stipulates that practitioners “should not use unfair means to win professional advancement or to injure the chances of another Public accountant to secure and hold employment”, reinforcing the concept of fairness in dealing with other people.

Furthermore, clause 10 requires that practitioners should only advertise their services by means of a “card”, the size of which should be small in a newspaper or directory and whose content should include only the name, title and address of the advertiser. Such advertising is very humble, suggesting that, at the time, the Society discouraged advertising of its professional members in order to avoid competition between them. It may reflect also professionals’ consideration and courtesy for their fellow practitioners and a collective distaste for image creation. Competition among practitioners may result in competing fees and it may be regarded as being not honourable to compete with each other for fees. This requirement has disappeared from the 2003
code, which is silent with regard to intra-professional competition. Indeed, for pragmatic reasons of legitimacy as Aldrich & Fiol (1994) observe image advertising may foster generalised attributions of good disposition.

In addition, Clause 11 specifies that practitioners have responsibilities towards ‘prospective investors, creditors, or others’ during the course of preparing or certifying statements. The responsibilities owed to prospective investors or other third parties in 1927 code were explicit. The 2003 code remains silent about duties towards ‘prospective investors’. The requirements prescribed in the 1927 COE focus on personal characteristics or the good will of rational beings. It reflects both a Kantian “duty”-based ethical approach, which believes that rational beings have a duty to act with good will, and a virtue ethics view of the codes as found in Mintz (1995). Values such as fidelity, consideration, loyalty, courtesy and honour are often used to characterise a good person. They assume a sense of self moral regulations governing how accountants should act. The 1927 code focuses on duty and, by repetitive practice, such duties become virtues, which in turn become the characteristics of accountants. Such virtues imply a deontological ethical philosophy underlying the 1927 code, which focus on virtue as forming character (Mintz, 1995).

The current COE comprises two parts, the first part being 63 pages long, and the second part, Independence in Assurance Engagements, being 60 pages long. It reveals a discourse as Previts & Merino (1979) found of increasing use of legalistic and technical rhetoric and a growing concern with public relations. The COE contains five fundamental principles, including Integrity, Objectivity and Independence, Competence, Quality Performance and Professional Behaviour. Each principle is broken down into detailed rules, with applications provided to illustrate how the rules apply in different situations. According to NZICA’s official website, the current COE comprises “fundamental principles and provide guidance on professional conduct needed to sustain public confidence in the profession” (NZICA, n.d.). This implies that accountants need to behave professionally in order to sustain public confidence and that sustained public confidence is an outcome of acting professionally. Therefore, the current COE promotes behavioural rules or regulations that instruct professionals how to behave with the aim of maintaining public confidence. The emphasis is that accountants should behave in such a way as to deliver the desired outcome. Their conduct is justified by the outcomes they lead to, implying an underlying consequentialist ethics philosophy.

There are two fundamental principles introduced into the current COE to regulate how accountants should do their job to ensure that they provide quality service. These are competence and quality performance:

- **Competence - Members must only undertake professional work in which they have the Competence necessary to perform the work to the technical and professional standards expected. (p 3)**

- **Quality Performance - Members must perform their professional work with due care and diligence, ensuring that all professional obligations are completed in a timely manner and are carried out in accordance with the relevant technical and professional standards appropriate to that work. (p 3)**

These two principles, not in the original code, mainly deal with technical competence and good quality work. Competence and Quality Performance are required to assure the public that accounting professionals are technically competent to deliver their service. This is similar to a quality control procedure in a manufacturing factory for ensuring the quality of products so that they can be competitive in the marketplace. It can be argued that this similarity suggests that the two principles are not so relevant to ethics, but are more like a quality control procedure. Some authors share this view. Velayutham (2003) analysed both New Zealand and Australian COE and argues that “the main focus of the codes … is quality rather than ethics” (p. 484). Further, he states that “Compliance with technical standards and professional behaviour could not be considered to be ethical principles since their compliance depends on law like statements and quality standards” (p. 494). In relation to competence, Fogarty (1995) adds, “The central message of quality … fails to express any coherent moral ideas” (p. 111). On the other hand, it may be argued that quality does have an ethical dimension especially when clients are unaware of what constitutes a quality standard. According to Dellaportas (2005) the social contract concept and clients’ reliance on the knowledge of the professional accountant professional competence should be perceived to be a duty of the professional accountant.

The addition of these two principles to the current COE implies that quality work is at least equally as important as accountants’ character, if not even more so. Velayutham (2003) also comments on the quality focus of the current COE and maintains that it reflects a shift from the ideals of sentient beings to standards of service, where “technique has character as an important value” (p. 501). This may reflect a Social Darwinian approach in that the accounting profession seeks competent people who can deliver quality work. People who are not technically competent enough should not be in the profession. The accounting profession needs such technically-competent people to maintain its public profile, and possibly improve its reputation and image, so that the whole profession becomes stronger and more influential in the business community and society.

Apart from the two new quality focused principles, other principles also reflect their utilitarian origin. For example, the purpose of the Integrity
principle is that “It is members’ adherence to the fundamental principle of Integrity that allows the public to derive their trust in the accountancy profession” (p.7). Although integrity can be seen as a virtue, in here, there is an aim to being honest. Integrity is required to gain trust from the public. Therefore integrity is a means to reach an outcome.

Some authors argue that the primary purpose of a COE is to improve the image of the profession and there is for pragmatic reasons of legitimacy good reason to promote such an image (Backof & Martin, 1991; Fogarty, 1995). According to Kantian ethics, this is not morally right because the purpose of having integrity or providing quality service is not to improve a profession’s image; rather, the motive is on goodness as an absolute moral principle. By contrast, according to utilitarianism, integrity and quality service are needed to earn a good public image for the profession. Accounting professionals’ characteristics are less relevant if they do not result in improving the public’s image of the profession. The focus of competence and quality performance are arguably primarily technical issues aimed at legitimising the profession’s monopoly particularly in assurance engagements (Mitchell, Puxty, Sikka, & Willmott, 1994). Furthermore, the principles of Independence and Objectivity outlined in Rules 3 &4 in the current COE are to ensure that professional accountants are objective when making professional judgements particularly for assurance engagements. However, Williams (1992) points out that independence in accounting has shifted from being conceived as an integral part of character to being regarded as an economic commodity. The consequence of this shift is that independence is now the focus of much interpretation as a claim to independence is not longer credible to the general public. Claims to independence need today to be supported by rules specifying its nature and scope (Preston, et al., 1995). Such rules of independence are expressed in rules that are seen to be more precise and legally interpretable so that compliance or non-compliance can be determined. The importance of codifying ethics into rules is, as Preston et al (1995) point out; a big part of legitimation. While rules may be a source of legitimisation in contemporary society, this increasing emphasis as Preston et al (1995) observe, “raises the question as to whether the code and the discourses surrounding it may be defined as moral” (p. 528). Rules require only conformity and no moral discernment. As Francis (1991) comments that the moral question as to how I, an accountant, should act in a particular situation becomes a legalistic rather than a moral one.

Some writers question the motive of this principle. For example, Mitchell et al. (1994) examine audit failures and alleged unprofessional conduct by accounting firms and their partners in UK. They find that professional accounting bodies failed to take effective action against offending firms or their partners. Therefore they argue that “The ideals of independence and integrity, [...] are little more than a smokescreen, or fig-leaf, for the pursuit and protection of sectional interests” (p. 48). Allen (1997) also states: Independence is not a value in and of itself. Independence in this context is an instrumental value. We value it because we think it helps produce something else: efficiency of the capital markets and thus, efficiency of the economy as a whole(p. 3).

According to Preuss (1998), utilitarianism offers an advantage to accountants in that it links self-interest with moral behaviour and is by definition self-serving (i.e. he argues that utilitarianism is formulated on a deterministic psychology that every individual seeks his own happiness). It is, he argues, by default the most influential ethical theory in the business context. The calculation of greatest happiness and harm shares similarities with the calculation of profit and loss.

Accountants can be seen as conveying neutral information on which users can base their decisions and, in this sense, the consequences can only be helpful. However, in as much as the COE focuses on the consequences of an ethical action, it would seem that the COE conveys legitimacy to both professional monopoly and the wider public.

The importance of these principles is reflected in the introduction section of the current COE. The Code of Ethics recognises that the objectives of the accountancy profession are to work to the highest standards of professionalism, to attain the highest levels of performance and generally to meet the public interest requirement. This Code is designed to provide members with authoritative guidance on minimum acceptable standards of professional conduct. The Code focuses on essential matters of principle and is not to be taken as a definitive statement on all matters.

Perhaps the exposure draft (ED) of the latest COE spells out the importance of fundamental principles more clearly. (An ED was issued by Professional Standard Board in December 2010 and the new COE became effective on the 1 January 2012). According to section 100.1 of the ED “A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. Therefore, a member’s responsibility is not exclusively to satisfy the needs of an individual client or employer. In acting in the public interest, a member shall observe and comply with this Code”.

Again, the COE emphasises that to adhere to the principles is to sustain a public interest. Public interest is what sets members of the profession apart as a group of “ethical and competent accountants” compared to accountants who are outside the profession. The paradox is that the professional qualified accountants are trying to limit their responsibility to the public by introducing something
like the Bannerman clause. Such clauses undermine the concept of public interest and, as a consequence, the COE looks more like a screen to legitimate the profession. The self-interest of the Bannerman type clauses imply a social Darwinist influence. As other have observed for some time the profession needs to have a COE to promote their own interests, secure privileges and stay competitive (Johnson, 1972; Larson, 1977; Preston, et al., 1995; Willmott, 1986). Overall, the differences between the 1927 and the 1927 codes illustrate a shift in the ethics philosophies underlying them. The 1927 code implies a deontological approach, whereas the 2003 Code reflects a teleological approach. Some of this shift may be explained by the confusion that the “new burst of interest in business ethics in universities” has evoked (Stackhouse, 2004, p. 238). He goes on to write:

Textbooks written for these [ethical] courses seldom treat theological issues, focusing instead on some combination of Kantian principles, utilitarian calculus and various versions of social Darwinism. (p. 238)

An explicit example of a shift in the COE to limit the obligations to stakeholders is evidenced by Baskerville-Morley (2004). She refers to the Graham case which led to statutory reform of the accounting profession in New Zealand. For some time prior to 1991, the Chartered Accountants Society in New Zealand had maintained a Fidelity Fund to recompense clients who had been cheated by their ‘black sheep’ members. It was a characteristic of being a ‘Chartered Accountant’ which, by having the fund, combined a sense of duty and virtue as hallmarks of a profession. That is, the profession, recognising that it must inevitably at some time have “bad” members, set out to protect unknown third parties from the effects of these members’ activities. However, as Baskerville-Morley (2004) points out, following the Graham case, which emptied the Fidelity Fund, the then ‘Big 6’ accounting firms in New Zealand in conjunction with other practitioners no longer wanted to maintain the fund and lobbied successfully for its cessation. Since then, injured third parties have no resort to the profession for recompense. The outcome is consistent with Sikka’s (2000) determination from the UK that power symmetries meant that private profit, not human welfare, was the dominant behavioural driver. The push to abolish the Fidelity Fund concealed a power asymmetry between the influence of the Big 6 firms and that of other members of the profession in small and medium partnerships (Baskerville-Morley, 2004).

The following section draws on another New Zealand case, that of the failure surrounding Hanover Finance, which shares similar features to the Baskerville-Morley’s (2004) Graham case in that it attracted high public attention because the majority, least dominant, stakeholders were marginalised. Like the Graham case, the Hanover Finance case illustrates how the shift in the COE is reflected in practice.

5 Pragmatic legitimacy: the Hanover Finance case

As described above legitimacy comprises a combination of moral, cognitive and pragmatic elements. Pragmatic legitimacy rests on the self-interested calculations of an organisation’s most immediate audiences according to Suchman (1995). The case illustrated reflects a shift towards pragmatic legitimacy and rather less of moral (what is morally appropriate) or cognitive (what is grounded on cognitive appropriateness) legitimacy. In this case, the audit firm’s most immediate audience was the small group of major shareholders controlling Hanover.

In December 2009, it was announced that 16,000 so-called “Mum and Dad” depositors in the failed finance company, Hanover Finance, had voted to take shares in Allied Finance, another New Zealand finance company, in order to seek future repayment (Eriksen, 2008). The “Mum and Dad” investors had, in reality, lost most of their money as the new shares that they had to accept in place of the deposits with Hanover Finance are of little and diminishing value. It is a story of social conflict, where accounting served the interests of one side of this conflict, that of the controlling shareholders - accounting taking the form of one of the Big 4 firms. The Big 4 firms enjoy considerable market place legitimacy resting on their recognisability (cognitive legitimacy) and good reputation for efficient audits (moral legitimacy). It is the third element in the legitimacy combination, the pragmatic that features as dominant in this story.

The case attracted huge media attention in New Zealand. Television cameras camped outside the homes of the controlling shareholders who, to avoid further interviews, fled the country. The media sensed corruption and fraud but, in fact, as the auditors were probably aware, the company’s financial reports were within the “form” of the law (such as existed) if not its substance. The Hanover Finance story begins in 2006. Thousands of depositors were drawn to Hanover Finance by television advertising fronted by a popular television news reader, Richard Long, who gave authenticity to what would subsequently be shown to be extravagant claims:

The Long advertising strategy was highly successful and at the end of the June 2006 year the company had total assets of more than $1 billion and was ranked number one in terms of total assets and net profit after tax in the KPMG Property Development and Commercial Finance category. (Gaynor, 2008)

What was not disclosed in the advertising and prospectus was that nearly 20% of the company’s assets were related-party loans with a capitalised
interest facility relating to property bought by the controlling shareholders that was worth much less than their book value. Amazingly, under accrual rules, the interest due but not received from the related-party loans were treated as income and the audits were not qualified. What is of significance is that as the years progressed increasingly more of Hanover Finance’s loans became related-party loans and 93% of these loans were on a capitalised interest basis, with only 7% paying interest. Moreover, a capitalised loan is where interest is added to the principal instead of being paid, so that interest is deferred. Nevertheless, “Hanover included this interest as interest received and, as a result, was able to give the impression that its earnings were far stronger than they actually were from a cash income point of view” (Gaynor, 2008). Such an accounting policy, while not strictly illegal, is misleading and says much about the how the auditors viewed these transactions. To accept the form rather than the substance of these transactions implies that drivers of moral and cognitive legitimacy were weakly held. If, as Suchmann (1995) observes, “Pragmatic legitimacy rests on the self-interested calculations”, then the driver in this sad story seems to be self-interest.

The accounting misdemeanours were several. In New Zealand directors are supposed to declare dividends only after confirming that the business is a going concern. The six major shareholders of Hanover Finance distributed 5.5 million dividends to themselves after its profits plunged and shortly before interest payments were suspended. As one business commentator observes, this action was hardly justifiable (Gaynor, 2008).

Whether the auditors questioned the solvency declaration is unknown. It may be argued that had the auditors respected the Bannerman judgment of responsibility to unknown third parties then they may have been prompted to ask further questions. But they chose not to this and the Big 4 firms are now adopting a specific “Bannerman” clause to their audits denying responsibility to anyone except the shareholders as a body. Quite what “as a body” means no one knows.

Inter-company loans can obscure the state of a holding company’s true financial situation. Without consolidated accounts, investors cannot be assured that so-called “stringing” or “hydraulicking” is not taking place. Stringing or hydraulicking is commercial slang used to describe the way a finance company might use one loan book as equity to raise another. The result is a complex structure that is more highly leveraged than is possible to see from the available information. When asked about the inter-company loans, Mr Hotchin, one of Hanover Finance’s controlling shareholders, pointed to each finance company’s trust deed as well as the signoff from the Big 4 auditors as reasons why investors should be reassured (Cone, 2004). In other words, the image of legitimacy created by the Big 4 firms was enough to silence critics.

Since the controlling shareholders of Hanover Finance always acted to just within such laws as exist to control finance company operations, their auditors also were always able to endorse their transactions. As Tinker (1991) observes, accounting inevitably favours one side of a social conflict. In spite of a new COE in 2003, the practices that ruined the New Zealand share market in the late 1980s were repeated: extravagant advertising to draw investors, unwarranted dividend payments from capital, lack of consolidation so as to hide illiquid subsidiaries, and inter-company loans to related parties.

The central point with regard to this case and its relevance to the paper is that the auditors – post-Bannerman – chose to issue unqualified audit reports which served the interests of a small group of Hanover Finance shareholders. The case is now under investigation. Chartered accountants are given a monopoly over audit work because they enjoy legitimacy. Cognitively, they are recognised as the appropriate professional body and their advertising is cultivated to convey an image of responsibility and integrity. Morally and cognitively, they enjoy legitimacy because of their professional image. Yet, the auditors in the Hanover Finance case sought to serve specific interests. This shift from ‘means’ to ‘ends’ is a shift exemplified in terms of the driving features of legitimacy.

6 Discussion

Ethical problems in accounting and auditing are global. Sikka (2010) refers to the Lehman insolvency and warns that the public should be sceptical of the audited reports published by large corporations. Sikka (2010) comments:

*Ernst & Young, Lehman’s auditors, collected $311mn in fees in 2007, and knew of Lehman’s $ 50 bn Repo 105 accounting gimmick, but did not make or demand public disclosures even though the insolvency examiner argues (page 735) that “the only purpose or motive for the transactions was reduction in balance sheet ... there was no substance to the transactions”. Repo 105 had been in existence since 2001. Perhaps, the auditing firm was unwilling to upset its paymasters. (p. 1)*

It is this question of accountants and auditors accepting the “form” of transactions rather than enquiring too deeply into their “substance” that is a troubling problem, as illustrated in the Hanover Finance case cited above. Reducing the balance sheet by off-balance sheet techniques may not be uncommon but most auditors would or should be aware of such practices. As Sikka (2010) states,

*Some estimates have suggested that banks may have organised as much as $ 5,000 bn off their balance sheets and window-dressed their leverage. Despite the chicanery, all distressed banks received*
clean bills of health from their auditors. If auditors are unwilling to speak up on accounting gimmicks of $50 bn or $5,000 bn, there is no point is continuing with the present arrangements. (“Lehman chicaneery is tip of the iceberg” The Guardian, 16 March 2010).

What this paper tries to show is that the practices referred to by Sikka (2010) and illustrated in the Hanover Finance case occur because of the economic practice of what Shearer (2002) refers to as “granting value to a desired object only insofar as the object stands in instrumental relation to the desiring subject” (p. 553). Shearer explains further, “In the language of Kant, the other is made a means rather than an end in herself, and by this act is objectified and her own subjectivity denied” (p. 553). The unfortunate Hanover Finance investors were of no consequence to the auditors and as “others” were only a “means” whereby audit fees were collected. In other words, calculation of self interest prevailed and served a legitimising strategy.

The practice of accounting is driven by the assumptions of neo-classical economics: “the subject will do that and only that for which he expects a net gain in well-being” (Arrow, 1979, pp. 111-112). This deep rooting of accounting within neo-classical economic theory has been observed by many (Cooper & Sherr, 1984; Gray, 1992; Hines, 1989; Lukka, 1990; Mouck, 1995; Preston, et al., 1995; Reiter, 1994; Thompson, 1998; Tinker, 1991; Tinker, Lehman, & Neimark, 1991; Tinker, Merino, & Neimark, 1982). The problem with neo-classical assumptions is that, as Shearer (2002) observes, If economic theory does not effectively restrict itself to discrete domains of human life, then it is at risk of colonizing the whole of human experience, ensuring that human subject understand themselves and one another as self-interested utility maximizers, even in those domains of human engagement most removed from market transactions. (p. 549)

In other words, neo-classical economic theory practices an imperialism that spreads to the whole of human experience. But where do these assumptions draw their strength? Stigler (1981) comments, “We believe that man is a utility-maximising animal …, and to date we have not found it informative to carve out a section of his life in which he invokes a different goal of behaviour” (p.176). The result as Shearer (2002) explains is that, “Within economic discourse each individual is properly held accountable only for the pursuit of her or his private good” (p. 556). As utility-maximising animals our origins and motivations can be explained by Social Darwinism. But this was not always the case. Before Spencer, there was Kant where, perhaps, more in theory than practice, society thought honour was paramount and that the means justified the ends. However, as the COE separated by time witness, other ideas prevail: “self-interest (broadly construed) becomes the only motive that appears rational for a sovereign and self-determining subject” (Shearer, 2002, p. 555).

To nail down their pragmatic self-interest further, accounting firms are issuing Bannerman-inspired disclaimers with their audits – a practice that as some firms are realising might have the self-defeating result of undermining the worth of the audit (ACCA, 2008). In this way, economic theory invites the imperialism of self-interest into every aspect of human behaviour as natural and self evident. The result is that, within economic discourse, each individual is properly held accountable only for the pursuit of her or his private good (Shearer, 2002, p.555). Thus, legal judgements (Caparo Industries v Dickman and Touche Ross & Co, 1990, and Royal Bank of Scotland v Bannerman Johnstone Maclay, 2005) based on this discourse have found that third parties (who do not pay directly for the audit service) cannot hold auditors accountable. However, as financial reports are held to be true and fair as a consequence of an unqualified audit, it seems odd that they are deemed only true and fair to those who can pay for them. These judgements represent as a consequence a shift in legitimacy to pragmatic considerations being paramount and give the green light to audit firms who seek to narrow their responsibilities as in the Hanover Finance case. Unfortunately for the auditors and the controlling shareholders, the wider public had not appreciated this shift in legitimising accounting as a more pragmatic calculation. The media attention that the Hanover Finance case engendered was huge, with television cameras camped outside the homes of the controlling shareholders to seek interviews which were not forthcoming as both main shareholders fled the country. One of the controlling shareholders was even pursued by the media to his new home in Hawaii. As has been cited, the only defence offered by one of the directors is that they had a clean audit, so what was the problem? However, the New Zealand media interest in the Hanover Finance case that was aroused can be explained because the public has not understood that audits are tailored to meet the expectations of their fee-paying clients. The image that accounting firms have cultivated is at odds with a legitimacy driven by more self-interested calculations. This was not the kind of legitimacy the New Zealand public expected it was granting to accounting firms. An expectation gap had emerged. The old unwritten social contract gave legitimacy that featured more cognitive and moral drivers though there was always present a pragmatic driver. Now it has emerged that, with or without disclaimers, some auditors are selling a “true and fair view”, which may not be a “true and fair view” for other stakeholders. In other words, self interest prevails and those that can pay receive what they pay for, those that do not or cannot pay for the service cannot expect to be catered for. This is how the invisible hand of Adam Smith works: people supply what people are willing to pay for. It is not the invisible hand of God but that of Social Darwinism. It was these principles from another age that the
earliest COE drew on. The current COE has a legitimising and reassuring role for its members and the public, but the source of such legitimisation has assumed more of a pragmatic, consequentialist direction and is part utilitarian and part Social Darwinist and less deontological. However, this analysis is limited by the extent that legitimacy is a motivating element for profession and their COE. Also, the analysis is based on the assumption that COE are derived from certain philosophical ethical theories and such COE may be drawn up without any prior thought as to underlying philosophical positions.

7 Conclusion

A longer, more detailed COE does not appear to have any effect on moral trends in accounting. Globally, there is evidence of a spread in self-interested “egoism” capitalism (The Economist, 2009), which may be a reflection of concepts drawn from social Darwinism. The cause of these shifts in the COE has been shown by Sikka et al (1989, 2000) and Baskerville-Morley (2004) to result from crisis situations and a subsequent asymmetry of stakeholders which allows some dominant stakeholders to become definitive. The effects have been, as argued in this paper, to narrow the sphere of public responsibility and promote self-interest. Although the current COEs aim to sustain public reputation of the profession, in reality the codes appear to legitimate the profession at a pragmatic level. The Hanover Finance case was cited as New Zealand’s contribution to this trend as this typical case explains why there has been widespread failure of most of New Zealand's finance companies. Audits were performed, but because of insufficient regulation, the same dubious accounting practices were condoned by the auditors who would seem to have interpreted their duty of care narrowly to serve their actual paymasters. Such end results undermine the advertising of the profession to convey an image of disinterested integrity and possibly have a consequence of calling for even more image advertising. By contrast, the original COE was carefully restrictive and reduced advertising to a small card.

The current COE would have us believe accounting can serve the public interest by being utilitarian – meaning objective and without bias, and serving both sides of any social conflict. While, in theory, everyone’s happiness is equally important, in practice, as some commentators have pointed out, such egalitarianism is inevitably denied. A calculation has to be performed by either appointed or unappointed moral legislators as to whose happiness constitutes the greatest happiness. Unhappily, such legislators may prefer their own happiness, or that of their paymasters, and bias the calculation. Arguably, utilitarianism in its ideal sense is the better ethical position for the profession to pursue. However, ethical preferences are contentious and discussion can serve to illuminate differences in practice. The point being that as "The Rot Spreads" (The Economist, 2009, p. 3) a focus on ethical issues in Accounting are worthwhile. Since the 1927 publication of the first New Zealand COE, the world has changed and other ideas now prevail. This is not to argue that before 1927 some ideal sense of duty and virtue existed. The celebrated Graham case illustrates that before Graham emptied the Fidelity Fund, such a fund existed to reimburse third parties who were the victims of predatory accountants. The Hanover Finance case in New Zealand illustrates how the self-interest driver of legitimacy is predominant. Arguably, such pragmatism is reflective of unconsciously absorbed Social Darwinist thinking which has an effect on institutions and accounting practices globally. For accountants such egoistical thinking, albeit often unconsciously absorbed, is a licence for practices that are directed to legitimising narrowly-served interests that, while possibly passing as legal, externalise an ethical cost to the wider public.

References


THE INFLUENCE OF BANK IMAGE ON LOYALTY MODERATED BY SATISFACTION

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Abstract

This study aimed to examine the effect of image, customer satisfaction, and the interaction between image and satisfaction to customer loyalty, convenience sample was taken of 250 bank customers in Surakarta, Central Java. Hierarchical multiple linear regression analysis was used to accommodate the relationship between observed variables. The results showed that bank's customer loyalty can be explained by the moderating role of satisfaction in behavioral processes. In particular, the results show that the image of banks has a positive effect on loyalty, satisfaction negatively affects loyalty, and interaction of satisfaction and image also negatively affect customer loyalty. This study does not consistent with previous studies; however, it reveals the implications of the study related to the theoretical and practical aspects.

Keywords: Loyalty, Image Bank, Satisfaction

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1 Introduction

Brand loyalty is an issue that is still interesting to study, because the literature review indicates the concept is still diverse, which is associated with the decision variables that affect the formation of loyalty (See Too et.al, 2000; Thurau, et.al, 2002). Diversity that occurs, possibly due to each of these studies relied on research design, which is limited in scope. This in turn has implications for the generalization of the model is limited. These conditions provide an opportunity to design a model that is relevant to the object and the setting under study.

In this study, the concept is constructed based on three observations of variables, namely customer loyalty, image, and satisfaction. Loyalty is the intention to commit the bank, preference or tendency to select the bank, the intention to trade again, the intention to resist on better alternatives, intention to tolerate the price, and intention to recommend to others. This understanding was adopted from the concept proposed by Brunner et al. (2008) which is used to explain consumer loyalty to the company’s rail service. In the banking context, the notion is relevant to explain the behavior of loyalty to the bank, because by understanding this concept can provide insight related to the efforts that should be done by the bank to improve customer loyalty, from the aspect of commitment, attitudes, and intentions of possible customers likely to re-save, resistance to better alternatives, tolerance to the bank, to recommend to others, and repeated transactions.

Furthermore, image is considered importantly by customers in affecting consumer loyalty to the bank. In general, this variable is defined as the perception of quality associated with the brand name (Aaker and Keller, 1990; Keller 1993). In the banking context, image is the perception of quality associated with the name of the bank, the customer is always stored in memory. In terms of loyalty, literature review indicates that the image is suspected as decision variable either directly or indirectly influences on loyalty (See Abdullah et al., 2000; Bigne et al., 2001; Zins, 2001; Park et al. 2004). The direct influence is shown by a direct relationship between image and loyalty, while the indirect influence is indicated by the presence of satisfaction variables that mediate the relationship of two variables. In this study, the image is a variable that is proposed as a variable affecting loyalty, and also proposed as a variable that interacts with the satisfaction in affecting loyalty.

Satisfaction is the last variable in this study used by customers as an important consideration in forming the loyalty to the bank. Satisfaction is the cognitive process of comparison between the performance and desired expectations in transacting the product. This process continuously adds and updates in forming the perceived satisfaction, which in turn can form a cumulative satisfaction (Cronin et al., 2000). Previous study indicated that from cumulative satisfaction in turn can form consumer loyalty toward the product or particular brand (see Zeithaml et al., 1996; Bergeron, 2004; Karatepe et.al., 2005; Brunner et al., 2008). In this study, besides the main effect between satisfaction and loyalty, it also proposed interaction...
effect between image and satisfaction in the process of forming loyalty. The phenomenon described is the satisfaction which is considered importantly by customers that moderate the influence of bank image on loyalty.

2 Literature review

The problem of this study focused on the relation of three variables namely bank loyalty, bank image, and satisfaction. Therefore, the discussion of the relationship of these three variables can provide a theoretical understanding in formulating the hypothesis. Thus, the hypotheses can be accounted from the theoretical aspect. Here is the discussion that followed the formulation of the hypotheses.

2.1 Consumer’s loyalty

Literature review indicates a different concepts of loyalty (See Leverin and Liljander, 2006; Brunner et al., 2008). First, loyalty is conceptualized as the degree of consumer desire to buy back the product, so in this context the high loyalty towards the brand is one of the greatest assets that must be maintained by the company (Leverin and Liljander, 2006). In this regard, the efforts made and focused on marketing is to retain customers, and this became an important priority to have attention more than gaining new customers. This effort of maintaining customer in turn led to the concept of marketing relationship. This concept is based on an understanding that the effort spent to find new customers is relatively more expensive but it also takes a relatively longer than retain existing customers, especially the extra cost for aggressive promotions and costs to other marketing mix. Conversely, to retain existing customers, the company just needs to concentrate on improving services to its customers consistently.

Second, customer loyalty conceptualized as an emotional commitment to buy back the brand consistently in the future (Oliver, 1999). This behavior is characterized by the purchase of products or services with the same brand over and over or purchase the same brand, which is not affected by situational influences and marketing efforts made by competitors, which aimed to change consumer attitudes.

In the context of the commitment, customer is expected to repeat purchase toward the same product, despite the influence of situations and a variety of marketing efforts that can potentially cause displacement of consumer action (Oliver, 1999). Thus, high commitment is always built by marketers to establish a loyal customer through marketing efforts, which aimed to maintain the closeness and nurturing relationships that already exist between customers and service providers.

Third, loyalty is conceptualized as behaviors and attitudes (Brunner, 2008). As a behavior, loyal customers will be expressed in the form of repeat purchase while the attitude of loyalty are grouped into four phases namely cognitive loyalty, affective loyalty, conative loyalty, and action loyalty.

Cognitive loyalty is a loyalty based on brand beliefs. In this case, the intensity of attention to customer information associated with a brand can be said that customers are loyal to their brand. Furthermore, affective loyalty shows customer preferences toward brands that are needed. This preference is based on some satisfying experiences which in turn led to the attitude of love. The key to successful marketers are making policies that are geared to build customer satisfaction. Meanwhile, conative loyalty implies a commitment to buy back a brand. In this context, customers feel more attached to the company rather than affective loyalty is just like the brand. Finally, action loyalty is a form of intent that immediately transformed into a readiness to buy.

Thus, as a form of behavioral, loyalty is measured using the possibility of buying loyalty, the possibility of choosing in the long run, or the behavior in choosing brands. Meanwhile, as a form of attitudes, brand loyalty is conceptualized as a preference or emotional commitment subsequently measured with the intention of buy back the product, resistance to better alternatives, price tolerance, and intention to recommend a brand (See Yi and La, 2004).

2.2 Bank image

This variable is defined as the perception of quality associated with the brand name (Aaker and Keller, 1990). At the corporate level, the image is defined as the perception of an organization which is shown as links contained in consumer memory (Keller, 1993). Relation to perceptions of quality, consumers perceive the image, by way of linking quality with brand names. The quality of the brand in question is a form of quality assurance, reliability, responsiveness, empathy, and tangibility (Parasuraman et al, 1991).

In the context of banking services, quality insurance is defined as the knowledge, friendliness of employees, as well as the ability to spontaneously carry out tasks that can guarantee good performance, so this can lead to customer trust and confidence in the banks. Meanwhile, reliability is the ability of banks to provide the promised service accurately and reliably. In this case, the performance shall be in accordance with customer expectations of timeliness and the same service to all customers without any errors.

Furthermore, responsiveness is a policy to assist and provide fast service to customers (Parasuraman et al, 1991). Next is the empathy that is defined as a form of attention that is individualized or personalized to the customer and trying to understand the customer desires. Finally, tangibility is a form of physical infrastructure is reliable, as well as the circumstances
surrounding environment as proof of services rendered by providers.

In terms of loyalty, literature review indicates that the image has an indirect influence, but rather mediated by satisfaction (Bloemer and Reuter, 1997), while others indicate that there is significant influence between image and loyalty (Andreassen and Lindestat, 1998), and several other studies replicate these findings using the service as an object of studies to explain the relationship between image and loyalty (Abdullah et al., 2000; Bigne et al., 2001; Zins, 2001; Park et al., 2004). Based on the mixed views on the relationship between image and loyalty, then in the context of banking, image bank is expected to have a positive relationship with customer loyalty towards the bank. The proposed phenomenon is, the higher perception of the image of the customer against the Bank Jateng, the higher loyalty to the bank. Thus, the first hypothesis can be formulated as follows.

Hypothesis 1: The higher the bank's image, the higher the customer loyalty towards the bank.

2.3 Satisfaction

Literature review indicates that satisfaction is estimated to influence loyalty, if the customer is able to evaluate the quality of the brand (Zins, 2001). Thus, evaluation of customer satisfaction is the result obtained from the efforts made by comparing between expectation and reality in the purchase of the brand (see Zeithaml et al., 1996; Bergeron, 2004; Karatepe et al., 2005). Therefore, the result of the evaluation is that satisfaction is an affective response in terms of the experience of expectation disconfirmation, which is a form of cognitive processes. Based on the results of this evaluation, customer then will compare with initial expectations in deciding the purchases of the product. Moreover, disconfirmation is said to be positive if the performance is higher than expectations, and vice versa, disconfirmation is said to be negative if the performance is lower than expectations. These expectations as the initial experience was then used to determine the quality brands that connoted by the customer.

Satisfaction is considered important to investigate because previous studies indicated a significant relationship between satisfaction and loyalty (see Cronin et al., 2000; Brunner et al., 2008). This can happen because a satisfied customer is expected to repeat or continue to use a brand. The phenomenon proposed in this study is, the higher the customer satisfaction, the higher the customer loyalty towards the bank. Thus, the following is the formulation of the second hypothesis.

Hypothesis 2: The higher the customer satisfaction of banking services, the higher loyalty to the bank.

In relation with the image, the literature review indicated the patterns of diverse relationships between satisfaction, image, and loyalty depends on the object of research (Abdullah et al., 2000; Bigne et al., 2001; Zins, 2001; Park et al., 2004). In this study, in addition to main effects, interaction effects are also proposed. In this case, satisfaction is proposed as moderating variables that influence bank image on loyalty. A phenomenon described is the higher the satisfaction, further strengthening the influence of image on loyalty (see Brunner et al., 2008). Thus, the following is the third hypothesis is formulated.

Hypothesis 3: The higher the customer satisfaction of banking services, further strengthening the bank's image influences on loyalty to the bank.

Based on the hypothesis formulated, the following is a research model that explains the relationship between variables in a comprehensive manner.

Figure 1. Research model

3 Methodology

Samples taken from customers who intend to loyal to the Bank Jateng, which is domiciled in Surakarta. Loyalty is a form of commitment which is embodied in the form of an intention to continue trading in the same bank, a commitment to reject a better alternative, and an intention to recommend to others. Samples were taken in the amount of 250 respondents, using convenience techniques. Implementation is conducted by approaching to the customers who intend to remain loyal to the Bank. Furthermore, respondents were administered a questionnaire that collected immediately after complete filling it up.
Through this way, it is expected to increase the response rate of success in collecting the questionnaires (Assael, 1998). In associated with a selected statistical tool, this study used Multiple Linear Regression. It is intended to explain the relationship between variables as hypothesized (Newman, 2000). Meanwhile, to support the truth of the quality of the data obtained, this study uses factor analysis and reliability testing, in an attempt to explain the ability of research instruments in implementing the measuring function, and internal consistency of those instruments.

Based on the measurement, this study used a Likert scale consisting of five points an answer that starts from 1 (strongly disagree) to 5 (strongly agree). This is because the variables are observable behavioral variables in the form of individual cognitive responses to the phenomenon under study (Lynch, 1982; 1999). Customer loyalty is the first behavioral variables which is conceptualized as a form of commitment to the customer in terms of repeat purchase, make purchases in the long run, does not intend to move banks, tend to stick with the bank, intend to loyal to the bank, resistance to a better alternative, tolerant against the bank, and intend to recommend to others. The second behavioral variable is the perception about the bank's image, which is conceptualized as a reputable bank, friendliness of service, social awareness, social responsibility, the good name of the bank, and speed of service. Customer satisfaction is the last variable which is conceptualized as the level of customer satisfaction with the service counter, service of other employees, bank performance, bank facilities, and bank infrastructure.

4 Results

To understand the generalization ability of the model, the following is an explanation of the profile of customers that is used as a respondent. Customer profile is explained by the variables gender, age, education, income (See Table 1). In terms of gender, there is a proportionate balance between male and female customers (mean 1.50). In terms of the lowest age is 19 years and the highest is 55 years, while the average age of respondents is about 32 years (mean 32.34). Furthermore, from the educational side, the lowest is passed the senior high school, and the highest is a post graduate degree, and most of the respondents are educated scholar (mean 1.645).

In terms of employment, it can be explained that the work of the respondents are varied as government employees, private employees, military, entrepreneurs, and other work that identified some of them are workers, peasants, and students. Most of the respondents’ occupations are private employees (mean 2.25). Finally, in terms of income, it can be classified into 4 groups namely the group of respondents who earn a million dollars or less, the next is an income between 1.1 million to 2.5 million dollars, then the group who earn between 2.51 million and 4 million, between 4.1 to 5.5 million, and the last is the group whose income is 5.51 million and above. Most of their income ranges from 1.1 million to 2.5 million (mean 1.99).

Overall, results of descriptive statistics indicated that the customer’s profile underlying the testing of this study were men and women, mostly aged around 32 years, educated scholar, owned a job as private employees, and earned between 1 million to 2.5 million a month. This gives insight to the Bank Jateng in an effort to create marketing programs directed to its customers so that they can contribute effectively and efficiently. In addition, this study is also expected to provide an understanding of the generalization ability of the model designed in this study, hence if it is applied in different contexts, no refraction occurred on the way interpreting the results, due to differences in respondent profiles underlying the research conducted.

Before interpreting the test results obtained, first presentation is the results of testing the validity and reliability of data. Test validity can be seen from the loading values obtained. The results show that there are several items that must be removed. This is due to the inability of these items in explaining the constructs to be measured. Thus in this study, there are five items used to measure loyalty, 4 items used to measure the service, and five items used to measure the image of the bank (see Table 2). To provide assurance of the validity of the results of this reduction, previously performed testing of goodness-of-fit model as seen from the value of KMO is .789 (cut off = .50) and Bartlett’s test value of 1675,903 to the significance of .000 (See Appendix 1). It can be concluded that the reduction factor has met the eligibility criteria to be accurately interpreted.
Table 1. Profile of respondents

<table>
<thead>
<tr>
<th>Variable</th>
<th>N</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Std Deviation</th>
<th>Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gender</td>
<td>250</td>
<td>1</td>
<td>2</td>
<td>1,50</td>
<td>0,51</td>
<td>1: Male</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2: Female</td>
</tr>
<tr>
<td>Age</td>
<td>250</td>
<td>19</td>
<td>55</td>
<td>32.34</td>
<td>9.776</td>
<td>Year</td>
</tr>
<tr>
<td>Education</td>
<td>250</td>
<td>1</td>
<td>3</td>
<td>1,645</td>
<td>0.651</td>
<td>1: &lt; high school</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2: Bachelor</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3: post graduate</td>
</tr>
<tr>
<td>Occupation</td>
<td>250</td>
<td>1</td>
<td>5</td>
<td>2.25</td>
<td>1.643</td>
<td>1: Employees of government</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2: Private Employees</td>
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<td></td>
<td>3: ABRI</td>
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<td></td>
<td>4: Entrepreneurs</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5: Other</td>
</tr>
<tr>
<td>Income</td>
<td>250</td>
<td>1</td>
<td>5</td>
<td>1.99</td>
<td>0.646</td>
<td>1: &lt; 1 million</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>2: 1,1 million - 2.5 million</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3: 2,51 million – 4 million</td>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>4: 4,1 million –5,5 million</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5: &gt; 5,51 million</td>
</tr>
</tbody>
</table>

Source: Results of processed data in 2010

Table 2. Results of test validity and reliability

<table>
<thead>
<tr>
<th>Variable</th>
<th>Loading Factor</th>
<th>Cronbach’Alpha</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customer loyalty</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Commitment to transact long-term</td>
<td>.644</td>
<td>.7808</td>
</tr>
<tr>
<td>- Commitment to not move</td>
<td>.644</td>
<td></td>
</tr>
<tr>
<td>- Resistance to other banks</td>
<td>.552</td>
<td></td>
</tr>
<tr>
<td>- Intend to continue saving</td>
<td>.798</td>
<td></td>
</tr>
<tr>
<td>- Intention to recommend</td>
<td>.699</td>
<td></td>
</tr>
<tr>
<td>Satisfaction</td>
<td></td>
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<tr>
<td>- Satisfaction with the service transaction</td>
<td>.619</td>
<td>.7661</td>
</tr>
<tr>
<td>- Satisfaction with the product</td>
<td>.639</td>
<td></td>
</tr>
<tr>
<td>- Satisfaction with the space</td>
<td>.738</td>
<td></td>
</tr>
<tr>
<td>- Satisfaction with the queuing system</td>
<td>.769</td>
<td></td>
</tr>
<tr>
<td>Image perception</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- The positive perception of the bank's name</td>
<td>.670</td>
<td>.8285</td>
</tr>
<tr>
<td>- The positive perception of ownership</td>
<td>.697</td>
<td></td>
</tr>
<tr>
<td>- The positive perceptions of service</td>
<td>.742</td>
<td></td>
</tr>
<tr>
<td>- The positive perception of social concern</td>
<td>.686</td>
<td></td>
</tr>
<tr>
<td>- The positive perception of the bank's reputation</td>
<td>.824</td>
<td></td>
</tr>
</tbody>
</table>

Sources: Appendix 2 and Appendix 3

Further reliability test results can be seen from the values obtained Cronbach’Alpha that each construct has a value > 0.6 (see Table 2). This indicates that each construct has a relatively high internal consistency. Thus, it can be said that the items used to measure the constructs that have measured relatively good reliability. In short, the validity and reliability testing results indicate that the quality of the data collected can be accounted for righteousness. Thus, the data obtained has met the eligibility criteria to be analyzed using statistical methods chosen. The following is a discussion of the results obtained by hypothesis testing.

Hypothesis testing is done using multiple regression analysis model with EGARCH (Exponential Generalized Auto-Regressive Conditional Heteroscedasticity). This method was chosen because there are problems of heteroscedasticity, which are auto regressive. Therefore, to accommodate it is done by entering a variance into the model in an effort to reduce the influence which affects the prediction results which are not effective and efficient. This can be explained through heteroscedasticity test results that indicate no significant relationship between the residual in regression testing in step 1 ($\beta = -1.07510; SE = -1.699157; \text{prob.} = .0905$) (See Appendix 6), as well as regression testing in step 2 ($\beta = .002953; SE = .046369; \text{prob.} = .9631$) (See Appendix 7).

Before interpreting the regression results, first to be analyzed is the role of moderation in the model. This can be explained through a two step regression
test results, which indicate that the value of Δ F-statistic was significant (Δ F-statistic = 3.724902, prob. = 0.01) (See Table 3). This explains that the regression model of step 2 is significantly better than the regression model step 1. It can be concluded that the process of formation of loyalty from the object being observed is a relatively complex phenomenon. Customers not only consider the image and satisfaction in the form of loyalty, but also consider satisfaction as a variable that can moderate the influence of image on loyalty. Here is the interpretation of the results of the regression testing phase 2.

### 4.1 The relationship between bank image and loyalty

The test results indicate a significant and positive relationship, thus supported Hypothesis 1 (β = 0.195945, SE: 3.841865; prob. <.01). This means that the higher the positive image the higher the bank's customer loyalty. This phenomenon can occur because customers use the bank's image as an important variable to decide his intention to loyal to a bank. Thus, important variables which are considered to establish a good image are the name of the bank, ownership, speed of service, and social responsibility.

Significant results indicate support for the regularity of the phenomenon that shows patterns of a positive relationship between bank image and loyalty, as proposed in previous studies (See Abdullah et al., 2000; Bigne et al., 2001; Zins, 2001; Park et al., 2004). However, this concept still needs further testing in different contexts. This is necessary so that the external validity of the hypothesized concept can be improved.

For practitioners, these findings may provide insight about the need for vigilance to build banking performance through increased customer loyalty, because through this loyalty which in turn is expected to form the customer's commitment to keep re-saving, resistant to competitors who offer more attractive, and also the willingness of customers to recommend the bank to others. All of this can be achieved through the creation of stimuli which capable to build a positive image of the bank's customers through the good name of the bank, build a good name of bank ownership, build a good service, and build a good social responsibility.

### 4.2 The relationship between satisfaction and loyalty

The test results indicate significant results that support hypothesis 2, but do show a reversed pattern (β = -0.229891, SE = 4.425418; prob. <.01). This explains a phenomenon that the higher customer satisfaction, the lower the loyalty to the bank. This phenomenon can occur probably caused by the potential variable of references from external agencies where the clients worked. This variable is expected to be able to direct customers to remain loyal to the Bank Jateng. Thus, the phenomenon occurred was that although the lower the customer satisfaction, if the higher the influence of reference then the higher the loyalty towards the bank.

For practitioners, these findings may provide insight about the need for vigilance to build banking performance through increased customer loyalty, because through this loyalty which in turn is expected to form the customer's commitment to keep re-saving, resistant to competitors who offer more attractive, and also the willingness of customers to recommend the bank to others. All of this can be achieved through the creation of stimuli which capable to build a positive image of the bank's customers through the good name of the bank, build a good name of bank ownership, build a good service, and build a good social responsibility.

#### Table 3. Multiple linear regression test results with the dependent variable Loyalty

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Step 1 Coefficient</th>
<th>Step 2 Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>- SQR (Garch)</td>
<td>1.832155***</td>
<td>1.533767***</td>
</tr>
<tr>
<td>- Constant</td>
<td>(3.346369)</td>
<td>(3.568860)</td>
</tr>
<tr>
<td>- Bank Image</td>
<td>-1.479634***</td>
<td>-1.212336***</td>
</tr>
<tr>
<td>- Satisfaction</td>
<td>(-3.888263)</td>
<td>(-4.330350)</td>
</tr>
<tr>
<td>- Image*Satisfaction</td>
<td>.168348***</td>
<td>.195945***</td>
</tr>
<tr>
<td>- R-squared</td>
<td>(3.344059)</td>
<td>(3.841865)</td>
</tr>
<tr>
<td>- Adjusted R-squared</td>
<td>-0.94761***</td>
<td>-2.29891***</td>
</tr>
<tr>
<td>- Durbin-Watson stat</td>
<td>(-2.109701)</td>
<td>(-4.425418)</td>
</tr>
<tr>
<td>- F-statistik</td>
<td>-0.210094***</td>
<td>-0.210094***</td>
</tr>
<tr>
<td>- Prob (F-stat)</td>
<td>-0.210094***</td>
<td>-0.210094***</td>
</tr>
<tr>
<td>- Δ F-statistic</td>
<td>3.724902***</td>
<td>.01</td>
</tr>
</tbody>
</table>

Note: *** sign < .01; ** sign < .05; * sign < .10
Source: Appendix 4 and Appendix 5
The pattern indicates a negative relationship is reversed the result of the regularity of the phenomenon as it has been observed in previous studies, which showed a positive relationship between satisfaction and loyalty (see Cronin et al., 2000; Brunner et al., 2008). This inconsistency requires further testing in different contexts. It is necessary to provide an explanation for the external validity of the hypothesized concepts. In addition, the indication for the presence of the reference variables that influence behavioral processes in the formation of loyalty requires further testing, so in the future it should be able to produce models capable to explain the phenomenon well.

4.3 The relationship between image bank, customer satisfaction, and loyalty

Test results on the effect of interaction indicates a significant and negative relationship (β = -0.210094, SE = -6.293410; prob. <.01). Significant test results indicate that hypothesis 3 supported, whereas a negative relationship patterns showed a reversed pattern of relationships from the concept that hypothesized. This explains that the higher the customer satisfaction further weakened the influence of image banks on loyalty. Such a phenomenon can occur may be caused by factors that enabled reference to direct customers to loyal to the bank, despite the perceived low satisfaction.

The pattern of negative relationships obtained in this study indicate inconsistencies result as has been done in previous studies (Abdullah et al., 2000; Bigne et al., 2001; Zins, 2001; Park et al., 2004). This requires further testing in the context that is relevant to the hypothesized phenomenon, so that the results obtained can be explained by either theory. It is also advisable to examine the role of reference in influencing the formation of loyalty. This is necessary so that in the future may develop behavioral models capable to explain the phenomenon of loyalty formation process as well.

Practically, these findings provide insight to the bank of the efforts should be made to increase loyalty, through image and satisfaction. The thing to note is the possibility of the presence of reference that influence the formation of loyalty. Thus, it can be suggested that in order to enhance customer loyalty to the bank, it takes effort to build brand image, but it is also advisable to establish good cooperation with external agencies authorized to provide references to its employees that are willing to loyal to the bank. In terms of satisfaction, it is recommended to the bank should not have to exploit the service excessively, because the customer does not feel the satisfaction with the quality of services provided by the bank that ultimately negative effect on loyalty.

5 Conclusion

In summary, that customer loyalty can be enhanced through the creation of a good image of banks. This image can be enhanced by making the marketing stimuli such as building a good name of the bank, the good name of ownership, speed of service, and concern for social problems. Through this effort, the bank is expected to improve the performance of an optimal service.

Furthermore, the pattern of negative relationships between satisfaction and loyalty requires caution to interpret the phenomenon. It is likely that there is a potential variable reference from external agencies. That affects the process of formation of loyalty, so that although the lower the satisfaction, if the higher reference then the higher the loyalty. The same thing occurs in the interaction effect that explains that the lower the satisfaction, further strengthening the bank's image influence on loyalty. These finding require further clarification related to the presence of external reference variable, which is capable to encourage customers to remain loyal to the bank.

Based on the findings obtained, the study is expected to provide a theoretical understanding of the concepts being tested. Test results are reversed, so it requires a theoretical study in order not to bias to the hypothesized theory that is universal. Thus, this study is expected to be used as a reference for developing theories that are relevant in the field of behavioral.

Methodologically, this study developed measurement instruments that are relevant to the object being observed. There are several things that need to be observed that there are some items that are not able to explain the measured constructs, among others, the desire for long-term deal and the customer wishes to continue to use other products on the construct of loyalty, in addition to satisfaction with overall service, ATMs, parking areas, and security in satisfaction. This requires a critical assessment in the future, so these items can be further developed to be relevant to the construct measured.

Practically, this study provides an understanding of the need for designing marketing stimuli that can enhance the image of banks, among others, by keeping the bank's good name and ownership, speed of service, and social responsibility. Associated with the satisfaction that have a negative impact on loyalty requires prudence to observe because the possibilities inherent reference variable that acts as an intervening variable that potentially affects loyalty. In this regard, it is recommended that banks build up cooperation with external agencies to be willing to provide references to clients in order to increase the desire for loyalty.

Although these studies have limitations due to the limitations in scope of research methods, but the testing procedures are rigid built not expected to
reduce the degree of confidence in the results obtained.

References


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**Appendix 1. KMO and Bartlett's test**

| Kaiser-Meyer-Olkin Measure of Sampling Adequacy | .789 |
| Bartlett's Test of Sphericity | Approx. Chi-Square | 1675.903 |
| | Df | 91 |
| | Sig. | .000 |

**Appendix 2. Rotated component matrix**

<table>
<thead>
<tr>
<th>Components</th>
<th>1</th>
<th>2</th>
<th>3</th>
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<td>L2</td>
<td>.644</td>
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<td></td>
</tr>
<tr>
<td>L3</td>
<td>.644</td>
<td></td>
<td></td>
</tr>
<tr>
<td>L5</td>
<td>.552</td>
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<td></td>
</tr>
<tr>
<td>L6</td>
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<td>L7</td>
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<td></td>
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<tr>
<td>S1</td>
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<td>.619</td>
<td></td>
</tr>
<tr>
<td>S3</td>
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<td>S6</td>
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</tr>
<tr>
<td>C1</td>
<td>.670</td>
<td></td>
<td></td>
</tr>
<tr>
<td>C2</td>
<td>.697</td>
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<td>C3</td>
<td>.742</td>
<td></td>
<td></td>
</tr>
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<td>C4</td>
<td>.686</td>
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<td>C5</td>
<td>.824</td>
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<td></td>
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</table>

Note: Extraction Method: Principal Component Analysis; Rotation Method: Varimax with Kaiser Normalization; Rotation converged in 5 iterations

**Appendix 3. Reliability test**

<table>
<thead>
<tr>
<th>Construct</th>
<th>Items</th>
<th>Cronbach’s Alpha</th>
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</thead>
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<tr>
<td>Loyalty</td>
<td>5</td>
<td>.7808</td>
</tr>
<tr>
<td>Satisfaction</td>
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<td>.7661</td>
</tr>
<tr>
<td>Image</td>
<td>5</td>
<td>.8285</td>
</tr>
</tbody>
</table>
### Appendix 4. Linier multiple regression test step 1

Dependent Variable: LOYALTY  
Method: ML – ARCH  
Date: 11/05/11  Time: 02:03  
Sample: 1 250  
Included observations: 250  
Convergence achieved after 42 iterations

<table>
<thead>
<tr>
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<th>z-Statistic</th>
<th>Prob.</th>
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</thead>
<tbody>
<tr>
<td>SQR(GARCH)</td>
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<td>3.346369</td>
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<tr>
<td>C</td>
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<td>0.380539</td>
<td>-3.888263</td>
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<tr>
<td>CITRA</td>
<td>0.168348</td>
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<td>3.344059</td>
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<tr>
<td>SATISF</td>
<td>-0.094761</td>
<td>0.044917</td>
<td>-2.109701</td>
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</table>

Variance Equation

<table>
<thead>
<tr>
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<th>Prob.</th>
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<tr>
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</tbody>
</table>

### Appendix 5. Linier multiple regression step 2

Dependent Variable: LOYALTY  
Method: ML – ARCH  
Date: 11/05/11  Time: 02:02  
Sample: 1 250  
Included observations: 250  
Convergence achieved after 85 iterations

<table>
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<th>Coefficient</th>
<th>Std. Error</th>
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</thead>
<tbody>
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<td>CITRA</td>
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<td>SATISF</td>
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<td>-4.425418</td>
</tr>
<tr>
<td>CITRA*SATISF</td>
<td>-0.210094</td>
<td>0.033833</td>
<td>-6.293410</td>
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</tbody>
</table>

Variance Equation

<table>
<thead>
<tr>
<th>Coefficient</th>
<th>Std. Error</th>
<th>z-Statistic</th>
<th>Prob.</th>
</tr>
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<tbody>
<tr>
<td>C</td>
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<tr>
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</tbody>
</table>

R-squared 0.374445  Mean dependent var 1.32E-06  
Adjusted R-squared 0.356350  S.D. dependent var 1.000000  
S.E. of regression 0.505726  Akaike info criterion 2.261370  
Sum squared resid 155.7631  Schwarz criterion 2.374057  
Log likelihood -274.6713  F-statistic 13.91376  
Durbin-Watson stat 2.327877  Prob(F-statistic) 0.000000
Appendix 6. Heteroscedasticity test (model 1)

ARCH Test:

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
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</thead>
<tbody>
<tr>
<td>F-statistic</td>
<td>2.887133</td>
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<td>0.090549</td>
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<td>Obs*R-squared</td>
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Test Equation:
Dependent Variable: STD_RESID^2
Method: Least Squares
Date: 11/05/11 Time: 02:06
Sample(adjusted): 2 250
Included observations: 249 after adjusting endpoints

<table>
<thead>
<tr>
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<th>t-Statistic</th>
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<td>STD_RESID^2(-1)</td>
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<td>-1.699157</td>
<td>0.0905</td>
</tr>
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</table>

R-squared   0.011554 Mean dependent var 0.947881
Adjusted R-squared 0.007552 S.D. dependent var 1.336066
S.E. of regression 1.331011 Akaike info criterion 3.417754
Sum squared resid 437.5829 Schwarz criterion 3.446007
Log likelihood -423.5104 F-statistic 2.887133
Durbin-Watson stat 2.012928 Prob(F-statistic) 0.090549

Appendix 7. Heteroscedasticity test (model 2)

ARCH Test:

<table>
<thead>
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<th></th>
<th>Coefficient</th>
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<th>t-Statistic</th>
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</thead>
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<td>Obs*R-squared</td>
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<td>0.962867</td>
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</table>

Test Equation:
Dependent Variable: STD_RESID^2
Method: Least Squares
Date: 11/05/11 Time: 02:12
Sample(adjusted): 2 250
Included observations: 249 after adjusting endpoints

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<td>0.046369</td>
<td>0.9631</td>
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</tbody>
</table>

R-squared   0.000009 Mean dependent var 0.962194
Adjusted R-squared -0.004040 S.D. dependent var 1.706014
S.E. of regression 1.709456 Akaike info criterion 3.918227
Sum squared resid 721.7934 Schwarz criterion 3.946480
Log likelihood -485.8193 F-statistic 0.002150
Durbin-Watson stat 1.997897 Prob(F-statistic) 0.963054
INNOVATION IN THE APPLICATION OF GRI TO VISUALIZE STRATEGIC GOALS FOR SUSTAINABLE DEVELOPMENT – THE CASE OF TERTIARY INSTITUTION, HONG KONG

Shirley Mo-ching Yeung*

Abstract

This paper explores innovation in how educators use GRI sustainability (CSR) related guidelines to engage different stakeholders and respond to the trend of sustainable development in higher education mentioned by UNESCO. Through the case of a tertiary educational institution in Hong Kong, examples of innovative KPIs are devised to align with the strategic goals of the case institution with implications to the institutional level and the community level. The case institution measures its performance, identifies its risks with priority and reports under three main headings – Responsible Business Management, Responsible Curriculum Design, and Responsible Partnership through stakeholder mapping with action plans for measurement (2015 –2017), the risk level with KPIs of activities with Social Return of Investment (SROI), and benchmarking with self-financed institutions offering business and management related degree programmes and CSR-related activities with impacts created from media reporting. This paper thus lies at the nexus of GRI sustainability (CSR) guidelines, innovative Key Performance Indicators (KPIs) and Strategic Goals to integrate environmental, social and economic impacts and the encouragement of good governance practices throughout the lifecycles of goods and services produced for sustainability.

Keywords: Sustainable Development (SD), Innovation, Responsible, Key Performance Indicators (KPIs)

*Supply Chain Management Department, The Centre for Corporate Sustainability and Innovations, Hang Seng Management College, Hong Kong

1 Introduction

In line with the UN Decade 2005-2014 on sustainability, many research papers have been found on the sustainable development (SD) in the higher education sector. Different institutions have their own interpretations of sustainable development. In general, sustainable development is related to economic, social and environmental impacts with responsible decision making of allocating resources to meet the present and future needs of a society. This links up to the way of management in defining and interpreting sustainability when setting and implementing their short and long term strategic goals with total involvement of academic and administrative staff. Buying in the concept of sustainable development is the first and the most significant step in implementing sustainability related actions in an institution as the perception of staff on SD well relates to their understanding and exposure on sustainability.

According to the definition of Brundtland Commission (1992) of the United Nations, “sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.” The basic element of sustainability is the economic aspect to support the business in short term, and support the new products, services, processes and people in the long term. In global initiatives of the “United Nations (UN) Decade of Education for Sustainable Development” (DESD) 2005-2015, the mission of DESD outlined by United Nations United Nations Educational, Scientific, Cultural Organization (UNESCO) is to meet the needs of the present without compromising those of future generations. Education is to learn how to learn, un-learn and re-learn through on-going helping people develop values, skills, attitudes, and knowledge with the principles, values and practices of sustainable development; and this kind of proactive thinking has to be integrated into all aspects of education and training to people in all nations at different ages to develop economic, social, environmental and cultural awareness and to seek solutions for these problems. Hence, ESD is relevant to all nations and all higher institutions. Management in higher educational institutions need to keep on practicing the rationale of ESD beyond 2015 through integrating ESD in their institutional operational level in setting strategic goals and performance indicators; and school / programme level in re-visiting the curriculum for the benefit of learners and the community.
As mentioned by UNDESD, quantitative and qualitative ESD indicators are needed to be incorporated into different aspects of education for regular monitoring and reviewing purposes. This paper is going to adopt the rationale of ESD with the principles of Global Reporting Initiatives (GRI) to present a case with organizational values and strategic goals to align with relevant performance indicators on four key areas—economic, social, environmental, and governance for demonstrating the linkage between stakeholder mapping and risk identification; the linkage between strategy and sustainability. The job of developing, monitoring and reviewing these ESD related performance indicators can be treated as co-production outputs of management, academic and administrative staff working in an institution. In fact, academics also need to work closely with industry practitioners to better understand the growing importance of sustainable development in higher education and in industries so as to generate meaningful economic, social, environmental, governance and cultural impacts.

2 Objectives and contributions

In recent years, the higher educational sector has started to address the issues of sustainable development in their operations and curriculum design. This has created a dramatic need of educators, especially curriculum designers, with a mindset of sustainability and social responsibility; and the skills of writing sustainability related reports to communicate with stakeholders for accountability and transparency. This triggers the author to study the steps of setting sustainability related performance indicators to align with institutional strategic goals and to prepare sustainability report with economic, social and environmental impacts.

The purpose of this paper is to explore the application of GRI reporting principles with the seven dimensions of ISO 26000 Corporate Social Responsibility (CSR) Guidelines to identify the steps of designing relevant sustainability-related goals for continuous improvement in management level, programme level and partnership level to fulfill the gaps between academics and industries in terms of developing talents with relevant knowledge, skills, attitudes and values for the future. It is expected that ESD goals can help measure performance from different perspectives for organizational improvement and for partnership and community development.

3 Sustainable development and knowledge-based economy

The concepts of sustainable development have been most debated subjects and of great importance in the future, especially in higher education sector where learners are educated to prepare how to face the challenges for the future and how to develop themselves personally and professionally in a sustainable manner. Szitar (2014) mentioned that community development was related to sustainability which needed to have stakeholder collaboration, linking up changes with sustainability, adopting interdisciplinary and multidisciplinary approach in teaching in architectural education, for example case study and PAPSA (Presentation, Analysis, Production, Selection and Application) methods and providing solutions in a holistic manner. Pinho et al. (2015) also university not only enabled professional growth, but also in the personal level (p. 162). Besides, they highlighted that contextualization in crucial in university education, including creating a variety of contexts for learners learning how to perceive the world, how to handle adverse situation, how to develop belonging to the syllabus, how to experience practical contents, and how to create professional network via opportunities in extracurricular activities that are complementary to their studies.

In fact, Gedzune (2013), Gedzune and Gedzune (2012) and Pohl et al. (2010) also mentioned that teacher training and engagement with reflection, action research and co-production of sustainability-related research were needed to understand the importance of a broader and inter-relating perspective on issues related to sustainable development for the future. Back to 2005, Kitagawa pointed out that the role of universities in the knowledge society was examined in light of the emergence of new research and learning systems, conditioned by forces of both globalisation and regionalization with impacts of these new relationships perceived in four principal dimensions: economy, human resources, governance and community.

As we know, the economic development of most countries is now turning from manufacturing into service production which calls for talents with professional knowledge, skills, attitude and values. Kivunja (2015) brought up that the economies had been increasingly globalised with digital technologies assuming ubiquitous presence and functional utility in peoples’ lives outside educational contexts. He mentioned that educationalists needed to prepare learners for the Digital Economy, requiring the teaching of new skills rather than the traditional core subjects. Kivunja (2015) named this realization as a New Learning Paradigm, teaching students with skills most demanded in the 21st century. He put forwarded the 4Cs super skills, that is, critical thinking skill, communication skill, collaboration skill and creative skill. If learners are taught with these four super skills with sustainability contents and community development mentioned by Szitar (2014) and contexts for development mentioned by Pinho et al. (2015), it is assumed that the community will be a better one under knowledge-based economy within a digital technology environment.
4 Sustainable development and corporate social responsibility (CSR) in higher education

Under keen competition for resources and unexpected risks from natural and human-made disasters, people are aware of the importance of sustainability in education. In fact, the concept of sustainability can be traced back to the thirteenth century but in more recent times it appeared in the environmental literature in the 1870s (Kamara et al., 2006 quoted in Jones et al., 2011). Jones et al (2011) suggested that sustainability was about human survival and the avoidance of ecological disaster’ with complex and technical meaning from a professional perspective. They argued that sustainability could be seen as the goal or endpoint of a process called sustainable development. They also mentioned that a number of attempts had been made from scholars in interpreting sustainability that theoretical frameworks of connecting the nature and society were needed to recognize social and economic development could not be viewed in isolation from the natural environment. (Amsler, 2009, p.123 quoted in Jones et al. p.258)

In 2011, Djordevic and Cotton realized that there had been a growing awareness in national and international policies to integrate sustainability into both business and educational arenas. They emphasized that education for sustainability development (ESD) was an issue of increasing importance in higher education, including the campus, curriculum, community and culture of institutions. They quoted the ideas of UNESCO that ESD was “a process of learning how to make decisions that consider the long-term future of the economy, ecology and equity of all communities”. From an institutional perspective, policy and strategy related to sustainable development in higher educational institutions have to be driven from the management, for example, curriculum design and development policy, teaching and learning policy, research policy, campus design and maintenance policy. Two years later, Ryan and Tilbury (2013, p.272) mentioned that though the need to embed Education for Sustainable Development (ESD) in the higher education curriculum was well recognized in international sustainable development dialogues, substantial obstacles were encountered which called for systemic education change. They uncovered that educators needed to re-think the purpose of education with a new angle of visiting existing pedagogy practices to extend learning opportunities for learners who could contribute more for the future. They concluded a deeper reflection on teaching and learning was needed to make ESD a viable education proposition for transferring skills. They also put forward that engaging learners with experiences on sustainable development was significant as this would lead learners to further develop their critical thinking, provocative questioning skills and devising new ways of living.

Besides, Yeung (2014) also highlighted that responsible corporations needed to adopt the seven dimensions of Corporate Social Responsibility (CSR) guidelines of ISO 26000 in their operations: labor practices, consumer issues, fair operating practices, human rights, organizational governance, community involvement and development and the environment. She mentioned that the priority of the seven dimensions was subject to the strategic planning of the management and the expectations of their stakeholders. According to Cujazeira (2008 quoted in Yeung, 2014), the major principles for ISO 26000 are: accountability, transparency, ethical behavior, consideration for the stakeholders, legality, international standards, and human rights. It is the responsibility of organizations to consider the needs of the stakeholders in these seven aspects when designing work processes or executing business-related activities. In fact, ISO 26000 CSR guidelines convey a message that non-economic inputs and soft side of outcomes are the trend of quality management system (QMS).

In order to fulfill the needs of UNESCO and the gaps uncovered by scholars, this paper focuses on exploring ways to link institutional vision and strategic goals with social reporting principles and ISO 26000 CSR guidelines to define steps of engaging stakeholders, identifying possible risks and setting sustainability / CSR related goals for making the institution becoming a more sustainable one. Yeung (2014) mentioned that building quality into products and services were not suffice for continual improvement. She called for new ways of integrating sustainability and CSR into organizational strategy for sustainable business. In fact, Mootee (2013, p. 59) brought up a similar viewpoint of Yeung (2014) that “More than 80 percent of our management tools, systems, and techniques are for value-capture efforts, not for value creation; this includes techniques such as total quality management (TQM), enterprise resource planning (ERP), Six Sigma, Lean Startup, and Agile Systems. These tools are valuable for keeping an enterprise running smoothly. But we should be focusing on value creation rather than value capture alone. This is where design thinking comes into play. Companies such as Apple, Amazon.com, Netflix, Samsung, Burberry, and BMW are winning by design and the thinking behind that design.” He mentioned that solving problems needed to have a multi-functional and multi-perspective approach that influenced many of the principles inherent in design thinking, that is, core values, identities, expectations, and views of the world. He emphasized that ‘responsibility to shape the future’ was critical and actions had to be humanized, meaningful and connective. When applying the concepts of design thinking in setting sustainability-related goals for educational institutions, it is recommended to embed the principles of empathy, an
approach to collective problem solving, and a framework to balance needs and feasibility.

5 Design thinking for sustainable institution

Problems that we come across may not be the same as those in the past. Hence, a new perspective for problem-solving is needed for sustainable development. Mootee (2013, p.39) put forward the idea of design thinking, a natural and inherent thinking, which was an approach to inquiry and expression that complemented and enhanced existing skills, behaviors, and techniques. He mentioned that design thinking was a date-driven analytical thinking with its own mode of analysis – one that focused on forms, relationships, behavior, and real human interactions and emotions. He recommended that design thinking could be applied in the following ways of which they were relevant for sustainable development in higher education:

1) How a product, service, system, or business currently lives in an ecosystem;
2) How people interact with the above and the nature, frequency, and attributes of that interaction;
3) How the different elements in the ecosystem relate to one another and if any systems-level impact exists;
4) What other ecosystems exist adjacent to your ecosystem;
5) How new insights may be gained by looking broadly at communicative events within these ecosystems and how they fit together from a systems perspective;
6) What the key characteristics and patterns of behavior of new relationships are when viewed from a system level; and
7) What the patterns of people’s information behaviors are and how to map them visually to make sense of them” (Mootee, 2013, p. 39)

From the above, design thinking can empower organizations and individuals to better understand their competitive and operational environment for perceiving and solving problems with realization of behavioral patterns, values attached to systems-level and processes of meeting challenges.

Apart from a system level, a process of level in programme / module design with sustainable development and social responsibility are also needed to be addressed. In the 17th International Conference on Teaching and Learning organized by UNESCO-APeID, Bajunid (2014) mentioned that any radical turning points in professional policy shifts required mid-set changes in teachers regarding their beliefs, assumptions, out the box thinking, time management, creativity, edupreneurship and wethanschaang. “The emerging of basic literacies and new literacies demand continuous learning by teacher as perennial leaner.” Bajunid (2014) also quoted the code of practice for quality assurance in public universities in Malaysia developed by the QA Department of the Malaysian Ministry of Higher Education (2008) that the key foci of programme quality were: conceptual framework, knowledge, skills, content knowledge, pedagogical content knowledge, pedagogical and professional knowledge and skills, professional disposition and assumption system with evaluation, field experience and clinical practice, diversity, faculty qualifications, performance and development, unit governance and resources (p.6) Moreover, he highlighted that all programmes objectives should align with the following learning outcomes:

1) Knowledge;
2) Practical Skills;
3) Social Skills and Responsibilities;
4) Communication, Leadership and Team Skills;
5) Problem-solving and Scientific Skills;
6) Information Management and Life-long Learning Skills; and
7) Management and Entrepreneurship Skills.

Yeung (2014) echoed the ideas of Bajunid (2014) that the following four characteristics were desirable for a social responsible teacher in the future teaching under the digital age. Teachers need to develop techniques to cater a diversified group of students through traditional and non-traditional classroom setting, for example, blending learning and virtual learning environment to motivate students as co-producers for meaningful and relevant curriculum. The eight characteristics are:

1) Knowledge and Intellectual Skills – Multi-disciplinary knowledge and multi-thinking with a mindset of change
2) Processes – Value creation and waste reduction via curriculum review and revision
3) Autonomy, Accountability and Application – Acceptance of professional responsibility with people respect and continual improvement
4) IT, Numeracy and Communication – Using technology and information with environmental concerns in teaching and curriculum design

In 2010, Fisher realised that corporate sustainability/ social responsibility was of utmost importance for the survival of organizations and their future generations of employees. “Organizations’ product/ service offerings and vendor networks are interconnected globally and are being recognized on a global scale “ (P. 29) If educators can visualise the sustainable development goals of UNESCO, crystallize the manpower projection into curriculum design, can realise the ways of implementing 4Cs into designing community development related programmes, the institution is working towards a sustainable organization for the benefit of learners, the industries, and the community as they can develop awareness of sustainability and social responsibility to their peers and influence students to learn in a sustainable way. Based on the literature of the above, the author has generated a model of sustainable institution (see Figure 1.0)
Figure 1. Model of sustainable institution with quality management and quality staff

<table>
<thead>
<tr>
<th>QUALITY OF SUSTAINABLE INSTITUTION</th>
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<tbody>
<tr>
<td>Consider inputs of social reporting related guidelines, e.g. GRI and ISO 26000 in system and process levels for economic, social, environmental, governance and cultural impacts</td>
</tr>
</tbody>
</table>

**Quality of Management**
- Align institutional mission, vision and strategic goals with sustainable development
- Aware global and local economic, social and environmental changes with impacts on operations and community
- Remain open-minded in creating new ideas for solving problems for the community

**Quality of Academic and Administrative Staff**
- Design thinking mindset
- Multi-perspective thinking with contextualization in understanding sustainable development
- Offer opportunities for learners and self to growth

6 Methodology – action research learning approach

The paper was conducted with the rationale of action learning approach. Through the years of quality assurance, CSR assessment, curriculum design and teaching experiences gained in the case organization, the author has adopted an approach of action research to organize ongoing inquiry with conceptualization of quality, CSR and sustainability raised in higher education in general and methods of advancing the institution from system and process levels with stakeholder mapping and risk identification for defining sustainability-related performance indicators. The author is expected that adopting action research approach could help to solving real problems from a holistic view and can benefit the case organization and the community as a whole. In fact, action research is a way of learning, un-learning and re-learning through a process of inquiry with the experience of not knowing ‘what to do next’ to finding answers from experience, expertise and reflection.

6.1 Research questions

1) What are the steps to cover the key dimensions to monitor the performance of a tertiary educational institution?

2) How can a tertiary educational institution turn to be a more sustainable one?

6.2 Background of case institution in Hong Kong

The case institution has been developing over time from a sixth-form school into a post-secondary/higher education institution offering business related mainly Bachelor’s degree programmes. This section is to provide an overview of its development in the past 10 years. The management of case institution decided in early 2001 that from 2003 to around 2007, the institution should run its Associate Degree (AD) Programme in parallel with its their senior years of secondary education, in preparation for becoming a full post-secondary/higher education institution operating at the AD level when A Level courses are finally phased out. In line with Government requirements for non self-accrediting institutions, the case organization has requested the Hong Kong Council for Academic Accreditation and Vocational Qualifications (HKCAAVQ) to conduct an Institutional Review and a Programme Validation of its first AD Programme, which was accredited and ready to offer an Associate in Business Administration Programme in September 2003. From 2003 up till 2014, altogether there are 10 undergraduate degree programmes and one AD Programme with a total of student number of over 4,600 in 2014/15.

6.3 Vision

The vision of the case institution is to be a leading private university, recognized for excellence in teaching, learning and research, especially in the areas of business and management. With the following 10 strategic goals (SG 1 - SG 10) in place, value can be created to our stakeholders - students, academic and non-academic staff and the community via complying the institutional requirements and programme accreditation requirements of HKCAAVQ, meeting the labor manpower projections of the Hong Kong government, and fulfilling the expectations of our potential employers in different industries.

6.4 Strategic goals (SG) of the case institution

1. To afford a modern and stimulating campus environment (SG 1) to facilitate and support teaching and learning activities.
2. To develop and offer innovative academic programmes (SG 2) which respond to changing community needs.
3. To provide a holistic and challenging educational experience for students (SG 3).
4. To cultivate students’ global perspective (SG 4) through internationalisation.
5. To develop strategic partnerships (SG 5) with industries and businesses.
6. To create internship opportunities (SG 6) for students to gain practical experience in the workplace.

7. To encourage and support dynamic research (SG 7) initially focusing on regional relevance and gradually broadening to more extensive horizons.

8. To strengthen governance structure (SG 8).

9. To enhance quality control (SG 9) through internal and external monitoring.

10. To explore new ways and sources of funding (SG 10) to augment the financial base of the College.

6.5 Turning vision into sustainability (CSR) vision

To the case institution, CSR is the responsibility of the College for creating impacts to the community, the environment, the marketplace and the workplace through continuing commitment in educating our students, influencing our staff and doing business ethically with economic, social and environmental contributions to the community while improving the quality of life to our staff and their families as well as the local community and society at large. The Sustainability (CSR) strategy is to support the case organization vision of becoming a private university through providing quality business and management related programmes to teenagers to meet the job market needs with business and management related knowledge, skills, attitudes with social responsibility and an ethical mindset.

7 Findings

7.1 What are the steps to cover the key dimensions to monitor the performance of a tertiary educational institution?

The followings are the steps of visualizing sustainability (CSR) vision for the case institution:

Step 1) Setting up a CSR Working Group:
- Engaging teaching, administrative staff and students of various programmes to discuss ways of maintaining quality in programmes/ students/ graduates/ campus with impacts in the workplace, the marketplace, the environment and the community.

Step 2) Arranging Awareness Training for Involved Academic and Administrative Staff:
- Providing on-going (e.g. quarterly) training to primary and secondary stakeholders about the relevant sustainability / CSR practices in higher education, expecting to have actions agreed with members of the CSR working group
- Updating the progress of the 10 strategic goals aligned with the risk level identified and action plans during the on-going training
- Inviting external parties for comments on improvements in programmes/ students/ graduates/ campus when training opportunities come up

- Engaging the community of Shatin area in New Territories, Hong Kong and the society as a whole when training is relevant to their needs

Step 3) Defining Sustainability related Goals and Strategy
- Table 3 demonstrates explicitly the above-mentioned 10 strategic goals of the case institution (SG 1-10) and strategy used.

Step 4) Meeting Sustainability related Reporting Guidelines to Engage Stakeholders
- Based on GRI 4 criteria to identify relevant action plans (see Table 1) to prepare a sustainability report with 3rd party endorsement for recognition, for identifying rooms of improvement, and for assessing the level of responsibility in the workplace/ the marketplace/ the environment/ and the society.
- The identification of primary and secondary stakeholders, the understanding of their needs and expectations, and the linkage between stakeholders and vision/ strategic goals are the critical points in the success of visualization the sustainability (CSR) vision of the case institution. Table 1 shows clearly the linkage among stakeholders, risks, impacts and action plans for sustainability (CSR) vision. For example: Maximizing graduates’ employment opportunities; increasing student exposure on green movements, anti-corruption, worker right protection, work-family balance, public education efforts; promoting business ethics, community services & engagement, implementing actions against global poverty, and other social innovations, etc.

Step 5) Communicating with Stakeholders for Sustainability/ CSR related Achievements for Engagement and Team Spirit Enhancement

On-going and effective internal and external communication plays an important role in the College’s overall performance, student and teacher performance and reputation. Regular communication with factual information drives our staff to make continual contributions to the strategic goals and the sustainability (CSR) vision of the workplace, the marketplace, the environment and the society.

Through adopting the Hong Kong CSR Advocate Index (ISO 26000 CSR guidelines) held by Hong Kong Quality Assurance Agency (HKQAA) since 2009, the commitment in the 10 strategic goals embedding sustainability (CSR) vision covering key and supporting processes to meet the expectations of the stakeholders has been shown with continual improvement. In the past two years (2013 and 2014), the case institution obtained a full score of “5” through the professional and third party on-site verification visit of HKQAA. This is the first comprehensive Index in Hong Kong with participants coming from diversified industries, for example, educational institutions, governmental department manufacturing, and service sectors. And, the case institution is the only participant from the tertiary education sector with 6 years’ promising track record in the advocate CSR Index with ISO 9001: 2008
system in place to support process management, with comprehensive College-wide Quality Assurance (QA) mechanism to measure and improve the performance of programmes, students and teachers, and with innovative green building assessment from third party to increase the awareness of the environmental related issues in the campus.

Through participating the CSR Index, the concerns of stakeholders have been addressed. The case organization believes the CSR Index assessment is not only a self-check exercise to look for opportunities of improvements under the changing external environment for the benefit of our stakeholders, but also a good learning platform to understand that sustainable organizational development is closely related to engaging stakeholders, implementing relevant policies, measuring performances, reviewing the polices for advancing further planning for reaching the strategic goals of the College, for example:

- Students, academic and non-academic staff, programme accreditation body, the potential employers, the strategic partners, the local community and the government have been identified for continual improvements with policies, action plans and measurements;
- Governance structure enhanced;
- External and internal control strengthened;
- Innovative programmes offered to meet the needs and expectations of the community; and
- Modern campus with environmental impacts for learning offered.

To quote an example, UNESCO mentioned that the entrepreneurship education needed to be strengthened to reduce the teenage unemployment issue in 2013. The case organization has supported the Entrepreneurship Project organised by an NGO – Ocean Junior Chamber (OJC) to publish a book written by our students of different degree programmes after interviewing entrepreneurs from different industries in 2014. Recently, the project details of the book and learning outcomes of students have been shared with UNESCO international entrepreneurship education members as a good practice. Through this project, active involvement with the local community has been demonstrated through sharing project experience, conducting research, developing skills for learners to meet the challenges in the future. All but not least, CSR is both a functional and an integrative tool to visualize the mission of the case institution to develop talents for the business and management area as the future managers are expected to be socially responsible for their business from different perspectives.

Step 6) Conducting Sustainability Assessment and Benchmarking

The case institution measures its performance, identifies its risks with priority and reports under three mean headings – Responsible Business Management, Economic Impacts/ Social Impacts and Building Relationship. The stakeholder mapping with action plans for measurement (2015 –2017) and the risk level with KPIs of activities with Social Return of Investment (SROI) has been illustrated clearly in Table 1. For example:

- Responsible Business Management
  - Harmonized employment with stable teaching staff
  - Green building assessment of the campus
- Economic and Social Impacts
  - New programmes offered, e.g. Asian studies and Cultural and Creative Industries undergraduate degree programmes in coming years
- Building Relationship
  - Building strong relationships with stakeholders, e.g. ministry of education in different countries and overseas universities for achieving the strategic goals and sustainability (CSR) vision and the vision of the case institution.

7.2 How can a tertiary educational institution turn to be a more sustainable one?

The following Table demonstrates actionable items to align with the sustainability goals defined. The key stakeholders can be classified into:

- Primary (students, teaching staff, management, programme accreditation body, government, potential employers) and
- Secondary (parents, related government departments, professional bodies, suppliers of e-journals and strategic partners on programme matters).

Based on the risk, impact and probably levels, the areas with the highest priority of actions with 15 points (“5” is the highest while “1” is the lowest) are: students programme accreditation and potential employers. It is also identified that the dimensions of ISO 26000 CSR guidelines – consumer issues, fair operations, and community involvement are linked to the key sustainability goals in market and society. Ongoing communication about the performance and improvement of the KPIs is also important for a sustainable institution.

8 Conclusion and discussion

Based on the GRI social reporting principles and ISO 26000 CSR guidelines, environmental, social and economic impacts and the encouragement of good governance practices throughout the lifecycles of goods and services produced by the case institution have been integrated for sustainable development. The case organization has achieved the objective of SC sustainability to create new and relevant programmes to meet the needs of the market, protect the rights of students and staff, and grow with long-term environmental, social and economic value for all stakeholders involved in bringing a diversity of business and management programmes and services to the community of Hong Kong.
### Table 1. Stakeholder assessment and future measurable goals

<table>
<thead>
<tr>
<th>Stakeholder</th>
<th>Risk</th>
<th>Impact</th>
<th>Probably</th>
<th>Priority</th>
</tr>
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<tbody>
<tr>
<td>Primary Students (SG 2 - 5)</td>
<td>Low employability rate, Student dissatisfaction</td>
<td>Reputation ruined without creating value to students and without developing talents to meet the labour market</td>
<td>3</td>
<td>5 x 3 = 15</td>
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**Future Measurable Goals for Areas of Improvement in 4 Sustainability Pillars of Workplace, Marketplace, Environment, Society (2015 to 2017)**

- Marketplace Sustainability Goal
- ISO 26000 CSR – Consumer Issues KPI –
  - e.g. 4 meetings / year with increasing total number of strategic local/overseas partners in internship offer from developing and developed countries with international exposure to let the students understand cultural diversity and skills of accommodation (GRI 4 – market presence/economic/social impacts)
  - e.g. On-going meetings (formal and informal) with students, teachers, programme accreditation bodies and potential employers to review performance of SG2-5 through engaging more relevant and external stakeholders along with the market change to review the quality of programmes/students/interns/graduates/teachers and the College as a whole
  - Example:
    - Develop students with skills of 4Cs (critical thinking skill for solving problems, communication skill for understanding and communicating ideas, collaborating skill for working with others, and creating skill for producing high quality work) mentioned by Kivunja (2015) to face the future challenges and to handle the sustainability related matters for community development.
    - **Other activities can be considered to widen students’ perspectives are:**
      - green movements,
      - anti-corruption,
      - worker right protection,
      - work-family balance,
      - public education efforts,
      - promoting business ethics,
      - community services &
      - engaging concerns/actions again global poverty, and social innovations which can be integrated with in-class and beyond-class activities
      - (Diarise the progress of identified KPIs with actions plans for improvement after meetings)
### Table 1. Stakeholder assessment and future measurable goals

|----------------------|----------------------------------------------------------------------|------------------------------------------------------------------------|----------|----------|----------------------------------------------------------------------------------------------------------------------------------|
| Teaching staff       | Pressure of research and heavy teaching assignments affecting the well being of teachers  
Dissatisfaction leading to high turnover | 3 High staff turnover and unfair teaching assignment affecting programme quality and low student intake | 3        | 3 x 3 = 9 | Workplace Sustainability Goal  
ISO 26000 CSR – Human Rights and Staff Issues KPI  
e.g. Add a new strategic goal of improving the well-being of academic and non-academic staff for improving quality of life  
e.g. Organise large scale activities / year with participation of staff from different industries and professional counselors to identify the source of pressure and methods of releasing them with methods passed over to students when appropriate to help release their study pressure.  
e.g. Invite experts in mindfulness and emotional quotient for maintaining quality of workplace and quality of family life to teaching staff and non-teaching staff  
e.g. Regularly review the fairness in research, teaching assignment and administrative duties for utilize the skills of staff to increase job satisfaction  
** Other on-going activities can be considered as staff development are:  
- green movements,  
- anti-corruption,  
- worker right protection,  
- work-family balance,  
- public education efforts,  
- promoting business ethics,  
- community services &  
- engaging concerns/actions again global poverty, and social innovations which can be integrated with student activities, if appropriate  
(GRI 4 – labor/ management relations/ equal remuneration/ labor practices grievances mechanism)  
(Diarize the progress of identified KPIs with actions plans for improvement after meetings) |
|------------|----------------------------------------------------------------------|------------------------------------------------------------------------|----------|----------|----------------------------------------------------------------------------------------------------------------------------------|
| College management (SG 1-10) | Programme quality not recognised  
                      Skills not relevant to employers required or expected  
                      Insufficient funding | 3 Gap appeared between what offered in the College and applied/expected in the workplace/ College Council/ Board | 3        | 3 x 3 = 9 | Society Sustainability Goal  
Marketplace Sustainability Goal  
Economic Sustainability Goal (GRI 4 – Product responsibility)  
ISO 26000 CSR – fair operations/ community involvement / consumer issues  
KPI-  
e.g. Fixing a certain number of meetings/ year with College management, teachers, students and relevant external parties for identifying the change in workforce structure and best practice in higher educational sector or industry to improve programme quality with 2 innovative improvements in programmes and 2 new sources of funding opportunities  
e.g. inviting research scholars and curriculum designers from Israel institutions  
(Diarise the progress of identified KPIs with actions plans for improvement after meetings) |
| Programme accreditation body (SG1-4/8-9) | Student attributes programme quality and College infrastructure not consistently meeting the requirements under the fast development of case institution | 5 Risk of losing confidence from HKCAAVID and the public | 3        | 5 x 3 = 15 | Marketplace Sustainability Goal (GRI 4 – Product responsibility/ Marketing communication)  
ISO 26000 CSR – fair operations, community involvement/ consumer issues  
e.g. On-going communication with a fixed number of announcements / year to staff and students for agreed outcomes / actions) with local and overseas programme accreditation bodies, psychologists and NGOs to understand the development of teenagers’ emotional, mental, psychological, physical changes and let them have more opportunities to work with CEOs and blue collar to realize personal potential, skills intended to develop and career to be pursued; and these experience will be embedded into programme design or college activities to fulfil the programme accreditation bodies, if appropriate, for the changes in requirements to align with the performance/ development of the College  
(Diarize the progress of identified KPIs with actions plans for improvement after meetings) |
### Table 1. Stakeholder assessment and future measurable goals

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<tbody>
<tr>
<td>Government</td>
<td>Not gaining recognition and subsidy of programmes for the benefit of students</td>
<td>3</td>
<td>3</td>
<td>3 x 3 =9</td>
<td>Society Sustainability Goal (GRI 4 – Product responsibility) ISO 26000 CSR – fair operations/ community involvement KPI- e.g. On-going collection of feedback/ media reporting (10 relevant reports / year to staff and students on programmes/ students/ staff / infrastructure) e.g. Collecting updated and relevant information from government in areas of research, programmes, teaching and students…etc. for funding application or opportunities of seeking support (Diarize the progress of identified KPIs with actions plans for improvement after meetings)</td>
</tr>
<tr>
<td>Potential Employers (SG 2-6)</td>
<td>Not developing talents with appropriate knowledge, skills, attitude, values for potential employers leading low employability and ruined reputation</td>
<td>5</td>
<td>3</td>
<td>5 x 3 =15</td>
<td>Market Sustainability Goal Society Sustainability Goal (GRI 4 – Product responsibility) ISO 26000 CSR – fair operations /community involvement / consumer issues KPI- e.g. On-going communication with a fixed number of announcements / year to staff and students for expected outcomes / actions and achievements of the College) with identified potential employers in targeted industries e.g. Inviting existing (from internship and job fairs) and potential employers to discuss the change of labor market, job structure and skills required to review the programmes (Diarize the progress of identified KPIs with actions plans for improvement after meetings)</td>
</tr>
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</table>
Table 1. Stakeholder assessment and future measurable goals

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<tr>
<td>Secondary Parents Related Government Dept. e.g. Labor Dept. Professional bodies for module exemption and programme recognition Suppliers of e-journals and research materials Strategic partners on programme matters, e.g. Exchange Partners/ Funding or Sponsorship Parties/ Employers</td>
<td>Dissatisfaction about study environment and treatment to students Minimal recognition from professional body for articulation and employability Irrelevancy and obsolete journals (mismatched with programmes and teachers’ research interest) Lack of communication</td>
<td>3</td>
<td>3</td>
<td>3 x 3 = 9</td>
<td>Marketplace Sustainability Goal Society Sustainability Goal Environmental Sustainability Goal Workplace Sustainability Goal ISO 26000 CSR – involvement of community / environmental issues E.g. On-going communication with a fixed number of announcements / year to internal and external stakeholders on all mutual concerned areas with communication of environmental issues to neighboring community, e.g. secondary schools E.g. Organizing different kinds of activities with external secondary stakeholders for analyze potential risks and impacts of mutual concerned matters to maintain or enhance brand name (GRI 4 – Product responsibility/ Market presence/ Economic Performance / Supplier assessment on impacts on society/ Local communities/ Environmental compliance) (Diarise the progress of identified KPIs with actions plans for improvement after meetings)</td>
</tr>
</tbody>
</table>
The case institution measures its performance, identifies its risks with priority and reports under three main headings – Responsible Business Management, Responsible Curriculum Design, and Responsible Partnership through stakeholder mapping with action plans for measurement (2015 –2017), the risk level with KPIs of activities with Social Return of Investment (SROI), and benchmarking with self-financed institutions offering business and management related degree programmes and CSR-related activities with impacts created from media reporting.

Examples on Responsible Business Management for Economic and Environmental Impacts are:
- Harmonised employment with stable teaching staff
- Green building assessment of the campus

Example on Responsible Curriculum Design for Economic and Social Impacts is:
- New undergraduate degree programmes will be offered in coming years

Example on Responsible Partnership for Economic and Social impacts is:
- Building strong relationships with stakeholders, e.g. ministry of education in different countries and overseas universities for achieving the strategic goals and sustainability (CSR) vision and the vision of the College

Based on the steps 1 – 6 and Table 1 of stakeholder mapping and future sustainability goals, the learning processes of applying 4Cs in sustainability - critical thinking skill, communication skill, collaboration skill and creative skill of Kivunja (2015) and the design thinking concept of Moore (2013) with ecosystem and multi-disciplinary interaction for problem-solving can be shown with the case institution. It is found that “Critical Thinking” process requires a full understanding of SD in higher education and the organizational culture of the institution in implementing SD related strategic goals.

For “Communication and Collaboration”, stakeholders in academics and industries need to be engaged with actionable items for creating new and diversified learning experiences to learners and the institution itself for economic, social and environmental impacts. For “Creative Thinking”, educators need to attempt the use of design thinking when defining sustainability related goals for the benefit of the learners, the staff, the management and the community.

Though the methodology of this study is action research approach, quantitative data on implementing SD actions is recommended to be collected in the future for a better understanding of how to implement SD into different perspectives for enhancing multi-disciplinary knowledge and for collaborating academic partners and industry practitioners to realize the definition of Brundtland Commission (1992) of the United Nations, “sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs.”

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THE IMPACT OF PRE-MERGER EARNINGS MANAGEMENT ON NON-CASH ACQUISITION PREMIA: EVIDENCE FROM THE EUROPEAN MARKET FOR CORPORATE CONTROL

Malek Alsharairi*, Emma L. Black**, Christoph Hofer***

Abstract

Using 1320 European mergers and acquisitions (M&As) completed between 2003 and 2012, this paper investigates patterns of earnings management and the implications for non-cash acquisition premia considering both the form of payment and the target firm’s listing status. The empirical evidence documented in this study suggests that management teams engage in pre-merger upward earnings management and that it is more evident for private rather than for publicly listed targets in order to compensate for the higher information asymmetry. This earnings management procedure leads to higher takeover premia even after controlling for variables such as the acquirer’s internal investment opportunities, profitability or available free cash flow.

Keywords: Mergers, Acquisitions, Earnings Management, Acquisition Premium

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1 Introduction

Mergers and acquisitions continue to be significant corporate investments that have been shown to create, destroy and redistribute shareholder wealth. Related studies have sought to ascertain whether acquiring firms manage earnings to provide a root explanation behind the initial equity overvaluation, providing compelling evidence of upward earnings management pre-merger announcement (Erickson and Wang, 1999; Louis, 2004; Gong et al. 2008; and Botsari and Meeks, 2008; Alsharairi, 2012). This paper enriches this existing literature by investigating pre-merger earnings management and non-cash acquisition premia within a multi-country sample from the European context, stratifying by target listing status.

However, there is an incentive for earnings management in share-for-share transactions. Specifically, in share transactions, the share exchange ratio determines the number of bidder shares each target shareholder receives for each target share held. In the first steps of the deal structuring, the acquirer and the target shareholders agree on a purchase price. The share-exchange-ratio is then calculated based on the price of the acquiring company at the time of the merger agreement. As a result, the higher the acquirer’s share price, the smaller the number of acquirer shares converted and distributed to the target shareholders. The direct influence of the acquirer’s stock price on the share exchange ratio is an incentive to increase the acquirers share price prior to merger talks.

As a consequence, the high value-relevance of earnings data is a main driver for an acquirer to manipulate its earnings prior to actions in the market for corporate control. In fact, the current literature provides convincing evidence of pre-merger earnings management indicating that a firm’s management succeeds in their attempts to influence reported earnings (Erickson and Wang, 1999; Louis, 2004; Gong et al. 2008; and Botsari and Meeks, 2008; Alsharairi, 2012). However, it is important to note that such evidence per se does not necessarily indicate that managers are also able to influence the investor’s perception – especially in the case of dealing with well-informed traders as in merger transactions.

This paper proposes that there is a direct and positive relationship between earnings management as proxied by abnormal current accruals and non-cash acquisition premia, following Alsharairi (2012). Using a European sample, we find that acquiring companies engage in earnings management, detectable up to one year before the deal’s announcement date. We also find a strongly significant and positive relationship between an acquirer’s earnings management prior to the deal being negotiated and the subsequent premium offered.

This paper contributes to the existing literature in several unique ways. First, this study sheds light on possible differences between the highly researched US takeover market and the European one given its
distinct characteristics such as a tendency to comprise of more private targets as well as a stronger requirement for predominantly cash payments. Merger and acquisitions have historically been dominated by deals originating in the US and as such it is not surprising to find much academic attention centred on this market rendering little to be unknown about the second most active market – the EU. Moreover, together, the GDP of the EU outstrips that of the US at over €12 trillion (Europa, 2013) and thus the growing integration of Europe indicates more research is required into this growing market. Second, this study extends the control variables used in the previous literature in order to examine the effect of earnings management on the non-cash acquisition premia as employed by Alsharairi (2012) through the inclusion of additional variables as proposed by Gondhalekar (2002, 2004) as well as the inclusion of other possible drivers of takeover premia.

2 Literature review

2.1 Pre-merger earnings management

Under normal conditions, acquirers have control over M&A timing and can therefore plan and implement their earnings management strategy to successfully manipulate their earnings in the desired way (Alsharairi, 2012). Erickson and Wang (1999) as well as Botsari and Meeks (2008) provide significant evidence that acquirers do use managerial discretion to inflate earnings upwards prior to mergers. However, this only happens if equity is offered as part of the deal’s payment structure.

Louis (2004) provided strong evidence of intentional exaggeration of pre-announcement earnings of acquiring firms in share-for-share deals. In a sample of privately held targets, Baik et al. (2007) argue that bidders have a greater incentive to inflate earnings in order to make up for the relatively higher information uncertainty. Guo et al. (2008) in addition document evidence that acquirers tend to manage their earnings upwards prior to acquisitions in order to manipulate their valuation. Conversely, they also document a tendency of share splits prior to share deals, motivated by the assumption that this could delay the market’s reaction to the earnings management. Pungaliya and Vijn (2008) further report that the larger the relative size of the target, the greater the incentive for the bidder to manage its earnings upwards prior to offering equity as payment method to reduce the real cost of the acquisition.

2.2 Cash and non-cash acquisition premia

As Gondhalekar et al. (2004: 735) point out, “in spite of [the] extensive literature regarding mergers and acquisitions, surprisingly little has been done to determine what influences the actual price paid by an acquirer for a target.” Bidding strategies represent a dilemma in all corporate takeovers. If the agreed upon premium is too high, the subsequent return on investment is reduced. On the other hand, a premium that is too low could result in a failed offer and hence the loss of a profitable opportunity.

Huang and Walking (1987) investigate acquisition premia from a tax perspective and suggest that target shareholders require a higher premium on the target’s actual market value under cash payment. This is due to the fact that cash deals will result in an immediate liability for capital gains tax whereas non-cash deals can offer the seller the option to defer this tax liability to a later date, and hence lower premiums should theoretically be accepted.

From a different viewpoint, Haw et al. (1987) assert that in order to avoid further risks, acquisitions of firms in sound financial conditions may result in different premia than acquisitions of financially distressed firms, although their empirical findings show that distressed firms with tax-loss-carry forwards result in significantly different premia. However, Crawford and Lechner (1996) claim that after controlling for liquidity and solvency using suitable proxies, these results are weak if not mixed.

Although earlier research views the acquirer as a passive recipient in an acquisition, Bugeja and Walter (1995) consider bidders’ and targets’ characteristics such as pre-merger performance or toehold investments in their analysis. According to their model, pre-merger performance shows a negative relation to takeover premia as opposed to toehold investments, which exhibit a positive relation. Choudhury and Jegadesh (1994) explain the latter as being due to the fact that a toehold investment signals the target’s higher valuation by the respective bidder. Schwert (2000) criticizes the former finding by claiming that both performance and size are not reliably related to resulting takeover premia, and alternatively introduces a competitive bidder setting as a possible driver of the resulting premia. His findings show that a hostile or competitive takeover process results in higher premia. Recent empirical findings by Wickramanayake and Wood (2009) offer a different perspective on toehold investments. They argue that their negative relation lies in the relatively lower number of additional shares that have to be acquired in order to hold a controlling stake. Such a setting weakens the position of competitive bidders and consequently lowers the offered acquisition premium.

Hauschild (1994) and Porrini (2006) shed further light, showing that the involvement of investment
banking firms in deals results in higher premia, explained by the fact that M&A advisory fees are linked to deal size and therefore maximised by higher premia.

In comprehensive analyses, Walkling and Edmister (1985), as well as Gondhalekar et al. (2002, 2004), examine an extensive set of target and acquirer characteristics to investigate motives that influence the price paid for targets. They find that hubris, as proxied using the volatility of the target’s earnings per share, is not a driving force for takeover premia. However, the free cash flow and agency-relationship is shown to play an important role in determining the magnitude of acquisition premia.

Recent work by Alshahrai (2012) is the first to explicitly investigate whether pre-merger earnings management practices have a significant influence on the resulting takeover premia especially when the payment structure includes equity share issues as takeover currency. His empirical study documents a very significant and robust positive relationship between non-cash acquisitions premia and acquirer’s pre-merger earnings management even after controlling for different sets of variables. No evidence, however, could be found for pre-merger earnings management in the case of 100% cash deals.

Alshahrai (2012) offers two explanations for this finding. On the one hand, this could be due to the fact that the target’s shareholders are able to detect the inefficient earnings management efforts by the acquirer’s management team and hence request a higher premium. On the other hand, he argues that this premium appears to be high from a nominal point of view but due to the earnings management comes at no extra cost and might be equal to or lower than otherwise on a real basis after accounting for the manipulation.

2.3 Target firm listing status

The financial statements of unlisted firms tend to be less reliable than those of publicly listed corporations (Van Tendeloo and Vanstraelen, 2008). The existing literature argues that this is as a result of greater information asymmetry. Investors tend to be restricted to being able to trade the shares of unlisted firms, while on the whole, they do not become as aware of the existence of unlisted firms in their financial decision-making as these firms tend to not fall into their visible spectrum in the buying process (Barber and Odean, 2008) with analysts and the media following only a select few in the unlisted market. As these firms do not fall on a listed stock exchange, shareholders do not have the accompanying regulatory requirements if they did. Together, these factors contribute to weaken the reliability of the financial statements produced (Vander Bawwede and Willekens, 2004; Van Tendeloo and Vanstraelen, 2008).

In a M&A setting, this can cause increased difficulty if acquirers are unable to ascertain a fair value for the target. Information asymmetry can cause acquirers enhanced risk as they face the risk that not only are they overpaying for the target, but the statements used in due diligence may not be as reliable as desired.

In European evidence, Faccio and Masulis (2005) study the M&A payment choices of public and unlisted targets from 1997 to 2000. They write that acquisitions of unlisted targets invoke sellers to consider their consumption/liquidity needs, with a preference for cash given the typical concentration of their portfolios (in that usually these firms are closely-controlled by shareholder-managers who exit at impending retirement). The empirical evidence finds much more concentrated ownership in Europe than in the US with a stronger effect on the M&A financing decision. Acquirers with favourable access to bank borrowing will use cash financing, while stock financing is less likely for unlisted targets to both avoid the creation of a new blockholder and increase the chance of the terms being accepted by the exiting parties.

2.4 Hypothesis development

Analogous to the aforementioned studies documenting empirical evidence found for samples from US M&A deals, this study investigates pre-merger earnings management of acquiring firms in Europe. Given the undoubtedly high value relevance of accounting earnings, the first testable proposition is as follows:

**H1: If a high capital market valuation of the acquiring firm, which engages in a share-for-share transaction, ceteris paribus lowers the share-exchange ratio and consequently mitigates EPS and share dilution effects and furthermore lowers other related costs, firms acquiring targets via share-swaps are expected to upward manage their earnings prior to announcing merger plans.**

Furthermore, built on the previous hypothesis, and the evidence documented in literature, if the acquirer’s pre-merger earnings are managed upwards in order to influence the share price, then the target’s shareholders, representing rational, sophisticated and well-informed user, are expected to detect these efforts. Furthermore, they are expected to correct them by discounting the acquirer’s stock price. This strategy aims to maintain acquisition premium at the same “real” level.

**H2: The study postulates a significant and positive relationship between pre-merger earnings management effects (i.e. a higher equity value) and the agreed upon non-cash acquisition premium.**

3 Methodology

The source of the data used within this paper for all variables related to European M&A transactions is
We use a cross-sectional industry-performance-matched accruals model similar to the research design of Louis (2004), Gong et al. (2008) and Alsharairi (2012). The following model is based on the Dechow and Sloan (1995) modified Jones (1991) model and considers Kothari et al.’s (2005) recommendation to use performance-based portfolios as a non-linear control in order to improve the reliability of the accrual regression model.

Following Kothari et al.’s (2005) recommendations, all firms within the same industry (based on their 2-digit SIC) are clustered by calendar years and semi-annual periods and subsequently ranked according to their efficiency – using the ROA of the same period in the previous year as proxy for performance – to form five quintiles.

We furthermore implement Gong et al.’s (2008) procedures for stronger robustness and reduced measurement errors. In order to discard outliers, the highest and the lowest 0.1 percent ROA are dismissed. Also, current accruals divided by the previous year’s total assets resulting in a ratio bigger than one are not used to estimate the coefficients in order to exclude erroneous database entries and extreme values. Finally, small portfolios with less than 10 constituents as well as insignificant current accrual forecasting models are excluded from the regression and forecasting process as well.

Following the aforementioned procedure, the cross-sectional regression and estimation model for each portfolio is as follows:

\[
\frac{CAC_{j,i}}{TA_{i,j-4}} = \sum_{q=0}^{3} \alpha_{q+1} Q_{i+q} + \alpha_{2} \left( \frac{\Delta REV_{i,j} - \Delta AR_{i,j}}{TA_{i,j-4}} \right) + \alpha_{3} \left( \frac{CAC_{i,j-4}}{TA_{i,j-4}} \right) + \alpha_{4} \left( \frac{PPE_{i,j}}{TA_{i,j-4}} \right) + \varepsilon_{i}
\]  

(2)

We explain the relation between the magnitude of non-cash acquisition premia and acquirers’ pre-merger earnings management, an ordinary-least-squares regression model as proposed in Alsharairi (2012) is applied in order to test this:

\[
\text{AR}_{i,j} = \alpha_{1} + \alpha_{2} \left( \frac{\Delta REV_{i,j} - \Delta AR_{i,j}}{TA_{i,j-4}} \right) + \alpha_{3} \left( \frac{CAC_{i,j-4}}{TA_{i,j-4}} \right) + \alpha_{4} \left( \frac{PPE_{i,j}}{TA_{i,j-4}} \right) + \varepsilon_{i}
\]  

(3)

\(\text{AR}_{i,j}\): semi-annual change in trade receivables;

\(\Delta REV\): semi-annual change in revenue;

\(\Delta AR\): semi-annual change in trade receivables;

\(PPE\): denotes the net amount of property, plant and equipment in a semi-annual period;

\(TA_{i,j-4}\): one year lagged total assets in the same semi-annual period;

\(\alpha\): coefficients’ index

\(\varepsilon\): represents the residual term of the regression model;

\(i\): sampled company’s index;

\(q\): index of the semi-annual period.
PR\(_i\) = \alpha_0 + \alpha_1 EM_i + \alpha_2 DEALVALUE_i + \alpha_3 RSIZE_i + \alpha_4 ROEACQ_i + \alpha_5 MBACQ_i + \alpha_6 FCFACQ_i \\
+ \alpha_7 DEACQ_i + \alpha_8 DIVERS_i + \alpha_9 CROSSB_i + \alpha_{10} TOEHOLD_i + \alpha_{11} ADVISOR_i \\
+ \alpha_{12} ROETARG_i + \alpha_{13} FCFTARG_i + \alpha_{14} DETARG_i + \alpha_{15} EPSG_i + \alpha_{16} EPSSTD_i \\
+ \sum_{y=1}^{m=10} \alpha_{y+18} D_{y+2003} + \epsilon_i \hspace{1cm} (3)

PR: acquisition premium in the M&A deal, based on the share’s price index four weeks prior to the deal’s announcement date;

EM: earnings management by the acquiring company as proxied by the aforementioned aggregate abnormal accruals over three months prior to the deal announcement;

DEALVALUE: natural logarithm of the deal value;

RSIZE: revenue size of the target relative to the acquirer;

ROEACQ: acquirer’s return on equity one year prior to the transaction announcement;

MBACQ: acquirer’s market-to-book value calculated the period prior to the transaction announcement;

FCFACQ: acquirer’s free cash flow to total assets calculated the period prior to the transaction announcement;

DEACQ: denotes the acquirer’s debt-to-equity-ratio;

DIVERS: dummy variable for diversifying deals—measured as the same first two digits of the SIC-code, 0 otherwise;

CROSSB: dummy variable, which indicates cross-boarder transactions, 0 otherwise;

TOEHOLD: acquirer’s toehold ownership interest in the target firm prior to the deal;

ADVISOR: dummy variable capturing a top-tier investment bank advising the acquirer on the M&A transaction;

ROETARG: target’s return on equity one year prior to the transaction announcement;

MBTARG: target’s market-to-book value calculated the period prior to the transaction announcement;

FCFTARG: target’s free cash flow to total assets calculated the period prior to the transaction announcement;

DETARG: denotes the target’s debt-to-equity-ratio;

EPSG: target’s average EPS growth three semi-annual periods prior to the transaction;

EPSSTD: target’s EPS standard deviation three semi-annual periods prior to the transaction;

BETA: target’s stock price beta prior to the transaction (DataStream: BETA);

BKNRPTCY: target’s bankruptcy risk measured via the Merton (1973) model;

D\(_{y+2003}\): dummy variable capturing the year of the M&A transaction;

\(\alpha\): coefficients’ index;

\(\varepsilon\): represents the residual term of the regression model;

\(\iota\): sampled M&A deal’s index.

### 3.1 Descriptive statistics

Table 1 demonstrates the characteristics of the sample. In Panel A of Table 1, the sample distribution by year shows that many deals in Europe are clustered in 2006 to 2007 with 418 deals being completed, whereas 2009 provides the lowest number of deals in the sample with only 103 M&A deals meeting the selection criteria. Table 1 furthermore reveals that of the overall sample, 1,173 deals (88.9 percent) were financed entirely by cash, while the remaining 147 deals (11.1 percent) were structured entirely as share-for-share deals.\(^7\) A further striking fact but a typical characteristic of the European market for corporate control is the notably high proportion of private targets, representing about 1,091 deals (82.7 percent) within the selected sample.

The distribution of deals per industry of acquirer and target are shown in Panel G of Table 2 Sectors that are highly represented in the sample are services advertising (SIC 73), services engineering (SIC 87), electronics (SIC 36) and chemicals (SIC 28). Collectively, these sectors account for the deals of 551 acquirers (41.7 percent) and 547 targets (41.4 percent).

The following descriptive statistics for deals are organised in three columns for the overall sample, for non-cash deals and cash transactions respectively. The statistics for the overall sample show an average premium of 40.19 percent, which is consistent with reported European takeover premia levels throughout literature.

---

\(^7\) The notably high amount of pure cash deals is one of the distinct characteristics of the European takeover market. (Cl. Faccio and Masulis, 2005)
Table 1. Sample distribution

The table presents the distribution of the overall sample of M&A deals. Panel A groups the sample into year of the announcement. Panel B shows deals grouped into country of the acquirer, distribution of the sample by industry relatedness (i.e. matched 2-digit SIC codes) is exhibited in Panel C, it’s cross-border status in Panel D, by method of payment in Panel E and by the targets listing status in Panel F. Finally, the industry distribution is exhibited in Panel G.

<table>
<thead>
<tr>
<th>Panel A: Deals distribution by year</th>
<th>Panel B: Deals distribution by country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freq.</td>
<td>%</td>
</tr>
<tr>
<td>2003</td>
<td>28</td>
</tr>
<tr>
<td>2004</td>
<td>125</td>
</tr>
<tr>
<td>2005</td>
<td>150</td>
</tr>
<tr>
<td>2006</td>
<td>199</td>
</tr>
<tr>
<td>2007</td>
<td>219</td>
</tr>
<tr>
<td>2008</td>
<td>155</td>
</tr>
<tr>
<td>2009</td>
<td>103</td>
</tr>
<tr>
<td>2010</td>
<td>149</td>
</tr>
<tr>
<td>2011</td>
<td>143</td>
</tr>
<tr>
<td>2012</td>
<td>49</td>
</tr>
<tr>
<td>Total</td>
<td>1320</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel C: Deals by industry relatedness</th>
<th>Panel D: Domestic and cross-border deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freq.</td>
<td>%</td>
</tr>
<tr>
<td>Unrelated</td>
<td>765</td>
</tr>
<tr>
<td>Related</td>
<td>555</td>
</tr>
<tr>
<td>Total</td>
<td>1320</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Panel E: Deals by payment method</th>
<th>Panel F: Deals by Target listing status</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freq.</td>
<td>%</td>
</tr>
<tr>
<td>Pure cash</td>
<td>1173</td>
</tr>
<tr>
<td>Non-cash</td>
<td>147</td>
</tr>
<tr>
<td>Total</td>
<td>1320</td>
</tr>
</tbody>
</table>

Table 2. Sample distribution

<table>
<thead>
<tr>
<th>Panel G: Sample distribution by acquirer and target industry</th>
</tr>
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<tbody>
<tr>
<td>SIC</td>
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<td>-----</td>
</tr>
<tr>
<td>10</td>
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<tr>
<td>12</td>
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<td>32</td>
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<td>33</td>
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</tbody>
</table>
When examining the data of the second and third column, one immediately noticed the average (median) value of cash premia is 44.44% percent (35.86%). This is significantly higher than that paid in non-cash deals, being 24.11% (22.57%). Huang and Walkling (1987) argue that the acquisition premium paid in cash is higher due to the fact that shareholders are compensated for immediate taxation of capital gains as opposed to non-cash deals where this tax component is deferred until realisation.

### 3.2 Summary statistics of acquirer and target data

Table 3 reports the descriptive statistics of the variables used in the regression i.e. acquirer and target characteristics, for the overall sample, as well as the relevant figures after segregation into groups according to the payment method. As expected, the pre-merger cumulative earnings management coefficient (EMC), proxied by abnormal current accruals, in share-for-share deals shows a mean (median) value of 9.3% (1.0%), which is significantly higher than the average (median) coefficient of cash acquirers, resting at almost zero. The observed difference between the cash and the non-cash sample is consistent with current literature on this topic as bidders offering cash lack the economic incentive to manage their earnings upwards unlike share-for-share acquirers, which are able to influence the share price used to calculate the share-exchange-ratio. (Erickson and Wang 1999, Alsharairi, 2012)
On average, acquirers paying in cash seem to be more profitable with a mean (median) pre-merger ROE of 13.54% (12.71%) compared to those which offered equity with a mean (median) ROE of 6.01% (0.13%), however they tend to have a much higher debt-to-equity ratio 35.00% (27.00%) than their non-cash peers 12.00% (0.00%). Table also reveals that acquirers structuring the deal a share-for-share transaction have a greater pre-merger toehold in their target with a mean (median) value of 4.43% (0.00%) as opposed to cash acquirer with a mean (median) value of 1.93% (0.00%). One could again set this in context with Choudhury and Jegadesh’s (1994) hypothesis and argue that acquirers try to obtain a higher pre-merger toehold as this provides them with a better negotiation position when it comes to convince management and shareholders to accept the offer. However, it contradicts Bugeja and Walter’s (1995) findings since they argue and document that the acquisition of a target using cash is more feasible if the acquirer already has interest in the target.

**Table 3.** Deal characteristics

<table>
<thead>
<tr>
<th></th>
<th>Total (N=1,320)</th>
<th>Non-cash (N=147)</th>
<th>Cash (N=1,173)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dealvalue</td>
<td>Mean 401.51</td>
<td>2,289.41</td>
<td>5,228.80</td>
</tr>
<tr>
<td></td>
<td>Med. 23.75</td>
<td>36.96</td>
<td>23.36</td>
</tr>
<tr>
<td></td>
<td>STD 2,289.41</td>
<td>873.72</td>
<td>342.34</td>
</tr>
<tr>
<td>Premium</td>
<td>Mean 40.19</td>
<td>33.65</td>
<td>16.13</td>
</tr>
<tr>
<td></td>
<td>Med. 33.05</td>
<td>22.57</td>
<td>35.60</td>
</tr>
<tr>
<td></td>
<td>STD 33.65</td>
<td>24.11</td>
<td>35.86</td>
</tr>
<tr>
<td>R.Size</td>
<td>Mean 2.33</td>
<td>15.21</td>
<td>21.53</td>
</tr>
<tr>
<td></td>
<td>Med. 0.46</td>
<td>6.58</td>
<td>1.68</td>
</tr>
<tr>
<td></td>
<td>STD 0.46</td>
<td>1.54</td>
<td>0.43</td>
</tr>
</tbody>
</table>

The following figure depicts the average cumulative abnormal accruals of the last three semi-annual periods prior to the deal announcement for the segregated non-cash and cash payment samples (N=147 and 1,173, respectively). T0 denotes the semi-annual period in which the M&A deal is announced. As opposed to T0 and T-1, T-2 and T-3 are non-significant.

**Figure 1.** Average and cumulative abnormal accruals

When examining the targets’ characteristics, one immediately notices that share-for-share deals tend to be more popular for less profitable targets with higher leverage, lower growth opportunities and available free cash flow as well as higher share price and bankruptcy risk. Furthermore, these targets tend to be younger and therefore offer a shorter track record of financial performance. This seems intuitive since non-cash acquirer are able to share the acquired additional risk with the target’s shareholders and are furthermore able to implicitly lower the real bid premium by conducting earnings management and hence including the risk in the takeover premium.

More descriptive statistics and the results of the several regression analyses are shown in the following sections.

### 4 Results and analysis

The applied linear regression model assesses the relationship between non-cash acquisition premia (PR) and an acquirer’s pre-merger earnings management as proxied by its abnormal current accruals (EM). Table 5a and Table 5b document the results of the regression. The explanatory power of the model is at its best Adjusted R-Squared of 0.5985 in setup (13), in which the acquirer’s earnings management (EM), the acquirer’s market-to-book ratio (MBACQ), the acquirer’s free cash flow to total assets (FCFACQ), and the acquirer’s pre-merger toehold (TOEHOLD) is controlled for.
Table 4. Summary statistics of acquirer and target data

This table presents the descriptive statistics of the study sample. Cumulative EM indicates the acquirer’s earnings management coefficient as proxied by abnormal current accruals of the last two semi-annual periods prior to deal’s announcement date. Toehold indicates the acquirer’s ownership interest in the target firm before the respective transaction. Leverage controls for the acquirer’s and target’s debt/equity-ratio and profitability is captured by the firm’s performance in the preceding semi-annual period. Bankruptcy risk is proxied by Merton’s (1974) default probability.

<table>
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<tr>
<th>Total Acquisitions - Firm Descriptive Statistics Summary</th>
<th>Total (N=1,320)</th>
<th>Non-cash (N=147)</th>
<th>Cash (N=1,173)</th>
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<td>2.12</td>
<td>3.70</td>
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<td>Listing age</td>
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The overall results indicate a significant and positive correlation between pre-merger earnings management efforts of acquiring companies and resulting non-cash acquisition premia. The coefficient of the acquirer’s pre-merger earnings management (EM) is significant at the 5 percent level and has a positive sign attached in most setups ran for non-cash deals.

Interestingly, it can be noticed that excluding the acquirer’s pre-merger earnings management coefficient (EM) when replicating best setup (13) for the non-cash acquisition premium leads to a deterioration of explanatory power as well as the significance of the model. More significantly, setup (14) loses approximately 21% of its explanatory power - Adjusted R-Squared from 0.5985 in setup (13) to 0.475 in setup (14) - and loses about 26% of its significance - F-Statistic from 4.35*** in setup (13) to 3.22** in setup (14).

The agency hypothesis for mergers is proxied by the acquirer’s free cash flow (FCFACQ) and its market-to-book ratio (MBACQ). The coefficient estimate to measure (BMACQ) indicates a negative association; the coefficient (FCFACQ) shows a positive sign in most models. The coefficients are significant or highly significant at the 10, 5 or 1 percent confidence levels in most setups. These results are consistent with the empirical findings of previous studies arguing that managerial self-interest in mergers is a driving force of takeover premia. The observed significant and positive coefficient of the acquirer’s free cash flow is consistent with Jensen’s (1988) free cash flow hypothesis. Complementing this finding, (BMACQ) indicates that firms with more attractive investment opportunities and growth potential tend to pay lower non-cash acquisition premia.

As Gondhalekar et al. (2004) argue, managerial hubris could be a cause to overpay for high-risk firms in the belief that the bidding management team is able to manage the firm more effectively. This variable is measured as the standard deviation of the target’s return. Consequently, a statistically significant and positive coefficient would imply that the hubris theory drives acquisition premia. This however cannot be found in any of the aforementioned models.

The control variable (TOEHOLD) documents negative coefficient estimates in setup (11) and (14). Consistent with the literature, the higher the acquirer’s stake prior to the transaction, the lower the premium becomes; this is a clear sign that acquirers do exercise bargaining power in obtaining control rights if they already hold a stake in the target (Stulz 1988; Bugeja and Walter 1995; Wickramanayake and Wood 2009). These findings, however, are in sharp contrast with Choudhury and Jegadesh (1994), who argue the opposite effect due to signalling of the target’s higher subjective value for the acquirer.

4.1 Concurrent analysis for cash deals

As Erickson and Wang (1999) and Alsharairi (2012) argue, pre-merger earnings management would only have an impact on offered acquisition premia if the M&A payment structure of the deal is a share-swap (i.e. equity is issued to pay for the transaction). In the alternative case of a 100% cash deal, they argue that the hypothesis itself implies that the coefficient for the acquirer’s pre-merger earning management is shown to be irrelevant to explain the acquisition premium. The former section directly tests the first hypothesis using a non-cash sample. Running a corresponding regression analysis, using a sample of cash deals, tests the latter hypothesis. This verifies the aforementioned theory and reinforces the findings of the previous section.

Table 6a and 6b document the ordinary-least-squares regression results of the models for a concurrent sample of cash deals. As expected, the coefficient of earnings management (EM) is insignificantly different from zero. The study documents a negative and insignificant coefficient in all regressions, which is in contrast to the results reported for the non-cash deals.

In summary, the analysis of cash-only deals does not indicate any significant relation between pre-merger earnings management of the acquiring firm and the agreed upon acquisition premium. The evidence documented in this section supports and furthermore adds greater robustness to the earlier findings regarding the documented significant relation in share-swap deals.

Table 7 reveals strong evidence of relatively higher positive abnormal accruals for acquiring firms prior to the merger announcement period if they bid for a private company, suggesting that the acquirers inflate earnings within the scope of managerial discretion in an effort to increase the share price. More importantly, this is particularly evident for acquirers of private targets, which report significantly greater abnormal current accruals. This result further supports Baik et al.’s (2007) pricing-uncertainty hypothesis: by taking the relatively higher information asymmetry into account, the bidder engages more aggressively in upward earnings management to transfer parts of this risk to the target’s shareholders.

Additionally, it appears that the reversal effects of prior earnings management at merger announcements are non-existent for private targets. These findings are in line with results by Louis (2004) and Eckbo (2009).

5 Conclusion

This research has investigated earnings management within a structured sample of acquirers listed in Europe’s biggest economies namely Germany, the UK, France, Spain and Italy. The study combines three streams of M&A relevant research to contribute to current literature – specifically to event-driven earnings management and non-cash acquisition premia.
### Table 5a. Analysis of non-cash acquisition premia

The following table presents the results of the ordinary least squares regression for non-cash acquisition premia. EM indicates the abnormal current accruals during the last two semi-annual periods prior to the deal announcement date, DEALVALUE indicates the natural logarithm of the target’s equity value, RSIZE indicates the relative sales size of the target firm, ROEACQ indicates the acquirer’s return on equity ratio in the semi-annual period preceding the deal announcement, MBACQ indicates the acquirer’s internally available investment opportunities as proxied by the market value of the acquirer to its book value, FCFACQ indicates the acquirer’s available free cash flow, DEACQ indicates the acquirer’s debt ratio before the deal, DIVERS is a dummy variable which takes 1 if the deal was within the first two SIC-code digits, CROSSSB is a dummy variable which takes 1 if the is located outside the acquirers country, and 0 otherwise, TOEHOOLD indicates the acquirer’s pre-merger ownership interest in the target firm. Finally, ADVISOR indicates that a top-tier investment bank provided M&A advisory services for the acquiring firm. The symbols ***, ** and * denote significance at the 1, 5 and 10 percent levels respectively.

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<td>(2.58)**</td>
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The following table presents the results of the ordinary least squares regression for non-cash acquisition premia. EM indicates the abnormal current accruals during the last two semi-annual periods prior to the deal announcement date. MBACQ indicates the internally available investment opportunities as proxied by the market value of the acquirer to its book value, FCFACQ indicates the acquirers available free cash flow, TOEHOLOD indicates the acquirer’s pre-merger ownership interest in the target firm, ROETARG indicates the target’s return on equity ratio in the semi-annual period preceding the deal announcement, FCFTARG indicates the target’s available free cash flow, DETARG indicates the target’s debt ratio before the deal, EPSG indicates the target’s earnings growth rate during the last three semi-annual periods before the deal announcement, EPSSTD indicates the target’s EPS standard deviation during the semi-annual accounting periods preceding the deal announcement, BETA indicates the targets stock market beta in the accounting period prior to the deal announcement, BANKRUPTCY indicates the target’s probability to default on its debt as proxied by the Merton (1974) model. The symbols *** , ** and * denote significance at the 1, 5 and 10 percent levels respectively.

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Table 6a. Concurrent analysis for cash acquisition premia

The following table presents the results of the ordinary least squares regression for pure-cash acquisition premia. EM indicates the abnormal current accruals during the last twosemi-annual periods prior to the deal announcement date, DEALVALUE indicates the natural logarithm of the target’s equity value, RSIZE indicates the relative sales size of the target firm, ROEACQ indicates the acquirer’s return on equity ratio in the semi-annual period preceding the deal announcement, MBACQ indicates the acquirer’s internally available investment opportunities as proxied by the market value of the acquirer to its size of the target firm. The symbols ***, ** and * denote significance at the 1, 5 and 10 percent levels respectively.

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The paper offers answers to three major questions. The first question is whether European acquirers near M&As manage their earnings and whether this practice changes in accordance with the listing status of the target firm. The second research question aims to offer an answer to whether this pre-merger earnings management has a significant influence on the non-cash acquisition premium offered.

From a methodological point of view, this study employs a cross-sectional model of accruals to detect the level of abnormal accruals in European acquiring firms at the time of estimation. The results indicate that the average stock-for-stock acquirer engages in significant and positive earnings management prior to M&A deal announcements. Furthermore, European acquirers feature roughly the same characteristics as their US peers – a significant and positive earnings management can be detected up to half a year before announcement of the transaction. Moreover, this research offers an answer to a research question raised in Alsharairi (2012) by revealing that firms that acquire private targets differ significantly from the ones acquiring public ones. Due to the different levels of information asymmetry, acquirers of private companies engage in more aggressive upwards earnings management. This fact suggests that acquiring firms let target shareholders implicitly participate in bearing the post-merger risks.

Furthermore, the results documented in this paper suggest that a very significant and robust positive relationship exists between the acquirer’s earnings management prior to negotiating a deal and the agreed upon non-cash acquisition premium – confirming the hypotheses constructed. This evidence is obtained from a sample of non-cash M&A deals, which holds under different sets of control variables. A concurrent analysis of cash transactions documents no evidence for a possible impact of the earnings management coefficient on the cash acquisition premium, as the acquirer’s management team lacks the motivation to inflate their earnings.

These results can be interpreted in two ways. On the one hand, it can be argued that well-informed target shareholders uncover the pre-merger earnings inflation and the results indicate that they demand a higher premium as compensation for the potential overvaluation of the bidder’s market valuation. As Alsharairi (2012) argues, this procedure helps to mitigate a possible adverse selection problem. On the

other hand, it can be seen as a procedure that implicitly enables higher bids such that it may appear to the target shareholders that a high premium is being offered, but in effect it is done at no extra real cost. In summary, a higher (nominal) premium can be offered to target shareholders or a higher (nominal) premium than the one of competitive bidders can be offered in order to successfully complete the M&A deal. Besides this, the study further documents a highly significant and negative relationship between non-cash acquisition premia and the acquirer’s pre-merger toehold investment and free cash flow as well as a significant and negative relation for the acquirer’s market-to-book-ratio as a proxy for internal growth opportunities. The results reinforce the commonly created hypothesis that managers use equity to pay for transactions when their stock is overvalued. Furthermore, it can even be argued that managers artificially overvalue their own stock before acquisitions in order to lower the real takeover premium paid.

In terms of potential limitations, concerns regarding data, generalizability and scope as well as heterogeneous reporting standards and ongoing changes in accounting principles besides intervening merger waves can be outlined herein. This study uses a sample of M&A transactions comprising companies of the major five European economies and, hence, extending generalisations to other countries should be done with extra care. Further, it is noteworthy to remember that countries throughout Europe still feature rather heterogeneous corporate reporting standards – the lack of appropriate quarterly accounting data for most countries may be noted here. Moreover, further research is encouraged to look into the relationship between earnings management and bidder characteristics besides payment structure and target listing status.

References


LACK OF QUALITY FINANCIAL REPORTING SYSTEMS AND ITS IMPACT ON THE GROWTH OF SMALL AND MEDIUM SCALE ENTERPRISES (SMEs) IN ZIMBABWE

Ongayi Vongai Wadesango*

Abstract

The importance of quality accounting records cannot be overlooked. Complete and accurate record keeping enables the business to identify and take count of its assets, liabilities, income and expenses. The purpose of the study was to investigate the impact of lack of quality financial reporting systems on the growth of small and medium scale enterprises (SMES) in Zimbabwe. The main findings of this concept paper revealed that the smaller the business the less the owners see the importance of keeping quality accounting records. It also emerged from literature reviewed that there is a strong relationship between performance and accounting records.

Keywords: Quality, Financial Reporting Systems, Impact, Small Scale Enterprises, Medium Scale Enterprises

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1 Introduction

In Zimbabwe, the Ministry of SMEs defines small enterprises as businesses that employ not more than 50 people while operating as registered entities and medium enterprises as those employing up to 75 and 100 people (Maseko and Manyani, 2011). The Small Enterprises Development Corporation (SEDCO) (2010) defines small and medium enterprises as firms that have less than 100 employees with maximum annual turnover of up to US$830,000. A firm with less than 10 employees is termed a micro entity (Sian and Roberts, 2006) quoted in Maseko and Manyani (2011). Small and medium scale enterprises play a major role in the economy. They contribute to the economy in developing entrepreneurial and managerial skills among the indigenous people of Zimbabwe, in creating participation of indigenous people in the economic activities of the country, and strengthening linkages among diverse sectors of the economy. In Zimbabwe 80% of economic activities are in hands of SMEs and big enterprises only contribute the remaining 20% (SEDCO, 2010) but out of the 80%, 75% of them either crumble or remain struggling small businesses according to Chichoni (2011). Many small businesses sprout out but very few of them move on to become big companies (SEDCO, 2010).

2 Factors contributing to the failure of SMEs

The open systems theory states that a business does not operate in isolation but interacts with the environment. A business system receives inputs, transforms these inputs and releases outputs back into the environment (Armstrong, 2009; Brammer et al., 2011). The nature of the inputs determines the output and the reaction of the customers who finally consume the products. The inputs are capital, human, natural resources and organisational skills. Therefore it is expected that managers and the owners of the SMEs should understand fully the operations of the systems that impact on the performance of the entity (Bozbura, 2007). Without the necessary skills and knowledge to scan and carry out feasibility study, the SMEs remain challenged by the systems working for and against them (Yan 2010; Zindiye 2008). The basic principle of the open systems theory is that the whole is more than the sum of its parts (Polose, 2010), which means the whole determines the nature of the parts, and the parts are dynamically interrelated and cannot be understood in isolation of the whole (Gartenstein, 2012). This means that the interaction between the environmental factors, both internally and externally have an effect on the existence and performance of the SMEs (Chidamoyo, 2012). Viewed from this angle, systematic functions like production, marketing, accounting and others are its sub-systems and each of these sub-systems has its respective functions which contribute to the overall organisational goal. In other words, these parts or sub-systems are not divorced.
from one another. For example, accounting whose function is to provide information of economic nature, is an integral part of management information system. When things are so related that one cannot operate without the other, this way of looking at things is called systems approach. In the management of the SMEs it is important to note that there exist loops and links between elements of a system. A business in the form of an SME is a loop, or a series of links that mutually reinforce one another (Gartenstein 2012). A series of disjointed links and loops in the management chain, for example, can cause a decline in quality of the product resulting in low sales and causing the owner to reduce prices in a frantic effort to maintain customers at the expense of profitability and viability. If the accounting function is disjointed it brings a negative effect on performance (Gartenstein, 2012)

In Nigeria, Mairura (2011) investigated and found out that research studies have been done on the factors contributing to either the success or failure of small scale enterprises. However, the main factors which most scholars (Kibuka, 1996; Miles, 1995; Maalu, 1990) have identified are, finance, management, experience, marketing and accounting records. Although accounting records have been cited as one of the possible factors contributing to success or failure, little so far has been done to find its relationship with performance. In Uganda, Magaret (2005) has propounded that small business owners are myopic, they always believe that things will get better on their own. International Monetary Fund Mission, 1999; Public Sector Foundation Ed 2000; Chen and Reinkkka 1999; Sejjaka 1996) quoted in Margaret (2005) observed that many small business entrepreneurs in Uganda appear ignorant about keeping books of accounts. Wabwire (1996) in Margaret (2005) emphasises that there is almost complete absence of record accounting in small businesses enterprises (SBEs) in Uganda.

In Thailand, Sarapaivanich (2003) concluded that SMEs lack access to capital and if capital is availed the interest charges are very high and unaffordable. SMEs are charged high interest because they are considered a high risk as a result of incomplete (or no) accounting records, and the inefficient use of accounting information. Poor record keeping and accounting information make it difficult for financial institutions to evaluate potential risks and returns (World Bank 1978), making them unwilling to lend to SMEs. As a result, SMEs pay high interest rates or fall back on the middlemen or moneylenders, whose loans are costly and often restrictive. The misuse and inaccuracy of accounting information causes SMEs to inaccurately assess their financial situation, and make poor financial decisions, as well as leads them to face a high failure rate (Byron & Friedlob, 1984; DiPietro & Sawhney, 1977; Fredland & Morris, 1976).

In Mauritius, Padachi (2009) concluded that the main factors that contribute to success or failure of small businesses are; financing, economic conditions, competition, government regulations, technology and environmental factors, managerial skills, workforce, accounting systems and financial management practice. Although it is recognised that management techniques which are relevant for large firms may not be appropriate for the small ones, but some basic record-keeping and financial awareness are essential for survival (Chittenden et al. 1998). Equally Jarvis et al. (1996) found that owner-managers of SMEs in Mauritius follow a wide range of personal and business goals which are inbuilt in the strategies which they adopt and are, therefore, prominent in their firms’ information systems. Nayak and Greenfield (1994) also reported evidence that micro firms in Mauritius lack signs of any systematic accounting practices. Berry et al.’ (2002) study also examined the extent to which owner-managers use external advisors and the findings revealed that most of the owner- managers work with accounting ideas in their mind rather than accounting data in the books, owner–managers operate without accounting systems that collect and analyse cost data.

In Kenya, a study was made on the relationship between proper book keeping and financial performance of small and medium scale enterprises in Kisii Municipality and the correlation matrix showed that the financial performance has a very strong positive relationship with effectiveness in book keeping with Pearson’s correlation coefficient of 0.944 according to Kengere, Okiamo and Nyakundi (2010). In South Australia, Peacock (1985) quoted in Kengere, Okiamo and Nyakundi (2010) made researches on association between accounting records and performance in 1985, 1987 and 1988 to different respondents and in all cases the investigations concluded that there is a relationship. Contrary to the above conclusions McMahon and Davies (1994) made a research for two years from 1991-1994. The study showed that the relationship between quality financial reporting system and performance of SMEs is insignificant (1991a, 1991b, 1992a, 1992b, 1994). Holmes also agrees with McMahon and Davies (1994) that the relationship between entity performance and accounting records is insignificant (Kengere, Okiamo and Nyakundi, 2010).

In Zimbabwe, Chidamoyo (2012) found that owner-managers in SMEs often possess the entrepreneurial drive but lack formal management training in running these businesses. Most of the owner- managers of the SMEs are not conversant with issues related to money management. This is regularly cited as the main difficulty for business operations and performance according to Chidamoyo (2012). Fielden et al, (2000) further examined SMEs in Zimbabwe and concluded that problems include a poor understanding of the Value Added Tax (VAT), insurance and bookkeeping. Another major challenge related to the management of money in the SMEs sector is the issue of difficulties in obtaining capital
and the absence of a guaranteed income. Dumbu and Musingafi (2010) made a study on challenges faced by SMEs in Zimbabwe from which they found out that SMEs are poorly managed, rely on outdated technologies to produce inferior products and services that do not attract clients, face competition from too many small businesses that sprout every day and most of all disturbances from erratic electricity power supply from the main supplier- Zimbabwe Electricity Supply Authority. While (Zindiyie, 2008; Chidamoyo 2012 and Maunganidze 2013) concluded that finance availability and financial management cause SMEs ‘downfall. Mbizi (2013) indicates that a large number of small enterprises fail because of non-financial reasons such as a lack of forecasting or planning skills, a lack of skilled human resources and poor management practices. To put it all in a nutshell, management practices are crucial on improving an entity’s performance.

3 Financial reporting systems

According to several authors (Kibuka, 1996; Miles, 1995; Maalu, 1990), accounting as a record keeping process has evolved over many centuries. As early as 3600 B.C, clay tablets were used in the Babylonian empire to record various facts according to Dayanand (2004). Many of these early records contained lists of events as they occurred or lists of goods belonging to an individual, estate or temple which we now call transactions. Similar types of activities of records have also been discovered describing business activities in ancient Greece, Egypt and Rome. Dayanand (2004). While these early records contained mostly inventories of goods and debts, later records began to reflect a concern for computing profit and loss. The first complete description of the double entry system was included in a book called Suninia de Arithetic, Geometria, Proportioni et and Proportionalita, published in 1494 by a Franciscan monk named Luca Pacioli (Mascove & Simici, 1983)). In this modern world an accounting system has become one of the most effective decision making tools of management. It provides an orderly method of gathering and organising information about the various business transactions so that it may be used as an aid to management in operating the business (Copeland and Dascher, 2000).

Basically, there are two types of accounting systems commonly in use, namely: single entry and double entry system. These could be operated manually or computerised (Baumback, 1983). According to Weber (2005), manual accounting implies that employees perform the whole accounting cycle manually on periodic basis; they calculate the trial balance, journalize transaction and prepare financial statement reports. The advantages associated with manual accounting are comparative cheap work force and resources, reliability, independent from machines, skilled workers available and disadvantages include; reduced speed, increased effort of accountants, relatively slower internal control reporting and routine work. This accounting system works well for a small business that is a sole proprietorship with a small payroll and very little inventory (Mutulich, 1980). With a Computerized accounting system, the employees do the recording of transactions into the computer which then processes the other steps of accounting cycle automatically or by request. Computer provides accurate calculations and smart reports according to Duranti (2001). However, computerized accounting requires extremely high cost to develop, introduce and use the system, special training for personnel and increased dependence on machine if a business has a large payroll, inventory, accounts receivable, or accounts payable, a computerized system may be better (Skaggs, 1999).

Any basic record keeping system whether manual or computer software program, should be simple to use, easy to understand, reliable, accurate, consistent and designed to provide information on a timely basis (Shepherd and Yeo, 2003). A successful record keeping system is one that does not limit record keeping solely to the documentation of a transaction but also includes the implementation and maintenance of written standards, operating procedures, documented training and education, all mitigating factors and demonstration of due diligence and reasonable care (Reynolds Sarah, 2010).

3.1 Single entry bookkeeping system

The single entry accounting system according to Osuala (1993) is the easiest accounting system to operate. The system records the flow of income and expenses through the business on daily summary of cash receipts, a monthly summary of cash disbursements. In single entry book-keeping there might be single aspects of certain transactions and no record at all of some. Generally, there are rough records of cash received and paid, and at times there might be records of amounts owing from sundry debtors and to creditors (Passion, 1989). According to Baker (2000), this system uses a cash receipts journal and a cash disbursements journal in addition to the checkbook. All transactions are recorded in one of these journals. It records the flow of income and expenses and is practical for a small business just starting out. The cash receipts journal records all the cash received. It has columns for various categories of receipts with a line for each receipt, including date, source of cash and total amount.

3.2 Double entry bookkeeping system

Double entry bookkeeping according to Passion (1989) means that every entry or record of transaction has two parts- a left side and a right side, and the value received is a debit and the value parted is a
credit. According to Barker (2000), this system combines the single entry system with additional information to provide you with a more complete picture of your business. Double entry systems include information on cash on hand, equity in building, equipment, accounts payable, mortgages and loans. Welsh et al. (2010) propounded that double entry system creates a convenient relationship which permits an interim check of accuracy of recording work at any time during the process. If one is not sure that an entry has been made correctly, one may stop and add up all the left side and then all right side, the two totals should be equal. In this system, the majority of the transactions usually fall into sales of merchandise on credit, purchase of merchandise on credit receipt of cash and payment of cash. This accounting system works well for a small business that is a sole proprietorship with a small payroll and very little inventory (Mutulich, 1980)

Osuala (1993) reported that generally many of the small enterprises record their transactions randomly without adherence to any established systems of accounting, hence, there is difficulty in keeping track of the cash flows in the enterprises. Mitchel et al. (2000) argued that accounting information could help the small scale enterprises manage short term problems in such areas as costing, expenditure and cash flow by providing information to support monitoring and control. International Federation of Accountants (2006) reported that there is evidence to suggest that small firms are aware of the importance of accounting information. In spite of this awareness, most proprietors of small enterprises in most times are not too keen to use standard accounting systems to run the day to day activities of their enterprises. The high rate of failure of small scale enterprises in developing countries has generally been traced to poor management and accounting systems employed by these enterprises (Ofonagoro, 1983).

4 Basis of accounting

There are two approaches used in recording transactions. These are cash basis approach and accrual basis approach. Small businesses find it more appropriate to use cash basis accounting (EC, 2008).

4.1 Cash basis

This means that cost or income is accounted for at the equivalent amount of cash paid or received for it. It also means that an entity recognises a transaction only when cash is received or paid. The cash book or the receipts and payment accounts is the main book in this system. In modern businesses, especially in retail shops, a point-of-sale or cash register trail is used (Maseko and Manyani, 2011). Cash basis accounting can’t be used if a store sells products on store credit and bills the customer at a later date. There is no provision to record and track money due from customers at some time in the future in the cash-basis accounting method. That is also true for purchases. With the cash-basis accounting method, the owner only records the purchase of supplies or goods that will later be sold when he actually pays cash. If he buys goods on credit to be paid later, he doesn’t record the transaction until the cash is actually paid out. Cash-basis accounting does a good job of tracking cash, but it does a poor job of matching revenues earned with money laid out for expenses. This deficiency is a problem particularly when, as it often happens, a company buys products in one month and sells those products in the next month (Maseko and Manyani, 2011).

4.2 Accrual basis accounting

It is based on the accruals concept of accounting which states that revenue and costs are accrued, that is, they are recognised as they are earned or incurred, not as money is received or paid, and is dealt with in the statement of comprehensive income for the period to which they relate (Maseko and Manyani, 2011)). Profit under this type of accounting, is the difference between realized revenues and associated costs, which are measured either by historic cost method, current costs method or fair value method. Accrual basis accounting involves accruing any receipts which have been earned in the financial year and accruing any payments which relate to purchases made in the financial year. The result of this is that, any receipts received or payments made in the current financial year which relate to accruals made in the last financial year, will not affect the current year’s profit. An entity may make a choice between the two bases of cash or accruals or apply both depending on the nature of its business transactions. However, in some jurisdictions, entities may be required to adopt one prescribed basis according to Maseko and Manyani (2011).

5 Documents and books used in record keeping

Quality financial reporting system involves the use of source documents from which records are derived. The following documents are expected from an entity that keeps formal accounts

5.1 Receipt

According to Saleemi (2008) a receipt is a document prepared to show evidence of money received. Receipts should be printed, having a counterfoil or carbon copy and should be consecutively numbered. Spoiled receipts should be cancelled and not detached from the counterfoil and no blank counterfoil should be accepted.
5.2 Invoice

This is a document submitted by suppliers demanding payments for the goods and services that they have an invoice provides information to the buyer about the cost of goods, trade discount and net amount as a document submitted by the suppliers demanding payment for the goods or services supplied that they had provided on credit and its normally reconciled with other documents such as delivery notes.

5.3 A voucher

It is documentary evidence in support of a transaction in the books of accounts (Saleem, 2008) and the act of establishing the accuracy and authenticity of entries in the books accounts is called vouching. Saleem (2008) further argues that the essence of the voucher is to substantiate an entry in the books of accounts with any documentary evidence such as agreement, receipts, counterfoils and also that the transaction has been authorized.

6 Books used in record-keeping

For quality financial reporting the following books are expected from any business that keeps formal accounts

6.1 Cash book

It is a book in which cash and cheque transactions are entered. Whenever cash or cheques are either received or paid out, the first book to enter such transaction is the cash book. In this way, the cash book is said to be a book of original entry, the debit side of the cash book is called the cash receipts journal while the credit side is called the cash payments journal.

6.2 Ledger

Transactions are posted from the journals to the ledger. Ledgers are categorized into, the general ledger which contains all the ledger accounts of the organization and the subsidiary ledgers which are created to avoid crowding the general ledger with all accounts (Saleem, 2008).

6.3 Journal

It is a book for recording business transactions in chronological order. A simple method of recordkeeping is to use 13-column paper for journals. You derive the information for each journal entry from original source documents, such as receipts for cash paid or received, cheques written or received, cash register tapes, sales tickets, etc. The information appearing on these documents must be analyzed to determine the specific accounts affected and the dollar amounts, and then the proper journal entry is recorded (Jay and Miller, 2004).

A transaction is entered in a journal before it is entered in ledger accounts. Transactions are entered into the journals by date, amount, description and account to which the transaction has been assigned. For example, when rent is paid, the journal entry would be made in the cash disbursement journal under the accounts of cash and rent. A journal is also called the book of original entry (Jay and Miller, 2004).

7 Benefits of keeping accounting records

According to Mc Lean (1999), complete and accurate financial records are crucial for any business success. Quality records provide the financial data that help to operate more efficiently thus increasing business profitability. Accurate and complete record keeping enable the business to identify and take count of its assets, liabilities, income and expenses. That information when compared to appropriate industry averages help to pinpoint both the strong and weak phases of business operations. Quality records are essential for the preparation of current financial statements, such as statement of comprehensive income, statement of financial position and cash flow statement, these statements in turn are crucial in maintaining good relationship with Banks and other financial institutions. In case the business enterprise is in need of financial support, such statements will be used for assessment because they present a complete picture of the business (Wang, 2003). The following are benefit of keeping records of accounting

1. Accounting Records assist the business to know how good or bad the financial condition of business is, to know whether the business activity resulted in profit or loss.

2. Accounting records obviate the necessity of remembering various transactions. With increased volume of business, however strong one's memory may be, all those detail cannot be remembered by recall.

3. Accounting records, prepared on the basis of uniform practices will enable small businesses to compare results of one period with another period.

4. Accounting records backed up by proper authenticated vouchers are good evidence in court of law in the event of fraud by the customers, suppliers and employees.

5. If a business is to be sold as a going concern then the values of different assets as shown by the balance sheet helps in bargaining proper price for the business.

6. Records are also helpful when, say , a new partner is to be admitted in the business.

7. Records are a necessity when applying for loans or bank overdraft. The books of accounts shall be required to ascertain the value of the business and how the business is performing. Banks can only lend money for working capital or for purchase of assets.
when they have clear evidence that the firms' cash flow can meet principal and interest payments

8. In order to monitor financial position and performance, there is a need for timely and relevant financial statements reflecting what has been achieved.

9. Forecasted records are used to plan for the future. Budgets assist the business to control costs and take measures or adopt and adapt as soon new conditions (William et al 1993)

8 Difficulties that are being faced in record keeping

Most small businesses use cash basis accounting which limits the concepts of going concern and their accounting records are incomplete, making objective judgment so difficult to make (Echomunt, 2001). The following are some of the challenges faced in account recording:

1. Accounting records are kept on a historical basis. When preparing these records they take into account actual events that have taken place, these statements present a view of past performance only but do not give due importance to future estimates and expectations.

2. A study by Lalin and Sabir (2010) concludes that regulations are the main drivers why small businesses prepare financial statements. This means that most owners and managers of SMEs engage public accountants not for using the information in decision making to provide required information to the authorities concerned.

3. Ismail and King (2007) argue that owners of small businesses have a low level of accounting knowledge and therefore find it difficult to develop sound accounting information systems.

4. Evaraert et al. (2006) and Jayabalan and Dorasamy (2009) however argue that the high cost of hiring professional accountants leaves small businesses with no option but to relegate accounting information management.

5. Zhou (2010) proposes the use of accounting software by small businesses to improve accounting practices but laments that developers of accounting software are yet to produce a software that is user friendly to small businesses.

6. McMahon (1999) argues that financial reporting practices in small businesses seem to fall short of what is expected of them by various external financial reporting imperatives that exist for them, further arguing that owners appear particularly reluctant to produce financial reports which might become accessible to outside parties either directly or through the offices of regulatory authorities.

9 Performance of a business

Performance of business refers to the ability of business to meet the required standards, increased market share, improve facilities, ensuring returns on profitability, and once this is achieved, a business is believed to be performing effectively (Flolick, 2006). Performance refers to an ongoing process that involves managing the criteria for which an institution, agency or project can be held accountable (Ticehurst and Conneron, 2000). Zinderman (1999) argues that business enterprises must improve performance if they are to effectively compete in this era of rapid economic and technical change, by improving capital investment as well as a work force that has the flexibility to acquire new skills for newly created jobs resulting from structural changes in the economy. SMEs may be termed successful if they have endured the first two critical years of existence and the owner has met the majority of his goals and objectives (Kesper, 2001). Others consider a successful business as having been in existence for longer than two years, having a staff component of more than five and making a profit and expanding in terms of infrastructure and growth (Niemann et al, 2003).

10 How to measure performance of a business

According to the Contingency theory there is no optimum method to systematize a firm and the organization structure of the company (Fiedler, 1964). In other words, contingency theory argues that the most appropriate structure for an organization is the one that best fits a given operating contingency (Woodward, 1965; Perrow, 1970). Each business is exposed to unique conditions making it difficult to use a standardized measure. Measurement of performance is the process of regular and systematic data collection, analysis and reporting to be used by a firm to follow up the resources it uses, and the results it obtained with the produced goods and services according to Tekeli (2003).

11 Objectives of measuring performance

1. According to Pareek and Rao (1992), measuring performance aims at providing feedback and guidance to management when they make decisions.

2. To identify training needs, to reward and promote employees as a way of encouraging future better performance

12 Common methods used in measuring financial performance

There are several parts in a business that are worth watching. Of particular interest are asset values, liabilities, cash flows, financing and investing activities. These variables need to be presented as facts and figures for analysis and evaluation so that
appropriate changes can be made to achieve goals effectively (Reh 2011). To understand the effect of the above variables, a Statement of comprehensive income and Statement of financial position should be prepared. Most of the small businesses prepare the Statement of comprehensive income to calculate profit. According to Stoner (1996), profitability has been the widely used measure of financial performance. Profitability is the excess of income over expenditure which can be expressed by the ratios like gross profit margin, net profit margin and return on equity. However, profit as a measure of performance has got a lot of limitations. Pandey (1997) argued that profit is ambiguous as it can be looked at differently by different people for example Economists and Accountants. It also involves a lot of estimations like depreciation and stock valuation which end up giving different values according to methods used.

Drucker (1990) points out that the common accounting performance measure of profit and cost rarely support changes in the organizational structure and size, thus non-financial measures like management and employee skills and their turnover must be used to fit within the strategic framework. Instead of putting all focus on profit small businesses could as well consider comparison of cost and sales to understand if the amount of stock accumulated is increasing while sales remains stagnant, indicating poor utilization of stock. They could also compare the debtor and creditor values between past and present balance sheets to measure credit history, understand the customer satisfaction level through complaints and reviews from the end users and employee satisfaction (Von and Wingard, 2009). According to a study by Tanwongsval and Pinvanichkul (2008), SMEs ranked ‘assessing profitability’ second on the list of reasons for preparing financial statements well after ‘sole purpose of tax preparation’ which was ranked first. Cooley and Edwards (1983), report that SMEs put emphasis on maximization of net income or net profit as the most important financial objective. Page (1984) also supports the idea that owners in SMEs focus on profitability and the measures of net profit. Small businesses have also been known to focus on current liquidity and short-term cash flows to fulfill requirements of the users of financial statements of who are more interested in current liquidity and short-term cash flows than long-term forecasts of cash flows and earnings (Sian and Roberts, 2006). Another area worth looking at is business competitiveness. Herciu and Ogrea (2008) and Lopez el al.(2005) describe competitiveness as comparison between a firm’s performance and standard performance in the industry in terms of relative market share and position, sales growth and measure of customer base.

### 13 Best method of measuring performance

#### 13.1 Balanced score card

Performance can be assessed by the use of the balanced score card (BSC), it addresses other aspects that do not incorporate financial measurements but rather intangible and intellectual assets such as high quality services or royal customers which are more critical to the success of the business (Kaplan and Norton, 1992). They further postulate that the need to integrate financial and non-financial measures of performance and identify key performance measures that link measurement to strategy led to emergence of the balance score card and integrated set of performance measures derived from business’s strategy that gives management a fast but comprehensive view of the business unit. Balance score card philosophy assumes that an organization’s vision and strategy is best achieved if the organization is viewed from the following four perspectives,

- customer perspective,
- internal business process perspective,
- learning and growth perspective
- financial perspective (Kaplan and Norton, 1992)

To implement the balance score card the major objective for each of the four perspectives should be articulated. Objectives should then be translated into specific performance measures, targets and initiatives which can be termed indicators. Key Performance Indicators, also known as Key Success Indicators (KSI), help a business define and measure progress toward business goals. Once a business enterprise has analyzed its mission, identified all its stakeholders, and defined its goals, it needs a way to measure progress toward those goals. Key Performance Indicators are quantifiable measurements, agreed to beforehand, that reflect the critical success factors of the business (Likert, R 1958).

A relevant performance indicator provides information to make a difference in a decision by helping users to either form predictions about the outcomes of past, present, and future events or to confirm or correct prior expectations. It deals with the predictive value and/or feedback value. Feedback value refers to the quality of information that enables users to confirm or correct prior expectations, while predictive value stands for the quality of information that helps users to increase the likelihood of correctly forecasting the outcome of past or present events (Financial Accounting Standards Board, 1980). A critical feature of the relevance is the timeliness. In fact, the information provided by the indicator has to be available to decision makers before it loses its capacity to influence decisions. The following are some of the ways through which performance of small scale businesses can be assessed: volume of sales and profitability this refers to the quantity of products not only produced but sold; level of production, this refers
to the effectiveness and efficiency in production, it looks at the learning curve and improvement on wastages and spoils; employees’ expenses (monthly), this is closely related to labour turnover, the more the workers come in and go the more the cost; Labour turnover this refers to the rate or frequency at which workers leave the job to another or from one employer to another; Level of absenteeism and late coming, this is closely associated with motivation and rewards, the less the rewards the more the employees find no reason to be loyal; the level of pilferage in a company can indicate lack of effective stock control methods in a business; the number of items returned or rejected by customers also indicates how well the company is performing; the number of complaints can also tell how well a company is performing.

It is therefore important for business owners/managers of small scale businesses to have a system of recording complaints, for example a suggestion box, a visitor’s register with columns for comments and questionnaires about the services offered to the customers can be used by the company to receive customer’s complaints and to solicit for their suggestion (Biryabarema Ennoock, 2007); Financial performance in terms of profitability, liquidity, capital structure and market ratio, quality of services in terms of reliability, responsiveness, appearance, cleanliness/tidiness, comfort, friendliness, communication, courtesy, access and availability of security, flexibility in terms of delivery speed and specification, resource utilization in terms of productivity and efficiency, innovation (Fitzgerald et al. 1996); number of customers’ claims, number of supplier claims, number of shifts of the delivery dates of orders/ planned orders (daily) and working minutes for employees/ estimated minutes daily (USAID center for development, 1996).

14 Relationship between accounting records and performance

Kengere, Okiama and Nyakundi (2010) made a study in Kenya and found that book keeping is a great challenge among many SMEs in Kisii Municipality. The research also discovered that 65% of the SMEs showed inadequate book keeping practices. The study showed an indication that book keeping greatly, contributes to the variation in financial performance. In other words there is a direct relationship between book keeping and financial performance. Therefore, poor book keeping would lead to poor financial performance and proper book keeping would lead to better financial performance of the SMEs. In Mauritius while the performance levels of small businesses have traditionally been attributed to general managerial factors, such as manufacturing, marketing and operations, accounting systems may have a strong impact on the survival and growth of SMEs Padachi (2012).

It is of interest to note that the Mauritian SMEs do not seem to attach the same importance to accounting and finance function as for the other areas of their businesses. Minimum records are kept just to comply with the external financial reporting requirements of the firm and no attempt is made to use key financial indicators as a measure of performance. Padachi (2012)’s study also discovered the absence of formal accounting systems in many firms due to lack of financial and accounting knowledge among the owner-managers. This implies that most of the SMEs in Mauritius are not yet able to evaluate their performance using accounting records. In Nigeria, Okoli (2012)’s study was prompted by the high rate of small scale enterprises failure. Summary of the results revealed that there are a number of accounting systems which are available for use to small scale enterprises operating in Enugu, but a significant number of SMEs use the single entry system of accounting which is a poor way of record keeping that contributes towards their failure. In Jordan Yousef (2013) made a study where he noted that SMEs business owners regard financial records as an necessary evil with no tangible benefit, demanded by government for tax purposes. His study is in line with Omran (2010) and Ben Kwame (2011) Sarapaivanich (2003) who studied small businesses in Thailand and came up with the suggestion that SMEs performance is influenced by a number of factors which include 1) a lack of demand for product or service, 2) poor management and/or administrative skills of the owner/manager, 3) a lack of experience in the particular industry, 4) insufficient capital invested by the owner, 5) an over-reliance on external borrowings, 6) poor record-keeping most of all. It implies that a poor accounting record-keeping and inefficient use of accounting information cause poor financing decision of SMEs and high failure rate.

Mairura (2011) made a study in Nigeria and discovered that although 97% of the respondents said that records were useful in business, only 74% maintained records, the most popular record kept by the entrepreneurs being the notebook, which 90% of them assumed to be the cash book. They used the information in this book to prepare (income and expenditure account) profit and loss account and very few of them kept the cash books, invoices, receipts together with the registers Mairura (2011). This shows that they are more interested in the immediate cash and not the future of their business. In Uganda Margaret (2005) examined the relationship between the quality of record keeping and performance of small business enterprises and findings depicted that quality of record keeping existent in many SMEs positively influenced the overall performance of a business. Magare (2005) also discovered that record keeping in the SMEs is characterised by inadequate and un-updated records and in some cases a complete absence of record keeping thus basing performance assessment on mental records.
Waweru (2012) examined the relationship between performance and accounting records and discovered that 85% of the sampled SMEs had some form of record while 15% did not have records at all. Of the 85% that had records only 31% professed of maintaining full records. On how often the records are used 53.4% professed of using the records for tax purpose and sourcing of finance and 31% said they use the records to reflect on performance according to Waweru (2012). This shows that the majority of SMEs do not maintain and make use of accounting records.

### 15 Conclusion

This manuscript exposes some empirical studies of findings on factors affecting performance of SMEs. Most of the conclusions pointed out that record keeping and performance have a relationship though most of them were not measuring the strength of the relationship. The main objective of this research was to analyse the strength that exist between keeping quality financial records and performance of SMEs. The study found out that there is a strong relationship between performance and accounting records.

### 16 Recommendations

Small scale businesses need to set yearly objectives for each performance indicator so that both the business owners and employees work with the yearly objectives in mind. Business owners and employees will work hard to achieve the yearly set objectives for each indicator.

### References

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