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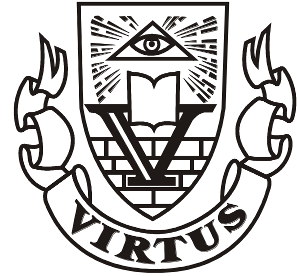

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CORPORATE GOVERNANCE, SUBSTANTIVE THEORY AND SOCIOLOGICAL INSTITUTIONALISM: THE CASE OF THE EGYPTIAN BANKING SECTOR

M. Karim Sorour*, Kerry E. Howell**

Abstract

Banking organizations have peculiar characteristics that make it difficult for them to adopt and apply traditional corporate governance models. However, little attention has been given to understanding and theorizing banking corporate governance. Deploying a grounded theory methodology this paper develops a substantive theory of banking corporate governance within Egypt. Subsequently, through sociological institutionalism the substantive theory is further analyzed and assessed; findings indicate that banking corporate governance is an evolving context or contingency based phenomenon. Corporate governance for banks in Egypt involves an institutionalization process based on regulative and normative pressures that looks to ensure legitimacy from shareholders, regulators and depositors. This said, to maintain legitimacy banks either comply or disguise their non-compliance. Overall, this paper contributes to non-traditional corporate governance theorizing and offers policy-makers a distinct in-depth understanding of the phenomenon.

Keywords: Corporate Governance, Sustainability Theory, Sociological Institutionalism, Egyptian Banking Sector

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1 Introduction

In any contemporary business environment appropriate corporate governance structures and practices are crucial for ensuring effective banking within developing, transitional and developed economies. It has been argued, that weak corporate governance has been a major reason for many banking crises (Barth et al., 2007; Nam and Lum, 2006). Indeed, the global financial crisis of 2007 indicated that appropriate corporate governance measures for financial institutions cannot be compromised (De Larosiére et al., 2009; Kirkpatrick, 2009). Furthermore, because banking has peculiar characteristics that intensify requirements for robust corporate governance (that is, they differ from other organisations) certain commentators consider that the corporate governance of banking has not been given the attention other sectors have experienced (Barth et al., 2007; Caprio and Levine, 2002; De Larosiere et al., 2009; Levine, 2003; Macay and O'hara, 2003; Mullineux, 2006). In short, corporate governance research has paid less attention to banking organizations than it has non-financial institutions (Shleifer and Vishny, 1997; Mulbert, 2010).

The financial crisis emphasized the importance of Bank Corporate Governance (BCG) especially in the context of developing economies given the dominant position of banks in these underdeveloped financial markets (Arun and Turner, 2004; Barth et al., 2007; Capri and Leveine, 2002; Das and Ghosh, 2004; Levine, 2003). Moreover, the recent liberalization of banking sectors in developing countries through privatization and divestment along with the reduction of economic regulation has given bank executives more freedom in determining management practices in setting priorities for interests (Nam, 2007). Fundamentally, analysis of banking collapses in developing economies illustrates close correlation with factors related to weak corporate governance.

The Egyptian Banking Sector (EBS) has specific reasons for necessitating robust corporate governance procedures e.g. the EBS provides over 85% of business financing so of paramount importance to the Egyptian economy (El-said, 2009). Furthermore, banks have been assigned the role of promoting compliance with the Egyptian codes of corporate governance (ECOCG, 2005; 2011) and before requiring full compliance from other organizations

should ensure that they themselves fully adopt corporate governance principles. Overall, weak corporate governance has been seen as a main reason behind Egyptian bank failures during the late 1990s and the associated non-performing loan problem that burdens the EBS today (CBE, 2008). Indeed, in response to corporate governance deficiencies the Egyptian authorities initiated a reform program to address improvements in corporate governance (CBE, 2003; 2009).

This paper queries theoretical perspectives usually used for explaining and analyzing corporate governance and through the development of a substantive theory and Neo-Institutional Sociological Theory (NIST) undertakes a study of Egyptian banking corporate governance. Initially, this paper critiques agency/shareholder and stakeholder theories and considers other frameworks that may provide means of assessing corporate governance procedures in banks. Second, we explain our methodological approach and identify how through data collection and analysis we develop a substantive theory. Third, a substantive theory is developed and through this and NIST issues relating to Egyptian banking corporate governance are further explored and analyzed. Finally, through the development of the substantive theory and analysis through NIST both theoretical and practical conclusions are reached.

2 Banks and traditional corporate governance theorizing

Two principal theories (agency/shareholder and stakeholder) are usually utilized to understand and explain corporate governance (Maher and Andersson, 2000; Chilosi and Damiani, 2007; Carillo, 2007; Freeman and Reed, 1983; Friedman and Miles, 2002; Gamble and Kelly, 2001; Kakabadse and Kakabadse, 2001; Keay, 2010; Letza and Sun, 2002; Letza et al., 2004; Letza et al., 2008; O'Sullivan, 2000; Omran et al., 2002). On one hand, Shareholder theory considers that the purpose of the corporation is to maximize shareholder wealth and identifies the main corporate governance dichotomy as emanating from agency problems which emerge from the separation of ownership and control. Fundamentally, with distinctions between ownership and control comes conflict of interests between the principal (shareholders) and the agent (managers) (Carrillo, 2007; Letza et al., 2004; Letza et al., 2008). On the other hand, the stakeholder perspective argues that the purpose of the corporation is to serve the interests of a number of stakeholders (not shareholders alone) and that corporate governance problems relate to the consideration of non-share owning stakeholder interests and potential conflict of interests between stakeholders per se (Carrillo, 2007; Letza et al., 2004; Letza et al., 2008). As such, the adoption of either perspectives of corporate governance (Shareholder v. Stakeholder) is to a great extent a decision based on particular conceptions of the company, its purposes and its legal and political foundations (Gamble and Kelly, 2001; Howell, 2007a; 2007b).

However, with their special features banks it is easier for insiders (managers and large investors) to 'exploit private benefits of control rather maximizing value for shareholders' (Zingales, 1994: 4 cited in Caprio and Levine, 2002). As such self-interest and associated short-termism and excessive risk taking will result only in more conflict of interests with shareholders, as well as interests of the fixed claimants (depositors) who are risk averse. This led many researchers to claim that managers of banks have a fiduciary duty to both depositors and shareholders (Barth et al., 2007; Macay and O'Hara, 2003; Mullineux, 2007). Accordingly, adopting the Anglo-Saxon shareholding model based on the agency theory and purpose of shareholder wealth maximisation only is deemed inappropriate in the case of banking organizations, because here corporate governance should look beyond those of the shareholders e.g. depositors (Mullineux, 2007). Macay and O'Hara (2003) recommended that banks should adopt a stakeholder model for dealing with corporate governance problems. However, adopting a pure stakeholder model of corporate governance in banking organization would face the difficulty of stakeholder identification (Phillips, 1997; Howell, 2007b). Therefore, the pure stakeholder model is also deemed inappropriate because it does not provide a concrete identification of stakeholders.

In addition, many researchers have argued that different banking organization have many factors that shape corporate governance practices (Lubatkin et al., 2005; Ratnatunga and Ariff, 2005; Rwegasira, 2000). Moreover, the factors shaping corporate governance in individual states do not necessarily have to be similar from one country to another. Consequently, a universal approach is problematic and issues may only be understood through relativist and empirical corporate governance research (Durisin and Puzone, 2009; Lee and Yoo, 2008; Letza et al., 2008; Ratnatunga and Ariff, 2005; Smallman, 2007). Indeed, it must be noted that the global financial crisis has demonstrated that these traditional corporate governance models (shareholding and stakeholding models) are inappropriate and different perspectives required if new avenues of improvement are to be investigated.

Letza et al. (2008: 22) argued that even though shareholder and stakeholder theories have specific worldviews and perspectives both share a 'normative rational model' when assessing corporate governance procedures. The principal-agent (shareholder model of corporate governance) is based on efficiency theory, while elements of the stakeholder model, despite its focus on corporate ethical behaviour and social responsibility, posits that 'ethical business is more rational and more efficient' (Letza et al., 2008: 23-

24). Interestingly, Freeman et al. (2004:366) acknowledged difficulties with single objective theoretical frameworks for explaining social phenomenon when he argued that ‘the world is complex, and managers and directors are bounded rationally (at least we can meet economists on their own assumptions)’. Indeed, it is argued that both shareholder and stakeholder theoretical perspectives share similar economic efficiency driven foundations and that such a normative stance may be criticized because it ignores social processes related to corporate governance that are embedded in particular contextual factors (Aguilera and Jackson, 2003; Ardalan, 2007; Kirkbride et al., 2005; Letza and Sun, 2002; Letza et al., 2004; Mason et al., 2007; Letza et al., 2008). Contextual factors that encompass crucial determinates relating to corporate governance may include many non-economic and efficiency factors such as ‘power, legislation, social relationships and institutional contexts’ (Ardalan, 2007: 511) as well as ‘politics, ideologies, philosophies, legal systems, social conventions, cultures and models of thought’ (Letza et al., 2004: 258). Moreover, traditional corporate governance theories adopt a closed system approach of institutional analysis, especially the shareholder perspective (Aguilera et al. 2008) which isolates corporate governance perspectives ‘from social and other non-economic conditions’ (Letza et al., 2008:256). Finally, the economic/efficiency perspective looks at corporate governance as a static object which is not ‘compatible with the fluidity and diversity of practical reality’ (Letza et al., 2004: 257). On the contrary, corporate governance is a socially embedded complex phenomenon that requires analysis based on a dynamic process driven basis to be able to explain ‘the temporary, transient and emergent patterns of corporate governance on a historical and contextual basis in a given society’ (Ardalan, 2007: 511). This given, a different approach to assessing and analyzing corporate governance procedures was deemed necessary and a number of researchers have employed New Institutional Sociological Theory (NIST) (for further details see Chizema and Buck, 2006; Chizema, 2008; Judge and Kutan, 2008; Lee and Yoo, 2008; Seal, 2006; Zattoni and Cuomo, 2008). The main focus of this paper is to present a grounded account of corporate governance using a non-traditional theoretical lens. It is an attempt to contribute towards greater understanding of bank corporate governance as a context based or contingent dynamic rather than a static phenomenon, As such, to set the substantive theory and NIST in context, we have opted to initially present, a critical account of traditional theoretical perspectives used for corporate governance theorizing. We then outline data collection procedure and research methodology through which, the substantive theory was developed then further explored using NIST. It is important to identify that the substantive theory is based on Straussian grounded theory coding techniques (open-axial-selective) and constant comparative method. Coding of data collected from the field eventually leads to the substantive theory of BCG reform in the EBS.

In the following sections of this paper a substantive theory is developed (section 2 and 3), an overview of alternative theoretical framework is presented (section 4) and an example of NIST analysis regarding corporate governance is employed (section 5).

3 Methodology and methods: developing substantive theory

Grounded theory research does not normally follow the traditional positivistic paradigm of inquiry and presenting grounded research in its pure form in an article of this type ‘would be neither efficient nor comprehensible’ (Suddaby, 2006: 637). In other words, reporting the detailed analysis of grounded theory research that is based on coding and the constant comparative method (open, axial, selective coding stages) would entail a lengthy and complicated exposition (Suddaby, 2006). In this paper, we outline the theoretical concepts that emerged through coding data incidents into categories which emerged from the both data and existing categories while these and their properties were integrated to identify the developing substantive theory (see Glaser and Strauss, 1967: 101-115)

This paper uses grounded theory methodology to build a substantive theory of corporate governance within the EBS. Grounded theory aims to develop a substantive theory through comparative analysis and coding procedures (Howell, 2000). Glaser and Strauss (1967: 32) argued that substantive theory is ‘developed from a substantive, or empirical, area of sociological inquiry ... such as ... organizations’. Grounded theory ‘is based on the systematic generation of theory from data, that itself is systematically obtained from social research. Thus, the grounded theory method offers a rigorous orderly guide to theory development’ (Glaser, 1978: 2). Indeed, through comparative analysis grounded theory aims to build substantive theory through developing ‘general categories’ (Howell, 2000). It does not assume that the inquirer knows the substantive areas better than those being researched nor does it assume that a theory will be incorporate a finished product (Howell, 2000). Grounded theory attempts to generate theory based on data collected and analyzed simultaneously as the research progresses (Howell, 2000). Grounded theory is an ‘inductive qualitative methodology that allows the researcher to identify the main concern of a group of subjects and the behaviours they use to resolve their main concern’ (Artinian et al., 2009: 3).

In this paper grounded theory methodology is illustrated in the following ways. First, through an application of the comparative method in the open

coding stage based on semi-structured interviews (A) conducted with bank directors and executives, government officials, auditors and central bank officials which developed categories and identified their properties and dimensions. Indeed, the interviews were informed by a survey of BCG practices. Second, through axial coding open categories were subsumed into broader categories, and the relationships among these categories established by means of the paradigm model. This led to the Bank Action Choice Matrix and the Paradigm Model of Evolving BCG in the EBS. The earlier models the relationship between the organizational characteristics of the bank and the choice of its strategic response of either to comply with governance requirements or disguising its non-compliance. While, the paradigm model of evolving BCG links various main categories with the phenomenon of *evolving BCG practices*. Axial coding provided the basis of the substantive theory. Third, selective coding based on a second round of semi-structured interviews (B) identified the core category, verified its relationships with other sub-categories and eventually presented the substantive theory of BCG.

The Survey was sent to senior bankers from 30 commercial banks with a response rate of 70%. The survey is composed of 14 statements that address corporate governance practices quality of banks (see Table 1). The issues that the survey identified were further investigated through the semi-structured interviews (A) which included: shareholder and stakeholder interests, the role of the board in corporate governance practices, transparency, and disclosure and ownership type. 58 semi-structured interviews were undertaken and broken down into categories (A) and (B). Interviews (A) included 44 interviews based on 14 questions as with grounded theory techniques however, as data collection and analysis were in parallel, emerging concepts were taken to subsequent interviews to be verified (see Tables 2 and 3 for interviews questions and statements) .

Categories that emerged during open coding can be further arranged and linked together to form a coherent overall system (Howell, 2000). The Axial coding process developed five main categories developed through axial coding involved: drivers, obstacles, reform strategies, contextual factors and evolving BCG practices. These categories were related together by means of the coding paradigm model which included identifying the phenomenon studied, the context where it is embedded, the intervening conditions, the causal conditions, actions/ interactional strategies and their consequences (Strauss and Corbin, 1990: 1998). More precisely *drivers* are the causal conditions, *evolving BCG practices* is the phenomenon; while *obstacles* represent the intervening conditions; *reform strategies* are the action / interactional strategies that occurred with the consequences of enhancing banks' legitimacy, improved protection of shareholders' and depositors in addition to bringing further corporate governance reform. Indeed the phenomenon represents the category and other components of the paradigm model are sub-categories.

Finally, at the selective coding stage, the Semi-structured interviews (B) contributed towards identification of the core category of BCG reform and verified relationships with sub-categories using Strauss and Corbin’s (1990; 1998) paradigm model, and eventually arriving to the substantive theory. Overall, the substantive theory is the result of coding, categorization and comparative analysis of data systematically collected for this study through a survey and the two rounds of semi-structured interviews. It reflects the opinions of bank directors and executives, CB officials and auditors. As such it is grounded on data obtained from substantive area (EBS). The substantive theory exemplify a system of BCG reform, it captures some of the complexities of the real life by accounting for both the structure where the phenomenon of BCG reform is embedded as well as the processes taking place. It shows the interaction and interplay between BCG reform and the banking environment that indeed leads to the evolution of BCG practices in the EBS.

Table 1. Grouped Survey Statements

Group	Related Statements
Stakeholders' Interests	1. The bank's current corporate governance structures serve the interests of shareholders. 2. The bank's current corporate governance structures serve the interests of the following non-share owning stakeholders. a. Depositors b. Employees c. Local society d. The Environment

Board of Directors corporate governance practices	3. The banks' board functions include over-sight and approval of corporate governance practices. 4. The Bank's key executives and broad members regularly attend training courses on issues of corporate governance. 5. The board of director's conducts self evaluation or reviews of its effectiveness. 6. The bank's chairman is independent of the CEO. 7. The bank utilized specialized board committees in relation to corporate governance e.g. Audit/ corporate governance, nomination, remuneration committees etc. 8. The specialized committees are composed of independent directors. 9. The banks overall risk strategy requires the evaluation of the clients' corporate governance quality.
Communication of Corporate Governance Information to Stakeholders	10. The bank's corporate governance structures are disclosed in the annual report along with latest financial results. 11. The bank publishes corporate governance information and announcements on its website.

Table 2. Interview (A) questions

INTERVIEW (A) QUESTIONS*

1. Does the type of bank ownership affect its quality of corporate governance practices? (Ownership type of the bank);
2. Do laws and regulations effectively promote bank corporate governance? (shareholder and stakeholder interests);
3. To what extent corporate governance affects competitiveness of the bank?;
4. What are the mechanisms used by the CBE to enhance bank's corporate governance practices? (shareholders and stakeholders interests);
5. On what basis a bank considers corporate governance reform? (shareholders and stakeholders interests);
6. What bodies play an important role in bank's corporate governance? What are these roles? (Bank Corporate Governance);
7. Whose interests do banks' corporate governance mechanisms protect? (shareholder and stakeholders interest);
8. What role does the board have in the corporate governance of the bank and how effective is this? (The role of the board in corporate governance practices);
9. How does the board (in general) ensure that members (of the board) understand their role in corporate governance? (The role of the board in corporate governance practices);
10. What are the corporate governance mechanisms that banks utilize? (The role of the board in corporate governance practices);
11. To what extent the bank insists on good corporate governance in credit operations and what benchmarks does the bank uses in this respect? (The role of the board in corporate governance practices);
12. What impact does the Egyptian business culture have on corporate governance of banks? (Corporate governance culture);
13. What is the basis to determine the risk management policy of the bank? (The role of the board in corporate governance practices);
14. Have the accounting standards adopted enhanced transparency? (Transparency and disclosure).

[*]The Brackets at the end of each question shows the areas emerged from survey analysis and were further investigated in semi-structured interview (A)

Table 3. Interview (B) statements

1. Bank corporate governance has witnessed reform due to pressures from the CBE, international organizations and the Egyptian government;
2. Bank corporate governance reform aims at minimizing potential conflict of interests between shareholders, depositors and the regulator (CBE); hence better serving their interests;
3. Bank corporate governance reform is an ongoing process taking place through the CBE's supervision to enhance the safety and soundness of the banking sector according to the international best practices;
4. Variability of bank corporate governance practices is related to the differences in the corporate governance identity of the bank (management control, competence and organizational perception of corporate governance) as well as the limited corporate governance scope of applicable laws and regulations;
5. Further reform should address the challenges of boards' ineffectiveness in corporate governance, market myopia (short-termism) and corporate governance cultural immaturity within the EBS.
6. Banks respond to evolving corporate governance requirements resulting from reform either by compliance or disguising of non-compliance.
7. The outcome of the compliance or disguising of non-compliance strategies in response to corporate governance reform includes enhancing bank's legitimacy towards the regulator and shareholders; improvement in interests protection and further corporate governance reform;
8. The impact of corporate governance reform will vary between Foreign, Private Domestic, Arab and State banks within the EBS given their different corporate governance identities and qualities.

4 Substantive theory of bank corporate governance reform

The substantive theory can be summarized as follows:

(a) BCG practices evolve from the on-going process of BCG reform.

(b) BCG reform occurs due to pressures from various banking sector stakeholders, with the most influential pressure coming from the regulator and shareholders given their respective powers.

(c) Improving BCG practices decrease potential conflicts of interests between shareholders, depositors and the regulator.

(d) Contextual factors such as laws and regulations, and BCG culture/identity (degree of management control, employees' competence and organizational perception) are determinates of how banks respond to BCG reform requirements.

(e) BCG reform faces obstacles that may alter or mitigate its impetus; this includes director's ineffectiveness, short-termism and immaturity of Hawkamat Al-Sharikat culture.

(f) Banks adopt two strategies in response to BCG reform, either compliance or avoidance by disguising non-compliance.

(g) The regulator manages BCG reform by the means of the supervision function and on-going updating and improving the function by investing in people and systems and co-operating with other central banks.

(h) BCG reform is given impetus by feedback regarding the achievement of reform objectives from both the regulator and recognized stakeholders perspective. As well as feed-forward by the regulator to enhance BCG by implementing internationally accepted practices.

(i) On-going BCG reform, induce banks to comply. While, supervision scrutinize compliance to address further BCG reforms. Meanwhile, the interplay with obstacles will eventually induce changes to occur, to cross these obstacles; this complex interplay will keep BCG practices evolving.

(j) The corporate governance model prevailing in the EBS is a pluralistic model that aims to serve recognized stakeholders: shareholders, depositors and the regulator.

As noted, the substantive theory is the result of coding, categorization and analysis of data systematically collected for this study through: a survey and two semi-structured interviews rounds. It reflects the opinions of bank directors and executives, CB officials and auditors. As such it is ground in data obtained from the substantive area (EBS). Finally, as the substantive theory exemplifies a system of BCG reform, it captures some of the complexities of the real life and demonstrates the interaction and interplay between BCG reform and the banking environment that leads to the evolution of BCG practices within the EBS. The next section develops the substantive theory further through using NIST to analyze and consider the issues raised and embed it in an institutional, cultural and environmental context.

5 Neo-Institutional sociological theory (NIST)

NIST involves analysis of relationships between institutions and their environments (Sandhu, 2009). Scott (2001: xx) considered that NIST involved a continuation of open systems theory and goes beyond the institution under analysis and concentrates on the 'importance of the wider context or environment'. NIST emphasizes legitimacy and centrality of worldviews, routines, scripts and schema (DiMaggio and Powell, 1983; Meyer and Rowan, 1977) and focuses on the 'deeper and resilient aspects of social structure' (Scott 2005: 460). Meyer and Rowan (1977) stated that institutional adoption of formal structures takes place regardless of the efficiency notion. Fundamentally, NIST can be considered as a departure from interpretations of institutions based on the economic conceptions of rationality and efficiency (Mason et al., 2007).

Because of the behaviour constraining nature of institutions legitimacy is a central concept for NIST; institutions operate through 'defining legal, moral, and cultural boundaries setting off legitimate from illegitimate activities' (Scott 2001: 50).Legitimacy refers to 'a generalized perception or assumption that actions are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions' (Suchman, 1995: 574). Indeed, organizations actively seek legitimacy as they need more than 'material resources and technical information if they are to survive and thrive in their social environments. They also need social acceptability and credibility' (Scott et al., 2000). Furthermore, legitimacy may lead to better access to resources because stakeholders are more likely to provide their resources to legitimate rather illegitimate organizations (Parsons, 1960). Finally, legitimacy affects how people act towards organization and how they perceive them, as such 'audiences perceive the legitimate organizations not only as more worthy, but also as more meaningful, more predictable and more trustworthy' (Suchman, 1995: 575).

5.1 NIST and corporate governance

NIST has been used as a theoretical framework by a number of studies on corporate governance (Aguilera and Cuervo-Cazuraa, 2004; Ben-Messaoud, 2002; Deo et al., 2007; Enrione et al., 2006; Khadaroo and Shaikh, 2007; Siddiquie, 2010; Yoshikawa et al., 2007; Zattoni and Cuomo, 2008). However, none developed a substantive theory then proceeded to use NIST for further analysis. This paper employs the notion of three institutional pillars (Scott, 1995; 2001). These pillars demonstrate 'different bases of order and compliance, varying mechanisms and logics, diverse empirical indicators, and alternative rationale for establishing legitimacy claims' (Scott, 2005a: 464). Moreover, each of the three pillars offers an ingredient for explaining institutions. Firstly, the regulative pillar gives priority to 'rule setting, monitoring and sanctioning activities' (Scott, 2005a: 52). This pillar utilizes coercion as its primary mechanism, here conformity with rules and laws seek legitimacy (Suchman, 1995). The second is based on 'normative rules that introduce a prescriptive, evaluative, and obligatory dimension in social life' and depends on values and norms as the basis of social obligation (Scott, 2001: 54). The third pillar focuses on the significance of culture as the 'shared conceptions that constitute the nature of social reality and frames through which meaning is made' (Scott, 2001:57). In this context, reality is constructed through interaction of individuals to create interpretations of what is going on in the surrounding environment (Scott, 2005b). This pillar explains how institutional structures and behaviour is shaped by cultural rules promoted within the external environment (Scott, 2005b). Here compliance of institutions with these cultural rules occurs because other types of behaviour cannot be understood (Scott, 2005b).

NIST provides a theoretical framework by which corporate governance phenomenon may be explored and useful for understanding issues such as corporate governance that is affected by the wider social environment (Scott, 2001). It can also be useful when examining the effects of an institution such as corporate governance on organizations within a particular field (Scott, 1987). NIST emphasizes how institutions are embedded in social structures and pays attention to legitimacy as the main reason of institutional change rather than the economic notions of rationality and efficiency (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Fundamentally, NIST is able to offer a non-traditional avenue for better understanding corporate governance which pays attention to the importance of power and its reflection on actor interests (Scott, 2001; Dillard et al., 2004; Mason et al., 2007; Powell, 2008). Indeed, the concept of power is central to corporate governance as it can be perceived as the 'exercise of power at the level of the corporate entity' (Tricker, 1997: 1). Indeed, legal, organizational, political and cultural factors affect BCG practices of various banking organizations. As such, from a NIST point of view, banking organizations can be analysed from an open system perspective, where their BCG practices are indeed, affected by 'the wider context or environment' (Scott, 2001: xx). Also this agrees with the argument that corporate governance is a social phenomenon that is affected by the institutional and social contexts in which it is embedded and based on non-economic factors such as culture, politics and legal aspects (Ardalan, 2007). Moreover, the institutional context includes human factors (Zingales, 2004). Here, the substantive theory acknowledges that banking organizations seen as firms are composed of

human beings as such directors and executives' competence has an influential impact on BCG practices. The substantive theory sees BCG practices as evolving and in continuous interplay with the environment, this also agrees with the social view of corporate governance that acknowledge that any corporate governance system will continue to evolve (Ardalan, 2007).

5.2 Egyptian banking corporate governance: substantive theory and NIST

According to the substantive theory BCG reform involves a process initiated due to the pressures exerted primarily by the CBE (Regulator). This said, other pressure groups indirectly influence this process such as international organization (World Bank and Basel committee on banking supervision); however these groups are only secondary and do not have the same power as the CBE. At the same time BCG reform is intended to serve and protect particular interests namely: depositors, shareholders, and the regulator. So the substantive theory is about the relative power of particular groups and how they protect their respective interests. Within the context of NIST, the BCG reform process can be considered as an institutionalization process, because 'institutionalization is a political process, and the success of the process and the form it takes depends on the relative power of the actors who strive to steer it' (Powell, 2008: 5). Indeed, the most powerful actors in the process of BCG are the CBE (as the regulator of the banking sector) and shareholders. The power base of the CBE is founded on coercive power and the authority this institution has on various banks. Shareholder power is based on ownership and the high concentration ratio in most of banks, thus shareholders are a powerful actor within this process. In relation to BCG depositor power is opaque however, the CBE protect these interests to achieve its overriding objective of maintaining the soundness and safety of the EBS and avoidance corporate governance related bank failures.

In addition, the substantive theory indicates that the Egyptian BCG reform process has been initiated on the basis of a regulative pillar that involves corporate governance related regulations issued by the CBE. It must be noted that the regulative pillar is accompanied with an informal structure or normative framework that entails obeying the CBE (where all banks agree that the interests of the CBE must be served at all times, indicating that obeying the commands is a binding expectation). This pillar utilizes coercive pressure on banks to comply with related BCG rules and regulations as well as normative pressures. From a NIST perspective this involves a situation where coercive power is legitimated by a normative framework (second pillar). NIST also proposes that the institutionalization process based on the regulative pillar is carried through symbolic routines and carriers (Scott, 2001). This is commensurable in the substantive theory where BCG rules and regulations included in the banking law 88/2003 as well as the CBE directives represent symbolic carriers. Symbolic carriers denotes 'uniformity and … consistency of action' (Scott, 2001: 78), which is compliant with BCG rules and regulations; they employ the third pillar of culture and shared ideas. The coercive power associated with these rules and regulations represent relational system carriers. Finally, the CBE enacts two types of routines to scrutinize and verify the compliance of banks with BCG rules and regulations. These routines are the supervision function (on-site and off-site examination) and the external auditing function implemented by auditing firms. Here routines are attempts by the CBE to use various actors to 'formalize processes for checking suitability of governance activity' (Mason et al., 2007: 294).

The substantive theory also indicated that compliance with the BCG rules and regulations is based on seeking pragmatic legitimacy which involved 'self-interested calculations' (Suchman, 1995:578). Pragmatic legitimacy must be perceived as appropriate by the CBE and shareholders and here entails adopting BCG requirements imposed by the CBE. Legitimacy is a principal framework governing banks and identifies the BCG adherence to a regulative pillar. Fundamentally, the substantive theory has indicated that even though normative pressures from the Egyptian Banking Institute (EBI), the Egyptian Institute of directors (EIOD) and international organizations exist the impact of these pressures is not strong enough to initiate change. The substantive theory indicated that the culture of corporate governance within the EBS is at its early stages of formation and that this requires deinstitutionalization of the rejection of corporate governance culture as well as the secrecy culture. Indeed the study acknowledges that this change involves a long term process. However, the NIST acknowledges that institutions and environments can be shaped by different combinations of the regulative, normative and cultural elements that vary from one context to overtime (Powell, 2008). Although currently the regulative element is salient, normative and culture-cognitive components may play a role over the long-term.

BCG reform indicates the institutionalization process within the EBS which is currently based on a regulative aspect. Indeed, institutionalization especially from a social constructivism point of view indicates a process 'by which organizational policies become instilled with value and ultimately taken for granted among external constituents' (Zajac and Westphal, 2004: 440). It entails a 'reciprocal typification of habitualized actions by types of actors (Berger and Luckmann, 1967: 72). However, institutionalization happens to organizations overtime and 'infuse with value beyond technical requirements

of tasks' (Selznick, 1957). This process proceeds till something is institutionalized, this occurs only 'when it is unquestioned and taken for granted' (Hasselbladh and Kallinkos, 2000; Sandhue, 2009:82).

As the substantive theory indicates, the institutionalization of BCG is now derived by a regulative pillar and legitimacy which is based on coercive mechanisms. However, normative pressures do exist, and with greater efforts from professional bodies such as EBI and the EIOD, overtime BCG practices may be adopted by the logic of appropriateness. This can occur because 'professional training institutions are important centres for the development of organizational norms among professional managers and their staff' (DiMaggio and Powell, 1983: 152).Such leads toward isomorphism and the adoption of BCG due to normative pressures. Overtime the wide spread of adoption of BCG practices will be taken for granted within the culture-cognitive institutional structure. Only then will BCG be considered fully institutionalized (Suchman, 1995). This incorporates a type of legitimacy that is neither based on serving particular interests but as an evaluation related to duty and doing the right thing. It is based on 'necessary or … based on some taken-for-granted cultural account' (Suchman, 1995:582). This type legitimacy reflects 'preconscious standards' related to how organizational activities should be performed (Mason et al., 2007: 293).

The substantive theory developed here also indicated that banking organizations based their corporate governance identity on a compliance or avoidance strategy (by disguising non-compliance tactics) (Oliver, 1991). Organizational responses to external pressures are an important aspect of NIST. Here the substantive theory has shown how some banking organizations adopt arising BCG requirements by real compliance, while other banks comply by appearance only or on 'ceremonial basis' (Meyer and Rowan, 1977).Banks disguising non-compliance do so because they too seek legitimacy, but they have internal organizational characteristics that hinder implementation and are more susceptible to external obstacles. Moreover, as a result of the CBE coercive pressures as well as the EBI and EIOD increasing normative pressures banks will either comply or move to another strategic choice such as 'defiance' which involves openly challenging or lobbying to influence the environment and make it more amenable for their needs (Fiss, 2008). As Carruthers (1995:324) identified 'organizations play an active role in constructing rationalized myths, playing them off against each other, or shaping how they are applied in particular instances, organizations are not only granted legitimacy; sometimes they go out and get it'.

Therefore, the substantive theory can be explained within the NIST framework, but not on the traditional basis of homogeneity of organizational responses, rather on the basis of accepting that organizations respond to institutional pressures in different ways through various strategies such as acquiesce, compromise, avoid, defy and manipulate (Oliver, 1991: 152). Overall, NIST offers a means of accounting for environmental factors and institutional change relating to the substantive theory.

6 Conclusions

Through a grounded theory study of corporate governance of the EBS, this paper has built a substantive theory that identified the drivers for change in Egyptian BCG. The substantive theory also accounted for contextual factors in which the BCG phenomenon is embedded including; management control, competence of board members and employees and organizational perception of corporate governance as well as the legal and regulatory frameworks. It also identified obstacles to corporate governance reform in terms of board of director ineffectiveness, short-termism and immature corporate governance culture in banks. Finally, the substantive theory accounted for the processes for dealing with BCG reform; that is, actions / interactions between banks and CBE. Indeed, the substantive theory identified the outcome of interaction between the structure and processes that lead to the evolution of BCG practices as well as enhanced legitimacy of banks and perceived better protection of stakeholder interests.

Subsequently, NIST was utilized to further explore the substantive theory. This further substantiated that corporate governance involved a social phenomenon that is affected by its environmental context as well as legal, organizational, political and cultural aspects i.e. it is socially constructed. Corporate governance practices evolve and continuously interact with the surrounding environment. Moreover, corporate governance reform involves a process of institutionalization derived from the regulative and normative pillars with the objective of achieving legitimacy. Unlike both shareholder and stakeholder models the substantive theory posits that banks adopt corporate governance practices seeking legitimacy regardless of efficiency. Further assessment of the substantive theory through NIST identifies that Egyptian corporate governance phenomenon involves a social process, embedded and attached to the institutional context; the phenomenon is affected by non-economic factors which incorporates legal, regulatory, human, organizational and cultural factors. Consequently, corporate governance is dynamic and continuously evolving. Organizational responses cannot be regimental because internal characteristics of the affect how corporate governance structures are affected by institutional pressures.

This paper attempted to further corporate governance theorizing and used NIST to explain the heterogeneity of organizational responses to

institutional and environmental pressures. Institutional explanation improves our understanding of the corporate governance phenomenon in general, and provides empirically evidence of the inability of the traditional corporate governance theorizing to capture the complex corporate governance phenomenon.

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CORPORATE GOVERNANCE REFORMS: BETWEEN INSTRUMENTALITY AND INSTITUTIONAL DRIVERS

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Abstract

Previous studies suggest that improvement in market confidence through credible signals to appropriate stakeholders is one of the primary motives for corporate governance reforms. Proponents of this view argue that corporate governance reforms, and by extension corporate governance disclosures by firms, is less imperative in a developing economy due to absence of demand for such disclosures and reforms. It seems that these arguments are not general and are only tenable in specific market settings. This study generates further insights on the motives for corporate governance reforms. The study finds that corporate governance reforms in settings with less market incentives such as Swaziland are motivated in ways that are different from documented evidence in existing literature.

Keywords: Corporate Governance Reforms, Motives, Developing Economy, Swaziland

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1. Introduction

This paper aims to investigate the motives for corporate governance reforms in a setting with less incentive for such. Discussions of corporate governance issues have become centre stage in many disciplines and have taken different forms and dimensions, which reflect the apparent difficulties in defining or agreeing boundaries on the issues of corporate governance. Existing perceptions appeared polarized in most cases, not only in terms of its models but also in its definitions. If we take the definition first, because it helps us to shape the context for the argument in this paper, we find that there are likely as many definitions as authors who bother to venture a thought on the subject. There are definitions that constrained its meaning within the purview of the firm and its constituents alone, and on the other extreme, there is a growing number of academics who see the pervasiveness of corporate governance, especially as it relates to its applications at governmental and national levels. There are definitions that are based on stakeholder and shareholders; static and dynamic; short term and long term; developed and developing economic; macro and micro; and private and public enterprise dimensions (see Filatotchev and Allcock, 2010; Aguilera, Filatotchev, Gospel and Jackson, 2008).

The major theoretical paradigm in the discourse of corporate government to date remains Agency theory (Filatotchev and Allcock, 2010), but, recently, apart from stewardship and stakeholder perspectives, there is a growing interest in the application of institutional and organizational theoretical perspectives. However, while these are ongoing at firm level, it is less so at the state level. Besides the extents of their influence in the growing governance discourses is still negligible.

The purpose of this paper, therefore, is to generate further insights on the motives for corporate governance reforms from an institutional perspective. Previous studies suggest that improvement in market confidence through credible signals to appropriate stakeholders is one of the primary motives for corporate governance reforms and consequently firm disclosures. For example, companies disclose voluntarily for several reasons including, capital market transaction, corporate control contest, stock compensation, litigation cost and proprietary cost (Collett and Hrasky, 2005; Healy and Palepu, 2001). Furthermore, strategic disclosure arguments have also been advanced, whereby firms use disclosure as a strategic instrument to take advantage of market opportunity in form of cheaper cost of capital (Karamanou and Vafeas, 2005; Anderson, Mansi and Reeb, 2003; Leuz and Verrecchia, 2000; Sengupta, 1998; Botosan, 1997), lower operating costs, improve competitiveness, and attract investment - instrumentality driver (Aguilera, Rupp, Williams and Ganapathi, 2007). Firms in the developed markets have real market incentives to have obvious corporate governance mechanisms and markets may reward

such transparency because there is a demand for it. It is therefore reasonable to expect corporate governance reforms in the scale experienced in these jurisdictions. But the case is somewhat different in settings with poorly functioning markets and challenging developmental infrastructures.

It seems that the arguments regarding the market incentives for instituting corporate governance reforms are not general and are only tenable in specific market settings. This therefore questions the motives for instituting these reforms in settings other than those with ample incentives for beneficial governance reforms, unlike in jurisdictions characterized with poor market infrastructure, political infancy, poor economic growth and severe human capital challenges. Using institutional theoretical lens, and multi-level analysis, this study argues that drivers for corporate governance reforms are heterogeneous and therefore discretely different, but institutionally driven. Furthermore, it argues that the corporate governance reforms in these settings are determined more by developmental contingencies (Aguilera et al., 2008) and by instrumentalist (Aguilera et al., 2007) motives, both of which are, strictly speaking, embedded in the external influence on the organizational field (Di Maggio and Powell, 1983; Pfeffer and Salancik, 1978). An exposition of these motives is important in appropriately categorizing the nature of corporate governance mechanisms in these settings, which until now is scarce in the literature but which may be representative of situation in the majority of developing countries.

The understanding of the impact of the external pressures on corporate governance reforms motives is also essential not only in terms of their policy implications which have developmental importance for these countries, but also in terms of their value for money assessment in settings where corruption remains a real problem with huge capacity to eclipse laudable development initiatives. This study therefore shifts the focus of the current corporate governance discourses towards national governments and probes their decisions to adopt corporate governance reforms.

In doing this, it extrapolates institutional theoretical perspectives beyond its usual firm context to a national government context, specifically in a setting with challenging developmental features. This approach is also important in order to show the limitations of current paradigm in governance discourses and avoid the pitfalls from a 'one size fits all' approach, which current approach could lead to, due to the overriding theoretical paradigm. Along this line, Aguilera et al. (2008) noted that agency theory does not permit adequate 'contextualization of discourse', while Filatotchev and Allcock (2010: 21) thought that it is unable to "accurately compare and explain the diversity of corporate governance arrangement across different organizational and institutional context". These deficiencies could easily lead to wrong prognosis of the governance demand and solution proffered, especially in the case of developing economies (Kabir and Adelopo, 2012). This is why a grasp of the key factors motivating corporate governance reforms should be understood clearly and properly contextualized. This will also further the discourse on corporate governance convergence in many ways, not least in the sense of the universality or otherwise of corporate governance drivers and how this could impact on the choice of governance mechanisms and bundles with due recognition of their complementarities, substitutability and dimensions (Ward, Brown and Rodriguez, 2009).

The rest of the study proceeds as follows; in the next section, we provide a discussion of institutional theory and its recent application in the corporate governance discourse. Here we focused on the Di Maggio and Powell (1983)'s isomorphism. After this, we present a context for the study and provide background information on the context. We then argue, in the following section, that corporate governance development in our focal country follows the continuum suggested by Di Maggio and Powell but also that it fits within the propositions of contingency model (Aguilera et al., 2008) and instrumentalist motives (Aguilera et al., 2007). We provide survey evidence to back our claims. The last section draws out the implications and conclusions and made suggestions for future studies.

2. Institutional Theory and its Relevance in Corporate Governance

The study of firms' external environment has received huge attention in the literature in many disciplines not least in organizational study and management, but not sufficiently within corporate governance discourse (Hambrick, Werder and Zajac, 2008) at least from an accounting and finance perspective. Consideration of the institutional environments of firms is likely to yield gains and enhance clarity on the theory of the firm, a severely contested concept which is insufficiently constructed within institutional frames compared to its economic and financial views. However, it will be wrong to think of a homogenous view of firms' external institutions. Indeed, institutional debates are equally very contentious and diverse. One such broad arguments relates to the nature of the interactions between firms in an organizational field, and whether their behaviours converge or diverge over time and what, if known, are responsible for this, and their effects on organizational strategy, structure and outcomes.

Institutionalists see the universe from a social lens in which each individual actor takes its place within the socially constructed reality (Carruthers, 1995). This gives rise to multi-layered analytic view of reality, comprising the individual, firms and organizational fields (Di Maggio and Powell, 1983; Pfeffer and Salancik, 1978). The firm as a social actor

comprises a nexus of social interactions and exchanges facilitated through social ties and diffusion (Granovetter, 1983). These social interactions provide space for the embeddedness of other realities (Granovetter, 2005), such as the economic objectives of the firm. Thus the firm, as a social institution, provides avenue for the construction, refinement, dissemination and enforcement of shared values. But as Tonoyan, Strohmeyer, Habib and Perlitz (2010) argued, these values are not only internally constructed; they are also eminently fluid due to external forces. These forces; internal and external, inadvertently shape the firm, and affect its strategy, structures, and consequently its outcomes. It is this realization that appeared taken for granted in the majority of previous studies on corporate governance, which see reality from the economic view of the universe alone, which, of course, does not present a complete picture of the firm.

Recent arguments by authors such as Aguilera and Jackson (2003), Aguilera et al. (2007), Filatotchev and Allcock (2010) and some few others reflect the importance of considering the organizational and institutional context of corporate governance debates and these have enriched the discussion on many crucial issues. This includes, for example, consideration of the motives, governance mechanisms and bundles, and debates over complementarity/substitution of mechanisms, and the merit and practicality or otherwise of corporate governance convergence. Although institutional contextualization of corporate governance is universally applicable, they result in different outcomes. Previously, Aguilera et al. (2008) examined the organizational interdependencies focusing on the costs, contingencies and complementarities of different corporate governance practices. They argued that "different aspects of the organization and its environment may also impact the role of corporate governance practices" (p.478).

Consequently, corporate governance roles and mechanisms are seen to depend on firms' life cycle (Filatotchev, Toms and Wright, 2006) and are argued to reflect current needs of the firms, which make them dynamic as oppose to a static structures. Furthermore, organization's ability to bear the various governance costs including systemic, opportunity, proprietary and reputational (see Aguilera et al., 2008 for detail analysis) are different and could account for differences in governance structures and mechanisms with impacts on outcomes. However, while their focus was on the organizational dynamics and its impact on governance mechanisms and outcomes, we are not aware of previous studies that have focused on understanding the different institutional dynamics that account for corporate governance reforms and structure in a developing economy. Thus, our focus in this paper is on how the consideration of the institutional context of the debate could privilege insight into the motives for corporate governance reforms in a setting with poor economic incentives.

Hambrick et al. (2008: 382) observed that "corporate governance does not begin and end with principals, agents, and the (in) completeness of contracts. There is considerable opportunity and need to explore the extensive web of institutional actors that influence governance practices in contemporary societies". Their view is consistent with Filatotchev and Allcock's (2010:21) observations that agency theoretical approach which dominates the discourse in corporate governance has paid little attention to the "distinct context in which firms are embedded".

This study takes clues from these important observations and adopts Di Maggio and Powell's (1983) seminal work on institutional isomorphism to refine our understanding on the external pressures that are shaping the adoption of corporate governance practices particularly in an environment where it is, perhaps, unlikely to lead to any real form of efficiency. For example, why would a country with poor and inefficient stock market with just few odd listed companies invest in instituting corporate governance codes? What factors are considered in the decisions by developing economies to adopt a model of corporate governance rather another? Our argument is therefore distinct from the general 'moralistic' contention about accountability and business ethics; instead we are concerned about the motives for corporate governance reforms, in developing countries context, which appear taken for granted in the literature.

Our choice of Di Maggio and Powell's (1983) analysis is due to the influential insight they generated from their consideration of the external pressures that shapes firms behaviours. Di Maggio and Powell (1983) (henceforth D and P) curiously observed that firms in a similar organizational field move towards a homogenous configuration even as they make frantic effort to differentiate themselves through innovation and strategic decisions. They suggested that firms are always in a continuum of organizational reconfiguration, and this process would reach its optimum where a further investment in reinvention[1] produces zero additional efficiency. And as firms in the organizational fields reach this optimal state, they converge towards homogenous features. To D and P, firms are in constant need to maintain societal legitimacy and this desire pushes them, unconsciously, towards uniform behaviours and outcomes. They argued that institutional rather than competitive isomorphism provides a cogent explanation for the observed drive towards homogeneity in the organizational field and later identified three distinct isomorphic forces responsible for this; coercive, mimetic and normative isomorphism.

Coercive isomorphic pressures are external forces on a focal organization by organization(s) upon which they are dependent for their resources. These

pressures could be formal or informal; direct or indirect. They could be mandatory or persuasive. They arise out of the need of the focal organization to maintain legitimacy within its operating environment, particularly with its most important stakeholders, at times referred to as its conferring publics (Adelopo, Jallow and Scott, 2012). Annual reports, budget cycles, reporting structures, accounting regulations and standards that companies have to produce are features of coercive mechanisms. The requirement to produce these statements or reports is uniform and obligatory amongst firms of certain sizes and they all have to produce one or more of these depending on the requirements of their conferring publics in order to secure, maintain or manage their legitimacy with them, otherwise their legitimacy may be at risk (O'Donovan, 2002). Economic and Social Research Council (ESRC) funding in the UK and how it has inadvertently resulted into homogenous practices by universities, for example, in staff training and support towards successful funding applications is another example.

Furthermore, the source of this coercion could be multiple; firm level, industry, regional, national and international in nature. It is also possible that the coercive forces are transitory, i.e. they could change over time depending on the state of the focal organization and the nature of interdependency between the focal firm and their benefactors. This is consistent with Aguilera et al.'s (2008) idea of firms' contingency factors, as they go through a typical life cycle. So that the coercive pressures on an Initial Public Offering (IPO) firm will be different to the pressures on a more established firm.

Secondly, firms move towards homogenous features due to mimetic isomorphic pressures. These are forces which stem from organizational ambiguity and uncertainty about future expectations and strategy. Poor understanding of technologies, goal ambiguity and environment created uncertainty are prelude to firms' mimetic isomorphic behaviours. Organizations in such field therefore respond to this perceived uncertainty, which may threaten their continued societal legitimacy, through contingency device e.g. by "imitating" firms in the same organizational fields that the focal company considers more successful and more legitimate. D and P argued that social actors could shape themselves structurally and strategically to be similar to these successful firms through modeling, even without the knowledge of the modeled firms. Furthermore, the models could be diffused unintentionally and deliberately through employee transfer, staff turnover, and consultancy among other means. According to D and P, "new organizations are modeled upon old successful ones" (p.152).

Lastly, D and P defined normative pressure as those that stem from the impact of professionalism that lead to uniformity in organizational structure and forms. They see "professionalism as the collective struggle of members of an occupation to define the condition and method of their work to control … and to establish a cognitive base and legitimation for their occupational autonomy" (p.152). Increase professionalism could lead to more structured and uniform approach to training as every entrant into a profession have to pass their professional examinations which serve as conditioning device to ensure uniformity in knowledge, perception and values. D and P made specific note of the level of homogeneity that is currently observed in management in organizations. They considered that firms copy themselves through their employment profiling. This involves employment of filtering process in order to determine the fit between the new employee and the existing caliber of staff.

It is worthy of note that severe criticisms have trailed D and P's propositions especially by intuitionalists that consider that firms move towards divergence rather than convergence. For example, Hambrick, Finkelstein, Cho and Jackson (2004:307-308) noted that while D and P were "correct about the forces that give rise to isomorphism", they failed to "anticipate several major macro-social trends that caused those forces all to move in directions that diminished, rather than accentuated, isomorphism". Furthermore, Ashworth, Boyne and Delbridge (2007) argued that D and P neglected three issues that are important in order to test the validity of their institutional theoretical propositions. Firstly, there is insufficient clarity on what they meant by conformity. According to Ashworth et al. (2007:169), conformity could mean compliance or convergences both of which were implied by D and P but were not discussed; neither in their seminal work nor in subsequent major books on institutional theory (see Scott, 2001; Powell and Di Maggio, 1991). Secondly, clearer understanding of institutional theory requires a "measurement of changes in a variety of organizational characteristics rather than a single feature of the firm. And lastly, they argued that institutional theory, as currently constructed, is silent on which organizational features are more open to institutional pressures, suggesting that "organizational culture and strategic stance may be relatively impervious to isomorphic pressures" (p.171) compared to structure and processes which may be "more open to influences from the institutional environment" (p.171). One other criticism of D and P proposition is inherent in their presentations of these isomorphic forces which were meant to be separate but are also overlapping. These seemingly inconsistencies have been a source of criticism by those who see firms diverging rather converging.

However, despite its defects, D and P propositions have been hugely useful in clarifying the role of the institution in many economic activities and on issues that have hitherto been constructed completely within economic and financial views. The application of their institutional isomorphic theory has

been beneficial in explaining misunderstood phenomenon that may have been restricted within narrow theoretical constructs. In particular, in this paper, we aspire to revisit the motives for corporate governance reforms and venture institutional theoretical explanation to make meaning of why corporate governance reforms are embarked upon in jurisdictions that have less incentive for their introduction.

To achieve our objectives, it is important to expand D and P's idea of an organizational field. According to D and P, it refers to "those organizations that, in the aggregate, constitute a recognised area of institutional life……" (p.148). In other words, an organizational field is not restricted to competing firms or firms in some kind of organizational network alone. Instead, organizational field refers to "the totality of relevant actors" (p.148). For example, according to D and P, the structure of an organizational field "cannot be determined a priori but must be defined on the basis of empirical investigation" (P.148). Consequently, it is reasonable to argue that D and P originally conceived the application of the idea of isomorphic pressure beyond the mere collection of firms in an industry as an organizational field. This is perhaps one of the reasons why their ideas have received wide applications in many management field compare to institutionally motivated theories such as resource dependency theory (Pfeffer and Salancik, 1978; Hillman, Withers and Collins, 2009), and it is therefore not surprising that studies have applied their idea in cross-country investigations, including for example, Guler, Guillen, and Macpherson (2002) on diffusion of organizational practices across countries; Glick and Rose (1999) on currency crises; and Frank, Hironaka and Schofer (2000) on policies to protect the environment. In this study we apply D and P's model to explain the motive for national corporate governance reform. The study proceeds by providing information on the country context.

3. Information about the Country Context

Swaziland presents a curious and unique setting to research the application of D and P's institutional isomorphism. The country adopted the corporate governance codes that supposedly should guide corporate behavior and disclosures by listed companies recently. For instance, Swaziland Stock Exchange (SSX) adopted a number of principles and guidelines from South African King II Report on corporate governance as a benchmark for listed companies. Very soon, Swaziland is going to follow King III Report which came into effect in 2010 in South Africa. This is also to enhance market participation by the citizen and divest state ownership of enterprise to private hands. Another objective of this was to attract foreign investment into the economy. However, since its establishment in 1990, over 20 years ago, there are only 6 listed stocks on the Swaziland Stock Exchange most of which are government own parastatals. Swaziland is still largely a traditional society with great attachment to land ownership; agriculture and subsistence farming remains the mainstay for the majority of the people with government as the largest employer of labour. This has huge impact on the health of the economy with over 60% of the GDP being labour cost.

Although there are large and medium size companies, the majority of Swaziland corporate landscape is dominated by very small, family owned business, which employs only a small fraction of the labour force in the country. There is obvious presence of multinational enterprises majority of which are subsidiaries of South African companies especially in the banking sector.

Table 1 shows some economic performance indicators of the country compare to its Southern African neighbours. Swaziland has one of the lowest GDP in the region in 2010.

Table 1. Descriptive Statistics of Some of the Countries in the Southern Africa

Country	World Bank Economic Classifications	GDP (2010)	GNI per capital	External debt % GNI
Botswana	UMIC	$14,857,275,330	$6,790	12%
Lesotho	LMIC	$2,132,495,561	$1,040	24%
Namibia	UMIC	$12,170,331,922	$4,500	Not Available
South Africa	UMIC	$363,703,902,727	$6,090	13%
Swaziland	**LMIC**	**$3,645,267,040**	**$2,630**	**17%**
Zimbabwe	LIC	$7,474,000,000	$460	72%
Note: UMIC refers to Upper Middle Income Country, LMIC = Lower Middle Income Country, LIC = Lower Income Country				

(Source: World Bank Development Indicator, 2011)

Swaziland has one of the weakest economies in the region; despite the population with age 0-14 and 15-64 constituting 37.8% and 58.6% of the population respectively, but she has the highest incidence of HIV/AIDS in the region. The problem of HIV/AIDS has succeeded in decimating her youthful population, wiping out its productive potential and instead increasing its dependent on the central government for the provision of health and antiretroviral drugs. Table 2 shows a consistent fall in foreign direct investment (FDI) into the country over the years, falling to a miserable 2.54% of GDP in 2010 compared to 7.84% in 2002.

Table 2. FDI inflow as a percentage of GDP

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Botswana	12.01	9.53	7.44	4.80	6.67	5.23	6.64	2.19	3.56
Lesotho	4.44	4.63	4.50	5.10	4.14	6.61	6.87	5.87	5.49
Namibia	Not Available	0.67	1.34	2.29	0.39	1.93	4.56	5.34	7.05
South Africa	1.33	0.47	0.32	2.64	-0.07	2.00	3.50	1.89	0.43
Swaziland	**7.84**	**-3.39**	**3.05**	**-1.82**	**4.53**	**1.27**	**3.73**	**2.24**	**2.54**
Zimbabwe	0.41	0.07	0.15	1.84	0.77	1.37	1.17	1.80	1.41

(Source: World Bank Development Indicator, 2011)

Apart from the social breakdown and economic difficulties, Swaziland presents a case of political infancy. A country rule by a constitutional monarch, King Mswati III but with dual government apparatus whereby the traditional rulers wield significant political power concurrently with the parliamentary system of government inherited from the British colonial rulers. The King combines all the three roles of the arms of government (legislative, executive, and judicial) and has the final say on all administrative and political resolutions in the country.

Amidst all these contrasts, the country has instituted corporate governance reforms and required the few listed companies to disclose compliance with the governance codes in their annual reports. Private companies and government parastatals have to fulfill similar requirements. This presents a curious case giving the poor investment incentives and the dismal contribution of private sector to the country's economy. It is however important to understand the drivers for these reforms and contextualize it properly in order to aid policy recommendations. This is the main objective of this paper. The next section presents the data and methods employ in this study.

4. Research Design

In order to help us answer our exploratory research question of what are the drivers for corporate governance reforms in Swaziland, guided by our theoretical frame, we developed a survey instrument which was administered on carefully selected respondents. We chose to develop a new survey instrument rather than adopt or adapt existing ones (Saunders, Lewis and Thornhill, 2007) because the issues addressed are context specific, therefore using existing instruments would not serve the purpose of the investigations. Because of the specialized nature of the issue addressed, purposive sample method was used focusing on respondent that are accountants and auditors or have accounting and auditing background. Previous studies have adopted this sampling technique (see Kaye and Johnson, 1999; Shaw, 1999). Accountants and auditors were used in the study because it is believed that they have sufficient knowledge and awareness on the issue under investigation. The choice was also facilitated due to access to the contact details of the potential respondent through the Swaziland's Institute of Accountants' website, as well as accounting academics.

The questions on the survey instruments were carefully design to elicit appropriate response from the respondent and were pilot tested to ensure its content validity before administration on the respondents. Following pilot testing, few amendments were made to the instrument mainly on avoiding technical terms. This involved replacing coercive, mimetic and normative isomorphism with economic, external, location and human resources drivers, since these are easily understandable and could enhance response. Furthermore on the content validity of the instrument, we followed Churchill (1995) suggestions which included conducting series of interviews involving respondent with similar features as the intended respondent. This allowed us to access the understandability of the instrument. We were able to test the instrument on respondents that closely match our targeted audience because one of the researchers is an academic in South Africa and anecdotal evidence suggest that a good number of Swazi accountants and auditors train in South Africa.

The questions were underpinned by findings from the literature and are intended to help us answer our research questions. We focused on the economic drivers and the coercive, mimetic and normative isomorphic factors. Questions under the economic drivers sought to establish whether respondents

believe that Swaziland was mature for the type and kind of corporate governance reforms and to find out the main economic drivers for the reform-instrumentality driver. Respondents were therefore asked to rank a number of suggested economic motives for corporate governance reforms in the country. The second set of seventeen questions sought to establish the external drivers for corporate governance reforms and these questions were designed to help answer whether corporate governance reforms in Swaziland fits D and P's coercive, mimetic and normative pressures. See appendix for a detail list of the items in the questionnaire.

Our respondents were carefully selected. We obtained the email addresses of accountants (including chartered accountants) and registered auditors in Swaziland and send emails to all the contacts. In all 156 questionnaires were sent out via email, 16 bounced back suggesting that either the email addresses were wrong or no longer in use. Thus 140 email questionnaires were delivered during our first round of emails. Two follow up emails were sent as a reminder with an attached questionnaire, as with the first round, 16 emails bounced back during the second and third round of emails sent out. Overall, 58 usable responses were received representing 41% response rate which is more than the 12-20% (Churchill, 1995) acceptable response rate for a study of this kind. The response rate was tested for non-response bias. We used the late response as a surrogate for non-response and conducted a chi square test which showed that there are no non-response biases in the data. In the next section, we present the data analysis and findings from the survey.

5. Findings and Analysis

The data analysis involved thematic analysis of the outcome of the survey. First we present findings from the preliminary and screening questions and followed these with findings on other questions in the instruments.

Is Swaziland Mature for the Type and Style of Corporate Governance Reforms?

The first question explored the suitability of the current corporate governance reforms in the country and sought to establish if respondents thought the country was mature enough for the type and style of corporate governance reforms. Table 3 summarized the finding on this issue.

Table 3. Question 1 - How would you describe the maturity of Swaziland's economy for the type and style of corporate governance reforms?

The maturity of Swaziland economy	Immature/Very immature	Mature/ very mature	Don't know
Please give your assessment of the maturity of Swaziland's economy for the type and style of corporate governance reforms	39	7	2
%	67	12	3

This result suggests that majority of the respondent believed that Swaziland is implementing an inappropriate corporate governance reform in that they do not think that the country is mature enough for it.

Is corporate governance important in Swaziland?

This is another preliminary question designed to explore the suitability of corporate governance reforms in Swaziland. Whilst Question1 established the immaturity of the country economy for the type and style of corporate governance reforms its currently implementing, this present question is aimed at exploring the importance of corporate governance in the country. This is because although the current approach may be faulty, the country still needs a corporate governance reform but may be not in the fashion currently being implemented. Question 2Bi and Question 2Bii explored this further. The response is presented in the Table 4 below.

Table 4. Question 2 - Corporate Governance Importance in Swaziland

Panel A: Question 2Bi	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
Corporate governance is only necessary in a country with significant number of listed companies on the stock exchange	11	47	Nil
%	19	81	
Panel B: Question 2Bii	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
Corporate governance is very important in Swaziland	45	13	Nil
%	78	22	

The outcome of the survey on the question suggests that majority of the respondents believe that although Swaziland may not have a huge number of listed stock on its exchange, corporate governance reform is still very important. Table 4 panel B shows that 78% feel that it is important to have a corporate governance reform. This view may also be informed by the fact that whilst private sector constitutes a negligible component of the government revenue, the public sector is the most important sector in the economy. Having established the importance of corporate governance in the country a number of questions were posed to the respondents with the intention of exploring the motives for this reform as perceived by them. These are analysed below.

Economic (instrumentalist) drivers for corporate governance reforms in Swaziland

The literature suggests that economic motive is one of the main drivers for firms' corporate governance disclosures. This could be in the form of more patronage or cheaper cost of capital. Similarly, there are suggestions that national governments could also be influenced by economic motive, especially attracting foreign direct investment (FDI), in implementing reforms such as corporate governance reforms. Aguilera et al. (2007) referred to this as the instrumentalist motive arising from competitive desire. In this study, we explore if corporate governance in Swaziland is motivated by economic considerations and the desire to use corporate governance to gain competitive advantage. We used two questions (Q2A and Q2Biii) to explore this because Mitchell (1996) suggested that the use of an alternative form of a question aids the reliability of the instrument. Consequently, in Q2A we asked respondents to rank a number of suggestions according to their importance as an economic driver for corporate governance reforms in the country, with one of the options being FDI, and in Q2Biii we asked them if they thought corporate governance reforms were influenced by the need to attract FDI into the country. The Tables 5 and 6 present the outcome of these investigations.

Table 5. Question 2A - Economic Drivers of corporate governance reforms in Swaziland

Economic Drivers	Number of Respondents				
	Ranked				
	1	*2*	*3*	*Total 1-3*	*Rank*
Economic Development	17	15	11	43	2nd
Attract Foreign Direct Investment (FDI)	**20**	**18**	**12**	**50**	**1st**
Signal Transparency and Accountability	16	10	16	42	3rd
Foreign Loan and Supports	15	10	15	40	4th
Millennium Development Goals	6	13	9	28	7th
Political Stability	8	6	9	23	8th
Irrelevant to Swaziland	Nil	Nil	15	15	9th
Global Acceptability	20	6	3	29	6th
Democracy	18	2	16	36	5th

The respondents' opinions on both questions Q2A and Q2Biii support the perception that corporate governance reform in Swaziland is driven by economic motive, and this is consistent with the view that countries implement corporate governance reforms as an instrument to improve their competitiveness. FDI was ranked as the main economic motives followed by economic development objective. The result in Table 6 supports this with 67% of the respondents agreeing that corporate governance reform in the country is influenced by the need to attract FDI. This view is particularly true for developing economies due to the need to build sufficient capital stock for developmental purpose. Earlier in Table 2 we showed that Swaziland has experienced consistent fall in FDI compare to majority of the countries in the South African region.

Table 6. Question 2Biii - Corporate governance reforms in Swaziland is influenced by the need to attract FDI

Question 2Biii	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
Corporate governance reforms in Swaziland is influenced by the need to attract FDI	39	13	6
%	67	22	10

External Drivers (Isomorphic Pressures) for Corporate Governance Reforms in Swaziland

Institutional theorists suggest that the firms are influenced by both internal and external factors. Di Maggio and Powell (1983) moved this further and identified three isomorphic pressures: coercive, mimetic and normative, that leads to homogeneity in firms behaviours.

Coercive Pressures

Our study extrapolates D and P's isomorphic pressures on national governments motive for corporate governance reforms. For this purpose and consistent with Gourevitch (1978), we looked at the impact of international organizations on domestic policies. To explore this, we asked respondents a number of related questions, results of which are presented in the Table 7. We find that majority of our respondent agree that international organizations as well as bilateral and multilateral organizations played influential roles in Swaziland's choice of corporate governance reforms.

Table 7. Questions 3Ai, 3Aii, 3Aiii

Panel A: Question 3Ai	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
Corporate governance in Swaziland is driven due to international pressure	43	13	2
%	74	22	3
Panel B: Question 3Aii	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
International organizations are key influence in Swaziland's corporate governance reforms	51	5	2
%	88	9	3
Panel C: Question 3Aiii	Agree/ Strongly agree	Disagree/ Strongly disagree	Uncertain or no Opinion
Regional bilateral and multilateral organizations are crucial in Swaziland's choice of corporate governance reforms	46	11	1
%	79	19	2

To be more specific, we identified a number of international organizations and regional organizations and asked respondents to express their opinions on the level of influence these organizations have on the choice of corporate governance reforms in Swaziland. Two international organizations stand out as being most influential on Swaziland's choice of corporate governance reforms. All our 58 respondents believe that Swaziland's choice of corporate governance reforms is influenced by the International Monetary Fund (IMF) and 49 respondents (84%) believe that it is also influenced by the World Bank (WB) (see Table 8). This finding is consistent with Soederberg (2003) in respect of the dominant role of the international organization in influencing the choice of corporate governance globally.

Table 8. Names of organizations that influence Swaziland's corporate governance reforms (Panel A: Questions 3B)

Which of the following organizations do you think influenced Swaziland's corporate governance reforms?	Influential / high influential	No influence / Low influence / very low influence
International labour organization (ILO)	34	24
International Monetary Fund (IMF)	**58**	**Nil**
The Swaziland Trade and Labour Union	34	24
The World Bank (WB)	**49**	**9**
Organization for Economic Cooperation and Development (OECD)	38	22
United Nations Conference on Trade and Development (UNCTAD)	36	22

We also find that South African Custom Union (SACU) and South African Development Community (SADC) are the two most influential regional organizations which influenced Swaziland's choice of corporate governance reforms (see Table 9). These findings are consistent with external pressures argument that underlies D and P's institutional convergence notions. The bodies have the potentials to benefit Swaziland. For example, the IMF and WB provide developmental loans and financial supports to member states. Similarly, the SACU and SADC are important sources of huge financial and developmental benefits to member states and are therefore influential in the choice corporate governance and internal policies of member states.

Table 9. Names of organizations that influence Swaziland's choice of corporate governance reforms (Panel B:Questions 3C)

Which of the following organizations do you think influenced Swaziland's choice of corporate governance reforms?	Influential/ high influential	No influence Low influence/very low influence
South African Custom Union (SACU)	**45**	**13**
South African Development Community (SADC)	**44**	**14**
New Partnership for Africa's Development (NEPAD)	38	20
Common Market for Eastern and Southern Africa (COMESA)	39	19
African Union (AU)	31	27
Others (e.g. Commonwealth)	14	15

Mimetic Pressures

D and P suggested that focal organization imitate similar organization that they considered to be better performing especially in a situation of uncertainty or strategic ambiguity. To explore this, we asked respondents a number of related questions and also asked them to ranks countries that they considered to be influential in Swaziland's choice of corporate governance reforms. Respondent agree that countries do imitate one another and majority of respondents believe that the choice of corporate governance reforms in Swaziland is largely influenced by developments in South Africa (see Table 10). Swaziland has adopted the South African King report II and would soon adopt the latest version as its own corporate governance code. This is a clear indication of where the influence is coming from and how it is shaping the corporate governance in the country.

Table 10. Names of countries that influence Swaziland's choice of corporate governance reforms

Countries have greatest influence on Swaziland's choice of corporate governance reforms	Number of Respondents				
	Ranked				
	1	*2*	*3*	*Total 1-3*	*Rank*
USA	14	16	23	53	2nd
UK	13	16	20	49	3rd
South Africa	**36**	**13**	**8**	**57**	**1st**
Nigeria	Nil	Nil	13	13	9th
Taiwan	10	12	10	32	4th
Russia	Nil	Nil	14	14	8th
China (Main Land China)	Nil	7	13	20	6th
Egypt	Nil	3	13	16	7th
Mozambique	6	9	8	23	5th
Others (e.g. Arab States)	Nil	Nil	12	12	10th

Normative Pressures

D and P describe normative pressure as those arising due to professionalism and managerial conditioning in order to achieve fits with the current practice in an organizational field. Normative isomorphism may appear vague at the national or country level but it could be better appreciated from its impacts on human resources development and broadly on a nation's social capital. We identified the role of Swaziland Institute of Accountant (SIA) and its affiliation with international and regional professional associations as sources of normative influence for corporate governance in the country. Respondents were asked to list the names of professional associations that are considered most influential in Swaziland's corporate governance reforms. Table 11 presents our findings.

Table 11. Professional associations influence Swaziland's corporate governance reforms

Name of the Professional Associations	Number of Respondents
The Swaziland Institute of Accountants (SIA)	52
Chamber of Commerce	24
Swaziland Law Society	31
International Bar Association	6
Federation of Swaziland Employers & Chamber of Commerce (FSE&CC)	33
Swaziland Association of Architects, Engineers & Surveyors	4
Institute of Personal & Training Managers	17
Swaziland Association of Auditors	38
Institute of Directors (RSA)	23
Banks Associations	16
Swaziland National Association of Teachers	2
ACCA	12
SAICA (South African Institute of Chartered Accountant	15
CIMA	9

Increase professionalism could lead to more structured and uniform approach to training as every entrant into a profession have to pass their formal professional examinations which are conditioning device to ensure consistencies and uniformity in knowledge, perception and values. Specifically in accounting, Swaziland Institute of Accountant (SIA) established through Act No 5 in 1985 is the only professional accounting body in the country. SIA is a full member of the International Federation of Accountants (IFAC) as well as the Eastern, Central and Southern African Federation of Accountants (ECSAFA). Apart from qualifying examinations, the SIA also provides regular training and technical updates, and members have to undertake continuous professional developments (CPD). This suggests practicing accounting professionals in the country have common minimum level of knowledge and skills sets, which act as a conditioning device. Consequently, increased global awareness in corporate governance is easily transferred into the country through association with IFAC and ECSAFA. The other normative influence is through the change in the syllabus of the international professional accountancy body such as the ACCA, which reflect current ethical and corporate governance development globally.

Conclusion

This study sets out to explore the drivers for corporate governance reforms in a country with less incentive for it. The study extrapolates Di Maggio and Powell (1983) on national governments motives for corporate governance reforms. Using questionnaires administered on accountants and registered auditors in Swaziland, the study found evidence that suggest that corporate governance in the country is motivated by instrumentalist reasons whereby reforms are embarked upon as a signal to international observers in order to attract foreign direct investments. It documents finding that supports the notion that national governments in these settings adopt corporate governance reforms to enjoy competitive advantage consistent with the instrumentalist arguments. Secondly, the study found that IMF and the WB are two international organizations that have significant influence in countries' choice of corporate governance reforms and this was found to be the case in Swaziland as well. It is therefore not surprising to note that Swaziland has recently agreed to have the IMF led assessment on the level of transparency and disclosures in the country. This is through the Reports on the Observance of Standards and Codes initiative. Furthermore, the study found that the SACU and SADC are two influential regional organizations that impacts on Swaziland's choice of corporate governance reforms.

It also documents evidence of coercive, mimetic and normative pressures on the choice of a focal country to adopt corporate governance reforms. The coercive forces stem from international organizations such as the IMF and WB, and regional organizations such as the SACU and SADC while the mimetic force is largely from South Africa. The normative pressure for corporate governance reforms in the country appears to emerge from the greater global awareness on corporate governance and due to the country's professional affiliation with international and regional accounting professional organizations. Thus corporate governance reforms appear to be adopted for contingency purpose due to developmental uncertainty.

It is important to identify that national corporate governance reforms are institutionally determined however, that these institutional factors are heterogeneous. In order to understand the mix and blend of the corporate governance mechanism to adopt in a country, it is crucial to have a clear understanding of the major drivers of the reforms. This is also important in order to contextualize the growing debate on the desirability or otherwise of corporate governance convergence.

This study suggests that arguments on the market incentives for instituting corporate governance reforms are not general and are only tenable in specific market settings. This therefore questions the motives for instituting these reforms in setting other than those with ample incentives for beneficial governance reforms compare to jurisdictions characterized with poor market infrastructure and political infancy.

This study's finding has significant policy implications and potentials to improve our understandings of corporate governance practices in an unusual institutional setting and identifies future opportunities for corporate governance research. This study opens up a number of potential options for future research in order to further crystalise our thoughts on the determinants of optimal corporate governance mix and bundles and indeed on variables that shapes the meaning and implications of corporate governance in difference context. Future studies may therefore wish to explore the role of different social actors in alluding meaning and context to corporate governance and how this may influence governance mechanism. Such research may explore the intersection in the views and perceptions of such actor with diverse background to uncover their latent differences and use this to broaden the discourse on whether and how country specific antecedents and training inform individuals' views on corporate governance reforms within a national context. Furthermore, while this present study has focused on a single country, future studies may seek to explore the comparative values of different governance mechanisms within an institutional context with a view to unpacking the effects of other salient institutional factors such as culture, varieties of capital and national path dependence on choice of corporate governance reforms especially in a developing country context. This will expand the discourse on the impact of institutional framework on national reforms initiatives beyond the usual shareholders' projection and legal orientation that is so popular in existing literature.

Note

[1] Organizational Reinvention has been used synonymously with its reconfiguration in this paper

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Appendix

Dear Respondents,
Thank you for your time in answering the questions below, which should only take about 10minutes. The study is about Understanding the Key Drivers for Corporate Governance Reforms in Swaziland. We assure you on the confidentiality of the information provided which is strictly for the purpose of this research. We would be glad to share our finding with you if you require. Your time is highly valued and appreciated.

(1) Please give your assessment of the maturity of Swaziland economy for the type and style of corporate governance reforms. With a (X) mark, please indicate the option which reflects your views:

VM = Very Mature, M=Mature, D= Don't Know, IM =Immature, VIM= Very Immature.

How would you describe the maturity of the Swazi economy for the style and type of corporate governance reforms?	VM	M	D	IM	VIM

(2) Economic Drivers:

(2. A) Please RANK the following drivers for corporate governance reforms in Swaziland according to their importance. (Rank with Number e.g. 1, 2, 3,….)

Economic Development	
Attract Foreign Direct Investment (FDI)	
Signal Transparency and Accountability	
Foreign Loan and Supports	
Millennium Development Goals	
Political Stability	
Irrelevant to Swaziland	
Global Acceptability	
Democracy	

To what degree do you personally agree/disagree with the following statements? With a (X) mark, please indicate the option, which reflects your views: SA = Strongly Agree, A=Agree, D = Disagree, SD = Strongly Disagree, U = Uncertain or No Opinion

(2. B)

Corporate governance is only necessary in a country with significant number of listed companies on the Stock Exchange	SA	A	D	SD	U
Corporate governance is very important in Swaziland	SA	A	D	SD	U
Corporate governance reforms in Swaziland is influenced by the need to attract Foreign Direct Investment (FDI)	SA	A	D	SD	U

(3) External Drivers:

(3. A)

Corporate governance in Swaziland is driven due to international pressures	SA	A	D	SD	U
International organizations are key influence in Swaziland's corporate governance reforms	SA	A	D	SD	U
Regional Bilateral and Multilateral organizations are crucial in Swaziland's choice of corporate governance reform	SA	A	D	SD	U

With the following statements, please select in order of influence high to low influence with a (X) mark: HI= High Influence, I= Influential; No influence, LI= Low influence and VLI= Very Low Influence

(3.B) Which of the following organizations do you think influenced Swaziland's corporate governance reforms?

International Labour Organization (ILO)	HI	I	N	LI	VLI
International Monetary Fund (IMF)	HI	I	N	LI	VLI
The Swaziland Trade and Labour Unions	HI	I	N	LI	VLI

World Bank (WB)	HI	I	N	LI	VLI
Organization for Economic Cooperation and Development (OECD)	HI	I	N	LI	VLI
United Nations Conference on Trade and Development (UNCTAD)	HI	I	N	LI	VLI

(3.C) Which of the following organizations do you think influenced Swaziland's choice of corporate governance reforms?

South African Custom Union (SACU)	HI	I	N	LI	VLI
South African Development Community (SADC)	HI	I	N	LI	VLI
New Partnership for Africa's Development (NEPAD)	HI	I	N	LI	VLI
Common Market for Eastern and Southern Africa (COMESA)	HI	I	N	LI	VLI
African Union (AU)	HI	I	N	LI	VLI
Others (please include)	HI	I	N	LI	VLI

To what degree do you personally agree/disagree with the following statements? With a (X) mark, please indicate the option, which reflects your views: SA = Strongly Agree, D = Disagree A = Agree, SD = Strongly Disagree, U = Uncertain or No Opinion

(4) Location Drivers:

(4. A)

Geographical location of a country could affect its choice of corporate governance reforms	SA	A	D	SD	U
It is easier to imitate neighbouring countries than other countries	SA	A	D	SD	U
Countries copy practices in other countries that are closer to them	SA	A	D	SD	U
Countries follow practices in other countries that are considered better	SA	A	D	SD	U
Choice of corporate governance could be due to imitating practices in other countries	SA	A	D	SD	U

Which of the following countries has greatest influence on Swaziland's choice of corporate governance reforms? Please RANK in order of influence. (Rank with Number e.g. 1, 2, 3…)

- [ ] USA
- [ ] UK
- [ ] South Africa
- [ ] Nigeria
- [ ] Taiwan
- [ ] Russia
- [ ] China (Mainland China)
- [ ] Egypt
- [ ] Mozambique
- [ ] Others (please specify…………………………………..)

To what degree do you personally agree/disagree with the following statements? With a cross (X) mark, please indicate the option, which reflects your views: SA = Strongly Agree, D = Disagree A = Agree, SD = Strongly Disagree, U = Uncertain or No Opinion

(5) Human Resources Drivers:

Country's choice of corporate governance reforms is influenced by the quality of human resources development	SA	A	D	SD	U

Professional associations are very important in building required manpower stock for development	SA	A	D	SD	U
Uniformity in training and education is important in ensuring high quality manpower development	SA	A	D	SD	U
Professional bodies in Swaziland have benefited from International Affiliations and membership	SA	A	D	SD	U
Increased professionalism in Swaziland has been a key factor in corporate governance reforms in Swaziland	SA	A	D	SD	U

List key professional association that you considered influential in Swaziland corporate governance reforms:
1)
2)
3)
4)
5)

The level of awareness about corporate governance within Swaziland Institute of Accountants members is very high	SA	A	D	SD	U

If you would like to receive a copy of the research findings, please provide your e-mail address below:
E-mail:

Thank you for your time

ACCRUAL QUALITY: THE PRESENCE OF WOMEN DIRECTORS ON AUDIT COMMITTEE BOARDS

Zalailah Salleh, Hafiza Aishah Hashim*, Nor Raihan Mohamad

Abstract

This article examines whether the participation of women on audit committee boards enhances audit committee effectiveness to control earnings management practices. While numerous studies have investigated the effects of women audit committee on earnings management, empirical evidence is rather inconsistent. Therefore, it is imperative to investigate the impact of female representation on audit committee effectiveness. In order to address the objective of the study, we use cross-sectional version of the performance-adjusted current discretionary accruals model to detect earnings management (Kothari, Leone and Wasley, 2005). Using a sample of 356 companies for the year ended 2007; we found a significant negative relationship between the presence of women directors on audit committee boards and earning managements. The results suggest that the presence of women directors on audit committee boards reduces earning management practices.

Keywords: Audit Committee, Accrual Quality, Gender Diversity, Earnings Management, Malaysia

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1. Introduction

Research concerning the audit committee characteristics and earnings management has increased dramatically in recent years. Previous research has investigated the association between audit committee characteristics and earnings management. However, despite the increased attention, there is a limited knowledge on the impact of increased women representation on audit committee effectiveness. Women representation on the audit committee boards is one of the sources of diversity in corporate boards. Businesses led by diverse boards that reflect the whole breadth of their stakeholders and their business environment are perceived to be more successful businesses. By having comprehensive board diversity, the board is perceived to be more capable of understanding risks and more capable to come up with robust solutions to address business problem.

A comprehensive diversity in corporate boards is fundamental for healthy businesses because it is imperative to have diversity of thought, experience, knowledge, understanding and perspective. Therefore, it is imperative to investigate the impact of female representation on audit committee effectiveness.

An audit committee plays significant roles in financial reporting as to ensure compliance with the regulatory requirements and auditing standards. Audit committee characteristics are suggested to be factors that influence their effectiveness (Song and Windram, 2004). Previous research have investigated an association between audit committee characteristics and earning managements (Klein, 2002, Bedard et al., 2004, Gul et al 2007 and Sun et al 2011). Gul et al (2007) and Sun et al (2011) specifically investigate the women representation on audit committee board; however both studies provide mixed results. Therefore previous research provides inconclusive results on the influence of gender diversity on the board on earning management. Thus it warrants further research to investigate whether women representation on audit committee board affects earnings management. In addition, previous research was conducted in the U.S listed firms.

In this paper, we attempt to address this gap in the research literature. In particular, we examine the association between earnings management and the gender of the board of audit committee. Previous literature suggests that women directors are more conservative, risk averse, high moral standards and more trustworthy than men, and are thereby less likely to manipulate corporate financial and other disclosures. Therefore, we hypothesize the increase in women representation on the board of audit committee; the committee becomes more effective in constraining the extent of earnings management. In particular, we expect a stronger negative relationship between the level of earnings management and women board directors. This

stronger negative relationship translates into a more limited ability for the board to manage earnings.

The study is based on a sample of 356 Malaysian companies for the year ended 2007. Results of a regression analysis confirm that there is a significant negative relationship between the presence of women directors on audit committee boards and earning managements. The results suggest that the presence of women directors on audit committee boards reduces earning management practices.

The reminder of this paper is structured as follows. Section 2 presents a review of the relevant literature and outlines hypotheses development, followed by the research design in Section 3. Section 4 examines the main hypotheses and presents the findings. Finally Section 5, some conclusions are drawn and the implications and limitations of the study are discussed.

2. Literature Review

2.1 Audit Committee and Earnings Management

Audit committees are formed to provide critical oversight of companies' financial reporting process. Particularly, the primary purpose of their formation is to enhance the credibility of audited financial statements. The committees are expected to act independently to resolve conflicts between the management and external auditors (Klien, 2002). In particular, the audit committees can act as an arbiter between management and the auditors by providing a formal communication channel between the board, management and the external auditor (Cohen et al, 2007, Turley and Zaman, 2004). In addition, audit committees are perceived to play a key role in constraining earnings management and enhancing earning quality (Klien, 2002; Bedard et al, 2004). Earnings management has been defined as an intentional alteration in the financial information to obtain private gain (Schipper, 1989). Earnings management practices are perceived to be unethical conducts because they involve a selection of accounting treatments resulting in biased reported earnings. It has been long acknowledged that managers may have incentives to manipulate accounting earnings by employing aggressive earnings management. Accounting earnings are considered the most widely used measure of company performance. Therefore, the practices mislead financial statement users about the underlying economic performance of the company. Moreover, it is widely recognized that the quality of financial reporting may depend on managerial motives and characteristics. Thus, the opportunism of the firm's managers tends to reduce earnings quality. Earnings management therefore, is of great concern to corporate stakeholders.

Previous research to a certain extent has documented that audit committee characteristics influence audit committee effectiveness in providing critical oversight of companies' financial reporting process and serving as an important governance mechanism. Audit committee independence, audit committee expertise and audit committee diligence are those characteristics of concern to researchers and regulators. Zhang et al (2007) investigate the relation between audit committee characteristics and the disclosure of internal control weaknesses. In particular, an entity's internal control is one of governance mechanisms and it is under the purview of its audit committee. Audit committee expertise was suggested to continue to be an important determinant of internal control weaknesses. Pomeroy and Thornton (2008) delineate measures being used in investigating audit committee financial reporting oversight roles. Aggressive earnings management was used to proxy a low level of financial reporting quality. Previous studies examine the relationship between earnings management and the characteristics of audit committees (Klein, 2002, Xie et al., 2003, Bedard et al., 2004). In particular, they examine whether audit committee characteristics affects the ability of the committees in constraining earnings management and thus their effectiveness in overseeing the financial reporting process. Klein (2002) examines whether the magnitude of abnormal accruals (the proxy for earnings management) is related to audit committee independence. The study uses a sample of 692 publicly traded U.S. firm-years, and finds that a higher proportion of outside directors on an audit committee is associated with lower earnings management. Bedard et al (2004) focuses on a different characteristic namely audit committee members' expertise. The findings suggest that audit committee members' expertise affects earnings quality. Xie et al (2003) argue that earnings management is less likely to occur in companies whose audit committees are active and whose members have corporate or investment banking backgrounds. Further, a recent study by Marra et al. (2009) addresses the question of whether the board of directors is more effective in constraining earnings management after the mandatory application of IFRS. Specifically, they explore how board independence and the existence of an audit committee impact earnings management. The findings further confirm that a company's corporate governance characteristics remain an important determinant of earnings quality.

In sum, previous results consistently indicate that earnings management is negatively related to audit committee independence, audit committee diligence and audit committee expertise. Therefore, a proper structured audit committee is expected to reduce earnings management because they provide effective monitoring of management in the financial reporting process. While these studies document audit committee characteristics are negatively related to

earnings management, but they do not investigate another source of diversity on the audit committee board namely gender.

2.2 Gender Diversity

Quantitative studies using publicly available data were conducted to examine the relation between women representative on audit committee board and earnings management, however provide mixed results. A study by Sun et al (2011) examines the impact of female directorship on the effectiveness of audit committees in constraining earnings management. They employed a sample of 525 firm-year observations over the period 2003 to 2005. They found that the proportion of females on the audit committee is not associated with earnings management. However, an earlier study by Gul et al. (2007) that used a sample of 1,508 firm-year observations for years 2001 and 2002, find that earnings management is lower if at least one female director sits on the audit committee. In addition, survey studies were conducted to address the relationship between earnings management and gender. However, both studies by Clikeman et al. (2001) and Al-Hayale and Lan (2004) find no significant differences in the men's and women's attitudes about earnings management. Previous studies provide inconsistent evidence whether gender diversity is related to earnings management, therefore, warranted further research on this issue.

A considerable corporate finance and management literature suggests that gender diversity to a certain extent has an implication on firm's financial performance. With the premise that gender diversity may lead to a wider knowledge base, which in turns may create a competitive advantage compared to companies with non-diversified boards; previous studies examine the effects of female executives and directors on the firm's financial performance, market value and accounting information. For example, Peni and Vahamaa (2010) investigate the effects of female executive on the quality of accounting information. The findings suggest that firms with female CFOs are associated with income-decreasing discretionary accruals, thereby implying that female CFOs are following more conservative financial reporting strategies. Thus, female representation may enhance the functioning and efficiency of corporate boards and committees and, more generally, that executive gender may affect managerial behavior. Female executives are argued to improve decision making by bringing different perspectives and opinion into discussion (Fondas and Sassalos, 2000). In addition, females are argued to be more conservative, risk averse, high moral standards and more trustworthy than men. Women are expected to be more risk averse, which impacts the types of investments they make, and men are thought to have more confidence with money matters (Barber and Odean, 2001; Bliss and Potter, 2002). Women are thought to be more focused on helping people, while men are more concerned with making money and getting ahead in their companies (Bernardi and Arnold, 1997; Betz et al., 1989). These studies suggest that women are less likely to engage in unethical behavior in the workplace to gain financial rewards. Further, Bruns and Merchant (1990) establish that earnings management is an ethical issue, and Merchant and Rockness (1994) argue that earnings management practices raise the most important ethical issues facing the business profession.

3. Hypothesis Development

The existing literature shows that the earnings management is associated with audit committee characteristics. The characteristic of audit committees are argued to be a source of diversity on the board. A diversified board is argued to be more effective than homogenous boards because they can bring different perspective and opinions into a discussion. Further, females are argued to be more conservative, risk averse, high moral standards and more trustworthy than men. Thus, we examine the following hypothesis:

H1: Audit committees with higher women representatives are associated with more effective in constraining earnings management

4. Research Design

4.1 Sample Selection

The sample examined in this study was selected from the Main Board of Bursa Malaysia for the year end 2007. As at 31st December 2007, there were 636 financial and non-financial companies listed on Bursa Malaysia's Main Board. Due to different statutory requirements and materially different types of operations, all banks, insurance and unit trust companies as well as utilities companies were excluded from the population of interest (Davidson *et al.*, 2005; Peasnell *et al.*, 2005; Abdul Rahman and Mohamed Ali, 2006). After eliminating industries with less than eight firms (Davidson *et al.*, 2005; Abdul Rahman and Mohamed Ali, 2006) and complete corporate governance data, the final sample consist of 356 non-financial companies listed on Bursa Malaysia's Main Board.

4.2 Regression Model

This study used a linear multiple regression analysis to test the association between the dependent variable of discretionary current accruals and the independent variable of the presence of female directors on audit committee board:

$PACDA = \alpha_0 + \beta_1\ ACFEMALE + \beta_2\ ACIND + \beta_3\ ACFE + \beta_4\ ACSIZE + \beta_5\ ACMULTIPLE + \beta_6\ ACMEET + \beta_7\ LGSIZE + \beta_8\ LEV + \beta_9\ ROA + \beta_{10}\ CFO + \varepsilon$

The dependent variable is earnings management measured by the absolute value of discretionary current accruals, scaled by lagged total assets *(PACDA)*. The independent variable consists of the presence of female directors on audit committee board measured by the proportion of female directors to the total number of audit committee members on the board of the company (*ACFEMALE*).

Consistent with prior studies (Peasnell *et al.*, 2000; 2005; Bedard *et al.*, 2004; Davidson *et al.*, 2005; Jaggi *et al.*, 2009), this study include audit committee independence *(ACIND)*, audit committee financial expertise *(ACFE)* audit committee size *(ACSIZE)*, audit committee multiple directorships *(ACMULTIPLE)*, audit committee meeting *(ACMEET)*, firm size *(LGSIZE)*, leverage *(LEV)*, return on assets *(ROA)* and cash flow from operation *(CFO)* as control variables in the regression model.

4.3 Dependent Variable

Recent study argued that current discretionary accruals are more subject to earnings manipulation and firm performance should also be considered in calculating discretionary accruals (Jaggi *et al.*, 2009). Taking these two factors into consideration, this study applies a cross sectional version of the performance-adjusted current discretionary accruals (PACDA) model to detect earnings management (Kothari *et al.* 2005).

$$TCA_{it}/AT_{it-1} = \alpha_0\,(1/AT_{it-1}) + \beta_1\,(\Delta REV_{it}/AT_{it-1}) + \beta_2\,(ROA_{it-1}) + \varepsilon_{it} \quad (1)$$

$$ECA_{it}/AT_{it-1} = \alpha_0\,(1/AT_{it-1}) + \beta_1\,(\Delta REV_{it}\text{-}\Delta AR_{it}/AT_{it-1}) + \beta_2\,(ROA_{it-1} \quad (2)$$

$$PACDA = TCA_{it}/AT_{it} - ECA_{it}/AT_{it-1} \quad (3)$$

Where;

TCA_{it}	=	total current accruals is net income (earnings before extraordinary items and discontinued operations) plus depreciation and amortization minus operating cash flows for firm *i* in the year *t*
ΔREV	=	change in revenue for firm *i* in the year *t*
ΔAR	=	change in accounts receivable for firm *i* in the year *t*
ROA	=	Ratio of net income before extraordinary items to total assets for firm *i* in the year *t-1*
AT	=	Total assets for firm *i* in the year *t*
ε_{it}	=	Error term for firm *i* in the year *t*

Consistent with Jaggi *et al.* (2009), the ordinary least squares (OLS) regression model was used to estimate industry specific parameters α and β. To estimate the industry specific parameter, Equation 2 was used comprising of data from all companies matched on the year of observation and categorized in the same industry grouping. Having estimated equation 2, the amount of discretionary accruals (PACDA) is calculated as the difference between the firm's total current accruals (TCA) and its expected current accruals (ECA). All variables in the accrual expectation model are deflated by total opening assets to reduce heteroscedasticity (Jones, 1991).

4.4 Descriptive statistics

Table 1. Descriptive Statistics for Dependent and Independent Variables

	Min	*Max*	*Mean*	*Std. Deviation*
ABSPACDA	0.00	0.71	0.06	0.07
ACFEMALE	0.00	0.67	0.05	0.12
ACIND	0.00	1.00	0.72	0.11
ACFE	0.00	1.00	0.34	0.16
ACSIZE	0.00	7.00	3.60	0.74
ACMULTIPLE	0.00	1.00	0.56	0.31
ACMEET	0.00	18.00	4.85	1.25
LGSIZE	4.46	7.65	5.78	0.50
LEV	0.01	0.91	0.43	0.20
ROA	-0.40	0.78	0.10	0.09
CFO	-1.87E5	7.07E6	1.5748E5	6.13742E5

As reported in Table 2, the mean of earnings management value as indicated by the absolute value of *PACDA* is 0.06 with minimum and maximum value of zero and 0.71, respectively. In terms female domination, the proportion varies from zero to about 67percent, with an average proportion of female directors on audit committee board of about 5 percent. The average, 5 percent, of the presence of female directors on audit committee board indicates the domination of male directors in the audit committee composition in Malaysia.

With respect to correlation among variables, the correlation matrix tested in the study confirms that no multicollinearity exists between the variable since none of the variables correlates above 0.80 or 0.90.

5. Results

5.1 Regression

Table 2. Regression Results

	Coefficients	t	Sig.
ACFEMALE	-.085	-1.685	.093*
ACIND	.029	.567	.571
ACFE	-.042	-.808	.420
ACSIZE	-.063	-1.185	.237
ACMULTIPLE	-.018	-.329	.743
ACMEET	.124	2.343	.020**
LGSIZE	-.241	-3.389	.001***
LEV	.201	3.602	.000***
ROA	.165	3.152	.002***
CFO	.339	5.525	.000***

***Significant at 0.01 level; **Significant at 0.05 level; *Significant at 0.1 level.

Consistent with expectations, this study finds a negative significant ($\rho < 0.10$) association between the presence of female directors on audit committee board *(ACFEMALE)* and discretionary current accruals *(PACDA)*. The negative relationship suggests that the increase in women representation on the board of audit committee limits the ability for the board to manage earnings. In particular board of audit committee is suggested to become more effective in constraining the extent of earning management when more representation of women on the board. This is because women are more conservative, risk averse, high moral standards and more trustworthy than men, thereby less likely to manipulate corporate financial and other disclosures.

5.2 Discussion on Control Variables

Out of nine control variables included in the model, five were found to be significant. The coefficients on audit committee meeting, leverage, return on assets and cash flow from operation are positive and significant with discretionary current accruals. The coefficient on size is negative and significant with discretionary current accruals. None other controlled variables were found to be significant in the study.

6. Conclusion

The main objective of this study is to examine the association between earnings management and the gender of the board of audit committee. This study applies a cross sectional version of the performance-adjusted current discretionary accruals (PACDA) model to detect earnings management (Kothari *et al.* 2005). Using a sample of 356 companies for the year ended 2007, we found a significant negative relationship between the presence of women directors on audit committee boards and earning managements. The results suggest that the presence of women directors on audit committee boards reduces earning management practices. This study contributes to our understanding that women representations on the board of audit committee are effective to minimize agency cost in an East Asian Country like Malaysia.

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EARNING QUALITY IN LISTED FIRMS: HOW MUCH AN ACTIVE FAMILY GOVERNANCE IS DESIRABLE?

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Abstract

The study investigates the relationship between family involvement in the governance of Italian listed companies and earnings quality (EQ). Family firms set incentives to extract private benefits ('entrenchment' effect), but, they also contribute to higher alignment between owners and managers ('alignment' effect). The literature shows mixed results about the relationship between EQ and family firms. We argue that family involvement in the governance affects EQ. The empirical evidence shows that in the Italian context, there is higher EQ in case of higher family involvement in the board, but only if the CEO is not belonging to the controlling family. On the contrary, in case of a family CEO, the higher family involvement in the board increases his entrenchment, reducing EQ. The results are valuable because we find that EQ in family firms is affected both by family ownership and by the attitude of the family toward governance practices.

Keywords: Family Firms, Board Familiness, Governance Practices, Earnings Quality, Alignment Effect, Entrenchment Effect

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Introduction

This study aims at contributing to the increasing stream of literature on the economic efficiency of listed family companies under the perspective of information transparency, with a focus on the relation between earnings quality, family involvement and corporate governance practices.
Accounting practices pursued by family firms remain particularly under-explored (Salvato and Moores, 2010). Moreover, the studies about the topic don't obtain unanimous results. It is a diffused common thinking that listed family firms are less transparent than publicly held companies, due to excessive power of controlling shareholders and ineffective monitoring systems counterbalancing it (Bebchuk et al., 1998; Fama & Jensen 1983; Morck et al., 1998, Shleifer & Vishny, 1997; Schulze, Lubatkin, Dino and Buchholtz, 2001; Fan & Wong, 2002; Francis et al., 2005). It is due to the so-called "entrenchment effect": concentrated ownership creates incentives for controlling shareholders to expropriate wealth from other shareholders and to manipulate earnings for private rents (Fama & Jensen, 1983; Morck et al., 1988; Shleifer & Vishny, 1997).

On the other hand, family firms benefit from the natural alignment between management and shareholders' interests, sharing the common purpose of creating value in the long run. And even if a non family-member is acting as CEO, the controlling family monitors management more effectively than in large public companies (Demsetz & Lehn, 1985; Shleifer & Vishny, 1986). Families have higher incentives to report good earnings quality for preserving their reputation for future generations and for long-term profitability (Weber et al., 2003). This is the so-called "alignment effect": the interests of families and other shareholders are aligned thanks to their long-term orientation. In this perspective, family firms are likely to report earnings of higher quality than non-family firms (Wang, 2006). In spite of the existing literature gap on the relationship between earnings quality (hereinafter also EQ), "familiness" and corporate governance practices, the topic is also relevant in order to better explain the agency problems affecting family firms.

In particular, family-controlled companies face less severe Type I agency problems arising from the separation between ownership and control but have higher Type II agency problems characterizing the relationship between controlling and non-controlling shareholders (Jensen and Meckling, 1976; Gilson and Gordon, 2003). These problems affect the quality of reported earnings.

In particular, the paper discusses if and how governance practices affect earnings quality. We argue that higher family involvement in the board leads to more effective monitoring activities and thus to higher EQ (alignment effect prevailing), but only when the CEO is not a member of the family.

On the contrary, if the family dominates the board together with a family CEO there are stronger incentives to extract private benefits with lower information transparency (entrenchment effect prevailing). The findings support our hypotheses.

The empirical analysis is performed through a sample of Italian listed companies, highly characterized by family capitalism.

Our results are valuable because they underline that EQ in family firms is not only affected by family ownership, but mainly by family involvement in governance practices, and in particular by CEO role. Moreover, these results could be useful both for financial statements users, suggesting that company's ownership structure and its corporate governance practices should be considered when using accounting data, and for policy makers in defining corporate governance incentives.

The paper is structured as follows. Firstly, the literature on EQ and family firms is reviewed. Then, the research hypothesis is developed. A following section explains the methodology of the analysis. The presentation of empirical results, their discussion and the conclusions close the article.

Literature Review

Family Firms and agency costs

Family firms represent a typical example of ownership concentration, controlled either by an individual or by a family. Family companies face less severe Type I agency problems (Berle & Means, 1932; Jensen & Meckling, 1976; Roe, 1994), especially when the leaders are either family members or linked to the family (Bertrand & Schoar, 2006; Miller & Le Breton-Miller, 2006), with alignment effect prevailing (Wang, 2006). But, on the other hand, they are more characterized by severe Type II agency problems (Gilson and Gordon, 2003; Shleifer & Vishny, 1997; La Porta et al., 1999), with a prevalence of the entrenchment effect (Wang, 2006). Prior studies suggest that minorities expropriation is likely to be more severe when the controlling shareholders are also managers and when countries' legal protection and enforcement of securities law are poor (La Porta et al., 1999).

Literature does not come to unique results about the economic efficiency and performance of family firms. Some authors, in fact, found that increasing the controlling shareholders' ownership it is possible to enhance the alignment of interests between them and minority shareholders (Fan & Wong, 2002; Fahlebrach, 2004; Gomes, 2000; Morck et al., 1988; Palia & Ravid, 2002; Shleifer and Vishny, 1986). Some other authors, instead, found that the stock market reacts negatively to the appointment of family heirs as managers (Smith and Amoako-Adu, 1999; Perez-Gonzàlez, 2001).

Family firms and the board of directors

The board of directors (BoD) is considered a mechanism insuring that management acts in the interests of shareholders (Shleifer and Vishny, 1997).

In case of dispersed ownership, the BoD could minimize agency problems (Fama and Jensen, 1983), always retaining ultimate control (Beasley, 1996), because its main role is to advise and support the management (Corbetta and Salvato, 2004b),

But in case of concentrated ownership, such as family firms, studies about family role in the BoD do not provide unique results.

On the one hand, in fact, family controlling owner can directly monitor the managers (Anderson & Reeb, 2003b; Demsetz & Lehn, 1985; Shleifer & Vishny, 1997; Luoma & Goodstein, 1999; Sundaramurthy & Lewis, 2003) having much longer investment horizons compared to other shareholders and helping in mitigating myopic investment decisions by managers (James, 1999, Kwak, 2003, Stein, 1989), consistently with the "alignment effect" of family ownership (Wang, 2006). Furthermore, families have incentives to create long-term employees loyalty (Weber et al., 2003). Firms with a relatively high level of goal alignment are even less likely to have a board of directors (Pieper et al., 2008; Jaskiewicz & Klein, 2007).

On the other hand, family members operating both as managers and as directors tend to dominate and extract private benefits (Anderson & Reeb, 2003a; Anderson & Reeb, 2004; Gilson & Gordon, 2003; Shleifer & Vishny, 1997). Thus, these firms may have inferior corporate governance and lower accountability because of ineffective monitoring by the board, which often simply ratifies the decisions taken by the majority shareholders. This is consistent with the "entrenchment effect" of family ownership (Wang, 2006).

Another controversial issue is CEO role inside the BoD. CEO often ends up controlling the composition of the board and lessening its monitoring role (Jensen, 1993; Hermalin and Weisbach, 1991). In this perspective, boards evolve over time as a function of the bargaining power of the CEO, and managers tend to reduce this power as their equity ownership increases resulting in a weak relationship between board structure and firm value (eDenis and Sarin, 1999; Hermalin and Weisbach, 1991; Mikkelson and Partch, 1997; Weisbach, 1988). Empirical evidence shows that family ownership creates value for all shareholders only when the founder is still active as CEO, while, in the firms run by descendent CEO, minority shareholders are worse than they could be in non family firms (Villalonga and Amit, 2006).

Family firms and the effect on earnings quality

Ownership structure affects the supply of financial reporting (Fan and Wong, 2002), together with corporate governance practices.

Prior research focusing on this relationship argues that high levels of ownership concentration may increase or reduce earnings informativeness depending on whether incentive effects or information effects dominate (Francis, Schipper, and Vincent, 2005), so that accounting earnings have a double role. In case of dispersed ownership, high levels of managerial ownership enhance earnings informativeness by aligning managers' interests with shareholders' (Warfield et al., 1995; Bushman and Smith, 2001; Christie and Zimmerman, 1994; Watts and Zimmerman, 1986). But, Fan and Wong (2002) argue that managers can use earnings management to maximize private benefits at the expense of other stakeholders.

Also in case of concentrated ownership, such as family firms, accounting earnings can have a double role. When the owner/family effectively controls a company he also controls accounting information even if the company is managed by non-family managers. In this case the reliability of firm's accounting information is reduced. Outside investors expect that the controlling owner reports accounting information more for outright expropriation than to reflect firm's true underlying economic situation (Fan & Wong, 2002), even through fraudulent accounting behaviors (Tiscini and di Donato, 2005).

In this context, family ownership could generate a twofold effect according to the alignment or entrenchment effect prevailing (Wang, 2006).

On the one hand, family firms convey financial information of higher quality compared to the non family ones (Cascino et al., 2010) thanks to the ability of controlling owner to directly monitor the managers (Ali A., Chen T.Y. and Radhakrishnan S., 2007; Anderson & Reeb, 2003b; Demsetz & Lehn, 1985; Shleifer & Vishny 1997; Anderson and Reeb, 2003a). This is consistent with the alignment effect of family ownership producing better EQ (Wang, 2006).

On the other hand, family owners being managers and directors tend to dominate and manipulate earnings (Anderson & Reeb, 2003a; Gilson & Gordon, 2003; Anderson & Reeb, 2004; Fama and Jensen 1983; Morck et al. 1988). This is consistent with the entrenchment effect of family ownership producing worse EQ (Wang, 2006).

Earnings quality and its different measures

In recent years the quality of financial reporting has become an increasingly interesting topic for the financial world. The academic literature embraces several definitions of EQ. Some of them focus on the persistence of earnings meaning that current earnings can be considered a good indicator of future earnings (Hodge, 2003; Chan et al., 2006); others consider the relation between accruals and cash flows (Mikhail et al., 2003). One of the main issues is the definition of "high quality" earnings. Kirschenheiter and Melumad (2004) state that high quality earnings are more informative and closer to the long-run value of the firm. In Continental-European countries the practice of conservative accounting is claimed as producing higher quality earnings, consistently with the definition of White et al. (2003). A possible explanation for the multiplicity of those different interpretations could be that different readers use information to make different decisions (Kirschenheiter and Melumad, 2004).

The main difficulty to treat EQ is the lack of a generally accepted measurement approach. Various measures have been proposed (Bernstein, 1993; Balsam et al., 2003; Dechow et al., 2004; Francis et al., 2006; Schipper and Vincent, 2003). In particular, Francis et al. (2004), identify seven measures of earnings quality widely used in accounting research. They characterize the seven earnings attributes as either "accounting-based" or "market-based" depending on the underlying assumptions about the function of financial reporting[1].

The accounting-based approaches use abnormal accruals as measures of EQ. The accruals models distinguish between normal or non-discretionary accruals (related to the firms' fundamental earnings process) and discretionary or abnormal accruals, assumed to be the result of intentional or unintentional accounting errors. Higher levels of abnormal accruals, not associated with companies' fundamental earnings process, are assumed to reduce the quality of earnings and, for this reason, are an inverse measure of EQ. Dechow and Dichev (2002) consider the importance of the matching function of accruals to cash flows and thus model accruals as a function of current, past, and future cash flows because accruals anticipate future cash collections/payments and reverse when cash previously recognized in accruals is received/paid[2].

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[1] The accounting-based earnings attributes consider cash or earnings (or other measures that can be derived from these, such as accruals) that are estimated using accounting data assuming that the function of earnings is to allocate cash flows to reporting periods via accruals. The market-based attributes take returns or prices as the reference construct and rely on both accounting data and returns data for their estimation assuming that the function of earnings is to reflect economic income as represented by stock returns (Francis et al, 2004).

[2] If "normal" accruals are the predicted value from a regression model of accruals associated with the firms' fundamental earnings process, then abnormal accruals represent estimation errors, which can be intentional or unintentional.

Research questions and hypotheses development

As the existing literature shows, the relationship between family ownership and EQ depends on the prevalence of entrenchment or alignment effect (Wang, 2006). We argue that the effect depends mainly on family involvement in the board and on the existence of checks and balances between decisional and control powers. So, the effects of family ownership on EQ are studied through family involvement in the governance bodies ("familiness").

We hypothesize that a higher family involvement in the board (i.e. board participation) leads to higher EQ but only if the CEO is not a family member. This is consistent with the evidence of nonlinear effects of familiness on performance (Sciascia and Mazzola, 2008).

The rationale is that the higher the family involvement in governance, the stronger the management monitoring activity by the family, with the alignment effect prevailing (Wang, 2006), unless the family becomes dominant and uses its power for its own interest, lowering the effectiveness of controls.

On the other hand, the lower the family involvement, the stronger the CEO excessive power if he is not a family member, with the entrenchment effect prevailing (Wang, 2006).

We expect that if the family is highly involved in the governance of the company, it will be more willing to protect its reputation through a transparent reporting (James, 1999; Kwak, 2003; Stein, 1989; Weber et al., 2003) and an effective monitoring role of family board members (Mustakallio, Autio and Zahra, 2002; Tagiuri and Davis, 1996), while, in contrast, a lower family involvement leads to higher information asymmetries between the board and the CEO (if he is not a family member) and higher incentives to earnings management[3].

But we expect the relationship to be different according to the familiness of the CEO. In case of a high family involvement coupled with an external CEO, we expect a higher EQ because of the effective monitoring and alignment attributable to family directors, balancing the power of the CEO and his earnings manipulation incentives.

We expect the same results in case of a family CEO but coupled with a low family involvement in the board. Also in this case the alignment effect prevails, thanks to direct ownership interests in the company (Mengoli, Pazzaglia and Sapienza, 2011). In this situation, CEO incentives to extract private benefits are mitigated by check and balance mechanisms.

Instead, in case of a family CEO along with many family members in the board, the entrenchment effect prevails because the family become dominant and checks and balances are ineffective. Non executive family directors are faithfully aligned to the decisions of the family CEO, implying that a higher family involvement in the board could increase the entrenchment of the family CEO, strengthening his excessive power (Burkart et al., 2003).

According to the general hypothesis of a positive effect of "checks and balances" on EQ, we formulate the following hypotheses.

Hypothesis 1: A higher family involvement in the board leads to higher earnings quality, but only when the CEO is not a member of the family.

The explanation of the above hypothesis is that higher board familiness increases the monitoring role of the family, but in case of a family CEO, the higher family involvement in the board increases the entrenchment of the family CEO, strengthening his excessive power. In this situation, in fact, check and balance mechanisms get to be ineffective.

Hypothesis 2: The presence of family CEOs leads to higher earnings quality, but only when it is not associated with high family involvement in the board.

The explanation of the above hypothesis is that the presence of a family CEO makes the alignment effect stronger thanks to his direct involvement in the ownership, but a dominant presence of family directors increases the entrenchment of the family CEO, strengthening his excessive power. In this situation, check and balance mechanisms get to be ineffective as well.

Family Firms in Italy

To test our hypotheses, we use a sample of Italian-listed companies. Italy is particularly suited for our purpose thanks to the high number of listed family firms where controlling families have a strong leadership (Corbetta and Minichilli, 2005; Bianco and Casavolta, 1999; Bianchi et al., 2001; Volpin, 2003; Brunello, Graziano and Parigi, 2003) and are usually involved in the activities of the firm through the appointment of family members to the board of directors or in CEO positions (Prencipe, Markarian, and Pozza, 2008).

In Italy there are very few publicly held companies, most companies are closely held and entrepreneurial families play a decisive role in the economic system performance. Moreover, in the last ten years, State controlling ownership has been reduced by privatizations with the spreading of a "coalition model" of companies' control, mainly based on shareholders agreements often involving families (A 2003 survey of listed non-financial Italian companies reports that 67% of these firms are

[3] In fact, family non-executive directors are much more active than other external non-executive or independent directors, thus causing the effect of family members involvement to be stronger than the effects of external independent directors (Davis, Schoorman, and Donaldson, 1997).

classified as family-controlled companies (Corbetta and Minichilli, 2005)).

Family ownership has also an effect on corporate governance systems because shareholders appoint both the board of directors and the controlling body.

In the last few years important reforms have strongly changed the features of corporate and financial markets law, which is nowadays characterized, at least formally, by a high degree of investor protection. Listed companies have also adopted a self-regulation code aligned with international best practices. Nevertheless, these reforms have not led to shareholding fragmentation nor to a decrease in family control. Thus, Italy is an important example of a country in which family capitalism is persistent even after important reforms in both corporate and financial regulation. So, Italian market represents a good setting to test the effects of *family governance* on financial reporting quality.

Methodology

The sample

The sample includes Italian companies listed on the Milan Stock Exchange Market (MSE) over the period 2002-2004. Banks, insurance companies, other financial intermediaries and public utilities were excluded from the study for different reasons. Firstly, family firms in these industries are quite absent and business activities are barely comparable with the ones where family firms are involved. Moreover, financial companies, in the observed period, had a different accounting regulation from other companies. Finally, public utilities have a special regulatory environment which is likely to influence incentives of earnings manipulation.

The sample was selected over the period preceding the adoption of the International Accounting Standards (IFRS), in order to avoid complexities related to the transition and implications of its adoption for EQ (Nevertheless we tested our hypotheses also considering two more years after IFRS adoption and the results were confirmed).

The Italian stock market is relatively small. The total number of companies listed on the MSE is 261, 262 and 263 in 2002, 2003 and 2004 respectively. Financial reporting data are taken from Datastream database. Due to some missing data and the selection criteria illustrated above, in order to provide homogeneity, the sample is restricted to 126 companies for every year (378 firm-year observations overall). Table 1 provides a description of the sample.

Table 1. Sample Composition

	YEAR 2002	YEAR 2003	YEAR 2004
Listed Companies on MSE	231	227	232
Financial companies and utilities	-92	-91	-99
Missing data (financial and/or governance)	-13	-10	-7
TOTAL SAMPLE	**126**	**126**	**126**

Methodology of the analysis

We use the residuals of the original Dechow-Dichev model as a measure for earnings quality (Dechow-Dichev, 2002)[4]. Earnings manipulation, and thus EQ, is strictly related to the management of discretionary items of financial statement, such as working capital, depreciation, R&D expenses. In the Italian context working capital items are the ones that better explain EQ as depreciation policies usually follow taxation rates and R&D activities are not so relevant for family firms. The working capital accruals are then the easiest items to be discretionarily manipulated, making the Dechow-Dichev model optimally fit the setting of the analysis.

Firstly, we confirmed the validity of the assumptions of the Dechow-Dichev (2002) EQ measurement model for our sample. Then, we calculated the EQ measure as the residuals from the regression of changes in working capital on past, present and future operating cash flows[5]. Finally, we performed two linear regression models in order to analyze the relation between the EQ measure and the independent and control variables.

The dependent variable: EQ measures from Dechow-Dichev

According to Dechow-Dichev (2002) method, we derived a practical measure of working capital accrual quality using the following firm-level time-series regression:

$$\Delta WCt = \alpha_1 + \alpha_2 CFO_{t-1} + \alpha_3 CFO_t + \alpha_4 CFO_{t+1} + \varepsilon_t$$

[4] Due to the small number of listed companies on Milan Stock Exchange, the use of alternative measures of EQ requiring time-series data and a very high number of companies related to the same industry classification could not be used.

[5] According to the model, these residuals are a proxy of the "abnormal accruals" that are discretionary adjustments expressing dis-alignment between earnings and cash flows from the operations of a given year, which do not reverse in the previous or in the following years.

where:

ΔWCt = change in Working Capital time t

CFO_{t-1} = Cash Flow from Operation time t-1

CFO_t = Cash Flow from Operation time t

CFO_{t+1} = Cash Flow from Operation time t+1

The relevance of the model is confirmed by the data of our sample (R^2 is high for every year of the analyzed period and in the pooled regression (378 firm-year observations) the adjusted R^2 is 0,53. The residuals of the regression analysis, expressing abnormal accruals, are then used as an EQ measure on a firm-year observation basis: the higher are the residuals the lower is the EQ).

The independent and control variables

We measured family involvement as the proportion of family members in the BoD (FAMDIR, also referred as "board familiness"). In order to test our hypotheses, we run the following regression models:

$$EQ_t = b_1 + b_2(\%FAMDIR)_t + b_3(\%INDIR)_t + b_4(ID/CO)_t + b_5(CEODUAL)_t + \\ + b_6(LOGASSET)_t + b_7(ROA)_t + b_8(LEV)_t + b_9(LOSS)_t + b_{10}(GROWTH)_t + e_t \quad (1)$$

$$EQ_t = b_1 + b_2(\%FAMDIR)_t + b_3(\%INDIR)_t + b_4(ID/CO)_t + b_5(CEODUAL)_t + b_6(LOGASSET)_t + \\ + b_7(ROA)_t + b_8(LEV)_t + b_9(LOSS)_t + b_{10}(GROWTH)_t + b_{11}(CEOFAM)_t + b_{12}(CEOFAM * \%FAMDIR)_t + e_t \quad (2)$$

where the subscript t represents the time and the other variables are defined as follows.

EQ is the absolute value of residuals expressing abnormal accruals according to Dechow-Dichev model. %FAMDIR is the proportion of family members in the BoD, measured as the ratio between family directors and the total number of board members. It is expected to mitigate the "entrenchment effect" and contribute at higher earnings quality. %INDIR, representing board independence, is measured as the number of independent directors out of total members of the board. It is expected to mitigate the "entrenchment effect" and contribute to higher earnings quality.

The name and the number of directors are disclosed by companies in their annual governance reports. The identification of family members is based on the surname and other information about independence and family relations included in the public reports, or in other public sources. The identification of independent directors is based on the compliance with the definition provided by the Self-regulation Code, as stated by the company.

ID/CO represents Bank/Firm connections. It exists if at least one director is in common between a firm and a listed bank (interlocking directorate) or if there is a cross-ownership between banks and the firm for at least 2% shareholding (cross-ownership)[6]. This is a dummy variable equal to 1 if at least one of the two conditions exists, 0 otherwise. Bank/Firm connections are expected to create incentives for better reporting quality.

CEODUAL represents CEO Duality. It is expressed by a dummy variable equal to 1 if CEO is different from the chairman of the board and 0 otherwise. CEO Duality is a signal of top management entrenchment expected to have a negative correlation with EQ.

Following prior literature (Becker et al., 1998; Rafournier, 1995; Reynolds and Francis, 2000; Ho and Wong, 2001; Wang, 2006), the models control for: Size, expressed by LOGASSET (logarithm of Total Assets), profitability, expressed by ROA (ROA), risk of bankruptcy, expressed by LEV (Debt/Equity ratio), LOSS (dummy variable equal to 1 if net income is negative and 0 otherwise), and growth opportunities, expressed by the growth rate in sales (GROWTH).

Moreover, in the second regression model we tested the effects of family involvement on EQ depending on the CEO being a family member or not, through the following independent variables:

- CEOFAM expressing the presence of a Family CEO, a dummy variable equal to 1 if CEO is a family member, 0 otherwise.
- %FAMDIR*CEOFAM expressing the interaction between the proportion of family directors and family CEO, in order to test the effects of their simultaneous presence.

Sample descriptive statistics

Before considering the results of our analysis, we briefly resumed descriptive statistics about the sample, divided into two sub-samples of family and non family firms. For the purpose of this descriptive analysis, a company is defined "family firm" if two conditions are respected: 1) there is a single or a few controlling families owning at least the 20% of voting rights[7]; 2) at least one member of that families (also relative in law), has a seat in the board of directors.

[6] This percentage is the thresold required by CONSOB in order to publicly declare relevant shareholding interests.

[7] The voting rights can be owned directly, indirectly or through voting agreements and voting trust (as a device for co-ordination between significant shareholders)

The information presented below refers to the period 2002-2004.

Family companies are around 56% of the total sample. We calculated means, standard deviations and independent samples t-tests.

Here the results:

Table 2. Descriptive statistics and t test

	Mean values		SD		t	Sig
	Family	Non Family	Family	Non Family		
Observations	213	165				
CEO Fam	0.65		0.48		-11.37	0.00
CEO Duality	0.43	0.36	0.50	0.48	-1.25	0.21
FAMDIR	2.28	0.18	1.33	0.60	-18.87	0.00
Net Debt/Equity	0.98	1.31	3.18	6.50	0.65	0.51
ID/CO	0.60	0.58	0.49	0.50	-0.49	0.62
ROA	0.79	0.16	29.96	27.62	-0.20	0.84
INDIR	3.03	4.14	1.71	3.16	4.35	0.00
LNTOTASSETS	13.05	13.26	1.27	1.78	1.26	0.21
GROWTH SALES	16.03	3.74	72.70	30.00	-1.96	0.05

Non family firms show, on average, a higher level of indebtness (1.31) compared to family firms (0.98), but the mean difference is not significant. Family firms also present higher ROA, although the significance level is not high. Moreover, on average, family and non family firms have more or less the same size and the formers are more characterized by CEO duality (even if mean values are not significant). This is consistent with the opinion that family control is a constraint to growth and entails higher risk of "entrenchment" of top management. The average percentage of independent directors is 37% in family firms and 63% in non family ones. Both family and non family firms have more or less the same frequency of connections with banks (0.60 / 0.58), a typical feature of Italian capitalism confirming the pervasive power still held by banks in Italy. Finally, the average number of family CEOs in family firms is around 0.65, meaning that many family firms have a family CEO.

Empirical Results

The regressions analyses have been performed through a panel model, on 378 firm-year observations. Table 3 and Table 4 present, respectively, the results for the first and the second regression. The "model fit" for both is quite good (*adjusted* R^2 0.338 and 0.333 respectively).

Table 3. First regression results (1)

Independent variables	Beta coefficients	t	Sig
COST 2002	-1073736	-9.490	0.000***
COST 2003	-1115322	-10.020	0.000***
COST 2004	-1109768	-9.976	0.000***
CEODUAL	54092.174	2.259	0.024*
%FAMDIR	-149419.681	-2.272	0.023*
LEV	-6575.141	-0.955	0.340
ID/CO	-53192.225	-2.182	0.029*
ROA	-92.692	-0.187	0.851
%INDIR	54143.678	1.049	0.295
LOSS	84454.673	2.945	0.003**
GROWTH	4168.321	0.336	0.820
LOGASSET	203436.517	10.719	0.000***
Adj. R square	0.338		
F-statistic	*15.897*		

Table 4. Secondo regression results (2)

Independent variables	Beta coefficients	t	Sig
COST 2002	-1079816	-9.226	0.000***
COST 2003	-1122892	-9.707	0.000***
COST 2004	-1115806	-9.686	0.000***
CEODUAL	55096	2.278	0.023*
%FAMDIR	-260890	-1.893	0.059
LEV	-14982	-1.330	0.184
ID/CO	-49803	20.230.706	0.044*
ROA	-6.173	-0.012	0.990
%INDIR	41697.00	0.7951	0.427
GROWTH	7068.00	0.374	0.708
LOSS	86043	2.882	0.004**
CEO Fam	-95380	-2.260	0.024*
%FAMDIR*CEOFAM	312480	1.796	0.073*
LOGASSET	209120	10.644	0.000***
Adj. R square	*0.333*		
F-statistic	*13.606*		

In both models, the regression coefficient of board familiness (%FAMDIR) is negative and significant (*t* equal to - 2.272 and - 1.893 respectively). Moreover, in the second regression model, the regression coefficient of family CEO (CEOFAM) is negative and significant (*t* = -2.260). The coefficient of the interaction variable %FAMDIR*CEOFAM is positive and significant (*t* = 1.796).

The results of the regression models confirm both *H1* and *H2*.

As the dependent variable is an opposite measure of EQ, the results of both regressions confirm that a stronger presence of family members in the board has a positive effect on EQ. Moreover, the presence of a family CEO has also positive effects on EQ confirming the alignment effect relevance (Wang, 2006).

But the positive effects of family directors and family CEOs are not confirmed when they are combined. The interaction variable between family CEO and the percentage of family directors (%FAMDIR*CEOFAM) shows that the positive effect of family involvement on EQ is no longer confirmed when they are simultaneously present. In our perspective, it happens because the board is more likely to be dominated by the key members of the family.

It is interesting to notice the result regarding independent directors. In both models there isn't significant correlation between EQ and independent directors in the board. The lack of correlation between these two variables is inconsistent with the dominant theory (a stronger presence of independent directors should positively affect firms' disclosures), but confirms doubts about the effectiveness of independent directors in the Italian context.

In order to test the robustness of our model, we performed a further regression analysis using the ratio Residuals/Revenues as dependent variable, instead of the absolute value of Residuals, for a better control of the size effect. On the whole, the results confirm our hypotheses.

Conclusions

The article contributes to existing literature about the analysis on the relationship between firm familiness and EQ, mainly focusing on the family attitude towards corporate governance practices. A general result is the existence of a positive correlation between family involvement in the governance of the company and EQ, but only when this doesn't imply an excessive power of the family. So, what really counts for earnings quality is not the "familiness" *per se*, but the distribution of powers and controls set by the governance system.

Hence, family governance is good for earnings quality, but not when the family gets to be dominant in the board (when, at the same time, many family directors and a family CEO join the board).

This result, as far as we know, is partially novel. These findings show the potential efficiency of the "family model" in reducing agency costs and gaining trust through transparency, thus creating an essential precondition for cost of capital reduction, but they also suggest as the "family model" is really efficient only in case of good governance practices, in order to moderate the entrenchment effects of family ownership and management. The findings have implications for entrepreneurs, regulators and financial reporting users, suggesting that, on the one side, family firms not adopting good governance practices deserve more attention by financial and accounting regulators and that, on the other side, the adoption of good governance practices increases the transparency and efficiency of the relation between entrepreneurs and investors.

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CORPORATE RISK COMMUNICATION AS PART OF CORPORATE GOVERNANCE – INSIGHTS FROM A BEHAVIORAL RISK PERSPECTIVE

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Abstract

When corporate ownership and control are separated, information asymmetries arise between the uniformed principal (investor) and the informed agent (manager). Within this principal agent conflict, the communication of risks faced by the entity is crucial within a corporate governance context, as investor decisions concerning a company are mainly driven by the evaluation of chances and especially of risks regarding the future prosperity of the company. Risks can thereby only be communicated reliably as part of corporate communication (i.e. without inducing unexpected behaviors), when the informational needs of the investors are understood. In order to derive insight about which variables are important in explaining how investors perceive risks disclosed by an entity, I develop a structural equation model in which I combine two theoretical approaches of human risk perception: the "decision theory view" and the "behavioral risk perspective". For estimating the model, I make recourse to data derived from a survey that was conducted with 32 students who were asked to assess five risks which the fictitious "Alpha group" discloses in its management commentary. I chose the management commentary as the object of study, as it has a unique and increasing relevance as an instrument of capital market communication. My results suggest that both theoretical approaches are important in explaining investors´ risk perceptions. This finding calls into question that standard-setters predominantly adopt a decision theory view concerning risk reporting, and has further implications for the development of a company´s risk communication strategy within a corporate governance context.

Keywords: Perceived Risk, Management Commentary, Risk Communication

JEL-Classification: M41

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1 Introduction

Social scientists have spent much effort on developing models of human risk perception and have identified multiple practical uses for such models (Yates (ed.), 1992). Especially, models of human risk perception can aid in predicting how people will react when being confronted with certain risks (Kraus and Slovic, 1988). Holtgrave and Weber (1993) remark that "studies of subjective risk perception and risk acceptability show, for example, that people tend to reject comparisons about the magnitudes of risks […] when these risks are qualitatively different" (e.g., voluntary versus involuntary, controllable versus incontrollable etc.). Comparable findings can help to guide the design of corporate risk communication and regulatory efforts.

While the international as well as the German standard-setter primarily focus on disclosures of loss probabilities and/or loss outcomes concerning risk reporting and thereby – at least implicitly – capture a decision theory view, which proposes that risk judgments are based on probabilities and potential outcomes, scholars that adopt a behavioral risk perspective argue that an investor´s perception of risk is influenced by risk dimensions that have little to do with outcomes and their probabilities (like for example, to what extent a risk is controllable, new, or causes worry; see also Koonce et al., 2005). I will later show that both the decision theory view as well as the behavioral risk perspective makes a major contribution to the explanation of risk perceptions of investors. This finding calls into question the regulatory framework´s primary focus on disclosures of loss probabilities and/or loss outcomes. Furthermore, in situations where corporate ownership and control are separated, my findings give advice on how managers should report about corporate risks out of a corporate governance perspective, in order to mitigate information asymmetries between the uniformed principal (investor) and the informed agent (manager). The determination of a corporate risk

communication strategy as an adequate solution of this principal agent conflict is of paramount relevance, as investor decisions concerning a company are mainly driven by the evaluation of chances and especially of risks regarding the future prosperity of the company.

To summarize, as Morgan (1993) puts it, "the only way to communicate risks reliably is to start by learning what people […] need to know" (Morgan, 1993: 29). Thus, the intention of this study is to contribute to a better understanding of an investor´s informational needs, because this understanding is not only essential for a prediction of an investor´s reaction to risk-related information. Furthermore, the definition of a risk communication strategy as part of the corporate governance structure of a company implies such understanding. So far, there is little empirical evidence on how the users of financial reports assess risk, as most risk-related research focuses on effects of risk. Correspondingly, there is little guidance on how risk reporting disclosure can support investors in assessing risks (Schrand and Elliot, 1998: 276). The first purpose of this paper is to provide evidence concerning the variables which explain investor´s risk perception. Second, the paper wants to give guidance to the reporting entity on how to report about risks under a corporate governance perspective in order to avoid unintended reactions by the investor. Third, the empirical findings could encourage regulators to reconsider and to extend the assumptions on which they base their risk-related disclosure requirements.

2 Regulatory framework

I chose the management commentary as the object of study out of two reasons: First, the management commentary has a unique an increasing relevance as a tool for investors to assess the reporting entity (Kajüter and Blaesing 2010), (1) as it provides information in addition to and different from the information provided in the financial statements and (2) because the management commentary supports the investors in evaluating an entity's future prospects through the disclosure of information about the entity's future risks and chances (Theis et al. 2012). Second, the management commentary is of major interest out of a corporate governance perspective, as normative requirements concerning the management commentary bear great discretionary latitude for the management in deciding what to disclose (in general, but about risks in particular) within the management commentary.

With the publication of the exposure draft ED/2009/6 "Management Commentary" in June 2009 (IASB, 2009) and the passing of the consequent Practice Statement "Management Commentary" in December 2010 (IASB, 2010) the IASB recognizes that financial statements do not necessarily provide all the information that potential investors could need to make their economic decision "because the financial statements largely portray the financial effects of past events and do not provide non-financial measures of performance or a discussion of future prospects and plans" (IASB, 2010: BC3). With the Practice Statement, the IASB presents a "broad, non-binding framework" for the presentation and preparation of a management commentary in accordance with IFRSs (IASB, 2010: IN1). The IASB thereby also takes into account that for many entities the management commentary is already an important element of their communication with capital markets because users of financial reports in their capacity as capital providers routinely use the type of information provided in a management commentary to evaluate an entity´s possible prospects and its general risks (IASB, 2010: IN3).

Consequently, risk information is one of the non-financial indicators of future performance that should be disclosed according to the Practice Statement. The disclosure requirement includes the "entity's principal risk exposures and changes in those risks, together with its plans and strategies for bearing or mitigating those risks, as well as disclosure of the effectiveness of its risk management strategies". With the disclosure of risk-related information, the opportunity "to evaluate the entity's risks as well as its expected outcomes" (both IASB, 2010: mn. 31) should be provided to the user of the management commentary.

In comparison to the recent development of the normative framework in terms of the IFRSs, the national German legislator as well as the European Union have early identified the need for insight that exceeds the disclosure of pure financial information. As early as 1986, the concept of a management commentary was codified[8] in the German Commercial Code (HGB), and therewith relevant for German corporations and groups (with exceptions according to German Company Law).[9] Since then, the requirements for a management commentary in accordance with the German Commercial Code have increased. One of the cornerstones of that legal development has been the introduction of risk reporting in 1998: As a reaction to prominent corporate crises and breakdowns, and in order to meet the informational needs of international investors (which by that time became increasingly important as capital providers for German public corporations), the Law on Corporate Control and Transparency (KonTraG) amended §§ 289(1), 315(1) HGB by requiring disclosures on the risks of the entity´s future development in the management commentary (Dobler, 2005: 1192-1193). Developed further by

[8] With the commencement of the Accounting Directives Act (BiRiLiG).

[9] See for further reading: Beurskens, 2010 and Tesch and Wißmann, 2009.

amendments after 1998,[10] German risk reporting exists in its present form since 2009 (with the commencement of the German Accounting Law Modernisation Act (BilMoG)): In addition, a description of the key characteristics of the accounting-related internal control and risk management system became mandatory. Hence, the German legislator has recently acknowledged the relevance of key corporate governance mechanisms in the context of risk reporting.

In order to specify the comprehensive legal risk reporting requirements of the §§ 289(1) and 315(1) HGB, the private standard-setter German Accounting Standards Board (GASB) issued a detailed German Accounting Standard No. 5 (GAS 5). Its risk reporting requirements will soon be incorporated by the recently introduced draft for a new GAS on Management Commentaries (E-DRS 27). The new standard will furthermore replace the existing GAS 15 "Management Reporting". According to the draft, risks are still – corresponding to GAS 5 – mainly understood as defined by loss probabilities and loss outcomes (E-DRS 27, mn. 154/164/165). As a reaction to the commencement of BilMoG, the draft also emphasizes the relevance of disclosure concerning the risk management system and internal controls.

For the purpose of the study it is important to understand in this context, that the international as well as the German national regulatory frameworks do not only leave leeway for the management to decide what and how to report about risks, but that they also have a strong focus on disclosures of loss probabilities and/or loss outcomes concerning risk reporting: In terms of risk reporting, in general, the international as well as the German standard-setter – at least implicitly – adopt a decision theory view, which proposes that risk judgments are based on probabilities and potential outcomes. That is, when assessing risk, investors (or people in general) are presumed to assess the severity and likelihood of the possible outcome.[11]

While empirical research supports this perspective (Weber, 1988),[12] scholars do not agree on how people think about risk (Slovic and Weber, 2002). Over the years, another dominant view on risk has developed in the academic debate: The behavioral risk perspective (Koonce et al., 2005). Both the decision theory view as well as the behavioral risk perspective shall be discussed in the following section.

3 Theoretical Background and Related Literature

Processes affecting risk perceptions can be studied scientifically. For this purpose, three approaches can be distinguished: the socio-cultural paradigm, the axiomatic measurement paradigm, and the psychometric paradigm (Weber, 2001). Studies within the socio-cultural paradigm examine the effect of group- and culture-level variables on risk perceptions. Studies within the axiomatic measurement paradigm focus on the way in which people subjectively transform objective risk information (like possible consequences of financial losses and their likelihood of occurrence) in ways that reflect the impact that these events have on their lives. Research within the psychometric paradigm wants to identify people´s emotional reactions to risky situations that affect judgments of the riskiness of physical, environmental, financial and material risks in ways that go beyond their objective consequences (Slovic and Weber, 2002). While the socio-cultural paradigm concentrates on how *a person*´s socio-cultural attributes influence this person´s risk perception, I am rather interested in which variables related to *a risk´s* attributes explain how a person perceives risk. In the following, I therefore exclude the socio-cultural paradigm from closer consideration.

The decision theory view can be considered as part of the axiomatic measurement paradigm and shall be discussed first in order to deduce the decision theory variables which are used in the study.[13] Traditionally, a dominant approach to study individual decision making under uncertainty relies on a probabilistic framework. It is assumed that the uncertainty about the state of the world is described by a probability distribution, and that the ranking of acts is done according to the expected utility of the consequences of these acts, when modeling a decision maker´s rational choice between acts according to the decision theory view. This proposal was initially made by Neumann and Morgenstern (1947) and Savage (1954). Not only does empirical research support this perspective. Also valuation models within accounting and finance exhibit the tendency to follow the decision theory view by defining risks in terms of expected cash flows or earnings, or in terms of the covariance of these measures with market factors (Froot et al., 1993). Altogether, the decision theory view seems to underlie many risk-related accounting standards and regulatory frameworks, which often focus on disclosure of loss probabilities and/or loss

[10] Especially for developments concerning the transformation of both the Modernisation Directive and the Fair Value Directive into German law by the Reform Act on Accounting Regulation (BilReG), see Dobler, 2004: 51-52.

[11] For a more detailed description of the respective regulatory framework see Theis, 2011.

[12] For further reading see Weber and Bottom, 1989; also see Weber and Bottom, 1990.

[13] For examples of uses of axiomatic measurement theory, see: Narens and Luce, 1993. Furthermore, the decision theory view was justified on an axiomatic basis by Savage in 1972; See Savage, 1972.

outcomes.[14] Although the decision theory view can be statistical in nature (by using calculated variances as a measure of risk), it can also be viewed in terms of perceptions, such as how people react to variance or perceive probability data (Koonce et al., 2005).

In contrast, adopting a psychometric paradigm, the behavioral perspective of risk argues that people´s perceptions of risks are influenced by risk dimensions that have little to do with outcomes and their probabilities. With a behavioral perspective of risk, the psychometric paradigm is a common approach for studying perceived risk by developing a taxonomy for hazards that can be used to understand and predict responses to their risks. A taxonomic scheme can help to explain people´s extreme aversion to some hazards as well as their indifference to others, and the discrepancy between these reactions and expert opinions. The psychometric paradigm "uses psychophysical scaling and multivariate analysis techniques to produce quantitative representations or 'cognitive maps' of risk attitudes and perceptions." (Slovic, 1987: 281). Within the psychometric paradigm, people are often asked to make quantitative judgments about the current riskiness of diverse hazards. These judgments are then related to judgments about other properties, such as the hazard´s status on characteristics that have been hypothesized to account for risk perceptions and attitudes. Slovic (1987) identifies several of such variables of perceived risk and aggregates them to two underlying factors which he labels as "dread" and "unknown". The dread factor captures a risk´s perceived controllability and voluntariness, as well as the amount of worry and the catastrophic potential associated with the risk. Supplementary, the unknown factor captures the observability of a risk, the immediacy of the risk´s effects, its newness and the knowledge about the risk.

While prior studies often tend to focus on either the decision theory variables or the Slovic variables there is evidence that the two sets of variables capture distinct information and that investors will rely on both types of information when judging risk (Loewenstein et al., 2001: 274). For example, as outlined by Koonce et al. (2005), the Slovic variable voluntariness describes, whether the decision to invest in a company with a certain risk would only occur if the participant had no knowledge of that risk, or whether the participant would also invest in knowledge of that risk, i.e. voluntary, *given* the loss probability and potential loss outcome for that certain risk. The variable controllability captures the degree to which the management engaged with the risk has control over the consequences evoking from the risk, i.e. whether actions can be taken to minimize an existing risk and not the likelihood of a particular risk or its magnitude. The four variables that form the unknown factor (newness, immediacy, knowledge, observability) capture how well a risk item is understood, which clearly differs from the probability of a particular outcome from that risk item. For example, the perceived probability of a risk could be low, yet a decision maker could either have a high or low understanding of the risk. Although Slovic variables might sometimes be correlated with decision theory variables (i.e., high controllability may suggest low loss outcomes), "the two sets of variables capture distinct information" (Koonce et al., 2005).

Following this line of reasoning I develop a structural equation model which includes the decision theory variables as well as the Slovic variables in order to achieve a better understanding of an investor´s informational needs. I also want to contribute to a better prediction of an investor´s reaction to risk-related information. While I will adapt the research instrument outlined by Koonce et al. (2005) by the introduction of a modified structural equation model for the purposes of my specific research question, I extend prior literature by investigating risk perception processes in the context of corporate risk reporting within the management commentary. Thereby, I acknowledge the paramount relevance of the management commentary as an instrument of corporate risk communication in the context of corporate governance.

In the following section I first describe the procedures of the survey and how my study was designed in general.[15] I will then present the estimation results of my structural equation model and discuss the findings.

4 Study design and procedures

4.1 Structural Equation Model

Merging the preceding theoretical deliberations, I introduce the structural equation model as depicted in figure 1. The model consists of four latent variables (constructs). For all estimations described in the following I applied the partial least squares (PLS) method and utilized the software SmartPLS (Ringle et. al 2007) to run the analysis (all constructs were specified reflectively, due to the nature of the data at hand). As suggested by theory, the exogenous construct "Decision Theory Variables" consists of the indicators "Loss Probability" and "Potential Loss Outcome". Accordingly, I included the two Slovic factors "Dread" and "Unknown" as latent variables into the model in order to cover the Behavioral Risk/Slovic variables. The endogenous "Dread" construct is reflected by the indicators "Controllability", "Voluntariness", "Amount of Worry" and "Catastrophic Potential" corresponding

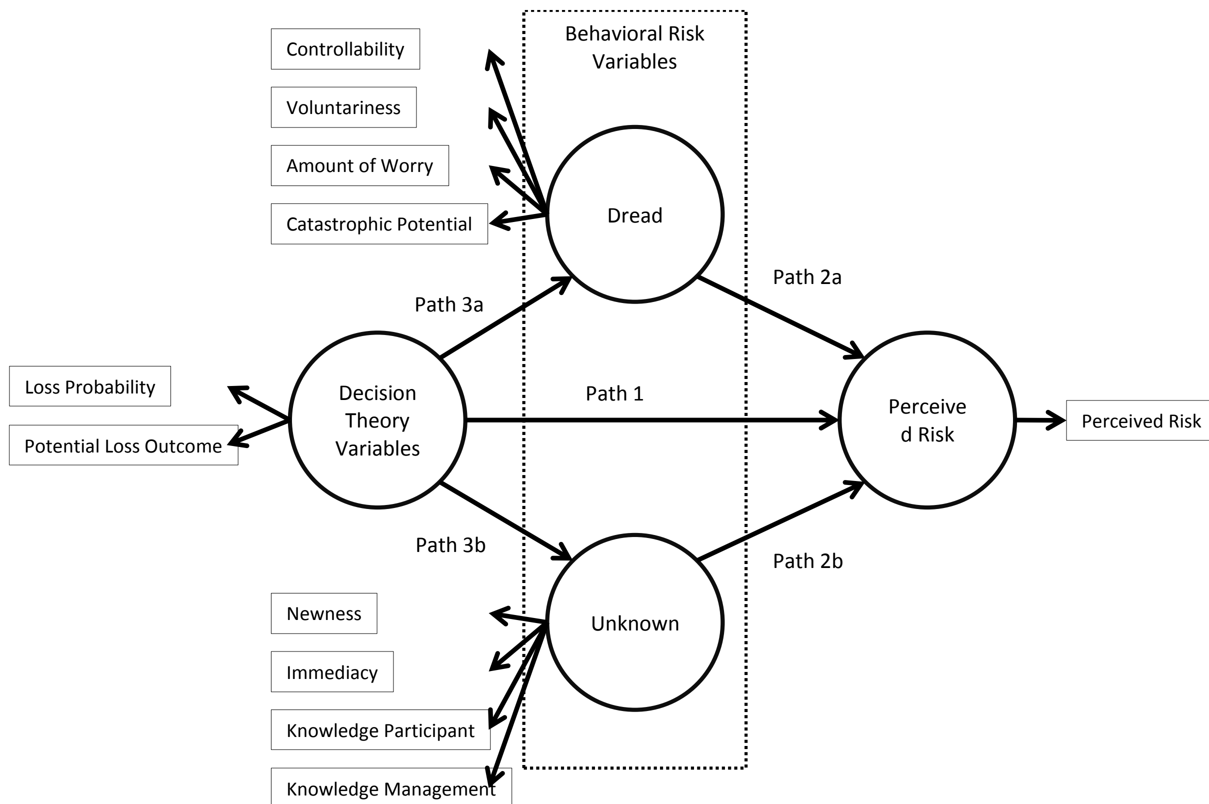
[14] See the evidence provided above. For US-American evidence also see SOP No. 94-5, FRR No. 48, SFAS Nos. 5, 106, and 140.

[15] For further details concerning the methodological approach see Theis, 2011.

with the described theoretical framework. In line with Koonce et al. 2005, I included two indicators to cover different aspects of the knowledge variable ("Knowledge Participant" and "Knowledge Management"). I did not include an indicator for the Slovic variable observability, as doing so proved to be obsolete in pilot testing. As a result of providing rather detailed information about the risk item that has to be assessed, in fact participants will always affirm the observability of a risk item. Hence, the construct "Unknown" consists of the indicators "Newness", "Immediacy", "Knowledge Participant" and "Knowledge Management". Finally, the endogenous construct of major interest, the "Perceived Risk" is reflected by a single corresponding indicator of the same name. To capture the described indicators, an extensive questionnaire was designed. Its general design and the questions asked for each indicator will be described later.

Mirroring the implications of theory, I implement a direct influence of both the decision theory variables and the behavioral risk variables on investor´s risk perception by modeling paths between the constructs "Decision Theory Variables" and "Perceived Risk" (Path 1) as well as between the constructs "Dread"/"Unknown" and "Perceived Risk" (Path 2a/2b). Path 1 reflects the not formally stated hypothesis, that *people´s risk perception is explained by decision theory variables* while the paths 2a and 2b stand for the not formally stated hypothesis, that *people´s risk perception is explained by Slovic variables*. In addition, I explicitly model an interaction between the decision theory variables and the behavioral risk variables by including a direct influence of the construct "Decision Theory Variables" on both Slovic factors ("Dread" and "Unknown", Path 3a/3b). Hence, I expect that the potential extent of a loss as well as its probability will have an effect on the behavioral aspects of risk perception, such as the perceived catastrophic potential of or the amount of worry associated with a risk. After a description of the research instrument utilized to capture the indicators, I will describe the results of the model estimation with reference to the recently described (not formally stated) hypotheses.

Figure 1. Structural Equation Model Including Behavioral Risk/Slovic and Decision Theory Variables



4.2 Questionnaire

4.2.1 General design

The questionnaire that was handed out to the participants consists of 14 pages, including a cover letter, an introductory part to the questions and the set of questions itself. With the cover letter the participants are instructed to carefully read the introductory part to the questions ("I. Introduction") first, where all risk items together with the corresponding excerpts of the risk report of a group

which I named Alpha group were consecutively presented (This procedure should enhance the ability of the participants to make meaningful distinctions among the items, as suggested by prior studies (Koonce et al., 2005)). The participants were then asked to continue with answering the questions – a set of 11 identical questions for each risk item – in the second part of the questionnaire (“II. Questions”), whereby the excerpts of the risk report of the Alpha group were repeated for each risk item before each block of questions in order to facilitate the participants´ assessments. The participants had 45 minutes to complete the questionnaire and returned it after 25-30 minutes on average.

While the name of the Alpha group is fiction, the risk information provided is not. I chose to utilize excerpts from the risk reporting section of the 2009 group management commentary of a German manufacturer of sports equipment. The choice was made after reviewing a quality-ranking for annual reports, which is conducted on a yearly basis. The group I chose scored high concerning the management commentary within the annual report 2009 (Manager Magazin, 2009). In order to avoid that participants´ responses to my questions are influenced by information other than the information I provided about risks, I took best care to ensure that neither the real-world counterpart to the Alpha group nor the industry in which the Alpha group operates, is revealed to the participant (I kept explanations as short as possible and did not reveal the intention of the study in order to avoid demand effects, which could be a threat to the construct validity of my study. For further reading see Shadish et al., 2002: 73). I use a German real-world management commentary as a pattern for the questionnaire, because the risk report within the management commentary supplies exactly the (risk) information needed as input for a study that intends to achieve a better understanding on how users of financial reports in their capacity as capital providers (investors) assess risks. Asking the participants of the survey to assess risk upon unique, company specific information, allows us to reproduce the scenario that is intended to be covered by the study best (Yet, choosing the described design involves the danger of a reduced generalizability): management commentaries are important tools of capital market communication for German groups and corporations (Kajüter and Blaesing, 2010: 459-460), and therefore a group (or corporation) uses the management commentary (and the risk report) to disclose the information that the group *wants to share* with the investor (within the boundaries of mandatory disclosure requirements).

4.2.2 Risk items

Figure 2 displays the risk-related information that I prepared to be assessed by the participants. The five risk items I chose to provide were the macroeconomic risk, the social and environmental risk, the personnel risk, the financing and liquidity risk, and the product design and development risk (I limited the number of risk items to five, as similar studies suggest that cognitive restrains lead to the maximum number of 5-6 items that could possibly be distinguished and assessed by the participants, if the items are presented within a complex context (Koonce et al., 2005)). The risk items were selected in order to reflect the wide range of the Alpha group´s economic activity. Besides that, the selection was made in order to create meaningful variations in the evaluations of the participants to ensure interpretable results (Koonce et al., 2005: 226). The intention thereby was to include risk items so that some were likely to be perceived as high (e.g., macroeconomic risk), some as medium (e.g., personnel risk) and some as low risk (e.g., social and environmental risk) (A review of the descriptive statistics in table 2 reveals that I indeed created meaningful variation in the perceived risk by choosing the mentioned risk items). Additionally, prior research has shown that making relative judgments (that is, having multiple items to evaluate) considerably improves the quality of judgments (Hsee et al., 1999).

Figure 2. Risk items utilized and provided excerpts of the annual report of the Alpha Group

Macroeconomic Risk

Growth in our industry is influenced by consumer confidence. Abrupt economic downturns, in particular in regions where the Alpha Group is highly represented, therefore pose a significant short term risk to sales development. To mitigate these risks the Alpha Group strives to balance sales across key global regions and also between developed and emerging markets. In addition, a core element of performance positioning is the utilization of an extensive global event and partnership portfolio where demand is more predictable and less sensitive to macroeconomic influence. In 2010, the Alpha Group expects the global economy to grow modestly after the global recession of the prior year. Nevertheless, a high degree of uncertainty prevails in expectations regarding the pace and magnitude of economic recovery. Performance per geographic region is also expected to be mixed.

Social and Environmental Risk

We have a continuing responsibility to our workers, suppliers and the environment. Malpractice in these areas, in particular human rights violations and dubious employment practices, can have a significant impact on the reputation and operational efficiency of our Group and our suppliers. To limit this risk, we have established workplace standards to which suppliers must conform before and during business relationships with the Alpha Group. Internal inspections of supplier factories verified by extensive independent audits are conducted regularly. In the event of non-compliance with these standards, we develop joint actions plans and set deadlines for compliance and further improvement. If these deadlines are not met, business relations are terminated. In order to minimize the environmental impact of producing and distributing our products, in 2009 the Alpha Group continued to proactively engage in developing more environmentally sustainable products which included the first products from our "Better World" program. In 2010, we intend to grow the share of sustainable products by intensifying our "Better World" initiatives within all product categories of the Alpha Product Performance division.

Personnel Risk

Achieving the Alpha Group´s goal of becoming the global leader in our branch of industry is highly dependent on our employees and their talents. Loss of key personnel in strategic positions, to competitors or others, is therefore a significant risk we face. In addition, as labour markets become increasingly competitive, we also face the risk of being unable to identify, recruit and retain the most talented people that best meet the specific needs of our Group. To reduce this risk and enable our employees to make use of their full potential, we strongly engage in developing a motivating working environment. Our goal is to make the Alpha Group the "Employer of Choice" within our industry. This is supplemented by offering attractive reward and incentive schemes as well as long-term career opportunities and planning. Our overall assessment of personnel risks remain unchanged compared to the prior year. Although we expanded our own-retail activities (where employee turnover is higher than the group average) and increased our employee base in emerging markets (where higher levels of wage inflation increase the volatility of the employment market) in 2009, the current economic environment is likely to reduce employee turnover.

Financing and Liquidity Risk

Liquidity risks arise from not having the necessary resources available to meet maturing liabilities with regard to timing, volume and currency structure. In addition, the Alpha Group faces the risk of having to accept unfavorable financing terms due to liquidity restraints. Our Group´s treasury department uses an efficient cash management system to manage liquidity risk. At December 31, 2009, Group cash and cash equivalents amounted to 775 million Euro (2008: 244 million Euro). Moreover, our Group maintains 2.2 billion Euro bilateral short-term credit lines and a 2 billion Euro vomited medium-term syndicate loan facility with international banks, which does not include a market disruption clause. The 4.2 billion in credit lines are designed to ensure sufficient liquidity at all times. In order to mitigate financing risks and to reduce the dependence on banking financing, in 2009 the Alpha Group issued a German private placement in the amount of 200 million Euro in two tranches with a maturity of three and five years respectively, and a Eurobond in a nominal amount of 500 million Euro with a maturity of five years. In 2009, we reduced net debt by 1.272 billion, which resulted in the achievement of our medium-term target of financial leverage below 50% at year end.

Product Design and Development Risk

Innovative and attractive products generate strong sales and – more importantly – create a halo effect for other products. The speed with which new product technologies and fresh designs are brought to market is decisive for maintaining competitive advantage. In 2009, all brands generated the majority of their sales with products which had been brought to market over the past 12 to 18 months. If the Alpha Group failed to maintain a strong pipeline of new innovative products over a sustained period of time, we would risk a significant sales decline. We focus on pursuing our innovation and design strength. To ensure we can quickly adapt to changing consumer preferences, we focus on streamlining research and development processes to speed up the time to market.

4.2.3 Questions

In the second part of the questionnaire ("II. Questions"), the participants were asked to answer a number of identical questions on a scale from 0 to 100 for each risk item. The questions asked are generally in line with those used by Koonce et al. (2005) but were adapted for the scenario which I intended to cover. With reference to each of the five risk items I repeated the same set of eleven questions: Relating to the decision theory view, the participants had to assess the loss probability and the loss outcome concerning the risk items. Relating to the behavioral risk perspective, I asked questions in order to capture the indicators associated with the conctructs "Dread" and "Unknown" (that is, the Slovic variables, see above). Finally, the participants had to assess their perceived risk in total for each of the five risk items. I

intentionally did not provide a definition of risk within the questionnaire, as doing so would have defeated the objective in determining how investors think about risk (Koonce et al., 2005). In order to enhance the participants´ comprehension and commitment, the survey was conducted in German. For a summary of the questions forming the indicators and for a presentation of how the endpoints of the scale from 0 to 100 were labeled for each question, see table 1.

Table 1. Indicators of the measurement model

Latent Variable		Indicators	Questions forming the indicator [Endpoints on Scale from 0 to 100]
Decision Theory Variables	x_{11}	Loss Probability	"What do you think is the probability of an economic loss to to the Alpha group from the risk item?" [0% probability], [100% probability]
	x_{12}	Potential Loss Outcome	"If there were an economic loss to the Alpha group, from the risk item, how big a loss would you expect?" [no loss], [very high loss]
Dread	y_{11}	Controllability	"How difficult is it for the Alpha group´s management to use their skill and diligence to control the risk item?" [very difficult], [very easy]
	y_{12}	Voluntariness	"Would you invest in the Alpha group in knowledge of the risk item or would you only invest without knowledge of the risk item?" [in knowledge of the risk], [without knowledge of the risk]
	y_{13}	Amount of Worry	"To what extent would you as a potential investor be worried because of the risk item to the Alpha group?" [no worry], [very high worry]
	y_{14}	Catastrophic Potential	"What do you think is the probability of a threat to the going concern of the Alpha group arising from the risk item?" [0% probability], [100% probability]
Unknown	y_{21}	Newness	"At your own valuation, is the risk item a novel or a long-known risk to the Alpha group?" [novel], [long known]
	y_{22}	Immediacy	"To what extent is the risk item to the Alpha group immediate or is it likely to occur over time?" [immediate], [over time]
	y_{23}	Knowledge Participant	"To what extent is the risk item to the Alpha group known by you?" [unknown], [known in detail]
	y_{24}	Knowledge Management	"To what extent is the risk item to the Alpha group known by the Alpha group´s management?" [unknown], [known in detail]
Perceived Risk	y_{31}	Perceived Risk	"At your own valuation, how high is the risk item for the Alpha group in total?" [no risk], [very high risk]

4.3 Participants

The participants of the study were 32 students of a German Business School which had attended advanced lectures in accounting. Although I am aware that conducting the survey with students could be considered as a threat to the external validity of my study, I argue that it was adequate to utilize students for my purposes. First, other studies suggest that students are valid surrogates for (nonprofessional) investors (Elliot et al., 2007).[16] Furthermore, the students are not only surrogates for nonprofessional investors, my participants *are indeed* (nonprofessional) investors, as their indicated investment experience suggests. However, with access to professional investors, it could be up to further research to provide explicit evidence that my findings hold for both nonprofessional as well as for professional investors.

[16] See also evidence from related research: Liyanarachchi and Milne, 2005.

4.4 Model Estimation and Results

The assessment of five risk items per questionnaire by 32 participants leads to 160 data sets which are included in the descriptive statistics and which are utilized to estimate the structural equation model as described below. Each data set consists of a value for the indicator constituting the endogenous construct of major interest ("Perceived Risk") and values for the indicators reflecting the other latent variables.

Table 2 provides the descriptive statistics for the decision theory, the Slovic and the overall perceived risk variables, including the means and standard deviations of the assessments made by the participants for each variable, grouped by the risk items.

Table 2. Descriptive Statistics

Descriptive statistics, grouped by risk items (Means and standard deviations)

	Risk									
	Macroeconomic		Social and Environmental		Personnel		Financing and Liquidity		Product Design and Development	
Variables	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.	Mean	Std. Dev.
Loss Probability	58.13	24.02	23.13	16.74	36.25	24.33	49.06	26.32	47.19	20.67
Loss Outcome	64.06	31.71	32.50	22.72	42.5	25.53	62.81	24.52	64.38	20.47
Controllability	25.94	21.38	67.50	28.51	58.44	27.13	42.19	21.06	46.88	25.20
Voluntariness	49.69	27.65	22.19	22.68	33.75	28.71	45.00	31.72	42.81	30.82
Amount of Worry	61.25	26.73	16.56	13.10	29.06	21.31	50.31	29.89	45.63	25.52
Catastrophic Potential	54.69	33.60	17.81	18.27	32.19	21.81	50.63	30.58	51.56	22.45
Newness	51.88	35.05	57.19	32.05	74.06	21.38	58.13	25.71	51.88	30.00
Immediacy	34.06	28.38	62.81	22.03	57.5	25.02	40.00	26.52	42.50	32.03
Knowledge Management	45.63	28.84	71.56	21.27	74.06	19.15	66.56	23.64	67.19	65.12
Knowledge Participant	30.00	26.27	41.88	21.91	43.44	23.36	38.75	24.98	34.06	25.00
Perceived Risk	66.25	24.59	21.88	15.33	41.25	21.96	52.5	25.27	60.94	23.47

The table reports the Means and Standard Deviations for all Slovic and Decision Theory variables, calculated over all participants and per risk item.

In a first step, it is necessary to assess the reliability and validity of the structural equation model. As outlined in table 3, the values for Cronbach´s Alpha and the Composite Reliability of the latent variables exceed in general the value of 0.7, which can be interpreted as the highest of potentially critical values (Fornell and Larcker 1981). The internal consistency of the indicators reflecting the constructs is therefore high and the construct reliability can be confirmed. As the values for the Average Variance Extracted (AVE) associated with the constructs are in general higher than 0.5 (Fornell and Larcker 1981), our measurement models are distinguished by a high level of convergence validity: the variances recorded by the constructs significantly exceed the variances induced by measurement errors. Both convergence validity and the reliability of the measurement model can be verified by the analysis of the construct´s standardized loadings and the respective bootstrap-t-statistics (Anderson and Gerbing 1988). The majority of the loadings takes values higher than 0.7, while all loadings are highly significant.

Table 3. Reliability and validity measures

Latent Variables	**Cronbach's Alpha**	**Composite Reliability**	**Average Variance Extracted**
Decision Theory Variables	0.77	0.89	0.81
Dread	0.81	0.88	0.64
Unknown	0.64	0.78	0.48
Perceived Risk	-	-	-

Lastly, the discriminant validity of the reflective measurement models can be largely affirmed with making recourse to the Fornell-Larcker criterion (Fornell and Larcker 1981): In general, the square root of the Average Variance Extracted for each construct is higher than the correlation between the respective construct and all other constructs. In other words, when discriminant validity is affirmed, each of

the latent variables explains the variances of its own indicators better than the variance of all other latent variables (compare table 4).

Table 4. Correlations between latent variables

Correlations between latent variables*	Decision Theory Variables	Dread	Unknown	Perceived Risk
Decision Theory Variables	**0.90**	0.81	0.52	0.79
Dread		**0.80**	0.52	0.82
Unknown			**0.69**	0.44
Perceived Risk				**-**

* Numbers shown in boldface denote the square root of the average variance extracted

When model estimation results of a structural equation model are assessed, the explanatory potential of the model is of substantial interest.[17] As shown in table 5, the R^2 values for the endogenous constructs are extraordinary high in comparison to other studies (for further discussion, see Mertenskötter 2011). The estimation of the model yields in an overall R^2 value of 0.728 for the main (dependent) construct “Perceived Risk”, and in an R^2 value of 0.664 (0.275) for the “Dread” (“Unknown”) construct. All in all, the explanatory potential of the presented structural equation model is very good, which again supports the validity of the study.

Table 5 also presents the estimated path coefficients with the associated significances and effect sizes. A significantly positive, moderately strong (effect size $f^2 > 0.15$, see Wilson et al. 2007 for all inferences concerning effect sizes) effect emerges from the exogenous construct “Decision Theory Variables” on the endogenous construct “Perceived Risk” with a loading of 0.368 (path 1). Hence, in a first step I can confirm that *people´s risk perception is explained by decision theory variables* in the context of corporate risk communication. With reference to the constructs that constitute the behavioral risk variables (“Dread” and “Unknown”), a significantly positive, strong effect (effect size $f^2 >\approx 0.35$) on the “Perceived Risk” construct can only be affirmed for the “Dread” construct with a loading of 0.535 (path 2a), while the respective path coefficient for the “Unknown” construct is negative and insignificant (path 2b). Consequently, I can only partly prove that *people´s risk perception is explained by Slovic variables*. The insignificant results for the construct “Unknown”, reflecting the respective Slovic factor, first of all correspond with findings in other studies.[18] In particular, the insignificant results could also partly be a consequence of the setting I chose. Out of the reasons explained above, participants were asked to assess risk upon unique, company specific information, *reported by the management* according to the case. Under these circumstances, participants might have judged the “Knowledge (of the) Management” to be to be high, no matter what their perceived risk for the risk item was. In contrast, as very specific risk information was provided, it is possible that participants judged their own “Knowledge (of the) Participant” in comparison to the knowledge of the management to be low in general (a review of the descriptive statistics supports this view). Finally, the results show significantly positive and strong effects of the exogenous construct “Decision Theory Variable” on the endogenous constructs “Dread” and “Unknown”, with loadings of 0.815 and 0.525. As expected, the potential extent of a loss as well as its probability has a determining effect on the behavioral aspects of risk perception, the Slovic factors dread and unknown, which amplifies the decision theory variable´s impact on the perceived risk. This again highlights the necessity of a broad understanding of all variables influencing an investor´s risk perception in order to define a corporate risk reporting strategy as part of good corporate governance and calls into question the general adoption of a decision theory perspective by regulators and standard setters.

[17] Please note that I controlled for participant-related biases when I estimated the structural equation model. All reported estimation results were obtained with a control-construct included in the model. The control-construct consists of the participant-specific demographic variables “Age”, “Gender” and “Investment Experience” and directly connects to the endogenous construct “Perceived Risk”. The control-construct is omitted in all figures and tables in order to avoid redundant complexity.

[18] See Holtgrave and Weber 1993, Koonce et al. 2005.

Table 5. Structural model results and effects sizes (f^2)

Criterion	Predictors	R^2	Path coefficient	f^2
Dread	Decision Theory Variables	0.664	***0.815	1.98
Unknown	Decision Theory Variables	0.275	***0.525	0.38
Perceived Risk	Dread	0.728	***0.535	0.34
	Unknown		-0.041	-
	Decision Theory Variables		***0.368	0.16

*** significant at <0.01 level (two-tailed test)

Effect size f^2 measures the relevance of each predictor of a dependent latent variable and is based on the relationship of determination coefficients when including or excluding a particular predictor from the structural equation.

5 Conclusion

I identify two sets of different variables that could potentially describe how investors perceive risks when they assess risk-related information from a management commentary by introducing two theoretical perspectives. Following the decision theory view, individual decision making under uncertainty relies on a probabilistic framework. Thus, the variables loss probability and loss outcome are expected to have a significant influence on an investor´s risk perception. In contrast, the behavioral risk perspective argues that an investor´s perception of risk is influenced by risk dimensions that have little to do with outcomes and their probabilities.

I argue that both sets of variables capture distinct information. The evidence that I generate with this study supports this view. In a structural equation model, both the decision theory variables as well as the Slovic variables significantly prove to be relevant for the explanation of how investors perceive risks when they assess risk-related information from a management commentary. Even further, through an interaction between both sets of variables, the behavioral aspects of risk perception amplify the influences driven by decision theory variables. These findings are of great importance, as I also show, that regulators mostly focus on disclosures of loss probabilities and/or loss outcomes concerning risk reporting, and thereby – at least implicitly – capture a decision theory view.

Interestingly, the recent change of the German Risk Reporting regulation focusing on key corporate governance aspects can be advocated adopting a behavioral risk perspective. With the commencement of the German Accounting Law Modernisation Act (BilMoG), a description of the key characteristics of the accounting-related internal control and risk management system became mandatory. Thereby, a strategy which my results would suggest to risk reporting companies became mandatory in Germany. An expanded disclosure of accounting-related internal control and risk management systems could mitigate an investor´s perceived risk through the favorable effects of a reduced amount of worry, higher perceived controllability and a better understanding of the risk item. Based upon the evidence which my study provides, I suggest, that:

(1) Companies, regardless of whether they are subject to the German regulatory framework (§§ 289(1), 315(1) HGB in particular), consider the beneficiary effects of a detailed description of key corporate governance aspects just as the characteristics of the accounting-related internal control and risk management system when they develop a risk communication strategy and rather exceed possibly existing legal requirements. This should especially be considered out of a corporate governance perspective in order to meet the investors´ informational needs.

(2) Future changes in the framework for the preparation and presentation of a management commentary in accordance with IFRS should contain explicit and emphasized disclosure requirements concerning an internal control and risk management system that reach beyond the recommendation for the disclosure of the management´s strategies for managing risks as well as the effectiveness of those strategies, as suggested by the Practice Statement. The forthcoming German Accounting Standard (GAS) on management commentaries could have the potential to serve as a model.

(3) The assumptions on which the international as well as the German regulatory frameworks are based in terms of risk-related disclosure requirements shall be extended, as my results suggest that an investor´s perception of risk is not only influenced by risk dimensions that capture outcomes and their probabilities, but also by dimensions that rather relate to emotional reactions to financial risks in ways that go beyond their objective consequences.

(4) Companies should not solely adopt a decision theory view (as suggested by the regulatory framework) when developing a risk communication strategy, because risks can only

be communicated reliably (i.e. without inducing unexpected behaviors) when the informational needs of the investors are met. From a behavioral risk perspective, a company could for example reduce an investor´s perceived risk concerning a reported risk item by appropriately reducing an investor´s dread and increasing his understanding of the risk (i.e., reducing the unknown-component of the risk item), *given* certain loss outcomes and loss probabilities related to the risk item. Thereby the company would communicate risks reliably and unintended overreactions of investors could be avoided. The definition of suchlike corporate risk reporting strategies needs to be subject to deliberations in the context of good corporate governance, as these strategies do not only fill the contentual gap left by the normative risk reporting frameworks, but should also narrow management´s discretionary in risk reporting, in favor of the investor.

My failure to provide statistically significant evidence for the relevance of the Slovic factor unknown in explaining the perception of risks could be a possible starting point for future research. Proving that unknown has a significant influence on the perception of an investor´s risk could have further interesting implications for a company´s risk disclosure strategy. GAS 5.10 states that information about a risk shall be provided within a risk report, when the risk is associated with "a danger that the economic position of the group could suffer a significant deterioration or when there are indications that the existence of the entity may be threatened either for economic or legal reasons", i.e. when the risk is highly material. In contrast, evidence for the relevance of the Slovic factor unknown in explaining the perception of risks would suggest a rather different disclosure strategy. The careful disclosure and early introduction of a risk which is not yet material could be beneficiary to the company, when the management anticipates that the risk will become highly material in the future. The behavioral risk perspective would suggest that slowly increasing the investor´s knowledge about the risk in combination with the reduction of the perceived newness of the risk leads to a mitigated perception of the particular risk when it becomes material.

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INVESTIGATING THE VIABILITY OF UNIT TRUST BUSINESS IN ZIMBABWE

*Kunofiwa Tsaurai**

Abstract

This paper uses a case study methodology to investigate the viability of unit trust business in Zimbabwe during the period from 2000 to 2005. The research revealed that unit trust companies at least managed to break even during the period under study except in 2004. However, factors which worked against unit trust business viability in Zimbabwe during the period under study include among others the restrictive regulatory framework, harsh operating economic environment, trustee inefficiency, low volume of funds under management, poor asset and liability management strategy, high levels of withdrawals and low confidence levels in unit trust companies. It can be concluded that unit trust business has good potential in Zimbabwe. The fact that unit trust funds' returns have been consistently outperforming both inflation and stock market growth shows a great potential for unit trust business in Zimbabwe. The author therefore recommends that policies, which are geared towards boosting unit trusts' funds under management, should be intensified, in order to promote long-term viability of unit trust business in Zimbabwe.

Keywords: Zimbabwe, Unit Trusts, Viability, Funds Under Management, Profitability

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1. Introduction

Unit trusts are a popular investment vehicle in the present day world financial markets as they represent a significant proportion of personal financial assets Sellon (2004). The developments in Zimbabwe seem to confirm the above research findings by Sellon (2004). According to Reserve Bank of Zimbabwe (RBZ, 2001), financial market deregulation allowed more participants in the provision of unit trust products in Zimbabwe. The number of unit trusts providing companies in Zimbabwe had gone up to 6 by 1997, namely First Mutual, Old Mutual, Tetrad, Kingdom, Syfrets and Fidelity unit trusts Zimbabwe Association of Unit Trusts (ZAUT, 2001). ZAUT (2005) report revealed that unit trust business reached its peak in terms of profitability and number of market participants in year 2003. The report further revealed that the number of unit trust companies in Zimbabwe had gone up to 13 by end of 2003 namely Old Mutual, First Mutual, Zimnat, GP2, Goal bold, Sunshine, African Banking Corporation (ABC), Syfrets, Fidelity, Barbican, Fins real, Kingdom and Tetrad. According to the RBZ (2004), 6 unit trust companies collapsed due to viability problems and failure to adhere to regulatory framework provisions. These include First Mutual, GP2, Sunshine, Goal bold, Intermarket and Barbican unit trusts.

Unit trusts worldwide have been proven to be having the capacity to mobilise meaningful resources even from the marginalised sectors of the economy African Development Bank (ADB, 2004). Like any other business, unit trust business need to be viable in order to remain vibrant in resource mobilisation aspect, argued Brookey (1999). Increasing costs associated with doing unit trust business in Zimbabwe exacerbated by a four-digit (1193.5%) year on year inflation, dwindling savings, shrinking purchasing power, foreign currency shortages and high nominal but negative real interest rates, makes it difficult for unit trust business to survive, Bankers' Association of Zimbabwe (BAZ, 2005). It is against this background that the researcher wants to investigate the viability of unit trust business in Zimbabwe given the prevailing harsh macro economic environment during period 2000 to 2005.

Strategic resources allocation is going to be made easy through the adoption of this research's recommendations. The research will benefit the unit trust business policymakers in coming up with their strategic business models meant to revitalise unit trust business in Zimbabwe. It is the researcher's belief that this research will provide a useful input in unit trust business strategy formulation, implementation and review process. Section 2 looks at unit trust business viability in Zimbabwe. Section 3 reviews major theoretical and empirical underpinnings of unit trust business viability. Section 4 looks at the presentation and analysis of results of the study. Section 5 concludes the study.

2. Unit trust business viability in Zimbabwe

The developments in Zimbabwe seem to confirm the above research findings by Sellon (2004). Return from unit trust funds on average had managed to consistently beat both inflation and Zimbabwe Stock Exchange Industrial Index (Comarton Survey, 2001-2005). The potential of unit trusts attracted new players in year 2001, namely Zimnat and Barbican unit trusts. Fins real, GP2, Sunshine and Goal bold were then launched in year 2002, further confirming the popularity of unit trusts not only in Zimbabwe but the world over, (ZAUT, 2005).

Muringari (2004) pointed out that poor macro economic environment that prevailed during the period under study was not suitable for unit trust business viability. The hyper inflationary environment, which recorded 1193.5% year on year and 28% month on month in May 2005, reduces income's purchasing power hence effectively reducing amount of savings on the part of investors. Reducing savings indirectly lower unit trust business viability and profitability (ZAUT, 2004). Muringari (2004) further pointed out that reduced savings was one of the reasons attributable to the collapse of some unit trust companies in year 2004.

According to ZAUT (2004), the fixed foreign exchange rate system had been causing some negative effects on the viability of unit trust business in Zimbabwe. The policy created foreign currency shortages in the official market thus negatively impacting on companies which uses imported unit trust systems. This has further constrained unit trust business operations and viability in Zimbabwe, (Old Mutual Unit Trusts Report, 2005). Delays to pay systems maintenance fees has created poor business relationships as the system vendors deliberately take long period to sort out a minor unit trusts system problem hence negatively impacting on quality of service delivery ZAUT (2004).

According to the RBZ (2005), foreign currency shortages have made it extremely difficult to send staff members to other countries to study modern ways of administering unit trusts. A greater portion of unit trust business profit goes towards payment of system maintenance fees as the local currency continues to depreciate against other currencies hence affecting profitability and viability of unit trust business in Zimbabwe, (Syfrets Unit Trusts Report, 2004). In addition, the report pointed out that stringent regulatory framework further pull down profitability and potential of unit trust business in Zimbabwe. High interest rate regime work against unit trust business viability as it increases interest rate exposure Zimbabwe National Chamber of Commerce (ZNCC, 2004).

3. Review of related literature

Nicoll (2005) described unit trusts viability as a situation where the return of unit trusts outweighs both inflation and stock exchange performance. Woodlin (2003) added that such a scenario can easily be achieved if unit trusts portfolio is properly diversified and actively managed. However, Lambrechts (1999) pointed out that unit trust viability has to be assessed in terms of its contribution to the overall profitability of the company and shareholder value point of view. Chiplin and Wriht (1998) supported this view and even further noted that tools such as the BCG Matrix Model must be used to assess if unit trusts in any country are viable.

According to Phillip (2000), unit trusts viability can also be analysed from the view of changes in units in issue or new business growth. An unprecedented increase in units in issue or new investments is an indicator of unit trusts viability. An increase in units in issue will obviously boost funds under management and enable unit trusts funds enjoy advantages associated with economies of scale (Phillip, 2000). Unit trusts viability can also be measured by assessing business volumes lost by banks and pension funds to unit trusts, argued Sellon (2004). The more business is lost to unit trusts by pension funds and banks, the more viable unit trusts products according to Sellon (2004).

Two approaches that explain unit trusts viability include the risk-return and cost-income approach (Jean, 1996). Risk-Return theory focuses on unit trusts from investors' point of view. According to Jean (1996), unit trusts can only be viable if return offered justifies the risk taken. This theory is also known as the opportunity cost theory on unit trusts viability. Jean (1996) further noted that unit trusts viability has to be analysed in the context of how much return could have been made if money had been invested elsewhere. However, the theory was criticised by John (2000) who cited theory's lack of imagination on the point of view unit trusts viability should be analysed. According to John (2000), any theory on this subject matter which fails to note that profitability and cash flow implications are core issues surrounding unit trust business viability in any country should be dismissed. Cost-Income theory states that unit trusts can only be viable as a business unit if cash inflows are greater than cash outflows. Jean (1996) further noted that unit trusts like any other business can only become viable if it does not face any cash flow problems. According to John (2000), the cost-income theory only stated but fell short of articulating the actual implications of negative cash flows on unit trusts viability.

Allen (1993) argued that active fund management strategy is the pillar for unit trusts viability management. In active fund management strategy, fund managers look for shares of companies they believe offer strong earnings growth potential.

Investment strategy focuses on shares with strong earnings, growth prospects, health cash flows and shares showing a positive relative strength. Unit trusts shares are continuously monitored to justify their inclusion in the portfolio and will be sold if they do not meet the selection criteria. Allen (1993) argued that the traditional 4Ps of marketing (product, place, price and promotion) are very crucial in designing the best marketing strategy to ensure unit trust business viability. Supportive unit trusts distribution channels, low cost strategy and heavy promotion of unit trust products are essential ingredients in achieving and sustaining unit trust business viability, argued Allen (1993).

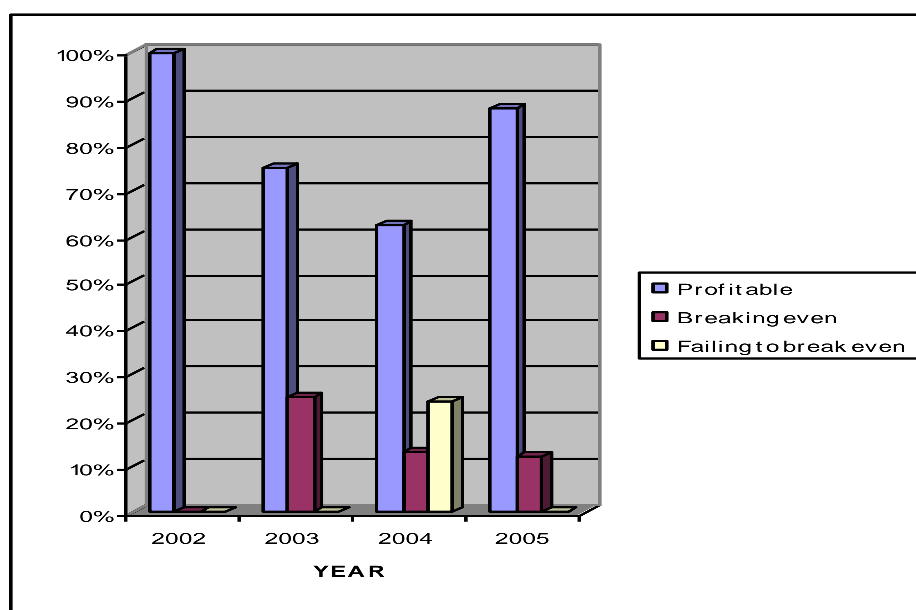
4. Analytical framework of viability of unit trust business in Zimbabwe

Three tools were used to critically analyse unit trust business viability in Zimbabwe, namely profitability, break even and cash flow analysis. The findings regarding these analyses are now considered in detail.

a) Profitability and breakeven analysis

Figure 1 below is a bar graph which shows percentage of profitable and unprofitable unit trust companies during the period 2002 to 2005.

Figure 1. Unit trusts profitability analysis in Zimbabwe (from 2002 to 2005)



Source: Zimbabwe Association of Unit Trusts (2006)

Seventy five percent (75%) of unit trust companies were at least profitable and 25 percent managed to break even in 2003. Undoubtedly, these statistics were inevitable as competition intensified, characterized by new players which were intending to establish themselves by engaging in rigorous marketing efforts. Marketing expenditure levels surged across all unit trust companies as the fight for market share control intensified in 2003.

Figure 1 also revealed that, 63 percent of unit trust companies were profitable whilst 13 percent managed to break even in 2004. On the other hand, 24 four percent failed to break even during the same year. The general decline in profitability levels in 2004 is attributable to the December 2003 monetary policy which tightened the liquidity provision policy to banks. The policy had produced some negative ripple effects as it led to the collapse of a number of asset management companies such as Barbican, First Mutual, ENG Capital, Fins real, GP2, First Factoring, Imperial, Sunshine and Goal bold only just to mention a few. The financial crisis of 2004 forced many unit trust investors to channel their money to traditional banks which they perceived as secure, ZAUT (2006). This greatly reduced general profitability levels in 2004. According to ZAUT (2006), eighty eight percent of unit trust companies were profitable in 2005 whilst the remainder managed to break even during the same year.

(b) Cash flow analysis

Banks in Zimbabwe lost a significant amount of business to unit trusts in the year 2002 and 2003 whilst the trend was opposite in the year 2004. According to Comarton survey (2004), Old Mutual unit trusts was the biggest beneficiary of investors pulling out their money from banks in favour of unit trusts, followed by Kingdom, Syfrets, Tetrad, Datvest, Zimnat and Merchant Bank of Central Africa

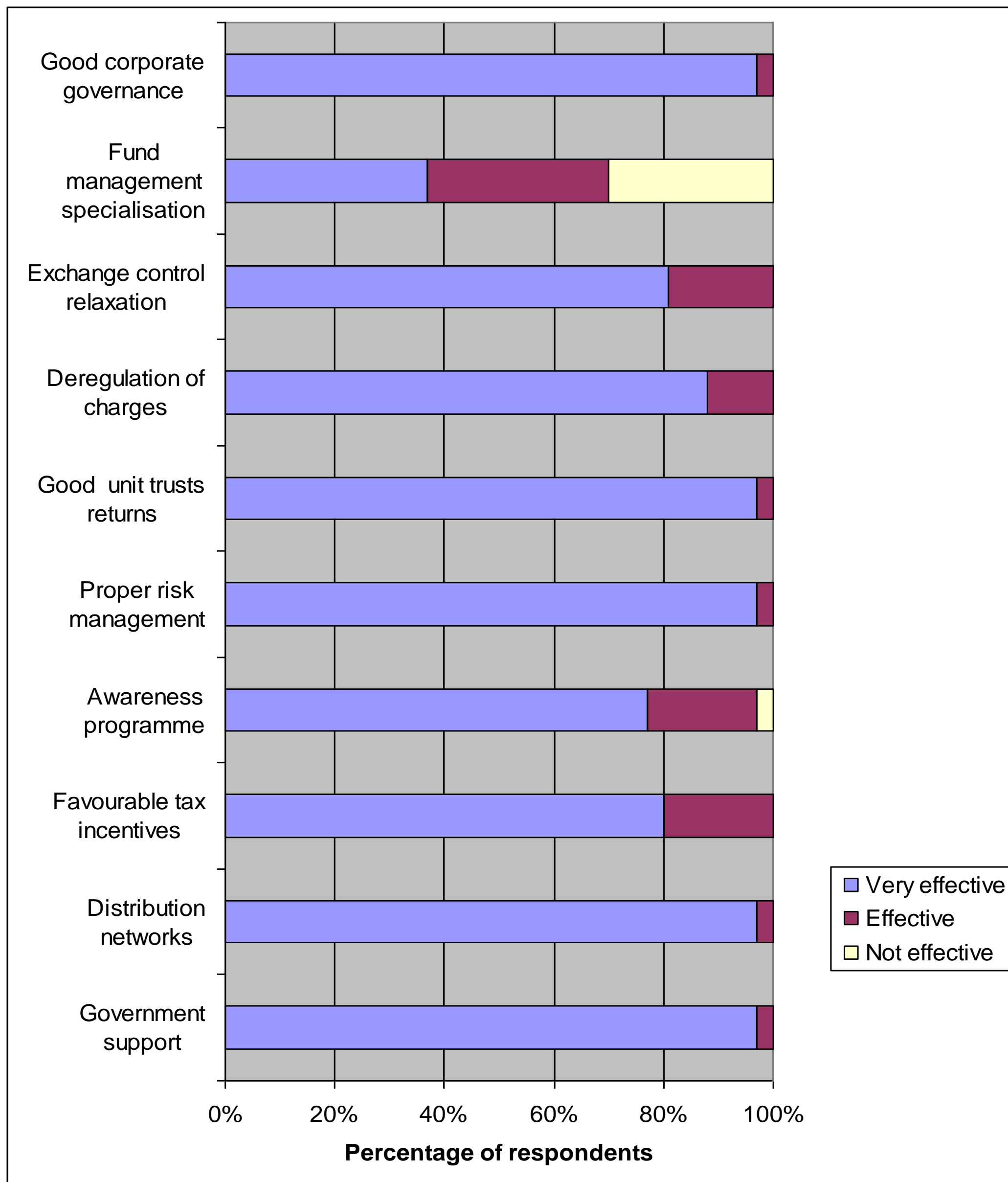
(MBCA). Comarton Survey (2005) revealed that strategic alliance was behind the increased investments from banks into unit trusts. For example the strategic alliance between Old Mutual unit trusts and Central African Building Society (CABS), Kingdom unit trusts and Kingdom Bank, Syfrets unit trusts and Zimbank, Datvest unit trusts and Interfin Merchant Bank.

Whilst all other unit trust companies were losing business to unit trust funds, Old Mutual in 2004 actually experienced the highest amount of new business injection from banks by approximately 26 percent because of high investor confidence in the company. According to RBZ (2004), the year 2004 was characterised by large amounts of funds withdrawals from unit trusts to traditional banks due to panic by investors as Barbican, First Mutual, GP2, Fins real and Goal bold unit trust companies were placed under curatorship.

c) Critical success factors for unit trust business viability in Zimbabwe

According to ZAUT (2006), there are ten critical success factors for unit trust business viability in Zimbabwe, namely good corporate governance, fund management specialisation, exchange control relaxation, deregulation of charges, good unit trusts returns, proper risk management, awareness programme, favourable tax incentives, distribution networks and government support (see Figure 2).

Figure 2. Analysis of effectiveness of strategies to promote unit trusts viability in Zimbabwe

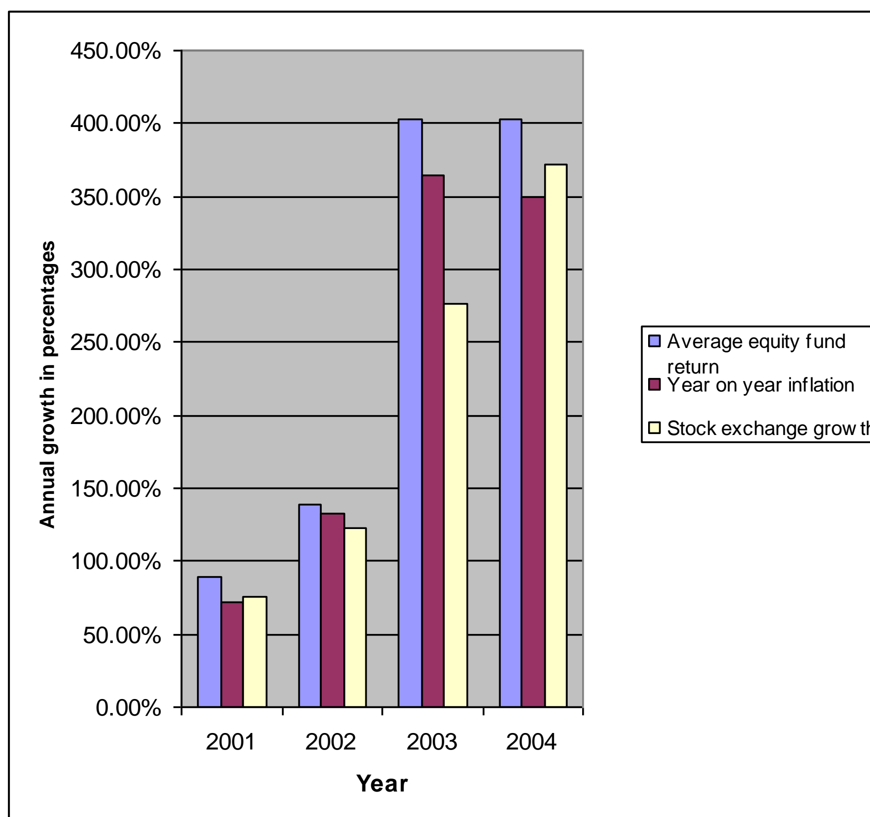


Source: Zimbabwe Association of Unit Trusts (2006)

d) Unit trust funds performance in Zimbabwe

The research compared unit trust funds return versus inflation and Zimbabwe Stock Exchange growth from year 2001 up to 2004. The study revealed that unit trusts have been performing consistently above both inflation and Zimbabwe Stock Exchange during the period under study (see Figure 3).

Figure 3. Unit trust funds return versus inflation and Zimbabwe Stock Exchange growth.



Source: Zimbabwe Association of Unit Trusts (2006)

The research revealed that superior stock selection, good diversification strategy and proper asset and liability management strategy were behind the impressive performance of unit trust funds in Zimbabwe during the period under study.

5. Conclusion

It can be concluded that unit trust business in Zimbabwe has been profitable but viable to a lesser extent during the period under study. Positive profit levels recorded by all unit trust companies during the period under study were inadequate to enable unit trust business expansion and infrastructural development. The research confirmed that government support is a chief factor in the growth, success and viability of unit trusts in Zimbabwe and this corroborates with empirical research findings by Syapouty (2004). The research also revealed that there is a positive correlation between cash inflow into unit trust funds and profitability levels thus confirming empirical research findings by Woodlin (2003). It can therefore be concluded that net cash inflow into unit trust funds is one of the chief factors necessary for unit trust business profitability and viability in Zimbabwe.

Research findings on the importance of proper risk management in ensuring unit trust business viability mirrors that of Jorion (2003). The latter found out that increase in the sophistication of risk analysis by better educated and more experienced managers in Singapore further added impetus to unit trust business viability. Kainja (1998)'s research findings to a larger extent confirmed those of the current research particularly on the critical success factors for unit trusts in South Africa.

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