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THE IMPACT OF AAOIFI ACCOUNTING STANDARDS ON EARNINGS QUALITY: THE CASE OF ISLAMIC BANKS IN BAHRAIN

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Abstract

The purpose of this paper is to examine the change in earnings quality after the adoption of AAOIFI Accounting Standards in Islamic Banks of Bahrain. In this paper, we hypothesize that, adoption of AAOIFI accounting standards could lead to high level of earnings quality. However, data were collected from the annual reports of 5 Islamic banks in Bahrain during 2002-2011. The findings indicate that the change in earnings quality after the adoption of AAOIFI in Islamic Banks of Bahrain is higher due to the improvement of the quality of financial reporting. The Adoption of AAOIFI accounting standards is expected to lead to high level of earnings quality among Islamic Financial Institutions and play a significant role in attracting global investors' interest in the local markets, especially in a developing country like Bahrain.

Keywords: Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Accounting standards, Earnings Quality, Islamic Financial Institutions, Bahrain

1. INTRODUCTION

Prior studies on the global accounting standards made tremendous efforts to ensure practical and standardized international financial statements. The standardization of financial reporting becomes more increasingly important to researchers, academics, investors and users of financial reports. However, the major challenges faced by financial institutions lie in the preparation of financial reporting under a variety of accounting standards which may result to problems of recognition, measurement and disclosure. Therefore, understanding the factors affecting the impact of AAOIFI adoption on the earnings quality need to be investigated. The acceptance and understanding of AAOIFI accounting standards can be of high significance for policy implications, regulators, and standard setters. The literature on the level of compliance with AAOIFI accounting standards has also generated a heated debate among the researchers. However, it is uncertain to determine whether there is any impact of AAOIFI adoption of AAOIFI accounting standards on earnings quality among the banks in Bahrain. It is therefore necessary that we should ask the following question: Does the adoption of AAOIFI accounting standards have a positive/negative impact on the earnings quality?.

The current study differs from other studies that examined the impact of accounting standards on earnings quality of banks. All other research studied earnings quality of conventional banks by using international accounting standards, whereas this study used a different set of accounting standards named AAOIFI accounting standards and non-conventional banks. Therefore, this study is unique to examine the impact of accounting standards for Islamic financial institutions on earnings quality in Bahrain.

2. LITERATURE REVIEW

This paper investigates the impact of AAOIFI adoption on earnings quality in Islamic Banks of Bahrain. The review of the literature shows that only a few researchers have been conducted to examine the impact of global accounting standards such as IFRS adoption on earnings quality, but no studies have been conducted to examine the impact of adoption of the AAOIFI accounting standards on earnings quality regionally and globally. In the international context for instance, study conducted by Sun, Cahan and Emanuel (2011) examined the effect of IFRS adoption on earnings quality from cross-listed firms in the U.S. and investors concerned with earnings quality increased during the last decade after many international companies announced about non-authentic and temporary earnings as part of their quarterly reports. Thus, investors became more cautious in considering net earnings. In another study, Ohlson & Feltham (1995) defines earnings quality as investor's ability to predict future abnormal earnings based on recent data. In line with that, Dechow et al. (2010) as quoted from (Sun et al, 2011) defines high-quality earnings as earnings that could provide adequate information about the features of a firm's financial performance that are relevant to a specific decision made by a specific decision-maker.

Accounting standard setters commonly perceive earnings management as undesirable to reduce management's discretion for earnings management by tightening accounting standards (Ewert and Wagenhofer, 2005). According to De-jun (2009), six factors affect earnings quality; accounting standards, firm characteristics, board and auditing committees' characteristics, managerial characteristics, auditing firm characteristics and others. Additionally, Ewert and Wagenhofer (2005) documented that IFRS adoption led to an improvement in earnings quality for cross-listed firms relative to matched firms in the U.S.

The significance of earnings quality stems from earnings on which many parties depend on their decision (Dechow & Dichev, 2002). According to Dechow & Schrand (2004) as quoted from (Hamdan, 2013) understanding earnings quality plays an important role in the process of financial analysis; earnings of high quality help financial analysts in analyzing three basic information which are: present functional performance of the company, future functional performance and value of the company.

There are different views regarding concept of earnings quality, while some use earnings continuity as a standard of its quality as explained by (Altamuro& Beatty, 2006). The continuity of earnings refers to the relationship between present earnings with future ones. As earnings are divided into cash flows and accruals, quality earnings is when cash flows are more than accruals (Sloan, 1996). Others indicate that earnings quality is better once free from earnings management practices; the less discretionary accruals also reflect better quality (Francis et al, 2004; Dechow & Dichev, 2002; Al-Sharif, 2008).

According to Dechow & Schrand (2004) as quoted from (Hamdan, 2012) the standard setters, regulators and auditors consider earnings quality to be good if information disclosed is in accordance with the generally accepted accounting principles. Also, the creditors consider earnings quality to be good whenever the company enjoyed a greater capacity to transfer its cash flows.

In a related study by Tony et al (2012), the earnings quality increases for mandatory IFRS adoption when a country's investor protection regime provides stronger protection. This study extends the current literature to show that accounting practices are influenced by country-level macro settings. The results highlight the importance of investor protection for financial reporting quality and the need for regulators to design mechanisms that limit manager's earnings management practices.

However, most of the previous studies focused on the impact of IFRS adoption on earnings quality globally. The impact of AAOIFI adoption on earnings quality in the Middle East, particularly in Bahrain has never been examined. Thus, it is interesting to study the impact of AAOIFI adoption on earnings quality. We consider this to be the first study to examine the impact of AAOIFI adoption on earnings quality in the kingdom of Bahrain. In Bahrain, for instance, Al-Mudhahki and Joshi (2001) found that, certain listed companies in Bahrain were complying with the international accounting standards. In addition, it was found that, size, auditors' reputation, the percentage of foreign sales, levels of foreign activity, listing, and profitability are the main determinants of the compliance with international accounting standards. However, to date there are no related studies to explain the impact of AAOIFI standards on earnings quality. Accordingly, we conducted this study to examine the impact of AAOIFI adoption on earnings quality to contribute to the body of knowledge.

3. RESEARCH METHODOLOGY

In this paper we hypothesize that, adoption of AAOIFI accounting standards could lead to high level of earnings quality. This paper uses the Richardson Sloan model in examining the change in earnings quality after the adoption of AAOIFI standards in Islamic Banks of Bahrain. This paper uses 5 years period before and 5 years period after the adoption of AAOIFI accounting standards. Data were collected from the annual reports of 5 Islamic banks in Bahrain during 2002-2011.

3.1. Research Design

The study sample included all Islamic Banks in Bahrain which their data is available and never been merged or deleted throughout the period of the study. The number of Islamic banks that met such conditions from 2002–2011 was five, Annual reports of 5 selected Islamic banking have been analysed. This study period was therefore selected to examine the impact of pre and post adoption of AAOIFI accounting standards on earnings quality among Islamic banks in Bahrain.

This study aims to measure the impact of AAOIFI adoption on earnings quality. The first step, we measured adoption of AAOIFI accounting standards and then the level of earnings quality. We also analyzed the relation between them.

The dichotomous disclosure index is employed in this paper for determining the dependent variable. The dichotomous technique used whereby a one score was given for pre-adoption and zero for post-adoption. The results reveal an overall compliance of 81% by the Islamic banks in Bahrain to the requirements of AAOIFI accounting standards.

3.2. Research Model

There are different interpretations of earnings quality, for instance, according to Sloan (1996) earnings quality implies continuity of cash flows more than accruals. Richardson Sloan model developed to determine the range of earnings continuity in the future as equation number 1 shows below.

$$ROI_{i,t+1} = \gamma_0 + \gamma_1 (ROI_{i,t} - TACC_{i,t}) + \gamma_2 TACC_{i,t} + \upsilon_{i,t+1} \quad (1)$$

Where:

$ROI_{i,t+1}$: is return on investment for firm (i) in the next year (t+1);
γ_0: is constant;
γ_1: is continuity of cash flows;
γ_2: is continuity of accruals;
$ROI_{i,t}$: is return on investment for firm (i) in year (t);
$TAAC_{i,t}$: is total accruals for firm (i) in year (t).

Earnings quality means that next year's earnings represents returns on investment ($ROI_{i,t+1}$ dependent variable in equation no.1) which is affected by earnings of the current year, represented in γ_1 coefficient more than total accruals represented in γ_2 (coefficient). Then, the hypothesis in the previous equation is γ_2-γ_1<0, which indicates continuity of earnings in the coming years is more than the continuity of accruals as $\gamma_2<\gamma_1$ known as earnings quality. Therefore, equation no.1 is modified as follows:

$$ROI_{i,t+1} = \rho_0 + \rho_1 ROI_{i,t} + \rho_2 TACC_{i,t} + \upsilon_{i,t+1} \quad (2)$$

This equation is then rewritten after taking into consideration the accruals in equation no.1 as follows:

$$ROI_{i,t+1} = \gamma_0 + \gamma_1 (ROA_{i,t}) + (\gamma_2 - \gamma_1)\, TACC_{i,t} + \upsilon_{i,t+1} \quad (3)$$

As $\rho_1=\gamma_1$and $\rho_2=(\gamma_2-\gamma_1)$, this evaluation saves us the direct evaluation for $\gamma_1-\gamma_2$ in equation no.2. The hypothesis is $\rho_2<0$ as it is more negative in accruals representing earnings that imply the presence of high quality earnings.

4. RESULTS, ANALYSIS AND DISCUSSION

Table 1 reports the mean, standard deviation, Skewness and Kurtosis for all variables. Skewness and Kurtosis were conducted to test the Normal Distribution of data as shown in Table 1. Moreover, Durban-Watson (DW) test was used in order to test the presence of correlations. As a result, DW test results 1.138 as shown in Table 2, and this shows that DW is located within the range of the data normality according to (Gujarati, 2003). In addition to that and to test the independency for all independent variables, Multicollinearity test was conducted to measure the tolerance of each variables through Variance Inflation Factor (VIF) test. The result as shown in Table 2 shows that, the VIF scores reported indicate that no score exceeds 10 for any variable in the model. It was, therefore, concluded that collinearity was not problematic. Thus, all variables less than 10 values; which mean the model doesn't have any Multicollinearity problem according to Gujarati (2003). Furthermore, Table 1 shows the descriptive statistics of all variables. Overall, the mean of all variables is positive and that reflects the adoption of the AAOIFI accounting standards could lead to high level of earnings quality and play a significant role in attracting global investors' interest to the local markets, especially in a developing country like Bahrain.

Table 1. Descriptive statistics for the dependent and independent variables

	Absolute value	ROE Profitability	LIQ Liquidity	SIZE (Ln)	AGE
N	50	50	50	50	50
Mean	2,184,213	8.662	3.329	4.782	19.35
Std. Deviation	8.243	1.223	4.340	5.443	11.272
Skewness	1.323	1.817	1.614	1.238	.652
Kurtosis	2.476	2.323	3.342	4.201	.326
Minimum	43725	4.123	0.118	2.626	6
Maximum	4,325,382	6.09604	1.955	2.541	43

Table 1 summarizes the mean of the dependent and independent variables of the sample size of Islamic banks listed in Bahrain BourseBB. The mean was indicating the relationship between the adoption of AAOIFI and earnings quality in Islamic banks in Bahrain. as well as a minimum and a maximum of the levels of which also indicate the relationships between the dependent and independent variables in study model as shown in table 1.

In addition to, a check for multicollinearity involves conducting the Variance Inflation Factor (VIF) as is shownin Table 2, indicating that no score exceeds 10 for any variable in the model. It was, therefore, concluded that collinearity was not problematic as discussed above.

Table 2 presents also the results of the regression analysis. This result statistically supports the significance of the regression model. The results also reveal that R-Square is 0.413, which suggests that independent variables included in the model explain 41% of the variation in the study. Furthermore, in relation to the relationship between the adoption of AAOIFI accounting standards and earnings quality in Islamic banks in Bahrain, the results indicate that the coefficient is low with a negative value indicating a high level of earnings quality declared by Islamic banks of Bahrain after adopting AAOIFI standards.

Table 2. Regression Analysis

Ind. Variables		t-statistics	Sig.	VIF
(Constant)		2.721	0.004	
ROE		2.523	0.008	5.86
LIQ		3.224	0.001	4.00
SIZE		2.321	0.009	4.68
AGE		1.987	0.010	1.073
Durban-Watson DW	1.138			
R	0.632			
R-Square	0.413			
No. of Observations	49			

Table 2 presents the results of the regression model that examine the relationship between the adoption of AAOIFI accounting standards and earnings quality in Islamic banks in Bahrain in terms of independent variables. The model is significant with R2 of 0.413. This means, the independent variables as identified in the literature review are influencing 41% of the relationship between the adoption of AAOIFI accounting standards and earnings quality. Furthermore, the results reveal that, there is a relationship between the adoption of AAOIFI accounting standards and earnings quality. The results support the research hypotheses that, the higher absolute value of discretionary accruals suggests lower earnings quality and vise versa. This has been supported by many previous studies such as Wan Ismail et al (2015) which concluded in their research using Malaysian listed firms at KL Stock Exchange; that the that adoption of accounting standards such as IFRS is associated with higher quality of reported earnings. It is found that earnings reported during the period after the adoption of IFRS is associated with lower earnings management and higher value relevant.

In related study conducted by Quttainah & Song (2013) they using a sample of Islamic banks and their matched non-Islamic banks in 15 countries, however, they found Islamic Banks are less likely to conduct earnings management as measured by both earnings loss avoidance and abnormal loan loss provisions.

Furthermore, in table 3, independent sample t-test results show the methods for measuring earnings quality. Thus, β or ρ2<0, is more negative in representing accruals of returns in equation 3 and this implies high earnings quality.

The results indicate that the coefficient is low with a negative value indicating a high level of earnings quality declared by Islamic banks of Bahrain after adopting AAOIFI standards. We used independent sample t-test in order to test the impact of AAOIFI adoption on earnings quality. The sample consisting of 50 observations were then divided into two groups:

First group consisted of Islamic banks before the adoption of the AAOIFI accounting standards, and the second group after the adoption. The mean values as shown in Table 3 were ρ2= 0.00085 for before adoption and ρ2= -0.00012 after adoption. A decrease in the mean value after adoption indicates a high adoption of AAOIFI accounting standards and also earnings quality. However, in order to study the relationship between the impact of adoption of AAOIFI accounting standards on earnings quality the independent sample t-test was carried out and the findings are shown in Table 3:

Table 3. Independent sample t-test results

Mean of EQR (ρ2) before adoption	T-test	Sig.	β	Df	T- Critical	Mean of EQR (ρ2) after adoption
ρ2= 0.00085	2.318	0.03	- 4.820008	50-1=49	1.68	ρ2= -0.00012

4.1. Implication of the study

This research may be considered as a first attempt to contribute to the Islamic Accounting literature in terms of examining the impact of pre and post adoption of AAOIFI accounting standards in Bahrain. According to Dechow & Schrand (2004) as quoted from (Hamdan, 2012) the standard setters, regulators and auditors consider earnings quality to be good if information disclosed is in accordance with the generally accepted accounting principles.

The findings of this research are consistent with accounting literature, and can be concluded that the adoption of accounting standards issued by an international accounting body will enhance the earnings quality and reporting of an organization. Accordingly, the findings should also be beneficial to regulators and researchers to adopt and undertake further studies on the impact of AAOIFI adoption on earnings quality in other developing and Muslim countries.

4.2. Implications for Theory and Practice

The findings show significant support for the impact of AAOIFI adoption on earnings quality. Logically, Islamic financial institutions comply with Shari'ah requirements due to religious necessities in the Muslim community. Thus, the results are expected to have a high level of earnings quality if Islamic financial institutions adopt accounting standards based on Shari'ah principles and the findings could serve as a guide to the regulatory bodies such as the Central Bank of Bahrain (CBB) and regulators of accounting standards for Islamic financial institutions. Therefore, adoption of the AAOIFI accounting standards could lead to a high level of earnings quality and could play a significant role in attracting global investors' interest in the local market, especially in a developing country like Bahrain.

The results indicate that Islamic banks in Bahrain have a high level of earnings quality after adopting the AAOIFI accounting standards. These findings are relevant to bridge the gap between theory and practice.

4.3. Data Limitations

This research like many other studies faces data limitations. Sample size employed for this study contains only Islamic banks of Bahrain, and did not include other Islamic financial institutions such as Takaful (Islamic insurance) companies.

4.4. Recommendations

The study focuses on Islamic banks in Bahrain. Thus, Islamic Banks in GCC should be included in future research. Also future research may consider auditing, governance, ethics and other Shari'ah standards issued by the AAOIFI to examine the impact of the AAOIFI accounting standards on earnings quality. In addition, future research could include Islamic banks from the Organization of Islamic Countries (OIC) in order to elicit international evidence. Furthermore, due to lack of prior research in this area, future studies can be extended by looking at AAOIFI standards adoption by Islamic banks in other countries where AAOIFI standards are mandatory or voluntary. Moreover, other factors should be included in future research to reflect the change in earnings quality after the adoption of AAOIFI accounting standards by Islamic Banks of Bahrain.

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THE DIFFUSION OF MANAGEMENT CONTROL SYSTEMS IN ITALY: A COMPARISON BETWEEN FAMILY AND NON-FAMILY FIRMS

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Abstract

The current economic crisis has accentuated the purchasing power loss and the decrease of companies' profitability; so, the strategic planning and management control systems become needful because they provide managers the tools to drive the whole organization towards established goals. For this reason, the research is focused on the use and the diffusion of advanced management control systems within a sample of Italian companies, both family firms (FFs) and non-family firms (NFFs). The research aims at investigating the diffusion of performance measurement systems within the sample of Italian FFs and NFFs and at analysing which kind of advanced managerial tools are more widespread. The research has been conducted using the method of questionnaire in order to photograph the state of the art in a significant number of Italian firms. The expected outcomes are that the most developed strategic planning and management control systems are still not widespread within the sample of small and medium enterprises. In addition, we also suppose that performance measurement systems are more widespread in NFFs than in FFs due to the significant presence of the family in company's running and a related lower power of managers.

Keywords: Management Control, Non-Family Firms, Family Firms

1. INTRODUCTION

The family firms (FFs) phenomenon is widespread around the world. Europe, Asia, Africa and Latin America are characterized by a vast majority of publicly traded family businesses (Acquaah, 2013; Garcìa-Ramos and Garcìa-Olalla, 2011). In Italy, as well as in Europe, there's a strong presence of numerous small and medium-sized companies, often family-controlled (Mediobanca, 2013).

For this reason, FFs manage most of the economic activity and are increasingly considered by both the literature (Astrachan and Shanker, 2003; Claessens et al., 2000; Faccio and Lang, 2002; La Porta et al., 1999; Morck and Yeung, 2004), public opinion and policy-makers as a driving force (Colli, 2013).

One of the dominant research topics in family business phenomenon is the diffusion of performance measurement systems, also in terms of a comparison between FFs and non family firms (NFFs).

Despite the fact that performance measurement systems are critical issues for the literature about family business, this topic has been largely overlooked by researchers, with few exceptions.

For this reason, as suggested by Songini et al. (2013), our main aim is to investigate the use of performance measurement systems within a sample of Italian companies operating in different sectors. In particular, the goal is to analyze the diffusion of advanced management control systems within a sample of FFs and to compare the results achieved with a sample of NFFs.

We consider this issue relevant both for the literature and for practitioners, especially in a context characterised by economic crisis. We have observed a gap in current frameworks concerning the role of performance measurement systems, in particular about the use of the strategic planning and management control systems (Songini et al., 2013). In addition, our contribution is also in terms of the analysis of the state of the art of advanced management control systems by comparing FFs and NFFs.

This topic is fundamental because appropriate managerial tools are relevant in supporting decision-making processes, especially for the improvements and growth of firms in the actual turbulent international scenario.

In this article, we first conducted the analysis of the theoretical background concerning FFs, drawing particular attention to the main issues of our paper. In the second section, we outlined our research method, while in the third and fourth section, the findings and the discussion of the results are presented. Finally, conclusions of the study are given, along with the limitations of the research.

2. LITERATURE REVIEW

Family businesses phenomenon

The FFs topic is significant in Europe, as the family businesses phenomenon is widely present and "the context is characterized by high ownership concentration and the presence of family groups that remain in control of a significant number of firms, in contrast to the less amenable American market" (Garcìa-Ramos and Garcìa-Olalla, 2011).

It is not easy to define a "family firm", also due to persistent ambiguities in literature and the complexity of the family businesses phenomenon (Hoy and Verser, 1994). These difficulties are also due to different criteria used to classify FFs. In particular, when considering the criterion of ownership and control, a FF is a company in which:

- "significant voting rights or ownership is controlled by a member or members of a single family" (Barnes and Herson, 1976);
- the largest group of shareholders in a firm is a specific family, and the stake of that family is higher than either a 10% or 20% control of voting shares (Morck and Yeung, 2004);
- capital shares are owned by a single family (Alcorn, 1982; Lansberg et al., 1988);
- one or more families having kinship or similar ties are the owners of the full risk contributed capital (Corbetta and Dematté, 1993);
- a firm governed and/or managed on a sustainable, potentially cross-generational basis to shape and perhaps pursue the formal or implicit vision held by members of the same family or of a small number of families (Chua et al., 1999);
- a family member has some identifiable ownership share of the company and multiple generations of family members have leading positions within the company (Zahra et al., 2004).

Some researchers defined FFs using a mix of criteria related to ownership and control (Smyrnios et al., 1998). According to these studies, a FF is a company in which (Chua et al., 1999): i) at least 50 per cent of the shares are owned by the family, and the family is responsible for the management of the company, ii) or at least 50 per cent of the shares are owned by the family, the company is not family-run, but the CEO perceives it as a FF, iii) or family ownership is less than 50 per cent, the company is family-run, the CEO perceives it as a FF, and a venture capital or investment company owns at least 50 per cent of the shares (Culasso et al., 2013).

Despite the issue about FFs definition, it is important to underline that there are some characteristics that distinguish FFs from NFFs such as the desire of FFs to preserve the family's socioemotional wealth and the pursuit of nonfinancial outcomes (Gomez-Mejia et al., 2011), a paternalistic relationship in FFs between the owners/managers and employees (Bertrand and Schoar, 2006), a clan cultures in FFs in which employees are hired for the long-run and treated generously (Miller and Le Breton-Miller, 2005) and a priority given to family members in top management and other sensitive positions (Bertrand and Schoar, 2006).

Management Control Systems

Management Control Systems (MCSs) are "the formal, information-based routines and procedures used by managers to maintain or alter patterns in organizational activities" (Simons, 2000). In this way, the control is a policy that facilitates an organization to ensure that its goals are reached.

Referring to Chenhall (2003), MCSs could include several parts: i) Management Accounting (MA), that is usually referred to accounting tools, such as budgeting, cost accounting and financial reporting; ii) Management Accounting Systems (MASs), thanks to which MA tools are used to achieve some goals in the company; and iii) Organizational Controls (OCs), which are referred to the control of the company activities, individuals or business culture, to achieve some company goals.

According to Simons (1990) MCS includes: i) management accounting systems; ii) budgetary practices; iii) performance measurement systems; iv) project management systems; v) planning systems; vi) reporting systems.

These managerial systems are useful to provide information for managerial decision-making, planning, monitoring and evaluation of organizational results (Merchant and Otley, 2007).

Some researchers underline how MCSs are indispensable to support both the implementation and the monitoring of the deliberated top-down strategies in a firm and to verify the reached performance level (Brusa, 2012; Bruining, Bonnet and Wright, 2004; Henri, 2006; Kober, Ng, and Paul, 2007; Langfield-Smith, 1997; Simons, 1990).

Another relevant issue on MCSs is the diffusion of managerial systems within companies, through the adoption and the implementation of management accounting and control tools (Anthony, 1956).

Researches stated that companies do not uniformly adopt managerial control systems, and management control technical structure is influenced by internal and external firm characteristics (Chenhall, 2003; Otley, 1980).

In literature there is a strong debate on the diffusion of MCSs, even if without unanimous conclusion, particularly focusing on the causes of implementation managerial control systems within companies (Chenhall, 2003; Luft and Shields, 2003). Indeed, many researchers identify different factors that impact on the diffusion of MCSs: environmental factors, such as national culture (Ciambotti, 2001) or industry features (Otley, 1980), and internal firms characteristics, such as size, complexity, technology, organizational structure, strategy or internal culture (Chenhall, 2003).

Management Control Systems in FFs and NFFs

Studies about family businesses mainly focus on organisational structures and the decision-making process (Gubitta and Giannecchini, 2002; Songini, 2007), corporate governance (Corbetta et al., 2002a; Montemerlo, 2000), second and third generational succession (Corbetta et al., 2002b; Montemerlo, 2010; Zocchi, 2004a; 2004b), international development (Stampacchia et al., 2008) and performance (Culasso et al., 2013; Faccio et al., 2001). In the literature, some studies also focus on the difference between the performance of FFs led or not led by their founders (Adams et al., 2003; Barontini and Caprio, 2006; Cucculelli and Micucci, 2008; Garcìa-Ramos and Garcìa-Olalla, 2011; Villalonga and Amit, 2004; 2006). Other researchers analyzed the performances achieved by FFs that reached the second or third generation, observing a destruction of values (Pérez-Gonzàlez et al., 2007; Villalonga and Amit, 2006).

Studies about MCSs focus especially on the role of these systems in strategy formulation and implementation (Bruining, Bonnet, & Wright, 2004; Henri, 2006; Kober, Ng, & Paul, 2007; Langfield-Smith, 1997; Simons, 1990). Songini et al. (2013) stated that managerial accounting systems represents an area in FFs that requires increasing attention from accounting scholars and necessitate to study in deep "why has accounting, representing one of the oldest business disciplines, only recently started to consider family business, representing the majority of business organizations around the world, as a relevant research context". Three main reasons were identified (Broccardo et al., in press):

- about the theoretical frameworks used in the accounting discipline: they are in part different from those used in the family business studies. Indeed, accounting scholars are more interested in accounting generalizations, principles and mechanisms, than in specific empirical contexts;
- about the different developmental levels of the two disciplines: family businesses phenomenon is a young field. Consequently, it may not have yet attracted a great number of accounting scholars;
- about the contingency approach: the accounting disciplines mainly focus on publicly listed companies, where agency conflicts prevail.

As it emerges, the literature about FFs did not focus on the implementation of MCSs in these kind of firms and, at the same time, researches about MCSs did not consider the relationships with the family businesses. Consequently, this paper tries to fill this gap, also underlined by other scholars (Acquaah, 2013, Songini et al., 2013). In particular, it aims to analyse the diffusion of advanced management control tools in the Italian FFs and NFFs, exploring the influence of the family variable on MCSs.

3. METHODOLOGY

The research methodology was structured around an empirical analysis. We used the tool of the questionnaire, randomly selecting companies operating in the Piedmont area, located in the North-West of Italy. We used a mixed approach, both qualitative, thanks to the analysis of the empirical evidence, and quantitative, measuring information.

About the questionnaire, it was composed of quantitative and qualitative data, managed by a software called Monkey Survey. The answers have been analysed using statistical tools. The questionnaire allows the collection of a significant amount of data, useful for statistical analysis and to draw up generalizations (Zimmerman, 2001). This questionnaire was created in June 2014 and sent to the companies in the months of July, August and September 2014. The questionnaire was structured in two sections:

- the first section focused on general information on the companies (corporate name, legal form, year of foundation, economic sector, number of employees, revenues, and the distinction between FFs and NFFs);
- the second section containing information on the use of the management control tools, distinguished between traditional tools as Budget, Financial Statement Analysis by ratios, Accounting cost centres, and the so-called advanced tools as Balanced Scorecard, Benchmarking, and Balanced Scorecard integrated with risk indicators.

The sample

The sample is composed of Italian medium companies, with the registered office in the North West of Italy and operating in different economic sectors. Firstly, 3.901 companies were included the original sample; secondly, we made a random and casual section, obtaining 1.800 companies to which send the questionnaire. The final sample was composed of 309 Italian companies, due to the response rate of 18%, in line with the main literature (Lucianetti, 2006) (Table 1).

Table 1. Characteristics of the sample

Economic sectors	**(%)**
Manufacturing	60.28
Services	22.76
Trade	8.48
Transport	4.02
Building and construction	4.02
Agriculture	0.44
Total	100
Dimensional features	**(%)**
Revenues between 5-10 mln €	43.10
Revenues between 10-20 mln €	29.60
Revenues between 20-50 mln €	27.30
Total	100

Thanks to the questionnaire, we made a distinction between FFs and NFFs. We asked the companies to indicate if they were FFs or NFFs, following a specific criterion explicated in the Guide of the questionnaire. The criterion used was a mix one (Chua et al., 1999), that is:

- a control participation in the capital by the family/ies; and
- the presence in the Board of at least one family member.

Then, we distinguished the sample in FFs and NFFs. A comparison between FFs and NFFs in the questionnaire findings allowed us to identify the features and characteristics on the paper topic.

Considering the 276 companies that answered to this question, 47,8% of them declared to be a FF (Table 2).

Table 2. The sample

Answer Options	Response Percent	Response Count
FFs	47.8%	132
NFFs	52.2%	144
	answered question	276
	skipped question	33

Research questions

The main research questions are following formulated. In particular, the management control tools investigated within the sample are both the traditional tools as Budget, Financial Statement Analysis by ratios, Accounting cost centres and the so called "advanced" tools as Balanced Scorecard, Benchmarking, and Balanced Scorecard integrated with risk indicators:

RQ1: What are the main management control tools adopted in the sample analysed?

RQ2: What is the diffusion of advanced management control tools in the Italian FFs and NFFs?

To understand the general context, the first research question focuses on the total sample, without considering the distinction between FFs and NFFs, made only in the second step.

4. FINDINGS

As regard the RQ1, "*What are the main management control tools adopted in the sample analysed?",* we collected the following data with the questionnaire.

First of all it emerges that the 84,50% of the sample adopts some management control tools, and only the 15,20% affirms that in the company they are not present (Table 3).

Table 3. Management control tools Adoption

Does the company adopt management control tools?		
Answer Options	Response Percent	Response Count
Yes	84,8%	190
No	15,2%	34
	answered question	224
	skipped question	85

As regards the management control tools adopted by the analysed companies, it emerges that the more widespread are: Budget (78,8%), Financial Statement Analysis by ratios (72,7%) and Accounting cost centres (63,6%), underling how the traditional tools are the most implemented by these firms. More useful tools to better plan the strategic goals, the so-called "advanced" tools, are not particularly used by the analysed companies: Balanced Scorecard (15,2%), Benchmarking (13,6%) and Balanced Scorecard integrated with risk indicator (1%) (Table 4).

Table 4. Management Control tools

What are the management control tools adopted?		
Answer Options	Response Percent	Response Count
Activity Based Costing	20,7%	41
Variance analysis	44,9%	89
Ratio Analysis (ROE, ROI, ROS, etc.)	72,7%	144
Balanced Scorecard	15,2%	30
Balanced Scorecard integrated with risk indicator	1,0%	2
Benchmarking	13,6%	27
Budget	78,8%	156
Co-design	3,0%	6
Simplified analytical accounting (without cost centres)	21,2%	42
Accounting cost centres	63,6%	126
Customers satisfaction ratio	25,3%	50
Productivity ratio	40,9%	81
Strategy Map	0,0%	0
Boston Consulting Group Matrix	0,5%	1
Process costing	3,0%	6
ERP systems	30,3%	60
Target costing	7,6%	15
Others	5,1%	10
	answered question	198
	skipped question	111

As it emerged analysing the kind of tools adopted, the diffusion of advanced management control systems is not particularly significant (Table 5). Indeed, the "advanced" tools (Balanced Scorecard, Strategy Map and more in general business performance models), that represent the tools more able to consider the long time perspective, are adopted only by 16% of the sample.

Table 5. Diffusion of management control systems

Management control systems	Frequency	Percentage	Cumulative percentage
None	7	4%	4%
Basic	64	34%	38%
Relevant	87	46%	84%
Advanced	31	16%	100%
Total	189	100%	

Starting from the achieved results, we investigate about the impact of the family variable on the diffusion of advanced management control tools. In this way it is possible to observe if the family members allow or not the evolution of the advanced tools.

Analysing RQ2 "*What is the diffusion of advanced management control tools in the Italian FFs and NFFs?*" it emerges, at this stage not yet distinguishing between traditional and advanced tools, that in the FFs the management control tools are less widespread.

Table 6. Management control tools Adoption in FF and NFF

Does the company adopt management control tools?				
Answer Options	**FF**		**NFF**	
	Response Percent	Response Count	Response Percent	Response Count
yes	79,6%	78	89,7%	104
no	20,4%	20	10,3%	12
	answered question	98		116
	skipped question	34		28

The previous exhibit shows that the diffusion of management control tools in FFs is 79,6% compared to NFFs that is 89,7% (Table 6).

Deeping the analysis on management control tools adopted by FFs and NFFs it emerges that the most widespread in FFs is the Financial Statement Analysis by ratios (74,7%), while in the NFFs is the Budget (85,8%) (Table 7).

Table 7. Management Control tools in FF and NFF

What are the management control tools adopted?				
Answer Options	**FF**		**NFF**	
	Response Percent	Response Count	Response Percent	Response Count
Activity Based Costing	19,3%	16	19,8%	21
Variance analysis	41,0%	34	50,0%	53
Ratio Analysis (ROE, ROI, ROS, etc.)	74,7%	62	71,7%	76
Balanced Scorecard	10,8%	9	17,9%	19
Balanced Scorecard integrated with risk indicator	2,4%	2	0,0%	0
Benchmarking	10,8%	9	16,0%	17
Budget	69,9%	58	85,8%	91
Co-design	3,6%	3	2,8%	3
Simplified analytical accounting (without cost centres)	22,9%	19	18,9%	20
Accounting cost centres	60,2%	50	66,0%	70
Customers satisfaction ratio	28,9%	24	21,7%	23
Productivity ratio	38,6%	32	42,5%	45
Strategy Map	0,0%	0	0,0%	0
Boston Consulting Group Matrix	1,2%	1	0,0%	0
Process costing	4,8%	4	1,9%	2
ERP systems	36,1%	30	24,5%	26
Target costing	6,0%	5	8,5%	9
Others	4,8%	4	2,8%	3
answered question		83		106
skipped question		49		38

Observing the sample of FFs, it emerges that the most used tools in the management process is the ratio analysis. However, the ratio analysis, if not properly linked to other managerial systems, cannot be considered as a planning and control tool, but only a financial accounting tool. Analysing the ranking of the most adopted management control tools by FFs and NFFs, it is evident that, until the sixth place, there is no trace of advanced tools (Table 8).

Table 8. Ranking in FF and NFF

Management control tools - Ranking		
	FF	**NFF**
1°	Ratio Analysis (74,7%)	Budget (85,8%)
2°	Budget (69,9%)	Ratio Analysis (71,7%)
3°	Accounting cost centres (60,2%)	Accounting cost centres (66,0%)
4°	Variance analysis (41%)	Variance analysis (50%)
5°	Productivity ratio (38,6%)	Productivity ratio (42,5%)
6°	ERP systems (36,1%)	ERP systems (24,5%)

Observing the characteristics of management control tools implemented, replying firms are divided into four classes (Table 9):

- "None", if companies don't adopt management control systems, or use only financial accounting, economic and financial measures or simple cost accounting;
- "Basic", if companies only have basic management control systems, such as budget, variance analysis, cost centres accounting;
- "Relevant", if companies declared to adopt, in addition to the systems of previous classes, at least one of the following: ABC/ABM systems, benchmarking, non-financial indicators, target costing;
- "Advanced", if companies are characterized by advanced management control systems, such as business performance models (Balanced Scorecard, strategy map), strategic plans, Boston Consulting Group, as well as systems of previous classes.

Advanced management control systems are implemented only by the 14% of FFs, compared to NFFs where the percentage is 18%. NFF shows a higher percentage (+4%), even if this is not so significant. However, the tools classified "Relevant" show a good diffusion both in FFs (43%) and in NFFs (48%) (Table 10).

Table 10. Diffusion of management control systems – FFs and NFFs

	FFs			**NFFs**		
Management control systems	**Frequency**	**Percentage**	**Cumulative percentage**	**Frequency**	**Percentage**	**Cumulative percentage**
None	6	7%	7%	1	1%	1%
Basic	29	35%	42%	35	33%	34%
Relevant	36	43%	86%	51	48%	82%
Advanced	12	14%	100%	19	18%	100%
Total	83	100%		106	100%	

5. DISCUSSION AND CONCLUSIONS

MCSs represents a topic, in which FFs requires an increasing attention from scholars. Indeed, it's very important to understand how these tools could help family businesses to improve their management.

The analysis of the general context evidences a low diffusion of advanced management control tools, showing that the most widespread tools are the traditional ones: Budget (78,8%) and Ratio analysis (72,7%). This result is confirmed also within the two groups of companies analysed, FFs and NFFs, even if some different peculiarities are underlined.

First of all the diffusion of investigated tools is higher in NFFs (89,7%) than in FFs (79,6%), showing a variance of +10,1%. More precisely, the findings show that the most implemented tool in NFFs is the Budget (85,8%), while in FFs is the ratio analysis (74,7%); however it is important to underline that the ratio analysis, if not properly linked to other managerial systems, cannot be considered as a planning and control tool, but only a financial accounting tool.

Observing the ranking of the most implemented tools in FFs and NFFs, it also emerges that the advanced tools are not present. Analyzing the frequency of the use of the advanced tools, we discover that NFFs adopt the 18% of this one, compared to the 14% of FFs, showing a not significant variance (+4%).

Deeping the effect of the family variable, it immediately appears that in FFs the management control tools are less widespread than in NFF, underlining as the influence of MCSs is contingent on whether the firm is a FF or a NFF (Acquaah, 2013).

In addition, in the analysed FFs, the most widespread tool is yet the financial statement analysis by ratio, a financial tool and not properly a management control tool, while in NFFs the most widespread is at least the budget.

FFs are usually characterized by a lower diffusion of managerial mechanisms, because of widespread entrepreneurship, and strong linkages between the family and the enterprise (Songini et al., 2013). We strengthened the assumptions of Songini et al. (2013), who observed a gap in current frameworks concerning the role of performance measurement systems, in particular about the use of the strategic planning and management control systems.

This previous affirmation is also confirmed by the analysis of the advanced tools adoption, which shows that in NFFs the advanced tools, as business performance models, are more implemented, even if the variance between FFs and NFFs is not so significant.

The paper can have some theoretical implications, as it can be considered as a development in the research studies of the family business management. In particular, it contributes to the literature concerning the role of the performance measurement systems in FFs compared to NFFs.

This study has some limitations that could be exceeded with future developments, such as the analysis of how the use of formal management controls, incentives and information systems to formulate and implement strategy can affect performances.

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STRATEGIC RISK MANAGEMENT FOR ENHANCED CORPORATE GOVERNANCE

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Abstract

The purpose of this research is to develop and apply risk management procedures to enhance corporate governance, using examples of Chinese company investments. Strategy and risk should be considered together by management and boards of directors as they need to know what risks are embedded in potential or approved strategies. Strategy and risk are linked and may be viewed as two sides of the same coin. One of the fastest ways to massive value destruction is to undertake a strategy without a thorough consideration of the related risks. Well-known financial fraud prediction models and ratios are applied to an ongoing, possible fraudulent Chinese company. They generated numerous red flags for possible fraudulent financial reporting, using one and two standard deviation measurements for risk assessment. This paper finds potential international equity and debt investment destruction of $12.9 billion for this one company and $34.5 billion when this company's investment losses are combined with three other ongoing possible Chinese fraud companies. In summary, a risk management approach for enhanced corporate governance is developed and applied to the strategy of international investing. A case study is used to demonstrate both a macro-economic risk assessment of an investment target country and a micro-economic risk assessment of an investment target company, using fraud models and ratios.

Keywords: Risk Management, International Investing Strategy, Corporate Governance

1. INTRODUCTION

Strategy and risk should be considered together as management and boards of directors need to know what risks are embedded in specific strategies. Boards of directors have an important and critical role to play in overseeing strategic and risk issues since businesses take risks for possible rewards. Management and boards of directors have to decide strategically what the proper level of risk is for a company and what the company's appetite for risk is (Vollmer, 2015). Strategy and risk are linked and may be viewed as two sides of the same coin. One of the fastest ways to massive value destruction is to undertake a strategy without a thorough consideration of the related risks. For example, The U.S. Securities and Exchange Commission (SEC) claimed that bad risk management by U.S. companies cost the United States $13 trillion from the financial crisis in 2007 through 2009. The SEC attempted to alleviate this problem in March 2010 by mandating board risk oversight and related disclosures for enterprise risk management of U.S. publicly-held companies (Walker et.al, 2015). There is also the international ISO 31000 Risk Management standard which has processes for risk identification, risk analysis, and risk evaluation (McNally and Tophoff, 2015).

The Financial Crisis Inquiry Commission (Commission) was appointed by the U.S. government to investigate the causes of the financial crisis of 2007-2010. Citing dramatic breakdowns in risk management, the Commission provided the following examples. Citigroup executives conceded that they paid little attention to investment risks in Citi's mortgage-backed securities. American International Group (AIG) executives were blind to their $79 billion risk exposure in AIG's credit-default swaps. Merrill Lynch managers were surprised when seemingly secure mortgage investments suddenly suffered huge losses. Such investment speculations were aided by a giant "shadow banking system" in which U.S. banks relied heavily on short-term debt, often undisclosed. For example, Lehman Brothers hid $50 billion of short-term loans off its books (Dutta et. al, 2010). The Commission concluded: "when the housing and mortgage markets cratered, the lack of transparency, the extraordinary debt loads, the short-term loans, and the risky assets all came home to roost" (Chan, 2011).

The tipping point for the financial crisis was generally acknowledged to be the Fall, 2008 bankruptcy of Lehman Brothers. Risk management was very weak at Lehman Brothers as indicated by its ineffective risk management committee (Grove and Patelli, 2013). Lehman Brothers' risk committee had only two meetings in 2006 and 2007 before the company went bankrupt in 2008. The chairman of the risk management committee was an 80 year-old retired banker who had little experience or competence with the bank's newer financial instruments, such as credit default swaps and mortgage backed securities. Such competence issues also existed for the other four members of this risk management committee: a 73 year-old, retired chairman of IBM, a 77 year-old, retired Broadway producer, a 60 year-old, retired rear admiral of the U.S. Navy, and a 50 year-old, former

CEO of a Spanish language television network. A similar competence issue was raised about AIG's Board which included several heavyweight diplomats and admirals. Richard Breeden, former head of the SEC, observed: "AIG, as far as I know, didn't own any aircraft carriers and didn't have a seat in the United Nations" (Das, 2011).

A corporate government specialist concluded: "these boards had no idea about the risks these firms were taking on and relied on management to tell them" (Barr, 2008). Risk management at the major U.S. banks appeared to be very poor and contributed significantly to the U.S. financial crisis. The July 2010 Federal Financial Reform (Dodd-Frank) Act now requires risk committees for boards of financial institutions. Thus, there should be a mix of skills for board members, such as industry knowledge, experience, financial accounting expertise (required by the U.S. Sarbanes-Oxley Act), and risk management expertise (required by the U.S. Dodd-Frank Act).

There should be effective monitoring of risk without dependence on any corporate bailout financing which happened with the U.S. Taxpayers Assistance Relief Act of $700 billion in 2009 for the 19 largest U.S. banks. Warren Buffett commented on risk control: "I believe a CEO must not delegate risk control. It's simply too important. If Berkshire Hathaway ever gets in trouble, it will be my fault. It will not be because of misjudgments made by a Risk Committee or a Chief Risk Officer. In my view, a board of directors of a huge financial institution is derelict if it does not insist that its CEO bear full responsibility for risk control. If he's incapable of handling that job, he should look for other employment. And if he fails at it – with the government thereupon required to step in with funds or guarantees – the financial consequences for him and his board should be severe" (Buffett, 2009).

Recent examples of faulty risk management for investing include JPMorgan Chase which had a $6 billion trading loss by the company's international investment office, i.e., the "London Whale" loss, and the sudden liquidation of UBS's $500 million Willow Fund, a closed-end investment fund. The UBS portfolio manager changed his investment strategy from distressed corporate debt instruments to international derivatives with risky bets against the debt of European nations. The fund's independent directors did nothing and investors learned the hard way that a fund's directors cannot be relied upon to protect investors from a fund manager's risky bets and, thus, board directors often disappoint by what they do not do, especially concerning risk management (Morgenson, 2013). Another example of the dangers of a high risk/high reward investing strategy occurred in December, 2015. The Third Avenue Focused Credit Fund, which invested in junk bonds and distressed debt, announced that it will liquidate as its assets decreased from $2.4 billion to $789 million just in 2015. Consequently, it has blocked its investors from withdrawing their money (Damato, Maxey, and Wirz, 2015). This paper develops and applies risk management procedures to the strategy of international investing with Chinese company examples.

2. INTERNATIONAL INVESTMENT STRATEGY AND RISK FOR CHINA OPPORTUNITIES

An investment strategy in Chinese companies has looked attractive since the Chinese economy had double-digit growth in the last decade and there is a potential market of 1.3 billion consumers. Since international investors have restricted access to Chinese stock markets, there were three waves of Chinese companies listing on U.S. stock exchanges in the last decade. The first two waves were the largest and well know Chinese companies, many of which were state owned enterprises. They were generally successful, as opposed to the third wave of about 500 small, private companies in the 2005-2010 period. 100 were delisted from U.S. stock exchanges in 2011-2012, destroying $40 billion in stock market value (McKinsey & Company, 2013).

International private equity funds and other international investors have still been investing in Chinese company stocks and bonds. Recently, large international mutual funds have been searching for higher yields and have been turning to international bonds issued by Chinese companies. They have been attracted to the higher interest rates being offered by Chinese companies. Chinese bonds recently offered a 9.36% yield, compared to 7.32% for Asian high-yield bonds. The current yield for U.S. bonds is 5.88% and 3.93% for bonds in the European Union (Li, 2015).

Since strategy and risk should be considered together in order to know what risks are embedded in potential or approved strategies, one has to ask: was the risk of international investing in Chinese companies really considered by such sophisticated investors, management, and boards of directors? For example, there is a valid reason that high yield bonds are called junk bonds! A "two-pronged" risk management assessment is advocated here for the strategy of any international investing, similar to the approach of private equity funds which have about $4 trillion globally to invest (Miller, 2015). First, the macro-economic risk of an overall economy (or industry sector) is investigated (China in this paper, especially with the issue of Chinese ghost cities helping to drive its recent double digit, economic growth rates). Accordingly, before any specific company investments should be considered, one should consider how the overall economy (or industry sector) is performing. Second, the micro-economic risk of investing in specific companies is assessed. A specific example of stock and bond investments in a Chinese property developer, Kaisa, is analyzed in this paper, as this company is in the same industry as the Chinese ghost city developers.

3. MACRO-ECONOMIC RISK: CHINESE ECONOMY AND GHOST CITIES

"China is the only country in the world that knows its GDP growth rate for the upcoming year on the first day of the year," observed Jim Chanos, the founder of a hedge fund now worth $3 billion after being one of the first analysts to short Enron, Tyco, and financial companies involved in the 2008 financial crisis. He commented: "In China's GDP calculations, they don't look at final sales, they look at production. So a condo being built but not sold contributes to GDP" (Tymkiw, 2012). Chanos has been bearish on China since 2009 when he and his team at his firm, Kynikos Associates, which has over $1 billion under global investment management, were analyzing commodity prices and the stocks of large mining companies. Chanos said: "Everything we did in our microwork on commodities kept leading us back to China's property market. China's construction boom was driving demand for nearly every basic material. By 2009 in the midst of a global recession, China was building almost 30 billion square feet of new residential and office construction. There are 1.3 billion people in China. In terms of new office space alone, that amounts to about a five-by-five-foot cubicle for every man, woman, and child in the country. That's when it dawned on me that China was embarking on something unprecedented" (Olster, 2010). In 2011, an Australian business reporter visited some of China's most infamous ghost cities and malls and wrote a report that broke this ghost city story internationally (Badkar, 2013).

Similarly, a "60 Minutes" U.S. television report in 2013 observed: "We discovered that the most populated nation on Earth is building houses, districts and cities with no one in them…desolate condos and vacant subdivisions uninhabited for miles and miles and miles and miles" (Belvedere, 2013). This same "60 Minutes" report interviewed the CEO of the largest Chinese real estate developer who said many developers are deep in debt, projects are being abandoned, and there could be a nightmare scenario like America's housing crash but worse (Lubin and Badkar, 2013). A 2014 report estimated that there were 11 major ghost cities in China but the Chinese government has told a Chinese reporter to "quit being a troublemaker" and cease doing ghost city investigations (Duffy, 2014).

In China, fixed asset investment accounted for more than 50% of China's overall Gross Domestic Product (GDP) in 2014 with just the property market accounting for about 20% of GDP (Liang, 2014). No other major economy even comes close. Of the Chinese fixed investment, about one-quarter is attributable to new real estate investment, and new property sales accounted for 14% of GDP in 2009. Bearish investors on China, like Chanos, question why there are so many apartments and villas that have been bought and paid for but remain empty. Vacancy rates for homes constructed in the past five years are at 15% but are projected to rise to over 20% in 2016-2017 (Badkar, 2014)

This ghost city phenomenon in China is facilitated by how local governments are forced to finance themselves. They are in a perpetual cash squeeze since they have to give the majority of their tax revenue to the central government which often forces them to build infrastructure projects without any central funding. Since the Communist Party owns all the land in China, local governments often seize land from their poorest residents for a small payment and then sell the land to developers for a much larger price which increases their GDP figures and chances of promotion within the Communist Party (Badkar, 2014).

Full-year 2014 GDP growth for the Chinese economy was only 7.4%, the slowest pace in over two decades. The real estate market has slumped, dragging down the rest of the Chinese economy (Barboza, 2015). United Bank of Switzerland (UBS, 2015) predicted that investment growth will not turn around and Chinese GDP growth will only be 7% in 2015. UBS recommended that investors stay selective in the Chinese property sectors and focus on developers with a strong focus on tier-1 and tier-2 cities (the largest cities) because high inventory pressure still persists in tier-3 and tier-4 cities (where the ghost cities exist).

4. MICRO-ECONOMIC RISK: KAISA, A CHINESE PROPERTY DEVELOPER

The following micro-economic risk analysis focuses upon a specific company, Kaisa, a Chinese property developer, which had raised over $3.2 billion of capital by 2012. Kaisa is located in Shenzhen, China but incorporated with limited liability in the Cayman Islands. In 2007, Credit Suisse brokered a $300 million equity investment deal with two international private equity funds, the Carlyle Group and the Temasek Holdings. In 2009, Kaisa raised $450 million with an initial public offering (IPO) on the Hong Kong stock exchange, led by the Bank of China International and Credit Suisse with an unqualified audit opinion by PWC Hong Kong, its ongoing auditor. From 2009-2012, Kaisa raised $2.5 billion in debt investments from over two dozen foreign fund investors, including BlackRock, Fidelity Investments, Lion Global Investors, and JPMorgan Asset Management (Barboza, 2015). These global bond offerings were led by Citigroup, JPMorgan Chase and Credit Suisse. There should have been many due diligence investigations of Kaisa by these investment banks, auditors, and international investors: private equity funds, IPO stock investors, and mutual fund bond investors.

However, by April 2015, Kaisa was on the verge of bankruptcy and all these investments were in danger of being lost. A lawyer representing some Kaisa bondholders commented: "Many investors are shocked at what happened. It's troubling that in a market as sophisticated as this, no one knew what was going on" (Barboza, 2015). One has to ask: where was the risk management analysis for all these international investment strategies?

A key contribution to risk management analysis could have been a Moody's Investment Service Report, "Red Flags for Emerging-Market Companies: A Focus on China," published July 11, 2011 (Moody's, 2011). It analyzed 20 potential red flags, grouped into five categories, for non-financial Chinese companies issuing corporate debt: 1) Possible weaknesses in corporate governance, 2) Riskier or more opaque business models, 3) Fast-growing-business strategies, 4) Poor quality of earnings or cash flow, and 5) Concerns over auditors and quality of financial statements.

Chinese authorities are sensitive to criticism of corporate governance and these other issues, concerning these Chinese companies, which could reduce their appeal for offshore debt investors. Moody's was fined $3 million by the government watchdog agency for Hong Kong markets in 2011 after this report was published. Kaisa raised 7 of Moody's 20 red flags (35%), compared to the average of 5.7 red flags (28.5%) for the 26 Chinese property developers in Moody's report (Whitfield, 2015).

A further risk for offshore debt investors is a lack of investment security, due to Chinese restrictions on foreign currency borrowing which prevent private companies from borrowing directly from foreigners. To work around this restriction, Chinese companies create offshore subsidiaries that issue debt, then invest these funds in their domestic parent as equity. Thus, offshore bondholders are subordinate to onshore lenders, trade creditors, and potentially mainland equity holders. They would also be excluded from any onshore bankruptcy proceedings. They may be able to take control of an offshore holding company but they have no direct security over the underlying onshore assets. Accordingly in early 2015, Deloitte Touche Tohmatsu warned Kaisa's offshore bondholders that they would be effectively wiped out if Kaisa was forced into liquidation (Whitfield, 2015).

5. RISK MANAGEMENT OVERVIEW AND GUIDELINES

A definition of risk management is provided by Coleman (2011): "Risk management is the art of using lessons from the past to mitigate misfortune and exploit future opportunities—in other words, the art of avoiding the stupid mistakes of yesterday while recognizing that nature can always create new ways for things to go wrong. Thus, risk management is about much more than numbers; it is the art of using numbers and quantitative tools to actually manage risk. Risk is a central, maybe the central, component of managing a financial organization." In assessing the overall risk of a company, Coleman focused on the variability of profits and losses (P&L) which provides a risk framework for levels of the firm from individual managers up through the board of directors if calculated and reported on a consistent basis. He observed that managing risk requires being comfortable with uncertainty and randomness and thinking probabilistically. He argued that such an approach requires quantitative analysis for understanding and dealing with uncertainty, especially to inform, guide, and correct intuition. Thus, risk managers and boards of directors' risk committees should be asking how good the quantitative tools are and how useful the quantitative analysis is, rather than focusing upon intuition (Coleman, 2011).

Coleman further argued that financial risk is all about money: profit and loss (P&L) and the variability of P&L. Future outcomes can be summarized by P&L and the uncertainty in P&L can be described by the distribution or density function which can map many possible outcomes of the profits or losses. For managing risk, the major contribution of a P&L distribution is an understanding of how variable the P&L can be. "When the P&L distribution is known, i.e., the possibilities of gains versus losses, when the generation of this distribution is known and what causes the gains and losses, then, virtually everything about financial risk is understood" (Coleman, 2011). The most important distribution aspect is the variability or the spread of the distribution. A common, well-known measure used to summarize the variability or the dispersion of the distribution is volatility, also known as the standard deviation. For most normal, well-behaved distributions, one standard deviation above and below the expected outcome indicates the result will be outside the range approximately 32% of the time. Two standard deviations above and below the expected outcome indicates the result will be outside the range approximately 5% of the time (Coleman, 2012).

One of the major goals of risk management is the avoidance of a significant surprise or an outcome other than what is expected. While surprises do happen, it is a large surprise, whether good or bad, that provides risk management problems. If the standard deviation of the distribution is known, then management and boards of directors' risk committees can predict the range of the outcomes with the best and worst possible values for both 68% and 95% confidence ranges. Knowing the end points of these ranges shows how good or how bad the outcome can be. An outcome outside of the 68% confidence range would be a surprise that could happen 32% of the time. An outcome outside of the 95% confidence range can only happen 5% of the time, but these surprises will be much better, or much worse, than the expected outcome. Management and boards of directors must know how much better or how much worse the outcome can be in order to plan responses to these large surprises.

Managing risk should be a core strategic competency for any international company as Coleman (2011) emphasized: "The ability to effectively manage risk is the single most important characteristic separating financial firms that are successful and survive over the long run from firms that are not successful. At successful firms, managing risk always has been and continues to be the responsibility of managers—from the board through the CEO and down to individual line managers." Volatility risk measures are backward looking, based upon historical performances but as Coleman (2011) observed: "Understanding the past is terribly important because understanding current exposures, and how they would have behaved in the past, is the first step toward managing the future." Since risk measurement techniques require expertise and experience to use properly, managers and boards of directors have a responsibility to understand their complex businesses and investments. Risk management techniques can try to put estimates around, but cannot properly represent, extreme or "black swan" surprise events. To enhance corporate governance, managers and boards of directors have to learn to live with such uncertainty and avoid a false sense of security.

6. RISK MANAGEMENT PROCEDURES

Coleman's risk focus is on the variability of profits and losses from the income statement. However, this narrow profitability focus is expanded in this paper to include a liquidity focus with the variability of operating cash flows from the statement of cash flows and a solvency focus with the variability of cash from the balance sheet. Thus, all three major financial statements can contribute to risk management procedures. These three initial risk management focuses are each expanded to assess additional volatility as follows. The net income profitably focus is expanded to consider the profit margin ratio. The operating cash flow liquidity focus is expanded to consider the quality of earnings ratio and the quality of revenues ratio. The quality of earnings is computed by dividing operating cash flows by net income. The quality of revenues is computed by dividing the cash collected from customers by revenues. The cutoff for a good result for both ratios is one or better, assessing whether accountants' accrual measures are being converted into cash (Schilit, 2003). These cutoffs follow the observation of many investment bankers: GAAP is CRAP, CASH is KING (Miller, 2015).

The cash solvency focus is expanded to consider the fixed charge coverage ratio, the Sloan accrual ratio, and the Altman bankruptcy model. The numerator in the fixed charge coverage ratio emphasizes free cash flow: Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) less capital expenditures less cash income taxes paid. The denominator emphasizes debt service: interest payments and debt repayments. The cutoff for adequate debt service is 1.15 per a private equity partner who looks at over one hundred possible acquisitions each year (Miller, 2015). Often, a typical bank loan covenant for such debt service is a more conservative 2.0. The Sloan accrual ratio numerator is net income less free cash flows which is computed as operating cash flows less capital expenditures. The Sloan denominator is average total assets and the cutoff is 0.10 where a result over this cutoff is a red flag (Robinson, 2007). The Altman bankruptcy model has the following overall cutoffs: below 1.8 is a bankruptcy prediction; 1.8 to 3.0 is a possible bankruptcy prediction and over 3.0 is a non-bankruptcy prediction (Altman and Hotchkiss, 2005).

An additional focus for possible earnings management or fraudulent financial reporting which can distort risk management procedures is still needed. A 2012 survey of 170 CFOs of U.S. public companies indicated a 20% possibility of earnings management up to a possible 10% distortion of earnings per share (Whitehouse, 2012). A 2013 McKinsey & Company report found that 100 small Chinese companies had been delisted from U.S. stock exchanges in 2011-2012 and destroyed over $40 billion in stock market value. Thus, two fraudulent financial reporting prediction models are also advocated for risk management. An "old fraud model" (Beneish, 1999) analyzed SEC investigations of U.S. public companies from 1982-1992 and has a -1.99 cutoff where a larger result is a red flag for fraudulent financial reporting (smaller negative or positive numbers). A "new fraud model" (Dechow et. al., 2007) analyzed SEC investigations from 1982-2006 and has a 1.00 cutoff where a larger result is also a fraud prediction.

7. RISK MANAGEMENT APPLICATION FOR CHINESE INVESTMENT STRATEGY

These eleven numbers, ratios, and models, advocated in this paper for risk management analyses, are now applied to Kaisa, a Chinese property developer, to demonstrate a micro-economic risk methodology. Eight years of income statements and balance sheets were available for Kaisa from 2006 to 2013. The 2014 financial statements have not yet been filed as of December 2015, pending resolution of negotiations with debt investors since a $23 million interest payment was missed in January 2015 (Law, 2015). Only six years of statements of cash flows were available from 2008-2013 and no common stock prices existed before the 2009 IPO. Thus, there were only five years of data to run various fraud models or ratios or the bankruptcy model. The volatility of all eleven numbers, ratios, and models are provided in Table 1 for risk management of Kaisa. However, the only three Table 1 absolute numbers (net income, operating cash flows, and cash) were converted from millions of Chinese renminbi to millions of U.S. dollars at an average foreign exchange rate of $1 for 6 renminbi for ease of discussion.

Table 1. Risk Management Kaisa Applications

			Standard Deviation Ranges			
Metric	Average	Red Flag?	One: 68%*		Two: 95%	
		# of Years				
Net Income	261		53	468	-146	668
				3 of 8		
Profit Margin	17.1		13.7	20.5	10.4	23.7
				3 of 7		
Operating Cash Flow	-185		-493	123	-788	418
				2 of 6		
Quality of Earnings	-0.42	Yes	-1.47	0.62	-2.47	1.63
		5 of 5		1 of 5		
Quality of Revenues	0.98	Yes	0.78	1.19	0.59	1.38
		4 of 5		2 of 5		
Cash	541		181	900	-164	1255
				3 of 8		
Fixed Charge Cover	0.59	Yes	-0.20	1.38	-0.96	2.14
		7 0f 8		2 of 8		
Sloan Accrual	0.09	No	0.04	0.15	-0.02	0.21
		3 of 5		1 of 5		
Altman Bankruptcy	0.92	Yes	-0.04	1.88	-0.96	2.80
		4 of 5		1 of 5		
Old Fraud Model	-0.94	Yes	-2.61	0.73	-4.22	2.34
		4 of 5		2 of 5		
New Fraud Model	1.84	Yes	1.26	2.42	0.70	2.98
		5 of 5		2 of 5		

**Number of years outside range*

Kaisa's average net income of $261 million over eight years had a 68% confidence range of $53 million to $468 million over the 8 years. Kaisa had an average profit margin of 17.1%, after eliminating the 46.7% outlier in 2010. There was a 68% confidence range of 13.7% to 20.5% and a 95% confidence range of 10.4% to 23.7%. Such superior profit margins should be investigated with competitor comparisons to see "if the story may be too good to be true," especially the 46.7% outlier, as recommended by various short sellers (Left, 2011 and Bases et. al, 2011). Kaisa's average operating cash flow over the six available years was a negative $185 million with a 68% confidence range of a negative $493 million to a positive $123 million. Accordingly, this poor performance led to an average quality of earnings of a negative 0.42 with each of the five available years showing a red flag below the acceptable cutoff of a positive 1.0. Since the 0.98 average quality of revenues and four of the five years were just below the acceptable 1.0 cutoff, such possible red flags could be ignored here.

Kaisa's average cash balance over the eight available years was $541 million with a 68% confidence range of $181 million to $900 million. The two standard deviation confidence range (for a 95% probability) was a negative $164 million to a positive $1,255 million; so, a manager or board member would expect that 5% of the time, the cash balance would be outside this range and it was on June 30, 2014. Cash was reported as $1,383 million which was above the upper limit of $1,255 million with a 2.5% probability of being correct. The small possibility was validated by cash being only $306 million on March 1, 2015 (Yeoh, 2015) so what happened to $1,077 million or $1.077 billion cash in less than nine months? A huge red flag for risk management is indicated, similar to both Parmalat and Satyam where over $1 billion in cash at each company was also missing in their last set of reported financial statements before the frauds were discovered. Parmalat had made up a major Bank of America cash account and Satyam had falsified cash confirmations.

The fixed charge coverage ratio had a 0.59 average with seven of the eight years showing red flags below the cutoff of 1.15. The eighth year was below the more conservative cutoff of 2.0. The average Sloan accrual ratio of 0.09 (just below the 0.10 cutoff) did not show red flags in three of the five years. However, the Altman bankruptcy model had an average score of 0.92 with bankruptcy predictions or red flags in four of the five years in the 68% confidence range of -0.04 to 1.88. The fifth year fell into the bankruptcy uncertainty prediction range of 1.8 to 3.0.

Additional risk management red flags could be fraud predictions by both the new and old fraud models. Such predictions happened for Kaisa. The old fraud model had an average score of a negative 0.94 and four of the five years showed a red flag, well above the fraud prediction cutoff of a negative 1.99. The 68% confidence range of a negative 2.61 to a positive 0.73 had fraud predictions for three years with a fourth year above this range. The only non-fraud prediction year was -2.62 which was just below the -1.99 fraud cutoff. The more comprehensive new fraud model had an average prediction of 1.84 and each of the five years showed a red flag, well above the 1.0 fraud prediction cutoff. The 68% confidence range of 1.26 to 2.42 included three years with the other two years above this range.

Using the expected outcome and the standard deviation from each distribution, three additional important probabilities were calculated. To enhance corporate governance, management and boards of directors should be concerned about the possibility of having a negative value for net income, operating cash flow, and cash. The probability that net income will be less than 0 is only 10.38%. While the probability that cash will be negative is only 6.68%, a significant concern is that the probability of having a negative operating cash flow is a very large 72.57%.

Thus, there were plenty of red flags for additional risk management investigations by international managers, boards of directors, sophisticated investors, investment bankers, auditors, and other interested parties in the four areas of profitability, liquidity, solvency, and fraudulent financial reporting. There are many examples of such investigative procedures, like competitor comparisons and site visitations, by various short sellers and financial analysts who detected fraud in small Chinese companies listing on U.S. stock exchanges (Left, 2011; Norris, 2011; Bases et.al, 2011; Bishop, 2011; Gillis, 2011).

8. KAISA EPILOGUE

In a 2010 government investigation into a judicial corruption case, the Kaisa chairman confessed to paying a $130,000 bribe to a judge who confessed to receiving this bribe which allowed Kaisa to take over the Sinopec Tower business complex in a large southern China city. The judge is now serving a life sentence but the Kaisa chairman escaped punishment. A government news agency described this Sinopec Tower deal as "a miscarriage of justice by a manipulated judiciary" (Barboza, 2015). In 2014, Kaisa's chairman was again being questioned in connection with this 2010 corruption case and another fraud investigation.

On December 10, 2014, this Kaisa company chairman and Kaisa co-founder resigned, "due to health reasons." The Kaisa vice-chairman and the CFO also resigned in December and by March, 2015, 170 other senior Kaisa managers had also resigned (White, 2015). A financial press writer has commented: "Make Leaders Lead—wouldn't it be nice if executives acted like leaders and accepted responsibility for the actions of their companies and their employees?" (Morgenson, 2012). On December 21, 2014, Shenzhen authorities were investigating a city property official for corruption and prohibited Kaisa from selling its homes at several major residential developments. As a result, the Hong Kong stock exchange halted trading in Kaisa's common stock on December 29, 2014 until late in January, 2015. (This home sale prohibition was partially lifted in April, 2015.)

On January 1, 2015, Kaisa missed a $23 million payment on a $50 million loan from the British bank HSBC. On January 9, $115 million of Kaisa bank accounts were frozen by a court at the request of 15 Chinese financial companies and these accounts are under investigation by several banks (Law, 2015). On February 1, 2015, Kasia disclosed its long-term debt was $10.4 billion, twice the debt reported in the financial statements and the Kaisa CEO resigned. An analyst said that Kaisa had been borrowing through off-the-books affiliated companies to cover up this $5 billion missing debt, similar to the off-balance-sheet debt strategy of Enron ($25 billion), Parmalat or "Europe's Enron" ($10 billion) and Satyam or "Asia's Enron" ($5 billion).

On February 4, 2015, Sunac, another Chinese real estate developer, offered $580 million to acquire 49% of Kaisa but the offer was contingent on the Kaisa international debt investors agreeing to reduce ("haircut") their investments. Sunac estimated that these bond investors would receive 2.4 cents on the dollar if Kaisa went into bankruptcy. On March 3, 2015, Kaisa missed two more debt interest payments totaling $52 million. On March 21, 2015, Standard & Poor's (S&P) Rating Services downgraded Kaisa's credit rating to default ("D"), saying it does not expect Kaisa to be able to restructure both its onshore and offshore debt anytime soon (Jim, 2015). The Kaisa debt market value has swung from 30 cents to 68 cents on the dollar, depending upon the status of the negotiations and related events.

By the March 31, 2015 deadline, Kaisa failed to file its 2014 financial statements, saying its auditors needed more time to resolve financial reporting issues (especially the going concern, bankruptcy issue). Accordingly, trading of Kaisa common stock was again suspended on March 31, 2015. On April 12, 2015, both the former Kaisa chairman and vice-chairman were reinstated to try to save Kaisa from bankruptcy (Fung and Law, 2015). On April 20, 2015, Kaisa defaulted on $1 billion of its global bonds, becoming the first Chinese home builder to default on its U.S. currency debt (Barbosa, 2015). On May 27, 2015, Sunac withdrew its rescue buyout offer and one analyst said Kaisa cannot survive on its own without another "white knight" rescuer (Frangos, 2015).

On June 11, 2015, the Kaisa vice-chairman resigned and a new CEO was appointed (Yung and Fung, 2015). On June 18, 2015, the Sunac CEO told reporters that he had decided to terminate the Kaisa purchase because "the financial report provided by Kaisa showed its net asset per share was HK$4.5 and our offer was for HK$1.8. But after we started the due diligence on Kaisa, I found out its net asset per share was only zero" (Clare, 2015). On June 25, 2015, S&P discontinued its "D" rating for Kaisa, saying there was not sufficient or timely information available to assess Kaisa's credit quality, and commented: "Kaisa is unlikely to restore operations in the near term and it would be very difficult for Kaisa to regain the confidence of its customers and business partners after the default" (Reuters, 2015).

9. CONCLUSIONS

Kaisa is not an isolated example of a troubled Chinese company as of Fall, 2015. The following four significant Chinese companies, Kaisa Group Holdings, Tianhe Chemicals Group, Sihuan Pharmaceutical Holdings, and Superb Summit International Group, have five factors in common: 1) they did IPOs on the Hong Kong stock exchange in 2009, 2014, 2010, and 2001, respectively, 2) they failed to file their 2014 financial statements on time by March 31, 2015, 3) their auditors have yet to sign off on these financial statements, 4) they still have their shares suspended from trading on the Hong Kong stock exchange as of December, 2015, and 5) their chairman or CEO resigned in 2014 after negative financial news was reported on their companies. The only exception is Superb Summit, who did issue their 2014 financial statements on March 30, 2015, but with a warning about a going concern or possible bankruptcy issue, due to negative operating cash flows, in the opinion of its auditor, a local Hong Kong firm. Accordingly, the Superb Summit shares are still suspended from trading since November 21, 2014.

To date, these four Chinese companies have potentially destroyed $33.5 billion (US dollars) in international equity and debt investments as follows: Kaisa $12.9 billion, Tianhe $8.1 billion, Sihuan $9.9 billion, and Superb Summit $2.6 billion. In summary, one must ask: where were the company managers, the boards of directors, and sophisticated investors with risk management procedures for their various strategies? Once again, they disappointed by what they did not do, especially concerning strategic risk management for enhanced corporate governance (Morgenson, 2013).

In August, 2015, the global stock markets were in free-fall with extreme volatility and it seems that Jim Chanos, the billionaire short seller, who has been warning about a Chinese real estate bubble since 2009, has been vindicated. China is an important reason for such global stock market volatility. China's economy is faltering, its stock market is collapsing, and the inefficient efforts by government officials to prop up its stock market have led to a loss of confidence in China and its leaders which have spooked global stock markets (Nocera, 2015). Per a McKinsey & Company China report (2015): "China's debt rose from $7 trillion in 2007 to $28 trillion by mid-2014. At 282% of GDP, its debt share, while manageable, is larger than either the U.S. or Germany. Several factors are worrisome: half of the loans are linked directly or indirectly to China's real estate market, unregulated shadow banking accounts for nearly half of new lending, and the debt of many local governments is likely unsustainable." Per Ken Rogoff, a Harvard economics professor, who has long warned of a potential financial crisis in China: "Financial meltdown leads to a social meltdown, which leads to a political meltdown. That's the real fear" (Sorkin, 2015). Finally, Jim Chanos recently declared about China: "Whatever you think, it's worse" (Sorkin, 2015).

The need for increased risk assessment of an international investing strategy on both macro-economic and micro-economic levels can be dramatically summarized by the following two examples. On the macro-economic risk level, official measures of China's GDP and growth are inflated and do not jive with typical economic indicators used to assess possible dodgy economic statistics, such as freight shipments, passenger travel, electricity use, and property development (Morici 2015). For example, in December 2015, local Chinese officials in China's Northeast region admitted to faking economic growth data in the past few years to show high growth when the real numbers were much lower, such as 12% versus 6.3%

and 9.5% versus 2.7%. They said that they had overstated data ranging from fiscal revenue to household income to GDP (Williams 2015).

On the micro-economic risk level, there was the following legal defense of Chinese executives in another Chinese company fraud, Sino-Forest, which destroyed $6.9 billion in market capitalization. Their lawyers said that these executives never committed any fraud but were just following common business practices accepted in China. Such "common business practices" included faulty accounting standards that make questionable the assessment of true profitability for most public Chinese companies, which enabled bond ratings to be AA or AAA for 97% of Chinese companies versus 1.4% for U.S. companies (Yu 2014). Thus, there is a need for enhanced corporate governance by both management and boards of directors when assessing the risk of an international investing strategy.

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RELATIONSHIP BETWEEN CEO PAY AND TOTAL SHAREHOLDER RETURN: AN EMPIRICAL ANALYSIS IN THE ITALIAN CONTEXT

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Abstract

This study examines the relationship between CEO Pay and total shareholder return, using data between 2008-2014 from Italian listed firms (FTSE MIB). We perform panel data regression analysis of CEO compensation on financial performance, and in this way we refer to research made by Gigliotti (2013), but we extend it considering the Total Shareholder Return instead of accounting based performance. TSR has become a crucial measure in a pay-for-performance approach for different reasons. Our results indicate that there is not a significant relationship between CEO compensation and corporate performance during 2008-2014. These results contribute to our understanding of the pay for performance mechanism in times of financial disturbance, highly relevant to the existing debate considering CEO compensation.

Keywords: Executive Compensation, Firm Performance, Pay-For-Performance, Total Shareholder Returns, CEO Pay, Italian Context

1. INTRODUCTION

Executive compensation is a popular topic both in the press and scholarly literature, as it is one of the most important governance mechanisms to monitor, motivate and discipline firm managers.

From the economic recession held in 2008, a recurring debate occurs regarding whether top executives are over-paid or under-paid, as well as the best approaches to align the interests of top executives with those of the firm, stakeholders and shareholders.

As emphasized by Maloa (2014, 2015), a huge part of research focuses on how executive pay varies with performance. Given the prominence of the debate on executive compensation, it is possible to distinguish between scholars in economics and finance and scholars outside of these two disciplines. The former advocate for the primacy of market-based explanations, while the latter highlight the importance of the power of social-psychological processes and the institutional environment in the creation of compensation practices. Focusing on shareholder value creation led to the development of a number of indexes to measure it (Bistrova et al., 2013; Damodaran 2012; Koller et al., 2010). However, there are ongoing debates regarding which ratio is the best in measuring shareholder value creation and which, therefore, has a strong relationship with executive compensation. The main objective of this study is to narrow the gap and to contribute to the existing body of literature by investigating the relationship between CEO compensation and company performance of Italian companies. This paper aims at extending the research made by Gigliotti (2013) in the Italian context across a wide variety of industries and in a longer time frame, investigating the relationship between executive pay and firm performance measured only by the Total Shareholder Return (TSR).

TSR is a financial index that represents the rate of returns that shareholders receive, calculated as the sum of dividend yield plus the percent change in share price over a holding period[1]. In fact, it is a measure of shareholder value creation and can be viewed as an ultimate criterion that investors can use to evaluate the success or failure of own investment. That is why many authors agree that the maximization of TSR should be taken into account by every company, especially concerning long-term investments and incentives related to them.

We chose not to use traditional performance accounting measures such as Return on Asset, Return on Equity and Return on Investment for many reasons. Above all, as Equilar's latest Equity Trends Report shows, almost 50% of S&P 1500 companies use TSR as a metric for performance equity[2]. This is probably due to the fact that the famous proxy advisor agency ISS (Institutional Shareholder Services) recently announced that it is using TSR "to test the adequacy of links between incentive pay and company performance". According to ISS, companies may use many financial, operational or qualitative metrics to design their incentive plans, but any improvement "in companies' incentive metrics should ultimately translate into improvements in total shareholder returns" (Stewart, 2013). For this reason, TSR becomes a crucial measure in a pay-for-performance approach, especially when the target is ensuring long-term alignment.

1 TSR = (Priceend − Pricebegin + Dividends) / Pricebegin
2 http://www.equilar.com/blogs/72-tsr-modifiers.html.

This need is being acknowledged also by American law, since in April 2015 SEC released a rule proposal on "pay-versus-performance" disclosure[3]. The proposal tries to "establish observable and measurable links between executive pay and firm performance" by requiring companies to show the historical relationship between Compensation Actually Paid (CAP, measure of executive pay) to the CEO and other executives, on one hand, and TSR (measure of corporate performance) on the other, and asking firms to compare their TSR with that of a peer group (Bank and Georgiev, 2015).

Given these premises, we aim at answering the following research question: "Does a significant relationship between CEO compensation and Total Shareholder Return exist?"

This paper is related to other recent studies that seek to examine the relationship between CEO pay and corporate performance and would contribute to literature in two ways. First, we contribute to Italian debate on executive compensation through an empirical evidence of the relationship between CEO pay and corporate performance of Italian listed firms. Second, we contribute to literature on pay-performance sensitivity in a period characterized by economic disturbances (post crisis) where they can have effects on corporate performance and remuneration.

The remainder of this paper is organized as follows. Section 2 discusses a brief of literature review about relationship between the executive compensation and the corporate performance. Section 3 presents the research design. Section 4 discusses the empirical results. Section 5 presents the conclusions and contribution of the paper.

2. LITERATURE REVIEW

The relationship between CEO compensation and the firm's performance has always attracted an increasing interest. It has been analyzed in literature from two different fronts (Devers et al., 2007): the first believes that compensation is a result of performance, while the second supports the opposite relation. Empirical results on this topic are considerable and various. The literature indicates that research on executive pay-performance, especially for CEOs, has yielded mixed and inconclusive results due to the principal-agent problem and managerial power approach. There is not a general agreement on what measures to use for performance, i.e. if the measures should be stock market-based or accounting based performance. Anyway, each of these measures has disadvantage of its own (Canarella, Nourayi, 2008). Nevertheless, in order to evaluate and compensate top managers, several studies have found evidence that executive compensation responds more to market-based financial performance. In fact, it is usually considered more related to strategic decisions and managerial initiatives, as well as representative of all the activities of the company.

As we already said before, Total Shareholder Return (TSR) has always been important as a measure for corporate performance, but in the last years it has achieved much greater significance.

One reason is that Institutional Shareholder Services (ISS), the largest proxy adviser, has announced that it is using TSR alone, in order to test the adequacy of links between the incentive pay and the company performance (Stewart, 2014). According to Burgman and Van Clieaf (2012), TSR primarily measures a shift in shareholder expectations about future cash flows. In this regard, TSR does not measure only a change in the actual economic profit of the underlying business, but it measures a change in expectations about the retention and changes to existing economic performance.

Gregory-Smith et al. (2014) show a high positive correlation between CEO pay and total shareholder return, suggesting a strong link between pay and performance for chief executives.

Canarella and Nourayi (2008), demonstrating that the relationship between executive compensation and firm performance is non-linear and asymmetric, find that the structure of this asymmetry is dependent on the measure of performance, with convexity characterizing the asymmetry of the correlation between pay and market returns (measured by TSR); this means that total shareholder returns truly affect executive compensation.

On the contrary, other studies have argued that TSR does not accurately measure performance, since it can be influenced by economic factors outside the control of the organization. Bank and Georgiev (2016) state that "these metrics can be easily distorted by one-off events and that they incorporate decisions from different time periods", so that historical and peer group comparison become useless or even misleading; moreover, it is important to consider that TSR is a backwards-looking measure, thus "not useful in assessing how well a company is performing in areas that will determine its long-term value and success". According to Reda and Schmidt (2014), TSR is the worst measure of performance, while the best performance measure is Earnings per Share ("EPS"), followed by Capital Efficiency.

In this context, also the results of researchers are discordant. Just think that Tosi et al. (2000) reveal that the performance of a firm can justify only 4% of the pay of top manager. Although it is possible to identify a lot of studies that have tried to investigate the relationship between executive pay and firm performance, the majority of them find only a weak relationship, for a number of reasons (Ntim et al., 2015): first, the executive remuneration is just one of the possible governance mechanisms that companies can use to minimize the agency conflict, so that its effectiveness can depend also on the simultaneous use of other mechanisms; second, the weak link can derive from the tendency of researchers not to focus on equity-based pay, which is generally more related to performance. The mixed results of previous studies may indicate that the relationship not only differs because of the specific features of the company, but also because of the institutional and cultural characteristics at national level. In fact, Ntim et al., (2015) point out that the link between executive pay and corporate performance in developing countries could be

3 Pay Versus Performance, SEC Release No. 34-74835; File No. S7-07-15 (April 29, 2015), 80 Fed. Reg. 26330
(May 7, 2015) ("Pay-Versus-Performance Release")

expected to differ from what has been found in industrialized countries.

In this regard, for example, using a sample of 601 Chinese firms from 2000 to 2003, Buck et al. (2008) report a positive and higher sensitivity between the CEO pay and the total shareholder return (TSR).

Jeppson et al., 2009, used a database of CEO compensation for 200 large public companies which filed proxy statements with the SEC for 2007, find a no significant relation between the pay (base salary, cash bonuses, perks, stock awards, option awards) and the performance (company revenue, year-to-year change in net income, year-to-year change in total shareholder return). Rapp and Wolff (2008) show that ROE and TSR indicate a significant positive impact on management board remuneration in the German context. While Andreas et al. (2012), only for the German context, show a significant positive impact of all key performance characteristics, expect of the total shareholder returns. Ntim et al. (2015) find a positive and significant (at least at the 5% level) association between corporate performance (TSR) and executive pay in South Africa.

With specific reference to the Italian context, although the issue of the executive compensation is discussed (a non-exhaustive list includes: Camuffo 2009; Zattoni, Minichilli, 2009; Barontini, Bozzi, 2011; Melis et al., 2012; Pittino et al., 2013; Menozzi et al., 2014; Brogi, 2014; Esposito De Falco, 2014; Cutillo, Fontana, 2015) there are a very few empirical studies that analyze the relationship between CEO pay and corporate performance. One of the main study is by Brunello et al. (2001), where the authors examine the determinants of executive pay in Italian firms using real accounting profits after taxes as a measure of corporate performance. The results, as hypothesized, show that "the specific economic environment in Italy affects the design of managerial pay", since although there is a positive relationship between performance and pay, the pay-performance sensitivity is proved stronger in firms "where profits are declining and profit variability is relatively low", than in domestic-owned firms.

An interesting study in this field, as said above, is by Gigliotti (2013). She analyzed a sample of Italian listed firms, in the period 2004-2009, in order to investigate the relationship between remuneration and corporate performance. With reference to the performance of firms, Gigliotti used ROE, ROA, ROI, market value of the shares and turnover. The author found no significant correlation between the company performance and the pay of top managers, concluding that "the pay-for-performance mechanism does not appear to be an instrument favored to motivate managers and improve performance".

To the best of our knowledge, this is the first study on the relationship between the CEO pay and the total shareholder return in the Italian context, and based on the literature reported, our further research hypotheses are:

H1: There is a significant correlation between CEO Pay and performance, measured as Total Shareholder Return.

In particular:

H1a: There is a significant correlation between fixed remuneration and TSR;

H1b: There is a significant correlation between variable remuneration and TSR;

H1c: There is a significant correlation between total remuneration and TSR.

3.RESEARCH DESIGN AND METHODOLOGY

The object of the analysis is to verify a possible significant relationship between CEO pay and Total Shareholder Return.

3.1. Sampling and data collection

The study sample is composed of 40 companies listed in the Milan Stock Exchange from FTSE MIB in the period 2008-2014. The FTSE MIB is the primary benchmark Index for the Italian equity markets; it approximately represents about 80% of the domestic market capitalization and it consists of highly liquid, leading companies across Industry Classification Benchmark (ICB) sectors in Italy.

Companies were selected according to the following criteria:

- Companies were listed on FTSE MIB during the period of analysis;
- Availability of data for the period of analysis.

Secondary data used in the empirical study was obtained from two sources. The data on executive compensation was obtained from firm annual reports while TSR data was obtained from Bloomberg terminal. Executive compensation was measured by two components: fixed (base salary, benefits) and variable (STI and LTI Bonuses).

The sample includes firms from 10 different industries; those with the largest representations were Financials (13) and Consumer Discretionary (10) (Table 1).

Table 1. Sample characteristics

Sector	Number	%
Utilities	5	12,50%
Industrials	4	10,00%
Consumer Discretionary	10	25,00%
Financials	13	32,50%
Materials	2	5,00%
Health Care	0	0,00%
Consumer Staples	1	2,50%
Energy	2	5,00%
Communications	2	5,00%
Technology	1	2,50%
Total	40	100,00%

3.2. Research methods

In order to verify the existence of a significant relationship between CEO pay and Total Shareholder Return, we set up three regression analyses with the components of TSR variation as independent variable and variations in fixed, variables and total CEO's remuneration as dependent variable for a period between 2008 and 20144. The comparison

4 We use the random effect model because the country is perceived as a random variable being part of a larger population of countries (Menegaki,

between changes in TSR and changes in remuneration is made with a "time lag" of 1 year, like in Gigliotti (2013). The reason of this choice comes from a simple assumption: if the pay of the Chief Executive Officer is linked to the Total Shareholder Return, it is correct to assume that the amount of the compensation granted for any given year takes into account the results obtained during the previous period, and not the results for the same year, which will in fact only be made available at the end of the period. Thus, for example, changes in remuneration in 2013 with respect to 2012 were compared, in a regression analysis, with the variation in TSR in the year 2012 as compared with 2011.

4. RESULTS AND DISCUSSION

Table 2, 3 and 4 show the relationship between TSR and fixed, variable and total remuneration of CEO during the period under study.

As the evidence of the tables show, it is not possible to observe a significant correlation between CEO pay and Total Shareholder Return. Indeed, there are not significant variables and these results are not consistent with the hypotheses described in section 2. Specifically, in all the regression analyses made, the p value of the independent variables has a value less than 0.1.

Thus, we can infer that, in the Italian context, the pay-for-performance mechanism does not apply neither when the performance measure is accounting-based (Gigliotti, 2013), nor when it is based on market measures such as TSR.

This result is consistent with that part of the literature (Bebchuk, 2009; Core et al., 2005) that disapproves the link between firm performance and amount of compensation granted to CEOs or, more generally, to executives and it is consistent with studies that reflect a lack of consensus on the pay-performance relationship (Abraham et al., 2014; Bruce et al., 2005). There is conflicting evidence as to whether the pay-performance relationship has weakened or strengthened over time and the evidence from other context (for example UK, USA o Australia) is mixed (Arthur, O'Neill, 2011; Smit, 2013; Merhebi et al., 2006). According to some studies, relationship between CEO pay and performance is in decline because of the recent global financial crisis (Van Blerck, 2012) although the pay arrangements were in some cases blamed for being a contributory factor to the financial crisis, because they created incentives for the managers encouraging them to take unnecessary risks beyond optimal limits (Gregg et al., 2012). This stimulates legislature and literature to revise the mechanisms of CEO compensation, also in order to prevent future financial scandals. Moreover, understanding how compensation is reflected on firm performance is not a simple task but also one that might be misleading. The marked based performance may depend on the market forces rather than the executive efforts. Bonuses tied to accounting based performance encourage executives to manipulate the balance sheet (e.g. earnings management). In this context, the European Union has engaged through reform on pay structures, with particular emphasis on the financial sector (Barontini et al., 2013). In this regard, mandatory disclosure and "say on pay" finalized to promote the role of governance and disclosure in the remuneration process are admired. Similarly, in Italy the Securities Commission (CONSOB) adopted in 2011 new rules on transparency of remuneration and on shareholder vote on remuneration's policy (Belcredi et al., 2014; Belcredi, Enriques, 2013). In conclusion, our results may also be understood considering that only 25% of the companies belonging to FTSE MIB declared a link between performance and variable compensation for 2014 (Report Ambrosetti 2015[5]). For this reason, our findings suggest that the way in which CEOs grant their compensation shall be taken into account. Moreover, it is necessary to identify a valid pay-for-performance model able to ensure that top executives are rewarded for increases in shareholder wealth (according to the agency theory).

2011) and because the random effect model is further strengthened after passing two tests (Breush–Pagan LM, and Hausmann chi square).

5 The goal of the Observatory on Corporate Governance Excellence in Italy is to provide concrete information and proposals to promote the attainment of excellence in the corporate governance of Italian companies. In the last report 2015 emerged that the health status of the governance of leading quoted Italian companies is improving, although margin for improvement remains regarding remuneration and incentive mechanisms. http://www.ambrosetti.eu/en/research-and-presentations/observatory-on-corporate-governance-excellence-in-italy-final-report-2015/

Table 2. Regression analysis. Dependent Variable Fixed Remuneration

	Coefficient	Std. Error	t-ratio	p-value	sign
const	0.962604	0.597456	1.6112	0.1086	
ΔTSR	−0.0673331	0.300518	−0.2241	0.8229	

Table 3. Regression analysis. Dependent Variable Variable Remuneration

	Coefficient	Std. Error	t-ratio	p-value	sign
const	3.57646e+06	922014	3.8790	0.0001	***
ΔTSR	−188131	377817	−0.4979	0.6191	

Table 4. Regression analysis. Dependent Variable Total Remuneration

	Coefficient	Std. Error	t-ratio	p-value	sign
const	2.0386	1.31288	1.5528	0.1220	
ΔTSR	−0.240351	0.660378	−0.3640	0.7162	

5. CONCLUSION

The main objective of this paper was to examine empirically the relationship between CEO remuneration and Total Shareholder Return. This study, conducted on Italian companies listed on the Milan Stock Exchange (FTSE MIB), for a period 2008-2014, does not recognize a link between company performance (TSR) and the CEO' pay. In this regard, the pay for performance mechanism, in Italy, does not appear to be a right instrument to improve performance and wealth of shareholders. Therefore, we can definitely assert that in order to align shareholder interests with those of managers, companies, in the Italian context, should use a different measure in bonus plans that provide all right incentives. Some authors state that the solution could be the use of proxy measures strongly linked to TSR and that managers can actually manage, as the Economic Value Added or simply EVA (Stewart, 2013; Bussin, Modau, 2015). Given the preponderance of studies regarding the US firms, we ascertained that the behavior of Italian firms, in terms of CEO pay and corporate performance, corresponds with the main findings of the literature on the topic. This research contributes to the literature on CEO remuneration by providing an evidence-based understanding of the nature of the CEO pay-performance relationship in Italy. Understanding this relationship is critical for different reasons. First, it is important to find a suitable model to structure executive remuneration that will protect either shareholders from over-remunerating executives and executives from being underpaid. Second, the relationship between executive remuneration, especially that of CEOs, and corporate performance continues to be an important issue in financial debate (e.g. executive remuneration has been widely regarded as one of the key contributors to the recent financial crisis). Following the adoption of a series of corporate governance reforms throughout recent years, we expected to find a significant correlation in this pay-for-performance mechanism over time, since a common theme in these reforms was that executive pay should be related to company performance. But this is not true in our research and for this reason, future researches could focus on other variables that influence the relationship between CEO pay and company performance considering older and newer corporate governance rules, in different contexts, as emphasized by Barontini et al. (2013). In conclusion, our study contains a number of potential limitations. Specifically, it only investigated the specific relationship between performance and pay and did not include information on the causal factors influencing CEO remuneration and the financial performance of the companies. Moreover, the analyzed sample is not very large.

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VOTING DISSENT AND CORPORATE GOVERNANCE STRUCTURES: THE ROLE OF SAY ON PAY IN A COMPARATIVE ANALYSIS

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Abstract

Shareholder activism is a vibrant field. This paper explores which variables can influence the direction of the vote and if they change depending on country, rather than considering the say on pay activism as an instrumental term in which its effectiveness depends on the ability to change the executive compensation. We focus on a sample of 120 firms in three different contexts (Italy, Australia and USA) observed in a period of three years, between 2012 and 2014. We find that factors affecting dissent depend on the context of analysis. In the insider system context dissent is positively correlated to the concentration of ownership, and in an outsider system context, like the American one, the variable of remuneration is positively correlated to the dissent. Instead, we find that in the Australian context, any variable is significant: this singular result could depend on the presence of “two strikes rule” that inhibits the role of other variables.

Keywords: Say on Pay, Shareholder Dissent, Shareholder Voice, Executive Compensation

1. INTRODUCTION

In recent years, the corporate governance research field is developing significantly with reference to shareholder activism (Daily et al., 2003; Gillan, Starks, 2007), *“a relatively young and vibrant field”* (Goranova, Ryan 2014). The shareholder activism is *“the use of ownership position to actively influence company policy and practice”* (Sjöström, 2008). Although the shareholders do not directly drive the company, there are several ways to influence the Board of Directors: exit (selling shares), loyalty (holding onto shares), and voice (communicating with management) (Hirschman, 1970).

In this perspective, in an effort to improve corporate governance and to mitigate potential conflicts of interest between shareholders and administrators, legislators and regulators in several countries have adopted a wide range of regulatory activities, especially with regard to remuneration policies or directors of listed companies, for example Say on pay, Pay-Versus-Performance disclosure, Pay Ratio disclosure, and Clawbacks (Bank et al., 2015).

Here, we focus on shareholders’ votes as a way to communicate their approval or disapproval for executive compensation. In this regard, we refer to shareholder voting in the form of say on pay voting. The introduction of say on pay should be considered as an additional channel for shareholders’ voice and the expression of dissatisfaction because it is an explicit vote of confidence and it is the only mandatory mechanism that regularly allows all shareholders to directly and publicly express their opinions of executive compensation with the purpose to improve corporate governance efficiency (Conyon, Sadler, 2010).

However, to date, most of research so far focuses on consequences of say on pay (Stathopoulos, Voulgaris, 2015). On one side, the supporters of say on pay affirm that this tool will encourage more effective monitoring, and therefore promote corporate transparency; others emphasize that could lead to situations of complicity between shareholders and board, with not optimal wage agreements and an increase in agency costs. The whole would be to the detriment of corporate disclosure. So, the impact of say on pay on executive compensation is nevertheless ambiguous (Kronlund, Sandy, 2015) and most of literature addresses the question of how effective say on pay regulation alters the pay setting process in aligning executive and shareholder interests (e.g., Conyon, Sadler, 2010; Armstrong et al., 2013; Ferri, Maber, 2013). To reconcile our theoretical understanding of the corporate governance role of shareholder voting, this study develops an alternative understanding of the corporate governance role of shareholder voting. Rather than understanding shareholder voting (say on pay activism) in instrumental terms in which its effectiveness depends on the ability to change executive compensation, we explore which variables can influence the direction of the vote. We aim to answer the following research questions: “*what are the firm-specific factors and corporate governance factors, at a national level, that facilitate the voting dissent (or say on pay activism) on remuneration policies?*” and in particular: *“can the ownership concentration, board structure and CEO Pay facilitate the voting dissent?”*

As other authors have done (Thomas, Van der Elst, 2013), voting procedures are affected by ownership concentration, the degree of social tolerance toward income inequality, and certain political influences in different countries.

We also support that the theory of path-dependence (Bebchuk, Roe, 1999; Esposito De Falco, 2014), may have effects in terms of variables that could influence the shareholder voting (say on pay activism).

First, this is confirmed by the evidence that corporate governance mechanisms are not equally effective. Second, different capitalist systems shape the relations between the firm and its stakeholders in distinct ways (Sauerwald et al., 2015).

Despite of an extensive theoretical interest in relationship between shareholder voting and corporate governance, little empirical work has been done to assess the determinant of voting dissent in a comparative study. Considering this evidence and according with Thomas and Van der Elst (2013), who argue that the justification leading to the adoption of these standards is due to *"the prevailing share ownership structure of corporations in the country in question"* and highlight differences for countries with dispersed or concentrated ownership structures, the aim of this paper is to identify the variables that determine the dissent in remuneration policies and to verify whether these variables differ according to the context. The empirical analysis is conducted on a sample of companies belonging to the Italian context, for insider system, and American and Australian, for outsider system, observed in a period between 2012 and 2014. This paper is related to other recent studies that seek to examine the relationship between executive compensation and shareholder activism. It also seeks to bridge the gap relating to determiners (and not the consequences) of the shareholder voting in the form of say on pay voting. In this way, it aims to contribute to the topic of shareholder activism, in particular, say on pay activism, where is not clear what are the drivers that encourage people to express dissent. Second, we contribute to the comparative corporate governance literature by investigating variables related to context of analysis and this would enhance both our understanding of corporate governance mechanisms and the role of regulation in enhancing their effectiveness. The remainder of this paper is organized as follows. Section 2 discusses literature review of the voting dissent and say on pay. Section 3 develops the hypotheses. Research design and sample and variables selection are discussed in Section 4. Section 5 discusses the empirical results. Section 6 presents the conclusions of the paper.

2. LITERATURE REVIEW

The topic of corporate activism has suffered a development related to the different perspectives from which to study the shareholder engagement. The academic literature surrounding this topic can be roughly divided into three strands: antecedents, processes, outcomes (Goranova, Ryan, 2014). This article is in the tradition of the first strand of research, more specifically determinants of the shareholder vote only on executive pay. At the heart of this dimension, we must necessarily identify the key actors, such as individual investors, public pension funds, religious groups, social activists, labor union funds, private pension funds, mutual funds, and hedge funds, which may raise both financial and social issues (O'Rourke, 2003).

Among the financial activities literature, it was mostly concentrated executive compensation (Cai, Walkling, 2011; Ertimur et al., 2011). Although researchers have long focused their attention to situations in which is possible to find a greater or lesser dissenting shareholders, no more has been said about what are the factors that could facilitate (driving) the say on pay activism (Edelman et al., 2014; Armstrong et al., 2013; Del Guercio et al., 2008).

In fact, many authors have analyzed the situations in which is possible to observe the shareholder activism, such as voice through shareholder votes. For example, some argue that companies with better operational performance tend to be less attractive to activists or activism is more likely to target firms whose stock market performance is suboptimal (Ertimur et al., 2011; Renneboog, Szilagyi, 2011) .

Sauerwald et al., (2015) analyze the degree and nature of the dissent of shareholders, on a sample of 12,513 proposals voted in 717 companies listed on the main lists of 15 countries of Western Europe. The study relates the dissent of shareholders with a range of factors, including: i) the presence of blockholder inside shareholder, assuming a negative correlation with dissent; ii) the total number of directors within the board, assuming a positive correlation with dissent; iii) equity-based CEO pay, assuming a negative bond.

Hillman et al., (2011), adopting a multi-level approach, analyze dissent in cases of election or renewal of the role of director of 500 candidates of companies belonging to the Fortune 2000. This multilevel perspective is consistent with Bebchuk's (2007), for which shareholders may withholding votes for two reasons or because unhappy of the entire board or because they are not satisfied with the individual directors. In this perspective, the authors suggest that dissent (votes withheld) is related to firm and director level. At the firm level, they find that CEO compensation level and board size are positively related to the withholding of shareholder votes in director elections, an indicative behavior of shareholder discontent. At the director level, they find that affiliated director status, tenure, and number of outside directorships are positively related and director block ownership is negatively related to shareholder discontent.

Although Cziraki et al., (2010) pose greater attention to the role of the recommendations issued by proxy advisors, they show that dissent is related to the changes of the Board of Directors, the remuneration perceived by the executive directors and the firm capitalization.

In addition to these issues, even national context plays an important role (Aguilera, Jackson, 2003; Zattoni, Cuomo, 2008) and may influence shareholder activism. Judge et al., (2010) study three common law countries (USA, UK and Australia) and three civil law countries (Japan, Germany, and South Korea) during a period between 2003 and 2007. They show that the size of the business is not related to activism in financial key, but positively correlated to social activism; the concentration of ownership is negatively correlated both to financial and social activism; and profitability is negatively correlated to financial activism, but positively correlated to social activism. Furthermore, these relations in case of financial activism are generally stronger in the legal systems of common law array, while the case of social activism is generally stronger in areas with a higher level of inequality of remuneration.

Melis et al., (2015) analyse the disclosure of directors' remuneration in Italian and UK listed firms. They consider as the dependent variable the VDI (Voluntary Disclosure Index) and find a positive correlation with the shareholders' dissent. Generally, they find that the level of voluntary disclosure is significantly associated with firm-specific incentives, such as the demand for information from investors and the need for legitimacy. This level of voluntary disclosure is significantly higher in the UK than in Italy.

As stated above, the empirical analysis on the say on pay activism is growing and few studies investigate the determinants of the shareholder vote on executive pay (Cotter et al., 2013; Conyon, Sadler 2010; Larcker et al., 2015). Foghani et al., (2015) point out, in the Australian context, the connection between dissent and variables concerning the nature of the remuneration, the composition of the board, the degree of independence, ownership concentration and performance values. They find that a change in CEO total remuneration is positively and significantly associated with a change in the shareholder dissent level in the year following the "first strike".

For the Italian context, we highlight the research done by Belcredi et al., (2014). This study is the first to investigate the role of the Say on pay in Italy[6]. They analyze how dissent is linked to multiple variables related to the ownership and control structure, the board composition, institutional investors activism, the level and the structure of remuneration and the level of remuneration policy disclosure. They find that dissent is higher in widely held firms and negatively correlated with the equity stake held by the largest shareholder. While dissent is positively correlated with CEO remuneration.

Gregory-Smith et al., (2014) find that executive remuneration and dissent on the remuneration committee report are positively correlated, using the population of non-investment trust companies in the FTSE 350 over the period 2003–12. Furthermore, they saw that: i) voting dissent is lower when shareholder returns in the previous financial year were high; ii) firm-specific governance factors (the percentage of directors, the number of executive and non-executive directors, the size of the firm as measured by sales) appear to have limited impact on dissent.

Conyon and Sadler (2010) find that dissent is higher in firms with high CEOs pay and as a result, they find little evidence that dissent alters the level and design of remuneration packages. Cotter et al., (2013) identify a positive relation between percentage vote on say on pay frequency and excessive pay practices, poor performance, and negative recommendations from proxy advisors.

Kimbro and Xu (2015) examine the results of the shareholder vote on executive remuneration during 2011 and 2012 for listed companies included in the Russell 3000 index. They find that the percent of approval say on pay votes is associated with firms with lower market capitalization, lower leverage, lower return volatility, higher CEO ownership, lower institutional ownership, a for Institutional Shareholder Services vote recommendation, higher returns and higher ROA.

3. HYPOTHESIS DEVELOPMENT

On the basis of the literature reported and the research question, our further research hypothesis are developed on the basis that we can distinguish insider and outsider system. In fact, the corporate governance systems are the result of a complex process of interaction between business and the specific political and institutional context in which they do business, environment permeated by norms, customs, traditions, but also by cultural values, social, political, and demands that are affecting the development of enterprises. These differences were found on different aspects, such as ownership, CEO pay, shareholder value or generally capitalist system (Yoshikawa et al., 2014; Desender et al., 2013; van Essen et al., 2013; Edelman, 1992).

So, we argue that the voting dissent may depend on the particular capitalist system (and the related corporate governance system) in a country. Hence:

Ownership. Ownership structure is the most important factor of corporate governance (Kostyuk, 2011). The ownership structure is different across countries, with dispersed ownership prevailing in the Anglo-Saxon country, and a more prevalent concentrated ownership in Continental Europe (La Porta, et al, 1999;). According to the literature, higher dissent on the remuneration policy is expected where ownership is dispersed (Ertimur, et al., 2011; Ertimur et al., 2013). We therefore formulate our hypothesis as follows:

H1: Shareholder voting dissent is negatively correlated to the ownership concentration.

Remuneration Committee. Board of directors is a crucial part of the corporate structure (Kostyuk, 2003) and it is the heart of corporate governance (Rossi et al., 2015). In order that it can perform a proper monitoring role must have appropriate size and composition. Even with reference to shareholder activism, this topic has long been debated since these are deemed that a more independent board may constrain agency problems. Normally, it is taken into consideration the board size equals the number of directors serving on the board, but we believe that in the event of remuneration policies, assumes greater importance the remuneration committee (Conyon, 2014) not only for its specific tasks (Hermanson et al., 2012; Kaplan et al., 2015) but also for effectiveness on the voluntary disclosure of information relating to executive remuneration action (Kanapathipillai et al., 2015), thus becoming an important key corporate governance mechanism. We therefore formulate our hypothesis as follows:

H2: Shareholder voting dissent is positive correlated to the size of the remuneration committee.

6 Belcredi et al., (2015) remarking their attention on the Italian context, observe how in Italy dissent on say on pay attests at low levels (values still in line with other industrialized countries), and largely look like dissent by institutional investors is surprisingly high. At this level it is also confirmed the strong relationship between the behavior of shareholders, dates from proxy advisor recommendations, saying that they do not suffer the vote in a passive way.

CEO Remuneration. The level and structure of CEO pay compensation has received considerable attention from researchers in accounting, economics, finance, law, and management. Dissent may also be correlated to CEO remuneration structure (Sauerwald et al., 2015) and with reference to say on pay most of the literature found that companies with high executive pay were more likely to attract greater shareholder dissent (Conyon, Sadler, 2010; Ferri, Maber, 2013). We therefore formulate our hypothesis as follows:

H3a: Shareholder voting dissent is positive correlated to fixed remuneration CEO.

H3b: Shareholder voting dissent is positive correlated to variable remuneration CEO.

4. RESEARCH DESIGN AND METHODOLOGY

We conducted an empirical analysis of the influence of several important factors that could explain the differences in shareholder voting patterns across various countries. We focused on the relationship between voting dissent and ownership concentration, remuneration committee, CEO pay (fixed and variable) because they were identified as important factors by literature and by the ISS in describing what seemed to influence shareholder say on pay voting.

To conduct our empirical study, we have collected a sample of 120 firms of three different contexts (Italy, Australia and USA) observed in a period of three years, between 2012 and 2014. In detail, the choice of these contexts is due to the fact that they are representative of different governance models, such as the Latin model and Anglo-Saxon model. Furthermore, all considered contexts apply non-mandatory Say on Pay. For this reason, as shown later, for the Italian context we have excluded financial companies which adopt a mandatory Say on Pay. About the methodology adopted, we used a panel cross-country analysis, focused on evolution of historical data across different countries. In this way we would like to observe how different effects on voting dissent could be highlighted by the observation of the phenomena.

4.1. Variables

All variables are as defined in Table 1, as follows.

Table 1. Description of variables

Variable Name	Label	Variable Definition
Dependent Variable		
Percentage of Shareholder dissent	*Voting_Dissent*	It concerns the percentage of dissent registered during the AGM for remuneration report vote. We measure it as the percentage of "NO" vote of the shareholder present during the vote.
Independent Variables		
Logarithm of fixed remuneration of CEO	*LN_FIX_REM*	It concerns the logarithm of the amount of fixed remuneration reported in Remuneration Report. We measure it as the total amount of fixed compensation of the CEO.
Logarithm of variable remuneration of CEO	*LN_VAR_REM*	It concerns the logarithm of the amount of total variable remuneration reported in Remuneration Report. We measure it as the total amount of variable components of compensation for the CEO (bonuses, stock option, benefits etc.)
First Top 10 Shareholders	*TOP_10_OWN*	It measures the percentage of the quote kept by the firsts ten shareholders. We concern it as the expression of the concentration of ownership.
Number of the members inside the Remuneration Committee	*SIZE_REM_COMMITTEE*	It measures the number of persons who has the role of member of Remuneration Committee. We concern it as a variable that expresses a kind of information about the composition of the board.
Control Variables		
Quick ratio	*QUICK_RATIO*	It measures a company's ability to meet its short-term obligations with its most liquid assets. The ratio excludes inventories from current assets, and is calculated as follows: *Quick ratio = (current assets – inventories) / current liabilities, or = (cash and equivalents + marketable securities + accounts receivable) / current liabilities*
Current ratio	*CURRENT_RATIO*	It measures a company's ability to pay short-term and long-term obligations. To gauge this ability, the current ratio considers the total assets of a company (both liquid and illiquid) relative to that company's total liabilities. We calculate it as follows: *Current Ratio = Current Assets / Current Liabilities*

Dependent variables is voting dissent as the shareholder voting activism, defined as all shareholder votes cast against the recommendations of management at shareholder meetings. Independent variables are ownership concentration (Top_10_Own), size of remuneration committee (Size_rem_committee), fixed and variable remuneration CEO (Ln_fix_rem and Ln_var_rem). As control variables, we use liquidity ratios (Current ratio and Quick ratio) for two reasons. First, empirical evidence shows a relationship between stock liquidity and CEO pay and pay-for-performance sensitivity (Jayaraman, Milbourn, 2011). Secondly, the relation between corporate governance and liquidity is important because it could understand how corporate governance affects shareholder wealth (Yun, 2009) and as a result we believe that can also influence voting of shareholders.

4.2. Data

Our sample is based on a database compiled by B*loomberg Professional*, *Thomson Reuters Datastream Professional*, *Bankscope Bureau Van Djck*; with particular attention about to data relating to the remuneration and composition of corporate governance, if do not inferable from previous databases, they were extrapolated from *BoardEx Data* e *S&P Capital IQ ExecuComp (from Compustat) - McGraw Hill Financial*.

Table 2. Sample characteristics

Sector	Italy		United States		Australia		Total	
	Number	%	Number	%	Number	%	Number	%
Utilities	5	12,50%	0	0,00%	2	4,00%	*7*	*5,80%*
Industrials	4	10,00%	4	13,30%	5	10,00%	*13*	*10,80%*
Consumer Discretionary	10	25,00%	3	10,00%	1	2,00%	*14*	*11,70%*
Financials	13	32,50%	5	16,70%	21	42,00%	*39*	*32,50%*
Materials	2	5,00%	2	6,70%	8	16,00%	*12*	*10,00%*
Health Care	0	0,00%	4	13,30%	2	4,00%	*6*	*5,00%*
Consumer Staples	1	2,50%	3	10,00%	2	4,00%	*6*	*5,00%*
Energy	2	5,00%	2	6,70%	5	10,00%	*9*	*7,50%*
Communications	2	5,00%	3	10,00%	1	2,00%	*6*	*5,00%*
Technology	1	2,50%	4	13,30%	3	6,00%	*8*	*6,70%*
Total	*40*	*100,00%*	*30*	*100,00%*	*50*	*100,00%*	***120***	***100,00%***

The sample consists of 120 companies concerned the main stock market of Italy (FTSE Mib 40), USA (Dow Jones 30) and Australia (ASX 50). Table 2 shows us the composition of the industry.

Therefore, papers using panel data were chosen in this study to investigate the interrelations between the selected variables, as following[7]:

$VotingDissent_{i,t} = \alpha + \beta 1\ Top10\_Own_{i,t} + \beta 2\ Size\_rem\_commitee_{i,t} + \beta 3\ LN\_fix\_rem_{i,t} + \beta 4\ LN\_var\_rem_{i,t} + \beta 5\ Quick\_ratio_{i,t} + \beta 6\ Current\_ratio_{i,t} + \varepsilon_{i,t}$

5. RESULTS AND DISCUSSION

Figure 1, 2 and 3 present descriptive statistics for each country.

The descriptive statistics show that the voting dissent appears, on average, higher in the Italian context. While the lowest value is registered in the Australian context. Figure 4, 5 and 6 provide the results of our analysis about the determinants of voting dissent.

As seen in figures reported above, the results are different depending upon the context of analysis.

In Italian context (Figure 4) the results show evidence of a relation between voting dissent and ownership concentration and variable remuneration of CEO. In the Australian context, any variable is not significant, while in the American context only the variable remuneration is related to voting dissent.

In detail, in the Italian context a negative and significant coefficient on Top10_Own (= -0.58; p = 0.001) suggests that an increase of ownership concentration is associated with a decrease in shareholders' dissents. These results are consistent with H1. Also, the variable remuneration has a negative and significant coefficient (=-1,10; p= 0.03) and this result is not consistent with H3b. While hypothesis H2 and H3a cannot find a validation of the model. However, in the Australian context the insignificance of the considerated variables may depend upon the existence of *"two strikes rule"*. In fact in the Australian context, different from other contexts, this rule is adopted: if 25 percent or more of eligible votes are against the remuneration report, the firm receives a *"strike"* and if the firm receives a strike during two consecutive AGMs, the company proceeds with the vote for the reelection of the board. It seems that in Australia, the opportunity to

7 We use the random effect model because it passes two tests (Breush–Pagan LM, and Hausmann chi square). Statistical software adopted: Gretl v. 2016a

express dissent is an attempt made by shareholders in order to put in the hands of the current activist company that follows from it: this activism in fact takes into consideration, and observes carefully, more *"what the company has done"* than *"how much the company is paying for management"*. In this way, the Say on pay becomes an explicit attempt to realign the interests of management with those of shareholders, who wants to be conscious of management activity undertaken by the company in which they have invested their own money. Finally, in the American context, only the variable remuneration is positively correlated with voting dissent (= 5.13; p = 0.008). This result shows that increasing the variable remuneration increases also the dissent of shareholders. These results are consistent with H3b. While we cannot validate the other assumptions.

Figure 1. Descriptive statistics for Italy

Variables	*Mean*	*Median*	*Min*	*Max*	*Dev. Std.*
Voting Dissent	35,3378	32,5600	12,3100	66,8200	11,8958
LN_FIX_REM	13,7927	13,8734	10,3189	15,0344	0,922822
LN_VAR_REM	13,5607	13,9683	8,51719	17,0356	1,74249
TOP_10_OWN	48,1728	48,9550	10,8600	76,2100	19,0580
SIZE_REM_COMMITTEE	3,54701	3,00000	0,00000	6,00000	1,11026
QUICK_RATIO	1,01012				0,580636
CURRENT_RATIO	1,47108	1,30000	0,510000	5,54000	0,819265

Figure 2. Descriptive statistics for Australia

Variables	*Mean*	*Median*	*Min*	*Max*	*Dev. Std.*
Voting_Dissent	5,64142	3,229	0,358001	44,87	6,55774
LN_FIX_REM	14,5031	14,529	13,2057	15,4078	0,356561
LN_VAR_REM	14,1959	14,2244	12,8954	15,7959	0,467498
TOP_10_OWN	34,684	31,08	14,84	77,62	15,8655
SIZE_REM_COMMITTEE	4	4	0	7	1,02762
QUICK_RATIO	0,758854	0,647307	0,152108	1,97168	0,419165
CURRENT_RATIO	1,50604	1,19342	0,364681	10,2888	1,38088

Figure 3. Descriptive statistics for USA

Variables	*Mean*	*Median*	*Min*	*Max*	*Dev. Std.*
Voting_Dissent	11,0685	5,615	0,44	99,26	17,4631
LN_FIX_REM	14,1391	14,221	12,941	14,8688	0,384808
LN_VAR_REM	16,5121	16,5444	12,7814	17,5996	0,690169
TOP_10_OWN	31,8389	30,99	20,93	67,54	9,39035
SIZE_REM_COMMITTEE	4,4023	4	3	10	1,21483
QUICK_RATIO	1,19423	1,01	0,2	3,4	0,737533
CURRENT_RATIO	1,59821	1,415	0,66	3,49	0,70368

The descriptive statistics show that the voting dissent appears, on average, higher in the Italian context. While the lowest value is registered in the Australian context. Figure 4, 5 and 6 provide the results of our analysis about the determinants of voting dissent.

Figure 4. Panel data regression results - Italian context

	Coefficient	*Standard error*	*t-ratio*	*p-value*	*Sign*
const	77,8141	26,5339	2,9326	0,0047	***
LN_FIX_REM	0,969039	1,79222	0,5407	0,5907	
LN_VAR_REM	-1,10737	0,498243	-2,2225	0,03	**
TOP_10_OWN	-0,585344	0,0771939	-7,5828	<0,0001	***
SIZE_REM_COMMITTEE	-2,32485	1,49911	-1,5508	0,1261	
QUICK_RATIO	6,84902	3,40216	2,0131	0,0485	**
CURRENT_RATIO	-6,86359	2,7271	-2,5168	0,0145	**

Figure 5. Panel data regression results - Australian context

	Coefficient	*Standard error*	*t-ratio*	*p-value*	*Sign*
const	6,01837	48,8782	0,1231	0,9024	
LN_FIX_REM	0,578564	3,29819	0,1754	0,8613	
LN_VAR_REM	-0,839829	1,89141	-0,444	0,6585	
TOP_10_OWN	0,0404821	0,0780747	0,5185	0,6059	
SIZE_REM_COMMITTEE	0,663745	0,899403	0,738	0,4632	
QUICK_RATIO	-0,851677	2,21294	-0,3849	0,7016	
CURRENT_RATIO	-0,220235	0,878123	-0,2508	0,8028	

Figure 6. Panel data regression results - American context

	Coefficient	*Standard error*	*t-ratio*	*p-value*	*Sign*
const	127,837	115,51	1,1067	0,2747	
LN_FIX_REM	−12,2982	9,00583	−1,3656	0,1793	
LN_VAR_REM	5,31819	1,9168	2,7745	0,0082	***
TOP_10_OWN	−0,273065	0,285706	−0,9558	0,3447	
SIZE_REM_COMMITTEE	−2,0087	1,55737	−1,2898	0,2042	
QUICK_RATIO	12,6447	6,34781	1,992	0,0529	*
CURRENT_RATIO	−17,9637	7,29138	−2,4637	0,0179	**

As seen in figures reported above, the results are different depending upon the context of analysis.

In Italian context (Figure 4) the results show evidence of a relation between voting dissent and ownership concentration and variable remuneration of CEO. In the Australian context, any variable is not significant, while in the American context only the variable remuneration is related to voting dissent.

In detail, in the Italian context a negative and significant coefficient on Top10_Own (= -0.58; p = 0.001) suggests that an increase of ownership concentration is associated with a decrease in shareholders' dissents. These results are consistent with H1. Also, the variable remuneration has a negative and significant coefficient (=-1,10; p= 0.03) and this result is not consistent with H3b. While hypothesis H2 and H3a cannot find a validation of the model. However, in the Australian context the insignificance of the considerated variables may depend upon the existence of "two strikes rule". In fact in the Australian context, different from other contexts, this rule is adopted: if 25 percent or more of eligible votes are against the remuneration report, the firm receives a "strike" and if the firm receives a strike during two consecutive AGMs, the company proceeds with the vote for the reelection of the board. It seems that in Australia, the opportunity to express dissent is an attempt made by shareholders in order to put in the hands of the current activist company that follows from it: this activism in fact takes into consideration, and observes carefully, more "what the company has done" than "how much the company is paying for management". In this way, the Say on pay becomes an explicit attempt to realign the interests of management with those of shareholders, who wants to be conscious of management activity undertaken by the company in which they have invested their own money. Finally, in the American context, only the variable remuneration is positively correlated with voting dissent (= 5.13; p = 0.008). This result shows that increasing the variable remuneration increases also the dissent of shareholders. These results are consistent with H3b. While we can not validate the other assumptions.

In sum, H1 is supported for Italian context and not supported for the other contexts, H2 is not supported, while H3b is supported for American context.

The results confirm that the variables that might influence voting dissent vary depending upon the context and so this study contributes to the research that argues "how performance effects of corporate boards, ownership concentration, and executive incentives may differ according to the legal system and institutional characteristics in a specific country" (Filatotchev et al., 2013). This has important implications because governance reforms that work well in one context, might not be as effective in another context (Schiehll et al., 2014). We emphasize, in particular, as the dissent is extremely low in the Australian context, although the possibility for shareholders to deeply affect the board, with the rule of two-strike. In this way we contribute to corporate governance research by reporting evidence that suggests say on pay voting may be ineffective (Ferri, Maber, 2013) and even neutralizes the firm specific variables and governance. Such a result would strengthen the claims of Levit and Malenko (2011), which not only non-binding shareholder votes to generally fail to convey shareholder preferences, but the two strikes rule would nullify the effect of other variables.

In contexts where this rule is not in force and where there is a non-mandatory vote we can make the following considerations. First, it can be observed in relation to dissent a low importance of the remuneration committee. This variable that has an average value ranging from 3.4 in the Italian context, to 4.4 in an American context, is not significant in any context. This result deserves to be further developed not only with reference to the number but also in the specific activities carried out, in terms of disclosure. Secondly, the only variable that can affect the degree of dissent is the variable remuneration. Therefore, it would confirm the empirical evidence of a relationship between dissent and CEO pay. The positive coefficient found in the American context is in line with previous literature (Carter, Zamora, 2009; Conyon, Sadler, 2010), which shows that shareholder dissent is associated with excess pay. The negative coefficient found in the Italian context, is not consistent with the results of Belcredi et al., (2014) where it is positive. However in the work of Belcredi et al., excess compensation is not relevant because it is not significant if firm size (control variable) is included in the analysis. Finally, the significance of the Top_10_Own variable is consistent with prior literature, especially for firms with high ownership concentration (Conyon and Sadler, 2010) and the Italian context is known for the high ownership concentration: also the average value of our results confirms it (48.17 for Italy vs 34. 68 for Australia or 31.83 for USA).

CONCLUSION

In this paper, we wanted to contribute to literature on Say on Pay and in particular "say on pay activism". We look at the determinants of dissent by considering a wide range of possible regressors that allow us to evaluate how dissent is linked to multiple variables related to the ownership structure, the board composition, the level and the structure of remuneration in a different country. We analyzed a sample of 120 firms for a period 2012-2014 and we investigated which factors can influence the voting dissent on three different contexts, one insider system (Italy) and two systems outsider (Australia, USA). We investigated whether shareholders' dissent vote on the remuneration report may depend by firm factors and corporate governance factors in a specific country. Our findings shed light on the way some characteristics of corporate governance influence voting dissent. We have found that, depending upon the context, the dissent is related to different variables. Specifically, the ownership concentration is negatively correlated to dissent in an insider system context, like the Italian one. The variable remuneration is positively correlated in an outsider contest system, like the American one. We also found that any variables used in the Australian context are not significant: this singular result could depend upon the existence of two strikes rule that would neutralize the other variables. This last result is definitely an interesting one. First it reveals how Australia is an interesting country for the effects of reforms of corporate governance. Second, a principle that strengthens "say on pay" lends itself open to interpretations by the firms and outcomes can be extremely varied and problematic. The implications of these findings are that a legislature should focus its attention on measures likely to secure a greater voting dissent because "not always by the same recipe comes the same dish" as indicated by the findings of this study (i.e the emphasis on strong ownership concentration and structure of remuneration).

In conclusion, the results show the importance to understand what factors facilitate dissent in various institutional contexts, as suggested by Schiehll et al., (2014) for other corporate governance factors. In fact, corporate governance cannot be studied in isolation from legislation, culture and institutional contexts (Young, 2009). This paper illustrates this crucial perspective in say on pay activism. Our study contains a number of potential limitations. First, it covers the period of analysis and sample. Future researches should expand the sample and see if in other contexts, both insider and outsider, the results are consistent. Second, our study has only begun the process of understanding which variables can influence voting dissent. Our attention has been paid only on some variables of interest related to ownership concentration, board composition and remuneration, but understanding each variable can have implications on Say on pay activism, it is a significant task for future research.

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THE DETERMINANTS OF HOME BIAS

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Abstract

Despite the well-known gains of the international diversification, investors have the tendency to overinvest in domestic equities. This irrational behavior is called home bias. It is considered by Obstfeld and Rogoff (2000) as one of the six major puzzles in the international macroeconomics. The present paper examines the different determinants to understand this major puzzle. Based on a sample of 564 observations (countries-years) that cover the period 2003 to 2013, we found that home bias is explained by the information asymmetry that exists between countries and their economic volatility (assessed by the growth rate of the gross domestic product). Furthermore, our findings indicate that home bias decreases among developed markets and countries characterized by a higher rule of law.

Keywords: Home Bias, Information Asymmetry, International Diversification

1. INTRODUCTION

Home bias is one of the six major puzzles in international macroeconomics. This phenomenon is defined as the tendency of investors to overinvest in domestic equities and forego gains from international diversification. This lack of international portfolio diversification, despite its well-known gains, has a negative effect on economic growth and international risk sharing (Pungulescu, 2013), firm and market value (Chan et al., 2009).

Recent evidence by Levis et al. (2015) demonstrates that this phenomenon persist until nowadays despite the effort of countries to open their financial market. Then, several explanations have been underlined to explain this phenomenon. Home bias was explained by the macroeconomic factors (Khurana and Michas, 2011), governance indicators (Daly and Vo, 2013), Equity Market characteristics (Baccouri and Fedhila, 2016), capital controls (Ahearne et al. 2004 and Solnik and Suo, 2014) and Information asymmetry (Beneish and Yohn, 2008, Ahearne et al., 2004).

There is wide literature on the determinants of home bias. Nevertheless, the present paper considers that the main ones are the information asymmetry and governance. There is a common explanation by prior research that the information asymmetry, due to barriers to information flows and different accounting standards, give rise to information costs that are supported by foreign investors. Moreover, the governance of a country is also considered as a key factor to explain home bias. In fact, Levis et al. (2015) predicts that country affects the availability of information in the FDI receiving country and makes investments in places of low country governance costly.

This paper examines the effect of others factors, which prior researches indicate that they affect the home bias, as the economic indicators, equity market characteristics and capital controls. The objective of this paper is to examine the determinants of home bias. This paper considers that the major hindrance in research on the determinants of home bias is the measure used to assess the effect of the information asymmetry of a country. In the past, this variable was estimated using indirect measures as the geographical distance and the language (Portes and Rey, 2005; Vanpée and De Moor, 2013). Nevertheless, we estimate that these measures are time-invariant proxies. Then, we will follow the proxies used by Giofré (2009). We expect that these proxies would capture the information asymmetry with the notable advantage of being time varying. Focusing in countries included in the Coordinated Portfolio Investment Survey “CPIS” our sample is composed by 564 observations (country-year) that cover the period 2003 to 2013. The regression results indicate that the information asymmetry proxies, the rule of law, market classification and the economic stability are the most important and significant determinants of home bias.

This paper is organized as follows: Section 2 provides a brief review of the literature and states the relevant hypothesis. Section 3 specifies the research methodology. Section 4 discusses the results and Section 5 concludes.

2. LITERATURE REVIEW

Levy and Sarnat (1970), Solnik (1974) and Adler and Dumas (1983), based on the international version of the capital asset process model, predict that investors should diversify their portfolio internationally to minimize its overall risk. However, early research as Beneish and Yohn (2008) underline that investors do not exploit this opportunity. These investors’ behavior is called home bias. To understand this irrational behavior, the present paper investigates the different determinants of home bias. Explanations in the literature for home bias are controversial. Therefore, we propose to present a theoretical framework of home bias and then we would highlight its different explanations.

2.1. International diversification and home bias

The Markowitz portfolio theory or the mean-variance analysis, predicts that investors could reduce portfolio risk by holding assets that are perfectly uncorrelated. In other words, they can reduce their portfolio risk by holding a diversified portfolio of asset. Moreover, Sharpe (1964) and Lintner (1965) extend Markowitz theory and propose the capital asset pricing model "CAPM". This model underlines that the risk of a portfolio is composed by a systematic risk and an unsystematic risk. Unsystematic risk, known as diversifiable risk, could be reduced through diversification. Nevertheless, systematic risk, known as market risk, could not be reduced into one market with diversification (due to the stock's dependence on the market).

Levy and Sarnat (1970), Solnik (1974) and Adler and Dumas (1983), build on the work of Sharpe (1964) and Lintner (1965), introduce the international version of the CAPM. This model suggests that within an economy a strong tendency usually exists for economic phenomena to move more or less in unison giving rise to periods of relatively high or low general economic activity. Then investors could not reduce the total portfolio risk when they diversify their portfolio in one market. They also suggest the possibility that risk reduction might be reduced by diversifying securities portfolio internationally.

Nevertheless, in practice investors don't exploit this risk reduction opportunity. They prefer to overweight domestic assets. The term used to describe this irrational investors' behavior is home bias. It is defined as the tendency of investors to overinvest in domestic equities and forego gains from international diversification.

2.2. Determinants of Home bias

Prior researches have examined the determinants of home bias. However, results were controversial. We propose to distinguish five factors that might explain this phenomenon: the information asymmetry, countries economic indicators, countries governance indicators, equity market characteristics and capital control restrictions.

a. The information asymmetry

Based on Merton model (1987), Ahearne et al. (2004) state the important effect of the information asymmetry on home bias. They suggest that investors prefer to hold stock that they know. Then, it might be a key factor that affects investors' behavior. Moreover, Levis et al. (2015) predict that prior research (Jeske 2001, Portes and Rey 2005) attempted to explain the observed home bias effects mostly as a consequence of information asymmetry. These authors measured the information asymmetry with two proxies: international telephone minutes per capita and financial times (FT) circulation per capita. Nevertheless, they found conflicting results. The international telephone call variable was not significant. However, the FT circulation per capita was significant. In the same context, Bradshaw (2004) did not support the fact that the information asymmetry is a key factor that explains home bias. Bradshaw et al. (2004) results indicate that the information asymmetry that affects home bias is multileveled, at least partially, due to reporting decisions made by the firm's managers. Then, they conclude that the information asymmetry don't affect significantly home bias.

Daly and Vo (2013) used two proxies to measure the information asymmetry. The distance and bilateral trade between Australia and the destination country. Using this two proxies these authors confirm the hypothesis that information asymmetry is an important determinant of home bias. In the same context, Baccouri and Fedhila (2016), using 512 observations (country –year) that cover the period from 2003 to 2015, found evidence that support information asymmetry as a key factor that explain this phenomenon of home bias.

Despite the contradiction in the prior researches' results investigating the relationship between information asymmetry and home bias, we predict the following:

H1: The information asymmetry affects positively home bias.

b. Economic indicators

Usually, investors take greater risks when macro-economic conditions are relatively stable. Then, positive macroeconomic conditions such as a high GDP growth, low inflation and low exchange rate volatility attracts foreign direct investment and might reduce home bias. Khurana and Michas (2011) predict that economic development of a country affects the percentage of foreign investment within it and consequently affects the home bias phenomenon.

Mishra (2011) and Mishra (2014) found that the real exchange rate volatility as an economic factor affects significantly the Australian financial integration in the global economy. It induces a bias towards domestic financial assets because it puts additional risk on holding foreign securities. This result confirms the findings of Fidora et al. (2007) that underline the role of the real exchange rate volatility as a driver of portfolio home bias. Nevertheless, Solnik (1974) demonstrated, in one hand, that exchange risk could be removed by buying a forward exchange contract (hedging the risk of exchange rate). In another hand, he showed that the risk of a portfolio unprotected is larger than a covered portfolio and smaller than a comparable undiversified portfolio. Accordingly, this author rejects that the exchange rate as an economic indicator explains home bias.

In the present paper, we suppose that economic stability is a key factor that could affect the home bias. Then,

H2: economic indicators explain home bias

c. Country governance

Dahlquist et al. (2003) showed that there is a close relationship between investor protection, governance and the portfolios held by investors. Furthermore, Kho et al. (2009) stipulate that governance affects home bias directly and indirectly. They suggest that, in one hand, poorer governance leads to a higher level of insider ownership, which limits portfolio holdings by foreign investors (direct effect). In another hand, poorer governance also implies higher ownership by domestic monitoring shareholders and, as the ownership of these investors' increases, domestic investors become more overweight in domestic stocks, further limiting the portfolio investment of foreigners. Using both country-level data on U.S. investors' foreign investment allocations and Korean firm-level data, they found empirical evidence supporting the governance as an important factor that explains home bias.

Finally, Daly and Vo (2013), Mishra (2014) and Levis et al (2015) also examined the effect of the worldwide governance indicators on home bias. They found that investors prefer to invest in countries where there is better governance. Then, we predict in the present paper that home bias is due to governance indicators. We suppose the following:

H3: countries' governance affects negatively home bias

d. *Equity market characteristics*

Equity market characteristics are considered as an important factor that influences foreign investors' decisions. Daly and Vo (2013) consider that the size and the liquidity of equity market affect negatively the home bias. Khurana and Michas (2011) found that equity market development attracts foreign investors and then affect the home bias phenomenon. These authors stipulate that investors tend to invest more in larger capital markets, increased market liquidity and non-emerging market. Finally, Kim et al. (2014) found that equity market development is a major variable that could influence this phenomenon. Based on twenty two developed countries over the period 2001-2011, they found that market performance factors (market return, volatility and liquidity) affect home bias more strongly than do economic development factors. Then, we suppose that:

H4: Equity market developments affect negatively home bias

e. *Capital control restrictions*

Capital flow liberalization is considered as a key factor that attracts foreign direct investment. However, to control their national sovereignty some countries use capital controls. Errunza and Losq (1985), based on a cross sectional analysis, consider these restrictions as a friction that affects investors' choice and lead them to invest in domestic market rather than internationally. Errunza and Losq (1989) extended their model to N countries. They proved that capital controls prevent investors from international diversification and force them to hold domestic equities. Furthermore, Daly and Vo (2013) considered that the capital restrictions are important in explaining home bias.

However, Ahearne et al. (2004) found that while capital controls affect the distributions of international portfolios in a statistical sense, it couldn't be an important explanation of home bias. Moreover, Solnik and Zuo (2014) Stipulated that the home bias is explained by behavioral factors and couldn't be driven by institutional factors (capital controls). Finally, Baccouri and Fedhila (2016) found that the capital controls don't explain the home bias. To investigate this relationship, the present study hypothesizes the following:

H5: Capital controls affect positively the home bias

3.RESEARCH METHODOLOGY

3.1. Measurement of Variables

a. *Home Bias Equity*

The present paper adopted the measure used by Fidora et al. (2007), Schoenmaker and Bosch (2008), Chen and Yuan (2011) and Baccouri and Fedhila (2016) and obtained from the CPIS "Coordinated Portfolio Investment Survey". The equity home bias is measured as the difference between the relative weight of domestic equity in the portfolio of country i and the relative weight of country i in the total world market portfolio. Then, the home bias is equal to:

$$HB = w_i - w_i^*$$

W_i = country i's domestic asset / country i's market capitalization

W_i^* = country's market capitalization / world market capitalization

Knowing that the weight w_i is country i's share of domestic assets to its domestic equity portfolio, while w_i^* denotes the world portfolio.

b. *Information asymmetry*

Ahearne et al. (2004), Giofré (2009) and Cao and Ward (2014) emphasized that there isn't direct measures of information asymmetries. There is a proxy for their reduction. The present paper would employ the six proxies used by Giofré (2009) and Baccouri and Fedhila (2016). The first three variables are labeled "size" and the others three variables are labeled "trade". These six proxies are:

- Logarithm of Gross Domestic Product per capita (log (GDP/POP)) indicates the market efficiency.
- M2 monetary aggregate over GDP: (M2/GDP) captures the financial sector development.
- The market capitalization over GDP (MCAP/GDP) associates the size of stock market capitalization to efficiency.
- The openness measures ((IMP+EXP)/GDP) captures the information factors.
- The export over GDP (EXP/GDP).
- The import over GDP (IMP/GDP).

It should be noted that the variables labeled "size" and "trade" would be assessed by doing a principal component analysis of these six proxies.

c. *Economic indicators*

Three variables are used to capture countries' economic stability. The present paper assumes that the economic stability of a country affects cross border equity investment. The three variables are: (1) the inflation rate measured by the consumer price index, (2) real exchange rate volatility and (3) the growth rate of the gross domestic product.

d. Governance indicators

To measure this variable we employed the instrument developed by Kaufmann et al. (2011) and used by Daly and Vo (2011), Mishra (2014) and Baccouri and Fedhila (2016). The governance indicator includes six dimensions: (1) Voice and accountability, (2) Political Stability and absence of violence, (3) Government effectiveness, (4) Regulatory quality, (5) Rule of law, and (6) Control of corruption. This variable is expected to have a negative effect on home bias. In the present paper, we used the principal component analysis of these six governance indicators given the higher correlation between them.

e. Equity market characteristics

The equity market characteristics of a country influence the home bias. The present research supposes that more the equity market in a country is developed less is the home bias. To capture the equity market characteristics, three variables are used: (1) the equity market liquidity, (2) the stock market index (annual % change) and (3) stock market classification.

f. Capital controls

Despite the fact that capital controls is reduced in many countries, many others countries still have restrictions on international capital flows. The present paper considers that investors prefer to invest in countries with fewer restrictions. To measure these restrictions imposed by countries on capital flows, we would follow Ferreira and Miguel (2011) and we will use the index created by the Economic Freedom Network. This index is calculated based on the international capital controls reported by the International Monetary Fund. High (low) values in this index indicate less (more) restrictions.

3.2. Sample

To operationalize our theoretical framework, we empirically tested it via countries included in the Coordinated Portfolio Investment Survey “CPIS”. At the beginning, we started with 55 countries whose data are available during the period from 2003 to 2013. Nevertheless, it should be noted that the data linked to some variables wasn’t available for some countries. Then, our sample consists of 564 observations (country-years). The countries included in our sample are:

Table 1. Countries included in our sample

Argentina	Colombia	Greece	Lebanon	Poland
Australia	Costa Rica	Hungary	Malaysia	Portugal
Austria	Cyprus	Iceland	Malta	Romania
Barbados	Czech Republic	Indonesia	Mauritius	Russian Federation
Belgium	Denmark	Israel	Mexico	Singapore
Brazil	Egypt	Italy	Netherlands	Slovak Republic
Bulgaria	Estonia	Japan	New Zealand	South Africa
Canada	Finland	Kazakhstan	Norway	Spain
Chile	France	Korea Republic	Pakistan	Sweden
Hong Kong	Germany	Kuwait	Philippines	Switzerland
Thailand	Turkey	Ukraine	United Kingdom	United States

3.3. Model specification

To operationalize our hypothesis, we estimate the following model:

$$HB_{it} = \alpha_1 + \alpha_2 IAR_{it} + \alpha_3 EI_{it} + \alpha_4 GI_{it} + \alpha_5 MC_{it} + \alpha_6 CC_{it} + \varepsilon_{it}$$

Where, HB is a measure of the home bias; IAR is composed by the different trade and size variables; GI indicate the six governance indicators; MC include the different proxies used to assess the equity market characteristics and the CC is a measure of capital controls imposed by countries.

4. INTERPRETATION OF RESULTS

Table 2 shows the different results of our regressions. Given the high collinearity between the different proxies of the information asymmetry (trade and size variables), we have made a principal component analysis. The table shows the regression results of home bias on trade and size variables, governance indicators, economic indicators market characteristics and capital controls.

As expected, the trade and size proxies used to assess the information asymmetry reduction have a negative and significant effect on home bias. Then, we can validate our first hypothesis. Concerning, the second hypothesis it supposes that the economic indicators explain the home bias. In particular, we have assessed the effect of the inflation real exchange rate volatility, the growth rate of the gross domestic product on home bias. The results presented in the different column of table 2 show that only the growth rate of the gross domestic product affects positively home bias. This result confirms our expectations and the findings of Khurana and Michas (2011) that predict that this variable captures the overall economic volatility in a country and then implies a decrease of foreign investors and an increase of home bias.

The third hypothesis predicts that governance indicators reduce home bias. At the beginning, given the high collinearity between the six variables a principal component analysis was made.

Nevertheless, the results show that this variable (labelled GOV) doesn't affect the home bias despite the negative sign that we found. Thus, we decided to examine the effect of each indicator separately. As indicated in column 6, only the rule of law variable affects significantly the home bias. This variable captures as indicated by Kaufman et al. (2011) the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the tendency of crime and violence.

Concerning the equity market characteristics, in one hand, regression results show that foreign investors are attracted by developed market. This result stipulates that the risk decreases in developed market and consequently the home bias will decrease in the presence of such market. In another hand, we notice that the liquidity has a positive effect on home bias. Consequently, this result contradicts our expectations and the findings of Daly and Vo (2013), but confirms the results of Hamberg et al. (2013) that indicate that investors are encouraged to invest in small and transparent firms despite their illiquidity. Finally, the present paper rejects the fifth hypothesis that predicts that higher capital controls will increase home bias. Indeed, it should be noted that this variable was inversely measured. This variable is ranging from 0 (countries with higher restrictions) to 10 (countries with less restrictions). Then, it expects that the sign should be negative.

5. CONCLUSION

This paper examines the different determinants of home bias. Focusing on countries included in the Coordinated Portfolio Investment Survey "CPIS", our sample is composed by 564 observations (country-year) that cover the period 2003 to 2013. This paper communicates the evidence that home bias is driven by the information asymmetry that exists between countries and their economic volatility (assessed by the growth rate of the gross domestic product). Furthermore, our findings indicate that home bias decreases on developed market and in countries characterized by a higher rule of law.

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Appendix 1. Descriptive analysis

Table 2. Regression results

Variables	(1)hb	(2)hb	(3)hb	(4)hb	(5)hb	(6)hb	(7)hb
trade	-0.0361***	-0.0381***	-0.0379***	-0.0349***	-0.0381***	-0.0348***	-0.0362***
	(0.0108)	(0.0109)	(0.0110)	(0.0108)	(0.0110)	(0.0107)	(0.0108)
size	-0.0883***	-0.0895***	-0.0909***	-0.0897***	-0.0909***	-0.0835***	-0.0904***
	(0.0139)	(0.0139)	(0.0137)	(0.0136)	(0.0139)	(0.0140)	(0.0137)
icp	-0.00222	-0.00203	-0.00209	-0.00236	-0.00209	-0.00240	-0.00215
	(0.00182)	(0.00182)	(0.00181)	(0.00183)	(0.00182)	(0.00182)	(0.00183)
reervol	0.000339	0.000338	0.000332	0.000363	0.000346	0.000316	0.000356
	(0.000615)	(0.000614)	(0.000615)	(0.000615)	(0.000613)	(0.000614)	(0.000616)
gdpgrowth	0.00695***	0.00686***	0.00683***	0.00692***	0.00682***	0.00687***	0.00689***
	(0.00136)	(0.00136)	(0.00135)	(0.00136)	(0.00136)	(0.00135)	(0.00137)
indibrsier	4.85e-05	4.72e-05	4.34e-05	5.34e-05	4.27e-05	4.70e-05	5.30e-05
	(0.000115)	(0.000115)	(0.000115)	(0.000115)	(0.000115)	(0.000115)	(0.000116)
liquidity	0.000625***	0.000619***	0.000627***	0.000636***	0.000627***	0.000611***	0.000629***
	(0.000111)	(0.000112)	(0.000110)	(0.000111)	(0.000110)	(0.000111)	(0.000111)
capctrol	0.0101***	0.00970***	0.00949***	0.0104***	0.00956***	0.0107***	0.00955***
	(0.00329)	(0.00324)	(0.00320)	(0.00334)	(0.00329)	(0.00327)	(0.00324)
1.mc	-0.112***	-0.120***	-0.123***	-0.112***	-0.124***	-0.0957**	-0.122***
	(0.0384)	(0.0369)	(0.0362)	(0.0377)	(0.0373)	(0.0383)	(0.0375)
2.mc	-0.0386	-0.0346	-0.0320	-0.0409	-0.0331	-0.0421	-0.0380
	(0.0373)	(0.0373)	(0.0374)	(0.0374)	(0.0378)	(0.0371)	(0.0377)
gov	-0.0107						
	(0.0108)						
va		-0.0157					
		(0.0272)					
psnv			-0.00413				
			(0.0162)				
ge				-0.0309			
				(0.0260)			
rq					-0.00374		
					(0.0275)		
rl						-0.0561**	
						(0.0273)	
cc							-0.00988
							(0.0207)
Constant	0.685***	0.700***	0.693***	0.711***	0.695***	0.719***	0.699***
	(0.0358)	(0.0364)	(0.0351)	(0.0367)	(0.0386)	(0.0360)	(0.0351)
Observations	564	564	564	564	564	564	564
Number of country	53	53	53	53	53	53	53

Legend : Standard errors in parentheses; *** p<0.01; ** p<0.05; * p<0.1 ; hb : Home Bias (the dependent variable ; trade: the trade variable; size: the size variable ; gi: governance indicators; icp : inflation, consumer price; reervol : real exchange rate volatility; gdpgrowth : the growth rate of the gross domestic product; indibrsier : the stock market index; liquidity (annual %change); the equity market liquidity; capctrol : capital control ; 1.mc : this variable takes 1 if the market equity is classified by S&P as a developed market, 0 otherwise and 2.mc : this variable takes 1 if the market equity is classified by S&P as a frontier market, 0 otherwise; va :Voice and accountability; psnv :Political Stability and absence of violence; ge : Government effectiveness; rq : Regulatory quality; rl: Rule of law, and cc: Control of corruption.

Table 3. Numeric variables

Variable		Mean	Std. Dev.	Min	Max	Observations
Hb	overall	.721362	.2553944	0	1	N = 605
	between		.2333	.0118182	1	n = 55
	within		.1081598	.0731802	1.128635	T = 11
Icp	overall	4.025737	3.479542	-2.5	25.29637	N = 605
	between		2.667401	-.0422978	10.22641	n = 55
	within		2.260528	-6.108534	19.39962	T = 11
Reervol	overall	5.463784	9.4718	.0049356	84.41906	N = 605
	between		5.861715	.7137931	26.50658	n = 55
	within		7.478246	-17.75356	70.29032	T = 11
Gdpgrowth	overall	3.010255	3.574675	-14.8	17.32	N = 605
	between		1.833881	-.8513931	7.136364	n = 55
	within		3.077476	-15.14662	14.6841	T = 11
Indibrsier	overall	17.47379	36.59847	-82.18989	189.23	N = 605
	between		8.884267	-2.774238	38.32101	n = 55
	Within		35.52217	-97.9334	179.099	T = 11
Liquidity	overall	53.70213	86.63824	.0224556	954.4281	N = 605
	between		77.6843	.3533553	500.1136	n = 55
	within		39.63898	-277.0504	508.0166	T = 11
Capctrol	overall	4.545802	2.660118	0	10	N = 605
	between		2.368786	0	9.16007	n = 55
	within		1.24819	-1.395387	9.227899	T = 11
Va	overall	.6879638	.7836858	-1.263728	1.82637	N = 605
	between		.7841056	-1.1107	1.643019	n = 55
	within		.0975756	.2714173	1.229105	T = 11
Psnv	Overall	.2926459	.9288634	-2.81208	1.664182	N = 605
	Between		.9121059	-2.302889	1.473787	n = 55
	Within		.2112439	-.67899	1.268986	T = 11
Ge	Overall	.8891951	.8528724	-.8742824	2.429651	N = 605
	Between		.8515525	-.6546519	2.172505	n = 55
	Within		.1193957	.4725941	1.626564	T = 11
Rq	Overall	.8602986	.7501599	-.9840401	-.9840401	N = 605
	Between		.7462817	-.7585509	1.91994	n = 55
	Within		.1225736	.3414672	1.264228	T = 11
Rl	Overall	.7570187	.9162838	-1.053395	1.99964	N = 605
	Between		.9189735	-.8556756	1.947305	n = 55
	Within		.0951092	.3293719	1.120933	T = 11
Cc	Overall	.7532786	1.051537	-1.095664	2.552692	N = 605
	Between		1.051126	-.9470351	2.454624	n = 55
	Within		.1384128	.1575243	1.304961	T = 11
Logppc	Overall	9.616959	1.083437	6.3	11.54	N = 605
	Between		1.052665	6.798182	11.27182	n = 55
	Within		.2899645	8.29605	10.74059	T = 11
M²gdp	Overall	103.628	61.09618	21.07	335.26	N = 605
	Between		59.55743	28.69	298.8082	n = 55
	Within		15.63273	34.48068	155.1961	T = 11
Mcapgdp	Overall	81.49458	127.0971	2.770278	1254.465	N = 605
	Between		120.3109	5.310281	877.6416	n = 55
	Within		43.80202	-353.3553	458.3183	T = 11
Mgdp	Overall	46.71509	33.71636	10.21754	227.3453	N = 605
	Between		33.45952	12.56782	197.4521	n = 55
	Within		5.982389	8.297	76.60825	T = 11
Xgdp	Overall	47.96119	36.96409	9.037519	230.269	N = 605
	Between		36.70866	11.58068	209.2815	n = 55
	Within		6.413108	11.24501	71.04517	T = 11
Mxgdp	Overall	94.67629	70.12365	22.0903	455.2767	N = 605
	between		69.67752	25.7715	402.2996	n = 55
	within		11.94781	19.54201	147.6534	T = 11

Table 4. Categorical variables

mc	Overall		Between		Within
	Freq.	Percent	Freq.	Percent	Percent
0	194	34.40	19	35.85	93.30
1	270	47.87	27	50.94	90.91
2	100	17.73	13	24.53	82.52
Total	564	100.00	59	111.32	89.83
(n = 53)					

Appendix 2. Bivariate analysis

Table 5. Correlation between governance indicators

	va	Psnv	Ge	Rq	Rl	Cc
va	1.0000					
Psnv	0.7386	1.0000				
Ge	0.7922	0.7309	1.0000			
Rq	0.8149	0.7393	0.9301	1.0000		
Rl	0.8289	0.7904	0.9549	0.9381	1.0000	
Cc	0.8075	0.7496	0.9554	0.9166	0.9603	1.0000

Table 6. Correlation between information asymmetry reduction variables

	logppc	m2gdp	mcapgdp	mgdp	xgdp	mxgdp
logppc	1.0000					
m2gdp	0.4512	1.0000				
mcapgdp	0.1903	0.4591	1.0000			
mgdp	0.0974	0.4068	0.6075	1.0000		
xgdp	0.1598	0.3643	0.6075	0.9685	1.0000	
mxgdp	0.1311	0.3876	0.6123	0.9914	0.9928	1.0000

THE INDUCTION OF BOARD DIRECTORS: A CASE STUDY PERSPECTIVE

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Abstract

This paper gives an overview on the induction process for board members with a focus on the Italian context. First, considering the limited prior academic literature, we contribute to the understanding of the induction term. We propose a multilevel theoretical framework that synthesizes and integrates the poor and contrasting prior literature on the definition and the attendees of the program. We posit that the process is intended for all the appointed directors as it is tailored and specific of each company, due to the peculiar environment in which the firm operates. Second, we investigate how these programs are designed and how they can be beneficial for a company. Using a multiple case study on five Italian listed companies, we support the view that induction programs are a fundamental tool to assure that each director fully contributes with his own human and social capital to the board meetings in the shortest possible time, thus guaranteeing a positive impact on the value creation. Instead, in order to increase future directors' knowledge, pre-appointment preparation courses are particularly relevant.

Keywords: Corporate Governance, Induction, Board, Director, Case Study

1. INTRODUCTION

In today's context, there are several external variables driving companies to quickly adapt their strategies to the mutating environment and to find the most efficient and performing internal structures (Wernerfelt and Karnani, 1987; Courtney et al., 1997; Reeves and Deimler, 2013). In an environment characterized by a persisting risk presence, the goal of governance, which is to ensure that the firm operates with effectiveness and integrity in the interests of shareholders (Fama and Jensen, 1983; Keasey and Wright, 1993), is becoming increasingly critical and is requiring directors to play more and more an active role (Kiel and Nicholson, 2004).

The board of directors cannot just monitor top management work but it has to give its full contribution and be actively involved in the definition of corporate strategies (Garratt, 2005; Machold et al., 2011). Therefore, it becomes imperative to appoint very prepared directors and to constantly give them all the information about the business, operations and industry of the company, so that they can properly carry out their duties (Mallin, 2005).

In this regard, the Italian corporate governance Code (Borsa Italiana, 2015) invites companies to organize initiatives, identified by the term *Induction*, aimed at providing directors with adequate knowledge of the business sector in which the issuer operates, the business dynamics and their evolution, the principles of good risk management and the regulatory and self-regulatory framework.

The relevance of the issue is unassailable as the diffusion of the provision among corporate governance Codes of different countries (e.g. Italy, France, Spain, the UK) testifies.

Further, given the beneficial role of the directors for the company (Zahra and Pearce, 1989; Hillman and Dalziel, 2003), we noticed an aware concerning of companies on the matter as highlighted in their corporate governance annual reports. Analysing the 2014 Corporate Governance reports of the first 100 Italian listed companies for capitalisation, we found out a broad diffusion of these practices: 75% of companies declares to undergo induction programs and properly describes them. Almost all these companies comply with the Code principle and make disclosure about the issue (93%), with just few exceptions as in case of double listing. 80% of companies compliant with the corporate governance Code undertakes induction programs or organize off-board sessions comparable to induction. The remaining companies either give vague indications, not enough specific to be considered induction, or do not provide specific development programs for their directors, justifying it either with the recent IPO, the absence of new appointments or underlining directors already have the necessary skills and experience to exploit their role.

However, a systematic analysis of the literature shows a clear lack of consistent studies on this subject. The few papers on Induction programmes (Garratt, 2005; Brown, 2007; Long, 2008; Roy, 2008; Schwizer et al., 2011) just give some superficial pills on how these programs are organised and why they could be useful, without proposing any clear definition about what an Induction program is. Further, to the best of our knowledge, no paper clearly describes the process through which an

Induction program is carried out, highlighting clearly its benefits of these programs at firm level.

This article tries to fill the literature gaps, proposing a consistent definition of induction programs, analysing how these programs are designed and therefore beneficial for the company, focusing on Italian listed companies.

The paper proceeds as follows. In the next sections, the review of the literature is followed by our preliminary theoretical framework derived from the existing literature. We then describe our research methodology and present our main results. Finally, we conclude discussing the contributions and limitations of the paper, and present suggestions for further studies.

2. LITERATURE REVIEW

The board of directors is in charge of governing, directing and monitoring (Demb and Neubauer, 1992; Adams et al., 2011; Schwartz-Ziv and Weisbach, 2013). The board of directors generally performs in a collective way different tasks (Monks and Minow, 2004) such as providing information and counsel to managers; addressing corporate strategy; safeguarding the interests of shareholders and stakeholders, monitoring and controlling the actions of management; linking the corporation to the external environment and monitoring the compliance with applicable laws and regulations. Assuming “the primary role of board members is to guide the firm” (O’Neal and Thomas, 1995), the better the board performs its tasks, the better will be the benefit for the company and thus its performance (Forbes and Milliken, 1999).

In order to have an active role in the board, it is essential that directors are probit, equipped and appointed by virtue of their experience, skills and knowledge, and that they undertake appropriate training and development to keep them up to date with all relevant areas of the business and its operating environment (Mallin, 2005). In this regard, induction is intended to “provide directors with adequate knowledge of the business sector in which the issuer operates, the business dynamics and their evolution, the principles of good risk management as well as the regulatory and self-regulatory framework” (Borsa Italiana, 2015).

Despite the widespread implementation of induction programs, a proper and validated definition of the term *Induction* referred to board directors has still not been provided. The Latin etymology of the term signifies “to lead into, bring in, introduce, conduct”. From its etymological derivation, “it is a process that guides someone to a certain path” (Gherardi and Perotta, 2010). Further, it is defined as “the formal act or process of placing” (Dictionary Merriam-Webster Collegiate) or “introducing someone into a new job, position, organization, government office, etc”. (Dictionary Oxford English).

Considering the main phases of the process, the discussion on Induction spread non-homogeneously on different points. A first point is the identification of the proper advocate of such programs at corporate level. Garratt (2005) and Long (2008) identify the Chairman as responsible to encourage a proper Induction process and the company secretary as accountable for facilitating and tailoring induction programs for every board member.

Further, due to the primary idea of the program, the need for a proper support in learning and understanding its role for a first time appointed director is particularly trivial in order to get up as quickly as possible (Spencer Stuart, 2013).

Regarding the induction process, however, there is not any distinction for executive and non-executive directors (Kakabadse et al., 2001). In fact, the benefit for the latter is clearly related to the enhancement of the knowledge about company business and operations on which they lack with respect to their executive colleagues. The former instead can draw on these initiatives to enlarge their knowledge and skills in order to be more effective and constructive in taking strategic decisions, deepening the knowledge on boardroom norms and what is expected from them as directors (Garratt, 2005).

Moreover, when considering induction programs, companies and boards should think about the themes and arguments they need to focus on. First of all, a board induction programme should give information about the role of a director (Kakabadse et al., 2001 Matheson, 2007) and the difference between governance and management (Garratt, 2005; Spencer Stuart, 2013). Another relevant argument to enable directors to be effective in their role is the culture and mechanisms of the specific board they are appointed into and the main corporate governance principles and requirements (Jackson et al., 2003). Directors should also be informed about the financial situation and the business, in terms of system of operation, portfolio of investments and corporate strategies (Lorsch and Carter, 2004). Further, they should be acquainted with the industry, the main competitors, the international best practices and the major risks (Jackson et al., 2003; Lorsch and Carter, 2004; Long, 2008).

Finally, firms can differentiate and customize their induction programs opting for an internal program (organized by the company itself), an external program (usually offered by universities, leading authorities and other organizations) or a combination of both (Epstein and Roy, 2007; Long, 2008; Roy, 2008). Companies chose how to structure their programs considering what their directors need: while internal programs take into account industry-specific and company-specific challenges, external programs address topics such as compensation, codes compliance, directors roles and responsibilities and ensure a minimum level of financial literacy (Epstein and Roy, 2007).

3. RESEARCH AIM AND FRAMEWORK

Our research framework builds on the board capital theory and on the resource dependence theory.

3.1. Board Capital

The concept of Board Capital, combining the Human and the Relational Capital of the board of directors, was introduced by Hillman and Dalziel (2003).

Expertise, experience, knowledge, reputation, and skills of a person are defined as “Human Capital” by Becker (1964) and Coleman (1988). In the board context, Human Capital refers to directors' knowledge, abilities, and experiences gained through education, training, and experience in firms, boards, and industry contexts (Westphal and Fredrickson, 2001; Sturman et al., 2008). Further, international experience, specific industrial know-how, CEO experience, and financial know-how improve the external consideration of the Human Capital of a director (Volontè and Gantenbein, 2014).

Relational Capital, sometimes called even Social Capital, explicitly refers to "the sum of actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual or social unit" (Nahapiet and Ghoshal, 1998). It refers to the resources that one is able to access through social relations and networks, which form the basis for action (Adler and Kwon, 2002). White (1961, 1963) and Jacobs (1961) studied the Relational Capital embedded in social ties, discussing the role of a board directorate ties to external organizations.

The access to information channels is thus critical for the development of human and intellectual capital (Coleman, 1988; Nahapiet and Ghoshal, 1998). The source and the nature of social relations influence the types of information and advice that flow to specific networks and individuals, and this knowledge flow shapes the type of human capital that is developed and mobilized for action (Adler and Kwon, 2002; Fischer and Pollock, 2004).

3.2. Resource Dependence Theory

The resource dependence theory (Pfeffer, 1972; Pfeffer and Salancik, 1978) emphasizes the interdependence between organizations and entities in their external environment that control important resources (Hillman et al., 2007). Companies are part of open systems and are dependent upon external entities for survival; thus, the resulting uncertainties pose significant challenges and costs to the organizations (Pfeffer, 1972). Pfeffer and Salancik (1978) developed the idea that a firm can form links with elements of its external environment upon which it is strictly linked to reduce dependency and obtain resources.

Boards of directors are a primary linkage mechanism for connecting a firm with sources of external dependency and, in this way, reducing uncertainty (Hillman et al., 2000). A further important board functions is the provision of resources (Hillman and Dalziel, 2003). This function directly refers to the ability of the board members to bring resources to the firm, resources being "anything that could be thought of as a strength or weakness of a given firm" (Wernerfelt, 1984). In terms of provision of resources, four primary benefits can be provided by boards (Pfeffer and Salancik, 1978): advice and counsel; legitimacy; channels for communicating information between external organizations and the firm; and preferential access to commitments or support from important elements outside the firm.

Investigating the relation between boards and firm performance under the Resource Dependence logic (see Fig. 1), scholars stated that resources help to reduce dependency between the organization and external contingencies (Pfeffer and Salancik, 1978), diminish uncertainty for the firm (Pfeffer, 1972), lower transaction costs (Williamson, 1984), and ultimately aid in the survival of the firm (Singh et al., 1986). Thus, the board provision of resources is directly related to firm performance (Hillman and Dalziel, 2003).

3.3. Board Capital and Resource Dependence Theory

Studies of the firm level benefits of directors' Human and Relational Capital represent a rich and growing research stream (Boyd, 1990; Westphal, 1999; Carpenter and Westphal, 2001) and provide evidence of Pfeffer and Salancik's (1978) board of director linkage benefits. In fact, Board Capital has been positively associated with the provision of each of the four benefits discussed by Pfeffer and Salancik (1978), since the personal Human and Social Capital of each director provides positive resources to the company.

In particular, Hillman and Dalziel (2003) make a deep analysis of the studies that enforce a correlation between Board Capital and each fundamental resource introduced by Pfeffer and Salancik (1978).

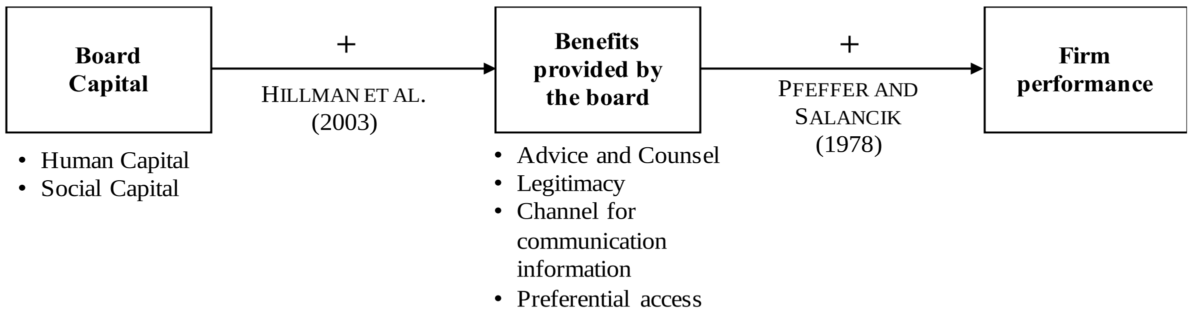
- *Board Capital & advice and counsel.* Boards are often composed of lawyers, financial representatives, top management of other firms, public affairs or marketing specialists, former government officials and community leaders, and other directors who bring important expertise, experience, and skills to facilitate advice and counsel (Baysinger and Butler, 1985; Gales and Kesner, 1994). For this reason, both insiders and outsiders on boards have important Human Capital that affects the provision of advice and counsel (Hillman and Dalziel, 2003). Regarding Social Capital, Carpenter and Westphal (2001) found that boards consisting of directors that are tied to strategically related organizations were able to provide better advices, which are positively related to firm performance (Westphal, 1999).
- *Board Capital & legitimancy.* Board Capital has been linked to the provision of firm legitimacy and reputation (Hambrick and D'Aveni, 1992; Daily and Schwenk, 1996). Pfeffer and Salancik (1978) note that "prestigious or legitimate persons or organizations represented on the focal organization's board provide confirmation to the rest of the world of the value and worth of the organization". Certo et al. (2001) found that more prestigious boards experienced better performance, e.g. less underpricing at their IPO, suggesting that the prestige of directors (Board Capital) can enhance the credibility and the performance of the firm they serve.
- *Board Capital & Channels for communicating information between external organizations and the firm.* As Hillman and Dalziel (2003) affirm, Board Capital provides channels of communication and conduits of information between the firm and external organizations, as it provides the firm with timely and valuable information and serves to reduce the transaction costs of dealing with uncertainties in the environment, thereby enhancing performance. For example Hillman et al. (1999) found that when directors established connections with the US

government, shareholder value was positively affected. Researchers have also found that executive directors external ties also facilitate access to strategic information and opportunities (Pieifer, 1991), enhance environmental scanning (Useem, 1984), and reveal information about the agendas and operations of other firms (Burt, 1983). Empirical evidence has shown that executives' external ties play a critical role in future strategy formulation and subsequent firm performance (Eisenhardt and Schoonhoven, 1996; Geletkanycz and Hambrick, 1997).

- *Board Capital & Preferential access to commitments or support from important elements outside the firm.* Board Capital can be helpful in acquiring resources from outside the firm, such as financial capital and influence with political bodies or other important stakeholders (Hillman and Dalziel, 2003). Directorate ties allow firms to secure critical resources, often on more favourable terms (Zald, 1969; D'Aveni, 1990; Boeker and Goodstein, 1991). Inviting relevant customers and/or suppliers to be represented on the board improves their commitment and involvement (Selznick, 1949; Baysinger and Butler, 1985; Hillman et al., 2001).

Moreover, some studies contend that the provision of resources, assumed by resource dependence theorists, is a function of Board Capital (Hillman and Dalziel, 2003). Hillman and Dalziel (2003), assume that each member has a unique human and social capital, namely a unique baggage of experience, expertise, skills and network on the basis of which he has been chosen by the company for the role of director. The union of the individual capital of every member, which forms the total capital of the board (i.e. the Board Capital), promotes during the board meeting the provision of those precious resources that, according to the Resource Dependence Theory, the board must bring to assure a positive impact on the firm performance (Pfeffer and Salancik, 1978).

Figure 1. Board Capital and Resource Dependence Theory scheme based on Hillman et al. (2003) and Pfeffer and Salancik (1978)



We deem Induction is an important additional element in this framework: every board director receives his appointment for his individual Human and Social Capital, on which he is expected to give his peculiar contribution. Thus, the critical aspect is bringing his own characteristics to the new environment and do that as quickly as possible. In fact, in providing his own Social and Human Capital to the board, he can face some informational obstacles, especially in a new company or in a new role. There are for sure some peculiarities of the new structure he does not know and needs to be informed of, perhaps trained about, that otherwise could prevent his full contribution.

Summing up, this study has three main objectives. First, to clearly identify what has to be called “induction” at board level. Second, from an exploratory view, we are interested in highlight relevant variables about the induction process. Third, we want to understand the benefits at firm level that such programs could have. Thus, our research questions are the following:

RQ1: How can be defined an induction program for board directors?

RQ2: How can an induction program be designed?

RQ3: How can be an induction program beneficial for a company?

4. METHODOLOGY

We conducted two studies to answer to our Research Questions. In Study 1, we work to clarify the meaning of the Induction term through a systematic literature review. In Study 2, we investigate induction programs structures and objectives through a multiple case study approach.

4.1. Study 1: Systematic Literature Review

Our paper aims at clarify the meaning of the Induction term. For this reason, we systematically review prior works on the topic. We search for “board”, “director” and either “induction” or “training” in Scopus database. We limit the analysis to English written papers, excluding those related to Medicine. We end up with 32 documents, some not related to our topic. Due to the limited evidence, we opted for enlarging our perimeter of analysis, considering even those papers which consider induction or training programs whose target is different than board directors (e.g. teachers, new employees). The motivation relies on the structure and scope of the programs which could be generally valid. We will build on these papers to propose a clearer definition of Induction program at board level.

Table 1. Search settings

Combination of Keywords	**(Induction OR Training OR Orientation) AND Board AND (Administrator OR Governance OR Directors OR Effectiveness)**
Database	Scopus
Subject area	No limitation
Search period	All years to Present (October 2015)

Figure 2. Search results

	# of papers
Induction	705.120
Board	4.380
Administrator	12
Papers of our interest	0
Governance	23
Papers of our interest	7
Directors	113
Excluding papers about Medicine, Immunology and Microbiology, Biochemistry, Genetics and Molecular Biology, Pharmacology, Toxicology and Pharmaceutics, Agricultural and Biological Sciences, Physics and Astronomy, Nursing, Agricultural and Biological Science, Chemistry	22
Papers of our interest	9
Papers of our interest not already founded in previous research	2
Effectiveness	414
Considering papers concerning Social Sciences, Business, Management and Accounting, Economics, Econometrics and Finance, Psychology	48
Papers of our interest	6
Papers of our interest not already founded in previous research	0
TOTAL PAPERS OF OUR INTEREST	**9**

	# of papers
Training	713.695
Board	22.960
Administrator	499
Considering papers concerning Social Sciences, Business, Management and Accounting, Economics, Econometrics and Finance	247
Papers of our interest	4
Governance	640
Considering papers concerning Business, Management and Accounting, Economics, Econometrics and Finance	138
Papers of our interest	17
Papers of our interest not already founded in previous research	14
Directors	2.385
Considering papers concerning Business, Management and Accounting, Economics, Econometrics and Finance	174
Papers of our interest	11
Papers of our interest not already founded in previous research	2
Effectiveness	4.190
Considering papers concerning Social Sciences, Business, Management and Accounting, Economics, Econometrics and Finance, Psychology.	286
Papers of our interest	11
Papers of our interest not already founded in previous research	2
TOTAL PAPERS OF OUR INTEREST	**22**

Figure 2. Search results (Continued)

	# of papers
Orientation	519.103
Board	6.576
Administrator	87
Papers of our interest	2
Governance	512
Considering papers concerning Business, Management and Accounting, Economics, Econometrics and Finance	327
Papers of our interest	3
Papers of our interest not already founded in previous research	0
Directors	380
Considering papers concerning Business, Management and Accounting, Economics, Econometrics and Finance	237
Papers of our interest	2
Papers of our interest not already founded in previous research	0
Effectiveness	644
Considering papers concerning Business, Management and Accounting, Economics, Econometrics and Finance	211
Papers of our interest	3
Papers of our interest not already founded in previous research	1
TOTAL PAPERS OF OUR INTEREST	**3**

4.2. Study 2: Case study

Further, our research should contribute to the understanding on how an induction program is designed and how it can be beneficial for a company. Due to the non-extensive and incomplete literature, we used exploratory holistic multiple case study. Exploratory case study methodology seems appropriate as we focus on a relatively new and under-investigated area in prior research (Yin, 2003; Sneller and Langendijk, 2007). Further, we opted for multiple case studies to improve external validity and help guard against observer bias (Luzzini et al., 2014). The unit of analysis for this study is the induction program.

We collected data for this study from both documentation and interviews. For this, we carefully prepared a case study database to facilitate later researchers (Yin, 1994) and replication (Gibbert et al., 2008). We considered different types of data sources to mitigate possible informant bias and to acquire a broader point of view (Yin, 2003). Further, for each topic, we triangulated archival data and interviews to ensure reliability to our accounts (Yin, 2003).

4.2.1 Case Selection

We considered several factors in selecting the cases. Following Yin (2003) recommendations, due to different corporate governance recommendations in different countries, we focus on a single country, namely Italy. In Italy, board Induction is advised by the corporate governance Code. As the recommendations of the Code are mainly intended to listed companies, we selected companies belonging to a stock index, namely FTSE All Share. We focus on companies whose listing and headquarters were in the same country as the Stock Exchange can ask for additional disclosure than the country of origin.

We opted for an information-oriented selection (Flyvbjerg, 2006), basing our initial choice on preliminary readings of all the Italian listed companies annual reports and/or corporate governance reports. Fifteen companies were initially identified and invited to participate in the study (Wu and Pagell, 2011) according to their disclosed induction practices, companies which can be considered the leaders when it comes to induction. Unfortunately, ten companies either did not answered or had no time. The five companies we studied show some similarities but even differences. In particular, the companies have a similar size as they are large and listed companies which ensures the presence of an induction plan, are Italian companies both in terms of country of origin and of listing, and disclosed a high maturity towards corporate governance. Their belonging to different industries can show that the peculiarities and specific contents of each induction programs are related to the specific business of the company; however, the aim and scope and the company effort are shared in any industry. Finally, all the companies have designed and organized an induction program but not all have an ongoing induction program in place, which can give more evidence to our research questions.

Table 2. Sample characteristics

	Case V	Case W	Case X	Case Y	Case Z
Industry	Consumer services	Consumer services	Public services	Oil & Gas	Finance
Stock index	FTSE ALL	FTSE MIB	FTSE MIB	FTSE MIB	FTSE MIB
Year of listing	2015	1997	1999	1995	1994
Revenues range	50 to 100 €m	1 to 5 €bn	50 to 100 €bn	50 to 100 €bn	500 €m to 1€bn
CG system	Italian	Italian	Italian	Italian	Two tier
# board members (of which independent)	7 (2)	13 (8)	9 (6)	9 (7)	18+5 (16+1)
Induction	Yes	Yes	Yes	Yes	Yes

4.2.2 Data Collection

For what concerns archival data, we began by analysing publicly available information from the annual report and the corporate governance report. Further, we consider companies' web sites, as well as articles from major economic journals and information from the Web. We opted for an extensive archival data for several reasons. First, the information provided historical insight on the process. Second, the documents are official reports and therefore express the formal consideration of the company on the issue. Third, the articles give timely and update information about the evolutionary process, and an in-depth analysis and perspective by most relevant questioners.

In addition to the analysis of the documents, we conducted several semi-structured interviews (see Appendix A) with executives of the companies we selected, after the study of preliminary readings, to complement the official documents and to obtain extensive coverage of the topics. Our key informants are responsible for the definition of policies and procedures related to corporate governance, thus involved in the organization and the definition of board induction programs. In addition, because of their role, they know the regulations strains affecting board of director.

For the definition of semi-structured interview, we followed Runeson and Höst (2008): we initially prepared the questions but the distinctive order was decided in relation to the development of the conversation, checking that the different major point were discussed.

We conducted most interviews on-site but in two cases via phone. The length of each interview ranged between 40 and 60 minutes. We recorded and analysed the audio files providing a transcript of each in its original language. We opted not to translate it from the original language to English to avoid any changes of the sense of the original text.

Table 3. Interview details

	Case V	Case W	Case X	Case Y	Case Z
Date	October 14th, 2015	October 9th, 2015	September 24th, 2015	October 6th, 2015	October 16th, 2015
Starting time	15:30	15:00	17:30	10:00	14:30
Duration	40 min	60 min	60 min	60 min	40 min
Mode	On site	Phone call	Phone call	On site	On site
Role	Head of investor relations and strategic planning	Group corporate & regulatory affairs director	Head of corporate affairs	Corporate governance rules and system senior VP (I1) and education & training VP (I2)	Head of corporate affairs
Informant Gender	F	M	M	F	M

4.2.3 Data Coding

Data were coded, abstracting the most relevant themes from the data (Kreiner et al., 2015), using typical content analysis procedures (Diesing, 1972; Taylor and Bogdan, 1984; Lincoln and Guba, 1985; Strauss, 1987) after each interview took place. We coded all data from interviews into a number of categories we grounded on our previous literature review and considering the Mintzberg model (1976), thus helping to focus attention on certain data that could produce compelling analytic conclusions (Yin, 2003). We began with in-vivo codes utilizing the language of our informants. From the first-order coding, the scheme evolved by considering the Mintzberg model (1976). We further considered all the main results emerged during our literature review. The final coding structure is reported in Appendix B.

Data coding was conducted by each of us, following Yan and Gray (1994) indications. First, we jointly developed the coding scheme and used it to analyse a case. Then, we divided the coding of the remaining interviews, with one of us coding the data while the others acted as an independent auditor (Lincoln and Guba, 1985) to ensure consistency and trustworthiness of our analytical procedures. Auditing consisted of verifying both the process (the steps followed by the coder) and the product of data coding (the tables derived from the interview data).

5. RESULTS

In this section we present the main results of our two studies, namely the systematic literature review and the case study to answer to our research questions.

5.1. A definition of Induction

Due to the limited evidence we found in prior literature about a definition of induction, we opted for a systematic literature review, considering the same process in different fields, namely staff and teacher induction.

In the context of human resource literature, staff induction is depicted as "any arrangement made to familiarize the new employee with the organization, safety rules, general conditions of employment, and the work of the section or department in which they are employed" (Skeats, 1991) and "the process of familiarizing new employees with whatever is necessary for them to feel at home and to understand and perform their duties efficiently" (St John, 1980).

In this context, often the term socialization is related to the induction one. Socialization focuses on how newcomers adjust to their new surroundings and learn the behaviors, attitudes, and skills necessary to fulfil their new roles and functions effectively as members of an organization (Van Maanen, 1976; Fisher, 1986), thus representing the social and cognitive process a new employee goes through when he faces a new work experience. Instead, staff induction appears as the instrument used from an organizational perspective to guide the process of socialization. According to Van Maanen and Schein (1979) staff induction is a program which seeks to govern the newcomer's socialization in a way that he will become a fully functional member of the organization quickly. Birnholtz et al. (2007) highlight that staff induction practices govern unconsciously or deliberately organizational socialization and together, they can be perceived as core mechanisms of the way in which firms introduce newcomers into the organization. Consequently, Bauer et al. (1998) identify staff induction and socialization important mechanisms for both organizations and newcomers. On one side, organizations continuously need new employees for their sustainability and for organizational growth in particular. On the other, employees need to reduce complexity when they enter into a new organization in order to be able to contribute to organizational activities.

Considering teachers' induction, a lively debate includes it among different drivers to increase students achievements. Teacher induction is a comprehensive, coherent and sustained professional development process organized by a school district to train, support and retain new teachers and seamlessly progresses them into a lifelong learning program (Wong, 2004). In other word, the process is important, but it has also to be followed by a lifelong professional development program to keep new teachers improving and increasing their effectiveness.

Considering the evidence so far, we consider board induction as a structured process of introduction of directors into the boardroom and into the context of the company, with the aim to give fundamental information to play their role actively in the shortest possible time.

We found support for our definition. Prior research consider board induction with a similar meaning, but not explicitly defining it. For Jackson et al. (2003) it is increasingly considered essential to undergo an induction process for newly appointed executive and non-executive directors. Ingley and Van der Walt (2003) consider crucial the induction phase following the appointment to integrate the new director into the board. Long (2008) states that an effective induction is essential for new board members.

Further, we noticed that different expressions or terms are used to indicate the same board induction process, creating ambiguities. Roberts and Connors (1998) state that, once the ideal board member is identified, the organization needs to provide orientation and training to ensure adequate preparation for the board members and to address the changing organizational environment. Brown (2007) too, uses the world orientation to indicate the process that provides basic guidance for new members. Inglis and Dooley (2003) highlight the need of a process that could facilitate the integration of new board members into the culture and performance expectations of the board, indicating mentoring as an instrument that can facilitate this process.

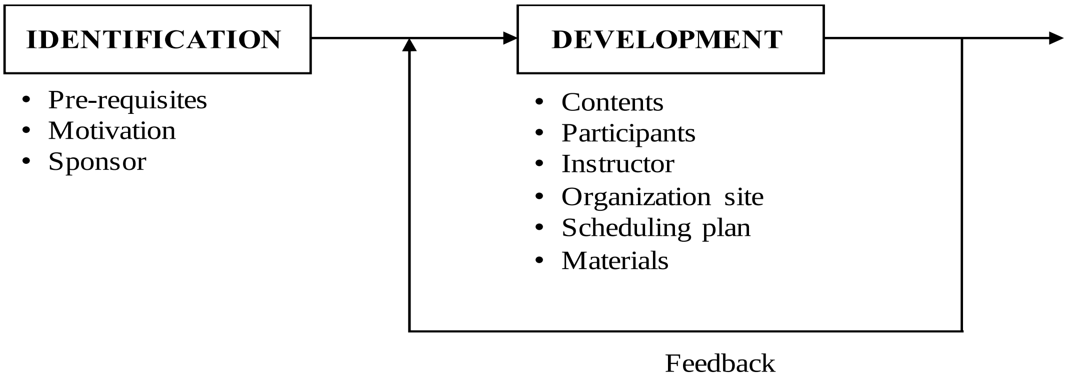
At the same time, we noticed even similar words used with different meaning. Board development consists of regular board development programs, board instructions, and board evaluations to increase board involvement (Demb and Neubauer, 1992; Lorsch, 1995; Conger et al., 1998). Under this view, board induction is just a part of the board development process, which has a wider purpose and application. Continuous improvement is particularly related to research on teachers which evidences the importance of the constant increase of knowledge during the life of a teacher. Training, education (Roy, 2008; Kakabadse and Van den Berghe, 2013) and updating (Coulson-Thomas, 2008) indicate regular and continuous sessions arranged for all the directors to build, refresh and maintain their competencies and knowledge in a variety of relevant areas. According to Long (2008), induction is meant to new board's member, while re-induction is a program for already appointed directors until they are part of the board. Existing board members who go through a re-induction program during their tenure will have a different approach, perspective and level of enquiry from those who have never attended a board meeting (Long, 2008).

Further, we complement our findings from a review of the academic literature with some elements showed by our cases. As a confirmation of the broad definition of the term induction and the light consensus about its meaning, we noticed that companies uses the term with a similar meaning to the one we indicated, i.e. a process directed to all the directors. In Case Y the informant described the induction session as composed of intensive courses provided right after the appointment of the directors in the board, which gives a general understanding of valuable information and content of the new environment. On-going training initiatives are instead organized later, also on the requests of the directors, to deepen, detail, and have a practical validation of some complex or unclear issues. Further, no mandatory presence is required in such initiatives, even if they experienced a broad and significant participation (e.g. Case X).

5.2. The design of induction programs

To describe the main results of our case study, we based on the decision process configuration as proposed by Mintzberg et al. (1976). We adapted the model to the induction process, as described in Figure 3. It starts from the identification of the need, which requires the decision marker (here identified as the sponsor) to recognize the stimuli (motivation), considering some form of diagnosis (pre-requisites). The development phase considers the "set of activities that leads to the development of one or more solutions to the elaboration of an opportunity" (Mintzberg et al., 1976). We detailed it including the definition of the contents, the participants, the instructor, the site, the scheduling plan and the material. Finally, feedbacks from participants are both a valuation issue and an incentive for subsequent induction programs. We present our results, directly linking with the scheme.

Figure 3. The induction process. Adapted from Mintzberg (1976)



Pre-requisites. A focal point that emerged from the interviews was that not only each board member but also the board as an entity should definitely have some pre-requisites in terms of previous competences, experiences, knowledge and skills in management, finance, compliance and audit, international view. Further, these pre-requisites can change over time in relation to the external and internal environment. As an example, the informant of case Y said "There is an upstream pre-requisite i.e. the mix of competences of the board members is a mix, in relation to business, governance, administration and finance, a mix that reflects the need of the company in that moment"[8]. Informant of company W and Z elaborated about the essential need of an excellent understanding of governance and regulatory aspects, even supported by the attendance to preparational courses. Company V and Y highlighted that at the same time the entire board needs to have some pre-requisites in terms of presence of a good balance of business, governance, administration and finance expertise to represent the contingent requirements of the company. The identification of such balance could be even suggested by the former Nomination Committee, as company Y grabbed from the board review.

Sponsor. According to our findings, the primary sponsor of such program is the Chairman of the company or both the Chairmen of the Management and Supervisory boards as in company Z, which is under a dualistic governance system, even as a consequence of the recommendation of the corporate governance Code (e.g. Case X). Case X and Y also mentioned the actual CEO. In case Y was reported the CEO showed guidelines about the optimal induction which resulted in the involvement of any first line. However, the informant of case X described the proactiveness of the CEO more in terms of presence during meetings and answers to specific questions than as real commitment.

Motivation. Cases showed that the design and the implementation of an induction program has its roots on the willing to give an overview (case W) and to improve the knowledge of each director (case X) of the business, the organization, the management system of the company, and of the company itself and its group and to shrink the transient state to an effective contribution (case V). On this, the informant of case V reported that "You have to take important strategic decisions without having, in some cases, the basis to perform a value added valuation"[9]. Further, it makes it reasonable an easier access to a better understanding of the company regularity (case V and Y). However, a strong push was the inclusion of a specific provision in the corporate governance code, not necessarily the Italian one, or the presence of a member with a previous experience in foreign countries, where the theme was earlier faced. It could be that, in line with the literature (e.g. MacNeil and Li, 2006), the idea that the market will penalise non-compliance companies, except if there is a justification to it, could hold even in this case. Further, companies could just follow those which are widely recognised as best practices.

Additional different motivations were reported. First, the substantial renewal or cooptation appointment of directors. In case X for example, 7 out of 9 members were renewed at the end of the fiscal year, even because of the partial State ownership of the company; in case Y only one member out of 13 was the *trait d'union* with the previous board. Company W reported the same concern, even if they renewed only 4 out of 13 members. The result was that only a limited number of directors had a good knowledge of the company, either from inside (e.g. the new CEO, former top manager of the company in case X or the general manager in case Y) or for the participation in the previous directorship in case of confirmed board members.

Second, the presence of a significant number of independent directors. For example, company W has 60% of independent directors, even if the major shareholder counts for more than half of the capital. This leads to a higher relevance of governance issues but asking for more understanding of the business. Further, company W reported the case of a tailored accelerated induction program directed to a coopted member due to the resignation of her predecessor. In such case, the program was aimed at aligning her knowledge with those of the remaining directors.

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8 Translation from Italian. The original sentence was "c'è quasi un pre-requisito a monte, cioè che il mix delle competenze espresse dal consiglio sia un mix, e quando dico mix mi riferisco a competenze di business, di governance, di amministrazione e finanza; un mix di competenze che rispecchi l'esigenza di quel momento contingente dell'azienda" and "L'induction deve adattarsi al tipo di consiglio".

9 Translation from Italian. The original sentence was "Si prendono scelte strategiche importanti senza che si abbia, in alcuni casi, la base per effettuare una valutazione a valore aggiunto".

Third, companies reported they prepare a detailed plan for the following year in terms of induction sessions. However, the explicit request from some board members is deemed as a serious trigger for an enhancement of the understanding of specific disciplines, such as management of related party transactions (Case W) and is therefore included in the program (Case Z). In this regards, informant of case W explicated that "the director says – I do not feel enough prepared on these themes, give me an induction"[10].

Participants. Cases show that induction programs are intended in a collegial way to both board directors and statutory auditors (or to the management and the supervisory board members in case of a two-tier governance system). In contrast with Long et al. (2005) cases show that the relevance of the program is not only limited to non-executives directors. Further, all the directors, even those already attending such board, were invited to the program (e.g. Case Y). However, an informant (case X) supposed that there could be a case in which it should address only a portion of directors in case specific topics are of restrict interest. With the same idea, participants were even free to not join the induction program (case X).

Companies Y and Z extended induction program even to those directors appointed by the company to serve in the board of its subsidiaries when the company is accustomed to nominate its managers. Reporting that "the invite is for both boards and some selected employees"[11], in Company Z invited even the head or top managers of a division in such sessions where the topic was specifically interesting for them.

Contents. All the cases show that the aim of induction is giving the basic information that a director, not only a new appointed one, should know about the company. In this sense, business related topics are deemed as more relevant. Company X focused the program on both organizational structure, staff and operation topics. In particular, they detailed on the functioning of the grid, on the Administration, Finance and Control function and on the Human Resources and Organization function. This choice was driven by the structural reorganization of the company which adopted a matrix, business-oriented model and whose major change were shared with directors. Further, they focused on regulation, which is a vivid matter for utility companies, and on business specificities such as generation, infrastructure, and renewable energies. Finally, company X recognises among the activities of the induction program the formative worth of the illustration and sharing of the strategic plan by the CEO and top managers.

Company Y covered also compliance and governance issues, including the role of the board, of directors and statutory auditors, its requirements and charges and the governance structure of the company.

Company W included a special focus on American customers peculiarities, illustrating the management process, the subsidiary history, the historical and actual numbers, and the regulation and introducing the top management of the subsidiary. Further, for its peculiar family ownership and the relevant issue of related parties, a session was devoted to the regulation and the specificities of the condition of the company with the support of an external specialized studio.

Company Z opted for a focus on legal and accounting while company X devoted a session to the individual analysis of international peer companies.

Moreover, company X included an induction session devoted to corporate social responsibility as part of a program sponsored by the United Nations, linking it to the company strategic plan and to the company strategy.

We noticed that some of these topics were faced in a local perspective. In fact, in some cases (e.g. regulation for company X) the informant revealed that, as the discussion during the board meetings is mainly centred on the national context, it seemed more relevant to tailored on it the specific induction session.

Instructor. The induction program could be designed and/or implemented by internal members (e.g. C-level of the company) or external companies (e.g. training companies) or professionals (e.g. experts of a given topic). Considering our cases, we noticed that companies primarily went for internal design and implementation. In this way, managers of the company such as direct reports of the CEO (Case X) or managers of a foreign subsidiary (Case W) are involved on sessions devoted to their business area, granting more effectiveness. Further, they are clearer and better than anyone else in describing what they do, giving the possibility to the directors to be personally in touch with the company staff (Case Y). As an example, the company secretary of company Y directly hold a session on governance affairs and the CEO of the company illustrated the business areas. In this regard, informant of company X stated "it is clear that the business cannot be illustrated by anyone which is not an internal member of the company"[12].

Even in companies which opted for an internal design, some external professionals led a session on non directly business related issues e.g. regulation, accounting, corporate social responsibility or to peculiar issue of a company e.g. related parties in company W. This is the case of company X and Y for the session devoted to corporate social responsibility. In this case, the choice is supported by the mastery of the topic by the educator and the sponsorship of a sovereign entity, namely United Nations. Informants of case Y highlighted that the role of an external speaker is closer to the one of an enabler of the board discussion about a topic. Company W availed itself of the support of an external studio to discuss the related parties issue.

Organization site. Companies reported the program was developed in the board meeting room (case X), around a table (case Y) or even with on-site visits (case Y and W). Company Y and W in fact consider part of the induction program making the board meeting in an abroad site of the company or in a relevant place for the company e.g. African

10 Translation from Italian. The original sentence was "Il consigliere stesso ti dice – su questi temi io non mi sento sufficientemente preparato, fammi l'induction".

11 Translation from Italian. The original sentence was "L'invito è rivolto ad entrambi, i board quindi 18+5 e come vi dicevo alcuni dipendenti".

12 Translation from Italian. The original sentence was "è chiaro che il business non può spiegarlo nessun altro se non chi è interno all'azienda di X".

region for Y and the US points of sales and the main subsidiary headquarter for company W. In fact, the visit of the directors of a strategic Region for the company Y or of a particularly innovative laboratory which is fundamental for the company competitive advantage is recognised as essential for their correct understanding of the business and of the company. Company W answered to the need of better understanding of the overseas business and operations, which count for more than half of W revenues and which showed different behaviour and need of customers.

Scheduling plan. The length of the program varies within companies. Company X opted for four induction sessions of about two hours in the afternoon downline of the board of directors meeting, and an annual session of two or three days upline of the strategic plan. Company Y decided to assemble directors and statutory auditors for a full immersion of an entire weekend, of which an entire day devoted to business description. Such concentration permit a good initial overview of the company but required further session on specific issues to deepen the concepts, especially for a complex and worldwide exposed company. Company Z instead opted for a year-based program, with monthly meetings.

Material. In company Y the attendees receive in advance the slides and the material the speaker will present during the session. Further, some glossaries on abbreviations and guides to the company documents are prepared ad-hoc and available for attendees through devoted apps on tablets.

Feedback. Both company X and company W reported positive feedbacks of the attendees to their program. Further, the program were on-going improved and updated considering the feedback of the attendees and according to specific in-depth requests from participants emerged during the annual board review.

5.3. The benefits of the induction process

Directors are often criticized for failing to meet their governance responsibilities in firms and to not have the level of knowledge necessary to efficiently exploit their role (Ladipo and Nestor, 2009; Levrau and Van den Berghe, 2009). Dealing with a wider variety of complex issues (Lee and Phan, 2000) and with growing responsibilities related to the strategic role of the board requires more information and engagement. Induction is therefore beneficial to be more effective in understanding the complexity of the business, the excessive dynamism and high riskiness of the markets.

Case V and W support this view. Giving the basic information a director should know about the company makes him more prepared and skilled on the different topics during the board discussion, more aware of his own responsibilities, have a timely and better understanding of the issue, and join a shared conscious decision (case W and V).

Even some indirect benefits of induction program emerged from cases. It favours team building (e.g. case Y) and mitigates the shock of being shot in a complex environment (e.g. case Y). For example, informant of case X reported that "this has eased the creation of a real team building"[13]. In fact, during these meetings, courses, and on-site visits, directors can stay together for a long time in a relaxed situation. Creating cohesion could be important during board's meeting to have insightful discussion and go deeper to the heart of the problem, without incomprehension (case X). Further, the decision to include in the induction session even those managers appointed as directors in the boards of the subsidiaries, creates a better link and alignment between the parent and the subsidiary companies. Finally, the presence of top managers of the company during the induction sessions, either as informants or as participants, foster the understanding of the business and of the future plans for the company.

6. DISCUSSION

From interviews and analysis of secondary data we found that companies have different definitions for induction, considering different and peculiar mechanisms. These main initiatives are:

i. experience in subsidiaries' boardrooms
ii. standard pre-appointment courses
iii. companies' structured programs for directors
iv. committees' participation
v. specific courses organized by external companies for directors

We consider two dimensions as more relevant to analyse companies' different approaches and understand the evidences collected, as Figure 4 illustrates. The first dimension is about the supplier of the programs, either internal, i.e. designed and organized by companies themselves, or external, i.e. planned by specialized organizations or associations. The second dimension considers whether the method of training is intended for figures not yet appointed in a board, but with the potential to be directors in the future (pre-appointment programs) or for directors (post-appointment programs). In each interaction we placed the five main practices emerged from interviews, on the basis of their peculiarities.

Data suggest that the experience in subsidiaries' boardrooms and standard pre-appointment courses are intended for people not already appointed in the board of the parent company. In addition, while the first is internal as the sponsor is the company itself, the second is external. These two practises have distinct aims: in the former case, the idea is to foster the abilities of colleagues for their new role, in the latter is to give some preliminary knowledge on non-company specific issues such as regulation and legal and to better clarify the responsibilities of being appointed.

Companies' structured programs for directors are internal post-appointment practices, and generally is what companies define as induction. Committee participation, which is restricted to board directors, is an internal way to train already appointed board members. Through the participation to committees, directors can better exploit their specific knowledge and deeply

13 Translation from Italian. The original sentence was "ecco questo ha agevolato la creazione di un vero e proprio spirito di squadra".

investigate the process of the company. Specific courses instead are organized by external experts for the directors of the company. This is the case of the Global Compact Board Programme of the United Nation, mentioned during the interviews, which aims at a better approach to corporate sustainability.

Figure 4. An analysis of the different initiatives companies undertake

	INTERNAL	EXTERNAL
PREPARATION Pre-appointment	Experience in subsiadiaries' boardrooms	Standard pre-appointment courses
INDUCTION Post-appointment	Company structured programs for directors	Specific courses organized by specialist for directors
	Committe partecipation	

Considering our main findings, we identify as induction programs those programs directed to appointed directors, while we classify as preparation programs the ones intended to high potential new board members. Pre-appointment instruments, although linked to this analysis for their relevance on the training of future directors, cannot be considered as induction instruments, since they are not intended for board members and are issued out of a board and company context. Providing some human and social capital to the participants (Westphal and Fredrickson, 2001; Hillman and Dalziel, 2003; Sturman et al., 2008), they give general knowledge about relevant topics and practical experience, making them more attractive for a future appointment and facilitating their chance of having a seat into a board. Further, they do not have the main peculiarity of being strictly linked to the needs of a specific boardroom.

Induction programs instead have the aim to enhance the board capital, fostering the human and social capital of the directors (Hillman and Dalziel, 2003) in order to better and fully exploit their potential, maximizing the quality and promptness of their contribution, enhancing the board effectiveness and the firm performance (Pfeffer, 1972; Pfeffer and Salancik, 1978). In line with Coulson-Thomas (1991), Long (2008) and Kakabadse and Van den Berghe (2013) we found that induction programs are powerful in guaranteeing board effectiveness by being more prepared about the topics under discussion and having a better understanding of the matters. A proper induction, in fact, promotes the construction of a framework of knowledge about the business, the strategic lines, the organizational framework, the industry and the regulation, peculiarities of the specific company, to foster debate and discussion among directors and to help the cohesion among the members of the board. It prepares directors to understand and discuss strategic topics, considering compliance and governance issues, and monitoring managers. In line with academic literature, informants see the board as designer and promoter of the strategy of the company, and monitor of its fulfilment and of the CEO conduct.

We implemented the strategic decision process model of Mintzberg et al. (1976) to the induction process. We found support that the induction process has several similarities with strategic process.

We noticed that the commitment on induction programs starts from the Chairman of the company, motivated both by the need of favouring a better knowledge of the environment even as a consequence of several cooptations, a significant renewal or independent members and compliance issues.

There are some main motivations to organize and undertake these programs. First, the influence of the presence of an explicit provision in the corporate governance codes, despite its non-mandatory compliance. Second, directors are often criticized for failing to meet their governance responsibilities in firms and to not have the level of knowledge necessary to efficiently exploit their role (Ladipo and Nestor, 2009; Levrau and Van den Berghe, 2009). Dealing with a wider variety of complex issues (Lee and Phan, 2000) and with growing responsibilities related to the strategic role of the board requires more information and engagement. They have to be effective in understanding the complexity of the business, the excessive dynamism and high riskiness of the markets.

Both directors and statutory auditors are invited to the induction sessions implemented, according to the illustrated content, both by internal and external companies or professionals which take place both in the boardroom and with on-site visits, either after the board meetings or in devoted days.

The results of our case study support the view of subsequent iterations only to improve the further implementation of the program.

Consequently, it is a process specific of each board and brings benefits only inside the boundaries of the company. It has to be structured considering firm’s peculiarities and directors’ characteristics; without these two ingredients, it would lose its meaning and its purpose. In this sense, it is not instrumental to the private benefit but to the business and cultural training and enhancement as directors in the interests of company shareholders. Data also suggest that directors themselves have often asked for deepening topics they either consider strategic or do not feel sufficiently prepared on. Further, frequent co-optation of directors as a consequence of resignations of appointed directors could result in a braking barrier to the deployment of the benefits of an induction program. Finally, pre- and post-appointment condition of a person has to be evaluated in consideration to a single company. In other words, a person benefits from induction in a company in which serves as director, with tailored benefits for such company.

Case studies revealed even that induction is a way to support the cohesion of directors in the boardroom. When group members are more attracted to one another, they have higher levels satisfaction (Katz and Kahn, 1978; Summers et al., 1988) and higher levels of commitment to the group

(Zaccaro and Dobbins, 1989). Cohesiveness plays a significant role inside the boardroom. Forbes and Milliken (1999) refer to board cohesiveness as the degree to which board members are attracted to each other and are motivated to stay on the board (Summers et al., 1988). It captures the affective dimension of members inclusion on the board and reflects the ability of the board to continue working together. Since boards are charged with complex, interactive tasks, the degree of interpersonal attraction among members is likely to influence the effectiveness with which such tasks are performed (Williams and O'Reilly, 1998), by promoting earlier and more extensive discussion of alternative scenarios (Hogg, 1996).

7. CONCLUSIONS AND FUTURE RESEARCH

The importance of effective boards is compelling as a way to limit market failures and corporate scandals (Daily and Dalton, 1994). The quality of appointed directors in terms of capabilities, skills, knowledge and network determines the board strategic (Pearce and Zahra, 1992) and monitoring effectiveness (Vafeas, 1999).

The aim of this research was to clearly identify what has to be called "induction" at board level, to give an overview on how an induction program is designed and how it can bring benefits at firm level.

First, our findings suggest that companies appoint directors on the basis of their personal characteristics and expertise; they expect them to have certain competences that assure they are capable enough to give precious contributions to boards' roles. In accordance with the theory, only the candidates with an adequate level of Human and Social Capital will be appointed.

However having this personal capital is not sufficient to assure that they will be effective board members. In fact, once appointed, directors need to receive the basic information about the particular new environment they will work in, otherwise there is the risk of not being active members and not fully using their human and social capital for companies' interests. Among the cases, induction is intended exactly as the instrument to give the fundamental information that clarifies the new context in which board members are going to operate in.

It is undeniable that this information is the focal point to guarantee the real comprehension of the topics discussed during boards' meetings and the engagement of all directors, assuring a fruitful discussion and the definition of successful solutions for the company, as the data collected in our case study clearly highlighted. Induction programs have the aim to enhance the board capital, fostering the human and social capital of the directors in order to better and fully exploit their potential, maximizing the quality and promptness of their contribution, enhancing the board effectiveness and the firm performance.

We propose a systematic categorization of the different approaches and understanding companies have when it comes to induction, identifying 3 possible ways through which induction can take place: companies' structured programs for directors; committee participation; and specific courses organized by external experts for the directors of the company.

While preparation courses have the goal to provide talented people with general knowledge about relevant topics and practical experience, making them more attractive for a future appointment, induction is meant to provide its directors with information of the firm and its environment, with tailored benefits for the company.

A proper induction promotes the construction of a framework of knowledge about the business, the strategic lines, the organizational framework, the industry and the regulation, peculiarities of the specific company. Cases showed that the commitment on induction programs starts from the Chairman of the company, motivated both by compliance issues and the need of favouring a better knowledge of the environment even as a consequence of several cooptations, a significant renewal or independent members. Both directors and statutory auditors are invited to the induction sessions implemented, according to the illustrated content, both by internal and external companies or professionals which take place both in the boardroom and with on-site visits, either after the board meetings or in devoted days.

For what we reported so far, the strict centrality of the company business leads to a company-customization. Further, the program has to be customized even considering the peculiarities of the director of the company and in particular their pre-requisites both at an individual and at a collegial level.

The findings of this Case Study provide evidence that the induction programs have significant impact on boardrooms effectiveness and, considering the link with the Resource Dependence Theory, it can have positive effect on the overall firm performance. The main benefits of such sessions are to foster debate and discussion among directors and to help the cohesion among the members of the board. In fact, it supports directors to understand and discuss strategic topics and monitoring managers. In line with academic literature, informants see the board as designer and promoter of the strategy of the company, and monitor of its fulfilment and of the executives conduct.

With this paper, we contribute to the understanding of the induction term, providing evidence of how an induction program is designed and how it can maximise the benefits provided by the board to the company.

This study has two significant practical implications. We deem policy makers to seriously consider the preparation of the directors. Considering our findings, we believe the presence of mandatory pre-appointment programs for newly appointed members at least in a listed company is compelling. Compliance and Regulation issues of listed companies require a serious understanding by each director, fostering the effectiveness of the capital market. As highlighted in the discussion of our main findings, induction programs cannot act as a substitute to fill the clear lacks in the preparation of the directors.

Further, cases showed some ambiguity surrounding the boundaries of an induction session. In case of presence of external experts as instructor, the separation with consultancy activities is not always clearly defined. Instead, in case of internal managers the likelihood of management-friendliness of directors increases, to the detriment of shareholders interests. Policy makers should consider the issue in a very straightforward way.

Future developments

This paper has been at attempt to deepen the knowledge in a research area in which prior literature is particularly scarce and peppered. For this reason, we are aware that there is a need to test the validity of our propositions, considering a statistically significant and enlarged sample. Second, we believe an effective way to deal with induction programs is related to the on-site observation of such programs. Further, we focused on listed companies for which the corporate governance code suggests the adoption of induction programs. It will be particularly interesting a comparative study with non-regulatory driven introduction of induction programs. Finally, we developed our case studies when such induction programs were already adopted by companies. A relevant future stream of research can be related to longitudinal studies and/or to the focus on the design and implementation process.

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Appendix A. Interview checklist

1) **Informant personal information**
   a) Role, previous experience
   b) Experience as a director
2) **Induction**
   a) Induction program: presence; reasons, sponsor, frequency and duration, structure, topics, internal/external speakers, compulsoriness (yes/no)
   b) Importance of the program, benefits perceived
   c) Drivers to explain the adoption, motivation to comply with the corporate governance code provision
   d) Feedback from directors

Appendix B. Coding

Codes	**Representative quotations**[14]	**Relation with the Mintzberg et al. (1976) model**
Pre-requisites	"To be effective, a board needs different expertise even from different industries"	Identification
Motivation	"The aim of the induction was to give an overview on the organization and the management system" "The induction helps you in defining were you are landed" "The input was years ago when this new recommendation of the Code [went out] "	
Sponsor	"A primary role in this field is taken by the Chairman … Together with the Chairman, a primary role was played by the CEO"	
Contents	"We started with business, then compliance and regulation"	Development
Participants	"Our peculiarity I think is the involvement of, in addition to board members, statutory auditors"	
Instructor	"The external consultant gives an overview and then we say – well, this is the general, we are here, we will do this and we are positioning in this way"	
Organization site	"We organized a board meeting in the US in the headquarters of a subsidiary … after this board meeting, there was an induction session …"	
Scheduling plan	"… for two entire days, I can tell you they were two weekend days, Saturday and Sunday"	
Materials	"For each induction, we give the material to study as well as additional documents we create which are guides on the main documents of the company"	
Feedback	"We will ask for feedbacks at the end of the year to understand how it went or if they prefer another way"	-

14 Translation from Italian.

CORPORATE GOVERNANCE, STRUCTURE AND ACCOUNTABILITY AS AFFECTED BY NATIONAL GOVERNMENT INFRASTRUCTURE IN DEVELOPING COUNTRIES

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Abstract

Businesses in developing countries face different challenges than those in economically developed countries. Markets and supply chains are less well-established. Dissemination of information is uneven. Because governmental infrastructure has limited ability to support business operations, businesses take on responsibilities that elsewhere are handled by a central government. This study reviews key elements of corporate governance. The study then reviews the banking and manufacturing sectors in Zimbabwe with attention to the presence or absence of financial infrastructure, legal infrastructure, market challenges, supply chain and government involvement to support corporate governance structures and systems. Recommendations for policy and practice changes are recommended. The present analysis of Zimbabwe can guide research on and policy recommendations for governance in other developing countries.

Keywords: Corporate Governance, Accountability, Developing Countries

1. BACKGROUND

Corporate governance can be described as a system of rules, principle of behaviours, practices and processes by which a company is directed and controlled. Claessens (2006) defines corporate governance as the rules under which companies are operating, deriving from such sources as the legal system, the judicial system, financial markets, and factor (labour) markets. Corporate regulations and standards model the nature of much economic activity and motivate, as well as regulate, the behaviour of actors in a given sphere of operations (Hitt et al., 2004).

Economically developed countries have established sound social systems and governmental infrastructure which interact with business operations. The interaction may be collaborative or adversarial but in every case there is an understanding from government and business what are the laws and customs of business operations, the so-called rules of the game. This arrangement allows for efficiency and consistency which are key elements in successful business operations.

Through a systematic review of pertinent studies, Ahmad and Omar (2014) compare and contrast two primary models of corporate governance: the Anglo-Saxon model and the Continental model. In doing so, they acknowledge that these models are widely used in developed countries in North American and Europe, and sometimes modified for other countries. Nonetheless, there is a dearth of studies examining other models (e.g. Japanese, Shari'h) as well as a dearth of studies examining how any models are adapted to developing countries in the world, such as in Africa.

A few elements of Ahmad and Omar's review are mentioned here because they are felt to have a strong bearing on understanding the governance challenges in a developing country.

Purpose: Anglo-Saxon and Continental governance models differ in terms of the corporate purpose. The former is focused on shareholders and the latter is focused on a broader group of stakeholders which include shareholders as well as key members or groups within the larger community. This basic difference has an impact on various aspects of a corporation's governance, ownership and role of government and measure of success.

Ownership structure: The Anglo-Saxon model is characterized by a widely dispersed ownership structure, including the many shareholders. The Continental model shows a stronger prominence of banks and institutional owners with their representatives on the boards of corporations. It is noted that in the Anglo-Saxon model, particularly in the USA, the prominence of large groups of shareholders creates, in effect, a sense of institutional ownership even if these large groups are not necessarily represented on the governing board.

Governance problem: The Anglo-Saxon governance model struggles with issues related to Agency theory. The shareholders, although they have power, do not have time to run the company and as a result the Board tries to represent the needs of the shareholders with varying degrees of success. The Continental model, focused on stakeholders rather than shareholders, nonetheless faces a similar problem of properly representing and acting on the needs of stakeholders. Given the widely different types of stakeholders, such a representation is challenging at best.

The business organization in a developing country does not have the advantages of developed countries in terms of ground rules, collaboration or at least mutual understanding between business and government and access to information. For example, owners and managers in developing countries must be willing to absorb large costs associated with inefficiencies or bear the additional cost of pushing for legal reform to remove these inefficiencies.

The capital markets, product markets and supply chains are less well-established in developing countries. The capital markets have limited resource allocation efficiency and information dissemination is uneven. The regulations coming from the legal system and financial markets comprise the most significant factor accounting for differences in corporate governance across countries (Gibson, 2003).

The present paper reviews the challenges faced by businesses in developing countries. With this foundation, the specific impact on one developing country, Zimbabwe, is examined. Examination of the Zimbabwean experience can provide guidance for addressing the business challenges in developing countries from both business and government perspectives.

2. CHALLENGES OF BUSINESS OPERATIONS IN DEVELOPING COUNTRIES

2.1.Governance infrastructure

Boards of directors

Many businesses in developing countries have been in existence for relatively short periods of time. Those that have a longer history carry with them the legacy of colonial and post-colonial eras. In an effort to jump start businesses, governmental officials may play an outsize role in the business of developing countries. Admittedly, some have mis-used this role as in order to maximize their power and personal financial returns.

Privatization has raised corporate governance matters in sectors that were formerly exclusively state owned (Claessens, 2006). State run businesses and those with a certain level of government shareholding usually exhibit problematic corporate governance issues because of political conflicts of interest which reduce entrepreneurial spirit and professionalism.

As a result of the aforementioned problems, Boards of Directors in developing countries, which should be guiding the business operations and assuring adherence to certain standards, are side-tracked from their key responsibilities. Moreover corporate boards lack the institutional memory and familiarity that boards in developed market economies have (McGee, 2009).

Professional credentialing and regulatory bodies

Often, businesses derive guidance on operations from professional regulatory bodies and trade groups. These organizations codify minimum standards and best practices and provide technical support as well as credentialing approvals to businesses. Developing countries usually lack well developed professional bodies that regulate the conduct of certain professions as compared to developed economies. Given their newness or structural limitations, businesses in developing countries may not be able to join trade organizations or do not even know about such organizations in order to build their skills and network.

The most important economic role played by governments is providing credible policy environment for investors and lowering the costs of bargaining, contracting, monitoring and enforcement (Henisz, 2002). Firms operating in developing economies usually incur more costs in bargaining and contracting compared to those in the developed countries because of the differences in institutional infrastructure. The costs divert resources which could otherwise be invested in the company's core business.

Market impact

Good corporate governance is associated with a lower cost of capital, higher returns on equity, greater efficiency, and more favourable handling of all stakeholders, although the direction of causality is not always clear (Claessens, 2006). Allen (2005) emphasizes that businesses should be run in the interests of shareholders and further states that this is an applicable objective function when markets are perfect and complete. In actuality, a perfect market is a conceptual ideal which is particularly the case in most emerging economies' markets.

2.2. Financial Infrastructure

Financial infrastructure consists of a set of market institutions, networks and shared physical infrastructure that enable the effective operation of financial intermediaries, the exchange of information and data, and the settlement of payments between wholesale and retail market participants (Making Finance Work for Africa 2015).

Claessens (2006) identifies the structure of the financial system, property rights, competition and real-factor markets, and ownership structure and group affiliation as foci of economic development.

Financial infrastructure also includes credit bureaus which allow lenders to assess creditworthiness by providing credit information about a borrower. Credit bureaus allow borrowers to establish a reputation or credit record, credit bureaus, credit ratings, and payment and settlement systems (Making Finance Work for Africa 2015).

Financial sector development usually lags in developing economies and most financial market structures and systems share the same weaknesses. Government control of banks and government intervention reduces the effectiveness of capital markets. The absence of organized markets and small investors gives rise to alternative constructs such as parallel markets whose existence prevents capital markets and market-based corporate shareholdings from emerging (Berglöf and Thadden, 1999).

2.3. Legal Infrastructure

Developing countries are affected by issues such as lack of rule of law and insufficient legislation. Investor protection and the legal systems also influence the amount and type of foreign direct investment in a country. Gibson (2003) notes that emerging market firms are commonly closely held by the founding family, do a relatively inadequate job of enforcing shareholders' legal rights, and need to improve their accounting and transparency.

Companies in emerging market economies are anticipated to have corporate governance problems arising from the family ownership structures and also conflicts between majority and minority shareholders. The benefits of a regulatory setup depends on how well it fits the with a country's prevailing institutions (Levy and Spiller 1994). A given piece of legislation might be good in principle but its effectiveness in practice is affected by the institutional environment. Developing countries also have weak laws pertaining to patents, copy rights and intellectual property.

The lack of property rights also affects capital and infrastructural investment developing countries. Klapper and Love (2004) provided evidence that firm-level corporate governance provisions matter more in countries with weak legal environments.

2.4. Marketplace

Developing countries are de facto the poorest countries in the world. The consumer market at the bottom of the global income pyramid is made up of four billion people with an income less than $2/day mostly who reside in developing countries. These poor people living developing countries have low individual purchasing power although their combined purchasing power also presents a huge market potential. Poverty is also associated with limited education leading this vast group of people to be uninformed consumers with markedly fewer choices or options for advocacy than their better off, better educated countrymen and women.

Firms operating in developing countries face challenges of dealing with impoverished consumers who live in sparsely populated rural areas, often in accessible due to poor road network system. The firms operating in developing countries have to contend with high distribution costs which make their products expensive to their lower income market segments. Companies face challenges when advertising their products and services mainly because of poor communication mediums that exist in these areas.

The consumers at the lower segment of the income scale often prefer shopping in an open, wet market; rather than in a supermarket mainly because the informal markets break the bulk further into smaller convenient packages which may not be available in supermarkets. The streets and open markets pose a health hazard and it is one challenge firms have to be aware of because their products end up being sold in these informal markets. The poor customers are very price sensitive which makes it difficult for companies operating in these countries to promote quality even if the price is higher.

Firms operating in developing countries do not have incentives to invest in pollution control because of weak implementation of environmental regulations. Ewah and Ekeng (2009) analysed challenges facing marketing in developing countries, they identified problems such as low marketing education, preferences for foreign products and low patronage for non-essential products, high cost of production and insufficient infrastructure.

2.5. Supply Chain

Well-developed supply chains require a number of market-related factors including the size or potential size of the market, proximity to markets, prices which follow similar patterns over a period of time and the ability to respond quickly to changing market conditions (Babbar et al., 2008). Many multinational managers in developing countries struggle to strengthen supplier compliance with international standards for environmental performance, quality assurance and worker safety.

Developing economies are exposed to extremely high economic risk due to high inflation together with great fluctuations in currency exchanges and underdeveloped financial market. Developing countries are characterised by poor and insufficient infrastructure, especially the transport network and energy facilities.

2.6. Government Involvement in Markets

Governments intervene in markets in ways that generally affect the overall cash and futures markets. These interventions may include embargoes, price controls, quotas, duties, direct purchases of buffer stocks, and other price-impacting policy measures (Hathaway, 2007). Government intervention gives a chance to harmonize the business and general economic environment to market requirements and international standards but the equilibrium between market and government forces has to be assured (Doval and Negulescu, 2011). The intervention of government in business has not always yielded positive results. Nee et al. (2007) states that direct state intervention into the governance of firms is likely to yield negative economic effects at the firm level.

3. ZIMBABWE

Zimbabwe's economy remains in a delicate state, with an unsustainably huge external debt and extensive deindustrialisation and informalisation according to the World Bank. In 2009, Zimbabwe commenced on a period of stabilization and growth ushered in by the Global Political Agreement and the adoption of a multi-currency regime, with the US dollar becoming the major trading currency. During 2009-12, the economy recuperated with growth rates averaging around 8.7% according to World Bank statistics. Since 2012, however, the economy has experienced a sudden slowdown owing to deteriorating terms of trade, adverse weather and increasing policy instability. The World Bank states that growth slowed to 4.5% in 2013, 3.2% in 2014, and is projected at 1.5% in 2015 by the Ministry of Finance. In 2013 Zimbabwe adopted a new constitution and is in the process of aligning its laws and regulations to this new framework.

3.1. Governance

Majority of Zimbabweans are Christian however like most former European colonies, Christianity is often mixed with indigenous beliefs. Entrepreneurship was formerly dominated by whites and after independence there has been an emergence of black entrepreneurs and the development has been more focused on addressing historical imbalances caused by colonization. Zimbabwe is an African country with Bantu people, the African culture values family and tribe. The composition of recruitment and company leadership and consequently appointment on boards are largely influenced by the Afro-centric values. The governance systems have resulted in problems such as nepotism and lack of consideration of competence and expertise. There is need to integrate and adapt modern corporate governance principles and also positively reflect traditional African values. Governance could be improved by way of integrating the best out of both the traditional and modern systems of leadership and governance. In Africa people have certain philosophies emanating from traditional customs and culture which also affect the way business is done. Most small businesses owned by indigenous have often been referred using one of the common totems, and also the word "indigenous" is now intricately linked to a certain quality of service, governance and business culture.

African countries have been dominated by colonization and recent political independence with now a drive towards economic freedom. The current government in Zimbabwe has an entrenched view that the state and its actors has a better claim on the future and market forces. The business sector no longer trusts that the government can act in good faith because of policy inconsistencies. The politics of control and regulation has often motivated been by short-term gains and self-interest of the ruling elite. A culture of impunity characterized by electoral fraud has engulfed Zimbabwe`s political landscape and this has defined the political culture of the system of governance (Chikerema and Chakunda, 2014).

Separation of ownership and control is usually very minimal, and quite an un-natural distinction in some respects hence the problems of corruption. The model of governance most suitable needs to accommodate cultural background and values, the extended family and tribe. Anglo-Saxon is focused on shareholders, in Zimbabwe shareholders are not the centre of governance and often their contribution is at the periphery. Continental governance model is focused on a broader group of stakeholders which most often in Zimbabwe various interests of various stakeholders are often not well represented in corporate governance. The following section briefly reviews the corporate governance issues in Zimbabwe's banking and manufacturing sectors.

3.2. Banking Sector

Financial Infrastructure

The financial infrastructure in Zimbabwe reveals a number of gaps and weaknesses:

- Zimbabwe has no currency of its own and, rather, utilizes the US dollar, South African Rand and others as currency.
- No credit bureaus : There are no credit bureaus or credit rating agencies in Zimbabwe and many clients have taken multiple loans from different banks and these constitute the majority of non-performing loans (see Ndlovu,2013).
- No active inter-bank market: There has been an absence of an active inter-bank market and lack of a lender of last resort ever since the collapse of the Zimbabwean dollar in 2009. The majority of Zimbabweans are unbanked with an estimated amount between $2billion-$7billion circulating outside banks. The financial infrastructure in Zimbabwe is not able to facilitate efficient intermediation.
- The central bank is not capitalised to act as lender of last resort
- Indigenisation Act and Zimbabwe Agenda for Sustainable Socio-Economic Transformation (ZIMASSET) which is the local ownership law requirements for businesses: Foreign financial investors have fled because of the Indigenisation Act and ZIMASSET which require all foreign owned businesses to sell 51% shareholding to locals. In 2000-2005 the government of Zimbabwe compulsorily acquired land and no longer enforced titles to land. As a result, there is now far less collateral for bank loans.
- Poor property rights protection

Market

The financial sector continues to experience structural vulnerabilities arising from the lack of confidence by depositors, liquidity constraints, rising non-performing and insider loans, high lending rates and low deposit rates, the absence of an active inter-bank market and the lack of an effective lender of last resort (Mary Manneko Monyau, 2014). In the World Bank report, Doing Business 2014, Zimbabwe was ranked 170 out of 189 economies in terms of overall ease of doing business (Mary Manneko Monyau, 2014). Mangudya, Governor of the Reserve Bank of Zimbabwe said company executives and directors failed to adopt sound corporate governance principles in line with international best practices, which he noted was key in developing the economy (Mhlanga, 2015).

Underdeveloped financial markets in Zimbabwe makes it very difficult for the finance sector to use modernized financial instruments (Ndlovu, 2013). Several banks have closed due to poor corporate governance, including reckless lending bordering on outright mismanagement, low depositor and tight liquidity constraints (Majaka, 2015). Ndlovu et al. (2013) also noted that where there is inadequate board monitoring, senior management oversight follows.

Legal Infrastructure

Perhaps the greatest legal obstacle to business operations in Zimbabwe is the lack of security of property rights. This insecurity followed moves by the Zimbabwe government through the Department of Indigenisation and Empowerment towards nationalisation or indigenisation of foreign-owned banks as reported by the University Stellenbosch Centre for Corporate Governance in Africa (2009). The judiciary in Zimbabwe is plagued by weaknesses that include politicisation, lack of independence, corruption and low remuneration (connected to low morale), too few judges, staff and lawyers with little commercial expertise (connected to the country's brain drain), and general ignorance of the legal system. These factors all lead to a slow and patchy process to obtain a satisfactory resolution due to backlogged courts, and bias or selectivity in judges (University of Stellenbosch Centre for Corporate Governance in Africa 2009). Poor property rights protection of foreign owned firms puts them at risk of being seized by the government.

Supply Chain

Supply chain finance enables customers with the required working capital to optimize their cash flows and improve liquidity through financing sales and purchases. There is a lack of supply chain finance in Zimbabwe with banks not offering trade debtors based financing, creditors' loans and inventory finance. Services such as debt factoring are scarce or limited in the Zimbabwean financial sector.

Most of the cash which Zimbabwean banks import ends up circulating in the informal sector and is unbanked. The majority of Zimbabwe's population live in the rural areas where there are no bank branches or ATMs. Because of the high cost for using banking services and their inaccessibility most people resort to cash and mobile money transactions.

Government Involvement

The Zimbabwean government's decision to demonetize local currency and adopt the multi-currency regime constrains monetary policy measures by the central bank.

The Zimbabwean banking sector has been characterized by a number of corporate governance disorders : domestic banks do not represent shareholders' interests in their governance practices and levels of compliance to Reserve Bank of Zimbabwe's corporate governance requirements is still lacking (Ndlovu et al., 2013). In 2003 there was a financial sector crisis in Zimbabwe in which 13 indigenous banks and asset management companies either collapsed or were placed under curatorship. The recent closures of AfrAsia Bank, Allied Bank, Trust Bank, Tetrad Bank, ReNaissance Merchant Bank, Interfin Banking Corporation and the surrender of licenses by Genesis Investment Bank and Royal Bank suggest a near-systemic banking crisis within the sector.

The frequency of collapsing banks may be attributed to the Reserve Bank of Zimbabwe (RBZ)'s failure to contain the recurring weaknesses. The government of Zimbabwe through the regulatory board Reserve Bank of Zimbabwe created a corporate governance code for banks in 2004.

The similar problems faced by indigenous banks before and after the regulatory changes introduced in 2005 suggest deficiency in the current regulatory regime, weaknesses in supervision and surveillance and continuous regulatory avoidance (Mambondiani, 2012). Findings of Maune (2015) showed that Zimbabwe was amongst a few countries that did not have a national code of corporate governance, it only being launched in April 2015. Corporate governance practice in Zimbabwe has been regulated by the Companies Act (Chapter 24:03), the Zimbabwe Stock Exchange Act (Chapter 24:18, Public Finance Management Act (Chapter 22:19) (PFMA) as well as rules of various other professional bodies such as the Institute of Directors of Zimbabwe (IoDZ) prior to 2015.

The corporate governance systems in Zimbabwe are under threat in the wake of indigenisation, a law that requires all foreign firms to sell 51% shares to locals. The very proponents of the indigenisation drive are rooted in political circles and the injection of politics into the corporate system has undermined corporate governance.

3.3. Manufacturing Sector

Zimbabwe had a well-developed industrial infrastructure and manufacturing sector when the country was granted independence in 1980, which used to be one of the strongest and most diversified in Sub-Saharan Africa. The most industrial development had taken place between 1965 and 1979 when the Rhodesian government declared Unilateral Declaration of Independence (UDI) and the regime was placed under sanctions and the country had to develop import substitutes. The major sub-sectors are beverages, metal products, chemicals and petroleum products and textiles. The Zimbabwe textile and clothing industries are struggling in the face of foreign competition, mainly from South Africa, where subsidies, export incentives and tariff protection are still in existence. Access to capital has remained a challenge that has undermined retooling and capital investment initiatives. There has been a decline in the number of people employed in the manufacturing sector from 118,600 employees in 2013 to 93,100 in 2014 according to the Zimbabwe National Statistics Agency. Formal sector unemployment is 90%, and effective demand has dropped.

Financial Infrastructure

The manufacturing sector faces challenges associated with underdeveloped financial sector; financial mediation is not effective with an estimated US3 billion circulating outside banks. There are currently liquidity crises, bank closures and a low depositor confidence in the bank system. Average lending rates are an exorbitant 20% per annum (Reserve Bank of Zimbabwe 2014). Zimbabwe is also a high risk due to political instability and uncertain economic policies which have led to shortage of external funding. Banks in Zimbabwe are also failing to access offshore credit lines.

There is lack of foreign investors willing to invest in local manufacturing sector resulting in companies operating at low capacity utilisation because of the lack of funding. The ZSE is open to foreign investors but share ownership is restricted to 40 per cent of the shares, and no one individual foreign investor is allowed to hold more than 10 per cent of the shares (Mangena and Tauringana, 2007). The Zimbabwe Stock Exchange has lost millions of dollars in potential investments to peer regional markets due to poor corporate governance practices since 2009 when the multicurrency system started Mhlanga (2015).

The Legal System

Indigenisation process is not directed at creating new wealth, but rather at distributing the little remaining foreign-owned wealth into a few hands (Mangudhla, 2014). The contest lies between the objectives of attracting FDI and indigenising the economy (Mary Manneko Monyau, 2014). The right to property is guaranteed and protected in the new constitution, however it can be set aside when the public interest is at stake (Mary Manneko Monyau, 2014).

The problems in Zimbabwe include poor legal protection and poor enforcement of laws. The judiciary in Zimbabwe is plagued by weaknesses that include politicisation and lack of independence corruption and low remuneration according to a corporate governance case study by University of Stellenbosch.

Market

Zimbabwe has high cost of production due to poor infrastructure, power and utilities are very expensive therefore the product prices are not competitive in markets against imports. The market faces a problems of poor demand attributed to the current liquidity constraints and falling disposable incomes.

There are power shortages in Zimbabwe the public utility Zimbabwe Electricity Supply Authority is failing to cope with the demand for electricity and the manufacturing sector is always loosing production hours due to power cuts. Zimbabwe has recently been facing de-industrialisation with companies closing and informal traders emerging. Company closures have been attributed to a number of economic bottlenecks such as the liquidity crunch and lack of credit, obsolete equipment, low aggregate demand, cheap imports and non-performing loans.

As an example the Zimbabwean clothing sector includes cheap imported clothing from Asia and second hand clothing. The local clothing manufacturing firms have found it difficult to compete with imported cheap products from other countries.

Supply Chain

Firms in Zimbabwe have remained stagnant in their practices, technology, and agility, many manufacturing companies in other countries like South Africa and China where they are employing agile manufacturing principles that drive them towards world class manufacturing status and sustainability in an ever-changing environment (Goriwondo et al., 2013). There are a limited number of suppliers willing and able to service remote sites, thereby creating delivery and project scheduling issues.

Seed oil processing plants, for instance, import soya bean which results in high cost of production due to high import duty. There are numerous Small and Medium Sized enterprises some of them who are not able to meet the quality standards required by local multi-national corporations posing a procurement challenge and they also fail to produce quality goods for export markets. Zimbabwe also has high transportation costs due to a poor road network, inefficient railways operator and inaccessibility of other parts of the country. Farmers in remote areas have poor access to markets for supplying the manufacturing sector raw materials for instance in agro-processing.

Government Involvement

The government is still in the process of drafting legislation to give effect to the National Code on Corporate Governance (ZimCode) which was launched in April 2015. Governmental intervention in the manufacturing sector has always resulted in economic instability due to policy inconsistencies. The government of Zimbabwe has reduced import duties on some of the raw materials and have increased import duty on cars in order to protect the local car assembly industries. The government plans to intervene through an establishment of an Industrial Development Bank to finance short and long term recapitalization of industry and Distressed Strategic Companies fund as a short-term measure according to Ministry of Trade, Industry and Commerce.

4. CONCLUSIONS, RECOMMENDATIONS, ONGOING CHALLENGES

Developing countries, particularly in Africa, differ markedly from developed countries due to insufficient financial, legal, supply chains and poor regulatory functions by the governments. The business culture and practices also differ from developed countries due to traditional African values and customs. Politics and governance is widely affected by ethnic differences. Most African states reflect regionalism based on major tribal differences.

The aforementioned Continental and Anglo-Saxon governance models are not widely applied in developing countries mainly because some stakeholders such as customers are not well informed of their rights and have few advocacy rights whilst shareholders interests are not always protected. The corporate governance practices of developing countries need to incorporate elements of the Continental and Anglo-Saxon Models. But they must adapt them to governance in a culture which values the family and the tribe.

In Zimbabwe the government compounds this problem. The government must reform its laws in order to create a good institutional environment for investing. The challenges discussed in this paper show that there is an opportunity for further institution building to upgrade corporate governance practices of Zimbabwean firms. Good governance in the private sector is inseparable from good governance in the public sector. If there is no rule of law and a culture of corruption in the public sector, the private sector's corporate governance practices will follow suit.

The government's corruption is closely linked to corporate governance practices especially in areas of compliance. Improving the corporate governance infrastructure requires dealing with the problem of corruption in order to strengthen the country's institutions and improve the regulations' effectiveness.

The major corporate governance problems in Zimbabwe concern family ownership structures emanating from culture entrenched in family and tribal traditional values. Minority shareholders' interests are not well represented. Trust, transparency and accountability have been the major challenges especially in the Small and Medium Sized enterprises (SMEs) evidenced by misappropriation of funds especially bank loans and a lack of financial discipline. These problems in turn affect partnerships, investment and access to capital.

The following recommendations are offered:

Table 1. Recommendations

1	Parliamentary legislation to support the National Code of Corporate governance.
2	Central Bank's establishment of a credit reference bureau
3	Reform laws to strengthen legal protection of investments and property rights
4	State guarantee and protection of property ownership rights
5	Judiciary sector reform to remove corrupt court officials and judges.
6	Improve surveillance, monitoring and enforcement by regulatory authorities to ensure that companies follow guidelines
7	Establish a corporate governance index or corporate social investment index in Zimbabwe Stock Exchange (ZSE) to promote good corporate governance practices.
8	Develop corporate governance structures and systems that can survive the competitive global environment and rides above sectorial risks such as political, sovereign and regulatory risks. Businesses need a governance system which otherwise respects the traditional values of respecting the institutions of family and tribe by ensuring that the group's interests are represented in ownership and control without compromising governance and performance.
9	Reform the Anti-Corruption Commission so that it can fulfil its mandate
10	Board appointments based on competence and expertise

It is felt that the challenges described in Zimbabwe are quite relevant to other developing countries, not just limited to Africa. Governance cannot be separated from culture. Rather, governance can be seen as a manifestation of culture. Therefore, governance guidelines must begin with an understanding of regional and national culture, rather than seeing culture as an afterthought to a governance structure. For this reason, the field of corporate governance and economic enterprise overall will benefit from future studies which examine the connection between culture and governance more closely.

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REMUNERATION POLICIES IN THE ITALIAN BANKING SYSTEM: COMPLIANCE WITH BEST PRACTICE AND FUTURE PERSPECTIVES

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Abstract

This paper focuses on remuneration policies in banking, an issue that is not particularly studied in relation to its importance to financial institutions' long-term viability and the sustainable growth of the economy as a whole. It aims to assess, through a gap analysis, the level of compliance with best practice in the remuneration policies of Italian banks prior to the implementation of new standards established as a result of CRD IV, as well as the FSB and EBA principles. It also seeks to analyse the evolution of remuneration systems in relation to new international standards in order to identify theoretical and practical implications. The study reveals that the long path through which today's standards have developed has basically fostered a learning process within the banking sector, which has led to a material respect for most of the best practices. In the same time, it also shows the presence of grey areas, which still undermine the full consistency of bank policies with sound remuneration practices.

Keywords: Remuneration, Banks, Best Practices, Compliance

1. INTRODUCTION AND OBJECTIVES

Lessons learnt from the global financial crisis, whose beginning is commonly associated with the collapse of Lehman Brothers in September 2008, have suggested the need to focus on strengthening corporate governance, given that the lack of effective control mechanisms was seen as a cause that led to excessive risk-taking in managing financial institutions (Adams and Mehran, 2012). Thereafter, corporate governance, which can be defined as the structure of rules and relations among stakeholders (owners, directors, managers and employees) that is useful for directing and controlling a company in a fair way in order to improve performance (Cadbury Report, 1992), has become a key point in the debate on the future of the banking industry and a means to rebuild credibility in the financial market (Mulbert, 2010). Today scholars are aware of the importance of developing mechanisms for balancing power and reducing agency costs inside banks, as well as banks' uniqueness at the heart of a more severe agency problem (Levine, 2004). Corporate governance, in this case, cannot simply be framed in terms of the solution of the conflict of interests between shareholders and the management, as banks' peculiarities increase both risk propensity of controlling shareholders in the short term and information asymmetry between majority and minority shareholders (Szego et al., 2008). In addition, especially when considering the public funding of the banking system by governments during the crisis, banks' creditors and taxpayers have become unprotected stakeholders whose interests, which are more oriented towards banking and financial system stability, are potentially divergent from those of shareholders. Furthermore, due to the Bank Recovery and Resolution Directive's introduction of a "bail-in" tool from January 2016 onwards, bank account holders with more than €100,000 must be rationally included within the categories whose interests need more protection. This is why the rules of corporate governance need to be adapted in order to take account of the specific nature of banks, and why supervisory authorities internationally are fostering good corporate governance practices in order to align the strategy, risk profile and appetite for risk of financial institutions with the goal of financial stability and long-term economic growth.

One of the main areas of intervention by regulators is the remuneration policy in the financial sector, as it is viewed as one of the factors that contributed to the crisis. In fact, the traditional lack of attention within compensation practices to long-term risk created a perverse mechanism in which high short-term profits led to excessive bonus payments to employees, that in turn amplified risk-taking and a shortage of bank resources to cope with the crisis. Europe is in transition towards sound compensation practices, with several countries, like Italy, currently implementing the Capital Requirements Directive 2013/36/EU, the so-called "CRD IV", which promotes new standards in the wake of the EBA and FSB principles. Nevertheless, remuneration policy in the banking system seems not to be significantly studied in relation to its importance to financial institutions' long-term viability and the sustainable growth of the whole economy. In particular, in the literature on bank corporate governance, most studies have focused on specific aspects, rather than considering all of the factors that contribute to improving a bank's remuneration policy. Even if a good number of studies has dealt with the assessment of the effectiveness of new regulations introduced in the aftermath of the financial crisis, it has mainly paid attention to executive remuneration.

This research intends to fill the gap by considering all best practices, established by regulations and guidelines at an international level, which enhance the soundness of remuneration policies. In this regard, the international standards on compensation mix and structure, compensation sensitivity to both risk and performance, the role and remuneration of a bank's boards and bodies, with particular attention to the remuneration committee, and the level of disclosure of the remuneration system are included in this investigation.

This paper aims to assess, through a gap analysis, the level of compliance with best practices in relation to remuneration policies in the Italian banking system prior to the implementation of new standards. Secondly, since the new requirements came into force in November 2014, the analysis of the remuneration systems adopted by Italian banks in 2015 enables the assessment of the possibility of alignment with international standards and the grey areas that still exist, with the final aim of presenting practical implications and identifying new research avenues.

2. LITERATURE REVIEW ON REMUNERATION PRACTICES IN BANKING

As mentioned above, in the literature on bank corporate governance, most studies have focused on specific aspects of remuneration practices, while a special interest has been devoted to executive remuneration policy. Słomka-Gołębiowska and Urbanek (2014), for instance, assessed the incompleteness of the enforcement of new regulations concerning executive pay in Poland and the difficulty in evaluating the progress made. Meanwhile, Chen et al. (2011), through a case study on five troubled UK banks, found that ineffective executive remuneration could contribute significantly to business failure. Many studies, following a quantitative approach, have explored the relationship between directors' pay and performance, such as that of Doucouliagos et al. (2007) on Australian banking, which revealed an absence of a relationship with contemporaneous and prior year performance. In general, no conclusive evidence was found on this issue, since some authors assessed a negative relationship between bank performance and CEO compensation (Joyce, 2001), while others found controversial results. Fahlenbrach and Stulz (2011), for instance, in their investigation, which was carried out during the recent financial crisis, revealed that banks with CEOs whose incentives were better aligned with the interests of shareholders performed worse, while there was no evidence that they performed better. In addition, they found that banks with higher option compensation and a larger fraction of compensation in cash bonuses for their CEOs did not perform worse during the crisis. Conversely, other authors, such as Bosworth et al. (2003) and Sigler and Portfield (2001), found a positive relationship between executive compensation and, respectively, efficiency and financial performance in the US banking system. Magnan and St-Onge (1997) pointed out that executive compensation was more related to bank performance in a context of high managerial discretion, while Shiwakoti (2012) analysed the determinants of executive remuneration in the UK financial services sector, finding that industry norms are more used than performance to attract and retain executives. A number of studies has addressed the relationship between compensation and risk appetite, such as that of Handorf (2015), which evaluated a sample of regional US bank compensation practices before and after the crisis, providing evidence that the more risky banks appeared to have rewarded management more generously. Similarly, Guo et al. (2015) found that bank risk during the crisis increased with both the percentages of short-term and long-term incentive compensation, as well as observing that a greater proportion of incentive pay reduced the likelihood of a bank becoming a problem or a failed institution. The studies of Bebchuk, Cohen and Spamann (2010) and Bhagat and Bolton (2014), which were carried out in the US banking system between 2000 and 2008, supported the finding that incentives generated by executive compensation programmes were correlated with excessive risk-taking by banks, while unforeseen risks were not necessarily correlated to poor performance. In relation to the US situation, as noticed by Becher et al. (2005), Bai and Elyasiani (2013), and DeYoung et al. (2013), the deregulation of the industry around the year 2000 expanded growth opportunities and increased competition, while also having a strong impact on risk-taking and executive compensation. In the period leading to the banking crisis, Fortin et al. (2010), using a sample of large US bank holding companies, revealed that banks paying CEOs high base salaries also take less risk, while those that grant CEOs more in stock options or higher bonuses take more risk. Interestingly, Vallascas and Hagendorff (2013), in relation to both US and European banking, showed that increases in CEO cash bonuses lowered the default risk of a bank, while claiming there was no evidence of cash bonuses exerting a risk-reducing effect when banks were financially distressed or when banks operated under weak bank regulatory regimes.

Today, it is well-recognized that the financial crisis has led to greater concern about bankers' incentive compensation, especially executive compensation (Jansen et al., 2015), among the general public, while little research has documented the impact of recent compensation regulations implemented to encourage a long-term perspective in decision-making and to limit excessive risk-taking (Proctor and Murtagh, 2014). Furthermore, very little is known about the remuneration of non-executive directors or employees below the top executive level. Kampkötter, in his studies of a sample of German and Swiss banks (2015a; 2015b), found that non-executive bonus payments significantly followed bank performance prior to the financial crisis, but this effect vanished in the crisis period. He also showed that the crisis had a deep impact on short-term bonus payments in favour of higher fixed salaries, leading to a lower performance sensitivity towards compensation. Furthermore, Kostyuk et al.

(2012) showed that independent directors' remuneration practices in banks were strongly related to the governance system in place. Surprisingly, little attention has been paid to the role of bank remuneration committees, in spite of the important reforms concerning these bodies that followed the financial crisis. Dell'Atti et al. (2013), through a qualitative analysis on 30 top European banks during 2008-2010, showed a high diffusion of these bodies within banks and a gradual disclosure of the information about their tasks and decision-making.

3. SOUND REMUNERATION POLICIES IN BANKING: EVOLUTION OF LEGISLATION AND GUIDELINES

The recent financial crisis has prompted the introduction of a number of legislative initiatives and guidelines by international and national institutions in order to strengthen corporate governance mechanisms in the field of remuneration of financial institutions. The inefficiencies of bank remuneration policies, such as their short-term orientation, excessive risk-taking and low sensitivity towards performance, were in fact pointed out as the possible causes of the crisis. Actually, the creation and evolution of international standards in relation to sound remuneration systems in banking have followed a long and turbulent path, which started around 10 years ago with the guidance issued by the Basel Committee on Banking Supervision (BCBS). The BCBS' guidance promoted principles for enhancing corporate governance and was inspired by the principles published in 2004 by the Organisation for Economic Co-operation and Development (OECD). Among the other key issues, it pointed out that compensation policies should be consistent with a bank's long-term objectives. Nevertheless, as with the first appearance of the crisis in 2007, official action by national authorities has been called upon in order to fix deficiencies in compensation practices within the financial industry, such as the perverse relationship between high short-term profits and bonus payments without any attention to longer-term risk and bank stability. In its meeting in Washington on 15 November 2008, for instance, the G20 set out the objective to improve, amongst other things, risk management and compensation practices within financial institutions. In this context, the Financial Stability Forum (then known as the Financial Stability Board [FSB]) published, in 2009, the "Principles for Sound Compensation Practices", targeted at significant financial institutions, and with the aim to "*ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation*". The principles, in particular, were oriented to increase effectiveness of the governance of the compensation, the alignment of compensation with prudent risk-taking and the supervisory oversight and engagement by stakeholders. The European Commission, drawing lessons from the crisis, adopted several recommendations (Recommendation 2009/384/EC and Recommendation 2009/385/EC) to tie remuneration policy, especially executive remuneration, to risk appetite and to include the cost of capital and liquidity ratios in the criteria used for measuring a bank's performance and individuals' goals. Nevertheless, the implementation of such recommendations by Member States was found to be neither uniform nor satisfactory, and the Commission, in its Green Paper of 2010 on corporate governance and remuneration policies in financial institutions, gave consideration to the need for new legislative measures. For this reason, the Commission decided to introduce explicit remuneration requirements in financial institutions in the revised Capital Requirements Directive (CRD III), the Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010, which amended Directives 2006/48/EC and 2006/49/EC. The main provisions regarded the identification of the "material risk takers" (MRTs), the group of people whose activity may have a material effect on a bank's risk exposure, as well as the definition of specific ratios and references about pay structure and pay mix (cash shares or equivalent, deferral thresholds and period, retention period), the obligation to establish a remuneration committee and the increase in the disclosure level on compensation practices. Actually, many of these standards were borrowed from the report issued by the FSB in September 2009, which proposed global standards on pay structure and promoted greater disclosure and transparency, as asked for by the G20 Finance Ministers and Governors in order to enhance the implementation of the FSB principles in significant financial institutions throughout the world. Furthermore, the Committee of European Banking Supervisors (CEBS), which is the predecessor of the European Banking Authority (EBA), was required, in 2010, to elaborate guidelines on sound remuneration policies in the financial sector in order to facilitate the compliance of the remuneration principles included in the CRD III. In the guidelines, the approach of proportionality among institutions and among categories of staff, which is strongly recommended in the implementation of the standards, is explained. In Italy, the Bank of Italy, which is the national supervisory authority, acknowledged the CRD III and the CEBS guidelines in March 2011.

The most recent European intervention is the CRD IV package (Regulation EU No. 575/2013 and Directive 2013/36/EU), which has introduced the global standards of the Basel III agreement into the EU law. The recent reform, even if in line with the previous legislation, sets new standards in a number of key issues relating to financial institutions' remuneration systems, such as the determination of the pay mix and cap (see the 1:1 ratio between fixed and variable pay), new governance mechanisms (see the power of a shareholders' meeting to approve a higher cap of the pay mix) and the reinforcement of ex-post risk adjustment (malus and clawback provisions). Meanwhile the EBA, which has supervised the European banking system since January 2011, has been given the power to elaborate *regulatory technical standards* (RTS), which are mandatory and directly enforceable. One of the most awkward aspects disciplined by RTS is the identification process of the MRTs, adopted by EU Delegated Regulation No. 604 in March 2014, on a proposal from the EBA. In general, the approach to the principle of proportionality in the application of the CRD IV package has changed, when compared to the 2010 CEBS guidelines. While the consideration of institutions' size, internal organization and the nature, scope and complexity of their activities is still recommended, it is argued that flexibility should not lead to "neutralization", as the principle of proportionality cannot lead to the non-application of these rules. In December 2015, the EBA also released, after a three-month consultation period, the final report with guidelines to facilitate the implementation of sound remuneration practices, to be applied from 1 January 2017. The Bank of Italy, after a consultation period as well, issued a new regulation on 18 November 2014 called *"Politiche e prassi di remunerazione e incentivazione"*, in order to comply with CRD IV and new international standards (EBA and FSB). Table 1 shows the main standards and best practices, classified for significant categories (structure, relation with risk and performance, role of bank bodies, remuneration of bank bodies, remuneration committee, disclosure), as well as the indication of the source, drawn from the evolution of legislation and guidelines. In line with the rationale of recent reforms, they all account for a remuneration system that is consistent with a bank's values, strategies and long-term objectives; related to bank performance; conveniently risk adjusted in order to reflect capital and liquidity levels that are adequate to sustain a bank's activity while discouraging excessive risk-taking and any risk to global financial stability.

Table 1. International standards on remuneration

Structure
• Only two categories: fixed or variable. Golden parachutes (not recommended) included under the variable part. [Sources: CEBS 2010; CRD IV] • Variable remuneration ≤ 100% fixed remuneration (exception: shareholders's meetings can increase the ratio to 200% with a special quorum). [Sources: CEBS 2010; CRD IV] • Variable remuneration is aligned with long-term performance and risk. [Sources: BCBS 2006; FSB 2009a, 2009b] • Minimum 50% of any variable remuneration in bank shares or equivalent instruments. [Sources: CRD III; FSB 2009b; EBA 2015] • Minimum 40% or 60% of the variable remuneration is deferred by at least three to five years for particularly high amounts or particular staff categories. Significant institutions: for members of the management body in its management function and senior management deferral periods of at least five years. [Sources: CRD III; FSB 2009b; EBA 2015] • The first deferred portion (also *pro rata*) should not vest sooner than 12 months after the start of the deferral period. [Sources: CRD III; EBA 2015] • For awarded instruments, a retention period of at least one year should be set. [Sources: CRD III; EBA 2015] • Proportionality: remuneration policies and practices should be consistent with the individual risk profile, risk appetite and strategy of an institution by considering the size, the internal organization and the nature, scope and complexity of the institution's activities. [Sources: CEBS 2010; CRD IV]
Relation to risk and performance
• The award, pay-out and vesting of variable remuneration should not be detrimental to maintaining a sound capital base. [Sources: Recc. 384-385 EC; FSB 2009b; CRD IV] • When assessing whether the capital basis is sound, the institution should take into account the Common Equity Tier 1 capital and the combined capital buffer requirement. [Sources: Recc. 384-385 EC; FSB 2009b; CRD IV] • The remuneration policy should not lead to shortcomings in an institution's liquidity. [Sources: Recc. 384-385 EC; FSB 2009b] • The objectives of the institution, business units and staff should be considered. [Sources: CRD IV; EBA 2015] • Individual performance: financial and non-financial indicators. [Source: CRD IV] • Quantitative and qualitative, absolute and relative objectives. [Sources: CEBS 2010; CRD IV] • Guaranteed variable remuneration is not permitted, except when hiring new staff, and only for the first year of employment. [Sources: FSB 2009b; CEBS 2010; CRD IV] • Institutions must be able to apply malus or clawback arrangements up to 100% of the total variable remuneration. [Sources: CRD IV; EBA 2015] • Malus and clawback arrangements can be applied within both deferral and retention periods. [Sources: CRD IV; EBA 2015] • Variable remuneration should not be assigned in the case of financial institutions in a loss position. [Source: FSB 2009a] • The variable remuneration should be consistent with and adjusted for all current and future risks taken. [Sources: FSB 2009b; EBA 2015] • Risk adjustment parameters: capital (amount and cost), liquidity (amount and cost), time and future earnings. [Source: CRD IV]

Table 1. Continued

Role of bank bodies
• The supervisory function or, where established, the remuneration committee should ensure that the remuneration policy and practices of the institution are subject to a central and independent internal review at least annually. [Sources: FSB 2009a; CEBS 2010] • The shareholders' meeting decides on the remuneration of the bodies that it nominates, the assignment of shares or equivalent instruments, and the increase of the pay-mix. [Source: CRD IV] • The supervisory function oversees the whole remuneration system. [Sources: FSB 2009a; 2009b; CEBS 2010] • All institutions should conduct a self-assessment annually in order to identify all staff whose professional activities have or may have a material impact on an institution's risk profile. The management body has the ultimate responsibility for the identification process. [Sources: CRD III; CEBS 2010; EBA 2015] • Group contexts: the consolidating institution and competent authorities should ensure that a group-wide remuneration policy is implemented. [Sources: CRD IV; EBA 2015]
Remuneration of bank bodies
• The remuneration of non-executive directors should only be fixed (exceptional cases: non-significant amount). [Source: CRD IV] • No variable remuneration for the President of the management body. His/her remuneration should be determined *ex-ante* and should not exceed the fixed remuneration of the top executives (CEO and senior officers). [Source: CRD IV] • Members of the supervisory board: only fixed remuneration. Incentive-based mechanisms based on the performance of the institution should be excluded, unless exceptionally awarded variable remuneration is strictly tailored to the assigned oversight, monitoring and control tasks. [Sources: FSB 2009b; EBA 2015] • Top levels of control function: remuneration related to their responsibilities and not to performance. Limit: variable remuneration no more than 33% of fixed remuneration. [Sources: FSB 2009a; CEBS 2010] • The remuneration of independent control functions should be predominantly fixed in order to reflect the nature of their responsibilities. If allowed, variable remuneration should be a little proportionate and related to their tasks. [Sources: FSB 2009a; CEBS 2010]
Remuneration committee
• All institutions, which are themselves significant, as well as listed institutions, must establish a remuneration committee. [Sources: CRD III; FSB 2009b; CEBS 2010] • Members should collectively have appropriate knowledge, expertise and professional experience. [Sources: CEBS 2010; EBA 2015] • Composed of members of the supervisory function who do not perform executive functions. The chair and the majority of members should qualify as independent. [Sources: CEBS 2010; EBA 2015] • Knowledge (internal or through external support) concerning remuneration policies and practices, risk management and control activities. [Source: CRD IV] • It should collaborate with the risk committee: a member of the risk committee should participate in the meetings of the remuneration committee, and vice versa. [Source: FSB 2009b] • It directly oversees the remuneration of the senior officers of independent control functions, including risk management and compliance functions. [Source: EBA 2015] • Meetings: number and duration. [Sources: CEBS 2010; EBA 2015]
Disclosure
• Official websites displaying the remuneration policy. [Source: CRD IV] • An annual report explaining decision-making, the role of remuneration committee, performance alignment and risk adjustment criteria, awarding and deferral mechanisms, and pay structure. [Sources:FSB 2009b; EBA 2015] • Remuneration policy: rationale, amount, implementation and results. [Sources: FSB 2009a; CRD III; EBA 2015] • Explanation of pay mix. [Sources: CRD III; EBA 2015] • Identification process: number, position and criteria. [Sources: CRD IV; EBA 2015]
Legend *CEBS: Committee of European Banking Supervisors* *CRD: Capital Requirements Directive* *EC: European Commission* *EBA: European Banking Authority* *FSB: Financial Stability Board*

4. METHODOLOGY

From a methodological point of view, a gap analysis, following a qualitative approach, has been carried out in order to assess the level of compliance with best practice in remuneration policies in Italian banking. The sample comprises all the larger and more complex banks in Italy, which are considered as significant according to Article 6(4) of the EU Regulation No. 1024/2013, which introduces the Single Supervisory Mechanism (SSM) of the European Central Bank (ECB) within Europe. In addition, the sample includes Italian-listed banks, even if they are not identified as significant by the ECB, given that they must be automatically considered among the larger and more complex ones (Bank of Italy, bank supervisory regulation No. 285/2013). The rationale that drove the sample selection is that the larger and more complex banks must fully apply the new regulation on remuneration policy in order to comply with CRD IV.

The final sample is made up of 18 banks, including the 13 Italian banking holding companies that the ECB recognized as significant credit institutions due to their having assets greater than €30 billion (excluding the Italian branch of Barclays Bank PLC), as well as 5 other banks currently listed on Italy's stock exchange known as

"Borsa Italiana S.p.A." (excluding Banca Sistema whose shares were listed for the first time in June 2015). Table 2 shows the banks included in the sample and their main characteristics, such as their asset class and number of employees, as well as whether they are significant institutions, holding or listed companies.

Table 2. Characteristics of the sample

No.	Banking company	Asset class (billion)	Number of employees	Significant	Holding	Listed
1	Unicredit	500<assets<1,000	144,972	·	·	·
2	Intesa San Paolo	500<assets<1,000	89,486	·	·	·
3	Monte dei Paschi di Siena	150<assets<200	25,961	·	·	·
4	Banco Popolare	100<assets<125	17,575	·	·	·
5	UBI Banca	100<assets<125	17,462	·	·	·
6	Mediobanca	50<assets<75	3,570	·	·	·
7	Banca Popolare dell'Emilia Romagna	50<assets<75	11,593	·	·	·
8	ICCREA Holding	30<assets<50	2,213	·	·	
9	Banca Popolare di Milano	30<assets<50	7,759	·	·	·
10	Banca Popolare di Vicenza	30<assets<50	5,295	·	·	
11	Banca Carige	30<assets<50	5,737	·	·	·
12	Veneto Banca	30<assets<50	5,590	·	·	
13	Banca Popolare di Sondrio	30<assets<50	2,596	·	·	·
14	Fineco	assets<30	1,008		[1]	·
15	Banco di Desio e della Brianza	assets<30	2,474		·	·
16	Banco di Sardegna	assets<30	2,033		[2]	·
17	Banca Profilo	assets<30	211			·
18	Finnat	assets<30	169			·

[1] *It is part of the Unicredit group*
[2] *It is part of the Banca Popolare dell'Emilia Romagna group*

A gap analysis has subsequently been carried out on the official documents which give information on the remuneration systems of the banks included in the sample, mainly the Compensation report, the Corporate governance report and the Annual report. In order to deal with the problem of lack of disclosure, online research was also used in order to gather information from banks' official websites. All reports used in the investigation date back to 2015 in order to assess the evolution of bank remuneration systems over the accounting years 2014-2015. It is important to note that the chapter on the remuneration policy has been added to the Bank of Italy's Regulation No. 285/2013, which acknowledged CRV IV, on November 2014, while the EBA's guidelines were released on December 2015 and will be enforced from January 2017. Therefore, the 2015 Compensation report, accounting for the results of remuneration policies in 2014 and the remuneration strategies for 2015, completely covers the period of change. This is why it has been useful to shed light on the level of compliance before the implementation of new international standards, the adjustments to bank remuneration policies in order to fill the gaps, and the grey areas that still remain and impact upon the full development of sound compensation practices in the future.

5. RESULTS

This section shows, category by category, the main results of the investigation on sound remuneration practices.

Structure
From 2015, there is a remarkably clearer separation between fixed and variable remuneration, even if some cases show the presence of third categories. In two cases "benefits" are not correctly included in the fixed part of remuneration, while one bank reports the presence of a "recurrent integrative remuneration". Golden parachutes are still used in six cases, while in two of them are beyond the parameters set for variable remuneration.

The introduction of the 1:1 ratio between variable and fixed remuneration is new in thirteen banks, but the majority already respected this cap unformally before 2015. In five cases, a lower cap already existed, while a lower cap was introduced in 2015 in another five cases. In six cases, which were mainly larger banks or banks focused on asset management services, the ratio was increased to 2:1 (in two cases, for top-managers only; in three cases, for top managers and executive directors; and, in one case, for all staff categories).

In 2015, the long-term orientation of remuneration incentives was strengthened in four banks. Meanwhile, in two banks, this propensity still seems to be patchy. A strong majority of banks already assigned shares or equivalent instruments, mainly to MRTs, before 2015. Nevertheless, in four cases, the 2015 policies set an amount of shares lower than 50% of the total variable remuneration. Before 2015, only one bank failed to defer variable remuneration. In ten cases, the new policies established salary thresholds to trigger deferral, while eight banks still failed to respect standard parameters of percentage or length.

In the entire sample the first deferred portion is vested after at least twelve months, except for two banks, which allow for the assignment after six months, and one bank, which allows for a possible anticipation of incentives. The bulk of banks established salary thresholds, under which each variable remuneration is in cash and up front. As regards retention for awarded instruments, two banks set a period shorter than one year, while nothing is said in another four cases. In general, the principle of proportionality has largely been applied since before 2015. In two cases, it has been strengthened by the new requirements, while it remains to be adopted in three cases.

Relation to risk and performance

The principle that variable remuneration should not be detrimental to maintaining a sound capital base is widely respected. In 2015, the connection with capital buffers was strengthened. In particular, the Common Equity Tier (CET) 1 (twelve cases) is usually used as a gate to variable remuneration, while only two banks have taken into account the combined capital buffer requirement. The connection with the liquidity level has been strengthened as well (in 2015, only one bank has not considered it), with the Liquidity Coverage Ratio (LCR) being the main gate to awarding variable remuneration (eight cases). As regards the nature of performance objectives, all financial institutions opportunely included firm, business unit and individual objectives. Financial and non-financial measures have also been widely used (even if the last ones could be better explained), while there has been a remarkable gap in the use of relative parameters, which are taken into account in just three cases. Except for seven cases, in which a welcome bonus has been used according to the law, two banks seem to have ignored the prohibition of assigning a guaranteed variable remuneration, while another five have involved or retained the possibility to use stability and non-competition agreements. One of the main innovations of 2015 concerned the malus and clawback mechanisms, introduced for the first time in six remuneration systems, even if two of them did not clearly define the validity time.

A grey area in the new systems has been the fair consideration of risk outcomes, since banks' loss position did not clearly turn into the prohibition of assigning variable remuneration in seven cases. This was due to the presence of waivers, ambiguous parameters or a simple bonus curtailment. Furthermore, in four cases, bonuses were not adequately aligned to the time horizon of risks.

Similar to what happens for performance objectives, risk adjustment reveals shortages in the definition of time and liquidity parameters (five cases), as well as in the use of relative parameters (six cases).

Role of bank bodies

This is the area where Italian financial institutions show the highest level of compliance. Role and functions of shareholders' meeting, supervisory functions and holding companies are clearly defined and consistent with law requirements. However, it is important to point out that, even if only two banks failed to conduct a self-assessment annually in order to identify MRTs before 2015, a deep revision and, in particular, a remarkable increase on MRTs' perimeter was made in eight cases following the new regulation (RTS adopted by EU, on a proposal from the EBA, in March 2014). There is a variety of bodies responsible for the identification process in the sample: in six cases, human resources play a key role, while a central role is played by the compliance function, the risk management or the remuneration committee in two cases.

Remuneration of bank bodies

There is wide agreement about the dispensation of non-executive directors from variable remuneration, which is theoretically possible but not applied in just one case. Actually, the principle is extended to all directors, except for managing directors (twelve cases), who are basically paid through a fixed remuneration, which is increased for particular offices or tasks, and attendance fees. Best practices for the remuneration of the President of the management body (whose cap in Italy is 100% of the fixed remuneration of the top executives, instead of 30% less than that as set by CRD IV) and the members of the supervisory board are basically respected. Things are quite different for control functions, as the principle of relating remuneration to responsibilities, rather than performance, is ignored in three cases, while a cap of 33% of fixed remuneration for top levels (it is lower than the 25% proposed by CRD IV) is already set in five cases, even if it will only be enforceable from 2016. With reference to all staff involved in control functions, currently no cap is present in two institutions, while another two expressly violate it.

Remuneration committee

The committee is present in the entire sample, even if three banks have introduced or significantly reviewed it from 2014. It is composed of 3.87 people on average, with 5.09% holding a school-leaving certificate and 94.91% holding a degree, mainly in the fields of economics (55.36%), law (23.21%) or engineering (7.14%). The bulk of members show adequate levels of competence (73.71%) and experience (85.71%). Most members are non-executive (96.78%, due to two members taking part in executive committees) and, in most cases, independent (72.58%). The sample reveals a variety in the way competences are integrated in the committee: three banks require just one member to be highly-qualified, three banks do not explicitly require any expertise and four banks turn to external support. In just one case, the absence of adequate professionalism is evident. In general, the remuneration committee collaborates with the risk committee, while four banks do not explicitly task it with overseeing the remuneration of senior officers involved in independent control functions. Remuneration committees meet, on average, 9.5 times annually (a minimum of three, a maximum of nineteen), while their meetings last one hour and 22 minutes each on average (a minimum of 30 minutes, a maximum of three hours).

Disclosure

All banks in the sample drew up a Remuneration report. Although, in six cases, this is not displayed in a dedicated space on the website, but is instead included among the deliberations of the shareholders' meeting. In one case, the report is attached to the Annual report; in another case, however, it is not present on the official website at all.

As regards the content, the main disclosure gap revealed by the analysis is the general lack of a comprehensive report. Except for one case, the sample shows insufficient transparency regarding essential aspects of remuneration systems. In particular, in seventeen cases, the report is not useful in order to assess the composition and qualification of the remuneration committee. For this purpose, supplementary information has to be gathered from the Corporate governance report (in nine cases, although two banks do not draw one up at all), or from the official website (one case). Incomplete information also involves pay-performance relations (four cases), the cash-instruments mix and deferral periods (four cases), and performance management and risk adjustment (two cases each). Finally, transparency regarding the identification process was significantly improved in 2015, but it is still a halfway process, since the same percentage of banks (50%) either disclose detailed information on the process or superficially refer to RTS.

6. CONCLUSION

This paper focuses on a key issue concerning the long-term viability of banks and the stability of the economy at an international level: namely, the remuneration policy within the banking system, which is certainly a topic that is not fully studied in the literature concerning bank corporate governance. In particular, this paper aims to advance the understanding of all factors enhancing the soundness of remuneration policies by analysing the remuneration practices in Italian banks before the implementation of new standards set by CRD IV, as well as the EBA and FSB principles. It seeks to shed light on the distance separating bank remuneration systems from best practices, together with their evolution, in order to facilitate alignment with recent international standards. Through this gap analysis, the way in which new regulations have been acknowledged within Italian banking is assessed, as well as the grey areas that still undermine the full consistency of bank policies with sound remuneration practices. This has permitted the identification of future research avenues and practical implications.

Indeed, the study reveals that the long and turbulent path through which today's remuneration standards have been developed has basically fostered a learning process within the banking system, leading to a material respect towards most of the best practices. The real innovations of bank remuneration policies promoted by the CRD IV package lie in setting a cap in the pay mix, in that the cap can be increased only through the decision of a qualified majority of shareholders, the reinforcement of long-term risk adjustment through malus and clawback provisions, and the significant increase of the number of MRTs, due to the new regulatory technical standards driving the identification process.

Nevertheless, a series of doubts remains about the real propensity of the new framework to overcome some critical factors, which have usually affected remuneration systems and caused excessive risk-taking. As regards the structure of remuneration, the pay-mix cap has been raised to 200% in a significant number of institutions, but mainly the larger ones or those focused towards asset management services. In addition, golden parachutes continue to be a widespread practice among financial institutions. In relation to risk and performance sensitivity of remunerations, a remarkable number of institutions does not clearly state the prohibition of assigning variable remuneration in the case of banks' loss position. Furthermore, both performance measurement systems and risk adjustment processes diffusely suffer from the lack of relative parameters, which could permit the assessment of bank results following a benchmarking approach. Bonus alignment to long-term risks is also often disregarded, while welcome bonuses or anticipated bonuses, assimilated to those assigned in relation to the probability of being fired, are commonly used in the sample. From a theoretical point of view, this implies that, in spite of a stricter regulation on specific aspects, which could promote excessive risk-taking, industry norms are hard to remove and compensation basically remains a strategic tool in order to attract and retain talented staff and management to increase bank competitiveness and performance, while the issue of balancing strategic goals and risks stays in the background of remuneration policy. From a policy perspective, this highlights the importance of regulatory and supervisory authorities' monitoring in the first stage of the implementation of new standards in order to prevent the use of waivers and dissuade bad practices.

The governance of remuneration systems is the area where Italian financial institutions show the highest level of compliance with international standards. However, a grey area affects the remuneration of control functions, for which a gap with best practices still needs to be filled. In fact, a significant percentage of banks does not correctly associate variable remuneration with control responsibilities, nor does it respect the cap between fixed and variable remuneration. This is even more surprising considering that the Bank of Italy, in relation to control functions, as well as the remuneration of the President of the management body, chose to establish a lower cap than that proposed by CRD IV. The unsatisfactory attention paid to control functions is also highlighted by the fact that a notable number of banks does not explicitly task, as recommended, remuneration committees with the oversight of the remuneration of senior officers involved in the independent control functions. Remuneration committees are present, well-qualified and committed in the entire sample, although the study reveals strong differences in their composition and functioning among institutions. This kind of "legal compliance", adopted by banks, has a key implication for future research. Much more investigation, in fact, is required into the real role and functions of banking bodies in the decision-making on remuneration policies beyond what is said in statutes, regulations and reports. A qualitative approach, for instance, could be used to shed light on key factors, such as the involvement of boards and bodies, as well as the quality of internal reporting on the topic inside financial institutions. Definitively, a significant contribution could be made by a more effective involvement of supervisory boards and control functions in the decision-making on compensation policies.

Finally, disclosure on remuneration practices should significantly improve, for instance, through the development of a real comprehensive report, which could be able to provide information on all variables impacting on the soundness of a remuneration system. In particular, transparency is still lacking in relation to the composition of the remuneration committee and the quality of its members, the pay-performance relationship, the cash-instruments mix, the deferral periods, the performance management system, the risk adjustment and the identification process. Hopefully, this information gap can be filled by intervention from regulators and supervisory authorities.

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PROJECT CONTROL AS A TECHNIQUE FOR ORGANISATIONAL EFFICIENCY: A CASE STUDY OF SELECTED FIRMS IN DELTA STATE, NIGERIA

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Abstract

The focus of this study is to investigate Project Control as a technique for achieving organizational efficiency. Efficient Management of project demands that project should be executed according to specification. This further requires control in the areas of time, quality, and cost. Control enables project managers to check variances, and possible reasons for deviation. This work seeks to address the problems of operational inefficiency in terms of deviation from project cost allocation, project time allocation resulting to delay, and finally deviation from required quality. To achieve the set objectives from a population of 125 employees, a sample size of 96 respondents was gathered from two companies in Warri, Delta State, and analysed using percentage. Based on the analysis, the following findings emerged; Project control measures operational efficiency in the areas of time, cost and quality. In the face of the above findings, the study concludes that Time plays a major role in organizational performance. Consequently, absence of project schedule and proper time management will negatively affect organizational operational efficiency. The impact of project cost control cannot be overemphasized. Without cost control project goals may not be accomplished, as working out of the approved budget is detrimental. Quality control enables the comparison of performance against set standard, to correct possible deviation from project objectives. Also, the following recommendations emerged 'in achieving success in project management, Project control should be a major concern of project managers. Suitable control plan should be formulated in advance, together with suitable information system to aid effective project control. More than that, project control in the area of cost, time and quality should be integrated in the managerial process to avoid deviations, and thus, achieving efficiency, and optimal performance.

Keywords: Organisational Efficiency, Nigeria, Project Control

1. INTRODUCTION

For development to take place in the society, and corporate organizations, there is a great need for quality project to be executed. When a project has been appraised in terms of economic, social and financial viability, it is as a matter of necessity to ensure its execution to specification in terms of quality, time and cost. (Kifordu and Ogbo, 2015). This calls for project control to avoid unnecessary deviations. According to Nagarajan (2012), "the term Control refers to verifying if the project progresses as per the plan and regulate the deviations found, if any." In other words, control is a means of regulating the activities of a project to ensure that it is mutually and satisfactorily completed. Also, Ward (2000) defined project control as *"series of related events linked with taking decisions concerning present issues based on the past and future project activities"*. All of these are normally on the basis of observation and the gathering of project performance data with the aim of guaranteeing that project execution is successful.

The successful and satisfactory execution of a project is a measure of operational efficiency of a project company. A project that is completed out of specified quality and time amount to a breach of contract. Nagarajan (2012) has stated: *"Delay in project implementation invariably results in cost-overrun, delayed project implementation means delay in getting return on the investment made"*. Also, a project that is executed out of project cost estimate is detrimental to profitability. And profitability being the major aim of business is a measure of operational efficiency. In achieving organizational efficiency therefore, project managers should be committed to "doing things right" in relation to inputs such as time, cost, etc. To be efficient according to Mullins (2010), *"the manager must attend therefore to the input requirements of the job. This is to ensure that the input will result to planned performance when compared to actual performance."*

2. STATEMENT OF THE PROBLEM

One major problem which this study seeks to address is that of operational inefficiency in project execution. This problem results from the following sub-problems: Firstly is the problem of improper use of time. Every project is time bound. However, in executing a project, most project companies fail to put time limit into cognizance leading to delay and loss of fund, because the more a project is delayed, the more funds are committed. Secondly, there is the problem of cost control. In every project, there is cost allocation or budget which carefully states the financial plan of a project work. Most organizations fail to properly plan work within cost allocation, thereby causing profitability problem. Finally, there is the problem of project satisfaction in terms of quality. Project organizations face rejection of completed project as a result low quality work. Some of the completed project cannot stand the test of time because of poor quality materials. This has led to poor performance and loss of corporate image.

3. RESEARCH QUESTIONS

The study will look into the following research questions:

- To what extent does project time control affect operational efficiency?
- To what extent does cost control affect project performance?
- To what extent does quality control affect operational efficiency?

4. OBJECTIVES OF THE STUDY

The following are the objectives of this study:

- To determine the extent to which time control affect operational efficiency.
- To ascertain the extent to which cost control affect project performance.
- To determine the extent to which quality control affect operational efficiency

5. THEORETICAL FOUNDATION

Project control from Chandra (2006) perspective, comprises a constant performance appraisal against the organisational goals with an effort to locate the causes of variance, and a commitment to put adverse deviation on check. Control is one of the best ways to ensure optimal performance, hence, Shellabear (2005) sees performance management as a form of employee control. In managing project, control cannot be undervalued. Eromafuru (2011) posits that, framework for effective control, planning and monitoring are checks against any possible failure. The human element makes it a sine-qua-non to correct deviations, which invariably enable the project objectives to be realised. It is also the human resource that is responsible for the control of the organization for optimal performance. In view of this, Ewurum and Oludare (2010) observed that, "*It is an acceptable fact that the human resources inevitably control the destiny of any business"*. In control, project managers monitor physical performance, and a wide range of disparate factors. The authors went further to state the major functions of project control as follow: (i) Ensuring constant monitoring of standards of performance and (ii) It seriously encourages team members in a project to strive towards the achievement of project goals. Consequently, Schwalbe (2007) succinctly writes that *"Monitoring and Controlling involves the measurement of project progress".* In line with stated goals, there is always a need to constantly monitor deviation from planned goal, in order to take remedial actions to harmonise the project progress pace according to plan.

Without close supervision and control, there is a likelihood that project personnel may deviate from the required standard. This, as a matter of fact, affects organizational performance. In monitoring and controlling projects, project managers cannot succeed without reliable information. In this regard, Nagarajan (2012) posits that, *"project can be controlled by gathering the required information from the project information system and comparing the actual performance with the planned performance. When deviations between the actual performance and the planned performance are noticed, immediate corrective actions are to be taken to realign the project back on the right track".*

Project Control and monitoring is carried out all through the period of a project in terms of time, cost and quality. According to Nagarajan (2012), "Control systems are designed to monitor three major factors, viz., cost, time and quality parameters." Control also takes place in the areas of cost by ensuring that the project budget is followed judiciously. And finally, is quality parameter. This of course is a major criterion of determining project success.

6. PROJECT TIME MANAGEMENT

Every project is time bound, therefore, it is imperative to complete a given project within the time frame. Delay in project completion amounts to inefficiency, and consequently result to poor performance. Schwalbe (2007), defined project time management as *"the necessary stages required and carried out to ensure timely completion of a project"* He went further to enumerate the main processes involved in project time management as follows:

- Activities of definition: This process clearly states the key activities that the project team groups and investors must carry out to produce the project deliverables. The main outputs of this process are the list of activities, characteristics, ground-breaking outlay schedule list and the required change.
- Activity sequencing: This describes the identification and documentation of the relationship between project activities. This process has a project schedule network flow chart algorithm, requested changes, updates to the activity list and attributes as the expected outputs.
- Activity resources estimating: This involves making of project estimate of the resources such as people, material, equipment that will be needed to accomplish a particular project. The main outputs here include a resource breakdown structure, required changes, resource calendars, and updates to activity, and activity resource requirements.
- Activity duration estimating: This estimate the work periods scheduled for project activities. The outputs here are activity duration evaluations and updates checks to activity attributes.
- Schedule development: This has to do with activity sequence analysis, the estimate of activity resource and duration to create the project schedule. The outputs here schedules in project, baseline, model data, requested changes, the particular

activity calendar, activity attributes, updates to resources requirements, and the project management plan.

- Schedule Control: This is a unique process that controls and manages changes to the project schedule. Outputs elements include evaluation of performance, changes required, proposed remedial actions, organizational process assets, the list of activities and characteristic, and the plan of the project management.

7. PROJECT COST MANAGEMENT

A project cost is the total amount of money required by a project for its completion. According to Horngren et al. as quoted by Schwalbe (2007); "Financial experts usually, defines cost as a component of resource sacrificed or forgone in an undertaken to achieve a specific objective" That is, for a project to be completed the project company needs to sacrifice some fund. Ward (2000) noted that project cost management is a *"sub unit of project management that includes the processes required to ensure that the project is completed within an approved budget which consists of resource planning, cost estimating, cost budgeting, and cost control."* Furthermore, Schwalbe (2007) is of the view that project cost management to include the procedures necessary to ensure that a project team completes a project within a stipulated time period according to budget.

8. PROJECT COST MANAGEMENT PROCESS

According to Schwalbe (2007), there are three project cost management processes. These are:

- **Cost estimate** - This has to do with the estimation of cost that is required for resources necessary to complete a project.
- **Cost Budgeting** - This is concern with the allocation of total cost to accommodate successfully an individual's work items.
- **Cost Control** - This deals with checking and controlling of deviations to approved budget of project plan.

9. PROJECT QUALITY MANAGEMENT

Quality in project management is of paramount important as it measures performance. International Organisation for Standard as cited by Schwalbe (2007) sees quality as the whole features of a thing that bear on its capability to fulfil specified or implicit needs.

According to Ward (2000) Project quality management is a *"part of project management that consists of processes required to ensure that the project will satisfy its objectives. It includes quality planning, quality assurance, and quality control."*

10. QUALITY MANAGEMENT PROCESSES

- **Quality planning:** This is the plan of relevant quality standard to be adopted in the project.
- **Quality assurance:** This is periodic evaluation of project performance to ensure that the project meets up to standard.
- **Quality control:** This is the monitoring of project activities and results to avoid deviations from standard

11. APPROACHES TO PROJECT CONTROL

The following approaches are used for project control;

11.1. Variance analysis approach

Variance analysis seeks to monitor and control a project for differences in the budgeted cost and the actual cost. That is, in controlling a project in terms of variance, the project manager's focus is to determine the degree of variability in terms of what is budgeted for and the actual cost. According to Chandra (2006) *"the traditional approach to project control involves a measurement of the actual cost with estimated cost to determine the divergence."* The divergence analysis enables the project manager to know whether more or less resources were used on the project within a given time frame.

11.2. Performance Analysis Approach

This is a systematic analysis which seeks to adopt analytical framework in analyzing performance based on

- **Budgeted cost for work performed (BWP):** This is made up of three parts:
  a. Estimates for work package successfully done,
  b. Budgets estimates related to the work- in -progress completed,
  c. Overhead budgets
- **Budgeted cost for work scheduled (BCWS):** This is made up of:
  a. Budget estimates for all work packages scheduled to be completed
  b. Budgets estimates for the portion of in-process work, scheduled to be accomplished
  c. Budgets estimates for the overheads of the period.
- **Actual Cost of Work Performed (ACWP)**: This is the real cost expended for completing the work executed within a specified period of time.
- **Budgeted Cost for total work (BCTW)**: This indicates the aggregate budgeted cost for the whole project work.
- **Additional Cost for total work (ACC)**: This is additional estimate for project completion.

Based the above information, a project can be checked as follows:

Cost variance= BCWP-ACWP
Schedule variance in Cost terms=BCWP-BCWS
Cost performance index=BCWP/ACWP
Schedule performance index= BCWP/BCWS
Estimated Cost performance index = BCTW/(ACWP+ ACC)

12. AN ILLUSTRATION OF PERFORMANCE ANALYSIS

A project was begun on 1st January 20X0 and was expected to be completed by September 20X0. The Project is being reviewed on 30th June, 20X0 when the following information has been developed:

	N
Budgeted Cost for Work Scheduled (BCWS)	1, 500,000
Budgeted Cost for Work Performed (BCWP)	1,400,000
Actual Cost of Work Performed (ACWP)	1, 600,000
Budgeted Cost for total Work (BCTW)	2,500,000
Additional Cost for Completion (ACC)	1,200,000

13. ANALYSIS

Cost variance = BCWP - ACWP
= 1,400,000-1,600,000
= -200,000
Schedule variance in cost terms = BCWP — BCWS
= 1,400,000 - 1,500,000
= - 100,000

Cost performance index BCWP/ACWP
= 1,400,000
1,600,000
= 0.875
Schedule performance index = BCWP/BCWS
= 1,400.000
1,500,000
= 0.933
Estimated cost performance = BCTW
(ACWP + ACC)
= 2,500,000
(1,600,000+1,200,000)
= 0.89

In performance analysis, Chandra (2006) listed the following questions to be clarified:

- *"Is the project seen as a whole (and its individual parts) on, ahead, or behind schedule? If there is a discrepancy, where did it occur, why did it occur, who is responsible for it, and what would be its implications?*
- *Has the cost of the project seen as a whole (and its individual parts) been as per budget estimates, less or more than the budget estimates? If there is a discrepancy, where did it occur, why did it occur, who is responsible for it, and what would be its implications?*
- *What is the trend of performance? What would be the likely final outcome: cost and completion date for the project and its individual parts?"*

14. REQUIREMENTS OF A GOOD CONTROL SYSTEM

Nagarajan (2012) has listed the following as the prerequisites for a good control system:

- It must be easy to understand by those who use it.
- It must be easy to extract data/information by those who use the system and the control must act as indicator for pointing out deviations
- It must be reduced to the form of tables/graphs/chart so that it will offer a visual display of the happenings. Since visual displays are easy for interpretation, this feature will improve the utility of the control system.
- The control system should report deviations (of time, cost and quality) from the plan on a timely basis and must have the capacity to anticipate or predict deviations so that timely action can be taken to correct the deviations.
- The control system is to be designed by the active participation of all of the major executives of the project team so that the system can satisfy the actual requirements.

15. THEORETICAL FRAMEWORK

This work is based on the learning curve theory. According to Schwalbe (2007), this theory states that, "When many particular parts of items are produced repetitively, the unit cost (UC) of those items falls in a steady pattern as additional units are manufactured. The relevance of this theory to this study is that it helps and guide cost estimation of projects requiring the development of large quantity of things by reducing cost. In addition, learning curve theory extends to the number of time measured that it takes to finalise some task. For instance, when a new employee performs a particular task for the first time, it may take ten times longer than required compare to an already experienced employee. Improvement, efficiency and productivity increases with less cost on a given task. This relates to project time management. In other words, to save time for the organization, project managers should assign a specific task to a particular employee for a reasonable time period as it also leads to specialization and experience, which invariably gives room for quality output.

16. RESEARCH METHODOLOGY

A quantitative survey method was used. The population for the study comprised of 125 staff of Gomene Projects Limited and SG Jones Limited in Warri, Delta State, Nigeria. As preliminary investigation, the study worked with a sample size of 96 staff selected from Gomene Project Limited and SG Jones Limited. Questionnaires were developed and distributed to the selected 96 staff members of Gomene Project limited and SG Jones Limited. All questionnaires were completed and returned by the respondents, which represents a 100% response rate.

17. RESULTS

Table 1. The extents to which project time control affect operational efficiency

Variable	Response	% of Response
High	50	52
Moderate	26	27
low	20	21
None	-	-
Total	96	100

Source: Field Survey, 2015

The table above indicates the high number of respondents, i.e., 52% supports notion that project time control affects operational efficiency, while 27% is moderate, while the remaining 21% is low on the claim.

Table 2. The extents to which project cost control affect project performance

Variable	Response	% of Response
High	58	60
Moderate	22	23
low	16	17
None	-	-
Total	96	100

Source: field Survey, 2015

Again, the above table shows that project cost control affects project performance as it has high response of 60% that supports the above claim, while 23% is moderate, and 17% is low on the claim.

Table 3. The extents to which project quality control affect operational efficiency

Variable	Response	% of Response
High	56	58
Moderate	26	27
low	14	15
None	-	-
Total	96	100

Source: Field survey, 2015

The table above indicates that 58% of respondents strongly support the claim that project quality control affects operational efficiency, while 27% is moderate, the remaining 15% is low on the claim.

18. FINDINGS AND DISCUSSION

- Table 1 show that 52% of the respondents favour the assertion that "Project time control affects operational efficiency". In other words, when there is delay in project completion, it affects profitability because as more time is wasted more money is involved. In support of the above finding, Nagarajan (2012) has stated: *"Delay in project implementation invariably results in cost-overrun, delayed project implementation means delay in getting return on the investment made".*
- Cost control has impact on project performance according to Table 2, as 60% of respondents highly supported the claim. This involves proper budgeting and planning. In other words, when project managers work out of the budgeted cost, it may definitely affect other things which may invariably hinder performance and profitability.
- It was also found in table 3 that project quality control affects operational efficiency as 58% of respondents supported the claim. Hence, with control, a project is monitored against any possible deviations. In support of this, Eromafuru (2011) posits that, framework for effective control, planning and monitoring are checks against any possible failure.

19. RECOMMENDATIONS

In the face of the above findings, the study recommends:

- In achieving success in terms time, project managers, should develop a schedule for the project. That is, suitable time control plan should be formulated in advance, together with suitable information system to aid effective project control.
- In the area of cost, project managers should forecast in advance information that relate to the project completion, and also update the cost management plan.
- Finally, quality control system should be designed jointly, and judiciously monitored. That is, both management and the project team should set the standard to be achieved; quality should be integrated in the managerial process to avoid deviations, and thus, achieving efficiency, and optimal performance.

20. CONCLUSION

In conclusion, time plays a major role in organizational performance. Consequently, absence of project schedule and proper time management will negatively affect organizational operational efficiency. The impact of project cost control cannot be overemphasized. Without cost control, project goals may not be accomplished, as working out of the approved budget becomes problematic. Quality control enables the comparison of performance against set standard, to correct possible deviation from project objectives.

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CORPORATE GOVERNANCE AND CHINESE GHOST CITIES

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Abstract

Sir David Tweedy, the former chair of the International Accounting Standards Board, observed: "The scandals that we have seen in recent years are often attributed to accounting although, in fact, I think the U.S. cases are corporate governance scandals involving fraud" (Tweedy, 2007). This paper will show that many of the recent Chinese cases of fraudulent financial reporting are also really corporate governance scandals involving fraud.

Keywords: Corporate Governance, Ghost Cities, China, Financial Reporting

1. INTRODUCTION

Jim Chanos, the founder of a hedge fund now worth $3 billion, was one of the first analysts to short Enron, Tyco, and U.S. mortgage companies involved in the 2008 financial crisis. His analytical strategy has typically focused upon financial engineering: "We're looking for companies masking bad operations by buying back stock and/or playing accounting games by using pro-forma adjustments" (Weil, 2014). However, additional analyses, which we will link to the investigation of corporate governance in possible Chinese fraud companies, are needed, as a Peking University accounting professor, Paul Gillis, observed: "Accounting fraud in the U.S. is usually from the overly aggressive application of an accounting principle. Accounting fraud in China has usually been situations where large portions of the business simply do not exist" (Kinetz et.al, 2014). Furthermore, as analyzed here, possible fraudulent Chinese companies may have supplied or benefitted from ghost city construction projects which were then dependent upon continued government sponsorship and support of such fixed-asset investments. Due to the opaque or poor disclosures by these companies, one cannot say for sure if they did supply or benefit from such ghost city projects.

Chanos has recently been shorting companies involved in supplying Chinese construction projects as he observed: "China is the only country in the world that knows its GDP growth rate for the upcoming year on the first day of the year. In China's GDP calculations, they don't look at final sales, they look at production. So a condo being built but not sold contributes to GDP" (Tymkiw, 2012). Chanos has been bearish on China since 2009 when he and his team at his Kynikos Associates, which has over $1 billion under investment management, were analyzing commodity prices and the stocks of large mining companies. Chanos said: "Everything we did in our microwork on commodities kept leading us back to China's property market. China's construction boom was driving demand for nearly every basic material. By 2009 in the midst of a global recession, China was building almost 30 billion square feet of new residential and office construction. There are 1.3 billion people in China. In terms of new office space alone, that amounts to about a five-by-five-foot cubicle for every man, woman, and child in the country. That's when it dawned on me that China was embarking on something unprecedented" (Olster, 2010).

2. CHINESE GHOST CITIES

In 2011, an Australian business reporter visited some of China's most infamous ghost cities and malls and wrote a report that broke this ghost city story internationally (Badkar, 2013). In 2013, a "60 Minutes" U.S. television report observed: "We discovered that the most populated nation on Earth is building houses, districts and cities with no one in them…desolate condos and vacant subdivisions uninhabited for miles and miles and miles and miles" (Belvedere, 2013). This same "60 Minutes" report interviewed the CEO of the largest Chinese real estate developer, China Vanke Co. Ltd., a publicly held company which was the second company ever listed on the Shenzhen stock exchange in 1991. This CEO said many developers are deep in debt, projects are being abandoned, and a nightmare scenario could be like America's housing crash but worse (Lubin and Badkar, 2013). This CEO also said that China's property sector was already in a bubble state with some cities seeing a 10-fold increase in prices that have driven the average home buyer out of the market. For example, the cost of a home in Shanghai would be about 45 times the average resident's annual salary (Harjani, 2013). A 2014 report estimated that there were 11 major Chinese ghost cities but the Chinese government had told a Chinese reporter to "quit being a troublemaker" and cease doing ghost city investigations (Duffy, 2014)

In China, fixed asset investment accounts for more than 50% of China's overall Gross Domestic Product (GDP) in 2014 with just the property market accounting for about 20% of GDP (Liang, 2014). No other major economy even comes close. Of that Chinese fixed investment, about one-quarter is attributable to new real estate investment, and new property sales accounted for 14% of GDP in 2009. Bearish investors on China, like Chanos, question why there are so many apartments and villas which have been bought and paid for but remain empty. One explanation may be that individual Chinese investors are limited in their investment alternatives. Bank accounts have a negative rate of return with inflation estimated to be 3%. Chinese stock markets are much more volatile than well-established stock markets and capital controls limit investment opportunities abroad so that leaves real estate. For example, one investor owns 43 flats in and around Shanghai and he has fully paid for all of them. Vacancy rates for homes constructed in the past five years are at 15% but are projected to rise to over 20% in 2016-2017 (Badkar, 2014).

However, there are many bullish investors on China, opposing these bearish investors. They have cited the examples of Pudong and Zhengzhou, initially ghost cities, which became successfully occupied and developed. Bullish investors have pointed out that Pudong is across the river from Shanghai, which has one of the world's largest ports. The bullish investors say that China is experiencing the greatest urbanization story the world has ever seen and that these ghost cities will soon become thriving metropolitan areas so just remain patient (Lubin and Badkar, 2013). One bullish investor, a chief investment strategist and long-time Asian resident, commented: "The truth is there are large, empty developments all over the world, including the United States. In those countries, ghost cities happen whenever developers may have misjudged demand. The difference is China's ghost cities appear on a grand scale because China itself is on a grand scale. China's ghost cities herald great expectations" (Madison, 2013). Also, the Chinese home real estate market, mostly units in high-rise buildings (see the following picture), are regarded as capital-gains machines, rather than sources of shelter. There are now over 50 million such units which are owned but vacant. The owners/investors will not rent them because used apartments suffer an immediate reduction in value while less affluent investors have bought fractional shares in luxury apartments and town houses (Liang, 2014). Also, the high-end condos cost over $100,000 but the average Chinese household made less than $10,000 a year (Nocera, 2015).

Many of the large Chinese ghost cities are located in the interior provinces of China, such as Inner Mongolia, Qinghai, Henan, Hunan, and Yunnan, well away from the thriving coastal economic regions. One of the most famous ghost cities is Kangbashi, Ordos in Inner Mongolia. It was built for $5 billion during the coal mining boom of 2008-2009 and projected to have one million residents. Then Chinese coal prices fell 20%-30% in 2012 which ended the mining boom and the 2014 city population is now 30,000. More than a dozen 20-story high-rise buildings have no signs of life and many migrant workers are renting vacant office spaces as apartments for as low as $65 a month. Ordos is in the middle of the desert and is running out of groundwater (Badkar, 2014). In contrast, the mayor of Ordos claimed a local GDP growth rate of 13% in 2012, which Chanos pointed out was predicated on the number of real estate project completions, not sales (Spano, 2013).

This ghost city phenomenon in China is facilitated by how local governments, like Ordos, are forced to finance themselves. They are in a perpetual cash squeeze since they have to give the majority of their tax revenue to the central government which often forces them to build infrastructure projects without any central funding. Since the Communist Party owns all the land in China, local governments often seize land from their poorest residents for a minor payment and then sell the land to developers for a much larger price which increases their GDP figures and chances of promotion within the Party (Badkar, 2014).

Another interesting example of a Chinese ghost city is Tianducheng, built for $1 billion as a replica of Paris with a 354 foot Eiffel Tower and a Champs-Elysees boulevard. It was supposed to hold 10,000 people but had only 1,000 by 2013. A more dramatic example is the New South China Mall which was supposed to be the largest mall in the world with 7 million square feet and 2,350 retail stores. It now has a 99% vacancy rate, ten years after completion in 2005. The local government has taken it over and classified it as a national tourist attraction (Badkar, 2013).

Chanos has responded to these bullish investors: "China's on an economic treadmill to hell. It's an economy on steroids. You have an economy that's 50% fixed-asset investment, and not even in the developing world is that sustainable. We've seen this movie before. Whether it was Dubai a few years ago, Thailand and Indonesia during the Asian crisis of the late '90s, or Tokyo about 1989, this always ends badly" (Olster, 2010). In a 2013 presentation, Chanos was still bearish on China and noted a multitude of problems in China, such as economic inefficiencies, real estate and credit bubbles, questionable audited numbers, inflation, ghost cities, money laundering and broad corruption by the ruling elite. He also pointed out that there was now greater leverage in China with borrowing increasing from 15% of GDP in 2008 to 30% of GDP in 2012 (Spano, 2013). In the fourth quarter of 2012, new credit surged to $1 trillion. With an $8 trillion GDP, Chanos observed that that this $1 trillion fourth-quarter amount projected to be $4 trillion on an annualized basis or 50% of GDP which is a real, growing credit bubble (Weil, 2013). In a 2014 interview, Chanos said that at the time of the 2008 U.S. economic recession, construction was only 16% of the U.S. GDP while today in China, construction is 50% of its GDP and also mentioned a new potential ghost city under construction that is a replica of Manhattan. He commented: "China's economy is now on a bigger treadmill to the same destination!" (Duffy, 2014), especially since these construction properties have no chance of generating enough income to pay down the related debt (Nocera, 2015). Similarly, a research director at a Chinese investment company observed that China is riding an "involuntary credit treadmill" where much new government stimulus money has to be "hosed into the economy" just to sustain ever mounting bad debt totals which never seem to get written down in China (Liang, 2014).

Full-year 2014 GDP growth for the Chinese economy was only 7.4%, the slowest pace in over two decades. The real estate market had slumped, dragging down the rest of the Chinese economy

(Barboza, 2015). By December 2014, the slowdown in year-to-date fixed asset investment growth had decelerated to 15.7% which was driven by property investment that fell to -1.9%. While sales in floor space in a sample of large cities, including all tier-1 cites, increased 28%, nationwide sales volume contracted by 4%. With still depressed sales, developers are struggling with funding problems with year-to-date growth of available funds turning negative by -0.1% in December. Given that property investment activity tends to trail sales with a significant lag, UBS (2015) predicted that investment growth will not turn around and GDP growth will only be 7% in 2015. UBS (2015) also recommended that investors stay selective in the property sectors and focus on developers with a strong focus on tier-1 and tier-2 cities as high inventory pressure still persists in tier-3 and tier-4 cities (where the ghost cities exist).

3. CHINESE IPO AND RTO COMPANIES WITH POSSIBLE GHOST CITY LINKS

There were about 500 small Chinese companies with an average market cap of less than $5 billion that listed in U.S. capital markets during 2005-2010, the heyday of double-digit Chinese GDP growth when China had the fastest growing economy in the world. A few Chinese company listings were by an initial public offering (IPO) but most were by a reverse merger often called a reverse takeover (RTO). These smaller Chinese companies found easy access to U.S. capital markets and investors who had become comfortable with the larger Chinese state-owned enterprises and private companies that had previously listed successfully on U.S. stock exchanges. These U.S. investors also had become comfortable or even enamored by the double digit growth rate of the Chinese GDP during the last decade (McKinsey & Co., 2013).

During the early part of this 2000-2010 decade, the Chinese double digit GDP growth had been powered by exports, government infrastructure projects, and government and bank financing. As this phenomenal growth started to slow down in the middle of the decade, it was reenergized by the construction of many new cities, mostly located in the interior of the country, away from the three major Chinese economic areas, all along the eastern seacoast: Bohai Bay Rim where Beijing is located, Yangtze River Delta where Shanghai is located, and Pearl River Delta where Hong Kong is located. Thus, the double digit Chinese GDP growth rate continued just past the end of that decade and helped keep U.S. investors enamored with these small Chinese IPO and RTO companies listing in the U.S. during 2005-2010.

Unfortunately, approximately 100, or 20%, of these 500 Chinese IPO and RTO companies were delisted or suspended by the New York Stock Exchange (NYSE) in 2011 and 2012. These 100 companies caused approximately $40 billion in market capitalization destruction even though the average market cap of each of the 100 firms was $68 million when listing on the U.S. stock exchanges (McKinsey & Co., 2013). As the Chinese GDP growth rate had fallen to single digits in this decade, investors were not as enamored with these small cap Chinese stocks. Also, many of these companies may have had economic activities with the Chinese ghost cities but such links were obscured by the typical opaque disclosures by these companies. With such large market cap destruction of over $40 billion by these Chinese IPO and RTO companies listed in the U.S., one has to ask: where were the Boards of Directors with effective corporate governance principles and practices?

4. TIMELESS CORPORATE GOVERNANCE WEAKNESSES

After the financial crisis of 2008, the NYSE sponsored a Commission on Corporate Governance to identify key corporate governance principles for boards of directors as well as management and investors. The Commission's report (2010) identified the following principles which are listed in an order to match with our own corporate governance research findings (Grove and Cook, 2007):

1. Independence and objectivity are necessary attributes of a board of directors which must have a majority of independent directors per U.S. stock exchanges' requirements. An appropriate range and mix of expertise, diversity, and knowledge is needed on the Board.
2. Management's role in corporate governance includes, among other things, establishing risk management processes and proper internal controls.
3. The Board's fundamental objective should be to build long-term sustainable growth in shareholder value. Thus, policies that promote excessive risk-taking for short-term stock price increases, and compensation policies that do not encourage long-term value creation, are inconsistent with good corporate practices.
4. Management's role in corporate governance also includes insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information both to the Board and to shareholders. Management has the primary responsibility for creating a culture of performance with integrity.
5. Good corporate governance should be integrated as a core element of a company's business strategy and not be viewed simply as a compliance obligation. A Board should be careful not to adopt a "check the box" mentality when implementing and complying with the numerous governance mandates and best practices. Transparency is an essential element of corporate governance, not only for companies but also for major shareholders who should have appropriate disclosure practices, including their ownership of other securities.

We have designated these five NYSE corporate governance principles as "structural factors" which are matched to our first five corporate governance weaknesses. These five timeless corporate governance weaknesses have existed since the 1970s when major shareholder lawsuits occurred, concerning U.S. external auditors' failures to detect fraudulent financial reporting (FFR) at their clients' companies (Grove et al., 1982). Our five weaknesses are similar to the five NYSE "structural factors" as follows:

1. All Powerful CEO and Insider Board Influence
2. Weak System of Internal Control

3. Focus on Short-Term Performance Goals
4. Weak or Non-Existent Code of Ethics
5. Questionable Business Strategies with Opaque Disclosures

For almost forty years, these five weaknesses or factors have interacted and facilitated FFR in the typical following scenario (Grove and Clouse, 2014). The Chief Executive Officer (CEO) is also the Chairperson of the Board of Directors (COB) and has insider Board influence, possibly even majority control of the Board. Senior management, including the Chief Financial Officer (CFO), then intentionally keeps the company's system of management and internal controls weak. Such weakness facilitates the achievement of short-term performance goals which are a key focus of senior managers concerning their executive compensation packages. There is a weak or non-existent code of ethics which also facilitates the achievement of these short-term performance goals as does the use of questionable business strategies. When such performance results are reported, they are often discussed with opaque disclosures while key performance manipulations are just hidden in the financial statements.

We have designated the last five of our ten corporate governance weaknesses as "behavioral factors" which are often facilitated by and follow the first five "structural factors" in FFR cases as follows:

6. Senior Management Is Uncomfortable with Criticism
7. Insider Stock Sales
8. Senior Management Turnover
9. Independence Problems with the Company's External Auditors
10. Independence Problems with the Company's Investment Bankers

The starting point for this sequence of "behavioral factors" often occurs as external users, primarily financial analysts and investors, are frustrated with the questionable business strategies and opaque disclosures and ask tough, probing questions. Often the CEO and other senior managers respond by attacking the questioner since they have insufficient, legitimate answers. They are not used to such tough questions from their less than independent or inadequate Boards of Directors. Meanwhile, they are quietly selling their own shares of the company's common stock. Then they "vote with their feet" by unexpectedly leaving the company, usually for the personal reason or excuse of "spending more time with my family." Finally, also facilitating FFR, there are independence problems with "watch-dogs" of the free market system, external auditors, and investment bankers. These entities may compromise their independence or integrity to earn additional fees from their client companies. Thus, the interaction of these ten timeless corporate governance weaknesses, typically in the "structural" and "behavioral" sequence listed above, has facilitated FFR by public companies (Grove et al. 2011, Grove and Cook, 2007).

These ten "structural" and "behavioral" factors are elaborated with corporate examples from major FFR and other companies in the Appendix which also includes strategies to correct each weakness from four fundamental guidelines for good corporate governance: strategic, control, integrated, and situational (Hilb, 2008). Each "structural" factor of corporate governance is further analyzed by Warren Buffett, who has over forty years of experience on various Boards of Directors and was voted the leading investor of the last Century. Appropriate guidelines are also cited from NYSE public company listing requirements for corporate governance.

5. CHINESE IPO AND RTO COMPANIES AND THEIR CORPORATE GOVERNANCE PRACTICES

Again, with market cap destruction of over $40 billion by these Chinese IPO and RTO companies listed in the U.S., one has to ask: where were the Boards of Directors with effective corporate governance principles and practices? Ineffective and deficient corporate governance practices are now cited from possible fraudulent Chinese IPO and RTO companies that may have supplied or benefitted from Chinese ghost city projects. Again, due to opaque or poor disclosures, one cannot say for sure if these companies did supply or benefit from such projects. The analysis is organized by the prior sequence of the five "structural" factors and the five "behavioral" factors of corporate governance.

6. ALL POWERFUL CEO AND INSIDER BOARD INFLUENCE

On October 23, 2007, Longtop Financial Technologies Ltd. did an IPO on the NYSE and sold 10.4 million American depositary shares at $17.50 per share, raising $182 million. Longtop was a Chinese software developer and technology services provider based in Xiamen, China. It provided technology services and created both standardized and custom-designed software for banks in China, including three of the four largest state-controlled banks: China Construction Bank, Agricultural Bank of China, and Bank of China. Thus, Longtop could have indirectly benefited from the ghost city projects which these banks helped to finance. In November, 2010, Longtop's market capitalization peaked at $2.4 billion.

In April, 2011, Andrew Left of Citron Research, a short seller, published a report on his website, accusing Longtop of widespread fraud: "Citron introduces a story that has all the markings of a complete stock fraud---with off balance sheet transactions that created outsized margins and management with backgrounds unsuitable to run a public company. The most obvious risk factor in the China space, and the factor that has linked so many of these collapsed stocks, is obviously that the story is too good to be true. It is the opinion of Citron that every financial statement from its IPO to this date is fraudulent…read on to understand" (Left, 2011).

In May, 2011, Longtop's chairman told its auditor, Deloitte Touche Tohmatsu (Deloitte) that "there were fake revenue in the past so there were fake cash recorded on the books." Branch bank managers had signed fake cash confirmations which was only discovered when the auditor subsequently sent the cash confirmations to the home office of the bank. The chairman did not answer when questioned as to the extent and duration of the discrepancies. When asked who was involved, he answered: "senior management." Such irregularities resulted in Deloitte resigning and the NYSE suspending trading of Longtop's stock (Norris, 2011).

On August 29, 2011, the NYSE delisted Longtop Financial Technologies Limited finding that the American depositary shares were no longer suitable for continued listing and trading. Thus, Longtop destroyed $2.4 billion in market capitalization (cap). A class action lawsuit was successful with damages of $882 million awarded to shareholders but, by then, Longtop's CEO and senior management had fled back to China, and Longtop did not even defend itself in the lawsuit (Stanford Law School, 2014).

On September 10, 2008, Deer Consumer Products, Inc. became a public company in the U.S. after completing an RTO. The company was a manufacturer of blenders, juice makers, soymilk makers, and rice cookers. Thus, the company could have indirectly benefitted from the ghost city projects when related apartments were being furnished. On March 9, 2011, Alfred Little, a short seller, issued his first report on Deer Consumer Products. He wrote that the company had impossibly high gross margins and operating margins at the same time as very low selling expenses. Also, the return on investment was impossible on a $40 million plant (Little, 2011). On October 2, 2012, NASDAQ delisted Deer Consumer Product shares and a partial settlement of the securities class action lawsuit against Deer was reached for $2,125,000. From its stock price peak, Deer had destroyed $374 million in market cap.

The following corporate governance variables, relating to all powerful CEO and insider board influence, the first NYSE "structural" factor, had a significant, negative impact on financial performance and market cap for both Longtop and Deer:

- CEO duality (the CEO was also the COB): Longtop did not have this duality factor but Deer did.
- Board of Directors entrenchment (only staggered re-elections of the Board versus all Board members re-elected every year): Longtop did have staggered, entrenched board elections and Deer Board members held one year terms or until their successors had been qualified and elected.
- Older Directors (over 60 years of age): Longtop's COB was over 61 years old (one of six Directors) and one of Deer's directors was 66 years old (one of five Directors).
- Short-term compensation mix (cash bonuses and stock options versus long-term stock awards and restricted stock): it was implied at Longtop since the COB gave away $80 million in stock to employees along with 25,000 restricted share units; Deer used base salaries plus equity compensation which were not disclosed.
- Non-independent and affiliated Directors (larger percentages of such directors versus independent directors): Longtop had 3 of 6 or 50% non-independent, senior management directors: the COB (founder), the CEO, and a Business Division manager. Also two other directors resigned in 2009 and were not replaced. Deer had 3 of 5 or 60% possible non-independent directors: the COB/CEO, the CFO, and a university aerospace automation professor. Both NYSE and NASDAQ require listed companies to have a majority of independent directors.
- Ineffective risk management committees: neither Longtop nor Deer had such a committee but Deer did delegate risk management to its audit committee.

7. WEAK SYSTEM OF INTERNAL CONTROL

On October 18, 2007, China MediaExpress Holdings, Inc. did an RTO to become a publicly traded company in the U.S. Its business consisted of placing television screens on Chinese buses in China and selling advertising on such screens. It was in the development stage until 2009. Such advertising could have benefited from real estate developers who were trying to attract Chinese investors to buy apartments and luxury homes in the ghost city projects during that time period.

During January and February, 2011, various short sellers were questioning China MediaExpress. An Australian short seller noted a key red flag: how exactly could such a simple business model earn the company $31 million on $57 million in revenue for the third quarter of 2010? He called it, "the fattest margin and fastest growth media company I have ever seen" (Weinschenk, 2011). Another short seller, Citron Research, called China MediaExpress a "phantom company." While digging into industry reports on mass transit advertising in China, he found no references to China MediaExpress. Articles that listed industry competitors didn't list China MediaExpress, despite the fact that the company claimed $155 million in revenue for the nine months ended September 30, 2010. The company also claimed double the revenue per television screen as its competitors. A third short seller, Muddy Waters Research, said the company only booked $17 million in revenue for 2009 with the State Administration for Industry and Commerce of the People's Republic of China (SAIC) while reporting $95.9 million in its 10-K report to the U.S. Securities and Exchange Commission (SEC). Citron also said that the company was lying when it claimed to have a deal with Apple. Another short-seller, The Financial Investigator, posted a video that claimed to be a tour of the China MediaExpress offices. The video featured sleeping employees, empty offices, and a business that was not the growth machine that China MediaExpress claimed (Bases et. al, 2011).

On March 14, 2011, both the company's CFO and its auditor, Deloitte, resigned and subsequently the company admitted that Chinese branch bank managers had falsified cash confirmations, just like the strategy used in the Longtop scandal (Weinschenk, 2011). In May, 2011, NASDAQ delisted China MediaExpress's shares. In January, 2013, a Hong Kong arbitration panel ruled that China MediaExpress was a fraudulent enterprise and awarded a shareholder $77 million in damages.

In June, 2013, the SEC charged China MediaExpress and its CEO with misleading investors. The SEC asserted that the company misrepresented its cash on hand: the 2009 annual report reported cash of $57 million but was actually $141,000 and in the third quarter of 2010, the cash was reported as $170 million but was actually $10 million. The company's audit committee then hired a forensic accountant from Hong Kong to investigate and the company's CEO offered a $1.5 million bribe to the investigator which was rejected and reported to authorities. From its stock price peak, China MediaExpress had destroyed $792 million in market cap. A class action lawsuit was successful with damages of $535 million awarded to shareholders but China MediaExpress's CEO and senior management had fled back to China, and the company did not even defend itself in the lawsuit, just like the Longtop scandal (Stanford Law School, 2014).

Similarly, China Shenga Tech, a Chinese RTO chemical company, had serious discrepancies regarding its bank balances and customer confirmations per its auditors who resigned (Norris, 2011). A successful shareholder lawsuit cited false cash and customer confirmation letters and counterfeit, forged certificates of deposit. Similarly, China-Biotics, another RTO company, directed its auditors to a fake bank website for cash confirmations. Subsequently, China Shenga Tech and China-Biotics destroyed $272 million and $380 million in market cap, respectively.

8. FOCUS ON SHORT-TERM PERFORMANCE GOALS

Typically, the all-powerful senior management intentionally has kept the company's system of management and internal controls weak. Such weaknesses facilitated the achievement of short-term performance goals which were the focus of senior managers in line with their executive compensation packages. Examples included bonuses based upon revenue and net income targets and stock options kept in the money by higher stock prices in the short-term. These first three "structural" weaknesses have contributed to significant market cap destructions of almost $14 billion by the fourteen Chinese IPO and RTO companies cited in this paper as follows:

Table 1. The fourteen Chinese IPO and RTO companies

Company (millions)	Market Cap Destruction
Sino-Forest	$5,000
Longtop Financial	2,408
Tianhe Chemical	1,900
Douyuan Global Water	960
Kaisa	900
China MediaExpress	792
Chen Zhou Mining	500
China Integrated Energy	490
Gulf Resources	442
China-Biotics	380
Deer Consumer Products	374
China Shengda Tech	272
Keyuan Petrochemical	265
Harbin Electric	118
Total	$14,801

9. WEAK OR NON-EXISTENT CODE OF ETHICS

Another non-ethical, bribe situation occurred that was similar to the China MediaExpress CEO offering a $1.5 million bribe to a Hong Kong forensic accountant hired by the company's audit committee. Kaisa was a property developer in China that did an IPO in Hong Kong and raised $450 million in 2009 and also issued $2.5 billion in offshore bonds. In a 2010 corruption trial in southern China, the Kaisa chairman and co-founder confessed to paying a $130,000 bribe to a judge to gain favorable treatment on a Kaisa property deal. This chairman resigned in December, 2014 for "health reasons" and is now in Hong Kong which has a separate legal system. He refuses to return to mainland China. Kaisa's possible 2015 bankruptcy is estimated to return 2.4 cents on the dollar to bond investors and its common stock is down 88% for a possible total market value destruction exceeding $2.7 billion for both bonds and stock (Barboza, 2015).

On December 12, 2006, Gulf Resources became a public company in the U.S. by doing an RTO with a Delaware company that from 1993-2006 had been a U.S. business owning, leasing, and operating coin and debit card photocopy machines, fax machines and microfilm reader-printers. However, this RTO company was now in the business of manufacturing and trading bromine, crude salt, and related chemical products in the Chinese chemical industry. There was a subsequent 2012 class action lawsuit (settled in 2014 for $2.1 million) which claimed that reported financial report filings to the SAIC showed a much smaller business that was indicated in filings to the SEC. Also, the company's largest customer was an undisclosed related party and many of the company's top customers were owned by Gulf Resources board of directors—also undisclosed in financial reports (Stan, 2012). Having such customers for this manufacturing business may have given the impression that this company was benefitting from the ghost city construction projects that contributed to the double-digit Chinese GDP growth rates during the 2005-2010 period.

In April, 2011, a Glaucus Research Group report highlighted many shortcomings for Gulf Resources. Key findings focused upon competitive analyses. Gulf Resources claimed an Earnings Before Income Taxes (EBIT) margin of 43.5% versus three major competitors' average EBIT margin of 14.4% and an EBITDA margin of 50.6% versus competitors' average EBITDA margin of 18.9%. A key conclusion in this report was: "It is highly unusual and in our opinion nearly impossible, for a commodity manufacturer to consistently produce the types of margins typically only achieved by the likes of Microsoft, Apple and other businesses with unique products, unless the commodity sector is benefiting from abnormal supply-demand imbalances… According to industry data, there are approximately 75 licensed bromine producers in Weifang City, Shandong Province, which produce approximately 85% of all the bromine produced in China" (Kerrisdale, 2011). Subsequently, Gulf Resources had $442 million in market cap destruction. One commentator concluded: "Gulf Resources is now a prominent member of the China reverse merger bad boy club, which includes quite a few companies that have been accused of accounting irregularities" (Stan, 2012).

In March, 2011, an Absaroka Capital Management report listed many serious concerns about the validity of the Shen Zhou Mining & Resources company. The company had encouraged the common misconception that it was a rare earth business to take advantage of investor interests in rare earth minerals even though it had no exposure to such business. Management had significantly exaggerated the size of its critical fluorite mine. Guidance for the upcoming year could not be reconciled with prior results and implied commodity prices were irrationally high, based upon revenue guidance. A recent company investment appeared to be a fraudulent scheme to transfer equity to related parties with a put option that was highly dilutive to public shareholders. There were misleading investor relations while insiders were selling stock prior to an equity offering which had no rational explanation, based on business needs, and significantly increased the risk of corporate malfeasance (Absaroka, 2011). Subsequently, $500 million in market cap was destroyed.

On August 10, 2006, China-Biotics became a public company in the U.S. after completing an RTO and was in the development stage until 2007. It was a Shanghai-based maker of probiotic yogurt cultures. It indirectly benefited from the ghost city projects that significantly contributed to the investor-attractive double-digit Chinese GDP growth rates during the 2005-2010 period when many of these RTO companies listed in the U.S. (Grove and Clouse, 2014).

In August, 2010, Citron Research issued a very negative report on China-Biotics which stated: "It would be easy to look at the gross discrepancies between the company's SAIC and SEC filings. It would also be possible to show pictures of the half-finished over-budget manufacturing facility side-by-side with company claims that it was already in production. Most compelling, it would be simple to question how a company who sells the bulk of their product through distributors, who then purportedly resell them to Wal-Mart (as claimed by China-Biotics) can generate EBITDA margins of 40-45% when their competition is at 27% max" (Nachman, 2010). In a second report on September 14, 2010, Citron questioned the network of 111 retail stores claimed by China-Biotics in years' worth of SEC filings and determined that their list of "branded stores" were not stores; 95% of them were just supermarkets and retail outlets that carried China-Biotics products on small shelf space or did not carry such products at all. Citron noted that China-Biotics claimed to have $160 million in the bank in its June 2010 SEC filing yet reported interest income of just $87,876 (0.0005%) while interest rates on free cash balances in China earn 1% for 3 month to 1 year term deposits (Left, 2010). On June 24, 2011, NASDAQ delisted China-Biotics' stock and a shareholder lawsuit was filed one month later. The company had destroyed $380 million in market cap.

10. QUESTIONABLE BUSINESS STRATEGIES WITH OPAQUE DISCLOSURES

For examples of opaque and misleading disclosures, the financial statements numbers reported to the SAIC have been compared to the financial statement numbers reported to the SEC numbers for various Chinese RTO companies. One example related to China Integrated Energy, one of the Chinese RTO companies, which may have supplied energy to ghost city projects. When it was delisted, it had destroyed $490 million in market cap. A short seller compared its SAIC 2011 numbers to its SEC 2011 numbers and found the SAIC numbers to be much smaller. The company responded by stating that its SAIC numbers misrepresented its financial performance, business prospects, and financial condition to investors (Lucy, 2011). A manager in this company said an independent and unregulated agent had persuaded the company to get listed on a U.S. market for easy accessibility of capital but did not inform the company of any risks. The agent described NASDAQ as the "land of honey and milk." Ironically, this same agent was later persuaded by a short seller to whistle blow on the company's problems (Fan and Xue, 2013).

Other examples of Chinese RTO companies reporting different numbers to the SAIC versus the SEC included China MediaExpress revenues of $17 million to the SAIC versus $96 million to the SEC, Harbin Electric's loss to the SAIC versus $77 million net income to the SEC, and Deer Consumer Products' loss of $1.2 million to the SAIC versus $17.5 million net income to the SEC. Deer also reported a land purchase of $11.3 million in Chinese property records versus $23.2 million to the SEC. In 2011, Chinese officials confirmed that both Harbin Electric and Deer Consumer Products committed multi-million dollar land fraud. A short seller said that this discrepancy was a typical method for Chinese executives to siphon off (steal) company cash (Left, 2011).

An outrageous example was from another Chinese RTO fraudulent company, China-Biotics. It's SAIC versus SEC reporting differences were also compared to the average differences between eight delisted Chinese RTOs and eight ongoing dual-listed Chinese companies (Chen et.al, 2015) as follows:

Table 2. SAIC versus SEC reporting differences

	SAIC	SEC	China Biotics	Average
Cash	$ 100,000	$64,300,000	643	24.3
Accounts Receivable	1,000,000	13,200,000	13	6.8
Revenues	500,000	42,300,000	85	17.4
Net Income	(1,200,000)	17,500,000	19	13.2

Such large discrepancies between SAIC and SEC financial reports have become warning signs or red flags for potential fraud by Chinese companies. Citing the China- Biotics numbers, a short seller concluded: "As far as lying to the Chinese government but not the SEC, you want us to believe that management who lives and pays taxes in China, where white collar crime can be punishable by death, will lie to the Chinese government but they will not lie to the SEC?" (Left, 2010). For example, Zeng Chengjie, a Chinese businessman, nicknamed "China's Madoff," was executed on July 12, 2013 by lethal injection for illegal fundraising and financial fraud. He allegedly defrauded more than 57,000 investors out of $460 million of which he had already repaid $280 million (60%) at the time of his execution, as compared to Bernie Madoff's lifetime jail sentence for his $50 billion Ponzi scheme (Lu, 2013).

Another example of opaque disclosure concerned the related party transactions of Keyuan Petrochemicals Inc. The SEC charged in a lawsuit filed against the company that numerous related party transactions between the company and its CEO, controlling shareholders, senior management, and family members were not properly identified or disclosed, causing the financial statements to be misstated, specifically cash, receivables, construction-in-progress, interest income, other income, and general and administrative expenses. An extreme example was the use of an off balance sheet cash account to pay cash bonuses to senior management, travel expenses and apartment rental to the CEO, and both cash and non-cash gifts to Chinese government officials (SEC, 2013). Subsequently, $265 million in market cap was destroyed.

11. SENIOR MANAGEMENT IS UNCOMFORTABLE WITH CRITICISM

In June, 2011, a short seller, Carson Block of Muddy Waters Research, released a negative research report on Sino-Forest, an owner of tree plantations and manufacturer of engineered-wood products. The company claimed to derive most of its revenue from the sales of wood fiber needed to produce industrial, commercial, and residential wood products. Thus, the company was an obvious beneficiary of the ghost city projects. Block claimed that the company had been inflating its assets and earnings and that the company's shares were essentially worthless as the company was a "multibillion-dollar Ponzi scheme" (Wikipedia, 2015). The company rejected these allegations and announced that it would sue Muddy Waters. Its shares were suspended in August, 2011 and in March, 2012, the company filed for bankruptcy (now in liquidation status) which was a $5 billion market cap destruction. Block's other negative research reports also initiated stock price decreases in the following Chinese RTO companies: China MediaExpress, Orient Paper, RINO International, and Duoyuan Global Water. Block said that his success has made him and his wife a target of threats. Thus, he has moved his main office from Hong Kong to an undisclosed location on the U.S. West Coast, removed his phone number for the Muddy Waters website, and has listed a false address on the website (Bases et. al, 2011).

In February, 2011, China MediaExpress released a letter, reaffirming its financial statements and operating practices in response to attacks by various short sellers. In May, 2011, Deer Consumer Products issued its own press release and asserted that it had "evidence of continuing illegal short selling in its stock and also asserted that its common stock has been manipulated in collusion among naked short sellers." The press release also asserted that the class action lawsuit was part of the attempted manipulation. Deer further asserted that "the supposed analyst, Alfred Little, is a fictitious character whose phony identity is a disguise used by one or more illegal short sellers in the short seller sale scheme." Deer claimed that the purported reports of Alfred Little were "published in collusion with short sellers to intentionally create fear in the general public to drive down Deer's share price." The press release also asserted that all of the allegations in the supposed Alfred Little reports were false and that the company intended to seek sanctions against the law firm that filed the lawsuit (Dando, 2011). In September, 2010, China-Biotics released a press release commenting on its stock. The company didn't defend their alleged false stores claim explicitly but instead stated that there were "market rumors" and blamed the shorts for stock price declines, similar to Enron's strategy. The short seller, Andrew Left, commented: "Don't forget the old adage: at every poker game there is a sucker, and if you don't know who the sucker is, it is you!" (Left, 2010).

12. INSIDER STOCK SALES

On August 20, 2005, Harbin Electric became a public company in the U.S. after completing an RTO. Headquartered in Harbin, China, Harbin Electric developed and manufactured electric motors, including rotary motors, linear motors, and specialty micro-motors. It was a development stage company until 2005. The company indirectly benefited from the ghost city projects that significantly contributed to the investor-attractive double-digit Chinese GDP growth rates during the 2005-2010 period when many of these RTO companies listed in the U.S. (Grove and Clouse, 2014).

In October, 2010, the Harbin Electric CEO and a private equity firm made a $750 million buyout offer to take the company private. In June, 2011, the short seller, Citron Research, posted a report on Harbin Electric, claiming the buyout loan was a fraud and had the documents to prove it. He said that the future of Harbin's stock price was currently propped on the crutch of a purported $24 per share buyout offer from its Chairman/CEO who owned 40% of the common stock. Citron stated that the Harbin Chairman/CEO had a history of fraudulent loan guarantee documents and claimed the offer was a sham with the CEO obtaining a signature loan for $400 million to buy out the remaining 60% of publicly-held shares at a 40% premium. The purported lender bank, China Development Bank, had become associated with China stock frauds. Citron questioned what bank would provide hundreds of millions of dollars in high-risk financing to fund a huge premium to pay off U.S. investors. Citron said that Harbin Electric's SAIC filings showed losses for both 2009 and 2010 while its SEC filings showed profits of $20 million and $77 million, respectively. Citron also claimed that the company had significantly understated its liabilities and overstated its revenues in SEC filings as compared to its SAIC filings (Left, 2011). However, Harbin Electric only destroyed $118 million in market cap, due to its successful buyout offer.

In June, 2011, an *Asian Times* reporter also questioned this buyout offer, saying that "for some Chinese RTOs, the trip to Wall Street has turned into a prolonged swim in a sewer of suspicion, innuendo, disdain, and exposure and prospects of U.S.

financing that, if available, would be grudging, onerous, and expensive. It is therefore not too surprising that Harbin Electric's CEO might decide to extract his company from the RTO morass by taking it private" (Lee, 2011). In September, 2011, another short seller read the customer footnote in Harbin Electric's 2010 annual report which claimed Jiangsu Liyang Car Seat Adjuster Factory was its second largest customer, accounting for 10% ($22 million) of 2009 revenues and 16% ($19 million) of 2008 revenues. He then investigated and discovered that this customer barely did any manufacturing of electric car-seat adjusters while Harbin Electric's major product line was electric motors. This customer said that 98% of its business was selling manual, not electric, car-seat adjusters and its total sales were $27 million in 2009 and $30 million in 2008. Thus, the electric motor sales to this customer that Harbin asserted "represented a big disconnection" (Boyd, 2011).

Concerning Longtop's insider stock sales, it was a short seller's opinion that believing an unrelated third party ran your human resource business to make $30,000 a year (according to filings) is as crazy as believing that a Chairman of a company would just give away $80 million in stock to his employees because money doesn't really mean that much to him (as per the CFO's explanation). This short seller hoped that these observations could end any debate as to whether the company has been deceiving its investors and said it was not the time to host any more conference calls or cover ups. "The excuses have run their course. It is now time to confess, let the auditors figure out the necessary restatements, and let the real Longtop Financial Technologies stand up" (Left, 2011).

13. SENIOR MANAGEMENT TURNOVER

On July 20, 2011, four members of Douyuan Global Water's Board of Directors resigned amidst allegations of fraudulent internal company controls which later in October, 2013 led to a $5.2 million settlement of a class action lawsuit. Carson Block, of Muddy Waters Research, had initiated coverage of the company on April 4, 2011 as a strong sell, alleging that the company's revenues reported in China were $800,000 annually versus the $154 million reported in the U.S. Block also caught the company forging its China audit report and cited improper undisclosed related party transactions that shifted money to its chairman (Block, 2011). Douyuan Global Water, another Chinese RTO company, specialized in manufacturing water and waste water treatment equipment for municipal, industrial and agricultural water systems. Thus, the company was another obvious beneficiary of the Chinese ghost city projects in the last decade and subsequently destroyed $960 million in market cap.

On March 13, 2011, a short-seller released a video claiming to be a tour of the China MediaExpress offices. The video featured sleeping employees and empty offices. The next day both the company's CFO and its auditor, Deloitte, resigned (Bases et. al, 2011). On March 16, 2011, the CEO of Shen Zhou Mining & Resources resigned after many analysts had whispered that is was likely a fraud (Rubin, 2011). Its stock had traded as high as $10 in January, 2011 on the hype about its rare earth minerals production and sales which may have been aided by China's ghost city projects and double-digit GDP growth of the last decade. Its stock now trades in 2015 at $0.04 with no recent trading activity which was a $500 million market cap destruction.

On June 24, 2011, China-Biotics's CFO resigned and its auditor, BDO Limited, also resigned, citing irregularities it discovered that "likely constitute illegal acts." BDO said that its auditors, attempting to review online bank records, were directed by staff of China-Biotics to "access a suspected fake web site" that supposedly belonged to the bank in question where the company kept one of its major cash accounts. In its 3/31/2010 balance sheet, the company had reported $156 million in cash which was approximately 150% of its market cap. Also, BDO stated that the company had forged sales documents and misstated interest income and failed to take "appropriate remedial actions." BDO had been the company's auditor for the last three financial years, 2008-2010 and had issued clean audit opinions for all three years but refused to certify the 2011 numbers (Bezek, 2011).

14. INDEPENDENCE PROBLEMS WITH THE COMPANY'S EXTERNAL AUDITORS

In March, 2013, an investor filed a class action lawsuit against Deer's auditor, Goldman Kurland and Mohidin LLP, who had issued clean audit opinions for Deer's financial statements in 2007 through 2010. The lawsuit alleged that Deer's revenues were overstated in 2009 and 2010. This auditor was claimed to be a favorite auditor for Chinese RTO companies per Alfred Little, a short seller (2011). In December, 2011, Harbin Electric's auditor, Frazein Frost, agreed to be shut down by the SEC without admitting guilt. This firm had issued clean audit opinions for Harbin's financial statements from 2006 through 2010. The SEC said the reason for the auditor shut-down was improper professional conduct in connection with the annual audits and quarterly reviews of the company's financial statements. In April, 2011, Longtop's Chief Financial Officer (CFO) tried to reassure financial analysts that the fraud claims were bogus. He wrapped himself in the prestige of his company's auditor, Deloitte, saying that those who questioned Longtop were "criticizing the integrity of one of the top accounting firms in the world." He also said that his relationship with Deloitte was "very close, third only to his relationship to his family and the CEO" (Norris, 2011).

15. INDEPENDENCE PROBLEMS WITH THE COMPANY'S INVESTMENT BANKERS

In May, 2011, a Morgan Stanley analyst wrote: "Longtop's stock price has been very volatile in recent days amid fraud allegations that management has denied. Our analysis of margins and cash flow gives us confidence in its accounting methods. We believe market misconceptions provide a good entry point for long-term investors." At the time of these reports, Deloitte was in the process of completing its Longtop audit for the fiscal year ending March 31, 2011. It had previously given unqualified or clean audit opinions to Longtop for six consecutive years and apparently was well on its way to providing a seventh clean opinion. However, two weeks later, Longtop removed Deloitte as its auditor when Deloitte sent bank confirmations to the bank's home office instead of to the branch bank managers as in the past (Norris, 2011).

16. CONCLUSIONS AND EPILOGUE

In conclusion, when Boards of Directors, auditors, forensic accountants, financial analysts, government regulators, and other risk managers are investigating possible fraudulent financial reporting, we advocate the use of the five "structural" factors of corporate governance and the five "behavioral" factors of corporate governance for risk assessment .By June, 2013, the SEC had filed more than 65 fraud cases and deregistered the securities of more than 50 Chinese RTO companies (Lynch, 2013). For a current example of users not following our recommended strategy to investigate these "structural" and "behavioral" factors of corporate governance, red flags existed for a recent June 2014 IPO for Tianhe Chemicals Group in Hong Kong. Its CEO was also its Executive Director since 2007 and also the Director of both of the two subsidiaries which conducted all of the company's business. He had completed only three years of education in commercial enterprise management from a university. Four of the eight directors were company officers, another director worked for another Tianhe company and a sixth director worked for Tianhe's IPO lead bank, Morgan Stanley. Thus, there was not a majority of independent directors as required by U.S. stock exchanges. Three of the eight directors were over 60 years old. An insider trading report listed one substantial individual shareholder who sold almost 90 million shares just four months after the IPO (Dun & Bradstreet, 2015).

Tianhe's IPO on the Hong Kong stock exchange had lost $1.9 billion in market cap in just over six months by early 2015. Morgan Stanley was the lead investment bank in that IPO along with Merrill Lynch and UBS AG with Deloitte as the auditor. Morgan Stanley twice conducted due diligence investigations into Tianhe Chemicals—once before its own private equity fund made an investment in Tianhe and again before the Tianhe IPO. Morgan Stanley spent over $2 million in these two due diligence investigations (Kinetz et.al, 2014). After an initial Tianhe fraud warning by a short seller, the Associated Press (AP) did an extensive investigation into Tianhe and found discrepancies in Tianhe's profitability and relationships with customers as well as the company's origins.

Short sellers and the Associated Press (AP) found that Tianhe revenues cited in government sources were $106 million in 2012 versus the $684 million in the financial statements reported to investors. Also, the AP found that one of Tianhe's principal customers had been reported to purchase about $100 million of chemicals each year which was about 15% of Tianhe's total annual revenues. However, governmental data for this customer showed its annual revenues being less than $6 million in 2012 and a negative net worth of $900,000. This customer's registered Chinese office was an unoccupied room containing broken furniture and old mattresses in a rundown apartment building (Kinetz et.al, 2014).

For another example of users not following our recommended procedures, the 2007 Longtop Financial Technologies IPO destroyed $2.4 billion in market cap by the time of its demise in late 2011. The lead investment bank was Goldman Sachs along with Deutsche Bank and Deloitte as the auditor. Morgan Stanley did a secondary public stock offering in 2009. Yet, only the short sellers were able to detect fraud problems with Longtop (Left, 2011).

As a result of these Chinese financial reporting frauds with their corporate governance failures, these companies were delisted by U.S. stock exchanges, their auditors resigned, investors filed class action lawsuits, and the SEC pursued investigations. For example, Longtop and China MediaExpress recently had large shareholder class action lawsuit settlements of $882 million and $535 million, respectively, in 2014. These lawsuits were not even contested by the defendants who went home to China. The same "Big 4" Chinese affiliated auditing firm, Deloitte Touche Tohmatsu, was held not liable in the first case but was held liable in the second case, guaranteeing future legal appeals (Stanford Law School, 2014).

Finally, a combined "structural/behavioral" factor is emerging in corporate governance, especially in the European Union: representation of women on boards. On March 6, 2015, the German parliament passed a law that requires 100 of Germany's biggest and best known companies to give 30% of their supervisory board seats to women, starting in 2016. In 2014, only 18.6% of supervisory board members or directors were women at these 100 German companies. A further 3,500 German companies have a September 30, 2015 deadline to submit plans to increase their share of women on boards. This vote means that Europe is really endorsing a quota line for women on boards. Norway was the first in 2008, joined by Spain, France, and Iceland, which all have minimum board quotas of 40% for women. Italy has a quota of 33% with Belgium and Netherlands at 30%. Both Britain and the U.S. just have voluntary efforts with 23% and 17% women on boards, respectively (Smale and Miller, 2015).

An August 2015 epilogue had global stock markets in free-fall and extreme volatility and it certainly seems that Jim Chanos, the billionaire short seller, who has been warning about China's real estate bubble since 2009, has been vindicated. China is an important reason for such global stock market volatility. China's economy is faltering, its stock market is collapsing, and the inefficient efforts by government officials to prop up its stock market have led to a loss of confidence in China and its leaders which have spooked global stock markets (Nocera, 2015). Per a McKinsey & Company China report (2015): "China's debt rose from $7 trillion in 2007 to $28 trillion by mid-2014. At 282% of GDP, its debt share, while manageable, is larger than either the U.S. or Germany. Several factors are worrisome: half of the loans are linked directly or indirectly to China's real estate market, unregulated shadow banking accounts for nearly half of new lending, and the debt of many local governments is likely unsustainable." Per Ken Rogoff, a Harvard economics professor, who has long warned of a potential financial crisis in China: "Financial meltdown leads to a social meltdown, which leads to a political meltdown. That's the real fear" (Sorkin, 2015). Finally, Jim Chanos recently declared about China: "Whatever you think, it's worse" (Sorkin, 2015).

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APPENDIX

Ten Timeless Corporate Governance Weaknesses Facilitating Fraud by Companies Related to Chinese Ghost Cities

1. All-Powerful CEO and Insider Board Influence

The Chief Executive Officer (CEO) is also the Chairperson of the Board of Directors (COB). Also, insiders (senior company managers) on the Board effectively have either significant influence or majority voting control.

- **Corporate Examples:** The CEO, often the company founder, was also the COB at **Parmalat, Enron, Global Crossing, Tyco, Lehman Brothers**, and **WorldCom**. The brother of **Satyam's** CEO was the COB with several Satyam Directors coming from the CEO's circle of friends from his Harvard University days. Thus, Satyam insiders had significant influence on the Board of Directors. The **Qwest** COB, who was the company founder and largest single shareholder, hand-picked the CEO. Parmalat's CEO, CFO, and the company lawyer continued to run the corporation together after it went public and controlled the Board of Directors. Both Enron and **Citigroup** paid their Board Directors such high compensation that at one time both were in the top ten U.S. Board compensation packages. Enron also contributed significantly to its Directors' favorite charities. Accordingly, these companies had significant influence on their Board of Directors.
- **Strategic Guideline: Effective Board Structure**

A small, legally accountable, well-diversified board should be comprised of a maximum of seven members, including an independent Chairperson, independent members, and the CEO. The board should conduct its activities through only two committees: an integrated audit and risk management committee and an integrated board management committee.

- **Warren Buffett Comments & New York Stock Exchange (NYSE) Corporate Governance Listing Requirements:** Concerning this Strategic guideline for an effective board structure, Buffett observed: "true independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare." He looks for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than $4 million of Berkshire stock. They are paid nominal director fees. No directors and officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur. Basically, Buffett wants the directors' behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He calls this approach "owner-capitalism" and says he knows of no better way to create true independence for board directors. The NYSE requires that its listed companies have a majority of independent directors and has defined independence as directors having no material relationships with the company over the past year after adoption of corporate governance listing standards.

2. Weak System of Management Control

The system of internal control (checks and balances, separation of duties, etc.) is so weak that senior management can override it anytime it wants.

- **Corporate Examples: Satyam's** CEO has admitted that $1.5 billion cash on its balance sheet was non-existent and that its revenues and operating margins were less than one-tenth of what was reported. Satyam admitted that it did not have a financial expert on its audit committee. **Parmalat's** CEO has admitted shifting over EUR 500 million cash from the company to other businesses. However, an investigative report prepared by an independent auditor for prosecutors in Milan put that Parmalat number closer to EUR 1 billion cash. Although Parmalat had reported profits each year, this report said that Parmalat only had one profitable year between 1990 and 2002. Major international investment and commercial banks, like **Lehman Brothers, Bank of America, JPMorganChase,** and **Citigroup**, had inadequate risk assessment procedures, especially for their mortgage-backed security investments (toxic assets). Board audit committees failed to perform this key risk assessment function, helping to cause the bankruptcy of Lehman Brothers and the necessity for government bailout money for Bear Stearns, Citigroup and 18 other major U.S. and international banks. Also, there were weak management controls at **Enron, Global Crossing, Tyco, Qwest**, and **WorldCom,** according to the Securities and Exchange (SEC) investigations of fraudulent financial reporting at these companies.

- **Keep It Controlled Guideline: Board's Auditing Function**

To improve the quality of internal control, effective cooperation is needed between the external auditor, the board, the audit committee (to which it reports) and the internal auditor (which should also report to the audit committee). The effectiveness of the internal control system and compliance should be a central focus of the audit committee.

- **Buffett & NYSE:** Concerning this Keep it controlled guideline for a board's auditing function, Buffett observed that many intelligent and decent directors failed miserably due to a "boardroom atmosphere." He elaborated: "It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision." To avoid these "social" difficulties, Buffett has endorsed the NYSE requirement that outside directors regularly meet without the CEO. Also, the NYSE requires that every listed company have an audit committee of at least three members composed entirely of independent directors who must be financially literate. Every listed company must have an internal audit function.

3. Focus on Short Term Performance Goals

The overriding performance goal is to "make the numbers," for each quarter and each year, especially for executive compensation. Performance emphasis is given to both revenue, or "top-line" growth, and earnings, or "bottom-line" growth. Aggressive or fraudulent accounting and business practices facilitate the achievement of such goals.

- **Corporate Examples: Qwest's** CEO was criticized by his own board for having a short-term focus on making the numbers, particularly double-digit revenue growth. For example, to help make its revenue goals in one year, Qwest recorded thirteen months of advertising revenues from its telephone directories, instead of the normal twelve months. Qwest also did quarter and year-end swaps of its fiber optic networks with other companies, such as **Global Crossing** and **Enron**, in order for all these companies to make their double-digit revenue growth targets. Both **Satyam's** CEO and Board constantly focused upon double digit revenue growth every year. A German firm rejected a proposed merger with Enron, citing Enron's huge off-balance-sheet debt in its Special Purpose Entities (SPEs) and use of aggressive accounting practices to create gains from its SPE transactions. Similarly, another German firm rejected a proposed merger with Qwest, citing its huge on-balance sheet debt and aggressive accounting practices. **Tyco** and **WorldCom** were "greedy corporations" as they were purely interested in short-term financial gain (Gladwell, 2009, p.366) Also, WorldCom's CFO never kept a single share of WorldCom stock in his personal investment account since he exercised and sold his stock options as soon as they vested. Many international banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup**, hid their toxic asset investments off their balance sheets in Structured Investment Vehicles (SIVs) and refused to recognize market value declines or impairments of such assets in their income statements. Board compensation committees at these companies encouraged short-term performance goals related to bonuses, stock options and stock grants.

- **Integrated Guideline: Executive Remuneration**

The total compensation package can be divided into fixed (e.g. 40%) and variable (e.g. 60%) components. The variable component can be made up of several performance measures: 1) long-term financial performance over three years, 2) comparative value indices (e.g. 50% Economic Value Added, 20% customer loyalty, 20% employee satisfaction, and 10% public image), and 3) functional performance assessments (20% board committee performance, 30% individual board member performance, and 50% corporate performance).

- **Buffett & NYSE:** Concerning this Integrated guideline for executive compensation, Buffett stated: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging." He noted that when CEOs meet with boards' compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often has seemed unimportant to the compensation committee, particularly when stock option grants had no effect on earnings under prior U.S. accounting rules. He observed that such negotiations often had a "play-money" quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders. Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation." The NYSE requires that all listed companies have a compensation committee comprised solely of independent directors. This committee must have a written charter which includes objectives for CEO compensation and performance evaluation. Also, Buffett has argued that a red flag should exist if a company always does meet its quarterly and annual goals, like Enron did, since such performance ignores the reality of competitive environments and business cycles.

4. Weak or Non-Existent Code of Ethics

Company employees are encouraged to push their behavior and financial reporting to or beyond ethical and professional limits. The company's code of ethics (if one exists) is not taken seriously.

- **Corporate Examples: Parmalat** unraveled quickly after it had trouble making a routine bond interest payment, prompting tougher scrutiny of its books by Italian regulators and its own auditors. A follow-up audit found that Parmalat's EUR 4 billion cash in a Bank of America account did not exist. The auditors had sent the confirmation request to the bank through Parmalat's internal mail system where it was intercepted. Then the written confirmation from the bank back to Parmalat's auditors was forged as were other supporting documents. The EUR 4 billion cash had just been fabricated to help cover up the CEO looting his company. Similarly, **Satyam's** $1.5 billion in cash disappeared, allegedly into the CEO's various family businesses. Also, the World Bank banned Satyam for at least eight years from its list of information technology providers, citing alleged bribing of its bank staff and data theft. A Fortune financial magazine reporter, Bethany McLean (2001), was the first national reporter to question **Enron's** value in the financial press. She noted that the use of the mark-to-market accounting method for pricing Enron's securities in illiquid markets with no fair value benchmarks was a red flag for fraudulent financial reporting. She said, "Enron often relied upon internal models which created serious potential for abuse." According to former Enron managers, salespeople used wildly optimistic assumptions about the forward price of commodities and other factors to value their contracts so profits would be inflated and their bonuses would be bigger. One power- industry consultant said, "That's valuation by rumor. There's no way for those results to be taken seriously." In a home video at a retirement party for an Enron manager, Enron's CEO, Jeffrey Skilling, boasted that he could "add a kazillion dollars to the bottom line anytime" by using this mark-to-market method. **Tyco's** CEO, CFO, and general council secretly took out $170 million in no/low interest loans from the company that had not been approved by Tyco's Board compensation committee. These loans had been hidden from Board members, shareholders and employees. Then, the CFO "forgot" to include $12 million of loans forgiven by Tyco as income in his personal income tax return. The three telecom companies, **Global Crossing, Qwest**, and **WorldCom**, all created cultures of fear to help override any codes of ethics and achieve earnings management goals. Weak codes of ethics facilitated the hiding of toxic asset investments in the SIV off-balance-sheet accounts by various banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup**.
- **Keep It Controlled Guideline: Board's Auditing Function**

There are three main audit tasks of the board: 1) financial reporting—observation and realization of the financial targets, 2) operations—observation and assessment of operational targets, and 3) compliance—surveillance of compliance with laws, regulations, and guidelines, such as a code of ethics.

- **Buffett & NYSE:** Concerning this Integrated guideline for board competence, Buffett commented: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation." The NYSE requires that its listed companies have a code of ethics and promptly disclosure any waivers of the code. Also, CEOs must certify annually that they are not aware of any company violations of NYSE corporate governance listing standards. CEOs must promptly notify the NYSE in writing if they become aware of any material non-compliance from these standards.

5. Questionable Business Strategies with Opaque Disclosures

Questionable and opaque business and disclosure strategies may exist for the company's business model and related financial reporting. Buffet (2004) has given this advice: "If you don't understand what a company does, don't invest in it. If management refuses to fill in holes and keeps investors in the dark, run!"

- **Corporate Examples:** Questionable business strategies existed along with opaque (unclear) disclosure strategies at **Enron**. The Fortune reporter McLean said: "How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms competitive reasons. The numbers that Enron does present are often extremely complicated. Seemingly basic questions, like the effects of lower natural gas prices and less volatility in energy markets on Enron's profits, are still unanswered." Another example of intentionally opaque, complex financial reporting and disclosure came from Enron's related party transactions with SPEs. As the short seller Jim Chanos said, "We read the disclosure over and over and over again and we just didn't understand it—and we read footnotes for a living." An A.G.Edwards energy analyst, Michael Heim, said, "I've never seen such complicated disclosures. It was hard to follow the movement of money." Also, Enron's CEO and CFO both repeatedly told financial analysts that Enron would never be liable for bank loans with its SPEs. However, there were credit triggers in the bank loan covenants that did make Enron liable for such loans. The two major credit triggers were Enron's common stock price falling below a certain level and Enron's credit rating falling to junk bond status. When pushed to reveal more, Enron management was uncooperative and pleaded confidentiality concerns. **Parmalat** used a similar SPE strategy to help earn its nickname as "Europe's Enron." It created an elaborate network of related party transactions, using opaque disclosures of its subsidiaries in tax havens such as the Cayman Islands and Luxembourg to hide the declining state of its finances. One subsidiary was called Buconero, which means black hole in Italian. **Satyam** used a similar opaque disclosure strategy to help earn its nickname as "Asia's Enron." After Satyam went public in 1991, it was supposed to stop using its cash reserves to invest in family owned companies. However, such problem practices surfaced again in 1998 and in 2008, just before its confession of fraudulent financial reporting. None of these cash reserve investments were adequately disclosed in Satyam's financial statements. Neither **Qwest** nor **Global Crossing** disclosed that their revenues from fiber optic swaps and equipment sales were non-recurring in nature. The strategy of both the CEOs at Qwest and **WorldCom** was never to disclose anything that would cause their stock prices to go down. **Tyco** did not fully disclose its transactions with its complex network of subsidiary and affiliated companies. Many banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup,** did not (and still do not) fully disclose the market values of their toxic assets which were often hidden in their off-balance-sheet SIVs.

- **Keep It Controlled Guideline: Communication Function**

The following two functions are most relevant: 1) the content function: to promote transparency of information at the board level through the exchange of information that is comprehensive, true, understandable, and relevant to board members, top managers, employees, shareholders, customers, and the public and that relates to financial, market, and other performance measures, and 2) the relationship function: to create a real culture of trust and learning through a constant improvement of the relationships between board members, top managers, shareholders, and other stakeholders, to deal with conflict constructively and to avoid unnecessary confrontations.

- **Buffett & NYSE:** Similar to the Enron short seller Chanos' comments, in his 2003 CEO letter to shareholders, Buffet observed the Enron SPE disclosures were just not understandable. The NYSE can issue a public reprimand letter for violation of any of its corporate governance standards in addition to the existing penalty of delisting. It can also list a flag next to the stock ticker of a company whose corporate governance policies are deficient.

6. Senior Management is Uncomfortable with Criticism

When questioned by outsiders, like financial analysts during conference calls, senior management is defensive and abusive to these outsiders. Senior management, especially the CEO and CFO and even board members, may wind up lying to outsiders.

- **Corporate Examples: Enron's** CEO, Jeffrey Skilling, was uncomfortable with criticism in a conference call with financial analysts as he called one analyst an "asshole" when questioned about Enron's performance. The prosecutors at the successful fraud trial of Skilling played a tape of that conversation to the jurors. Jim Chanos, who was the first hedge fund manager to question Enron's performance, called Skilling's conference call a disaster and the final piece of the puzzle. He began to short Enron's stock shortly thereafter while it was still trading at around $70 per share. Similarly, the CEOs of **WorldCom, Lehman Brothers**, and **Citigroup** had problems with their conference calls, especially being challenged on the issue of excessive executive bonuses, primarily at the big Wall Street banks after being given U.S. government bailout money. **Qwest's** CEO criticized the Morgan Stanley financial analysts who questioned his company's performance and downgraded Qwest's stock from a buy to a neutral status. He said that they were "not the sharpest knives in the drawer" and called their report "hogwash." He pledged never to talk to them again and terminated any future investment banking business with Morgan Stanley. **Parmalat's** CEO was uncomfortable with criticism from his Italian bankers and new auditors. Italian law requires audit firms to be rotated every five years. To mitigate this law, he moved 51% of Parmalat's operations and its questionable business practices to the Cayman Islands where the former lead audit firm had been rotated. He began using American banks and fabricated EUR 4 billion cash that was supposed to be in a Bank of America account in the Cayman Islands.

- **Strategic Guideline: Constructive and Open Minded Team Culture**

To overcome the traditional, mechanistic, confrontational, and secretive board environments, an effective board culture must be created with five factors: an outward, learning orientation; a holistic perspective; a consensus orientation; a constructively open, trusting environment; and a mix of global effectiveness and local adaptability.

- **Buffett:** Concerning this Strategic guideline for an effective board culture, Buffett observed that when the CEO cares deeply and the directors don't, a necessary and powerful countervailing force in corporate governance is missing. He said: "Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners—big owners. Twenty, or even fewer, of the largest institutional investors, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior."

7. Insider Stock Sales

Senior managers, especially the CEO and the CFO and even board members, are selling their own company's common stock at current prices, rather than holding these shares for the long term. At the same time, they are publicly saying that their company's stock is undervalued and has a great future.

- **Corporate Examples:** Significant insider trading occurred at **Enron** in the last half of 2000 and the first half of 2001 before its stock crashed in the last half of 2001. The former CEO, Ken Lay, and the CEO during that time period, Jeffrey Skilling, as well as the general council, the CFO, and other chief executives all sold large blocks of stock. In 2000, Lay made $66.3 million and Skilling made $60.7 million from exercising stock options and selling the shares, roughly double the amounts of the year before. A shareholder lawsuit alleged that 29 Enron executives made $1.1 billion in profits on insider sales. Since the selling at Enron was prolific and it persisted even as the stock price fell throughout 2001, one financial analyst at Thomson Financial, Paul Elliot, called such insider sales a "screaming red flag," and questioned: "If Lay and Skilling believed that the stock was undervalued and headed for $120, as they repeatedly told investors, then why were they cashing in so heavily?" Lay and Skilling were convicted by the United States Department of Justice for numerous counts of conspiracy and securities fraud. **Tyco's** CEO, Dennis Kozlowski, and the CFO secretly sold over $400 million of shares without announcing it just before Tyco blew up. Similar insider trading occurred at **Qwest** where eight Qwest senior executives made $2.2 billion in profits while still "touting" the stock price prospects at Qwest. Qwest's CEO has also been convicted on nineteen counts of securities fraud. Similarly, both **WorldCom's** CEO and CFO have been convicted of securities fraud for insider trading. All these individuals, except the deceased Key Lay, are now serving, or have served, long jail sentences. **Global Crossing's** CEO returned over $50 million of insider stock sales to his shareholders.

- **Integrated Guideline: Targeted Remuneration**

An effective company performance system includes four dimensions: 1) customer, 2) shareholder, 3) people, and 4) public company image. Then targeted remuneration can proceed on the three dimensions previously discussed: 1) long-term financial performance, 2) comparative value indices, and 3) functional performance assessments, not just granting huge stock options to senior executives.

- **Balanced Scorecard & NYSE:** Concerning this integrated guideline for effective performance systems, researchers similar to Hilb (2008) have advocated that the balanced scorecard approach be used to evaluate both the company and the board's performance since boards are rarely evaluated. One of the four strategic perspectives of the balanced scorecard would be slightly modified. The customer perspective for the company would be expanded to a stakeholder perspective for the board. The other three balanced scorecard categories would remain the same: financial, internal processes, and learning/growth. The NYSE requires annual performance evaluations of the board and its committees.

8. Senior Management Turnover

The CEO, senior managers, especially the CFO, and even outside Board members quit their "dream jobs" to "spend more time with their families."

- **Corporate Examples: Enron's** CEO, Jeffrey Skilling, resigned only six months after being promoted to his "dream job", and called it a "purely personal" decision, elaborating that he wanted to devote more time to his family. One investment-fund manager, John Hammerschmidt, said: "That was the worst excuse I've ever heard. As soon as I heard that, I dumped my shares." Others, including Sherron Watkins, the Enron whistleblower, have speculated that Skilling knew that Enron's falling stock price would cause Enron's loan guarantees of its SPE partnerships to be exposed and then lead to Enron's bankruptcy. Similarly, **Qwest's** CFO resigned over one year in advance of its accounting problems surfacing and **Parmalat's** CFO quit nine months before it went into bankruptcy after a bond issue was surprisingly pulled out. **Satyam's** CEO abruptly resigned after admitting fraudulent financial statements, saying "It was like riding a tiger, not knowing how to get off without being eaten." Two months after **Tyco** restated its earnings from $2.20 to a loss of $0.96, due to unusual costs, the CEO resigned for "personal reasons" which turned out to be a tax evasion indictment. Four months later, both the CFO and the general counsel left as Tyco's false financial reporting was being uncovered.

- **Integrated Guideline: Targeted Executive Selection**

Potential senior managers and board members need to have the following four competences: 1) personality (integrity, independence and breadth of perspective), 2) professional (risk management experience, management and/or board track record, and international experience if necessary), 3) leadership (strategic thinking, planning skills, and controlling skills), and 4) social (constructive openness, listening skills, and team role of coach).

- **NYSE:** The NYSE requires that each listed company have a nominating/corporate governance committee comprised solely of independent directors. This committee must have a written charter which includes the criteria and responsibilities to identify individuals qualified to become board members.

9. Independence Problems with the Company's External Auditors

The company may pay the audit firm additional consulting or other types of fees that may be significant in relation to the audit fees. Using the same audit partner as the lead or engagement partner is often a condition for retaining the audit firm.

- **Corporate Examples:** Italian securities laws require that a company change its external auditors every five years. However, **Parmalat** defeated that requirement in two ways: (1) it initially had its lead audit partner change auditing firms, and (2) it subsequently switched 51% of its business to the Cayman Islands where the former lead audit firm had been rotated. Thus, the same audit partner had signed various parts of Parmalat's audits for twenty years. There were also independence problems with **Enron's** auditor, Arthur Andersen (AA) which led to AA's demise. Its consulting fees with Enron were $27 million, larger than its audit fees of $25 million for total fees of $52 million or $1 million per week! Many former AA auditors worked for Enron and Enron outsourced its entire internal auditing work to AA. AA was also the auditor of **Qwest, Global Crossing** and **WorldCom** and earned large consulting fees from those firms as well. Also, PriceWaterhouseCoopers had been the auditor of both **Tyco** and **Satyam** for many years as these companies had not rotated external auditors. Three U.S. companies have had the same auditors for over 100 years!

- **Keep It Controlled Guideline: Board's Auditing Function**

The external auditor is the only external institution that can give an objective view of the financial condition of a company and effective cooperation is needed with the board and its audit committee. In order to ensure the independence of the external auditors, both the auditors and the auditing firm should be changed periodically.

- **Sarbanes Oxley Act**: This U.S. Act was passed in 2002 after large U.S. financial statement frauds, such as Enron and WorldCom, were not detected by external auditors who are now prohibited from doing consulting work with an audit client.

10. Independence Problems with the Company's Investment Bankers

Favorable "buy" recommendations from an investment banker's financial analysts may be a requirement for a company to do any new business with an investment banking firm. Investment bankers' research, which is provided free, may not represent an independent analysis of the company's investment potential.

- **Corporate Examples:** The sell-side financial analysts, who worked for the investment bank firms that earned significant fees from **Enron, Parmalat, Global Crossing, Tyco, Qwest, and WorldCom,** had the same independence problems as the external auditors. Typically, investment banking fees are much higher that equity research fees. For example, 17 of the 18 sell-side analysts following Enron still had buy recommendations the day after the CEO Jeff Skilling resigned, ignoring that red flag. One investment banking firm fired a financial analyst for changing his investment rating to a "sell" recommendation on Enron and was rewarded with $50 million of new investment banking fees by Enron. Another big firm told its financial analysts to maintain a "buy" recommendation for Enron no matter what. One of Parmalat's investment bankers upgraded its investment recommendation from hold to buy, saying the current price was a bargain since Parmalat's restructuring was attractive at that price. That bank was subsequently sued by investors.
- **Situational Guideline: Internal Business Context**

The majority of board members should be totally independent directors who have no vested interests. The board should not comprise 1) more than two members of senior management (ideally only the CEO should represent management and should have none of the following vested interests), 2) persons who have an active business relationship with the firm (such as suppliers, customers, vendors, consultants and auditors), and 3) representatives of the main source of debt and/or equity financing.

New York Attorney General Lawsuit: In December 2002, the twelve largest U.S. investment banking firms agreed to pay $1 billion in fines to end SEC and other investigations into whether they issued misleading stock recommendations and handed out hot new shares to obtain favor with corporate clients. These firms also agreed to pay an additional $500 million over five years to buy stock research from independent analysts and distribute it to investors to help restore integrity and confidence to the marketplace.

FOREIGN DIRECT INVESTMENT FLOWS AND THE GLOBAL ECONOMIC CRISIS

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Abstract

In recent years, Foreign Direct Investment has become an increasingly important feature of the globalized economy. The importance of FDI flows raises several of important questions. First of all is the question of the impact of FDI on host and home countries. Second crucial question is about FDI flows during the recent financial crisis and the role of FDI flows in promoting growth in less developed countries. Then,what can host countries do to become more attractive to foreign investors, and benefit from their activities?

Keywords: Foreign Direct Investment, Global Economic Crisis, Foreign Investors

1. INTRODUCTION

In recent years, Foreign Direct Investment (FDI) has become an increasingly important feature of the globalized economy. The rapid growth of global FDI reflects major underlying policy changes toward FDI in host and home countries. Additionally, as a consequence of a widespread liberalization of national investment policies, especially in developing countries and former centrally planned economies, many countries have now also adopted active FDI attraction strategies and policies. The importance of FDI flows raises several of important questions. First of all is the question of the impact of FDI on host and home countries. Second crucial question is about FDI flows during the recent financial crisis: in late 2007, at the beginning of the financial markets crisis, also FDI flows have been affected by the global recession. Some authors (Krugman and Obstefeld, 1999) considers FDI inflow to a country as a positive sign, suggesting that this is a result of a correction of a domestic distortion (crony capitalism). In contrast, other authors (Hausman and Fernandez-Arias, 2000) consider high level of FDI inflow as a sign of a weakness of the host country (poor property rights, inefficient markets and weak legal and financial institutions), rather than its strength. Then, the share of FDI inflows in total capital flows is larger when the legal and economic risks of doing business in a particular country are higher.

Recent attitudes toward FDI have changed considerably, as most countries have liberalised their policies to attract investment from multinational enterprises. In particular, structural adjustment programmes such as privatisation, trade liberalisation, reduction in state ownership, more and better transparency in economic systems, internationalisation of capital markets and macroeconomic stabilisation policies have led to increasing market integration at a global level , making FDI more interesting for both advanced and less advanced industrial countries. In this context, the key issues for both less developed countries and emerging economies is how to attract and retain foreign investments, how to maximise the benefits of the foreign presence within the domestic economy, and choosing which policy to pursue? There is a still open debate over the appropriate policies and the macroeconomic response to the above-mentioned questions. Consequently, the role and effect of multinational enterprises debated within international economics and multinational enterprises are characterised by the fact that their international operations can have significant effects on both source and host countries. The purpose of this research is to analyze some of the important issues and trends in the contemporary debate on FDI, and to promote a wide-ranging discussion about the policy implications of these trends and events. The description of this research is divided as follows: Section.1: definition of direct investment; Section 2: review of the main literature; Section 3: comparative analysis and presentation of some data; Section 4: some critical considerations of two alternative approaches: climb to the top and race to the bottom theories and major problems and hypotheses addressed in this research. Section 5, concludes.

2. DEFINITION OF FDIs

Foreign Direct Investment (FDI) is an international direct investment characterised by a long-term relationship and a significant degree of influence on the management of the enterprise in the host country. At the heart of the definition of FDI is the concept of control and ownership of another firm. According to the fifth edition of the IMF Balance of Payments Manual (BPM5) and the OECD Benchmark Definition of Foreign Direct Investment (Benchmark):

"Foreign Direct Investment is an international investment which is made with the objective of obtaining a last interest, by a resident entity in one economy in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise. Direct investment involves both the initial transaction that establishes the relationship between the two entities, and all subsequent transactions between them and among affiliated enterprises, both incorporated and unincorporated. A direct investment enterprise is an incorporated or unincorporated enterprise in which a direct investor that is a resident of another economy has 10 percent or more of the ordinary shares or voting power (for an incorporated enterprise) or the equivalent (for an unincorporated enterprise). The direct investor may be an individual, an incorporated or unincorporated private or public enterprise, a government, or associated groups of individuals or enterprises that have direct investment enterprises in economies other than those in which the direct investors reside".

Then, "….Foreign Direct Investment (direct investment) takes place when an investor (direct investor) based in one country (the home, source or parent country) acquires an asset in another country (the host country) with the intent to manage that asset (direct or indirect ownership)". Thus, it is an investment made by firms or individual entrepreneurs that own and control assets in another country. The definition of direct investment enterprise extends to the branches and subsidiaries of the direct investor which can be directly or indirectly owned . BMP5 and the OECD Benchmark consider that direct investment statistics should cover all directly and indirectly owned subsidiaries, branches and associates.

Usually the terms "foreign direct investment" and "multinational enterprises" are used interchangeably. In reality these are characterised by some differences. International economic literature claims that a firm becomes multinational when it engages in foreign direct investment acquiring a substantial controlling interest (ownership, control) of a foreign firm in two or more countries. For example, a multinational enterprises works in a oligopolistic market and, through horizontal and vertical investment diversifies or fragment the foreign production of goods and services. Additionally, multinational enterprises can undertake economic activities independently of foreign direct investment, including licensing activities. Then, in this research the terms "multinational enterprises" and "foreign direct investment" will be not use interchangeably. In the next paragraph, we will identify the major themes and models of the literature on FDI and multinational activities.

Statistics on foreign direct investment are considered an important means in analysing the phenomenon of economic globalisation activities. In fact, at the national and international levels, policy recommendations are established in order to assist both source and host countries in maximizing the potential benefits and minimizing the adverse impact of FDI for the domestic economy. Data on FDI are generally compiled by national authorities, such as national central banks, national statistical institutes or investment promotion authorities and are collected and disseminated by regional-international organizations, such as UNCTAD, OECD, IMF and some statistical agencies (i.e. Eurostat).

International institution have also elaborate some index as the new FDI Contribution Index. This index shows relatively higher contributions by foreign affiliates to host economies in developing countries, especially Africa, in terms of value added, employment and wage generation, tax revenues, export generation and capital formation. The rankings also show countries with less than expected FDI contributions, confirming that policy matters for maximizing positive and minimizing negative effects of FDI.

3. REVIEW OF THE MAIN LITERATURE

In general, in deciding whether to invest abroad, a multinational must develop a competitive advantage (i.e. economies of scale and scope, superior technology, managerial expertise etc.) powerful enough to compensate the firm for the potential disadvantages of operating abroad (higher agency costs, political risks, cultural and linguistic differences, unknown market, foreign exchange risks, etc.). In addition, in order to successfully compete abroad, a multinational musts possess also some ownership-location (O,L) and internalisation (I) advantages, and it must combine these advantages in ways that maximise its market shares and growth. Much of the New Classical and New Trade Theory (NTT) have expended efforts on providing support for the increased importance of trade between industrialised countries and the prevalence of intra-industry specialization (horizontal and vertical patterns) between them, rather than the growing importance of multinationals relative to trade (Markusen and Venables, 1998). The theoretical challenge in terms of the pattern of multinationals' activities, however, lies in attempting to explain the existence of MNEs within the general equilibrium theory of trade. This means that one needs models to explain why some firms choose to invest abroad rather than exporting. To achieve this, trade economists have mainly relied on Dunning's OLI paradigm (1998) as a starting point. In it, MNEs are seen as firms which internalise a specific ownership advantage that provides them with some market power. Firms are willing to exploit this through FDI instead of exports in order to benefit from some location advantage and to avoid the possible asset dissipation that may occur, for example, with licensing. In the pioneering analyses of Markusen (1984) and Helpman (1985), firms are seen as being willing to engage in direct investment instead of alternatives such as exporting or licensing, if firm-level economies of scale are important relative to plant level economies. This may be the case if, for example, R&D activity is important for the firm, as R&D has some of the characteristics of a public good. In particular, the output of R&D can be transferred between different plants within the firm at low or zero costs (Markusen, 1995). This conclusion may be linked to an alternative explanation for the reason of direct investment flow across countries, which considers FDI as the flow of technology, knowledge and ideas abroad to be controlled by multinationals, which in turn contribute to a country's growth prospects. Additionally, it is important to note that the distinguishing features of direct investment are both control and transfer of knowledge. Producing abroad can be accomplished through subsidiary production or licensing, franchising, or other mode of entry such as joint venture, greenfield, merger and acquisition. Each different mode of entry in a foreign market may be more appropriate than the others under different circumstances and each is an important factor in the project's success. Considering FDI as a transfer of technology, knowledge and ideas, the theory argues that a firm in order to overcome the disadvantages of investing in foreign markets, must possess firm specific advantage over local firms. Typical example of firm specific advantage is superior technology. The reason why multinational enterprises might want to relocate production abroad rather than sell its technology to a local firm is that in the latter case it loses control over its knowledge of technology. In other words, multinational enterprises want to enter the country in order to secure for themselves the economic benefit of the knowledge they created. On the other hand, host countries have interests in receiving knowledge spillovers from multinationals, because the multinational which owns the assets in the host country has been given the incentives to take its knowledge to the country. Strictly related to transfer of knowledge is the concept of spillovers. Many authors include spillovers (the external effect of FDI) among the consequences of direct investment, concluding that a firm must possess some specific assets (management skills, technology) to be able to compete in foreign markets and to capture the positive effects of direct investment.

In recent years the view of FDI has been influenced by the effects of financial crises. Some authors (Krugman and Obstefeld, 1999) considers FDI inflow to a country as a positive sign, suggesting that this is a result of a correction of a domestic distortion (crony capitalism). In contrast, other authors (Hausman and Fernandez-Arias, 2000) consider high level of FDI inflow as a sign of a weakness of the host country (poor property rights, inefficient markets and weak legal and financial institutions), rather than its strength. Then, the share of FDI inflows in total capital flows is larger when the legal and economic risks of doing business in a particular country are higher.

Even though there is currently no exhaustive general theory explaining FDI flows, new researchers (Shatz, 2000; Talamo, 2008; Fazio, Talamo, 2008, Talamo 2013) have recognised the importance of country-specific differences in political and institutional factors as determinants of direct investment. As a consequence, empirical studies claim that cross-country differences in growth and productivity may be related to differences in institutions, political stability, level of education and legal environment. Most of these studies conclude that the firm must design a strategy that will attract international investors. This requires improving the quality and level of firm's transparency: disclosure, i.e. , making its accounting and reporting standards more transparent to foreign potential investors.

Consequently, recent attitudes toward FDI have changed considerably, as most countries have liberalised their policies to attract investment from multinational enterprises. Indeed, FDI has actively been promoted by the Washington consensus as a panacea for economic development. In particular, structural adjustment programmes such as privatisation, trade liberalisation, reduction in state ownership, more and better transparency in economic systems, internationalisation of capital markets and macroeconomic stabilisation policies have led to increasing market integration at a global level, making FDI more interesting for both advanced and less advanced industrial countries.

In this context, the key issues for both less developed countries and emerging economies is how to attract and retain foreign investments, how to maximise the benefits of the foreign presence within the domestic economy, and choosing which policy to pursue?

These questions assume a special importance in an era of increasing global economic liberalization in which it has been recognised that, in order to realize FDI's full benefits and to increase FDI inflow, it is necessary to pursue policies that allow host countries to open up the local market to foreign investors. As a result, an increasing number of host governments have provided different forms of measures and incentives to encourage foreign firms to invest in their countries: fiscal incentives, financial incentives, infrastructures and monopoly rights.

4. A COMPARATIVE ANALYSIS

Recently, empirical works have found that the composition of FDI activities across countries varies significantly when considering host countries' policies and characteristics. Econometric analysis reveals that firm characteristics are only one part of the explanation behind investing abroad. Among traditional factors, multinational enterprises are influenced also by host country size in terms of GDP (the size of the market accessible to foreign investor), per capita income and distance from major investors. Empirical analysis (Shatz 2000, 2001), for example, using data of US multinational affiliates, reveals that the GDP accounts for about two-thirds of the variation in the worldwide distribution of production by multinational. Considering distance, for example, studies conclude that it can encourage or discourage investment. If a firm wishes to sell in a distant market and exporting is expensive due to transportation costs, one solution could be the creation of a subsidiary in that market. Thus, distance is strongly linked to transportation and coordination costs and, at the same time, it serves only as a proxy, having little effect on its own. Recent literature has also demonstrated that the quality of the investment climate may play an important role in the multinational enterprise's decisions. There has been an increasing acceptance that administrative procedure, corruption, bribery, legal rules, enforcement system, investment openness and transparency can significantly influence the location of multinational firms and their productivity. There are also a number of other general determinants concerning, for example, the level of education (i.e. secondary and higher education), the hosts country's infrastructure, national policies, investment openness, etc. All of these determinants contribute to higher levels of multinational enterprises activities. Thus, many authors and, in particular, international organisations believe that all these factors influence direct investment and multinational enterprise activities and consequently influences the opportunities for future investments. Empirical studies analysing the relationship between

FDI flows and indicators of economic development (i.e. GDP, GDP per capita, Population) found that FDI flows have been positively and significantly related to investment growth. There are several mechanisms through which FDI could generate positive spillovers for the receiving countries. First, part of the theory support the view that the beneficial effects of FDI flows are more likely to be detected when the receiving country has a certain amount of absorptive capacity in term of human capital, quality of governance and macroeconomic policies. For example, Borensztein et al (1998), find that FDI has a positive effect on growth when the level of human capital in the host country is sufficiently high (threshold effects). Thus, in order to benefit from the advanced technology introduced by foreign firms, the host country need to build up a certain amount of absorptive capacity in orders to take advantage of financial globalization. However, FDI may also lead to negative spillovers, as domestic firms may be displaced by the foreign firms, or find that the cost of factors of production increases as a result of the foreign direct investment. Second, authors (Cheng, 1999; Stiglitz 1999) support the view that benefits of FDI for the host countries may depend on the manner in which FDIs are attracted to a country. For example, in a context in which countries compete aggressively by offering subsidies to potential investors, it is possible that any potential net benefits generated by FDIs will be competed away, and will accrue to the foreign investors. As alternative way to attract FDI, authors have considered other forms of competition. For example, countries could compete by improving their governance, the quality of their labour forces or the quality of their infrastructures. For example, efficient legal systems, low levels of corruption, high degree of transparency and good corporate governance may have a quantitatively important impact on a country's ability to attract foreign direct investment. Countries with high level of human capital and good governance attract more FDI flows. In addition, lack of transparency and corruption have a strongly negative effect on FDI inflows. In particular, high degree of corruption may affect the composition of a country's capital inflows in a manner that market is more vulnerable to the risks of speculative attacks and contagion effects. Wheeler and Mody (1992) have tried to determine the relative importance of market size (measured by the population size) and the development level (per capita GDP) of the host country to account for FDI flows. They found that market size is more important for developed countries, while per capita GDP for developing countries. Wei (1997, 2000) find that corruption, as well as uncertainty regarding corruption, has significant and negative effects on FDI location. Hausmann et al. (2000), study the effects of institutional variables compiled by Kaufmann et al. (1999), as well as indices of creditor and shareholder rights from La Porta et al. (1998). They find that better institutions lead to a reduction of share of FDI inflows. They conclude that, in comparison to FDI, other forms of capital flows are more sensitive to the quality of institutions. Alesina and Dollar (2000) consider the traditional explanatory variables (market size: GDP, Population) and in addition they test for the impact on FDI of trade openness, the level of democracy and a set of dummy variables including common religion and political alliances with the source country, the rule of law and the number of years as a colony of the host country). They use a panel of countries (1970-1994) and found that FDI responds to economic incentives, such as the trade regime and the system of property rights in the host country, more than to political incentives (e.g. colonial past and political links).

Several empirical contributions in the literature have recently used gravity models to explain FDI flows. Such models incorporate both macroeconomic and geographical factors as explanatory variables in the econometric model. In particular, beyond the market size, the development level of the host country and other institutional variables, FDI flows are assumed to depend upon the geographical distance between the home and the host country.

Recent data show that in 2011 the increasing flow of direct investment has been concentrated almost entirely in developed countries. Flows to developed countries increased by 21 per cent, to $748 billion. In developing countries FDI increased by 11 per cent, reaching a record $684 billion. FDI in the transition economies increased by 25 per cent to $92 billion. Developing and transition economies respectively accounted for 45 per cent and 6 per cent of global FDI. UNCTAD's projections show these countries maintaining their high levels of investment over the next three years (UNCTAD, 2011).

5. FDI: A "CLIMB TO THE TOP" OR A "RACE TO THE BOTTOM"? SOME EXAMPLES AND POLICY CONSIDERATIONS

Recent attitudes toward FDI have changed considerably, as most countries have liberalised their policies to attract investment from multinational enterprises. Indeed, FDI has actively been promoted by the Washington consensus as a panacea for economic development. In particular, structural adjustment programmes such as privatisation, trade liberalisation, reduction in state ownership, more and better transparency in economic systems, internationalisation of capital markets and macroeconomic stabilisation policies have led to increasing market integration at a global level[15], making FDI more interesting for both advanced and less advanced industrial countries.

In this context, the key issues for both less developed countries and emerging economies is how to attract and retain foreign investments, how to maximise the benefits of the foreign presence within the domestic economy, and choosing which policy to pursue?

These questions assume a special importance in an era of increasing global economic liberalization in which it has been recognised that, in order to realize FDI's full benefits and to increase FDI inflow, it is necessary to pursue policies that allow host countries to open up the local market to foreign investors. As a result, an increasing number of host governments have provided different forms of measures and incentives to encourage foreign firms to invest in their countries: fiscal incentives,

15 These policies are associated with the so-called New Economic Model (NEM).

financial incentives, infrastructures and monopoly rights.

There is a still open debate over the appropriate policies and the macroeconomic response to the above-mentioned questions. Consequently, the role and effect of multinational enterprises debated within international economics and multinational enterprises are characterised by the fact that their international operations can have significant effects on both source and host countries. Advocates of the "climb to the top" approach consider that MNEs provide the best option for achieving efficient international financial markets and allocation of international capital flows. The theory suggests that MNEs tend to invest in countries with a high absorption capacity, good infrastructure and an educated work force. On the other hand, the school of the "race to the bottom" theory asserts that MNEs induce countries to compete against each other (countries offer subsidies, tax reductions and remove restrictions on the activities of MNEs) to attract FDI, thereby worsening their living standards. Furthermore, the benefits of MNE activities in less developed and emerging economies are not always reflected in domestic firms' value added growth. When domestic firms lack the capacity to absorb and internalise spillovers, FDI is not the most effective tool to promote technological and industrial development. In such cases the advantages of FDI go solely to the multinationals who can pursue their interests: profit's maximization, protection of its patents, blueprints and technology. In other words, there is the possibility that the liberalisation of restrictions on FDI only results in "a race to the bottom". In particular, we should be concerned whether the basic philosophy of neo-liberal policies, i.e. the neo-classical school of economics, offers an appropriate analytical framework. This problem with the race to the bottom can be examined in three aspects. Firstly, FDI does not necessarily go to the countries that have implemented deregulation or have offered some schemes to attract them. Secondly, it has not been proved theoretically whether the liberalised regime for FDI contributes to economic growth. Thirdly, there are several countries which have successfully achieved better economic performance by adopting strategic approaches to FDI (i.e. China). The race to the bottom approach holds that potential host countries compete with each other to attract FDI by removing restrictions on the activities of multinational firms and offering benefits them. As previously mentioned, determinants of FDI are associated with characteristics of potential host countries, such as institutional features, market size, and growth prospects linked with firm-specific assets, factor endowment and factor intensity. A race to the bottom approach relates especially to the institutional aspects of potential host countries whose governments can be changed by their policies. Examples are fiscal incentives, such as exemptions, financial incentives like subsided loans and grants and non-financial incentives, such as basic infrastructure provision. On a more general level, measures can be the removal of the upper limit of shares multinational firms can acquire or the removal of the rule prohibiting entry of foreign companies, simplifications of procedures to admit their entries and lower standards of environment or labour to enable them to cut production costs. These policies themselves are not inherently a race to the bottom. However, the problem is that, in the current global economic environment, this competition may result in incentive inflation, which would damage economies of the host countries. As a result, this may culminate in a race to the bottom.[16] This competition has been taking place based on certain pictures drawn by neo-liberal economists. As Chang (1999) points out, there are three points in their arguments. Firstly, FDI is the main engine for globalisation and economic growth. Secondly, multinational firms have come to the stage in which they move their core activities outside their home countries. Thirdly, the hypothesis that liberal policies toward FDI benefit host countries has been proved by the experience of developing countries such as East and Southeast Asian countries. These arguments have various problems. Firstly, it is quite doubtful whether each point is accurate. Secondly, it seems that these neo-liberal views tend to ignore specific features of each FDI and each developing country. FDI has been flowing mostly among developed countries and the flows to developing countries have been concentrated into a few countries, generally in Southeast Asia and Latin America.[17] It is obvious that FDI is unevenly dispersed throughout the world. Secondly, the insisted causality that FDI has pushed economic growth is only an assumption. In reality, multinational firms are likely to invest in the developing countries that grow rapidly or have potential to grow fast[18] ,meaning that causation runs from growth prospects to FDI, not vice versa. Multinational firms may even be happy with strict restrictions as long as they are stable and predictable (Chang 1999). It seems that this is especially the case for the local market-oriented FDI because what matters is the market size and potential demand rather than the incentives offered by host countries. Thirdly, it is misleading to state that multinational firms are increasingly becoming transnational and even shifting their core activities such as R&D outside their home countries. As Chang (1999) argues, most multinational firms remain strongly rooted in their home countries and when they shift their core activities, the destination is mainly other developed countries. In addition, as discussed in the first part of this study, there are various types of FDI, which significantly differ in character. Thus, it is too general to evaluate them without distinguishing certain categories. In conclusion, liberal policies toward FDI do not necessarily attract multinational firms. It now seems clear that the neo-liberal implications that FDI brings benefits to host countries have been based on the misunderstanding, or at least too simplistic comprehension, of basic phenomena.

In general, FDI itself is neither good nor bad, meaning it can bring both positive and/or negative spillovers. The effects depend on the conditions and context in which certain FDI takes place. Thus, it is important to analyse the current international environment for FDI as well as the features and conditions of host countries and FDI. Firstly, features of specific FDI should be taken into

16Kozul-Wright & Rowthorn, 1998.
17 Kozul-Wright & Rowthorn 1998, De Mello 1997.
18 Chang 1999, Kozul-Wright, 1998.

consideration. In the case of so-called footloose investments, for example garment and toys industries, there is a high danger that multinational firms withdraw from the country as soon as they exploit or take advantage of incentives offered by host countries without transferring any technologies. However, the other FDI such as chemicals, electronics and automobiles that involves higher sunk costs in establishing subsidiaries and/or that necessarily creates networks with continuous efforts, is not easily withdrawn once subsidiaries are established (Chang 1999). Secondly, differences in the characteristics of countries is important. There are some cases that host countries gain relatively strong bargaining power over multinational corporations (Chang 1999). For example, in the case of countries like China and India, which have large potential domestic markets, local-market oriented FDIs compete with each other for entry, putting the potential host country in a superior position over multinational corporations. In the case of resource-oriented FDI, there may be some cases that host countries, which are endowed with specific natural resources such as mining or with particular types of skilled labour, eventually gain bargaining strength over multinational firms. However, if countries have no such advantages, the bargaining power of national firms dominates. Thirdly, the current world environment for FDI should not be overlooked. Crotty, Epstein & Kelly (1998) point out that, in the current regime, the race to the bottom outcome is most likely. They argue that the threat of moving by multinational corporations has negative effects on wages, working conditions and tax rates by lowering bargaining power of host or potential host countries. This view seems persuasive, firstly because mainstream optimistic views are based on the insufficient understanding of the underlying situation as discussed above. Secondly, as Crotty, Epstein & Kelly (1998) stress, in the current neo-liberal regime, aggregate demand is insufficient to achieve full employment and effective rules controlling the activities of multinational firms are absent, and thus competition between countries to invite them is destructive. This is because the neo-classical school of economics, in the belief that the market is almighty, discourages state intervention for markets and recommends the removal of restrictions on FDI. The international institutions dominated by the neo-classical school of economists tend to advise that there is no alternative for developing countries to grow faster but to compete in the invitation of multinational firms.

It is clear from the above discussions that the implications of neo-liberal economists that multinational firms bring benefits to host countries have not been proved theoretically. Rather, the outcomes of FDI on host countries depend upon contexts and circumstances. Furthermore, under the current neo-liberal regime, there are high risks for the developing countries to engage in the race to the bottom, as they are losing their potential control even over the footloose or speculative activities of multinational corporations. As Kozul-Wright (1995) rightly points out, "measures to attract FDI will be of limited success unless selective-supply-side measure can be used to ensure that stronger links with international production are consistent with the continuous upgrading of domestic economic activity"(p.167).

The other assertion of neo-liberal economists that some developing countries have achieved better economic performance through a liberal approach toward FDI is inaccurate, as well. The policies of developing countries toward FDI, which achieved rapid economic growth, were not always to liberalise the restrictions imposed on the activities of multinational corporations. Countries like Korea and Taiwan, for example, took a strategic approach to FDI. Although they were not hostile to multinational firms, they had kept strict regulations in regard to entry of and ownership by foreign firms during their heyday of economic development (Chang 1999). While domestic market oriented industries, such as durable consumer goods, were reserved for domestic companies, multinational firms were welcomed in industries involving high technology, such as petroleum refining, or labour intensive export industries, such as electronics assembly. Furthermore, the governments of those countries preferred and promoted the invitation of FDI in the form of joint ventures so that technologies and management skills were likely to be transferred. These experiences of Korea and Taiwan show that it was their strategic approach towards FDI that brought them fruitful results. As Chang (1999) stresses, the role of multinational firms "needs to be clearly defined in relation to the overall industrialization strategy and with reference to the specific needs of the particular industries concerned"(p.107). In that sense, the nation-states shall take strategic and selective approach to FDI to assure knowledge and technology transfers by inviting multinational firms, rather than engaging in the race to the bottom approach.[19]

The other cause of the race to the bottom is the absence of international institutions and international rules dealing with multinational firms and FDI. Tolentino (1999) argues the possibility of building international rules through WTO for the activities of multinational firms as well as for the activities of potential host countries to invite them. If these rules enable and promote potential host countries to take strategic approach toward FDI, it seems that realisation of such rules is important for developing countries. This is because, in the current neo-liberal regime, countries without any relative bargaining strength over multinational firms cannot but compete to the bottom to invite them at the cost of workers and communities of the country. In the light of this debate, several studies investigates whether multinationals can improve the growth prospects of countries by improving the quality of institutions. Economists and international organisations tend to view good governance (UNCTAD, Kaufmann) as one possible conduit for first attracting and then retaining FDI and therefore affecting countries' economic performance.

A particular case is China that have experienced the success of multinational investments in expanding exports and gaining new technologies. Chinese FDI flows are more focused on developing countries and, in particular, ASEAN countries and Africa have become the main goals of Chinese investments (UNCTAD, IMF). In particular,

19 Kozul-Wright 1995.

for several years, China has shifted its foreign investment on African continent, investing billions of dollars to ensure all natural resources essential to its economy and to affirm the political influence of Beijing on developing countries. Chinese FDIs are diversified in 48 countries of the African continent. Most of these (54.6% of the total) reaches States that are rich in natural resources. All relations between China and the Ssub- Saharan African countries have experienced a boom between 2000 and 2008 (the year in which they exceeded 100 billion U.S. dollars). This increase of FDI flows in Africa is a general result of a growing social cooperation, economic and political relations. Despite the global economic crisis, the value of Chinese investments it is always more stable compared to Western countries, who instead tend to fluctuate significantly. The greater stability of Chinese FDI may depend on the fact that the majority of firms investing in the Asian country is state-owned. The majority of Chinese FDI has been made in the natural resources sector , which absorbed about 75% of FDI . More than half of the investments in mergers & acquisitions are made for 90% of Chinese public companies and involved commodities sector. Chinese investment in Africa focus more on manufacturing, extraction of natural resources, in the construction of infrastructure, and to a lesser extent in agriculture, tourism and goods. Investment in textile and manufacturing are performed as China has a relatively advanced technology in the production of textiles and clothing. The extraction of natural resources is a very important sector as China, despite having a vast territory, has few natural resources . Natural resources are fundamental to the domestic industry in expansion and economic growth of the country. Investing abroad in these areas China meets its domestic needs. The Chinese government has also identified a number of areas and types of projects in Africa that encourages its businesses to invest. Chinese FDI flows to African countries have focused mainly in sub -Saharan Africa , as this is one of the world's richest areas of natural resources. However, Sub -Saharan Africa countries attract foreign investments for its natural resources , the low cost of labor and as consequences , the pattern of growth that occurs has different origins than those that have characterize the Chinese economic boom. Several are the motivations that drive Chinese enterprises to invest in African countries: · direct access to the market; increased market penetration; re-use of materials; to establish import quotas imposed on Chinese products important for the textile industry and for industrial products. Chinese FDI are diversified in 48 countries of the African continent, but most of these FDIs (54.6% of the total) reaches State that are rich in natural resources (Angola , Nigeria, South Africa, Congo, Gabon, Sudan and Zambia). For example, Nigerian oil sector represents the largest recipient of FDI flows, and also other countries such as Ghana and Liberia have had a growing number of investments in some crucial sector. For some African countries, FDI Chinese flows have become the only investor and the Chinese capital is considered as essential in promoting growth and investments. In the last years, and during the economic crisis, the number of Chinese FDI projects in Africa has grown and has attracted 82 billion FDI flows and IMF estimates that it could reach $ 150 billion by 2015. In particular, the number of FDI flows in Sub -Saharan Africa grew by 27% compared to 2010, in particular this growth occurred in metals, telecommunications and in food and tobacco. According to IMF, Sub-Saharan Africa countries is expected to grow by an annual average of 5.5%. Despite these good percentage, it is possible to present some doubts on the economic relations between China and Africa. This is because, for example, the 95% of agreements on investments between China and sub-Saharan countries present some clauses stipulating that, 70% of workers hired for the performance of the works have Chinese nationality and only 30 % of the shares is reserved to the local people. In addition, African workers are usually hired at low wage level and poor working assistance. Finally, it is also possible to see some dumping phenomena that have forced many small- medium African entrepreneurs out of the market, while large Chinese companies get benefits from the central government that allow to import products (oil, minerals) at lower prices than market value. Then the role of Chinese foreign investment in Sub -Saharan Africa countries is still ambiguous.

CONCLUSION

This study[20] aims to investigate the determinants FDI flows across countries before and during the recent financial crisis. In particular, it explores the role played by both institutional, geographic and other variables on FDI location and mode of entry into a foreign market. In this context, the key issues for both less developed countries and emerging economies is how to attract and retain foreign investments, how to maximise the benefits of the foreign presence within the domestic economy, and choosing which policy to pursue? These questions assume a special importance in an era of increasing global economic liberalization in which it has been recognised that, in order to realize FDI's full benefits and to increase FDI inflow, it is necessary to pursue policies that allow host countries to open up the local market to foreign investors. As a result, an increasing number of host governments have provided different forms of measures and incentives to encourage foreign firms to invest in their countries: fiscal incentives, financial incentives, infrastructures and monopoly rights.

There is a still open debate over the appropriate policies and the macroeconomic response to the above-mentioned questions. Consequently, the role and effect of multinational enterprises debated within international economics and multinational enterprises are characterised by the fact that their international operations can have significant effects on both source and host countries. Advocates of the “climb to the top” approach consider that MNEs provide the best option for achieving efficient international financial markets and allocation of international capital flows. The theory suggests that MNEs tend to invest in countries with a high absorption capacity, good infrastructure and an educated work force. On the other hand, the school of the “race to the bottom” theory asserts that MNEs induce countries to

[20] This article is a synthesis of a monograpf “ Foreign Direct Investment and the Global Economic Crisis”, G. Talamo, 2013

compete against each other (countries offer subsidies, tax reductions and remove restrictions on the activities of MNEs) to attract FDI, thereby worsening their living standards. Furthermore, the benefits of MNE activities in less developed and emerging economies are not always reflected in domestic firms' value added growth. When domestic firms lack the capacity to absorb and internalise spillovers, FDI is not the most effective tool to promote technological and industrial development. In such cases the advantages of FDI go solely to the multinationals who can pursue their interests: profit's maximization, protection of its patents, blueprints and technology.

In conclusion, multinational activities have been and still are the focus of hopes and disappointment.

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