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CONTENTS

LEGISLATION OF ETHICS IN THE EARLY YEARS OF THE SECURITIES AND EXCHANGE COMMISSION

Dan G. Teed, Troy University

ABSTRACT

Enforcement action by the Securities and Exchange Commission in the years following its formation and prior to the beginning of World War II created reporting sanctions viewed as symbolic by much of corporate America. That is, powerful chief executive officers of many of America's giant publicly held corporations believed these sanctions were instituted only to placate a worried investing public and would not be enforced with rigor. These managers, therefore, believed they could either ignore the Securities and Exchange Commission pronouncements or implement them only superficially. I submit the result has been many continual challenges of authority and corporate disregard of ethical behavior throughout the remainder of the 20th century. This paper will explore the history of the early part of the 20th century to determine reasons why these symbolic pronouncements may have been perceived by the Securities and Exchange Commission as a necessity for its continued existence.

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KEYWORDS: Symbolism, Power, Ethics, Fraud, Acquiescence, Conciliation

INTRODUCTION

Ethics may be generally thought of as actions that are in accord with right or moral conduct. The American Bar Association (ABA) equates ethical conduct in business with proper corporate responsibility and morality, which they define as "behavior by the executive officers and directors of the corporation that . . . results from the proper exercise of the fiduciary duties of care and loyalty to the corporation and its shareholders . . . [well] beyond that demanded by minimum legal standards" (ABA, 2003, p. 4).

The Securities and Exchange Commission (SEC) was formed as a result of the passage of the Securities Exchange Act of 1934 (SEC, 2011). It was a direct response by the newly elected American government to restore public confidence in the U.S. capitalistic system that had been severely eroded by the stock market crash of 1929 (the "Crash") and the subsequent Great Depression of the 1930s.

Determining how and why the SEC responded to corporate abuses of ethical behavior during its first six years of existence is the research topic of this paper. More specifically, this paper explains why the SEC functioned symbolically – enforcing the new securities laws by using symbolic pronouncements – in the face of extenuating circumstances over which it had only partial control.

I submit, however, such symbolic solution to fraudulent corporate activity not only emboldened those corporate managers bent on a disregard for ethical behavior, but also created an atmosphere of acceptable disregard throughout the remainder of the 20th century. Regulatory attempts to strengthen corporate governance, particularly in the last half of the prior millennium, finally culminated in the swift passage of the Public Company Accounting Reform and Investor Protection Act of 2002, better known as the Sarbanes-Oxley Act of 2002 (SOX).

Examination of the history of the SEC's early years and of the economic situation leading to its formation is important. It points out problems that continue to exist in our capitalistic system today. Examination of the history of the American capitalistic system and of early attempts to mitigate bad corporate governance may therefore prove fruitful in examining current day problems and regulatory attempts. Indeed, parallels between the exuberance and subsequent sharp economic decline of two periods – the 1920s and the 1930s and the final decade of the 20th century and the first of the 21st century – are striking. Both periods had similar scenarios that lead to financial difficulties. Both had extended periods of prosperity that seemed to be without an end. Both periods were characterized by a headlong participation in the market, and both were governed to a large extent with a *laissez faire* governmental attitude. This was especially true of the 1920s. Both had subsequent periods of corporate crisis that created anger and resentment; both created outcries for strong governmental oversight; and, perhaps most importantly, both postured the accounting profession in a defensive position which was only partially of its own making.

Several early authors (Berle and Means, 1933, Dodd, 1932, 1935, Douglas, 1934) supported intervention into corporate governance and ethics by governmental fiat. These legal pluralists believed that the powerful corporate managers of their day were incapable of controlling their acquisitive instinct for power and could be restrained in no other way. Still others, particularly in later years (Anonymous, 1977, Kalbers and Fogarty, 1998, Levitt, 1998), point out that regulations cannot control a person or a group if those persons or groups are determined to utilize their power in an unethical manner.

The SEC was granted regulatory powers by Congress in 1934 (Merino, 2003), but Bealing et al. (1996) and Merino and Mayper (2001) both report a conciliatory stance by the SEC in dealing with the business world during its early years prior to World War II. This same conciliatory stance, however, produced symbolic pronouncements that emboldened already-powerful management of corporate giants, because they understood that the SEC's pronouncements could be ignored with impunity.

The remainder of this paper is organized as follows: The history of the exponential growth of American corporations and of the attendant lack of ethical corporate governance in the early 20th century is examined in detail. Enforcement actions by the SEC in its first decade of existence are studied and justified in light of pressures on the organization that were applied by various political factions and by existing economic circumstances. Three major frauds of the early 20th century are then examined. Finally, concluding comments are made, not only justifying the SEC's early enforcement actions but also suggesting reasons for continuance of bad corporate governance during the remainder of the 20th century.

THE HISTORY OF SECURITIES AND EXCHANGE COMMISSION REGULATIONS

Two periods must be analyzed to determine reasons for the Securities and Exchange Commission's (SEC's) methodology of dealing with instances of corporate fraud in its first decade of existence. The first period, from approximately the middle of the 19th century through the crash of the stock market at the end of the Roaring Twenties, elicits circumstances leading to the organization's birth. The second period, from the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934 through the 1939 examination of the McKesson & Robbins fraud, explains the organization's struggle to remain viable in the face of opposition from its opponents and, at the same time, exert its influence on the economic morass in which the United States found itself during this period.

First Period – American Capitalism Prior to 1933

Capitalism was present in the 19th century in the United States, but to a limited degree. Officers of corporations were, for the most part, locally or regionally connected with corporate shareholders in their locale. Boards of directors were composed of individuals with whom these owners were acquainted. Mutual trust among owners, officers, and stockholders was generally accepted by all as part of corporate financial dealings.

The last half of the 19th century witnessed significant lifestyle changes in America. A pattern of power began to emerge within the economy of the United States that created an interruption of this mutual trust and of the agrarian lifestyle in America. The pattern emanated primarily from two major sources: compacting of the nation by the "Iron Horse" and vastly increased technology in communications.

Compaction of the nation resulting from the Iron Horse not only made areas of the country more accessible, but also created a need for vast amounts of capital and funding. Local and regional funding of corporations in the manner of prior years had no ability to provide the massive amounts necessary for this growth of the nation. Funds for production of a transcontinental connection needed to come from persons and institutions throughout the nation. Technological advancements, such as the telegraph and telephone, provided access to persons and businesses previously unknown. Together, these two factors created a change in the country that would never be reversed. Corporate growth exploded, almost totally lacking the attendant accounting for organizations' financial dealings. Urbanization proliferated in America's population, with jobs made available in large city factories that created significantly different lifestyles for many who had been used to slower agrarian circumstances (Previts and Merino, 1998).

Individuals with keen foresight realized that significant wealth and power could be amassed by controlling the production of items needed by the railroads, as well as controlling the railroad companies themselves. These individuals maintained control of emerging giant corporations through a device called a "voting trust" (United States House of Representatives, 1913). Terms under such an agreement generally called for shareholders to relinquish their voting rights to a trustee. These trustees, then, elected boards of directors for the corporations and, in general, controlled operations of the company (United States House of Representatives, 1913, p. 1018-1020).

It appeared that Congressional legislation in 1913 dealing with voting trusts had restored a balance between U.S. capitalism controlled by large corporations and protection of individuals. Very quickly, however, World War I – the "War to End All Wars" – interrupted. After a period of neutrality, America joined Allied forces and assisted in the defeat of Germany. This was a period in American history when dramatic major sociological changes occurred. Giant corporations drove the American capitalistic system and produced a significant amount of war material that had been instrumental in the Allies' victory in Europe. Businesses as a group received much of the credit for the effort that had won the war, and the general feeling was that business was no longer to be regarded as an evil. "Many people attributed the Allied victory to the creativity and ingenuity of American business people" (Previts and Merino, 1979, p. 197). "[T]he war had proven that business was 'moral'" (Previts and Merino, 1998, p. 238), and any thoughts of legislation restricting the power of corporate managers were reduced to insignificance.

The decade of the 1920s in America was one of significant growth -- described as a "wave of prosperity" (Carey, 1969, p. 35), as a booming economy (Adelberg, 1975), as "the so-called Golden Age of Business" (Previts and Merino, 1998, p. 238). A desire for new items on the market existed in all parts of the country; consequently, the decade was aptly described as the "Roaring Twenties." Allied victory in World War I produced a headiness in America, omnipresent from architecture to music to consumerism. Accompanying this headiness was the desire of many Americans to participate in the economic growth.

Berle and Means (1933) reported that the concept of wealth in property ownership was changing rapidly from material items – land, machinery, buildings – to ownership of passive property – stocks and bonds of the growing giant corporations. These two academicians were disturbed by their perception of the sinister direction that power within corporate America was taking in the Roaring Twenties. Their classic work, *The Modern Corporation and Private Property*, highlighted unchecked power accorded to managers of corporate giants and the accompanying dangers to the U.S. economy.

The power placed in the hands of managers of giant corporations, these authors asserted, threatened the foundation of the capitalistic system because it had been used in any number of cases without regard for what was best for stakeholders of the corporation. Power was accomplished through the use of handpicked, subservient boards (Berle and Means, 1933, p. 86) and the use of proxy certificates. Through the use of the proxy, corporate managers possessed power that was virtually unchecked and would therefore soon rival the power of the State. It thus required governmental regulation for its mitigation (Means, 1983).

Here, then, an economic set of circumstances created an incubator for fraud and unethical practices. Corporations were growing exponentially. Some maintained good internal controls; some had nothing remotely resembling controls. The profession of accounting was floundering in attempting to report on the financial condition of these entities because of a lack of auditing standards. Americans seeking wealth were putting their life savings into corporate stock and were being completely unconcerned with methods being used by companies to amass that wealth. Regulation of securities markets was virtually nonexistent.

Five days in 1929 – from Thursday, October 24th, through Tuesday, October 29th – precipitated a period in which life in America would forever change.

> The [Crash] in the fall of 1929 was a catastrophe beyond the worst predictions of the most pessimistic observers. The financial community was in a state of shock. Thirty *billion* dollars of quoted value of securities vanished in less than a month. . . . Financial paralysis gripped the country. Public reaction was bitter, and a critical review of the processes of the financial market . . . became an obvious political necessity. (Carey, 1969, p. 38, emphasis added)

The enormity of this free-fall can perhaps be put in better perspective by understanding that new Fords and Chevrolets were selling at the time for less than $1,000. Seligman (1982) reports that the loss over the next three years, measured in real dollars of the period, increased to more than double the thirty billion initial loss. Small investors who had put their entire life savings into the market lost everything. Large investors – millionaires before the Crash – became little better than wage earners within the ensuing first year. Indeed, as demonstrated by the loss of more than sixty billion in securities value over these following three years, the American Dream crept close to extinction. Initially, the government under President Hoover exuded confidence that the American economic system would stabilize. Everything would be all right in a few months; let those companies who faced bankruptcy do so; have faith in the capitalistic system (Berle, 1963, p. 80). When things did not stabilize, investors pressured the federal government to step in and mandate reforms that would bring about stabilization.

<u>Second Period – The First Decade of the SEC</u>

A new and energetic President assumed leadership of the United States government in 1933. He promised to deliver democracy from Wall Street conservatives back into the hands of the American people. Franklin D. Roosevelt's inaugural address assured the American people that "the only thing we have to fear is fear itself – nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance" (Roosevelt, 1933, para. 1). A theme that resonated with many who had lost everything was Roosevelt's description of the Wall Street managers as "unscrupulous money changers" (Roosevelt, 1933, para. 1).

Within a very short time, the new administration established control over publicly held securities by enacting the Securities Act of 1933 and the Securities Exchange Act of 1934. This latter created the Securities and Exchange Commission (SEC), a federal agency to which any corporation selling their stocks and bonds on public markets were required to report on an annual basis.

All during these early years of the SEC, when disagreements between New Deal liberals and big business conservatives created a form of political limbo in the United States, the fate of the new organization was less than firm. On the one hand, President Roosevelt had promised to create stability in the marketplace and restore confidence of investors in the U.S. capitalistic system. On the other hand, business conservatives were adamant that the *status quo* remain solidly in their favor.

New Dealers in the Congress and the administration were facing a very strong lobby in the business powers of the day on the one hand and an unhappy accounting profession on the other (Kaplan and Reaugh, 1939). An SEC Accounting Series Release (ASR) in 1938 provided for compromise: accounting principles were to be promulgated by the accounting profession (with governmental oversight provided by the SEC), rather than by federal fiat (SEC, 1938). To a limited degree, then, this acquiescence by federal powers portrays a tenor of SEC early years. That is, enforcement hesitancy and willingness to accede to conservative Wall Street power signaled to managers of large corporations that much, if not all, SEC rhetoric was symbolic only and not meant to be rigidly enforced (Edelman, 1964, Merino and Neimark, 1982, Kalbers and Fogarty, 1998, Merino and Mayper, 2001, Merino, 2003). Epitomizing this conciliatory posture were the actions of the SEC's third chair, William O. Douglas.

In the years before he became the third SEC chair, Douglas argued, as did Berle and Means, that because of the widespread ownership of corporate stock, "managers came to be their own supervisors, and the stockholders were moved into a position of effective subservience to those who by tradition and law were their servants" (Douglas, 1934, p. 1308). He asserted (p. 1327) that a fiduciary relationship between the board of directors and shareholders must be embodied in the board of directors as an initial contention of proper corporate governance. This necessity emanated from disparate shareholders' inability to control management or to "act intelligently" (p. 1316) in matters involving their investments. Government, therefore, must intervene, enforcing regulations for fiduciary relationships and protecting shareholders from rampant managerial power, as well as from themselves.

Merino and Mayper (2001) suggest that after he assumed SEC chair, Douglas "appears to act in favor of the *status quo* [restoring the American Dream in a liberal environment] due to his close relations with the accounting profession [and with business] and, in our view, being 'captured' by the [accounting] profession" (p. 502). They note that although he had been a strong proponent of regulatory enforcement in the years prior to his assuming chairperson, Douglas nevertheless became an active proponent of acquiescence as SEC head.

I submit that Douglas may not have had much choice in this matter. I suggest Douglas was not so much "captured" by the accounting profession as he was placed in a precarious and delicate balancing position by circumstances over which he had only partial control. Douglas was, after all, directly responsible for the continued existence of the fledgling SEC organization. External pressures on the SEC were significant – from all sides – and its continued existence very likely depended on a "middle of the road" posture. In addition, President Roosevelt could not afford to lose any majority opinion that may have been present in Congress for his New Deal policies, nor could he afford to renege on his commitment to the American people to have social values as bedrock for their part of the American Dream. Unfortunately, this compromising governmental posture translated to corporate managers as nothing more than symbolic rhetoric.

<u>Fraudulent Activities during the 20th Century</u>

Carey (1969) notes "[i]n the absence of any regulation of the securities market, abuses were inevitable" (p. 35). Indeed, fraudulent activities began to proliferate in the Roaring 1920s. I suggest three incidents in the early 20th century serve to define problems facing the new Securities and Exchange Commission as it attempted to mitigate bad corporate governance and restore stability and confidence in the capitalistic system. They are (1) the fraud committed by Kreuger & Toll, Inc., (2) the embezzlement by Richard Whitney, and, most particularly, (3) the fraud perpetrated by McKesson & Robbins, Inc.

The Kreuger & Toll, Inc. empire paralleled the Roaring 1920s with its meteoric ascendance and collapse and created much of the outcry for regulative protection for investors and stockholders of corporations (Flesher and Flesher, 1986, Clikeman, 2003).

For the accounting profession, Kreuger & Toll, Inc. represented a nightmare. The founder, Ivar Kreuger, known to the world as "the Match King," insisted on complete secrecy concerning the company's financial dealings. Kreuger apparently made up all of his company's financial statements and then instructed his corporate accountants to agree the company books and records with the made-up statements (Churchill, 1957, p. 249-255, cited in Flesher and Flesher, 1986, p. 423).

The Match King's empire started in 1913, when Kreuger took over control of three small match factories belonging to his family. After the First World War ended, Kreuger realized that European countries – struggling to restore their economies after the vast destruction on the Continent – would be willing to do just about anything to obtain funds to rebuild. Kreuger & Toll offered governments of these countries loans of up to $125 million dollars. The *quid pro quo* was a complete monopoly of the match market in that country (Marcosson, 1932, Flesher and Flesher, 1986, Clikeman, 2003).

Kreuger used the company's capital, rather than earnings, to pay shareholder dividends, and then depended on increased inflow from investors, in addition to any possible repayment of the European loans, to rebuild the company's capital base. In the 1920s, however, Americans were unconcerned that the methodology of maintaining the pyramid thus built was an unknown.

The stock market crash, of course, brought to an end Kreuger's Ponzi-type scheme. Faced with a significant lack of inflow from American and other investors and defaults on a number of the loans made to European countries, and unwilling to be branded as a criminal while alive, Kreuger shot himself in the heart on March 12, 1932. Within a month, Price Waterhouse auditors revealed that almost $250 million of assets reported by Kreuger & Toll did not exist (Flesher and Flesher, 1986, p. 425).

Kreuger epitomized the fear expressed by Berle and Means in their exposition of the economic situation of the 1920s. That is, Kreuger's Ponzi-type methodologies were illicitly practiced because the man had significant power and was, to his own mind, beyond the reach of ethical dicta and precedent. His refusal to allow any examination of the financial records of his company displayed not only an understanding of the vast separation of his position from proper corporate governance but also an untouchable aura in his own self-regard. He believed he was immune to any ethical or socially responsible principles.

A significant part of the disputation between those empowered by the new legislation – the New Dealers – and the "old guard" conservative business faction was the question of whether those who had been in a position of power could be relegated to a lower status by governmental fiat. Businesspersons who were accustomed to authority that was virtually unchallenged were now being required to follow mandates that were not to their liking. A habitude to unchallenged authority, however, creates an acquisitive need to maintain a constant or higher level of power and status, regardless of the methodology used to achieve this. The result in many cases was disdain for morality or ethics. Richard Whitney was such a case, but disposition of the Whitney fraud by the SEC represents another example of appeasement by the SEC.
Whitney was president of the New York Stock Exchange (NYSE) from 1931 to 1935. He was the embodiment of the monied "old guard" of Wall Street, having been born into wealth and position. He was educated in the finest of schools, represented the J. P. Morgan Company as its Wall Street financier, lived in very expensive residences, and functioned as treasurer of the exclusive New York Yacht Club. Whitney had a glowing reputation among investors and a worried public, yet this well-respected

individual had been embezzling for years from funds of investors who were using him as their Wall Street representative, thereby supporting his extravagant lifestyle (Anonymous, n.d., Maeder, 1999).

I suggest the Whitney fraud represents a telling example of an action that should have but did not occur. Such a blatant case of fraud, even when uncontested by Whitney himself, affecting the American investing public should have elicited an immediate investigation by the SEC. Faced with the overwhelming evidence that outright fraud had occurred within the NYSE, however, the SEC drafted a response, basically stating their belief that matters were of a private club nature and should be handled internally by the NYSE. When it became clear that the NYSE would do little more than censure Whitney, the SEC functioned, as it should have in the first place, in convicting Whitney of embezzlement.

Two points appear salient: (1) The SEC, faced with very strong opposition from monied financiers who had considerable influence with members of Congress, had a very real necessity to use appeasement/ compromise/acquiescence to maintain continued funding and existence (Oliver, 1991, p. 146). President Roosevelt, seeking earnestly to restore confidence in the capitalistic system and placate investors, while at the same time advancing his New Deal policies, must have also understood that "draconic control" and regulatory enforcement would not be in his best interest.

(2) Corporate managers quickly perceived from both the Richard Whitney case and the McKesson & Robbins investigation that rigid regulatory enforcement by the SEC would not ensue. These rules were *symbolic* – meant only to dissuade investor worries by stating regulatory corrections to wrongdoings – and could be ignored or obeyed only superficially. Punitive measures for noncompliance would be nonexistent or enforced only lightly.

Just as the Richard Whitney embezzlement appeared to have given the SEC a victory in establishing a modicum of governmental oversight in the public marketplace, a third major fraud – perhaps the largest – became known in late 1938 and challenged SEC authority – the McKesson & Robbins fraud.

McKesson & Robbins (McKesson) was the largest distributor of pharmaceuticals in the United States at the time. The total consolidated assets reported on the December 31, 1937, McKesson balance sheet were somewhere in excess of $87 million. Approximately $19 million of these assets (approximately 21 percent) were nonexistent inventories and accounts receivable of the drug division of the Connecticut subsidiary of McKesson and of the Canadian subsidiary of the company (SEC, 1940, p. 3).

Conclusions of a preponderance of twelve expert witnesses at the SEC investigation agreed that having a "buffer" between the auditor and the CEO would have alleviated to some degree the inability of the auditor to challenge the power of corporate CEOs. These witnesses pointed out that (1) auditors were appointed by the CEO or senior managerial personnel of the corporation, and (2) limitations by client management on the extent of the audit were a reality. Most importantly, eight of the twelve witnesses said they would strongly favor a committee of the board of directors (which several of the witnesses even called an "audit committee") as being responsible for appointing the auditor and handling the details of the audit, such as scope and fee. Three of the remaining four said the board itself should be responsible for this task (SEC, 1940).

Of singular importance to corporate managerial understanding of the *status quo*, regulatory pronouncements emanating from the McKesson & Robbins investigation by the SEC were directed *at the accounting profession*, not corporate managers. I suggest it was significantly easier for the SEC to impose regulatory promulgations on the external auditing profession – the CPA – than it was to inject these into corporate accounting and corporate governance. To foist regulatory edicts on major corporations meant the SEC would be challenging corporate power, something the liberal encampment was unwilling to do. Were this to be done, I submit the SEC very likely would have been committing political suicide. Realization of this meant symbolic pronouncements were needed, and translation of this symbolism to corporate managers meant "business as usual" for their future conduct.

CONCLUDING COMMENTS

Following Berle and Means (1933), I note an incredible amount of power was placed in the hands of a few key corporate individuals because of the way in which the capitalistic system in the U.S. evolved. Many of these individuals, instead of functioning as fiduciaries for corporate owners throughout the U.S. and the world, used their power to create unassailable empires for themselves.

I posit ethical misconduct in the capitalistic system and "bending" the system to one's advantage, done in the early 20th century by a number of key management persons in large U.S. corporations, emanates from the symbolic enforcement of the securities laws by the Securities and Exchange Commission (SEC) in its early years. I suggest these corporate managers "learned," from this symbolic enforcement of regulatory edicts by the SEC in its early years, that aggressive accounting and bad corporate governance not only was still possible but also was the methodology that should be employed to maintain the immense power held by these individuals.

This conciliatory approach to oversight of America's capitalistic system is best shown by what amounts to an abrupt political metamorphosis of the third chair of the SEC, William O. Douglas. My analysis of the political situation during the first decade of the SEC's existence suggests that Douglas may have adopted this acquiescent stance to maintain Congressional funding of the SEC and maintain its viability, not because of any "capturing" by the accounting profession.

The fledgling organization was expected from the outset to control unchecked corporate managerial power and restore morality and social ethicality to the system. From the outset, though, the organization was faced with a multitude of conflicting concepts, each powerful in its own right, of the way the system should be corrected (or left alone). Both Congress and the SEC were pressured by a very powerful bloc of conservative businesspersons to thwart any attempt at federal regulation of corporations. If the SEC were to achieve institutionalization, however, it would need continued funding from these Congressional legislators. Labor unions actively sought federal regulation of corporations and of the accounting profession; the accounting profession was adamant in its refusal to agree to this federal control. Faced with pressures from these different factions, the SEC adopted a conciliatory stance in many of its early decisions and rulings.

Finally, the SEC succeeded in two important ways: (1) It mollified investors and re-established a modicum of faith in the capitalistic system, and (2) it institutionalized itself by maintaining continued funding from Congress. In the final analysis, it was very likely the use of conciliatory/acquiescent action that allowed these successes.

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BIOGRAPHY

Dan G. Teed is an assistant professor of accounting at Troy University in Alabama. His research has appeared in the *Journal of Accounting and Finance Research* and in the *European Journal of Management*. He may be reached at Sorrell College of Business, Troy University, 500 University Drive, Dothan, Alabama 36303, email dteed@troy.edu.

EMOTIONAL INTELLIGENCE OF FINANCIAL PLANNERS IN MEDIATION

Randy Braidfoot, Ashford University
Andree C. Swanson, Ashford University

ABSTRACT

A commonality of the professions of mediation and financial planning is dealing with the emotional aspects of the client(s). It is surprising then that more formal training on management of the client's emotions has not been presented by either vocation. The four aspects of self awareness, self management, social awareness, and relationship management make up the components of Emotional Intelligence. This allows an individual to monitor his or her own emotions, the emotions of others, and to use this information to create a positive outcome. The professional Financial Planner who works in Mediation can benefit greatly from the study and mastery of Emotional Intelligence.

JEL: G11, Z00

KEYWORDS: Emotional Intelligence, Financial Planners, Mediation, Money

INTRODUCTION

Emotions are a control factor determining outcome in both Financial Planning and Mediation. The environment of a mediation where two conflicting parties meet to negotiate some form of agreement (with a neutral third-party to preside as a communications facilitator) fosters a setting in which a broad range of emotions are normally exhibited. An experienced financial planner must be prepared to answer the following questions: What happens when the two different mediums combine to create a volatile situation? How does the financial professional manage this and stay in control? How can the financial professional enhance the process to create greater opportunity for a more positive outcome?

Financial issues are a main source of emotional stress. "Money evokes emotions such as stress, fantasy, irrationality, and fear" (Danford, 2012, p. 25). This financial stress is also one of the main drivers of the emotional outbursts experienced in both Financial Planning and Mediation meetings. Numerous Financial Planners are familiar with the adage of being the professional to assist in taking the emotion out of the investing process. Much research has been produced regarding the recognition and acknowledgement of an individual's emotional connection to his or her money or financial well-being (Britt, Huston, & Durband, 2010; Colfax, Rivera, & Perez. 2010). Mediation is also an environment where many times financial discussion or negotiation is the main focus, whether it be civil or family mediation, and if not, certainly an important secondary topic.

Being able to recognize and manage these emotions, from one's own viewpoint, and that of the other participants, is part of the basis of Emotional Intelligence. Emotional Intelligence is the ability to recognize, assess, and control one's own emotions and that of others (Mayer, Caruso, & Salovey, 1999; Mayer & Salovey, 1997). "Emotions can influence financial decisions in surprisingly predictable ways" (Sullivan, 2011, p. 4). Numerous studies have demonstrated how an individual with high emotional intelligence can enhance and increase the potential for positive outcomes (Cherniss, 1999).

The introduction of this paper provides an overview of the importance of including emotional intelligence in the fields of financial planning and mediation. The remainder of the paper includes a literature review, a discussion on the importance of emotional intelligence, empathy and the financial planner, emotional intelligence and mediation, financial issues and mediation, emotional intelligence and the financial planner, the methods for increasing emotional intelligence, and the concluding comments.

LITERATURE REVIEW

The purpose of this literature review is to identify what is available in current periodicals and websites on the topic of emotional intelligence and the financial planners in mediation. The research took place over a one-year period using ProQuest, Google Scholar, and the Internet.

Table 1: Key Word and Title Search

Theoretical concepts and research topics	Peer-reviewed journal articles	Dissertations, books, reports and proceedings	Websites	Newspapers and magazines
Emotional intelligence	351	711	0	31
Emotional intelligence + financial planning	3	0	15	0
Emotional Intelligence + mediation	0	0	0	0
Emotional Intelligence + mediation + money	0	0	0	0

Key word searches are: 1) emotional intelligence, 2) emotional intelligence and financial planning, 3) emotional intelligence and mediation, and 4) emotional intelligence and mediation and money.

Within ProQuest and Google Scholar, no literature was found with key word searches of 1) emotional intelligence, 2) emotional intelligence and financial planning, 3) emotional intelligence and mediation, and 4) emotional intelligence, mediation, and money.

Emotional intelligence in relation to financial planning is only briefly discussed in peer-reviewed literature. Grote (2009) discussed a financial planner who manages two financial planning firms, and limits the discussion of EI to the mandate that staff must "exhibit a high degree of emotional intelligence" (p. Abstract). Grote (2012) does not address financial planning per se, but addresses the need for planners to coach executives on EI.

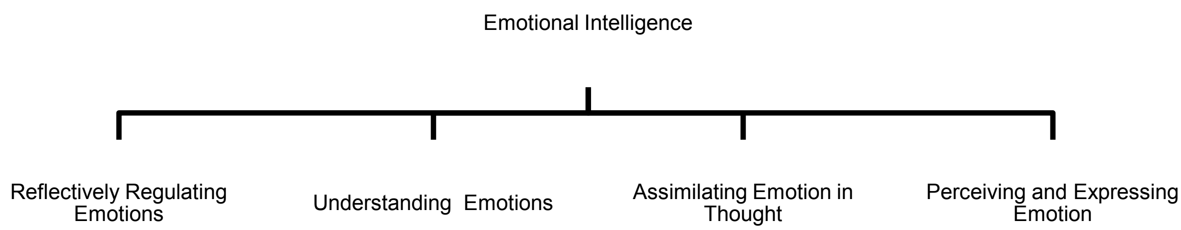
On the Internet, few websites were found that added substance to the literature review. An Australia company offers courses in emotional intelligence (Langley Group, n.d.). Makunike (2012), a business consultant in Zimbabwe, wrote an article that supports Makunike (2012) stated, "According to the Harvard Business Review’s “Breakthrough Ideas for Tomorrow's Business Agenda” article emotional intelligence isn't a luxury you can dispense with in tough times but a basic tool that, deployed with finesse, is the key to professional success" (para. 12). This does not emphasize the need for emotional intelligence in financial planners, but in the overall business world. Other than these two websites, the few that were found merely used the phrase of "emotional intelligence" as a passing thought.

UNDERSTANDING EMOTIONAL INTELLIGENCE

Emotional Intelligence (EI) was first used in an English doctoral dissertation in 1983 (Payne, 1983/1986). The term was actually derived prior though in 1966 by B. Leuner in a German article titled “Emotional Intelligence and Emancipation” (translated) to describe women who, because of perceived low Emotional Intelligence, rejected their social roles (Leuner, 1966). Salovey and Mayer (1990) further developed the concept. EI is the capacity to perceive emotions, assimilate emotion-related feelings, understand the information of those emotions, and manage them (Mayer et al., 1999).

The ability to recognize the meanings of emotions and relationships, in addition to reasoning and problem solving based on these emotions is at the core of EI (Mayer et al., 1999). A four-branch model was designed by Mayer, Caruso, and Salovey. Emotional Intelligence has four components: 1) reflectively regulating emotions, 2) understanding emotions, 3) assimilating emotion in thought, and 4) perceiving and expressing emotion (Figure 1).

Figure 1. The Emotional Intelligence Four-Branch Model



Emotional Intelligence has four components: 1) reflectively regulating emotions, 2) understanding emotions, 3) assimilating emotion in thought, and 4) perceiving and expressing emotion.

To understand EI, one must understand the components that form the basis of EI. Psychologists recognize the mind (or brain) as having three distinct divisions; cognition (thought), affect (which includes emotion), and motivation (Mayer & Salovey, 1997). The first area of the brain is cognition, which refers to memory, reasoning, judgment, and abstract thought. Intelligence is measured here, reflecting the ability to combine and separate concepts, judge and reason, and the ability to engage in abstract thought (Mayer & Salovey, 1997).

The second area of the brain is the affective area of the mind represented by emotions including the actual emotions (anger, happiness, fear, etc.), moods, evaluations, and other states of feeling, including physical states such as being tired or energetic (Mayer & Salovey, 1997). Both heredity and learned behavior play a role in establishment and development of the individual components of cognitive and affective spheres of the brain (Mayer & Salovey, 1997).

The third area of the brain is motivation. Mayer and Salovey (1997) described motivation as the biological urges or learned goal-seeking behaviors. Motivation is considered to be a secondary factor in comparison with the other components of cognition and affect with regard to EI (Mayer & Salovey, 1997).

Realizing all three components may be a part of genetics in addition to learned behavior provides for a myriad of different attitudes and intelligence. The ability to understand a concept or learn something new may be easier for one individual than for another. In the same manner, one individual may consistently be in an upbeat mood, full of energy, whereas another person may show negative emotions in addition to lacking in motivation on a consistent basis.

Being able to recognize these in oneself and in others, and the ability to manage or improve these components in both one's own makeup and that of others is representative of EI.

Tests are available to actually determine the level of EI an individual possesses. In the 1980s, Dr. Reuven Bar-On produced an assessment tool known as Emotional Quotient Inventory (EQ-i) to provide a quantitative measure of EI (Colfax, Rivera, & Perez, 2010). This provided a better understanding of the components making up EI measuring fifteen elements on an individual basis, grouped into five major composites. Since then, the assessment tool has been updated to EQ-i^2, building on the basis of EQ-I (Ferraro, 2012).

The Importance of Emotional Intelligence

Emotional Intelligence is essential to effectiveness in the work force. "Emotional intelligence is your ability to recognize and understand emotions in yourself and others, and your ability to use this awareness to manage your behavior and relationships" (Paterson, 2011, p. 80). Since the awareness of Daniel Goleman's research on emotional intelligence, the willingness to look at emotional awareness has turned into a positive benefit for both individuals and organizations. "Goleman compared star performers with average ones in senior leadership, nearly 90% of the difference in their profiles was attributable to emotional intelligence skills rather than their cognitive capabilities or technical skills" (Paterson, 2011, p. 80).

Numerous academic studies provide empirical evidence that improvements in EI are highly correlated with increased performance in both learning and in the workplace. Studies in both Affective Neuroscience and Biobehavioral Science demonstrate "some of the most impressive evidence for brain plasticity is emotional learning" (Davidson, Jackson, & Kalin, 2000, p. 890). In effect, with proper training one can rewire and reshape the emotional circuitry of one's brain to maximize emotional performance. Bradberry and Greaves (2009) indicated that EI is "so critical to success that it accounts for 58% of performance in all types of jobs" and "is the single biggest predictor of performance in the workplace and the strongest driver of leadership and personal excellence" (p. 20).

Businesses and governments are now in agreement with Oscar Wilde who said, "I don't want to be at the mercy of my emotions. I want to use them, to enjoy them, and to dominate them" (Wilde, 2007, p. 228). Oscar Wilde recognized the power of emotions in his classic, *The Picture of Dorian Gray.* The United States Air Force used the EQ-i test by Bar-on to select recruiters and increased their ability to predict successful recruiters by nearly three-fold, with an immediate savings of $3 million annually (Cherniss, 1999). Cherniss (1999) offered 19 unique examples in business (with the Air Force being one example) demonstrating the significant effect EI had within an organization.

Empathy and the Financial Planner

Empathy is the ability to reflect on one's situation and feelings, and to show that you care. Goleman stated, "If your emotional abilities aren't in hand, if you don't have self-awareness, if you are not able to manage your distressing emotions, if you can't have empathy and have effective relationships, then no matter how smart you are, you are not going to get very far" (Hughes, 2004). The effective financial planner has the ability to demonstrate empathy through empathetic communication (Fishman, 2011). "Empathic mirroring is the ability to take in what other people are saying and feeling and then communicate that you have internalized their thoughts and feelings" (Fishman, 2011, p. 26). An example is when a manager says to a subordinate "I can see you are angry." Empathetic mirroring acknowledges the right to feel how the subordinate feels, although it does not communicate approval of the action (McCabe, 2011).

Emotional Intelligence and Mediation

Emotional Intelligence, remarkably, has not been a major component in mediation training and practice. An environment whereby two opposing sides meet, more often than not with attorneys by their sides, to negotiate some form of agreement with an impartial, non-judgmental third-party to preside and act as negotiator between the parties creates a environment in which a broad range of emotions are normally exhibited. The discussion regarding lack of emotional recognition in mediation has been ongoing for some time. "It seems ironic that conflict, which is among the most emotion-arousing of phenomena, has been predominantly studied as though those emotions had no bearing on it" (Thomas, 1992, p. 702).

Jones and Bodtker (2001) stated four assumptions that support the use of EI in Mediation. The first assumption is that "emotion is the foundation of all conflict" (Jones & Bodtker, 2001, p. 219). The second assumption is that emotion is central in all mediation contexts. The third assumption is that to be maximally effective, mediators must focus on three key components of emotion in the mediation; expressive, physiological, and cognitive. The final assumption is recognition of the mediator's role in attending to the emotional experience of both the mediator themselves in addition to the disputants in order to fully understand the implications of emotion during the mediation (Jones & Bodtker, 2001).

Lund (2000) contended that mediators need training and preparation in order to manage their emotions. Lund proposed four methods for preparing: 1) Avoid being overwhelmed when emotion is expressed, 2) Deal with their own emotional reactions to disputant's emotions, 3) Increase sensitivity and detach themselves from the situation, and 4) Promote a realistic understanding of results (Lund, 2000).

FINANCIAL ISSUES AND MEDIATION

Knowing that financial issues are a main source of stress, it is not surprising then that many mediations stem from financial issues or become more complex because of financial issues. In many divorce mediations, money becomes a major source of conflict (Benjamin & Irving, 2011). Five distinct patterns where money becomes a major source of conflict in mediation (Benjamin & Irving, 2011). The patterns should be somewhat recognizable to individuals: 1) money is power, 2) money is security, 3) money is a painkiller or revenge, 4) money is compensation (payoff), or 5) money is closure.

Benjamin and Irving suggest that mediation involving money issues should involve both technical and clinical expertise although they suggest a therapeutic approach in mediations of this type. This can be seen as a suggestion of using Emotional Intelligence in the process.

Emotional Intelligence and the Financial Planner

Approximately 25% of the time a Financial Planner is dealing with non-planning issues such as "human drama and frailties" (Sussman & Dubofsky, 2009, p. 48). Although, EI has been correlated to increasing the business of financial planning, the emphasis for effective financial planning should be on how to increase positive relationships (Darwish, 2008). Sussman and Dubofsky (2009) and Darwish (2008) provided information that supports the need for EI training in the Financial Planning field.

A client that shares his or her personal financial information, goals and dreams, may be confiding in their Financial Planner more than they would his or her doctor, priest, or therapist. Any number of financial items may trigger an emotional response from the client. The issues of providing for survivors on one's death, the subject of divorce, or sheltering or hiding assets from a family member, the possibility of outliving one's assets, or concern about an investment loss, all of these may trigger a display of emotional volatility.

Seventy-four percent of planners had experienced a meeting in which a client became emotionally distraught (Sussman & Dubofsky, 2009). Sussman and Dubofsky (2009) determined that 40% of respondents had no training or coursework of any kind in regard to non-financial coaching or counseling. Forty-eight percent of respondents had mediated (informally) marital discord with another 44% mediating parent-child issues (Sussman & Dubofsky, 2009). Additionally, 34% of the planners in the survey were asked by a client if they should seek a divorce (Sussman & Dubofsky, 2009). From the results of the Sussman and Dubofsky study, EI should be considered when preparing a Financial Planner for Mediation.

For Certified Financial Planner™ practitioners, Principle 3 in the Code of Ethics states that a practitioner must maintain the knowledge and skills necessary to provide professional services competently.

Competence also includes the wisdom to recognize the limitations of that knowledge and referring to another professional when necessary. As practitioners dealing with emotional issues, Financial Planners are not psychology experts nor should Financial Planners refer every client to such. Emotional recognition of the client plays a crucial role in understanding the client's motivation and feelings about his or her finances. One interpretation of Principle 3 is the practitioner should consider increasing their EI to be competent in dealing with clients.

METHODS FOR INCREASING EMOTIONAL INTELLIGENCE

Bradberry and Greaves (2009) stated that one's professional success would improve if one can improve his or her emotional intelligence. "EQ is so critical to success that it accounts for 58 percent of performance in all types of jobs. It is the single biggest predictor of performance in the workplace and the strongest driver of leadership and personal excellence" (Bradberry & Greaves, 2009, pp. 20-21). People with higher EQs make more money too (Bradberry & Greaves, 2009).

Finley (2008) created five techniques to increase your emotional intelligence. Based on Goleman for emotional and social competencies, Finley presented the following items for improvement: 1) emotional self-awareness, 2) emotional management, 3) self-motivation, 4) highly empathetic, and 5) relationships under management.

The best method is to approach this one step at a time. Many EQ assessments exist on the Internet. A free assessment is provided by Institute for Health and Human Potential (IHHP) at http://www.ihhp.com/?page=freeEQquiz. You can answer a few basic questions, select submit, and then a response appears (see Figure 2).

Figure 2. Sample EQ results from IHHP Free Quiz (Source: IHHP Free Quiz)

Test Your EQ	SAMPLE	Quiz Score
	Your Results: 25 – 34: People in this range often find themselves blowing up at their co-workers, even their loved ones. They seem to have less 'buffer' for dealing with change, stress and difficulty. Some people also report depression or feeling 'lost' in life. Are you allowing the 'winds' of change to direct you – instead of setting your own course using an internal compass? Are you responding to life and its challenges with fear and insecurity rather than passion and purpose? Emotional intelligence can be learned and improved – with big payoffs! …	

Emotional Intelligence has four components: 1) reflectively regulating emotions, 2) understanding emotions, 3) assimilating emotion in thought, and 4) perceiving and expressing emotion.

The next step is to select one skill at a time to work on. Evaluate what areas you may be weakest in. Perhaps start there. Most importantly seek a mentor to help you with this process.

Breaking down Finley's techniques for Emotional Intelligence provides basic instructions that an individual may take advantage of to increase one's EI (Finley, 2008, pp. 20-21). Emotional self-awareness is the ability to be in touch with one's emotions. An emotionally aware individual is aware of his or her emotional state at any given time and understands when his or her feelings change and the impetus behind it.

Even if one has a command of self-awareness, he or she must also be able to self-monitor his or her emotions. This ability of emotional management allows one to manage expressive control appropriate to the situation (Gangestad & Snyder, 2000). Self-awareness and emotional management both tend to vary widely based on an individual's emotional makeup and the environment he or she was raised in. An example of emotional management is one individual reacting automatically to a situation, whereas a second person may not react but respond to the situation by choosing the appropriate response. The first individual has no control of the situation because of an automatic reaction whereas the second individual chooses the most appropriate response, and in effect, controls their response to the situation.

Goleman strongly believes that meditation, not to be confused with mediation, is a way to increase self-awareness. Of interest is Goleman's doctoral dissertation at Harvard was on the topic of meditation; in addition he has published extensive research on meditation. Bowling and Hoffman (2000) also suggested some individuals develop greater self-awareness through yoga, meditation, or religious disciplines.

CONCLUDING COMMENTS

Throughout this study, an intensive search for literature on the field of emotional intelligence and financial planning and mediation was conducted. Limited literature is available for the financial planner to specifically learn the skill of emotional intelligence.

The limitations of this study relate to the availability of research in the area of emotional intelligence and financial planning. Research has been conducted in fields such as management and leadership, but not to this specific career field. Further research could be done to evaluate the emotional intelligence of financial planners, and to determine if there is a need for training in the field of emotional intelligence. A qualitative Delphi study could be done to see if experts in the field of financial planning can come to consensus as to the level of emotional intelligence required for Certified Financial Planners™ to be successful. Future research can be expanded to other countries.

EI skills are equally important to a financial planner functioning as a financial specialist in support of mediation or as a planner in a financial planning session. More recognition needs to be given to the importance of EI and the impact it has on the outcome of either a mediation or financial planning session. The underlying commonality that these proceedings share is the strong emotions regarding one's personal finances.

One major distinction between the two is that mediation involves two opposing sides with each having separate goals from the mediation (in a divorce, for example). In a financial planning meeting, the husband and wife normally have the same agenda. Although it has not been stated in any literature found from this research, this is possibly why in mediation the two parties are split up in two separate rooms with the mediator working and delivering communications between the two rooms, a process known as *caucusing*. In the same manner, it may be possible. This is why many financial planners are trained to focus on the primary money-manager when they meet with both spouses, because the money-manager is the decision maker. Viewed from an EI perspective, that may be the best possible solution. In mediation, if there are two opposing individuals with different ranges of EI, it presumably would be much easier to get agreement from both sides working with them individually (in separate rooms) in comparison with having both in the same room discussing an emotionally charged topic like money. Likewise, with a couple together in a financial planner's office, it is going to be much easier to work primarily with one individual. In effect, working with two individuals with different ranges of EI presents a greater challenge (trying to find a common ground emotionally) than that of working with one individual.

Both mediation and financial planning demand the professional be credible and empathetic toward the client. These traits can be conveyed by an individual with a high degree of EI. For a financial planner or mediator then it is imperative to understand the role of EI in his or her practice and what one can do to increase his or her EI. If one considers Sullivan's (2011) research regarding emotions, influencing financial decisions is predictable as valid. In addition, Cherniss (1999) comments on studies demonstrating how an individual with high EI enhances and increases the potential for positive outcomes is true, certification and training programs for both financial planning and mediation should consider EI training as essential.

A financial planner functioning in a mediation environment must be technically proficient as a planner, understand and appreciate the mediation process, and have a high level of EI to assist the other parties in reaching their goal through an emotionally charged process. This demands that financial planners must be skilled and knowledgeable in EI, not only to augment the mediation process, but to also be a competent planner.

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BIOGRAPHY

Randy Braidfoot is a securities principal and CFP® practitioner. He holds a Master of Science in Personal Financial Planning and a Bachelor of Arts in Mass Communications. He is a "subject matter expert" for the Certified Financial Planner Board of Standards. He also volunteers as a Texas judiciary-approved mediator. In 2011, he was honored as Mediator of the Year. Braidfoot is an adjunct professor for Ashford University. He can be reached at P O Box 582, Panhandle, TX 79068, email: braidfoot@msn.com

Andree Swanson is an assistant professor with Ashford University (Denver, Colorado) and adjunct associate professor with the College for Financial Planning (Greenwood Village, Colorado). Dr. Swanson holds a Doctorate in educational leadership and a Master of Arts in organizational management. She also holds a Master of Human Relations. Dr. Swanson has worked for the US government (DoD, USAF, & USA), corporations, and higher education. She can be emailed at10259 Jill Avenue, Highlands Ranch, CO 80130: andreeswan@aol.com

A STUDY OF SUSTAINABLE BEHAVIORS AMONG CALIFORNIA HISPANICS REGARDING TRANSPORTATION

Mary Beth McCabe, National University
Ramon Corona, National University
Richard Weaver, National University

ABSTRACT

Hispanics represent a significant and growing population segment in the United States (56% of all population growth, and California represents the largest percentage of Hispanics (37%). This research concentrated on learning more about Hispanics and their sustainable behaviors regarding transportation, both public and private. By studying Hispanic transportation behaviors, marketers can understand their future needs, supplying the products/services through effective promotional media channels. This project allowed researchers to identify behaviors of Hispanics in California regarding green transportation and the media that influences them. The use and purchase patterns of hybrid vehicles were analyzed, as well as the use of car pools and public transportation, current gas mileage (mpg) and media they prefer. It was found that Hispanics drive hybrids slightly less than non-Hispanics. There is a somewhat higher preference for the next purchased car to be a hybrid for Hispanics than for non-Hispanics. In addition, fewer Hispanics use public transportation or a car pool than non-Hispanics. The researchers believe that the conclusions from this exploratory study will help marketers of transportation services in the public and private sectors. Additional research and discussions on Hispanics and sustainable transportation are expected and welcome after this pilot study.

JEL: M-31

KEYWORDS: Sustainable Transportation, Hybrid Vehicles, Hispanic Marketing, Sustainable Behavior, Green Transportation, Marketing Strategies, Shared Transportation, Green Advertising, MPG, Eco-Friendly

INTRODUCTION

This paper examines the behaviors of Hispanics vs. non-Hispanics in California regarding some specific transportation issues related to environmental sustainability, to determine preferences and buying propensity for both groups. Given the importance of the Hispanics in terms of growth which accounted for 56% of the total growth in the US, and in population in California of 37%, this study can help marketers understand future needs of this segment and therefore provide crucial information for decision-making. Given the increasing trend in sustainability and environmental issues, the findings are very relevant. Hispanics vs. non-Hispanics personal use of hybrid vehicles, miles per gallon (mpg), and modes of transportation was researched.

Various related articles about this issue were analyzed, but there were mostly related to general behaviors and characteristics of the Hispanic Marketing, i.e., perceptions and cultural differences, influences and decision-making, etc., but nothing specific about the comparison between Hispanics and non-Hispanics regarding the transportation issues were found. This exploratory paper will provide valuable information to marketers and scholars related to the comparison between Hispanic and non-Hispanics about buying hybrid cars, using public transportation, mpg consumption, and media preferences.

Green issues are among the many concerns of the world's population. Hispanics represent a significant and growing part of the US population, and California has been a bell weather state for environmental issues. In studying the behaviors of Hispanics, we learned about three areas of eco-friendly attitudes and behaviors: automobile trends, public transportation usage and media preferences.

The organization of this paper includes a literature review section to incorporate relevant information about these issues from previous research, a data and methodology section describing the data collection process and how the survey was applied, using the convenience sample. A final results section explains the data obtained and the implications for each of the panels, and finally the concluding comments section summarizes the relevancy of the findings as well as future research.

LITERATURE REVIEW

Family, religion, language, and music are important to Hispanics. (Meneses, 2011) Hispanics use products with less attachment to schedules and timeframes, and enjoy the moment. It is an advantage to be poor but happy rather than rich and unhappy. Income levels lag, with the percentage of households with incomes over $100k indexed at 50% of the general population. In other words, the percentage of Hispanics earning $100K or more is half of that percentage of the people living in the US. However, for many Hispanics, just to have enough to get by is satisfactory. Hispanics cultural values retain optimism, enhance human experience, and embrace spirituality. (Korzenny, Korzenny, 2005)

In California, 81% of Latinos had a high school diploma in 2005, ranking #46 out of 50 states. However, for Bachelor's Degrees, California ranks #10 with 31%. For masters or additional education/degree, there were four million out of 50 million in the West (8%). Looking at who is enrolled in school, over 3 years of age, Blacks ranked highest, 34%, Hispanics 32% and Whites 26% (2005 results). (Gauquin, Ryan, 2007)

Companies trying to target high income Hispanics should understand their behaviors regarding environmental practices. Affluent Hispanics ($100k+) generally used less water and recycled more waste than non-Hispanics. These same affluent Hispanics had a higher incidence of solar water heaters (23% vs. 5.7%) of non-Hispanics. (McCabe, Corona, Weaver, 2012)

The US population is spending a higher percentage of its income on transportation than ever before. Living in sprawling urban areas has put U.S. families in the car more often to get to work, shopping, and recreation. Since 1991, America's total transportation bill has grown faster than inflation (Katz, Puentes, 2005)

Rising gasoline prices are forcing American drivers to consider using mass transit, an electric car, moving, or changing their job. Moreover, one in three consumers would consider purchasing a higher mpg vehicle if the price of gasoline rises to more than $5 per gallon. (Jacome, 2011)

Eco friendly beliefs can translate into improved transportation utility. Sustainable transportation is promoting our environment. Those who live in green communities have more sustainable travel experiences than others. (Kahn, Morris, 2009) Becoming more aware of the environment can improve sustainable behavior, such as more car pooling, mass transportation and hybrid use.

Why are people in California buying hybrid electric vehicles? They are concerned about 1) the environment, 2) energy efficiency, 3) global warming, 4) price of gasoline, and 5) high occupancy vehicle (HOV) lane use while driving alone. A statewide survey found that people wanted energy and the environmental information to be included in the marketing materials. (Sangkapichai, Saphores, 2009)

A California study found that even if fuel prices double, individuals are more likely to change their vehicle choice (i.e., higher mpg) than their driving patterns or usage. (Spissu, Pinjari, et al, 2009)

A recent study predicts global growth for hybrid vehicles of 20% through 2015. The reasons for this include more worldwide oil consumption and government initiatives, as well as buyers' awareness and acceptance. Consumers know more about the green benefits of driving a hybrid, including less carbon emissions and less of a dependence on oil as a natural resource. However, the higher cost and longer breakeven point of a new hybrid are sales barriers. (Newcomb, 2012)

Household vehicle consumption growth is expected to increase by 31% over 25 years to 235 million cars. More white non Hispanic and Hispanic homes will acquire vehicles than black non Hispanic and Asian and other non Hispanic Households. The South and the West will have the greatest growth in new vehicles. (Feng, Wang, et al, 2011)

Out of 15 eco-friendly activities, the fewest responded to "own or lease a hybrid vehicle" by both non-Hispanics and Hispanics in a 2011 Scarborough study report in California. Hispanics index at 24 compared to the general population index (100), due to the large financial commitment and high involvement in the product purchase. (McCabe, Corona, 2011)

There are currently dozens of hybrid autos to choose from, including hybrid-gasoline-electric and fuel cell technologies. Americans, including US Hispanics, are making the purchase decisions on these vehicles, and businesses need to be audience relevant in their marketing messages. (Deen, 2003)

If someone is considered "green" or eco-friendly to begin with, his or her involvement with the environment is greater. A laundry detergent study concluded that the green involved group had no significant differences for environmental benefit vs. cost-saving benefit print advertising. However, for those not already involved with the environment, the green appeal was more persuasive than the cost appeal considering purchase intent, attitudes, and support arguments. (Schuhwerk, Lefkoff-Hagius, 1995) The conclusions here are that those who are not already green thinking could be appealed to by specific advertising.

Those who rate concern for waste as highly important are willing to pay more for eco-friendly products. Educational strategies for different consumer groups, with a goal of a healthier environment are presented. Willingness to pay differs across demographic groups, with African Americans willing to spend significantly more than Caucasians on eco-friendly products. (Royne, Levy, Martinez, 2011)

Hispanics participate in eco-friendly activities that require less personal or financial investment. They also do more with a financial reward, such as recycling cans or bottles and reducing their electric bill using energy efficient light bulbs. (McCabe, Corona, 2011)

For marketers trying to reach Hispanics, TV is fundamental; however, competition is expected to expand, especially among digital and interactive channels. (Korzenny, Korzenny, 2005) For radio, Spanish Contemporary (Romantic, Baladas) is the most preferred format among Hispanics followed by Mexican Regional (Banda, Rancheras) in the West and Southwest US regions. (Meneses, 2011) Radio was something of a folk carrier for Hispanic immigrants for education about finances, cooking, etc. (Korzenny, Korzenny, 2005)

Hispanics like to read news, and younger, more acculturated Hispanics will be using the Internet for sports news, such as soccer, baseball, and boxing, and for national and international news. For Hispanics without Internet access, newspapers in hard copy will be preferred. In addition, Hispanic consumers surf channels seeking entertainment, education and to satisfy their interests, in both English and Spanish languages. (Meneses, 2011)

Overall, Hispanics prefer TV and the web for media, and non-Hispanics selected magazines/newspapers and web. Facebook® ranked about the same for both Hispanic and non-Hispanic, but Twitter® is only used by 5% of Hispanics, vs. 18.4% for non-Hispanics. (McCabe, Corona, Weaver, 2012)

DATA AND METHODOLOGY

This research was designed as an exploratory study of the similarities and differences between Hispanic and non-Hispanic attitudes towards sustainability and their engagement in associated transportation activities. A convenience sample was utilized, drawn from contacts maintained by the three researchers and databases of members of a variety of Hispanic professional organizations. While convenience sampling has known limitations, such as not being representative of the larger population, this approach has been used productively in other studies, especially exploratory research. Particular attention to sample selection insured including a sizable proportion of known Hispanics from those invited to participate.

The survey instrument collected behaviors such as green activities and interests plus standard demographic information. The instrument was tested and appropriate modifications increased both clarity and ease of completion. Potential responders were invited via email to participate. The instrument was made available utilizing SurveyMonkey.com over a two-week period in November 2011. Approximately 310 invitations were sent to potential responders. 144 completed the survey. This constituted a 46% response rate. Of these, 29 were discarded due to respondents not being residents of California. The remaining 115 responses were sorted, tabulated, and correlated using standard statistical processes.

RESULTS

We have identified attitudes of Hispanics in California regarding green transportation and the media that influence Hispanics. Results include the usage and purchase patterns of hybrid vehicles, the use of car pools and public transportation, current gas mileage (mpg) and media preferences.

Tables 1 and 2 show the results of the various panels analyzed with their corresponding measures for both Hispanics and non-Hispanics in the selected categories for this paper.

Regarding hybrid cars from Panel A below, high income Hispanics "always" pay attention 31.3% of the time vs. 14.3% of high income non Hispanics. More than two times the percentage of respondents who are Hispanic are "always" paying attention to information on hybrid cars. This difference is significant, and near the same level of difference as solar energy (41% for Hispanics vs. 20% for non Hispanics). Of the four categories listed, the most attention is paid to water and then solar energy. Hybrids rank third, ahead of recycling.

Overall, Hispanics are driving cars with the lower range of mpg and the higher range. From Panel B, Non-Hispanics are more likely to drive cars with gas mileage between 16-20 mpg. 17.1% of non Hispanics and 12.8% for Hispanics drove their primary vehicle with this mileage per gallon. The mpg averages are not significantly different for the 21-30 mpg (34.2% for non Hispanics and 33.3% for Hispanics).

As shown in Panel C, Auto Behaviors/Intentions, 10% of Hispanics currently drive a hybrid, compared to 14.5% of non Hispanics. However, 46.2% of Hispanics, mostly highly acculturated, plan to buy a hybrid for their next car, vs. 43.1% for non-Hispanics. This is a significant jump in intentions for both groups, which would lead researchers to look for a spike in hybrid sales for the next two to three years, for both Hispanics as well as non Hispanics. There is not a significant difference between the demographic groups for this behavior and intended behavior.

Table 1: Results from Panels A-F for Selected Measures from the Survey

Measure	Hispanics	Non-Hispanics
Panel A: High Income who always pay attention (%)		
Solar energy	41	20
Hybrid cars	31.3	14.3
Water	47	37.1
Recycling	17.9	26.5
Panel B: Mileage per gallon in primary vehicle		
10-15 mpg	7.7	2.6
16-20 mpg	12.8	17.1
21-25 mpg	33.3	34.2
26-30 mpg	23.7	15.4
Panel C: Auto behaviors for hybrid and future intentions to buy hybrid (%)		
Currently drive a hybrid	12.8	14.5
Intentions to buy a hybrid car	46.2	43.1
Panel D: High income respondents hybrid cars (%)		
Drive hybrid	17.6	14.3
Next car hybrid	53	45.5
30+ mpg	29.4	22.9
21-30 mpg	36	60
Panel E: Higher education respondents regarding auto and intentions (%)		
Drive hybrids	10	14.6
Next car hybrid	30	39.1
Panel F: Shared transportation (%)		
Car pool	41	37
Public transportation	70.6	67.6

The Table I above shows the results for Panels A-F for selected measures from the survey, in percentages or mpg as noted.

When looking at Hispanics earning $100k and greater in panel D, there is a pattern of driving a hybrid and planning to purchase a hybrid. In both categories, Hispanics rank higher than non Hispanics. Those Hispanics with higher incomes tend to purchase and plan to buy hybrids at somewhat higher percentages than non Hispanics. We also see a difference in 21-30 mpg driving among high income Hispanics (36%) vs. non-Hispanics (60%). Similar to Figure 2, Hispanics rank higher in the 30+ mpg category than non Hispanics.

Unlike the income factor in panel D, Hispanics with higher education (Panel E) are less likely to drive a hybrid or to purchase a hybrid for their next vehicle. 10% of Hispanics with a higher education are driving a hybrid vs. 14.6% of non Hispanics. 30% of Hispanics with higher education are planning to buy a hybrid, vs. 39.1% of non Hispanics.

Of all Hispanics surveyed, panel F shows that 41% never use a car pool, vs. 37% for non Hispanics. 70.6% of Hispanics surveyed never use public transportation, and of non Hispanics, 67.6% never use public transportation. These findings indicate that Hispanics are slightly less likely to use shared transportation than non Hispanics. Note that this study was conducted in California, that has been known to enjoy private transportation overall rather than other parts of the United States. In many areas of California, there is no public transportation.

Table 2: Results from panels G and H for selected measures from the survey.

Measure	Hispanics	Non-Hispanics
Panel G: High Income media preferences %		
Flyers	13	9
Web ads/sites	60	54.5
TV	66.7	42.4
Radio	53.3	30.3
Mag/newspapers	46.7	57.6
Facebook®	33.3	27.3
Twitter®	6.7	18.2
Panel H: Higher education media preferences %		
Flyers	0	2
Web ads/sites	73.7	59.1
TV	36.8	34.1
Mag/newspapers	26.3	50
Facebook®	26.3	29.5
Twitter®	10.5	18.2

The Table 2 above shows the results of Panels G and H regarding the results from High Income and Higher education respondents for media preferences, in percentages.

The Panel G above describes the high earning Hispanics vs. non Hispanics choices for media to inform them about environmental issues. Hispanics with high incomes selected TV as their primary choice for media information, followed by websites and radio. Non Hispanics selected magazines/newspapers as their preferred information source. Web sites were their second and TV third choice. High Income non Hispanics used radio (30.3%) and Facebook® at 27.2%. Twitter® usage is lower for higher income Hispanics (6.7% vs. 18.2%) for non-Hispanics.

The Panel H above displays the highly educated Hispanics vs. non Hispanics choices for media to inform them about environmental issues. Hispanics with high education selected web ads/sites as their primary choice for media information, followed by TV and radio. Non-Hispanics selected their second choice as magazines/newspapers with TV third choice. Highly educated Hispanics do not prefer to read magazines/newspapers. Facebook® and radio preferences are similar. Twitter® usage is lower for highly educated Hispanics (10.5% vs. 18.2%) for non-Hispanics.

CONCLUDING COMMENTS

The purpose of this paper was to determine the possible differences in behavior between Hispanics and non-Hispanics in California regarding transportation-related issues, including the use and propensity to buy hybrid cars, the best media to reach both groups, and the use of public transportation. A convenience sample was used based on existing contacts of the researchers, and email invites were sent to respond an electronic survey with relevant questions. 115 valid responses were collected and analyzed, and the results were cross-tabulated to narrow down the findings. Among the most relevant findings, here are the following:

Nearly one third (30.3%) of high income respondents who are Hispanic are "always" paying attention to information on hybrid cars (Fig. 1) vs. 14.3% of non Hispanics in the same income category. This is a significant finding showing that Hispanics with money are seeking information about this product category, and twice as likely to pay attention always to information to news and marketing information on hybrid vehicles. Marketers who are interested in attracting the Hispanic segment should take note of the level of interest for their future advertising campaigns. Many high income Hispanic respondents (Fig. 4) are interested in buying or already drive a hybrid car. This segment of the market could be a very valued one for manufacturers and dealers of hybrids.

Hispanics resemble non Hispanics in the area of mpg for the most part. They differ slightly on the lower mpg and higher mpg (both are higher for Hispanics). Hispanics get more miles per gallon of gasoline or they get less mileage on their primary vehicles, however, for the most part, the patterns are similar.

High income Hispanics prefer TV and then websites for information (Panel G). High income non Hispanics prefer newspaper/magazines to electronic media. High education Hispanics prefer websites well above any other media, with TV second (Panel H). Highly educated non Hispanics answered that they prefer websites first and then newspapers/magazines as second choices. This is an indication that if you want to reach Hispanics, one media channel for high income and a different media channel for high education Hispanics would be more effective. For example, high income Hispanics may see hybrid cars on TV and make their choice from this exposure only. In addition, highly educated Hispanics may seek more detailed information that one can find online, before shopping for their hybrid car.

Despite its limitations in terms of sufficient sample size and data, this exploratory research provided meaningful data to marketers and researchers. The findings from this exploratory study of Hispanics and their transportation habits and intentions will help marketers in the government and commercial segments of commerce. Because of this study, the opportunity for further discussions and additional research to be conducted on Hispanics and their sustainable transportation needs is encouraged, available, and welcome.

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BIOGRAPHY

Dr. Mary Beth McCabe is a full-time Professor at the School of Business and Management at National University, where she is lead faculty for Marketing. She has a Doctorate in Marketing from United States International University and an MBA in Marketing from DePaul University. Her research is in the fields of Hispanic Marketing, Media, and Sustainability and her contact email is mmccabe@nu.edu.

Dr. Ramon Corona is a full-time Professor at the School of Business and Management in National University, where he teaches Marketing and Strategy courses. He has a Ph.D. in Education from Universidad Iberoamericana (Tijuana, Mexico) and a Postdoctoral Certificate in Marketing from Tulane University (New Orleans). His research is in the field of Marketing, specifically in Retail and Hispanic Marketing, and his contact email is rcorona@nu.edu.

Dr. Richard Weaver is a fulltime Professor at the School of Business and Management in National University, and has a doctoral degree in Human and Organizational Systems from Fielding Graduate University. He is also the lead faculty for the Masters in Global Management Program and teaches Management and Strategy courses. His contact email is rweaver@nu.edu

THE SECURITY CRISIS IN MEXICO AND ITS IMPACT ON BUSINESS MANAGEMENT

Mario Aguilar, University of Guanajuato
Emigdio Archundia, University of Guanajuato
Rafael Regalado University of Guanajuato

ABSTRACT

In Mexico, antisocial behavior affects and concerns the population. This behavior has produced a vicious circle involving a high rate of criminality. This, in turn discourages investment, and reduces economic growth, it causes unemployment and increases poverty and economic inequality. Official databases reveal that during the last five years, the number of people murdered by organized criminals has increase to more than sixty thousand. With a population of over 112 million residents, Mexico has 52 million people living in poverty conditions. Seven million young people called "ninis" (ni estudian, ni trabajan) don't work or study. Business executives have reduced production levels with the purpose of reducing losses and criminal acts. Companies have closed because of antisocial acts and because of a lack of funds. During 2011 over one hundred and sixty thousand companies shut down in Mexico because of organized crime, according to the Employers' Confederation of the Mexican Republic (Coparmex).

JEL: F52, H56, L25, N6, N86

KEYWORDS: Legal Economic

INTRODUCTION

The federal government has postponed many subsided programs such as education and health, to reallocate funds to combat antisocial behavior. Antisocial behavior has a negative effect on companies, which must spend funds on security guards and alarms. Funds are used to pay for kidnappings, stolen electrical equipment, clothes, groceries, equipment, and seeds. The underground cost of paying extortion has become a taxing load for enterprises. Criminal behavior has caused companies to reduce their production standards. This leaves less for reinvention and other employment.

The purpose of this research is to identify methods to invest more public funds on education and create more employment solutions. We wish to encourage creation of a true democracy with active participation within an organize society. We hope to include citizens isolated and individually idle. We encourage passage of an article of the democratic constitution. We hope to improve the way of living based on social, economic and cultural betterment.

The organization of this paper is as follows: The literature review section discusses ideas, arguments, facts, figures and statistics, supporting the use of prediction models for the failure of the government's security policy. Information given to official sources and to the organization of business owners comes from business and economic sectors including. offices for mediation and rating markets. International experts and specialists, and accounting firms also contributed. Next, we present the methodology used. We highlight key areas of the problem. We also develop an analysis that allows us to identify mechanisms and procedures for proposals. We hope to support further research that offers companies a way to confront and resolve this dispute. Finally, we present the results of the investigation, proposals, conclusions and future research.

LITERATURE REVIEW

Plato, the Greek philosopher the founder of the Theories on the Ideal State (Organicism). Plato compared the structure of political domination within a living organism (polis). In a sense, the current Mexican State as a living entity is "ill", and the prognosis of its illness is critical. Mexico Mexico is affected by one of the largest disorders that impacts political organizations, public insecurity. Because of the extent and seriousness, of this illness it is threatening.

In Mexico the social problem that most affects, and concerns citizens is not poverty, unemployment, nor political, economic, or cultural. Rather, organized and not organized crime is the primary concern. This circumstance and its impact on the business industry have an alarming overtone. There is a vicious circle in which high crime rates discourage investment, curbs economic growth, exacerbates unemployment and increases poverty and economic inequality. All of which, creates more crime and violence. Data show that during the past five years, the number of people killed by gangs of organized crime has risen to more than fifty thousand. The number of missing persons has risen to over ten thousand. The innocent victims include around nine hundred dead children, called "collateral damage".

Criminals operate with a degree immunity. Some 95% of murders go unpunished. An estimated 90% of these deaths are of members of the mafia (López-Dóriga, 2011). To add fuel to the fire, as the adage says, another phenomenon that integrates the triad of the crisis is corruption. Research carried out by a prestigious institution of higher education, shows that companies spend 5.1 percent of their income on administrative bureaucracy corruption. They purchase favors from politicians, (bribery) so they transcend laws. This benefits their interests by bringing them contracts, concessions, permits or licenses.

This research shows some of the impact of crime's aggression on the productive sector. This analysis provides deeper, methodological rigor and integrity. The problem that harms the collective fabric and inhibits developing the society's potential has various causes and effects. We analyze economic progress and income distribution. We reference investments losses, damage to the state, society, and especially the productive areas during the growing criminal crisis.

Criminal behavior causes distortion in earmarking funds, both public and private. The Government channels huge amounts of money, goods and services to combat crime. These funds could be allocated to other areas such as welfare and social improvement. The private sector are transferring of a portion of their income and property to those engaged in illegal activities. This situation results in reduced profit margins for firms and implies less funds being directed to productive projects. Employers have reduced their production levels to lessen losses by criminal acts. Because of insecurity caused by crime closures have occurred, as well as suspension or diversions of investments to other destinations.

To reinforce the previous argument, we note that insecurity has a negative effect on enterprises. Enterprises have to spend more for buying instruments to guard, hiring private security and surveillance services for prevention. Companies lose from paying for kidnapping, theft of goods like, electrical appliances, clothes, groceries, machinery, grain, and pets. Underground extortion payment prices become a tax on the company. Many entrepreneurs would prefer to pay criminals than the Government. Economic and social costs are high and, in the end, all Mexicans pay for them.

Conceptual Framework

Quasi-leaders hire professional specialists in media of mass communication and public relations. They take advantage of the particular political situations, directing them to their own goals, to gain the support of the population. They do this through advertising, dramatic and psychological, and publicity arenas.

June 6th to 10th of 2011the National Autonomous University of Mexico (UNAM) and the Ibero-American Institute of Constitutional Law (IIDC) gathered for a conference on International Security and Justice in Democracy. They composed a document called "Elements to construct a State Policy for security and justice in a Democracy”. At that Conference 88 Specialists took part in eighteen panels, which discussed various the topics at length. The participants were national and foreign experts. They drafted and recommended a proposal as follows:

"From previous information, we consider that current public policies in security, present problems that could be explained in the following way:" The theoretical and conceptual support is insufficient. There is in Mexico and abroad academic and professional production that offers a framework of analysis. In general, the Government's policy is detached. Official documents where the reasons for the rules, institutional designs, programs, strategies and actions being displayed. They only appeal to related policy which does not reflect knowledge of the specialized literature. This weakness is showed in the general confusion of ideas for "Homeland Security", "Public Security", "Public Safety" and "Human Security". "Given the inertia in this confusion, it overloads the concept of National Security. As if it was a bag where all the risks and threats are put into it and contained there. It even ignores the Constitution makes reference to “Homeland Security”, “National Security "and" Public Security", assigning each of them a scope and responsibility clearly defined.” (UNAM-IIDC, 2011).

Information presented by UNAM, and critics from all areas of the community, imply the Mexican government hasn’t clearly defined insecurity. When the government doesn’t want to talk, for example of the “war” against delinquency, ambiguity occurs. Referring to it as “combat”, it uses euphemisms, which tries to cover the sun with a finger. It thinks that by expressing softly or decently an ideait can avoid the population’s worries. Because of the half-truths in their language the situation cannot be well defined, so Mexicans live with a resulting anxiety. Examples of the use of euphemisms suitable for children are pure or innocent souls or mentally handicapped. In the same way laws don’t precisely say what a fiscal credit is, or doesn’t present the idea of a tax or duty. When there is not a definition, everything fits.
Article 42 of The Fiscal Code of the Federation says it can practice home visits to taxpayers for the following reasons: 1. To collaborate taxpayers or third parties jointly liable with them have complied with the related fiscal terms. 2. Where fitting, to identify omitted contributions or tax credits, to check tax offenses and to provide information to other tax authorities. 3. To collaborate compliance with tax duties about issuance of tax receipts and filing applications or notices in the Federal Register of taxpayers. 4. To fulfill duties from Customs permits, licenses and registration, or established in the rules related to that matter. 5. And to verify the electronic systems and records.

Addressing the subject of this research, several ideas need theorizing. In its original and etymological sense of observation and in detail this analysis gets to the root of the issues. It is known that public insecurity includes attacks and assaults with impunity, damage on the physical integrity of people, their goods, their properties and their rights. In Mexico, this social cancer public insecurity has the State in crisis. The state is not able to effectively insure public security. Security is a state of mind, a feeling, an intangible quality. It can be understood as a goal and an aim which any person as a human being, constantly longs for. It is a primary necessity according to Maslow’s pyramid.

Safety is a human being’s longing to be safe from all danger, harm or risk coming from nature, fate or fellow human beings. Safety is a value in which people sacrifice part of their original rights and freedoms in order to enjoy peaceful living. Additional rights are property and. Luciano Parejo and Roberto Dromi (1997) state: Security is a founding value. Security is a value engraved in the catalog of human rights as set up in the Universal Declaration of Human Rights of December 10, 1948. Article 3 states everyone has the right to security, and all other civil and political rights stated in it. (ONU, 2011)

Security is a need. In this sense the Spanish Baroque Francisco Alonso Pérez (1994) notes the need for security is innate in man since he leaves the mother's womb and faces life. "Man needs to be safe in all the acts of his existence. Those related to labor issues and health care, whose protection is specifically entrusted to the forces and bodies of security."

Drawn from the doctrinal of a legislative analysis different security models register including: Legal Security, Individual Security, Public Safety, Social Security and National Security. Each of these are integrated and interconnected by the state organization with the purpose of achieving public stability which requires functioning and fulfillment of goals.

Next we turn to the contrary argument, and ask, "What do we mean by insecurity?" Insecurity is the difficulty to select between different choices, to achieve a certain objective. There is always doubt if what has been done or said, either by us or others, is right or wrong. This allows us to formally define Insecurity as "lack of security". Public safety should not be confused with other types of security. Security is not a state role or public service. It is a *sine qua non*; priori state. It provokes and forms public order and social peace, and this is an inseparable pair setting up the prior and essential elements for achieving stability (Aguilar, 2006). The objectives of public safety granted by the State are the following: 1. to preserve liberties; and 2. to preserve public order and peace.

We should not forget the subject, object and purpose of public security, the human being. The person is the creator and fundamental element of any human organization, its creation, its agent and its end. When you incorporate people, as the priority, preeminent, first part of the organization, the people of the state emerges as proto-nationalist. Therefore, the term "*people*" has a legal and political scope. Namely people are the holders of constituent power, as the electorate, and the national body as a sovereign subject. The people legitimacy can exercise power on its behalf. It is required by the law, to articulate the role of the people in the composition and dynamics of the state with clear diagrams. The people receive a new dimension that transcends its factual and natural aspects, and coexistence is rendered possible.

The law says the people, not as the disorganized crowd, the masses, or the Hobbesian state of nature, form an organizational perspective. The people are holders of public power, as subject of rights and duties. Jellinek (1954) wrote: "The people, in their subjective quality, form, because of the unity of the State, are a corporation". That is, all individuals are united, linked among themselves as subjects of the State. They are members of the State therefore; they are both corporate Association and Association of authority at the same time. These two elements are resolved in the necessary unity of the State Corporation. Because of the authority of the State, the people are subject to *imperium*. It is from this belief in subordination, individuals of the State, finds themselves members in this situation and is subjects. Individuals are members and are therefore subjects. In this sense, they live in a coordinated fashion. Individuals, as objects of state power are subject to duties, and as members of the State are, by contrast, subjects of law.

The state is a political organization of a popular community. The people have personal limits to executing state standards. No one can conceive a state without the personal element. In short, there is no state without people. The key to understanding politics, government power, and sovereignty, is people. We focus and refine this conceptual treatment. We define the task of achieving and keeping state public safety. This focuses on the exercise of police work, whose main objective is to combat crime. The objective is to prevent misconduct of any type, thereby avoiding harm to people. Thus, *police* is a broad idea, and has several legal and political meanings, 1. An agency or organization responsible for ensuring and preserving the peace and public safety. 2. Monitoring the behavior of individuals for them to conform to the rules of public order. A) Monitor and preserve peace and social security (strict sense). B) Monitor that individuals comply with the provisions of the rules of public order (broadly speaking). 3. Regulatory rules of restrictive nature of the activity of individuals (Aguilar, 2006). The police task does not refer only to the agent or agency to oversee peace and order. It is a task that includes identifying and planning for social needs. It contributes to identifying critical aspects of social, economic and cultural well-being. It provides the basis for developing policies, programs and public actions. It also prevents private and social reverse repetition and the deepening or triggering of violence. Finally, the task of the police covers supervision and inspection of social activities so they conform to legal rules and prevent unlawful acts.

The concepts expressed so far, are of a legal doctrine, which can be interpreted, as a little baroque. Certainly Mexicans have gained by direct experience, the right to make individual definitions of insecurity. There are various definitions that apply from the ordinary Mexican's view, depending on their role in society. A youngster would define insecurity as the fear of growing up in a society submerged in terror, without confidence in a promising future. Parents could define it as the fears of seeing their children grow and mature in a society without moral and ethical values, without a hope of seeing them grow up to be successful in the future. There are many definitions, depending on the feelings of those who live the problem.

Mexico in Numbers

To try to understand the damage that insecurity causes to the productive sector we examine data and statistics. Mexico is a country full of cultural, economic, social and political contrasts. On the one hand there is a country with vast wealth, which faces, paradoxically, one of the highest percentages of poor people. The nation is one of several that have seen wide discrepancies between a few people who have everything and a huge crowd that has little. The gap between the holders of wealth and those without minimum welfare widens daily. Mexico has one of the greatest inequality levels on a global scale. Northern Mexico includes the town of San Pedro, Nuevo León. It has the highest Human Development Index (HDI). It is almost on par with Norway, which is the leading country in this category. In southern Mexico, we find the opposite. The town of Metlatónoc, Guerrero has an HDI similar to Sierra Leone. It placed 158 in the world ranking, published by the United Nations Development Program (UNDP, 2011).

Mexico is a multicultural mosaic. Evidence of this is the fact there are 56 national indigenous groups of about 8 million Mexicans, in a total population of just over 112 million people. Of that number, 40% live in poverty and 20% in extreme poverty. These poverty stricken individuals are almost all indigenous. There are fifty-two million people living in poverty (INEGI). Mexico ranks 13th in world based on Gross national income in 2010 (GNI) at 1,012,316 million US dollars (World Bank, 2011). According the Bank of Mexico, on April 8th the international reserves were estimated to be $150 million (Verdusco, 2012). Having said this, foreign Nongovernmental Organizations (NGO), according to various international indexes, notes that Mexico has overwhelming violence. It is regarded has having a high rate of corruption. Similarly, they classify it as a nation with low signs of democratic development and see it as a country with one of the lowest levels of prosperity.

Among its population of 112 million inhabitants are a number of young people aged 12 to 29 years who are neither studying nor working. The so-called "ninis" are increasing and currently constitute 8 million individuals, according to data from the employers' Confederation of the Mexican Republic (COPARMEX, 2010). UNAM shows there are only 7.5 million young "ninis" (Olivares & Paul, 2010). The Organization for Cooperation and Economic Development (OECD), says Mexico is number 3 of 34 with this condition. Turkey, Israel and Brazil which belong to the G-20 overtook them. Mexican women represent the highest average since they represent nearly 40% of the country. The report spread among the media on Tuesday, September 13, 2011. It said there are 7.212 million people with no education and are unemployed. From this group 38% (more than 2.6 million) are women and 1.930 million are between 15 and 19 years. The Government reported 70% (nearly 1.350 million) who are in a training plan for a job but are formally not considered students or employees (Sánchez J. , 2011). These overwhelming figures contrast the fact the federal Government has decreased the percentage of the funds for priorities such as education and health, to be used to combat crime.

NGO Transparency International (TI) is dedicated to combating political corruption. They disclosed information described under 3.1 to Mexico in its annual report for the year 2010. In 2009 it won a 3.3 rating on a scale of zero to ten. A rating of zero represents a perception of higher corruption levels and 10 a perception of low corruption levels. Thus the results suggest a serious problem with corruption. This assessment reveals that Mexico went, in one year, from 72nd to 98th place among 178 analyzed Nations.

Mexico went from 49th to 53rd, from 110 countries in the measurement of the prosperity by the Legatum Institute of the United Kingdom organization. Mexico ranks below Latin American Nations of Uruguay, Chile, Costa Rica, Panama, Argentina, Trinidad and Tobago and Brazil (Legatum Institute, 2011). Meanwhile, the German Konrad Adenauer Foundation presented the Demographic Development in Latin American Index 2011. The index shows that Mexico fell from the 5th to the 7th place, partly because of problematic condition caused by increasing violence and organized crime (Konrad Adenauer Stiftung and Poli-Lat, 2011).

The central problem of public finances in Mexico is low tax collection. Taxes represent 18.1% of GDP (including social security contributions and oil taxes). This is less than half of the earnings of the European Union (40.6%) and the OECD member countries (36.3%). It is less that what is raised by our commercial partners, Canada (33.9%) and the United States (26.4%).

The paper "Mexico a comprehensive development agenda for the New Era" elaborated by the World Bank in 2001 provides and interesting viewpoint. While this paper is aged, its considerations continue to be valid. The paper identifies the following problems of the Mexican tax system: 1.) Evasion is easy, and sparsely discovered or punished; 2.) The payment, even for those willing to pay, is difficult; 3.) The tax laws are complex; 4.) Their application by those who govern them is inconsistent (discriminatory) between taxpayers and time; 5.) The system collects inadequate information and fails to use it well. This report, made by the World Bank and intended for Vicente Fox Quesada, incoming president of México, consisted of diagnosing and a series of recommendations of policies for the sectors which contribute to the country's development. The six big areas structured by the report were: 1. Fiscal sustainability, 2. Development, 3. Competitiveness, 4. Poverty, 5. Inequality, and 6. Sustainable future and demand for quality government. All one of them covered several chapters about policies for the specific sectors (Giugale, Lafourcade, & Nguyen, 2011).

President Calderón on October 29, 2009 received the PAN Senators, at the presidential residence of Los Pinos. There he sought to seek consensus for the adoption of the regime of fiscal consolidation. That companies pay taxes deferred from 1999 to 2004. The owner of the Executive body argued that 100 consortia in the country pay 1.7 percent income tax. Most Mexicans pay 28 percent (then Secretary of finance and public credit Agustin Carstens). He noted it is one small step to stop tax havens (Vega, 2009). The president asked all the areas of the country to assume their responsibilities.

More than 400 major business consortiums in the country enjoy an exceptional privilege, the so-called tax consolidation regime. The Ministry of finance recognizes them in an official document Building major contributors. Four hundred large business groups amassed income of 4.906 trillion pesos in 2008. But they pay only 1.7% on average of income tax. They also have the benefit of postponing paying their taxes. They postponed so much that in 2008 their debt had risen to about one 132 billion pesos (Garduño, 2009).

Small and medium sized enterprises do not receive the same privileged treatment. Pedro Salcedo García, President of the Latin American Association of Micros, entrepreneurs (Alampyme), said the low sales produced by the economic crisis and tax payments stifled small industry in Mexico. Since last October, to date micro and small businesses have lowered their productivity by 15 to 20 percent of their installed capacity. About half a million small and micro entrepreneurs resorted to closure in one year. Although some of them have simply become informal businesses (SoyEntrepreneur, 2007).

Economic growth from 2007 to 2010 was only 1.1%.On the other hand unemployment rose from 3.6% to 5.2%, while informal traders grew from 11.4 to 12.9 million. (INEGI) Informal businesses do not pay taxes, and yet it receives benefits such as the popular insurance. The federal Government created this arrangement for the self-employed and people who do not have employment. This also provides for those who do not have access to health services because they are not benefactors of the social security institutions granted by the Government. This discourages those who are acting formally and causes them to engage in tax evasion and become informal.

<u>Facts and Figures of the Insecurity Problem</u>

Insecurity exists everywhere. Man may be good or bad as he wishes, however, the misuse of freedom or free will sometimes occur. They deprive their fellow human beings, making him into a violent, abusive and confrontational individual. Insecurity is not new because of the situation. However it may be more alarming because of new methods of communication and the population growth. For nearly seventy years a single political party has dominated Mexico. Mexico enjoyed a seeming "*pax octaviana romanae*". But this arrangement has a cost. Mexicans today suffer the results.

The Federal Government (2011) during the President Felipe Calderón administration 2006-2011, captured 147,414 suspects with almost 70% linked to drug trafficking. They released more than 128,000 of all detainees, many of them presented to the media as dangerous criminals. Perhaps it is why the speech against judges and officers of the public prosecutor's Office do not punish criminals and release them. There is about 106,036 crime incidences reported for every 100,000 inhabitants. In Mexico the prosecution and punishment of crimes are divided into two areas, the common law and the federal jurisdiction. Drug trafficking is a criminal offense by federal jurisdiction. State and Municipal Governments have evaded their responsibility for combating crime. There are two types of organized crime, one groups of drug traffickers, and another of common crime. The first is the responsibility of the Federal Jurisdiction, while the second is the responsibility of the common law. Combating crime is up to States and City Members, which either out of fear or bribes have not fulfilled their duty.

But among federal jurisdiction Crimes (350 daily), it is striking the fiscal crimes grew by 87%, the banks, credit card fraud and similar by 46.7%; those committed by public servants, is 35.1%. There are crimes without clear victims, which undisputedly stand out from others, which are consumption, trafficking and drug production. Mexico has identified drug trafficking as the enemy to defeat.

Drug trafficking is the trade of toxic drugs in large quantities (RAE, 2001). Drug trafficking is known as a global illegal industry, which consists of the cultivation, manufacture, distribution and sale of unlawful drugs. While certain drugs are for sale and legal for possession (certain drugs containing tobacco, alcohol, etc.), in most jurisdictions the law forbids the sale, and even the offer or assignment of certain types of drugs (UNODC, 2011). Mexican Federal Criminal Code "Article 194" says there shall be imprisonment from ten to twenty-five years and one hundred to five hundred a day in fines to those who traffic drugs. This means produce, transport, traffic, trade, even free supply or prescribe any narcotic suggested in the previous article, without the authorization referred to in the General Law of health". In general terms, drug trafficking is an illegal industry of a global nature which consists of the cultivation, manufacturing, distribution and sale of illegal drugs.

The United States is the number one market and drug consuming country and Mexico is the most important provider through the drug cartels that traffic Colombian cocaine and heroin through its territory destined for the United States. Much of the marijuana and methamphetamine sold in the United States has been produced in Mexico. This activity is carried out by air, land and maritime routes. Mexico shares a huge border area with United States of America. The border is 3.185 kilometers, 1951 miles (SRE α IBWC, 2012). The drug trade operates through cartels that vary in size, consistency, and organization. The chain ranges from street dealers of low rank, who sometimes are drug users themselves, to intermediaries who transport the drugs, who can be compared to contractors. They are similar to multinational empires that rival in size with national Governments.

A renowned prestige specialist suggests Mexican organized crime has diversified. He estimates that, as well as drug trafficking, they are involved in 22 crimes or unlawful markets, in 22 countries. It has expanded in countries with Law Status such as Spain and Germany…"These groups in Mexico have not been touched because they sponsor political campaigns. Cartels have an internal government directory. There is not only a head but they have a paramilitary organization with weapons, equipment, and sophisticated communications systems. They operate based on autonomous cells.

There is a turning point. The failed Fast and Furious Operation planned and carried out by the Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) of the United States Government. They sent more than two thousand weapons to drug cartels in Mexico in 2009. To place this in context, the 75 U.S. Army Rangers regiment has about two thousand five hundred soldiers. This means that because of this failed operation, the Sinaloa cartel may have received nearly as many weapons as those needed to assemble a complete Regiment. In Mexico, individuals note the Americans sell their weapons to both sides, government and criminals. The Mexicans have the deaths.

The border between the United States of America and Mexico has the largest number of legal crossings in the world, with 50.23 million pedestrian crossings each year (Spolaore & Wacziarg, 2002). It is considered the border with the most illegal crossings in the world with almost 12 million in 2007 (Zhang, 2010), of which about 250,000 on average die each year (EFE, 2010). They are mostly of Mexican nationality, and in descending order, Central American, South American, Caribbean and Asian.

In this sense the V Presidential Report shows the number of complaints for violation of the laws of the people (migrants) decreased 4.4%. This is because of the flow of undocumented Central Americans, up by 70% from five years ago. They no longer venture to the United States in search of the American dream. Also the terror of abduction, torture, extortion, murder, and women raped, in their transit through Mexican territory dropped dramatically.

The fifth report of President Calderon shows the arrest of 6,560 kidnappers. He does not specify the number sent to prison in the five years. From September 2010 to July 2011 there were 1,774 people in captivity released and 1,410 kidnappers captured. Many Public Ministries (prosecutors) and judges colluded or threaten with the words: What do you prefer silver or lead? They do not do their homework.
Prison overpopulation, according to the presidential report, is at 21.7% and there is lack of physical space for more than 40,000 inmates. The report does not explain the reasons why in 2007 there were 445 detention centers in the country and currently only 429 (16 fewer).

On the other hand, the number of prosecuted and sentenced inmates grew to 224,246, a ratio of 20 to 80 among the federal jurisdiction and the common law crimes, respectively. To quantify the prison problem we note that if they had condemned only half the detainees in the six-year term, the number of inmates would have risen to 300,000. But there would not be a physical place to detain them.

The financial intelligence of drug trafficking has found various ways to introduce and invest, wash money product of unlawful activities in the country. Every year between nineteen to twenty-nine million dollars comes into Mexico from United States from unlawful activities. Although most enters as cash by land, another part does enter by more sophisticated methods that seek to avoid confiscation (Sánchez & Mosso, 2010). Estimates assure that 37% of companies infiltrated illegal money.

As noted earlier, the dollar in cash is one of the main monetary instruments used to transfer the profit from the sale of drugs in US cities. In Mexico traffickers launder nearly $25 billion each year. The Department of State, of the United States, details this in its annual report on drugs, called International Narcotics Control Strategy 2010. Despite these profits, the U.S. Government considers that for the first time cartels face an existential threat from the State because they cannot win with bribery or intimidation.

From 2007 to 2010, the number of intentional homicides increased 96%; kidnapping, 188%; extortion, 101%; robbery with violence, 47 percent, and cars theft with violence 123%. UNAM gave these figures in the publication Elements for the construction of a State Policy for security and justice in democracy. *"In 2007 only 53 cities had an average of at least one monthly execution." "For 2010, 200 cities meet that condition. This concentration of violence was in 17 cities in 2008 and 24 in 2010". "In reality, funds available from public security under the Executive Secretariat of National Public Security System figures grew from 1998 to 2011. This equals almost 350 percent."* (UNAM-IIDC, 2011). The index of *visible and invisible victims* and the organization "Mexico Evaluates" presented figures from the National Public Security System. It states "Crime has not been contained even with the presence of Federal Forces, but to the contrary". "Crime extends to other entities where an increase of at least one crime in the last 5 years is observed" (México Evalúa, 2011).

The Secretary of Finance and Public Credit, (La Secretaría de Hacienda y Crédito Público) unveiled its proposal for the Federation's budget, which needs approval by the Chamber of Deputies. It's one of two bodies that are members of the General Congress of legislature. The sought authorization to grant 13 percent more than in 2011 to combat crime. Mexico's 2012 budget would be the highest of its history. Security would go over $800,136,000 pesos as compared to $700,154,000 pesos proposed by the Federal Executive. That implies an increase of 13.1 percent, according to the economic package presented to Congress by the Secretary of Finance and Public Credit (SHCP) Ernesto Arroyo Cordero.

Corruption and Public Service

Paraphrasing Aristotle, politics is the most sublime of human activities. Aristotle justified this assertion on the fact a professional seeks for excellence, not for the welfare of a particular group, but the common welfare, the welfare of the polis. (Aristóteles,1994). The small bourgeois attitude has set up camp in Mexico depicting some sayings: With money the dog dances, So you have, so you are worth, Who doesn't cheat, doesn't progress. These are the Mexican ethical standards, because the illiterate way of living and the attitude that confuses them. The reflection is serious. Most Mexicans are ethically illiterate. Corruption affects the viability of the social structure. It transforms the nature of the relationship between Government and citizens. A relationship where civil servants do not do what they should do, and do not give what is expected of them. For this reason citizens lose confidence in authorities.

Jorge Fernández Ruiz says that corruption is the essential framework of insecurity. Politically it destroys the credibility of authorities. Economically, corruption distorts the supply, the demand, the prices, and general market. It discourages investment, increases distrust to perform banking transactions, stock market transactions and commercial transactions, and in general increases the transaction's costs of enterprises. This results in damage to sustainable development. (Fernández, Reflexiones en torno a la Seguridad Pública, 2008).

The Instituto Tecnológico de Estudios Superiores de Monterrey conducted a study on the connection between corruption, business and government. The study entitled, *Index of opinion of corruption of enterprises in Mexico*; cataloged the following types of corruption: A. Captured by the State. Payments paid in the private-sector to legislators aiming to influence the definition of the rules of the game. Thirty-nine percent of companies recognized companies similar to theirs pay unofficially to influence new laws, policies and laws. B. Administrative-bureaucracy corruption. Payments made by businesses to public officials to distort the prescribed implementation of laws, policies and laws. Sixty-two percent of companies recognized companies similar to theirs pay unofficially to public officials of lower rank. From their prospective, these companies spend 5.1 percent of their income on Administrative-bureaucracy corruption (ITESM, 2009).

The Economic Cost of Delinquency

The Citizen Institute for Studies on Insecurity (ICESI) declares the cost of insecurity in Mexico during 2009 represented little more than one trillion pesos. This represents 8.9 percent of Gross Domestic Product (GDP) PIB. (ICESI, 2011) By the year 2010, according to a study by the Inter-American Development Bank, the costs created by criminal acts in Mexico were roughly 15 percent of the Gross Domestic Product. This 15 percent is more than $ 95 billion dollars according to estimates. The study also spoke about the lack of employment and opportunities and lack of values in the Formative Education Process. The Economic Studies Center of the Private Sector (CEESP) estimates the cost of insecurity exceeds 15% of the Gross Domestic Product. (PIB) This is equal to around $ 130 billion. (Miranda, 2010) The official position, extended by the Ministry of Finance and Public Credit, is the doubt related to organized crime costs the country about 1.5% of GDP. This information says that in addition, the violence strips potential growth of the country by up to 1.2% of the GDP (Federal Government, 2011).

Enterprises' Losses

The Mexican Association for the Studies of Consumer Protection states that corruption represents a cost for Mexican consumers equal to 20 percent of the gross domestic product (PIB). In other words, this is nearly 120 billion dollars (Consumers international, 2011). It states there is a theft of 31.7 billion pesos through the sale of gasoline, electricity, different telephonic services, domestic gas and others. Frauds perpetrated, for example, on 30% of the petrol stations are kept secret.

This becomes a vicious cycle that consumers take revenge on with the theft of articles in self-service and departmental stores of around 8% of sales, which translates into 17.6 billion pesos (Univision, 2010). Small theft, known as robbery Ant, causes losses of up to $100 million a year to Mexico commercial chains, and a decline between 30% and 35% in net profits of the big corporations. These robberies lessen inventories of companies by up to 10%. Usually, it is an offense committed by the same workers, visitors, or suppliers, making early detection difficult. The problem doesn't stop there. The industries resist these losses, 10 billion pesos, plus payment of surveillance and protection services which translates into a rise of 15 percent in prices. There is a notable lack of security systems under such a problematic condition. The underground extortion payment price becomes another "tax" on the company.

Criminal acts reduce company profit margins, which results in fewer resources for reinvestment and employment generation. Entrepreneurs have reduced their production levels to reduce losses by criminal acts. There are closures and suspended investment because of insecurity. Companies point out that investing in Mexico represents losses in several ways. These range from the economic losses to administrative problems. Some of the most important are as follows: *1.) To interrupt operations within the company; 2.) Temporary loss of the market because of insecurity or the immediate supply, because of loss of raw materials; and 3.) The losses of material allow supplying a black market and favors unequal competition."* (Fraser, 2001) Noting these, it is not difficult to predict the confidence the international market gives to Mexico. However, we note that Mexico has several International Treaties that want reliable platforms (SICE, 2012).

The cost the Mexican society is paying is not merely the price of insecurity, but also corruption and impunity. According to estimates, the climate of violence that shakes Mexico cost, without counting the any lost profits, 50 million pesos a year. This number represents half the total annual budget for education. Moreover, during 2011 over 160 thousand companies shut down in Mexico because of organized crime, according to the Employers' Confederation of the Mexican Republic (Miranda, 2012).

The Diagnosis on the Social, Economic and Cultural Reality of Crime

Mexico is part of the Group of emerging countries with dual economies with relevant differences. On the one hand it is considered a modern, industrialized State strongly linked to the needs of the global market for export and import. At the same time, large sectors of the society are lagging. They are lacking for the minimum of well-being and without the capacity or possibility of development.

The document of Mexican Manufactures gives us insight from the 80´s. The Mexican Government adopted a macroeconomic policy, little conducive to growth, productive investment and industrialization. It favored stability overgrowth, and promoted financial stability over productive and social stability. Preserving stability comes from support from an overvalued exchange rate, and less public investment. But has not raised the competitiveness of the national economy or boosted private investment.

A cloud over the spectacular growth of manufacturing exports from the automobile industry, automobile spare parts industry, and electronics is NAFTA. They focused increasingly on a few branches and target markets. One half of assembly plants (fabric) for export, with national minimum content (2%), face depressed wages and ridiculous tax contributions. The funding from commercial banks and the enterprise's development bank drastically reduces national capital enterprises.

This situation preserves the counterproductive macroeconomic sector strategies. In times that need creativity and pragmatism, rulers oppose implementing heterodox measures. The main developed and emerging countries are adopting policies to raise their levels of employment and exports and defend themselves against predatory imports. The Brazil government launched a package of extraordinary actions for financial, fiscal support and purchases in the public sector. The goal was to promote and defend priority industries. At the same time real wages are improved to strengthen the internal market.

The Mexican Government remains committed to reducing tariffs and protection of national production to boost their competitiveness. The American technical inspection and unilateral certification of standards procedures has damaged the Mexican companies in various sectors. Now it continues its departure hacking into the domestic industry, besieged in particular by Chinese and Asian imports. Part of this attitude occurs when emerging countries and developed countries recover the role of manufacturing and generate stable and prosperous economies. It also occurs by the development of comparative advantages of knowledge and low wages that depress the domestic market (MBGE, 2011).

METHODOLOGY

Quantitative studies work with data and figures expressed in statistical equations. They collect data from different sources to gain a diagnosis of delinquency. It comes by a situational analysis that helps explain the reality and to propose strategies. We comparing and contrast official sources with the owners' organizations, service providers and managers of companies engaged in different sectors. We examine information provided by higher education institutions, office of mediation and rating market, nongovernmental organizations and foreign-national experts and specialists in public safety. Also information were obtained from financial organizations, both public and private. Economic activities were affected by or benefited from the crisis of insecurity.

RESULTS AND DISCUSSIONS (THE PROPOSAL)

The political class and the media try to hide reality in Mexico. Similarly many people try to pretend nothing happens. Mexico is in crisis. No person or institution will make fundamental changes unless it knows that it is in serious trouble and needs to do something new to survive. Mexicans must accept that the country is in crisis. It is at a tipping point of good or bad. It suffers from a social pain attack, anxiety, or a disorder function. There is a crisis when there is a significant event or radical change in a person's life. Here is the key moment to act. It is a time for change. The great crises are the times of great opportunity for the victorious.

Miguel Bahena Pérez (2004) said that: the largest citizen march in Mexico against insecurity, took place on June 27, 2004. It allowed space for a reemerging civil society who demands citizens' rights beyond electoral rights. Security is the demand on the state for assuming its responsibility, facing crime and corruption. However, the romantic mystification of civil society leads to the extreme. The opposition between State and society, refusing the possibility of finding areas of agreement between both define them as contradictory. The climate of political confrontation between the parties and political actors has become clear. Each of them only strives to get power for power's sake. This is further proof that Mexico is a hostage of the political class: *partycratic*.

The solution to the problems facing Mexico is a challenge. We can tackle this challenge from different angles. It can be from citizen mobilization and pronouncement of fairer and less corrupt government policies. Planning and developing alternative models with a solid social economy, through information and awareness in educational spaces among others will be useful. We need to rethink organizations and social welfare. We must also properly assess the ethical values of cooperation, solidarity, subsidiary, self-management, social development, and promote them. The goal is to achieve efficiency, productivity, competitiveness and economic growth in organizations. (Monroy, 2005)

The Mexican legal political system needs to consolidate for social participation, preparation of the budget and its review. There must be a State Ethics Policy, as well as establishing a so-called participatory budget. We need to make clear there is no institutional ways for society to oversee permanently legislators, judges and public servants. Society as a whole is distant from the indirect representation of political parties. The government oversight body called the Superior Audit of the Federation is in charge not allowing the society as a whole to interfere in the appointment or performance of public servants. This is the same for States and Cities governments.

There is an urgent need to make effective the 3rd Constitutional Article. We define Democracy in Mexico as a national project. It is a way of life, based on the constant improvement of the economic, social and cultural conditions of the people. It has not met the last three criteria. Therein follows the plot of "failed" democratic State.

Andreas Schedler says: the magic word, the key idea, is accountability. As well as other political ideas in English, is a term that has no precise equivalent in Spanish, or a stable translation. It translates sometimes as control, as inspection, others as responsibility. However, the most common translation and the nearest is (*rendición de cuentas*) accountability (Monroy, 2005).

The solution is essential for joint actions and social responsibility of the state and organized civil society, not individualists. These actions should be done through institutions and nongovernmental organizations. We stress that it is vital we carry out an integral reform, of all justice administration machinery. Only with decent wages we can count on reliable police and judges.

Richard Fowles and Mary Merva (1993) published a study that covered heart attacks, strokes, and crime. This study carried out in the U.S. proved that newly unemployed workers are especially vulnerable to diseases and epidemics. He noted that unemployed people are more predisposed to stress and depression, to consume more alcohol, cigarettes and to less healthy diets. The document points out that each percentage point of growth in unemployment affects the following rates: 1. 5.6% Increase in cardiac effects. 2. 3.1% Increase in deaths from heart. 3. 6.7% Increase in homicides. 4. 3.4% Increase in violent crimes. 5. 2.4 Percent in robbery. These results come from surveys carried out in 30 cities with more than 80 million people in the United States. How is the situation in Mexico? What impact will unemployment have? Will it be the same? Will it be smaller, bigger? How does the fact there are groups who admire the rapid and illegal money affect? Are businesses above the law? What is important is not knowing how much, but knowing how to avoid this negative impact. Perhaps the best way is the education of our children and young people at home. Teaching respect and tolerance, inculpating hard work and honesty is everyone's task.

A fairly feasible solution to the problem of insecurity would be to create a winning attitude in the youth. The attitude would be based on moral and ethical values such as prudence, strength, aesthetics and good use of freedom. We base society as a whole on its educational system, and the Mexico has failed to meet the needs to create a society with future. The proposal is to invest more public spending in education and in creating sources of employment. To set up a true democracy with the active participation of organized society. This would make Article 3 to the Constitution effective in the sense that democracy is not only political or legal. That it is a way of life based on the steady social, economic and cultural improvement of the people.

Paradoxically, setting up security conditions requires creating jobs. If there were an attractive job offer, thousands of young people would give up drug trafficking and others jobs related to organized crime. Mario Sánchez Ruiz, President of the Business Coordinator Council committed himself to creating more and better-paid jobs. However to create these “worthy and generous" posts, we must first have security. The claim makes sense. No sensible executive would want to invest if he knows that crime will not take long to extort him and ruin is business. We have to ask ourselves why there are so many people engaged in extortion and kidnapping in Mexico? Despite the fight the President of the Republic has undertaken considerable efforts against organized crime, it has not stopped. Would there be so many drug dealers, kidnappers and extortionists if the country had decent and generous jobs? In developed countries, jobs are the result of market laws and the growth of manufacturing. They are not a gesture or a commitment.

The fight against crime is of paramount importance. You cannot understand democratic state of law without this frontal struggle. But that is not enough. Unjust monopolies should be open so that there are several TV chains, telephone companies, bread makers, cement plants, soft drink companies, and pharmaceutical companies. If employment were offered in these businesses to those who now are extortionists and kidnappers, organized crime would plummet. Having the opportunity to make more money legally and making less money illegally, few would take the second choice.

We also need to carry out labor reform, which makes flexible the working conditions and change unions into what they should be. Do not use political pressure groups and even political electoral forces for defending the union members' rights. We read in this text, from UNAM "Elements to build a State Policy for security and justice in a Democracy", there are some proposals highlighted:

"To hold a broad political and social pact this reorients the institutions of security and justice to face the violent crisis. To set up a national document this will make the account rendering operative, through integrating citizens to the National Public Security Council and to the Polices Civic Audit. To set up a national register of victims. Take to its maximum intensity prosecuting the crime of money laundering. To form a political and social consensus to give immediate changes to the security strategies. Center it on crime prevention, depressing impunity, decreasing the number of deaths and injured. Preserve people's integration and their human rights. Concentrating on a transparent and participative diagnosis which defines the problems faced. Add the course to follow and a periodic evaluation. To design a social political program which develops models to help consumers of addictive substances to accept their problem and look for treatment. To set up programs which recognize youth's heterogeneity and consider forums for their expression and their link to the community. To create programs to be conducive and reinserting young people into the educational program, with supplies for their labor development. To redesign work policies to highlight the importance of the link school and work, and foster the stability of work and the employees training. To offer fiscal stimulants to enterprises who hire young people and try to train their employees. To create a national subsystem of youth distribution and commercialization this fosters an entrepreneur culture in this part. To set up a council which will orient young people, advises and protects in the family, school, civic, criminal, labor and administrative environments. On topics related to the National University, create a formal mechanism in the National Association of Universities and Higher Education Institutions (ANUIES). Design it with a system to connect the investigation and development of security and justice (UNAM-IIDC, 2011).

Affect the neurological center of organized delinquency by breaking up the organization of illegal groups; strengthen the legal instruments for preventing and combating money laundering and terrorism financing. 1. Regulate cash operations, monetary instruments and equivalents. Bring into line those administrative subjects obligated by law to follow the procedures of preventing money laundering and terrorism financing. Focus on organizations with foreign currency, traveler's checks, prepaid cards, international money transactions and operate in high criminality zones. 2. To limit the cash payments of real state, cars and other items of high value. Impose the duty to report to SHCP the cash payments that a person receives for any idea. 3. Adjust penal types, A. Recognize new penal related to money laundering and financing terrorism. This will allow combating in an efficient way money laundering and the terrorism financing, as well as formalized specific investigation techniques. B. New subjects obliged to report transactions. Hold enterprise responsible for the prevention money laundering and terrorism financing. This should include gambling centers, nonfinancial bidders' loan, card issuers' bank payments or services. Also include real estate agencies, automotive and construction, professional jeweler. Business shielding, notary public, lawyers and accountants, transport of valuables, galleries and art auctions. We should include professional service providers to corporations, and companies at high risk of money laundering and terrorist financing schemes, as determined by the SHCP.

We need to consider the NGO (2011), proposed strategy based on national integrity to combat corruption. According to this strategy, governments alone cannot solve the problem of corruption, but need the attention of the whole society. Independent media, executives, legislature and judiciary powers, civil society organizations, private and public servants, regulatory commissions, and effective institutions should all play a role in reducing corruption. Leadership and political are important, but it takes a coalition of "people".

The Convention of Palermo notes: to prevent political corruption, a "Moncloa Pact" self-purge of political parties, following the example of Italy, to not allow the infiltration of organized crime. To set up plans for social crime prevention (it is common to hear children between 12 and 16 years old take the arms and leave school). It is essential to set up international cooperative alliances such as the Red Libera in Italy, following the example of Bari, and several others.

With no security to enjoy liberties and rights of its inhabitants, the state loses its reason for being. If the government fulfills its job then somehow the blame lies with the people. The people must not allow this to happen. In the words of Carlos Llano: people are as big as their projects. Mexico is condemned to be a world power, but making it a reality and that its benefits are shared we democratically need good governors, better political leaders, but above all excellent managers.

CONCLUSIONS

During 2011 over 160,000 companies shut down in Mexico because of organized crime. During the last five years, the number of people murdered by organized crime has increase to more than 60,000.
This document describes the scenario of insecurity that occupies Mexico. We conduct further calculations to identify the cost companies pay because of insecurity. The methodology We highlight key areas of the problem and provide an objective view. We develop an analysis to identify the damage and loss from various types of crimes and offenses.

The government channels large amounts of money, goods and services to combat crime, resources that could go to other areas of welfare and social improvement. Companies spend extra for security for crime prevention, as well as hiring private security for surveillance. No security leads to losses in business because they pay for extortion, kidnapping, theft of goods, and other types of suffering. They transfer a part of their income and business properties to those engaged in illegal activities. It results in reduced profit margins, which results in fewer resources to channel profits to productive projects, savings, consumption of goods and services, and reinvestment or job creation. Employers have cut their production levels to reduce losses from criminal acts. The lack of security causes closures, suspension of investments and diversions to other destinations. The price they pay for extortion becomes just another tax on the company. The economic and social costs are high.

During the investigation, we noted limitations on two points. There is a lack of economic studies of losses suffered by businesses, because of crime. Estimates showed different and contrasting facts, figures, and impacts. We see this especially with regard to information provided by government agencies, who paint a picture for your benefit. This work is one of several parts of a comprehensive study. The short-term goal seeks to identify the figures and economic and social disruption on the firm. In a second stage of this research we will develop an inventory of company and government institutions needs for the fight against insecurity. The long-term goal is to develop formulas, mechanisms and procedures that serve as support to address and solve this social cancer.

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BIOGRAPHY

Mario Jesus Aguilar Camacho has a PhD. in Law from the University of Pan Americana, a specialist in business administration, human rights and social and public policy. Professor at the University of

Guanajuato, Celaya-Salvatierra, Campus. Mexico. Academic Research: Environment and Culture Tax Attorney. E-mail direction: macamach@prodigy.net.mx. He can be reached at University of Guanajuato.

Emigdio Archundia Fernandez has a PhD. In Fiscal Science. Also is the Former Director of the Faculty of Economics and Management, Professor at the University of Guanajuato, Celaya-Salvatierra Campus. Mexico. Academic Research: Environment and Culture Tax Attorney. E-mail direction: emigdioaf@hotmail.com. He can be reached at University of Guanajuato.

Rafael Regalado Hernandez has a PhD in Educational Science, Public Accountant and Bachelor in Business Administration. Director of Finance and Administration, Professor at the University of Guanajuato, Celaya-Salvatierra Campus. Mexico. The Academic Research: Environment and Culture Tax Attorney. E-mail direction: eldoez @ msn.com. He can be reached at University of Guanajuato.

LESSONS FROM EASTERN EUROPE POLITICAL TRANSITIONS FOR REUNIFICATION OF THE KOREAN PENINSULA

Benedict E. DeDominicis, The Catholic University of Korea

ABSTRACT

The political circumstances of Korean reunification will significantly determine the political environment for future public administration. This paper argues this context will create parameters for governments to implement the exercise of sovereignty over the united Korean peninsula. Pan-Korean nationalism will be exploited as a political mobilization resource for creating the foundations for reintegrating a pan-Korean state and society. A reunited national community will be upon shared historical commonalities. They will serve to mobilize political cooperation after nearly 70 years of separate development under radically opposed political and economic regimes. The North's vestiges will likely remain in the form of organized crime networks in a post-reunification state. Peace strategists should prepare to respond to the political tendency to manipulate and exploit anti-Japanese symbolic appeals by Korean political entrepreneurs. The latter will do so to mobilize prospective supporters both in North and South Korea. Some relevant comparisons with East European cases of transition from Communism provide insights into what to expect.

JEL: F50

KEYWORDS: Bulgaria, Communism, Crime, Germany, Imperialism, Japan, Korea, Nationalism, Reunification, Stereotype

INTRODUCTION

A strong political attitudinal legacy from the historical experience of Communism will remain in northern Korea in a post-reunification context. North Korea's regime is closer in terms of its general domestic public support to Communist-era Bulgaria than to East Germany. The economic and political disparities between North and South will result in the latter being the nucleus for a pan-Korean nation state. North Korean security services will likely be the nuclei of influential organized crime/illicit economic networks. The processes by which reunification will occur will affect how North-based organized crime structures will evolve including their relationship to political elite factional and party configurations. The level of efficacy that the authorities in a reunited Korea will demonstrate in suppressing corruption will not be as great as it has been in the reunited German nation state.

This analysis first presents a typological outline for comprehending the polarizing intra-community legacy of external imperial intervention applicable to Eastern European polities as well as to Korea. It then presents a political psychology-based theoretical framework for relating nationalism to collective patterns of political perception and consequent behavior. This approach to nationalism is used to infer the prevailing trends in Korean political perceptions and behavioral attitudes towards internal and external actors and constituencies that have dominated the Korean nation. The following section briefly compares these prevailing trends in Korean political perceptions and behavioral attitudes with selected national cases in Eastern Europe. It highlights the differential consequences of diverse historical development paths within the shared international context of deep Soviet, Chinese or US postwar internal political intervention. The likelihood of the transformation of North Korean police and security organizations into persistent organized crime formations in a future, reunified Korea is highlighted. The final section infers from the preceding analyses to underscore the likelihood of Japanese scapegoating to be an intensifying feature of Korean intra-peninsular political interaction.

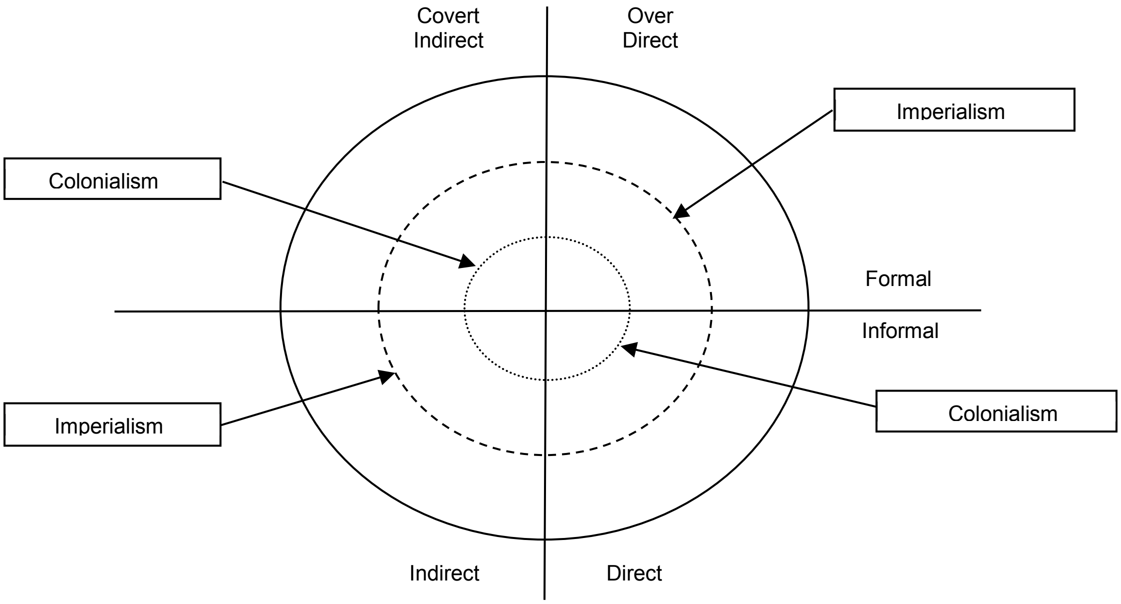
Imperialism and State Evolution

The Bulgarian state, partly as a consequence of centuries of colonialism and dependent development, is a comparatively weak administrative state today as evidenced by its relatively high levels of corruption (Miller, 2008). In the 1989 Eastern European “demonstration effect” environment, mass protests also occurred in Bulgaria to bring down the Communist regime on 10 November 1989 (Linden, 2009). Yet, as in North Korea Communist Bulgaria never earlier manifested an elite dissident movement, not to mention one with active support among the mass public base (US Government). Explaining the relative absence of organized public dissent in the Bulgarian or North Korean case as due to exceptional levels of coercion is necessary, but not sufficient. Neo-Stalinist post-1968 Czechoslovakia and the German Democratic Republic developed significant dissident social movements (Stokes, ed. 1970; Pfaff, 2001). An explanation should include the paradoxes and dilemmas in Bulgarian “national” identity that significantly stem from its largely dependent, colonial Balkan historical political evolution. Beginning in pre-modern, feudal conditions, generations of Bulgarians and Koreans underwent lifetime socialization during periods of imperial intervention. The Orthodox Christian Bulgarian lands were under Ottoman Turkish Muslim control for centuries, before a relatively brief period of sovereignty saw it pass under Russian Soviet domination. Korea was a friendly Confucian tributary state of imperial China for centuries before falling under Japanese domination, followed by Cold War partition and occupation (D. Kang, 2010). They passed on these behavioral attitudes to their succeeding generations. Policy-relevant understandings of Bulgarian and Korean political attitudes towards their own respective states and communities can benefit from a theory-informed consideration of the impact of imperialism. Their respective national political self-determination drives reflect this legacy. Nationalism is this drive for national self-determination through acquisition of the perceived situational political prerequisites for national sovereignty.

The approach by which the external imperial power attempts to control another, pre-modern community will affect significantly the latter’s subsequent political development. The history of imperialism can be examined in terms of the temperament and the forms of control as categorized in Figure 1.

The impact of these imperial experiences shapes the subsequent socio-political mobilizational processes of national identity value formation and behavioral political attitude expression. They include the ethnic, sectarian, racial or territorial identity community foci for nationalism as well as the prevailing ideological self-expression that associates with a particular national case (Rock, 2008). In direct, formal colonial rule, the imperial power imposes its ultimate control through placement of a supreme political ruler publicly representing the sovereign authority of the imperial state. This type of colonial experience has a greater potential to unify the native pro-reform elite of different constituencies in the community in the development of resistance to this form of imperial control. It is probably the least detrimental in terms of its community polarization legacy for state-society relations; the local population at least can more clearly ‘see’ who the enemy is. Japanese imperialism in Korea and Ottoman control of Bulgaria may be categorized as such. In contrast, indirect-formal rule is in place when local, traditional elites rule in the community with the ’advice’ of the imperial power in the form of advisors, security arrangements, etc. Today, it may also be attempted through formal legitimation of an external intervention by international organizational mandates granted, for example, by NATO, the EU, ECOWAS or the UN Security Council.

Figure 1: "Variance in Perceptions of Foreign Policy" from *Foreign Policy Motivation: A General Theory and a Case Study*, by Richard W. Cottam, © 1977. Reprinted by permission of the University of Pittsburgh Press.



Indirect-informal imperial control is maintained without the overt presence of imperial personnel. Local nationalist actors perceive the imperial power exercising ultimate control over the policies of the local ruling elite. During the postwar period, Moscow exercised control through its client elite in local Communist parties and the respective security apparatus in each Warsaw Pact country. If these control mechanisms collapsed, the USSR would intervene militarily, as in East Berlin in 1953, Hungary in 1956 and Czechoslovakia in 1968. In 1989, the USSR had no military bases in Bulgaria and Romania, unlike in Poland, Hungary, East Germany and Czechoslovakia. A current topic of media speculation is whether the People's Republic of China would militarily intervene to prevent the collapse of the DPRK regime so as to prevent reunification with the US-allied South (Lim, 2012). In this case, the nature of the North Korean regime would change with the overt presence of Chinese soldiers supporting the DPRK authorities. Such a scenario would constitute another test of the strength of pan-Korean nationalism today in the DPRK. Finally, in informal, direct imperial control, the imperial power invades and becomes the ruling class (e.g. Arabs into Egypt, Normans into England). In the contemporary era, one case that may plausibly be moving in this direction is the Israeli colonization of Palestine.

Informal imperial rule typically means that the imperial power does not acknowledge that it has ultimate authority within the country; the embassy of the imperial power works through the local bureaucracy (Chandler, 2010). Chandler (2010) focuses on Africa. David Chandler (2006), focusing on Eastern Europe, argues that imperial powers today do not admit that they are hegemonic because it is no longer acceptable to global public opinion. Chandler highlights the greater divide between the state authorities and their European and American international patrons, on the one hand, and the mass public in post-colonial states, on the other hand. The inference is that indirect control aims to reduce the costs of imperial control by lessening resistance to it through attempting to obscure it. This obfuscation can be promoted through a dependent, compliant local elite that has formal sovereignty. Whether or not the political influence of an external imperial power is intolerably high is a subjective judgment by different interest groups and evolving constituencies within the target community. One unfortunate legacy particularly of informal imperial intervention is a stronger propensity for the emergence and crystallization of local community identity cleavages. Consequent, polarizing stereotypes and intense suspicions are more likely to emerge within the previously subjected community regarding who ‘collaborated’ with the imperial powers in the past. In political competition, they are more likely to be portrayed as prone conspiratorially to ‘collaborate again’ in the perceived contemporary machinations of the imperial powers in the area. During intense conflicts, these tendencies may contribute to acts of genocidal violence against suspected ‘traitors.’

Political Psychology and Korean Nationalism

Cottam and Cottam’s theory of nationalism identifies patterns in image perception towards perceived sources of challenge to the national “in-group.” These systematic stereotype simplifications in perception shape policy decision-making. Imperial-colonial relationships leave their legacy in these tendencies towards political stereotyping prevailing in the post-colonial polity (please see Table 1).

Table 1: Image Attributes of a Perceived Source of Comparative Challenge (i.e. threat or opportunity) to Perceived Status of the Nation (in this case, Korea) (adapted from Cottam and Cottam, 2001).

Image/Stereotype	**Capability** (as perceived)	**Culture** (as perceived; today, tends to be equated with perceived technological proficiency)	**Intentions** (as perceived)	**Decision Makers** (as perceived)	**Threat/ Opportunity** (as perceived)
“Enemy”	Equal	Equal	Harmful	Small elite	Threat
“Barbarian”	Superior	Inferior	Harmful	Small elite	Threat
“Imperial” (stereotype of imperial power by the colonial/client)	Superior	Superior	Harmful	A few groups	Threat
“Colonial/Client” (stereotype of targeted colonial subject by the imperial power)	Inferior	Inferior	Benign	Small elite	Opportunity
“Degenerate”	Superior or equal	Weak-willed	Harmful	Confused, differentiated	Opportunity
“Rogue”	Inferior	Inferior	Harmful	Small elite	Threat
“Ally” (the individual social relationship analogue is “friend.”)	Equal	Equal	Good	Many groups	Threat (jointly shared towards a third actor by two “allies”; i.e. the enemy of my enemy is my “friend”)

The national legacy of imperialism includes a predisposition by the subject of control to stereotype historic, imperial external actors in accordance with the “imperial” image. The controlling power, in turn, is prone to stereotypically view the controlled community in accordance with the “colonial/client” image. After generations of domination by the Ottomans followed by Russia, the post Cold War democratic regime in Bulgaria has recently become a Western ally in the US-dominated North Atlantic Community. After 35 years of occupation by Japan, postwar South Korea is historically a client and today an ally of the US against North Korea, the USSR and/or main land China.

These perceptual stereotypes associate with psychological behavioral pattern predispositions that, in turn, become the basis for derivate group behavior orientations by the perceiver as outlined below in Table 2.

In responding to a negative social comparison by a strong in-group towards an out-group, the members of the in-group may tend to respond psychologically in different ways. Between actors mutually perceived as threatening, relative power equals, social “competition” refers to direct competition between these groups for status and influence. A ‘zero-sum’ perception of interaction is a tendency in these intense conflicts. One side’s perceived systematic gain in influence and status in the domestic or in the global political system, as in full-scale war (hot or cold) situations, is perceived as the other side’s loss (Cottam and Cottam, 2001). The Cold War Korean conflict can be understood in these terms. A leitmotif of this analysis is tendencies in prevailing Korean constituencies’ post Cold War images of ‘self’ and ‘other’ in relation to North or South Korea, Japan, the USSR/Russia, the US or China. Social “creativity” strategies aim to preserve a positive in-group self-image through creating a collective perceptual reality in which different, equally valid ’yardsticks’ for evaluation apply to different groups. Groups are thereby ‘different but equal.' One may argue, for example, that the North Korean renewed emphasis on the *juche* ("self-reliance") ideology and strategy may be understood partly as a new regime post-Cold War self-justification. As with all stereotypes, it is self-justifying, emerging with the collapse of its USSR patron and the ending of its subsidies following the end of the Cold War. In this regard, B. R. Myers notes North Korea's self-referent, derogatory references to South Korea as a "yankee colony" (2011b). Daniel Byman and Jennifer Lind note the poverty-stricken North's reference to the prosperous South as "the foul whore of America" (2010).

Table 2: Political Images and Social-Identity Strategies Towards the Challenger (Cottam and Cottam, 2001)

Group Image/Stereotype of perceived challenger	Social-Identity Orientation Behavioral Patterns towards the perceived challenger
"Enemy"	out-group; creativity, competition when possible
"Barbarian"	out-group; creativity, indirect competition
"Imperial"	out-group; mobility, creativity, competition when relationship is unstable
"Colonial/Client"	out-group; maintain status quo
"Degenerate"	out-group; competition
"Rogue"	out-group; competition, destroy
"Ally"	in-group; mobility, creativity

Stereotypes develop out of extended, conflictive political relationships directly or indirectly on the basis of perceived critical group cultural and capability differences. They produce patterns of social perception and behavior towards the perceived source of political challenge. The social psychological perception of a national in-group towards a perceived source of challenge in turn produces systematic behavioral attitudinal predisposition patterns in interaction. These patterns are in terms of social "mobility," "competition," and "creativity" by the perceiver on the basis of these stereotypes.

Social "mobility" strategies seek to join and assimilate into the perceived, 'superior' out-group, with a postwar South Korean focus on an Americanized-globalized international business community. The pervasive influence of American political, economic and cultural models within South Korea is arguably more acceptable due to the provision of social mobility opportunities. South Korea's Cold War client status relationship with the US provided enormous social mobility options both for individuals and the southern two-thirds of the Korean nation. This development occurred while confronting the Communist control of the northern third of the population and its territory, with American tutelage helping to provide this social mobility (Cottam and Cottam, 2001). It provides a strong incentive to the ROK to continue to acquiesce to American hegemony while national reunification, as a prerequisite for national self-determination, has not been achieved (Greenberg, 2004). South Korea serves to validate the development model that the US promoted during the global Cold War conflict. American authorities advocated this model in the midst of its perceived Cold War global social competition with the USSR. Both sought allegiances among the newly independent countries emerging or re-emerging from the postwar wreckage of empires (Linantud, 2008). The neighboring propinquity of North Korea magnifies this South Korean appeal: the failed, "alternative" Korea lies across the 38th parallel conveniently available for immediate comparison. The division of the Korean nation apparently created a de facto laboratory for comparing the two systems to determine their value. The perceived triumph of the US-led alliance over the USSR poses critical dilemmas for the DRPK regime authorities that now rely on PRC economic subsidies (ICG, 2012).

The application of this nationalism-focused theory of image formation provides insights into the competitive and cooperative challenges confronting pan-Korean nation state building. National communities having a collective recent memory of Great Power imperial domination may manifest this legacy in identifiable, lingering patterns of policy behavioral predisposition. This political interaction predisposition derives from a consequent, predominant national image of 'self' versus the external and internal 'other' and the affective orientations that associate with it. It is evident in the imperial-colonial/client image relationship that can emerge under extended periods of domination (Cottam and Cottam, 2001) (Please see Table 3).

Table 3: Images and Policy Predispositions (Cottam and Cottam, 2001)

Image/Stereotype of perceived challenger	General Policy Predispositions towards perceived challenger	Policy Predispositions towards perceived challenger in intense conflicts
"Enemy"	Wary suspicion, containment	Hostility, defense
"Barbarian"	Fear, form alliances	Preemptive strikes, precipitate alliance intervention (potential for genocide)
"Imperial" (stereotype of imperial power by the colonial/client)	When domination is stable: fear, avoid conflict, submit	When conflict is unstable: anger, shame, struggle for liberation
"Colonial/Client" (stereotype of targeted colonial subject by the imperial power)	Paternalistic policy guidance and direction	Most commonly nonviolent repression
"Degenerate"	Contempt, mobilize for competition	Disgust, offensive aggression
"Rogue"	Derogate, isolate	Hostility, violent repression (potential for genocide)

Perceptual and behavioral attitudinal patterns generate policy behavioral predispositions by a national in-group towards the perceived source of political challenge. In the imperial-colonial image dependent relationship, policy behavioral predispositions may change as the political relationship becomes unstable, weakening assumptions regarding relative capability and cultural superiority and inferiority. Perceived opportunities and threats to the relationship may thereby intensify, producing more intense political conflicts. They may reinforce stereotypes and the emotional affect that accompanies them, creating significant potentials for violence.

A future, unified Korean polity will include various constituencies that have their respective, collective historical memories of external and internal domination and their corresponding attitudes. In states with a recent memory of extended imperial control by external actors, the state is more likely to be seen in popular attitudes as a distant, threatening, powerful entity serving its own interests. However, South Korea has had a liberal democratic political regime for a generation since 1987. The contemporary North Korea state had much of its foundation established under Japanese imperialism followed by the "Sultanism" of the continuing, decades-long dictatorship of the Kim dynasty (Hymans, 2008; Myers, 2011a). Sharp portrays this view as a monolithic or "self-sufficient" image of the state and its power capabilities (Sharp, 1973). It stands in contrast to a popular consent-based image of the state and its power (Ackerman & Kruegler, 1994). Both Koreas, however, share a memory of direct Japanese imperial domination until 1945 under which Korean mass political mobilization accelerated out of its preceding feudal, agrarian societal setting.

Comparative Communist and Post-Communist National Development

Upon the arrival of Communism with the Soviet Red Army, Germany was already an industrialized and politically mobilized society. The section of the German public that lived in what became the German Democratic Republic had previously undergone mass political mobilization processes into a common German nation state identity. German mass public state identity for the nation, in other words, had by this time been established. As a consequence, the forcibly imported and coercively maintained, East German "national" state identity never gained sufficient intensity to supersede pan-German national identity. This failure resulted despite strong efforts by the Communist regime to inculcate one (Federal, "East Germany"). Partly for this reason, the collapse of the East German regime was not only peaceful, but the GDR legacy left comparatively little impact on prevailing political attitudes in the former East Germany. The post-Communist "Party of Democratic Socialism" had some electoral support. Yet, eastern German politics is dominated by the same major parties that have dominated western German democratic politics since the formation of the German Federal Republic in the 1950s.

During the postwar period, both Bulgaria and North Korea underwent a period of rapid, forced economic, social and political change under a Communist totalitarian regime. During this same period, the People's Republic of Bulgaria acquired a reputation as the closest ally of the USSR in the Warsaw Pact (Dyer, "Bulgaria won't be celebrating 1989"). North Korea's political development under Communism was rather more similar to the experience of the east European nation states, particularly in regard to the Balkan states. In these states, Communism largely brought "modernity" to these societies that, with few regional exceptions (e.g. the Czech lands) had been overwhelmingly agrarian. Consequently, the respective former national Communist parties, after reforming themselves, have become one of the pre-eminent political parties in all of these states. A positive correlation appears between the level of economic development at the time of the imposition of Communism and the level of popular political support for post-Communist/socialist parties (Toole, 2007). Toole concludes that the pre-Communist historical legacy of Eastern Europe affected significantly the respective post-Communist political party structure that emerged in east central Europe. Toole views this structure as in accordance with the Lipset-Rokkan model's focus on the historical legacy in political cleavage formation in contemporary west Europe. In countries such as Bulgaria and Romania, these parties have successfully transformed themselves into successful electoral parties since 1989. They have won, lost, and then regained control of the government through winning national elections and leading parliamentary coalitions. They represent an organizational model for an enduring, successful East European political party (Klesner, 2007).

In the Communist Romanian case, the correspondence with North Korea is not only empirical, but also intentional. According to one report, Nicolae Ceausescu actually sought to emulate the political model he personally witnessed in North Korea while visiting there in 1971 (Tolnay). In the case of Bulgaria, a strong parallel exists with North Korea insofar as the agrarian Bulgarian political economy industrialized, like North Korea, under Communism. They both did so through close modeling of their own development strategy after one or both of the Communist Great Powers. Bulgarian politics today, a generation since the 1989 revolution, continues to include charges of national treason against the Bulgarian Socialist Party. The latter (i.e. previously the Communist Party) is still domestically attacked for its refusal to repudiate its leaders in the 1970s that voted to apply to join the USSR as the USSR's 16th republic ("Bulgaria," 2012).

Communist Romania under the Ceausescu dictatorship adopted the posture of vigorous non-alignment vis-à-vis the Warsaw Treaty Organization until the late 1980s (Deletant, 2007). Yet, Romania remained in the Council for Mutual Economic Assistance and therefore it remained economically integrated in the Communist block. The DPRK did not have the public pretense of being ostentatiously politically independent from either the USSR or the PRC or both until the end of the Cold War. The latter resulted in far-reaching declines in economic subsidies heretofore provided to the DPRK. The DPRK political economy did not liberalize. Consequently, the loss of the Soviet economic subsidies in the early 1990s resulted in mass starvation and death for perhaps 5% of its population (O, 2011). At this time, the regime accentuated its *juche* (self-reliance) official ideological doctrine.

Prior to the end of the Cold War, North Korean development strategy appeared to be ideologically orthodox in terms of conformity with Marxist-Leninist-Stalinist principles. The DPRK represented the attempt by the North Korean leadership to prevail in the domestic and international competition for representational legitimacy for the entire Korean nation. At first, North Korea displayed development success in comparison with the American-dominated South until the 1970s, during which per capita income was similar to that in the ROK (Lankov, 2006).

The DPRK confronted Cold War adversaries in South Korea, the United States and Japan after the disastrous and catastrophically destructive Korean War. Accordingly, the DPRK regime had strong Cold War incentives to ally closely with the USSR and the PRC and adopt their general economic and political models. The legacy of this commitment remains an existential issue because unlike Bulgaria, the survival of the DPRK regime equates with the survival of the state. Post-1989 Bulgaria, a nation state, could adopt far reaching liberal political and economic reforms, albeit in comparative fits and starts. Due to the intensity of pan-Korean national identity throughout the peninsula, the DPRK regime does not have this option without abnegating itself like East Germany (Cottam and Cottam, 2001). Yet, the DPRK identity profile among the DPRK public is notably stronger than was the GDR among its population (Myers, 2011b). The comparative political obeisance of the DPRK public to the DPRK authorities contrasts with the comparatively awkward identity allegiance of the South Korean public. Specifically, the latter's relationship to the ROK state (as distinct from the pan-Korean nation) is disputed (Myers, 2011b). The DPRK security apparatus is not so readily going to dissolve as it did in the former GDR. Modernization within the DPRK framework has created stronger political identity allegiances. They will likely translate into elements of the coercive apparatus transferring their slowly decaying pro-DPRK identity profile into parochial organizational identities. Their relative cohesiveness and expertise, as well as their extensive social networks, will be conducive for transforming into illicit political economic syndicates in a reunified Korea. As in Bulgaria, they are more likely to evolve into organizations that will continue to specialize in organized illegal economic activity, such as illicit arms shipments (Hope and Troev, "Bulgaria struggles").

The legacy of Japanese, Chinese, Soviet and American imperialism in Korea will likely generate a significant potential for state fragmentation in a post-unification political environment. Korean organized crime organizations emerging out of the security services will likely seek domestic political support partly by associating themselves with romantic nationalist stereotypes. The heroic mythologization of Kim Il-sung and his family as guerrilla unit fighters in the anti-Japanese struggle is noted, for example, in Daniel Byman and Jennifer Lind (2010). It compares with the romantic "bandit" image in Balkan folk imagery of early resistance against the Ottoman Turks that supports extensive organized crime activity currently in the Balkans (Giatzidis, 2007). It implies that this theme would be readily available as a set of romantic national symbols to manipulate to appeal for public support by political entrepreneurs in a reunified Korea. The disputed legacy of the ROK state and its 1945-50 foundations with the rise of Syngman Rhee will become more prominent in the competitive political discourse of a reunited Korea (Greenberg, 2004). Greenberg recounts Syngman Rhee's reliance on the Japanese-associated Korean National Police, with American backing to become the first president of the ROK in 1948. Rhee and his allies killed the most prominent political figure in the South, Yo Un-hyong, and thousands of his supporters to pave the way for the former's own election. The disappearance of the lingering threat from the North will end incentives for some degree of collective regime-enforced or self-censorship. A fuller discussion by groups, parties and constituencies competing for political support in the democratic political system will ensue regarding the Japanese occupation and subsequent partition period (e.g. "Censorship"; "South Korean Journal Backs Down").

During the Cold War, the US worked with local authorities that it saw as cooperating with the US containment strategy in Asia and elsewhere. Containment wars contributed to horrendous suffering, but this US policy strategy also contributed to South Korea's economic "miracle" (Linantud, 2008). China's intervention in the Korean War saved the Kim Il-sung regime. China's perceptions of and policies toward a reunited Korea will largely depend upon the political circumstances and scenarios under which the reunification dynamics occur. China's acquiescence to the disintegration of the DPRK regime will require that the Chinese authorities view the ROK as not being a threat to China's security interests in East Asia. Success in persuading the Chinese authorities of the benign intentions of the ROK will depend upon various factors. Some of these factors are not directly under ROK control, i.e. the intensity of conflict in the US-PRC relationship. The ROK authorities may work to convince the PRC that a reunited Korea under the ROK regime will generate greater economic and security benefits for the PRC. The ROK authorities would feel strong pressure to accommodate to the economic investments that the PRC is evidently already undertaking in the DPRK in mining and other sectors (Choe, "North Korea"). The South Korean leadership has emphasized that the recently adopted ROK-US Free Trade Agreement will make the ROK a more attractive site for Chinese (and Japanese) investment. It will generate more opportunities for accessing the US market ("S.Korea," 2012). China's investments in the DPRK, therefore, may become even more valuable as part of an expanded ROK. It will serve as another incentive to Chinese constituencies to accommodate to the extension of sovereign ROK law, including public administration law, into the North.

Should US-PRC relations become more hostile, their relationship will display more intense competition. The ROK authorities will experience more domestic, nationalist public opinion pressure to distance the ROK from the US to achieve PRC acquiescence to reunification if the latter appears increasingly feasible. It will constitute another test of the strength of pan-Korean nationalism as the pace of change accelerates in North Korea; unlike the USSR in Eastern Europe in 1989, the PRC is a rising Great Power.

The Potential for Japanese Scapegoating in Korea

In the southern part of Korea as well, portrayals of the founding South Korean ROK authorities as 'traitors' to the nation may receive a surprisingly receptive audience (Myers, 2011b). This contextual factor implies that the prospect of violence in the reunification process may be significant. Demagogic references to a common, traditional Japanese 'enemy' will be politically useful for political coalition formation through intra-Korean evocation and manipulation of the 'ally' stereotype. This political competitive predisposition will be useful to overcome intra-Korean political cleavages and polarizations due to nearly 70 years of partitioned, separate development. Political entrepreneurs will seek to create political coalitions by mobilizing public opinion to the extent possible around claims to nationalist legitimacy (Lankov, 2006). In addition to the state of Japan, a focus on Japan's "collaborators" internally against whom to ally will intensify. In various reunification political scenarios, the legacy of the conditions leading up to and during 1945-50 will in all likelihood re-emerge among competing elite factions and their constituencies. ROK President Lee Myung-bak's provocative August 2012 visit to territorially disputed Dok (Korean)/Takeshima (Japanese) island evoked latent but strong anti-Japanese Korean public sentiments (e.g. "BBC," 2012). Currently under ROK control, Lee's first visit of an ROK President to the island arguably enhanced the December 2012 electoral prospects of his party's nominated successor, Park Guen-hye. Lee's actions occurred in the midst of low public opinion survey findings for his concluding administration. These low ratings reportedly resulted from public disappointment over low economic growth, growing income disparities, nepotistic corruption reports, and worsening relations with the North ("Lee Myung-bak," 2012).

Lankov highlights the ongoing official public commitment to pan-Korean nationalism defining the formal ideology of the ROK (2006). This ideology contrasts with the differing policy reality of increasing ROK discouragement of economically burdensome DPRK refugee flows into the ROK as of the mid-2000s. South Korean political discourse today has legitimated renewed investigations regarding pre-1945 charges of collaboration with the Japanese. During the administration of Lee Myung-bak's predecessor, Roh Moo-hyun, South Korea's equivalent of a "truth commission" issued a report listing various foundational ROK figures as Japanese "collaborators" ("Colonial Collaborator List Released"). Roh had also continued his predecessor's strategy loosening restrictions on economic investment and humanitarian aid in the North as part of the "Sunshine Policy," which Lee subsequently abandoned. The list included Park Chung-hee, the military ruler during 1961-79 popularly credited with overseeing the formative period of South Korea's economic "miracle" (Kang, 2009). Park Chung-hee's daughter, Park Geun-hye, won the December 2012 ROK presidential election (McCurry, 2012). Park Geun-hye received primary credit for leading the ruling "New Frontier" (*Saenuri*) party to the surprise retention of its majority in parliamentary elections in April 2012. Her party colleague and rival, Lee Myung-bak of the *Saenuri* party, has been ROK president from 2008 until February 2013 and was constitutionally prohibited from seeking re-election.

In a process that accelerated beginning in the mid-2000s, the South Korean authorities expropriated property from the descendants of identified collaborators with the Japanese (Ryall, 2010). According to this report, the South Korean authorities had seized 11 million square meters of land evaluated at 112 million British pounds. In sum, South Korean political discourse has already contributed to the legitimation of this theme of collaboration. Integration of a post-Communist North into the ROK state will very likely witness an intensification of this subject in democratic politics to appeal to discontented constituencies across the political spectrum. In the South will be located those constituencies paying the very large bill for integrating the economically decrepit North into South Korean market institutions. Similarly, in post-unification Korea, calls will likely intensify for indemnities and reparations from Japan for its actions during the 1910-45 colonial period (Hancocks, 2012). Japanese reparations to S. Korea were supposedly resolved under the "Treaty on Basic Relations between Japan and the Republic of Korea" signed in 1965, under the Park Chung-hee military dictatorship. The post-1987 South Korean democratic system, together with subsequent publication in 2005 of the treaty preparation documents, has generated continual demands for revision of the terms of the treaty. These calls have a particular focus on the plight of South Korean women enslaved as sex workers for the Japanese imperial military during World War, the so-called "comfort women" ("Treaty").

After reunification, public polarization will be great in response to the high profile political attitudinal differences between southern and northern residents as well as towards internal economic migrants. In the North will be based constituencies and groups experiencing invidious comparison and often perceived humiliating treatment by the South (O, 2011). The political context will be favorable for political entrepreneurs manipulating romantic Korean anti-Japanese nationalist symbols. It will be an effective means to mobilize political support that bridges the legacies of the North-South divide. Manipulating anti-Chinese or anti-US symbols and sentiment will be comparatively less pronounced partly because of the perceived much higher comparative economic and political costs of doing so. The economic, cultural and security investments of South Korea in its relationship with the US and China will likely be too great. China became the ROK's largest trading partner in 2003, surpassing the US (Klinger, "China Shock for South Korea"). As long as trade-dependent Japan also remains dependent on the US for security, it will be the least dangerous scapegoat. US and PRC Cold War military intervention in 1950-53 contributed to horrendous Korean suffering ("South Korea shuts down Korean-war human rights probe"). Continuing alliance of a reunified Korea with the US or PRC may generate cognitive dissonance. It can be self-servingly resolved by viewing this historical suffering as ultimately the consequence of Japanese imperialism that led to Korea's partition and subsequent tragedies.

CONCLUSION

The legacy of imperialism and partition in Korea will manifest itself in a reunified Korean peninsula in terms of challenges to public administration. The situational political dynamics on the Korean peninsula surrounding DPRK disintegration are likely to include appeals to pan-Koreanism utilizing anti-Japanese entreaties. DPRK military and police security structures are likely to enjoy strong albeit declining national popular authority in reunified Korea. The interrelated sources of this authority are likely to include nationalist pride, habitual obedience and utilitarian incentives through the economic resources that they will still control. This northern security elite will continue publicly to associate itself with popular anti-Japanese sentiment. These appeals are more likely to transcend the substantial perceptual, attitudinal and value differences between northern and southern populations that would characterize a reunified Korea. These security structures will likely continue to linger on as organized crime networks at least on a scale comparable to that witnessed in post-Communist states in Southeast Europe. Elements among them are likely to transition into becoming the nuclei for elite political factional and party formations not to mention legitimate, as well as black and grey, economic formations. Among their objectives, South Korean state and civil society actors should prepare today to counteract anti-Japanese nationalist demagoguery in Korean public opinion now and in a future, reunifying Korea. They should continue developing transparent, cooperative ties with Japanese governmental as well as non-governmental civil society representatives. Private sector actors should promote corporate philanthropy endorsing Korean-Japanese dialogue relying on their extensive Japanese corporate ties and partnerships.

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BIOGRAPHY

Benedict E. DeDominicis is an assistant professor in the International Studies Department at the Catholic University of Korea. He came to CUK after 15 years at the American University in Bulgaria. He received his BA in political science and Russian from the Ohio State University and his MA and PhD in political science from the University of Pittsburgh. He can be reached at: The Catholic University of

Korea, International Studies' office, room 260, 150th Anniversary Building, Songsim Campus (College of Humanities and Sciences), 43 Jibong-ro, Wonmi-gu, Bucheon-si, Gyeonggi-do, 420-743, Korea
E-mail: bendedominicis@gmail.com, Office tel: +82-2-2164-4393, Office tel/fax: +82-2-2164-4411, Korean cell: 010-2076-4401, US cell: 419-852-1796. Skype display name: Benedict Edward DeDominicis

PRESIDENTIAL ELECTIONS AND STOCK RETURNS IN EGYPT

Yvan Nezerwe, University of Phoenix

ABSTRACT

This paper examines the relationship between two Presidential elections and Stock returns in Egypt. The available literature showed mixed results on the relationship between Presidential Elections and Stock Returns. The author examined daily data and used an OLS regression. Each Event Window covered 90 days around the Presidential Election. The results showed that both elections had positive impact on the stock returns in Egypt.

JEL: F30, G14, G17

KEYWORDS: Egypt, Event Studies, Presidential Elections

INTRODUCTION

This paper examines the relationship between two Presidential Elections and the Stock Returns in Egypt. The Egyptian Exchange (EGX), one of the oldest and largest stock exchanges in Africa, lists 145 member firms. It touts itself with a vision to be a world-class and premier stock market in Africa and the Middle East. The listed firms are divided into several industries (Financial Services, Chemicals, Construction, Real Estate, Telecommunication, Food/Beverage, Healthcare, Retail, Media and Utilities). From 2005 until 2010, fifteen companies had their initial public offerings on the EGX. Table 1 shows the market indicators of the EGX for the last 3 years. The Market Capitalization is the number of listed shares multiplied by the Market Price at End of Year.

Table 1: Market Indicators of the EGX

Indicator	Year 2010	Year 2011	Year 2012
Number of listed companies	212	212	212
Market Capitalization End of Year (Billion LE)	488.2	293.6	375.6
Turnover Ratio (%)	42.89	34	34.12
Number of Trading Days	247	207	245
Number of Transactions	9,793,720	5,516,916	6,160,985
Volume	27,955.10	16,896.20	32,804.10
Value Traded	272,904.20	130,536.40	166,459

This table shows the market indicators of the EGX. The Market Capitalization is the number of listed shares multiplied by the Market Price at End of Year. The Turnover Ratio is the Value Traded of listed shares divided by the Market Capitalization. The Number of Trading days is lower for 2011 as the EGX closed during the "Revolution" (January 2011). This historical data was pulled from the EGX website www.egx.com.eg.

The first presidential elections were held on September 7th 2005. The incumbent President Hosni Mubarak won 88% of the final votes. Several other candidates such as Ayman Noor and Fawzi Ghazi contested the elections. These elections were the first multi party elections in Egypt. Before the 2005 elections, the Egyptian voters were subjected to a referendum on the ruling party`s candidate. With this referendum, President Mubarak won several presidential terms and stayed in office from 1981 until 2011.

A popular uprising removed President Mubarak from office in February 2011. During the three week "Revolution", millions of Egyptians demonstrated and asked that President Mubarak resigns as Head of State. The "Revolution" was mainly due to high unemployment, low wages, corruption and lack of free speech in Egypt. The demonstrations and strikes negatively affected the Egyptian economy. The tourism sector, an important revenue generator for Egypt, was affected as tourists feared for their safety. The civil strikes also affected the food and transportation sectors. The second President elections were held on June 17th 2012. The first Post-Mubarak elections were reportedly the first "democratic" elections and registered twelve candidates. Mohamed Morsi, candidate of the Muslim Brotherhood, won the election with 51% of the votes. The motivation of this paper is to examine the relationship between Presidential Elections and Stock Returns in Egypt. The available literature showed mixed results on the Impact of Presidential Elections on Stock Returns. This study is therefore a contribution to the literature on this topic. This study used an OLS regression and the daily data was retrieved from DataStream. The Event Windows covered 90 days around the Presidential Elections. The results showed a positive impact for both Presidential elections on stock returns in Egypt. The rest of this paper is as follows: Section 2 reviews the literature on the topics of this paper. Section 3 describes the data and methodology used in the study. Section 4 provides the results and Section 5 concludes the study.

LITERATURE REVIEW

This paper covers the topics of Egypt, Standard Event Methodology and the relationship between Presidential Elections and Stock Returns. This section reviews the different studies on these topics. Egypt is a North African country with rich history. Several books and research studies have focused on Egypt`s history, religions and geology. Grimal (1992) and Trigger (1983) thoroughly reviewed the Egyptian history and society in general. The Egyptian Stock Exchange (EGX) has also received some attention on its market efficiency and its reaction to external events. In terms of efficiency, Mostafa (2007) noted that the performance was sub-optimal for top listed companies in the EGX. There are other research studies on the impact of external events and factors on the EGX stock returns. Shahid (2003) found no evidence of a relationship between the ownership structure and the performance of firms in Egypt. Omran (2001) found that the inflation rate had an impact on the Egyptian stock market performance. Bennaceur (2009) found that the monetary policy does not impact the equity prices in Egypt.

Several research studies used the Event Study Methodology in assessing the markets` reaction to events such as monetary policies, mergers, earnings announcements, change of accounting rules and change of regulations. Binder (1998) reviewed the methodology`s evolution and how it can be used in Financial Research. In the case of Mergers, Hackbart (2006) stated that acquiring firms earn negative returns after a merger. In regards to macroeconomic policies, Darrat (1990) found a significant relationship between fiscal policies and stock returns. The market reaction to earnings announcement has led to what is referred to “post earnings announcement drift” in Finance. Studies such as Atiase (1985) and Ball (1993) found significant abnormal returns around earnings announcements. A change of regulations might affect the way companies do business and to some extent affect the stock prices. Bowman and Navissi (2000) investigated the impact of regulatory threats on the pharmaceutical industry. They found significant negative abnormal returns around regulatory threats events. There is an extensive literature on the impact of political events on stock returns. The existing literature has mostly covered presidential elections. A change of regime brings new economic and foreign policies. This would likely affect some stock prices.

For the case of Germany, Pierdzioch (2005) found no impact of elections but Fuss (2008) found that German small-firm stock returns were positively impacted by the election of right-leaning coalitions. For the case of the United States, Gibbs (1970) stated that the stock market performed better under Republican Presidents. But Siegel (1998) did not find abnormal stock market performances under Republican and Democrat Presidents. As reviewed in this section, the results are mixed in the case of Presidential Elections and Stock Returns. This study is therefore a contribution to the available literature on this topic.

DATA AND METHODOLOGY

This research examined the relationship between Presidential Elections and Stock returns in Egypt. This study used an OLS regression, similar to Floros (2008). There are two events (Presidential Elections) and the dates are as follows:

Event 1: September 7th 2005

Event 2: June 17th 2012

The EGX30 index data was obtained from DataStream and from the websites www.marketwatch.com and www.investing.com. Table 2 shows the EGX30 Data around Event 1. Event 1 was the first Presidential Election on September 7th 2005. On September 7th 2005, the EGX30 gained 1.5% (from the previous trading day) and was at 5064.75.

Table 2: Selected EGX30 Data around Event 1 (September 7th 2005)

Date	EGX30 index
September 1st 2005	4907.3
September 5th 2005	5023.25
September 6th 2005	4990.01
September 7th 2005	5064.75
September 8th 2005	5091.57
September 12th 2005	5058.16
September 13th 2005	5078.3
September 14th 2005	5075.91

This table shows the EGX30 Data around Event 1. Event 1 was the first Presidential Election on September 7th 2005. On September 7th 2005, the EGX30 gained 1.5% (from the previous trading day) and was at 5064.75. This data was pulled from DataStream.

Table 3 shows the data around Event 2. Event 2 was the second Presidential Election on June 17th 2012. On June 17th 2012, the EGX30 gained 0.02% (from the previous trading day) and was at 4419.04.

Table 3: Selected EGX30 Data around Event 2 (June 17th 2012)

Date	EGX30 index
June 6th 2012	4484.71
June 7th 2012	4489.55
June 10th 2012	4471.83
June 11th 2012	4394.32
June 12th 2012	4448.84
June 13th 2012	4421.38
June 14th 2012	4410.01
June 17th 2012	4419.04
June 18th 2012	4267.87
June 19th 2012	4087.45
June 21st 2012	4031.6
June 24th 2012	4166.32
June 25th 2012	4482.48
June 26th 2012	4612.14

This table shows the data around Event 2. Event 2 was the second Presidential Election on June 17th 2012. On June 17th 2012, the EGX30 gained 0.02% (from the previous trading day) and was at 4419.04. This data was pulled from DataStream.

Table 4 shows Summary Statistics used in the study. There are 342 observations used. The skewness measures the asymmetry of the series` distribution around its mean. A negative skewness shows that the series is skewed to the left. The kurtosis measures the peakedness of the distribution of the series.

Table 4: Summary Statistics

	EGX30 index
Observations	342
Mean	0.000510
Median	0.000582
Standard Deviation	0.007363
Skewness	-0.918659
Kurtosis	3.740864

This table 4 shows Summary Statistics used in the study. There are 342 observations used. The skewness measures the asymmetry of the series` distribution around its mean. A negative skewness shows that the series is skewed to the left. The kurtosis measures the peakedness of the distribution of the series.

The daily return was calculated as:

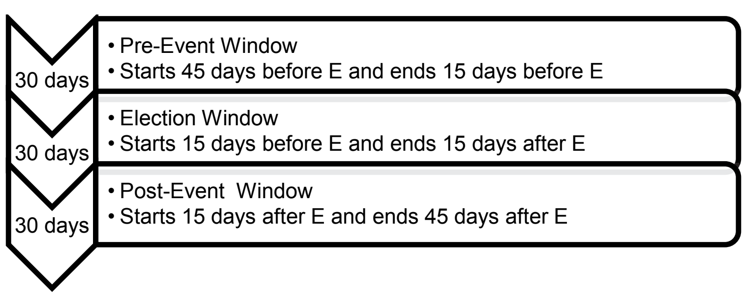
$$Rt = \log(Pt) - \log(Pt - 1) \quad (1)$$

Where *Rt* is the return of the EGX30 index on day *t*; Pt is the price of the EGX30 index on day t; Pt-*1* is the price of the index on day t-1. An ordinary least square (OLS) model was used. The OLS model was as follows:

$$Rt = a + bDt + \varepsilon t \quad (2)$$

Where R_t is the return of the index on day t and ε_t is an error term. The dummy variable *Dt* takes a value of 0 in non-election period and the value of 1 in an election period. The dummy variable Dt shows if the Presidential election has positive or negative effect on the EGX30 index. The event window covered 90 days (45 days before the Presidential election and 45 days after the Presidential elections). E is the Election Day. Figure 1 shows the three different phases of the event window.

Figure 1: Event Window Used in the Study (90 days)



This figure shows the Event Window and covers a total of 90 days. E is the Election and midpoint of the Event window (Day 45). The Pre-event window (30 days) starts 45 days before E and ends 15 days before E. The Election window (30 days) starts 15 days before E and ends 15 days after E. The Post-Event window (30 days) starts 15 days after E and ends 45 days after E.

On the first Presidential election, E is the Election Day (September 7th 2005). On the second Presidential election, E is the Election Day (June 17th 2012). The election window starts 15 days prior to the Election Day and ends 15 days after the Election Day. The pre-event window covers 30 days before the election window. The Post event window covers 30 days after the election window. T-tests were calculated in assessing the statistical significance of the impact of the Presidential Elections on the Egyptian Stock Returns.

RESULTS

The regression analysis was performed on the Excel program. Table 5 shows the regression estimates of the equation:$Rt = a + bDt + \varepsilon t$. The dummy variable takes the value of 0 in non-election and the value of 1 in election period. The second column represents the different coefficients (Dummy Coefficient and α Coefficient). The third column represents the coefficient values. The last column shows the T-Test.

Table 5: Regression Results on Event 1 and Event 2

Event	Coefficient	Coefficient Value	T-Test
Event 1	Dummy	0.6850	0.812
	α	0.0020	1.060*
Event 2	Dummy	0.9000	0.924
	α	0.0035	1.290*

This table shows the regression estimates of the equation:$Rt = a + bDt + \varepsilon t$. The dummy variable takes the value of 0 in non-election and the value of 1 in election period. The second column represents the different coefficients (Dummy and α). The third column represents the coefficient values. The last column represents the T-Test. indicates the significance at 5% level.*

The results show that both Presidential Elections had a positive impact on the Stock Returns in Egypt. The T-Test showed a statistical significance (at the 5% level) on both events` α coefficient.

CONCLUSIONS

The purpose of the study was to examine the relationship between Presidential Elections and Stock Returns in Egypt. The Presidential Elections took place on September 7th 2005 and June 17th 2012. This study is a contribution to the available literature on the relationship between Presidential Returns and Stock Returns. The study used an OLS regression and the daily data was pulled from DataStream. The results showed that both Presidential elections had positive impact on the stock returns in Egypt. In this paper, we mentioned the 2011 Revolution and the different studies on Egypt. Given that the 2011 Revolution was an important event in Egypt, a future study may examine its impact on the Egyptian stock returns. Other studies may examine the Impact of Presidential Elections on different industries of Egyptian Stock Exchange.

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THE AUTHOR

Dr. Yvan Nezerwe is an Associate Faculty of Finance at the University of Phoenix. He can be contacted at: The University of Phoenix, School of Business, San Diego Campus. 9645 Granite Ridge Drive, San Diego CA 92123. Email: Yvanez1@email.phoenix.edu

TRACING THE TRAJECTORY OF INDUSTRY LEADER'S DRUG INNOVATION CAPABILITY: THE AMGEN CORPORATION CASE

Victor Oladapo, Webster University, USA
Godwin Onyeaso, Shorter University, USA

ABSTRACT

The origin of organizational capabilities remains elusive to strategy managers and scholars. Because of this elusiveness, a scholar has questioned: "where [do] capabilities come from [and] what kinds of investment in money, time, and managerial efforts is required in building them" [Ethiraj, et al. 2005, Strategic Management Journal, 26, 25-45]. Using the lens of the upper echelon theory, this case provides evidence that Amgen's President hired "stair-scientists" who then developed the first drugs that launched Amgen as the global biopharmaceutical industry leader. This way, this case study contributes answers to the questions raised by Ethiraj and colleagues (2005). In sum, this real-world case discussion has practical significance to managers and academics alike.

JEL: MOO, M1, M2

KEYWORDS: Upper Echelon, Drug Innovation, Capabilities, Network Capabilities

INTRODUCTION

On one hand, copious literature suggests that non-imitable and non-substitutable organizational capabilities are the bedrock of inter-firm sustainable competitive advantage and performance (see, e.g., Barney, 1991; Wernerfelt, 1984; Rumelt, 1984; Dosi, Nelson & Winter, 2000; Nelson & Winter, 1982; Henderson & Cockburn, 1994). On the other hand, research suggests that the extant strategy literature is not clear where in the organization the answers to the following practical questions---can be found (Ethiraj, et al 2005): (1) Within the organization, where is the starting point of organizational capability? (2) Within the organization, what types of asset and resources are necessary to build organizational capabilities? (3) Outside the organizational boundary, what role does social capital (Granovetter, 1985;Coleman, 1988; Uslaner, 2003) play in organizational capability building strategy? (4) Are external ties and networks of top managers critical to the development of organizational capabilities? Our paper makes contributions by providing answers to the above questions in the framework of archival data on Amgen.

The reminder of this paper is organized as follows. The literature review section discusses works on the fusion of theory and managerial practice---pertinent to the research questions examined in this discussion case. Following this, data and methodology section presents the data sources and methodology used in the study. Next, the results of the study are articulated. Finally, a concluding section wraps up the discussion case study as it underscores the academic and managerial significance of the study.

LITERATURE REVIEW

To address the questions posed in this case discussion, a fusion of theory and managerial practice was used especially answers the questions posed by Ethiraj and colleagues (2005). Answers to these critical questions are important for a number of reasons. First, because the extant strategy literature is at best silent on the answers to these questions, they represent gaps in scholarly knowledge on the development of organizational capabilities. Second, it has been established that the development of theories that managers can apply is among the major objectives of the strategic management discipline (Hofer & Schendel, 1978; Chandler, 1990; Leonard-Barton, 1995). To this end, scholars agree that sound knowledge of the theories of the origins of organizational competitive advantage rooted in capabilities----is critical (Cockburn, Henderson & Stern, 2000; Teece et al. 1997). In deed, Mahoney and Sanchez (2004:34) cautioned that "theory building in strategic management should also recognize that inquiry from the inside [of the firm] is vital in developing integrative capabilities and more integrated strategy theory." That said, they also stressed that "researchers interested in developing useful strategy theory" should gain rich insights from the managerial actions of practitioners in the real business world, as discussed in the present case study. Of course, this is not an entirely new proposition because landmark works in strategic management grounded on practical insights of practitioners have long been documented (see for e.g., Penrose, 1959; Leonard-Barton, 1995; Chandler, 1990; Argyres, 1996; Williamson, 1975). These distinguished strategy and organization researchers agree that history matters, and called for more research for theory development in strategy grounded on the practical experience of managers in strategic management and organizational economics (Chandler, 1990).

Since three decade ago, there has been a growing consensus among strategy scholars that resources and capabilities are critical determinants of organizational innovations and differential performance (Penrose, 1959; Barney, 1991; Rumelt, 1984; Wernerfelt, 1984). Consequently, research on strategic leadership started to focus on executives who have the overall responsibility for organizational success especially under the rubrics of the upper echelon theory (Hambrick & Manson, 1984), and resource-based view (Barney, 1991; Wernerfelt, 1984). These perspectives suggest that superior leadership remains an intangible resource for crafting organizational strategies (Barney, 1991) as well as the implementation of those strategies (Schoenecker & Cooper, 1998). Even though conceptual definitions of resources and capabilities may differ among scholars (Makadok, 2001; Priem & Buttler, 2001; Amit & Shoemaker, 1993), there is a consensus that inter-firm differences in intangible managerial capabilities constitute the inimitable and non-substitutable organizational capabilities instrumental to inter-firm differences in performance (Dierickx & Cool, 1989). Consistent with this notion, the relationship between leadership and innovation has become the focus of empirical research (Halbeslebenet al., 2003; Sharma & Rai, 2003; West et al., 2003; Elenkov, Judge & Wright, 2005), particularly---the strategic actions of the topmost organizational leader has attracted research attention (Halbeslebenet al., 2003; Elenkov, Judge & Wright, 2005). However, the persistent empirical question still remains: where and when do organizational capabilities originate in the organization (Cockburn, Henderson & Stern, 2000)?

In this case study, we argue and then illustrate with examples, that the beginning of any meaningful attempt to trace the trajectory of the origin of organizational capabilities, should begin with the strategic roles played by the organization's topmost executive—the CEO. Our rationale for this assertion is rooted in research suggesting that the CEO is the best informed person about the mission of the organization (Hambrick & Mason, 1984). That is why research suggests that organizations reflect the actions of their top executives (Hambrick & Mason, 1984; Cyert & March, 1963; Hambrick, 1989).

DATA AND METHODOLOGY

In this case study discussion, archival data were extracted from Amgen's records (*10K and 10Q Annual Reports* and *Letters to Stockholders*) to analyze the strategic actions in asset deployments of Amgen's managers cumulating in Amgen's industry leadership. However, additional data were also extracted from the membership directory of the Biotech Industry Organization (BIO).

Methodologically, we now turn to the birth of Amgen as a legal person for practical illustrations of the preceding theoretical analyses. Amgen was organized as a company in April 1980 when *four venture capitalists* legally registered it as a corporate person, and then hired Dr. George B. Rathmann to be the President and CEO of Amgen Corporation (hereafter Amgen). As can be seen, the recruitment of Dr.

Rathmann by the four venture capitalists marks the beginning of the answer to "the kinds of investment in money, time and managerial efforts required in building [capabilities]" (Ethiraj et al, 2005).

Consequently, the first thing Dr. Rathmann (hereafter, the President) did was to craft a business strategy for Amgen. Keeping in mind that: "Strategy is a firm's theory [assumption] of how it can gain superior performance in the markets within which it operates" (Drucker, 1994), Amgen's business strategy at the time of its incorporation was unambiguously stated as follows:

Product development based on <u>own</u> <u>advanced</u> biotechnology [underlining is mine].

As can be seen, this corporate strategy is a three-part strategy subsumed in one: (a) develop biotechnology products, (b) the products must be developed using Amgen's own proprietary technology (blueprint), and (c) the technology must be advanced technology. Then, the trajectory of strategic actions taken by the President had the following critical linkages: to acquire *advanced technology* demands the possession of hi-tech human resource (first-class research scientists) as the most competitive asset of the firm (Grant, 1996). In the innovation literature, the task of these scientists has been variously dubbed "radical innovation" (Henderson & Clark, 1990), "breakthrough" innovation (Tushman & Anderson, 1986), and "paradigmatic" innovation (Hara, 2003). In essence, these first class scientists invented the all-important *advanced technology* necessary to develop the biotech products that would make Amgen the leader of the biotech industry.

Further, a cursory reading of research on radical or breakthrough innovation (Henderson & Clark, 1990; Hara, 2003) allows the understanding that scientific knowledge embedded within the organization is typically insufficient to invent the type of new-to-the-world blueprint that would catapult Amgen to biopharmaceutical industry leadership envisioned by the President in Amgen's corporate strategy. That is, scientific knowledge outside the boundaries of the organization must be accessed to implement the strategy entailed by *advanced technology,* as discussed next.

It is well established that the past and present experience of the organization's CEO (Amgen President in this case) in external ties, is directly related to the CEO's capability in tapping on available network capitals for strategy implementation. Stated unequivocally, within the purview of the boundary spanning activities of the CEO, the quality of the social and political ties available to the CEO is directly related to the degree the young organization will successfully draw legitimacy and identification from established organizations (D'Aveni & Kesner, 1993). Relating this theory to Amgen's case, our archival research found that, between April and May, 1983, president Rathmann---was a former Vice President of R&D (Diagnostics Division) of Abbott Labs. Interestingly, Amgen's President capitalized on his social epistemology and networking capability to get Abbott Labs to sign a *collaborative agreement* with Amgen for a five-year $19 million R&D partnership deal. Accordingly, these deliberate conducts (strategy implementations) allows us to suggest the following proposition:

Proposition 1: External collaborative partnership for R&D is among the first strategic investment by a biotech organization to acquire drug innovation capabilities.

Because primary focus of this case study discussion is a focus on practical managerial application, the study must therefore underline the following encouraging observations about the importance of the *Collaborative Agreement* discussed above. First, industry observers said that the collaborative agreement would have been impossible without the prior experience of Amgen's President with Abbot Labs where he (the President) served prior to joining Amgen. Hence, the President's networking capability was instrumental in getting Abbott Labs and Amgen to sign this all-important collaborative R&D agreement. Stated another way, absent the President's networking capabilities that associated him with Abbott Lab, the collaborative agreement would not have occurred in the first place.

Therefore, it is noteworthy that, the networking capabilities of Amgen's CEO is, per se an important leadership capability which cannot be ignored in Amgen's success history in the same sense that forecasting capability in the mutual funds industry (Makadok & Walker, 2000) is a source of competitive advantage. Another parallel support comes from previous research which corroborates the notion that a CEO with previous R&D management experience "is clearly beneficial to a biotechnology firm's productivity," (Deeds et al, 1999:225). Hence, superior leadership is indispensable for the genesis of organizational innovation capabilities. Accordingly, we propose as follows:

Proposition 2: Superior leadership is at the epicenter in tracing the origin of organization innovation capabilities, especially in the biotech industry.

Importantly, a lion share of the $19 million collaborative agreement was deployed as monetary compensations to attract and retain the best research scientists in the biotech industry to work for Amgen. These best scientists were dubbed "star scientists" (Zucker et al, 1998). To see that this is a classic illustration of strategy implementation, it was these star scientists that developed (invented) "*the advanced technology*" blueprint stated in Amgen's strategic vision discussed above. In other words, strategic acquisition of the star scientists was a necessary precursor to building "*the advanced technology*" required to acquire the proprietary drug innovation capabilities envisioned in Amgen's business strategy. We believe that these practical chronologies of strategic events are practically informative to the practical manager grappling with similar practical strategic issues. The word *practical* is underscored because implementation is the most important aspect of strategy (Hofer & Schendel, 1978; Chandler, 1990). Finally, consistent with the question about the *kinds of investment in money, time, and managerial efforts required in building them* [capabilities] (Ethiraj et al, 2005), we now discuss further how this strategy translated into organizational innovation capabilities.

In a short time (May to December, 1983) the strategy behind the $19 million R&D collaboration with Abbott Labs started to payoff. How? One of the star scientists hired via that Agreement---led a team that discovered *New Molecular Entities* called Epoetin alfa which later was commercialized as a product called EPOGEN. The team leader was Fu-Kuen Lin. Therefore, we propose as follows:

Proposition 3: *The origin of organizational innovation capabilities begins with a team of scientists who discover the first new Molecular Entities commercialized as a product.*

In fact, a confidential informant close to Amgen said that no one can challenge the fact that the discovery of EPOGEN by Lin's team launched Amgen's fame and fortune as a biopharmaceutical industry leader. This way, the hypotheses about the *kinds of investment in money, time, and managerial efforts required in building them* [capabilities] (Ethiraj et al, 2005), begins to be addressed in this case study. In addition, this inference is supported by previous research suggesting that human capital is a critical first resource for the implementation of a firm's strategy (Lee & Miller, 1999), because human resource (Penrose, 1959; Barney, 1991) is needed to build innovation capabilities. Evidently, this finding is in line with previous research in the biotechnology industry indicating that the quality of research teams is the backbone of new product innovation capabilities (Deeds et al, 1999). In addition to that, following Makadok (2001) theory of embeddedness of capabilities, innovation capabilities are embedded in the teams of research scientists working in unity for a common purpose---innovation. Hence, the following proposition is suggested:

Proposition 4: Drug innovation capabilities are embedded in teams of scientists.

Being an intangible strategic asset (Amit & Schoemaker, 1993), an organization's drug innovation capabilities should positively impact the overall economic performance of the organization, according to strategic assets theory (Barney, 1986). Consistent with this theory, previous research suggests that as much as 70 per cent of the market value of Fortune 500 companies is based on investors' assessment of the intangible assets of these companies (Srivastava et al, 1998, a, b), which includes superior leadership (Cho & Puck, 2005; Barney, 1991), corporate reputation for quality (Shapiro, 1993), corporate culture Barney (1991), forecasting capability (Makadok & Walker, 2000), and innovativeness (Cho & Puck, 2005).

Then, the question could be raised: to a young biotech firm (Amgen), what mechanism would be used to send signals of drug innovation capabilities to potential investors during the initial public offering (IPO) stage? Briefly, IPO shares are not sold directly to the public. Instead, institutional investors (investment bankers), broker the IPO deal between the issuing firm (Amgen) and the public by selling to the latter (Benveniste & Spindt, 1989). Here again, the network capabilities (external ties) of the issuing firm's CEO is directly tied to the quality of investment banker the CEO is able to attract to handles the IPO process. If all is well done, then both the issuing firm's CEO and the investment banker must work closely together to provide information that will showcase the value potentials in the young firm---a critical part of this information is the leadership capabilities of the CEO of the young firm issuing the IPO. At this critical stage, the investment banker strives to overcome the "liability of market newness" (Certo, 2003) of the young firm.

To be exact, verifiable evidence clearly indicates that Amgen's president and CEO did a superb job during Amgen's IPO process stage. That is, investors perceived value in Amgen's drug innovation capability and believed in the quality of Amgen's leadership. Investors' risk aversion reduced to the extent that they were willing to pay $18 per share for Amgen's IPO. Altogether, the IPO netted $40 million for Amgen. Amgen's management called this event the "Ticker Event." that launched Amgen as biotech industry leader.

Two years later (1985) another team of star scientists led by Larry M. Souza discovered another New Molecular Entities called *Filgrastim* which was later produced and commercialized as a product called *NEUPOGEN*. These two products contribute more than a half of Amgen's $5 billion sales yearly. EPOGEN and NEUPOGEN received *Fortune Magazine's product of the year awards* in 1989 and 1991, respectively. Currently, Amgen's R&D financing is generated internally from sales revenue from EPOGEN and NEUPOGEN, which in turn has made Amgen a biopharmaceutical company with global presence and industry leadership. We now turn to Amgen's resultant track records from the foregoing strategic implementations.

RESULTS

Amgen's archival data reveal that in December 1994, Amgen was awarded the *National Medal of Technology* (NMT) which is "the highest presidential tribute for extraordinary achievement in commercial application of technology and the equivalent of a Noble Prize." In addition, Amgen received *Fortune Magazine's Product of the Year Award* several times. To the extent that R&D spending leverages a firm's capability for radical innovation through organizational learning (cf: Cohen & Levinthal, 1990), Amgen records indicate that Amgen "invests heavily in research and development, having invested 22 per cent of total product sales in R&D in 2002."

Work by O'Brien (2003: 419) concludes that "The R&D intensity [ratio of R&D to sales] of a firm, relative to its industry rivals, indicates the strategic importance of innovation to a firm." Amgen realized this strategy because, to the extent that R&D spending reflects the level of importance a firm attaches to innovation (O'Brien, 2003; Hall & Bagchi-Sen, 2002), Amgen ranks first above all firms in the two industries--- biotechnology and pharmaceutical industries. Finally, in a profile of the top ten biotech firms in the US and Europe, Amgen ranked first in the following indices: unit sales, total revenue, R&D expenditure, and operating income (Dummett, 2003).

CONCLUDING COMMENTS

This study was an attempt to respond to calls for research on the origins of organizational innovation capabilities, and to do so by drawing practical illustrations and insights from the strategic actions taken by top managers. This way, the study drew practical illustrations from Amgen Corp. and tied it to the theoretical discussion of the origin of organizational innovation capabilities. Consequently, after elaborate discussion of the theory of the origin of innovation capabilities buttressed by practical insights drawn from Amgen Corp., the following striking results emerged. We found that it was President Rathmann who orchestrated and implemented an R&D collaborative agreement with Abbott Labs. Under this collaboration, Amgen was able to hire and finance the R&D drug innovation activities of the star scientists. In other words, absent the R&D collaborative agreement with Abbott Labs, Amgen's star scientists could not have been hired in the first place. In addition, we found that absent the leadership of President Rathmann, the R&D collaboration with Abbott Labs could not have taken place. Therefore, we found evidence that the role of Amgen's top leadership in supporting drug innovation activities resulted in the ability of the star scientists to acquire drug innovation capabilities that leapfrogged Amgen to the biotech industry leadership position. Hence, we concluded that leadership matters in the theory and practice of the origins of organizational innovation capabilities.

We also discussed the theory of embeddedness of organizational capabilities. We found evidence in support of the theory in the case of Amgen Corp. In particular, we found evidence that drug innovation capabilities were embedded in the teams of star scientists. This finding is consistent with Makadok's (2001) notion of embeddedness of capabilities in organizations. Finally, we found that absent the four venture capitalists that incorporated Amgen in 1980 and hired Dr. Rathmann as President, Amgen could not have come into existence at all. Hopefully, these findings will be insightful to entrepreneurs and academics grappling with the research questions addressed in this study especially the role of leadership in providing support to corporate innovation strategies, and the origin of capabilities.

Yet, another unique contribution of the study is that, even though the upper-echelon theory enriched our knowledge of strategic leadership, it has the caveat that it failed to study actual leadership behavior (Cannella & Monroe, 1997). In fact, the extant strategic leadership research underpinned in upper-echelon theory enlisted demographic proxies of leaders to draw inference about their leadership behavior---this point is underscored. In contrast, our case study used actual leadership strategic behaviors data to trace the trajectory the President's deployment of organizational strategic assets, which allowed us to glean answers to the research questions. Of course, the pattern of asset deployments of a firm is the x-ray of its corporate strategy and its implementation (Hofer, 1992; Hofer & Schendel, 1978).

To sum up, the key roles played by Amgen's top echelon in the initiation and implementation of the collaborative R&D agreement without which the star scientists would not have been hired, is worthy of emulation by entrepreneurial managers who wish to build innovation capabilities for new or existing organizations. Intrusive research methods such as in the present study hold the key to finding the origin of organizational innovation capabilities, not quantitative methods as some scholars would insist.

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BIOGRAPHY

Godwin Onyeaso is the President of Jesus Blood Spirit (JBS) Ministry, Inc, and Professor of Strategic Management and Research Methodology at Argosy and Shorter Universities, as time permits. Prior to that, Dr. Onyeaso was tenured on the faculty of Concordia College-University System, USA. His research interests focus on the use of time series econometric methods to investigate the dynamic trajectories of the impact of intangible strategic assets on firm performance. Professor Onyeaso has published in a number of peer-reviewed international journals including: *Journal of Services Marketing, Journal of the American Academy of Business, Journal of Business Strategies, International Journal of Management, Quarterly Journal of Business and Economics, and Management Decision,* among others. He has a forthcoming book on the impact of Spirituality and Religion (The Nine Gifts of the Holy Spirit) on Employee Productivity). He is a consultant to many organizations on the impact of Spirituality and Religion on Organizational Outcomes, among others. Dr. Onyeaso may be contacted at: gonyeaso@bellsouth.net

Victor Oladapo is on the faculty of Webster University (USA) where he teaches Human Resource Management and allied courses. Related to his teaching area, Dr. Oladapo's research interests focus on the use of latent factor and econometric methods to investigate the multivariate relationships between High Performance Work Systems (HPWS) and other strategic organizational outcome variables. His research articles have appeared in some academic and professional conference proceedings, and are being reviewed for journal outlets. Currently, he is a co-author of a forthcoming book on the impact of Spirituality and Religion on Employee Productivity in small business organizations, where he is a consultant. Dr. Oladapo may be contacted at: voladapo@aol.com

FINANCIAL CONTRACTS IN CONVENTIONAL AND ISLAMIC FINANCIAL INSTITUTIONS: AN AGENCY THEORY PERSPECTIVE

Khaled Aljifri, UAE University
Sunil Kumar Khandelwal, Wolters Kluwer Financial Services

ABSTRACT

This study examines the differences in the relationships between different stakeholders in conventional and Islamic financial institutions. The accounting and finance literature identifies the major contractual relationships as being those between managers and shareholders (employment contracts) and between shareholders and debt-holders (lending contracts). Both these types of contracts are usually considered to be financial-based contracts, because they rely, among other things, on the firm's reported earnings. This paper applies agency theory to examine these contractual relationships in the two different financial system. The agency problem can have various forms in Islamic institutions. The agency problem has an additional dimension when managers deviate from the Islamic principles of Shariah. This study is intended to fill a gap which exists in the current literature, relating to the implications of Shariah rules for agency relationships. It also provides an analysis of how agency relationships are different as compared to conventional counterparts and the implications that this has for optimizing the agency relationships by reducing inherent frictions. In this way, this study extends and develops the literature on agency relationships in Islamic finance, thus paving the way for future studies in the direction of corporate governance, contractual relationships, and better disclosure in Islamic financial institutions. The study concludes that Islamic financial institutions have fewer agency problems than their conventional counterparts.

JEL: G2, G3, M4

KEYWORDS: Accounting Contracts, Islamic Finance, Agency Problems, Compensation Schemes, Conventional Finance, Corporate Governance

INTRODUCTION

This paper adopts a theoretical approach to examine the difference between agency relationships in the conventional and Islamic financial systems. It focuses, in particular, on those relationships affected by financial contracts. In the accounting and finance literature, the majority of contractual relationships that have been identified are those between managers and shareholders (employment contracts) and those between shareholders and debt-holders (lending contracts). Both of these contracts are usually considered to be financial-based contracts because they rely, inter alia, on the firm's reported earnings. For instance, management compensation schemes are frequently tied to the firm's performance, which is measured using accounting measures (e.g. net income). Another example relates to lending contracts, which may include some financial covenants such as restrictions on minimum tangible net worth, a certain level of interest cover ratio, and a certain level of gearing. These contracts may be used to reduce agency problems between principals and agents. The contractual relationships in Islamic financial institutions (IFIs) are based on financial contracts and on Shariah principles. "This is to ensure the establishment of justice in contracts and the avoidance of unjust exploitative elements such as riba, elements of gharar (uncertainty), maysir (gambling) and speculation", Manan & Kamaluddin (2010) state. The additional element of relationships based on Shariah law has specific implications for the agency problem and can take different forms. The agency relationships are carefully specified in the Islamic principles of Shariah. Therefore, the agency problem has an additional dimension when managers deviate from the Islamic principles of Shariah. However, it is believed that the Islamic moral code and ethical values that relate accountability and governance through religion make for good agency relationships. This study is intended to fill a gap which exists in the current literature, relating to the implications of Shariah rules for agency relationships. It also provides an analysis of how agency relationships are different as compared to conventional counterparts and the implications that this has for optimizing the agency relationships by reducing inherent frictions.

In this way, this study extends and develops the literature on agency relationships in Islamic finance, thus paving the way for future studies in the direction of corporate governance, contractual relationships, and better disclosure in Islamic financial institutions. In addition, to the best of our knowledge, no study has yet addressed the issues of agency relations in financial contracts in IFIs. The nature of Islamic financial contracts changes the landscape of agency relationships. This study is an attempt to link Islamic contractual structures to agency relationships. The study extends the previous literature through analyzing and discussing the financial contracts and managerial behavior in the case of two major approaches, behavior oriented contracts and outcome oriented contracts. These contracts are discussed for both conventional and Islamic institutions, thus bringing out important differences between them. The study will prove useful not only to researchers, but also to policy makers, bankers and Shariah scholars in interpreting the agency relationships in Islamic finance in order to create a solid foundation for the future growth of Islamic finance. Section 2 presents a literature review and background of Islamic Finance. Section 3 reviews the structure of Islamic Finance contracts. Section 4 explains the nature of contracts in the two systems and agency relations. Section 5 provides concluding comments.

LITERATURE REVIEW AND BACKGROUND

Research in Agency Theory in IFIs was rarely reflected in literature as pointed out by Haneef (1995), until 1994, when Banaga et al. (1994), published a book covering CG in IFIs, albeit focusing more on auditing and accounting aspects of Corporate Governance. Most of the other literature also focuses on Corporate Governance and there are only a handful studies directly looking at agency theory perspective of Islamic financial contracts. Choudury and Hoque (2004), Iqbal and Mirakhor (2004), and Chapra and Ahmed (2002) provide insight into the stakeholders model of Corporate Governance in IFIs, in particular Choudury and Hoque (2004) emphasize that the IFIs are using a different model of Corporate Governance based on the principle of consultation where all stakeholders share the same goal of *Tawhid* or the oneness of Allah. Hasan (2012) states that, "corporate governance in IFIs is founded on the epistemological aspect of Tawhid, Shari'ah and ethics. Iqbal and Mirakhor (2004) opine that managers are treated as trustees and not as managers, thus bringing in the concept of trusteeship and IFIs protect the interest and rights of all stakeholders rather than the shareholders per se.

A significant contribution towards Corporate Governance in IFIs have been made by Chapra and Ahmed (2002) with the publication of first book on the topic which dealt extensively with the topic of Corporate Governance in IFIs although the focus was mainly on auditing and internal control. Tapanjeh (2009) presents a comparative analysis of Islamic principles of Corporate Governance and conventional principles of Corporate Governance with special reference to OECD.Corporate governance in IFIs is recently and slowly getting the required attention from researchers. However, there are few studies of agency relationships in Islamic finance notably among them are by Archer et al. (1998), Sarker (1999), and a brief discussion of agency relationships in the context of the design of the Islamic financial system by Ismail and Ahmad (2006). Archer et al. (1998) discuss contractual relations arising out of Investment Accounts in IFIs and its impact on the agency relations, although their study focuses on monitoring and reporting aspects. Khan (2012) explains that, "Islam supports the view that Muslims do not act as creditors in any Investment but are actual partners in the business". Sarker (1999) argues that if an Islamic institution implement the Shariah approved contracts, the principal-agent problem could be minimized. However, he fails to acknowledge various shortcomings in monitoring and reporting mechanisms and also in inherent weaknesses of Shariah supervision. Samad et al. (2005) focuses on comparative usage of seven basic Islamic financial contracts. This has a direct bearing on agency theory as each of the contract proposes a unique relationship between stakeholders. Safieddine (2009) addresses agency theory with reference to corporate governance. He states that there is a problem in the actual practices of governance which remains agency issues unresolved. Lewis (2005) talks about challenges in implementing Corporate Governance in Islamic Financial Institutions and presents the legal, economic and accounting view of Corporate Governance. Hagendorff et al. (2007) suggest that the banking sector requires a separate agency theory. Before analyzing the agency relationship in IFIs, it is essential to understand the basic tenets of Islamic finance and the differences between conventional finance and Islamic finance. Islamic finance relies on equitable distribution, supports small investors, provides financial support for the poor and needy, and promotes lending with a reason (Khandelwal, 2008d). There are some noticeable differences between conventional and Islamic finance (Table 1).

The foundation of Islamic finance is sharing the risks in all situations and avoiding undue advantage to either party and is therefore based on justice and ethics. It is also based on conducting business activities within the framework of the Holy Quran, and the word of Allah as revealed to his prophet Muhammad (PBUH) (Lewis, 2005). Debt-based financing, which is the basis for agency relationship in conventional finance, does not exist in Islamic finance. Economic relations in Islam are based on property rights and contracts (Iqbal and Mirakhor, 2004) and therefore extend to stakeholder models rather than the narrow shareholder models in conventional finance. An economic relationship without a formal contract can be considered null and void in Islamic finance. Thus there is a strong reliance on having transparent and firm contracts for all economic relations. Contracts are mandatory for all types of transactions, whether small or large (Holy Quran 2:282).

Table 1: Conventional Finance (CF) Compared to Islamic Finance (IF)

	Conventional FIs	Islamic FIs
Moral Dimension	No moral or ethical dimension	Strong moral and ethical dimensions, activities which are not permitted are haram.
Deposit Insurance	Available and mandatory based on a threshold	Not available
Risk Management Practices	Highly developed and advanced with availability of several advanced model	Being developed, still in infancy
Upside & Downside Protection	Available by freezing the spread	Not available since involvement is mainly based on equity participation
Structured	Formal, structured and organized sector	Informal, not very well structured and still unorganized in many respects
Cause of Lending	Purely based on financial gains arising out of interest and other incomes – not linked to the purpose of lending	Partially based on financial gains – but also includes the link to the purpose of lending
Money Market	Structured, formal and organized money market is available	Access to Money market is generally limited and many times not available
Overnight Loans	Proper, systematic availability of overnight loans for liquidity management	Systematic availability of overnight loans is not common and is being developed
Interest	Most transactions are structured around interest rates keeping a spread	Interest is not permitted and hence transactions are to be centred around profit
Legal Support	Developed legal framework is available, with past cases as a precedence	Legal framework is either missing or existing CF (contract acts) framework is used to support IF.
Educational/Research Support/Qualified Manpower	Formal degrees, training programs, professional certificates are available. Extensive research is conducted. Qualified manpower is available	Very few formal educational programs are available. Professional certification is largely missing. Qualified manpower is difficult to find.
Government Support	Government has been supporting for past several decades. Formally accepted form of banking. Fully integrated with Economic and Fiscal Policies	Government support is slowly coming up, integration with Economic and Fiscal Policies is being done.

This table includes the key areas of differences between conventional and Islamic finance. Notable differences from agency theory perspective are moral dimension, upside and downside protection, and cause of lending.
Source: *Khandelwal, (2008b).*

STRUCTURE OF ISLAMIC FINANCE CONTRACTS

Agency relations in IFIs are largely defined by the underlying contract, which is derived from one or more of the base Islamic financial contracts shown in Table 2. The contractual relationship in Islamic finance is complex and dynamic (Khandelwal, 2009). Table 2 summarizes the different relationship dimensions of these Islamic financial contracts.

Table 2: Islamic Financial Contracts

Type Of Contract	Relationship
Mushārakah	Partnership relation – both partners have right to participate in management. This translates into better access to information for both the partners.
Mudārabah	Partnership relation – financing partner does not participate in management, but has access to information.
Murābaha	There is a tri-partite agreement. A bank purchases the asset for the client based on a binding agreement (promisee and promisor), after purchasing the asset from the original seller the bank sells the asset to client (seller and buyer).
Salam	This is a promisee and promisor agreement, where a bank agrees to purchase the product in the future from the customer by making an advance payment.
Istisnã	A bank agrees to purchase a commodity which is yet to be produced, hence the relationship of promisee and promisor.
Ijãrah	This is a leasing agreement and the relationship is of lessee and lessor

This Table summarizes the six basic types of Islamic financial contracts. Fundamentally the structure of these contracts defines the relationship structure between stakeholders. Various types of relationships are explained in the table covering six basic Islamic financial contracts.

Most of these relationships can exist on either side of the balance sheet of an Islamic financial institution via different representative contracts. The principal agent relationship appears on several nodes of the balance sheet of Islamic institutions. A typical balance sheet of an Islamic bank looks like following:

Assets

Cash and Balances with Central Bank
Balances and Deposits with other banks
Islamic Financing Assets (Murãbaha, Salam, Ijãrah, Istisnã)
Islamic Investment Assets (Mudãrabah and Mushãrakah)
Fee Based Services (Wakala etc.)
Investment Securities

Liabilities and Equities

Liabilities
Customers Deposits
Due to Central Bank
Due to other Banks and Institutions
Sukuk financing instruments
Other Liabilities
Equity
Share Capital
Statutory Reserves
Special Reserves
Treasury Shares
Retained Earnings

Under balances and deposits with other banks, the assets are mainly grouped into three categories, viz. asset based (Murãbaha, Salam, Ijãrah, Istisnã), profit and loss sharing based (Mudãrabah and Mushãrakah), and fee based (Wakala). These three group cover almost all the types of Islamic finance contracts and thus cover all the relevant types of relationships under agency relations. Similarly on the liabilities node, demand deposits represent a principal agent relationship, where funds are accepted from clients for general (unrestricted) or specific (restricted) investment purposes as Amanah. Liabilities on account of Mudãrabah and Mushãrakah sharing are recorded as Special Investment Accounts. Note that the exact composition of the Balance Sheet will differ greatly based on nature of business and also disclosure requirements from the Regulator.

The two relationships thus represent principal agent relationships in IFIs, with shareholders investing and providing the authority to the management of IFIs to act on their behalf, and a relationship between Investment Account Holders (IAH) as principal and IFI (not directly the management) as an agent and this is cited as one of the key reasons Sarker (1999) gives to explain the variation in agency theory for IFIs. For example, in the case of an unrestricted *Mudãrabah*, the IAH provides authority to the bank to invest funds on his or her behalf in any Shariah approved activity without any restrictions, whereas in case of a restricted *Mudãrabah*, the authority is restricted, with the need for more disclosure. The aggregate behavior of the agents, in both types of principal-agent relationship, is subject to Islamic law, and as such dependent on religious approval. The concept of wealth and income (*Al Maal*) is unique in Islam and '*Maal*' is not to be accumulated or spent lavishly, but should be a source of charity (Ishfaq and Inayat, 1995).

Nature of Contracts in the Two Systems and Agency Relations

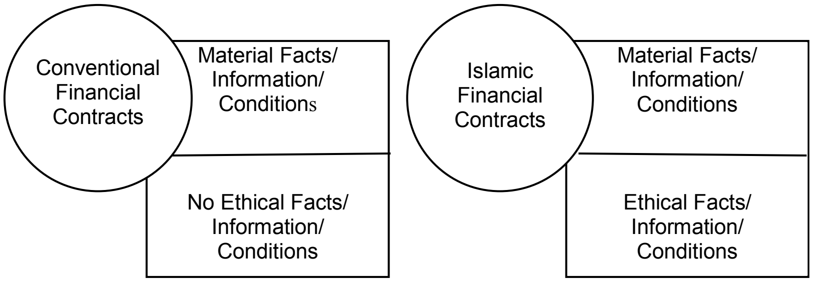
The unit of analysis in the agency context is the contract between the principal and the agent. Therefore, the specific contract terms may be analysed to determine the extent to which they may affect the agency problem. Researchers in accounting and finance who have investigated principal-agent relationships have tended to emphasise the owner/CEO relationship. Berhold (1971) mentions that principals tend to motivate agents to perform appropriate actions by connecting a characteristic of the agent's performance to his or her remuneration (i.e., by reward or punishment).

According to Day and Taylor (1996), in the principal-agent relationship, the agent causes a problem to the principal by engaging in activities that the principal himself or herself would not undertake. When the principal can observe the agent's actions, the principal contracts to reward the agent with a specific level of compensation based on the level of the desired action and punish him or her for undesired actions. On the other hand, if the principal cannot observe the agent's action, he or she contracts to reward the agent for an outcome-based action. The emphasis is on determining the situations in which the goals of principal and agent conflict, and on identifying the governance mechanism that eliminates the self-serving behavior of the agent. Therefore, a specific question in agency theory is the selection of the most efficient contract. The choice is between a behavior-oriented contract and an outcome-oriented contract.

The agent's actions can be aligned with the requirements of the principal through a behavior-oriented contract. An outcome-oriented contract, on the other hand, rewards the agent on achieving certain objectives required by the principal. Both types of contract are attempts to align the interests of the agent with those of the principal (Baiman, 1982). Fulfilment of contracts in Islamic finance has special meaning as explained in several verses of the Holy Quran (Iqbal & Mirakhor, 2004). "Thus contracts in Islam consist of two elements, one the material fulfilment and two the sincerity, truthfulness, and insistence on rigorous and loyal fulfilment of what he/she had consented to do." (Iqbal and Mirakhor, 2004, p 55). Contracts in conventional financial system are purely drawn and based on material information, facts and conditions, whereas the contracts in Islamic financial system are made of material and ethical components (Figure 1).

The two types of contracts are largely similar in terms of material facts but differ greatly in ethical components. Islamic financial contracts are based on Shariah principles and thus have a heavy reliance on an ethical dimension (Asyraf, 2006). Any breach of ethics relating to a contract can render the contract invalid under Shariah law. The financial part of the contract is tightly linked to the ethical part and usually both are inseparable. The dual components of Islamic financial contracts have an impact on relationships based on contracts, governance rules, and legal responsibilities. The main differences are presented in Table 3.

Figure 1: Contracts in Conventional Financial System and Islamic Financial System



This Figure highlights an important aspect of Islamic contracts where ethical facts, information, and conditions form an integral part of the legal contract vis-à-vis conventional financial contracts which are purely based on material facts and does not carry any ethical facts/information/conditions.

Table 3: Conventional vs. Islamic Financial Contracts

	Impact on		
	Relationship	Governance	Legal
Conventional Financial Contracts	All relationships are most commonly governed by Contract Law and Partnership Law. There are no ambiguity in terms of roles and responsibilities. However all relationships are covered only from material aspect. There is no role for ethical dimension in relationships.	The governance structure is defined by the contract and is usually rigidly defined. There are specific disclosure rules and standard reports required for each type of contract. In addition, there is specific role of internal and external audit. There is however no governance from ethical dimension.	Most commonly the prevailing conventional law is applicable and there is no scope for any interference from any other body over the court authority. The rulings by court are final and binding. Usually there are standard set of formats for contracts.
Islamic Financial Contracts	All relationships are primarily based on Contract Law and Partnership Law, however are strongly supported/supplemented by Shariah rules. Shariah rules add ethical dimension to relationship and bring in concept of trusteeship and greater role towards society and mankind.	In addition to the existing governance structure as in conventional, there is Shariah Supervisory Board, which mainly takes care of ethical aspects. Board oversees all areas of operations of an Institution, including financial and operational. Thus there is additional check and control exercised by Shariah Board.	The contracts documents are non-standard and have several non-material clauses. There is no unanimity on supremacy of law in case of dispute. In addition, there is no clarity on enforceability in case of dispute.

This table reveals the impact of conventional and Islamic contracts on relationships based on contracts, governance rules, and legal responsibilities. Three dimensions of relationships are explained in this table in relation to two types of financial systems.

Islamic financial contracts thus have the following impact: (1) Relationship impact**:** Islamic financial contracts are expected to increase the level of information sharing. Due to the nature of a PLS contract, more information sharing is needed. For contracts which are based on buyer/seller relationships (Murãbaha), the relationship structure demands more transparency of terms of trade. For example, in the case of Murãbaha, it is mandatory for the Bank to disclose the profit being made on sale, (2) Governance impact: Management and control functions depend on authority, reward, risk and responsibility (Dar & Presley, 2000, p. 7). In Islamic finance, the principal has a secondary authority as he or she is a trustee. Responsibility delegation is usually a combined function governed by terms of contract and Shariah rules, and (3) Legal impact: Due to the absence of dedicated legislation governing Islamic financial contracts and the existence of several non-materiality clauses, it is difficult to enforce the contracts.

The contracts in IFIs are generally based on profit and loss sharing agreements where there is no down side or upside protection for either party in the case of profit or loss. The outcome of the contract affects both parties, and thus both have an incentive to reduce the risk and improve performance. Moreover, the contract between the shareholders and managers also has an element of Islamic trust principles, in addition to an employment contract. The manager is usually selected on a judicious mix of his understanding of Islamic values and market expertise, thus embedding the best of both. In the case of IFIs, there is reduced stress on the outcome as measured in purely pecuniary terms. The two types of reward structure, as pointed out in conventional agency theory, based on behavior and outcome, have different implications for IFIs. The contracts in IFIs are based on the basic Islamic financial contracts, such as *Mudãrabah*, *Mushãrakah* or *Wakala*. For example in the case of an unrestricted *Mudãrabah*, the principal (IAH) provides an unrestricted authority to the agent to invest funds as found appropriate by the IFIs, but under the supervision of the Shariah Supervisory Board (SSB). Thus the contract between the two parties is a mix of behavior and outcome. Compliance with Shariah addresses the behavior part, whereas the generation of decent returns is addresses the outcome part. The Islamic value base is broad and negates the idea of individual good. The equitable distribution of profits and losses is considered to be the norm. Excessive risk taking, simply to increase personal gain, is to be avoided and in principle excessive risk taking is not encouraged in Islamic finance. This brings about alignment of actions between the principal and the agent.

The combination of behavior and outcome based contracts in IFIs provides a much needed cushion and protects both the sides from the undesired actions of the other. The two propositions for reducing conflict between the principal and the agent, outcome-based contracts and reducing information asymmetry, are present in Islamic finance contracts. When shareholders invest funds in an IFI, they provide a clear mandate that the outcome be approved under Shariah. Also the stress on having all the investments and activities approved by the SSB provides a level of disclosure which is not seen in conventional finance. The principal (shareholder), in this case, transfers some of his or her monitoring activities to the SSB, who have access to the level of information equivalent to the managers'.

Similarly when a principal (IAH), provides a mandate to the agent (IFI) to manage funds, it is subject to supervision and approval under Shariah. Thus in this case also, the IAH transfers some of the monitoring rights to the SSB, who have same level of access to information as the IFI. The argument that shareholders (IAH) have no right to interfere in the management of their funds, which is the sole prerogative of the *Mudarib* (IFI) and that at present the corporate governance of Islamic banks does not give the IAH any power to appoint (or dismiss) the management, the SSB or the external auditor (Archer et al., 1998) does not stand up if examined within the broader context of Islamic principles. The presence of the SSB itself provides a layer of checks on the activities of the agent (managers and IFI), and raising question about the effectiveness of the SBB is neither desirable nor necessary. The assessment of a manager on the dual grounds of commercial success and Shariah adherence is a strong force limiting moral hazard. The presence of the SSB significantly reduces information asymmetry.

CONCLUDING COMMENTS

This study has examined financial contracts in conventional and Islamic financial institutions focusing on their agency relationship. In agency theory, the firm is a nexus of contracts between different parties (i.e., managers, shareholders and debt-holders). It is assumed that such contracts will rely on accounting numbers and will reduce conflicts between parties. The root cause of the agency problem is the fundamental structure of the relationship, which arises from the method and reason for financing. When financing is undertaken for the sake of financing, without the full involvement of the financier, several issues relating to the agency relationship arise. Delinking the cause and effect of financing activity and intermediation leads to agency problems. The generation of money from money, without taking into account the underlying asset value, is more or less gambling with uncertain results and skewed benefits.

The inequality of income and wealth in the conventional world is a culmination of the effect of defects in agency relationships where shareholders, who contribute all the funds, ultimately secure fringe benefits from the growth of the organization which they fund. The managers get huge monetary benefits in the event of profits and go scot free in the case of losses. It thus appears that the current model is not perfect.
The fundamentals of a contract, when based on unbalanced distribution of profits, will lead to agency issues. Also, due to a complete detachment from the purpose of financing, the investor renders himself or herself open to exploitation, misrepresentation and biased reporting. The moral dimension of Islamic

finance prohibits anyone from benefiting at the cost of others, which represents a check on the activities of managers. Moreover the stress is not purely on profit maximization, but on benefit maximization, providing maximum benefits to maximum stakeholders. Compensation schemes are not linked solely to profits but also to adherence to Shariah rules. Finally, the Profit and Loss Sharing (PLS) nature of equity-type financing contracts provides a disincentive to dishonesty (Ismail & Ahmad, 2006).

Islamic finance limits the problems in agency relationships because of the following reasons: (1) contracts are based not only on commercial terms, but include moral and ethical elements based on religious codes of conduct, (2) PLS based contracts, which are considered to be the purest form of Islamic finance, are the corner stone of Islamic financial activities and allow better flow of information between principal and agent due to the nature of the partnership, thus reducing information asymmetry, (3) The presence of the SSB acts as an important layer of checks on all the activities of the institution. The SSB protects the interests of all stakeholders, balances the commercial and social aspects of business activities, and approves all the activities and transactions based on Shariah principals, thus reducing the problems of moral hazard, (4) The principals in IFIs are considered to be trustees and not owners, thus the concept of *Amanah* brings in a sense of discipline, reducing greed and excessive commercialization, and reduces the problems in agency relationships, and (5) The performance of an agent is jointly measured on the basis of commercial success and adherence to Shariah rules, thus reducing the pressure to secure commercial success at any price. An agent in an IFI cannot succeed (and may even be removed) if he or she opts for non-Shariah compliant ways to generate more profits.This study demonstrates that the agency relationship in IFIs has fewer issues as compared with conventional counterparts. However, the study needs to be further extended by studying the performance of SSBs, measuring the effectiveness of agents and satisfaction of principals. There is also a need to enhance the study in relation to non-PLS based contracts.

APPENDIX

Word	Definition
Mushãrakah	*Mushãrakah* : Mushãrakah means a relationship established under a contract by the mutual consent of the parties for sharing of profits and losses in the joint business. It is an agreement under which the Islamic bank provides funds, which are mixed with the funds of the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by each partner strictly in proportion to respective capital contributions.
Mudãrabah	*Mudãrabah* : A form of partnership where one party provides the funds while the other provides expertise and management. The latter is referred to as the Mudarib. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne only by the provider of the capital.
Murãbaha	*Murãbaha* : Literally it means a sale on mutually agreed profit. Technically, it is a contract of sale in which the seller declares his cost and profit. Islamic banks have adopted this as a mode of financing. As a financing technique, it involves a request by the client to the bank to purchase certain goods for him. The bank does that for a definite profit over the cost, which is stipulated in advance.
Salam	*Salam*: Salam means a contract in which advance payment is made for goods to be delivered later on. The seller undertakes to supply some specific goods to the buyer at a future date in exchange of an advance price fully paid at the time of contract. It is necessary that the quality of the commodity intended to be purchased is fully specified leaving no ambiguity leading to dispute. The objects of this sale are goods and cannot be gold, silver or currencies.
Istisnã	*Istisnã :* It is a contractual agreement for manufacturing goods and commodities, allowing cash payment in advance and future delivery or a future payment and future delivery. Istisnã can be used for providing the facility of financing the manufacture or construction of houses, plants, projects and building of bridges, roads and highways.
Ijãrah	Ijãrah is a contract of a known and proposed usufruct against a specified and lawful return or consideration for the service or return for the benefit proposed to be taken, or for the effort or work proposed to be expended. In other words, Ijãrah or leasing is the transfer of usufruct for a consideration which is rent in case of hiring of assets or things and wage in case of hiring of persons. *Source:* FAQ on Islamic Banking issued by State Bank of Pakistan, date of publication unknown.

Source: FAQ on Islamic Banking issued by State Bank of Pakistan, date of publication unknown.

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BIOGRAPHY

Dr. Khaled Aljifri is an Associate Professor at Accounting Department, UAEU. He can be contacted at UAEU, CBE, P.O. Box 15551, Al Ain , United Arab Emirates. Email: k.aljifri@uaeu.ac.ae.

Dr. Sunil Kumar Khandelwal is the Head of Risk Management Middle East & Africa, Wolters Kluwer Financial Services. Email: drsunilk@gmail.com.

A NEW KIND OF SOCIAL ENTREPRENEURSHIP IN PUERTO RICO: "MUJERES AYUDANDO A MADRES"

Elizabeth Robles, University of Puerto Rico

ABSTRACT

How can a "doula", be the originator of such a creative business that combines a nonprofit organization with three profitable micro businesses and in addition, be a socially responsible organization? "Mujeres Ayudando a Madres" (women helping mothers) is a Puerto Rican nonprofit organization whose goal is to support women in the childbearing stage and promote a constructive culture based on the physical and psychological health of families. Vanessa Caldari, a midwife and a certified "doula" (a trained labor support person), created it. The mission of "Mujeres Ayudando a Madres" is to promote the rights, education and wellbeing of women during their pregnancy. Its integrated hybrid model produces both social value and commercial revenue through a single, unified strategy. The purpose of this case study is to present a nonprofit organization with a social responsibility mission and describe its hybrid model. This model is an alternative for nonprofit organizations to be self-sustainable. During this era of increasing cutbacks government funding, the hybrid model helps organizations to survive and grow.

JEL: M1, M14

KEYWORDS: Social Entrepreneurship, Hybrid Model, Social Enterprise, Social Responsibility

INTRODUCTION

How can a "doula" be the originator of such a creative business that combines a nonprofit organization with three profitable micro businesses and in addition, be a socially responsible organization? "Mujeres Ayudando a Madres" (women helping mothers) is a Puerto Rican nonprofit organization whose goal is to support women in the childbearing stage and to promote a constructive culture based on the physical and psychological health of families. Vanessa Caldari, a midwife and a certified "doula" (a trained child labor support person) is the founder of "Mujeres Ayudando a Madres" (MAM). The mission of MAM is to promote the rights, education and wellbeing of women during their pregnancy. Its integrated hybrid model produces both social value and commercial revenue through a single, unified strategy.

The purpose of this case study is to present a nonprofit organization with a social responsibility mission and describe its hybrid model. This model is an alternative for nonprofit organizations to be self-sustainable. During this era of increasing cutbacks in government funding, the hybrid model helps organizations to survive and grow. In the global marketplace, non-profit organizations play new, emergent and influential roles. They act as policy advisers to governments, strategy advisers to corporations, thought leaders for public opinion, and catalysts for action by bankers, investors, suppliers, customers, and even religious organizations.

There is a concurrent evolution in the form, purpose and role of the for-profit and non-profit sectors (Alexander, 2000). This evolution creates a blurring of boundaries between them such that a new vocabulary becomes necessary to recognize a hybrid form. These hybrid forms defy traditional categorizations employed by organizational theorists. On one section, there are some non-profit organizations adopting the practices of a for-profit firm. On another section, there are some for-profit companies operating according to social and environmental sustainability agendas (Hoffman et al., 2010).

The phenomenon of hybrid organizations emerges at a time when the role of the state as the principal agent of environmental governance is declining and other alternatives such as market and voluntary mechanisms are proliferating (Hoffman et al., 2010). Research on hybrid organizations is notably lacking, and has primarily focused on the topics of Corporate Social Responsibility (CSR) or social entrepreneurship (Battilana, 2012, Hoffman et al., 2010). Due to its growing importance, hybrid organizations offer an interesting empirical domain for study, one that will produce an ongoing stream of research.

The organization of the article is as follows. The first section describes the relevant literature review of nonprofit organizations and social entrepreneurship. The next sections present MAM's philosophy, Doula's Benefits, MAM's Model, and concluding comments.

LITERATURE REVIEW

Nonprofit Sector

The nonprofit sector is large, growing, important and challenging**!** The nonprofit sector is surprisingly large and has tended to grow faster than the private sector, and even more so internationally (Wing et al., 2008). Nonprofit organizations provide more than 8% of all jobs in society, more than 28% of all American adults volunteer in the nonprofit sector. This sector is anchored by a number of large nonprofit entities taking in more than $4 billion a year (Andreasen and Kotler, 2008). In the last decade, nonprofits grew in number by more than 28%, and public charities grew by more than 50% - reaching the point where, in 2006, there were more than an estimated 1.5 million nonprofits in the United States alone (Wing et al., 2008). Estimates by the Independent Sector of full-time, part-time and volunteer employment in nonprofit organizations found it to approximate 10% of all workers. In 2006, nonprofit groups contributed more than $666-billion to the U.S. economy through their activities and its wages and salaries totaled $489.4 billion (Wing et al., 2008). Other research indicates that the global international civil society sector comprises a $1.3 trillion industry and equates to the seventh largest world economy (Andreasen and Kotler, 2008).

According to Andreasen and Kotler (2008), three theories justify why society needs nonprofit organizations. Public Goods Theory argues that they exist to provide services the government does not; Contract Failure Theory focuses on the concept that nonprofits can provide certain services that should not be in the commercial sector – such as day care; and, Subsidy Theory, which says that government directs what nonprofits offer through tax breaks and funding.

The role nonprofit organizations have in society can be characterized as evolving through four stages tied, in part, back to these theories (Andreasen and Kotler, 2008). These stages are: a voluntary/civic model where citizens band together to provide services the government does not; philanthropic patronage by the wealthy; a rights and entitlements model where groups serving the public interest claim a share of public taxation funds; and the Competitive market stage where nonprofits must compete with each other in the marketplace of donor support.

A New King of Social Entrepreneurship

In light of diminishing funding from traditional sources and increased competition for these scarce resources the non-profit sector is facing intensifying demands for improved effectiveness and sustainability (Hoffman et al., 2010). Social entrepreneurship is a new phenomenon that emerges as a response to the complex needs of society (Zietlow, 2002). Over the last few years, the concept of social entrepreneurship has been rapidly emerging in the private, public and non-profit sectors, and interest in social entrepreneurship continues to grow (Jiao, 2011).

According to Zahra et al. (2008), four key factors fuel the globalization of social entrepreneurship. These factors are global wealth disparity; movement of corporate social responsibility; market, institutional and state failures; and technological advances and shared responsibility. Jiao (2011) adds two additional reasons why social entrepreneurship emerges in the society. First, social entrepreneurship can help non-profit organizations to operate with innovative approaches to solve social problems. Therefore, when traditional resources continually reduce and competition for these common resources becomes fierce, it is necessary for non-profit organizations to employ business professional operations and marketing techniques to improve efficiency in products and services to serve better the community. The second factor that Jiao (2011) describes is that the actual conditions in the market call for an alliance between corporate and non-profit organizations and cooperation among different components in society to make steps toward a better life. Due to the increasing social problems, corporations need to respond positively and take responsibilities in the social sector. Such reaction will encourage social entrepreneurship activities by corporate and non-profit organizations, which will enhance both business value and have a positive social impact.

Innovation or the creation of something new, rather than simply the replication of existing enterprises or practices (Noruzi et al., 2010) characterizes a social entrepreneurship. The social problem addressed is the core driver for social entrepreneurship to exist. The particular organizational form a social enterprise takes should be a decision based on which format would most effectively mobilize the resources needed to address that problem (Noruzi et al, 2010). Examples of social entrepreneurship can be found within or can span the nonprofit, business, or governmental sectors.

According to Noruzi et al. (2010), social entrepreneurship refers to innovative activity with a social objective in the for-profit area, such as either in social-purpose commercial ventures or in corporate social entrepreneurship. It could also be in the nonprofit sector, or across sectors, such as hybrid structural forms, which mix for-profit and nonprofit approaches. A common denominator across all definitions of social entrepreneurship is the fact that the underlying drive for social entrepreneurship is to create social value, rather than personal and shareholder wealth.

Martin and Osberg (2007) define three components that distinguished social entrepreneurship. The first component is an ability to identify "a stable but inherently unjust equilibrium that causes exclusion, marginalization, or suffering of a segment of humanity." The second component is an ability to identify an opportunity in this unjust equilibrium and develop a social value proposition. The third component is willingness to take action in order to forge "a new, stable equilibrium that releases rapped potential or alleviates the suffering of the targeted group . . . and even the society at large," (Martin and Osberg, 2007, p. 2).

Abu-Saifan, S. (2012) states that social entrepreneurs operate within the boundaries of two business strategies: (1). Non-profit with earned income strategies: a social enterprise performing hybrid social and commercial entrepreneurial activity to achieve self-sufficiency. In this matter, a social entrepreneur operates an organization that is both social and commercial; revenues and profits generated are used only to further improve the delivery of social values. (2). For-profit with mission-driven strategies: a social-purpose business performing social and commercial entrepreneurial activities simultaneously to achieve sustainability. In this matter, a social entrepreneur operates an organization that is both social and commercial; the organization is financially independent and the founders and investors can benefit from personal monetary return.

Makhlouf (2011) asserts that social entrepreneurship starts with an entrepreneur who has a novel idea, an innovative product or service, a creative approach to solving a perceived problem, a new business model, and/or a previously untried approach to product or service delivery. This new business model is the hybrid organization.

Traditional business models are no longer adequate to address the social and environmental problems of our day (Alexander, 2000; Draper, 2005). According to Hoffman et al. (2010), hybrid organizations call for mission-centered business models that employ market tactics to address social and environmental issues. Hybrids create and diffuse positive social change within the social and environmental contexts they operate (Hoffman et al., 2010).

The phenomenon of hybrid organizations is emerging at a time when the role of the state as the principal agent of environmental governance is declining and "private alternatives" (e.g. market and voluntary mechanisms) are proliferating (Pärenson, 2011, Hoffman et al., 2010). Nonprofit organizations, trade unions, religious groups, corporations and a host of other entities have emerged to develop sustainability solutions that have import for national competitiveness, global development and trade flows. Within this context, there is a concurrent evolution in the purpose, form and role of the for-profit and non-profit sectors (Hoffman et al., 2010, Krlev, 2011).

MAM

<u>Mam's Philosophy</u>

Vannesa Caldari founded "Mujeres Ayudando a Madres" (MAM) in 2007 with the purpose of empowering mothers during pregnancy. The MAM center was officially open to the public in the year 2010. The idea of having a center like MAM was born from the Sisterhood of Midwives of Puerto Rico (Hermandad de Parteras de Puerto Rico) to which Caldari belongs and represents the Latin American and Caribbean Network for the Humanization of Labor and Birth in Puerto Rico. Although Caldari's educational background is in nursing, she is a perinatal educator who works as a midwife and a doula. Through her work, she saw the need of many pregnant women to receive education and support through their pregnancies, especially women of limited economic resources.

MAM pursues the doula's philosophy of personal empowerment of the mother. The mission of MAM is "to promote the rights, the education and the wellbeing of women during their pregnancy." The purpose of the center is to empower women during their pregnancy and postpartum stages. As an organization, MAM aims to educate Puerto Rico's society to see that pregnancy has the potential to be an event that positively changes the life of a woman. It promotes the humane care of women during maternity.

MAM channels efforts to reduce the cesarean rate, to increase the percentage of mothers who breastfeed, create better bonding between couples during the stage of motherhood, lower the rate of mistreatment of children with humanitarian teachings and warmth, and assist mothers in their reintegration into society after the childbirth. In addition, MAM creates awareness in the community about the proper management of health and physiology, which has shown to reduce morbidity and mortality in pregnancy, childbirth and postpartum. It educates and promotes family planning and parenting. MAM sees that by raising awareness, women make decisions that support their emotional, mental and physical health of their lives. This can prevent problems such as abuse, depression, and disease in women.

MAM wants every woman be armed with the knowledge they need to have a healthy pregnancy, childbirth and postpartum, full of positive memories. In summary, MAM meets the need that the community of Puerto Rico has to achieve lower rates of unnecessary cesarean operations, increase lactation, lower the number of domestic violence, lower government dependency and support low-income single mothers.

<u>Doula's Benefits</u>

Doula care provides the following benefits: shorter labors, reduced need for pain medication, fewer episiotomies, cesarean sections and operative vaginal deliveries, better mother infant interaction, improved neonatal outcomes, improved breast-feeding rates, and greater maternal satisfaction (Stein, Kennell and Fulcher (2004). Rohwer (2011) indicates that doula support increased teen mothers knowledge of the birth process, provided unbiased and nonjudgmental support and information, gave them confidence in their ability to give birth, and encouraged mothers to be proactive in communicating with their care providers. According to Mottl-Santiago et al. (2008), a hospital-based doula support program is strongly related to improved breastfeeding outcomes in an urban, multicultural setting. In addition, having doula support is significantly related to: (a) higher rates of breastfeeding intent and early initiation rates for all women, regardless of parity or provider with the exception of multiparous women with physician providers, and (b) lower rates of cesarean deliveries for primiparous (first birth) women with midwife providers.

In their study, Deitrick et al. (2008) states that doulas provide four kinds of support, including physical comfort, physical assistance, socio emotional support, and verbal support. Campbell et al. (2007) concludes in their study that labor support by a minimally trained female friend or relative, selected by the mother-to-be, enhances the postpartum well-being of nulliparous mothers and their infants, and is a low-cost alternative to professional doulas. Gilliland (2011) declares that doula care has the potential to enhance paternal involvement with labor support and increase satisfaction of fathers and mothers with their birth experience. In addition, it may have the potential to reduce a father's stress level during the birth experience by employing a variety of techniques, thus improving the quality of his experience.

Previous randomized controlled studies in several different settings demonstrate the positive effects of continuous labor support by an experienced woman (doula) for low-income women laboring without the support of family members (McGrath and Kennell, 2008). McGrath and Kennell (2008) conclude that the continuous presence of a doula during labor significantly decreased the likelihood of cesarean delivery and reduced the need for epidural analgesia for middle-class women, laboring with the support of their male partner.

Mam's Model

"Mujeres Ayudando a Madres" (MAM) offers childbirth educational seminars, doula and midwives certification courses. It has support groups for women that had lost a child, support groups for postpartum depression, breast feeding mothers and mothers with cesarean operations. In addition, it offers educational seminars of nutrition, health and parenting. MAM does not receive money from the government nor private sectors, nor any grants. The funds are raised from the certificate courses and the seminars given at the center.

MAM has the structure of being a nonprofit organization that is the umbrella of three other profit micro businesses. These micro businesses are the ones who support MAM paying the rent of the organization. The first micro business is a vegetarian restaurant called Cocobana Café owned by a young couple, Vanessa Díaz (also a doula and a former beneficiary) and her husband Manuel Collazo. The second micro business is called Natural Mama owned by Jennifer Rodríguez, a former beneficiary of MAM. The third microbusiness is called Paperdolls owned by Nacha Zurinaga, also a former beneficiary of MAM.

Originally, the clients of the three micro businesses were beneficiaries of MAM services, as pregnant mothers and mothers. Now their client base is changing, attracting additional market segments such as the local community and the public. This is the case of Cocobana Café that although it caters to MAM"s beneficiaries, it is also serving the public from the local community. The mission of the restaurant is to provide healthy food to MAM's beneficiaries. Regarding Natural Mama, the products available are baby ring slings manufactured by Rodríguez, reusable cloth diapers, homeopathic products, and some donated articles that are sold to single mothers at reasonable low prices. The donated baby clothing is given to single mothers and mothers with no or low economic resources. Paperdolls sells women's apparel and accessories. None of these entrepreneurs has a formal business background or studies. In fact, only Mrs. Díaz has a bachelor degree and is in education.

The synergy around this model is that it provides flexibility to the three entrepreneurs, to have a job and to take care of their children while on the job. Their first job is to be mothers and take care of their children and then comes the business! According to Battilana et al. (2012), MAM's business model is called a hybrid business. This is a new business model created because of the recession. It is innovative in creating the resources needed to pay the bills and still has a social mission. The hybrid model uses product sales to fund its social mission, reducing dependence on donations, grants, and subsidies, as well as to scale up the organization. MAM's integrated hybrid model produces both social value and commercial revenue through a single, unified strategy.

During the last five years the increase in the number of hybrids results in part from social entrepreneurs' willingness to be less dependent on donations and subsidies, as well as from an increased interest in creating sustainable financial models in the wake of the 2007-08 financial crises (Battilana, 2012, Hoffman et al., 2010). The leaders of hybrid businesses must make deliberate cultural decisions to keep the mission on course while still making enough money to sustain their operations (Battilana, 2012). They must identify and communicate organizational values that strike a healthy balance between commitment to both social mission and effective operations. In addition, the selection, development, and management of employees who are capable of recognizing and pursuing social and economic value are equally important.

CONCLUDING COMMENTS

Social entrepreneurship is still emerging as an area for academic inquiry. There is a need to explore adequately its theoretical underpinnings. In addition, the need for contributions to theory and practice are pressing (Austin et al., 2006). During this era of constant cutbacks in government funding, the hybrid model helps organizations to survive and grow. This case study presents the case of "Mujeres Ayudando a Madres" (MAM), a nonprofit organization with a social responsibility mission and describes its hybrid model. This model is an alternative for nonprofit organizations to be self-sustainable.

According to Makhlouf (2011), a social entrepreneurship such as MAM has to establish external relations as well as the kind of management and operational systems that would allow them to function as a viable enterprise. In addition, these organizations have to build dedicated teams that believe in the mission, are committed to the cause, and have the skills needed to: build and maintain strong relations with all the external stakeholders, attract the resources required for the financial viability of the organization, and assist in the development and implementation of strategic and operational plans. Those external stakeholders include "constituents intended to benefit from the initiative (e.g. poor and marginalized people); resource providers, who offer financial, technical, or political resources; allies who help carry out programs; and actors who are targets of programs or campaigns" (Makhlouf, 2011, p. 7).

MAM needs a well-organized structure in order to succeed in the end. In addition, it needs a solid group of volunteers that stays in the organization for a long period. Presently it needs ample facilities to accommodate more clients/beneficiaries. The businesspersons need to be trained in management and business areas to be more effective with their selling and administrative strategies. In addition, the center needs to implement promotional strategies in order to increase the clients/beneficiaries base. For MAM much work lies ahead to continue creating social value, and maintaining it over time in a sustainable way. MAM is creating a path for others to replicate. Next year a MAM center will open in Colombia. All this is happening thanks to the idea of a "doula," a midwife, Vanessa Caldari, who has a social vision of empowering mothers in their pregnancies.

The limitations of the study are lack of literature on this topic, very few studies and no sound theories on the area of hybrid organizations. Further research could answer questions such as What is the impact of hybrid models on solving social problems. How many cases like MAM exist in Puerto Rico? What can we learn from them?

There is a need to develop public policy for social innovation, for creating alliances between the social entrepreneurs, the public sector and private companies. Social entrepreneurs use creating solutions to solve difficult social problems and are self-sustainable, but their number needs to increase. The private sectors and the government as well must use the lessons from social entrepreneurship. A good way to share ideas and spread best practice will be to develop a Social Entrepreneurs' Network. A first step could be to promote twinning agreements and partnerships between schemes in different parts of the country. It is important to encourage the development of supportive financial relationships among the government, the private sector and the social entrepreneurs.

The government, universities and private sector can join efforts to create a Center for Social Entrepreneurs, which would provide a physical presence and focus for meetings, conferences and courses. Most of all, the word should be spread to let the world know what good these hybrid organizations are doing, to their communities and their countries. "Mujeres Ayudando a Madres" is a successful social entrepreneurship that others can emulate to make a difference in this world!

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BIOGRAPHY

Dr. Elizabeth Robles is a marketing professor at the Management Department of the University of Puerto Rico. Her areas of research are consumer behavior, public relations, marketing in a noncapitalist system, fashion marketing, corporate social responsibility (CSR), and spirituality in the workplace. Dr. Robles has published her research in Marketing News, Forum Empresarial and Inter Metro Business Journal. She is available at elirobles@yahoo.com.

GAAP VS. IFRS TREATMENT OF LEASES AND THE IMPACT ON FINANCIAL RATIOS

Peter Harris, New York Institute of Technology
William Stahlin, Stevens Institute of Technology
Liz Washington Arnold, The Citadel, The Military College of South Carolina
Katherine Kinkela, New York Institute of Technology

CASE DESCRIPTION

As of January 1, 2011, most of the world financial market economies are using International Reporting Standards (IFRS) as the required framework for financial statements. A non-comprehensive listing includes the European Union Countries, Canada, Australia and New Zealand. In the United States, US Generally Accepted Accounting Principles (GAAP) is still required but adoption of IFRS has support of many accounting firms and professional organizations and is under consideration by the SEC. This case study focuses on differences in the treatment of leases and the impact of these differences on financial statements and selected financial ratios. Students take GAAP financial statements and prepare an IFRS based balance sheet and income statement. It is necessary to understand both GAAP and IFRS rules regarding leases to address this case study. This case study is suitable for use at both the undergraduate and graduate levels. It may be used in an Intermediate Accounting II, Accounting Theory, Financial Statement Analysis or an International Accounting class, as well as an Investment Finance course. The case can be offered as an individual case study or as a group project.

JEL: M4, M41, M42, M48, M49

KEYWORDS: US GAAP, IFRS, Capital Lease, Operating Lease, Financing Lease, Ratios.

CASE INFORMATION

ACE Corp, a publically traded NASDAQ company (symbol ACE), is a manufacturer of electrical automobiles. It is based in Detroit, Michigan and the company has been operating since 1996. The company sells their electrical automobiles to auto manufacturers as well as the retail market on a worldwide basis. Its major clients are Ford, General Motors and Toyota. Ace has captured about 10 percent of the world market of the electrical automobile sales. Its stock sells at 25 US Dollars per share, and its 52-week price range is between 19.75 and 27.15 US Dollars, with a market cap of 10.6 billion dollars.

Their financial statements presented below for the year ending December 31, 2011 has been prepared using GAAP (Tables 1 and Table 2). The controller would like to see the effect of IFRS treatment of leases on the financial statements, and you have been assigned this task. In particular, the controller would like to see the impact GAAP and IFRS differences have on balance sheet, income statement and selected financial ratios. The company would like to adapt IFRS by as early as next year as it is considering a new stock issue in the Tokyo Stock Exchange, which requires IFRS compliance.

Table 1: GAAP Balance Sheet for ACE Corp. at 12/31/2011

ACE Corp. Balance Sheet (in 000's) 12/31/2011			
ASSETS		**LIABILITIES AND SHAREHOLDERS EQUITY**	
Current Assets			
Cash	$ 33,000	**Current Liabilities**	
Accounts receivable	25,000	Accounts payable	$20,000
Investments	10,000	Accrued expenses	15,000
Inventory (FIFO)	50,000	Taxes payable	5,000
		Total current liabilities	$40,000
Total current assets	**$118,000**		
Property, Plant and Equipment		**Noncurrent Liabilities**	
Assets (cost)	100,000	Bonds payable	50,000
Less: Accumulated Depreciation	(30,000)	Total liabilities	$90,000
Total property, plant and equipment	$ 70,000		
		Shareholders' Equity	
Intangible Assets		Common stock ($1 par)	$50,000
Trademark	5,000	Retained earnings	60,000
Goodwill	7,000	Total shareholders' Equity	110,000
	$12,000		
Total assets	$200,000	**Total Liabilities and Shareholders' Equity**	$200,000

Table 1 shows the GAAP Balance Sheet for the case. Students must covert this GAAP statement to an IFRS Statement

Table 2 ACE Corp. GAAP Income Statement for the year ended 12/31/2011

ACE Corp Income Statement (in 000's) 12/31/2011	
Sales	$ 250,000
Cost of goods sold	175,000
Gross profit	$ 75,000
Selling and administrative expenses (Exclusive of amortization and depreciation)	31,000
Earnings before interest, taxes, depreciation and amortization	$ 45,000
Amortization and depreciation expense	10,000
Earnings before interest and taxes	$ 34,000
Interest expense	4,000
Income before tax	$30,000
Tax expense (30 %)	9,000
Earnings from continuing operations and before Extraordinary item	$21,000
Net loss from Hurricane (net of 4,500 taxes)	(10,500)
Net Income	$10,500

Table 2 shows the GAAP Income Statement for the case. Students must covert this GAAP statement to an IFRS Statement.

ADDITIONAL INFORMATION

Ace entered into a lease on January 1, 2011 with the following terms:

1. Ace leased specialized machinery manufactured by the lessor, Bell Corp., which will enable Ace to manufacture their electric cars in a much more efficient manner. This machinery does not have a resale market and was made specifically for ACE to meet its specifications.
2. The lease term is for 3 years with a minimum lease payment of $10,000. Payment is due on December 31 of each year, with the first payment due on December 31, 2011. At the end of year 3, Ace has the option of leasing the equipment for one additional year for $2,500. At the end of the lease term, ownership reverts to the lessor. There is no option to buy the equipment.
3. The lessee will pay all executor costs.

4. The estimated useful life of the lease is 49 months (4 and 1/12 years.)
5. The fair market value of the equipment is $30,000.
6. The implicit rate of Bell Corp. is 6 percent, and the lessee, Ace, knows this.
7. The incremental borrowing rate of Ace is 7 percent.

QUESTIONS

1- Differentiate between an operating lease and a capital/ financing Lease for GAAP financial reporting purposes.

2- Under GAAP, has this been treated as a capital lease / financing Lease for Ace or an operating lease?

3- Under IFRS, should this lease be classified as an operating or a financing lease?

4- Describe the different reporting results between GAAP and IFRS and make the necessary adjusting entries to conform the financial statements to IFRS compliance for Year 1.

5- Prepare an income statement under IFRS for year 1. Assume that the net income remains the same under IFRS as it does for GAAP and any difference is reconciled in the tax expense and tax payable accounts.

6- Prepare balance sheet under IFRS for Year 1.

7- Compute the following ratios for Year 1, under both IFRS and GAAP reported totals:
   a. Current Ratio
   b. Quick Ratio
   c. Cash Ratio
   d. Times Interest Earned
   e. Debt to Capital Ratio
   f. Debt to Shareholder Equity Ratio

8- Comment on your findings in 7 above.

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GAAP VS. IFRS TREATMENT OF LEASES AND THE IMPACT ON FINANCIAL RATIOS

TEACHING NOTES

Peter Harris, New York Institute of Technology
William Stahlin, Stevens Institute of Technology
Liz Washington Arnold, The Citadel, The Military College of South Carolina
Katherine Kinkela, New York Institute of Technology

CASE DESCRIPTION

This case focuses on GAAP and IFRS differences in the treatment of leases and the grounds for classification as an operating or capital lease. It is designed to have students conduct research on GAAP and IFRS pronouncements. They must compare and contrast the differences in the treatment of leases under the two frameworks. It also requires students to prepare the adjusting entries for the IFRS conversion. They will prepare IFRS statements, and compute and compare financial ratios for both GAAP and IFRS statements. Finally, they will discuss the status of IFRS adoption and the impact of its adoption in the US.

Since this case requires research into GAAP and IFRS pronouncements, it is most appropriate for students who have completed or are currently enrolled in intermediate financial accounting II. It can be used at the graduate or undergraduate levels in a variety of additional financial reporting courses including accounting theory, international accounting, and financial statement analysis, as well as an investment finance course.

CASE LEARNING OBJECTIVES

The case is designed to have students identify reporting issues and apply U.S. and international authoritative accounting literature by researching the FASB Accounting Standards Codification and the International Financial Reporting Standards (IFRS).

The specific learning objectives are for the student to:

a) Identify differences in GAAP and IFRS treatment of leases:
b) Prepare adjusting entries to convert GAAP based financial statements to IFRS income statement and balance sheet and
c) Prepare an IFRS income statement and balance sheet

Suggested Teaching Approach

The case may be offered as an individual case study or as a group project. For more advanced accounting students, this case should be an individual project. It could have a weight of 10-15 % of the final course grade. When offered as an individual project, students will need three to six hours to research and prepare the case solution.

For less advanced students, the case may be offered as a collaborative group project. This would enable students to demonstrate and develop team-working skills. The case presents an opportunity to discuss the status of IFRS implementation in the US and the impact IFRS had on JAL Corp. The in-class review of the solution and case discussion can be completed as part of a 50-minute class.

In grading the case write-ups, instructors should evaluate the identification of relevant issues, proper accounting for the IFRS conversion and computation of the ratios including the computational accuracy of numbers, quality and depth of research as evidenced by proper citations of the literature. We suggest that the instructor explain the basis for grading at the outset.

Pointers for Classroom Discussion.

After the review of the IFRS statements, the instructor may wish to discuss the impact of IFRS. Suggested questions to ask the class are: What impact will IFRS have on AXE Corp.'s income statement and balance sheet? What are the benefits of adopting IFRS? What are the disadvantages of IFRS?
You may wish to have students research the status in the US of IFRS adoption.

SUGGESTED SOLUTION

Question 1: Differentiate between an operating lease and a Capital/ Financing Lease for financial reporting purposes.

Solution 1: An operating lease is treated as a rent expense and recorded on the income statement. An operating lease is an off balance sheet transaction and is preferred by companies because it lowers the liabilities and the debt ratio. A GAAP capital lease is treated as a purchase of a Property, Plant and Equipment and capitalized on the Balance Sheet. Capital leases are termed as a financing lease under IFRS.

The minimum lease payments required on the lease are recorded as a liability on the Balance Sheet at the present value. The discount rate is the lessee's incremental borrowing or the implicit rate of the lease, if it is lower and known by the lessee. The liability is separated into its current and long-term components, which affects the current ratio.

Pointers for Classroom Discussion

Discuss the differences between rule based US GAAP, versus principles based IFRS requirements for distinguishing between operating versus capital/financing leases.

Question 2: Under US GAAP, is the lease treated as a capital lease / financing lease or an operating lease?

Solution 2: Under GAAP, if the lessee meets one of the four tests listed below, the lease is treated as a capital lease; otherwise, it is an operating lease.

Test 1: Economic Life Test: The lease term is equal to or greater than 75% of the economic life of the asset. In this case, the lease term is 3 years divided by the economic life of 4.1 years, yields 73%. Test 1 not met.

Test 2: Transfer of Ownership Test: If at the end of the lease term, ownership transfers to lessee, then this test is satisfied. Test 2 is not met in this case, as there is no transfer of ownership at the end of year 3.

Test 3: Bargain Purchase Option: If the lessee has the option to purchase the lease at a bargain purchase price, then this test is satisfied. In this case, there is no bargain purchase option, so test 3 is not met.

Test 4: Economic Recovery Test: If the Present Value of the Minimum Lease payments is 90 percent or greater than the fair market value of the asset.

In this case, the present value of the Minimum Lease Obligation is $26,730. This divided by the fair market value of the leased asset of $30,000 is 89 percent; just shy of the 90% requirement. Test 4 is not met.

Table 3: Minimum Lease Payments

Minimum Lease				
	Assuming a Capital/ Financing Lease		**Obligation-Payable**	
Year	Payment	Interest-6%	Principal	$26, 730
1	$ 10,000	1,604	8,396	18,334
2	10,000	1,100	8,900	9,434
3	10,000	566	9,434	0
Total	$ 30,000	3,270	26,730	N/A

Tables 3 shows interest and principle payments for each year of the lease liability at the end of each year.

Table 3 shows the interest and principle payments for each year of the lease. It also shows the liability at the end of each year. The interest expense is the beginning lease obligation multiplied by the interest rate. Since none of the four tests is met, the lease is treated as an operating lease to the AXE Corp. under US GAAP. Note should be made that AXE just missed some of these tests by fractional amounts.

Pointers for Classroom Discussion

Discuss why a corporation has an incentive for making a lease classification as operating rather than capital.

Question 3: Under IFRS, should this lease be classified as an operating lease or a financing lease?

Solution 3: Under IFRS, this lease is clearly a financing/capital lease as the criteria of lease type is based on principles, and not rules. Under IFRS, if the lessee assumes the economic benefit and risks of the leased asset, and the facts of the situation are such that the lease resembles a financing lease, then it is treated as a financing lease. The fact that the lessee has a fourth year rental option at a very significant discount, coupled that this machine is specialized in nature for ACE's use, and many of the tests under GAAP are nearly met which are an indicator of a financing classification rather than operating lease. The lessor manufactured this equipment to ACE's specifications and in effect transferred the risk to AXE upon the inception of the lease. Further, ACE was able to circumvent the capital lease rules under GAAP by making estimates work to its advantage.

Question 4: Describe the different reporting results between GAAP and IFRS and make the necessary adjusting entries to conform the financial statements to IFRS compliance for Year 1.

Solution 4: In each of the three years of the lease, GAAP treats the operating lease payment of $10,000 as rent expense on the income statement and no liability is recorded on the balance sheet.
A: Year of lease Inception:

Under IFRS, the financing/ capital lease is treated as a purchase of property, plant and equipment and capitalized on the balance sheet as such for $26,730. Additionally, the Minimum Lease obligation is shown on the balance sheet as a liability of $18,334 ($26,730 less the year 1 payment of $8,396). Of this amount, $8,900 is classified as a current liability and $9,434 is classified as a long term liability. On the income statement, depreciation expense is $8,910 (26,730 divided by the lease term of 3 years) and interest expense is $1,604, for a total of $10,514.

B: Subsequent to Year of Inception-years 2 and 3 of lease payments:
IFRS: The $10,000 lease payment is treated as an interest expense as calculated above; $1,100 in year 2 and $566 in year 3 in addition to a depreciation expense of $8,910. Over the 3-year period, the total expense will be the same at $30,000 under both methods of reporting (operating v. capital/financing.)

ADJUSTING ENTRIES YEAR 1 TO CONFORM TO IFRS

1-Dr. Leased Asset-Financing Lease: 26,730
Cr. Minimum Lease Obligation-Financing Lease: 26,730

To record capitalization of the lease
2-Dr. Depreciation Expense: 8,910
Cr. Accumulated Depreciation: 8,910

To record depreciation expense on the capitalized lease
3-Dr. Interest Expense: 1,604
Dr. Minimum Lease Obligation-Financing Lease: 8,396
Cr. Rent expense/Selling and Administrative expense:10,000

To adjust lease from operating to capital/financing
4-Dr. Minimum Lease Obligation-Financing lease: 18,334
Cr. Minimum Lease Obligation-Financing lease -Current liability: 8,900
Cr. Minimum Lease Obligation-Financing lease -Long Term Liability: 9,434
To correctly classify the Minimum Lease Obligation to its liability term components
5- Dr. Selling and Administrative Expense: 15,000
Cr.- Extraordinary Item: 15,000

To reclassify extraordinary item as an operating expense
This is calculated by the extraordinary loss , shown net of taxes of 10,500 divided by 1 less the tax rate of 30 percent, or 0.7, which yields a before tax loss of 15,000.

Pointers for Classroom Discussion

There is no prompt for this reclassification. Students must demonstrate critical thinking by identifying that IFRS does not allow for the use of an extraordinary item. It is important to point out that we should not be so focused on one issue (lease treatment) that we overlook other issues that should be apparent.

Also, note that the reclassification of the extraordinary loss is shown before tax (10,500+ 4,500)
6- Dr. Tax Payable 514
Cr. Tax Expense 514

To reconcile a net income total of $10,500; an amount equal to the GAAP reported total.

Pointers for Classroom Discussion

Show that under capital/financing lease treatment, the expense will be greater in the early year(s), resulting in lower income, and lower in the latter year(s), showing a higher income. In the entire term of the lease, each method will yield identical expense totals. Use of the amortization schedule will illustrate this clearly.

Question 5: Prepare an Income Statement under IFRS for year 1. Assume that the net income remains the same under IFRS as it does for GAAP and any difference is reconciled in the tax expense and tax payable accounts.

Solution 5: Table 4 shows the impact of the conversion to IFRS.

Table 4 ACE Corp. IFRS Income Statement for the year ended 12/31/2011

ACE Corp Income Statement (in 000's)	For the year ended 12/31/2011	
Sales		$250,000
Cost of goods sold		175,000
Gross profit		$ 75,000
Selling and administrative expenses	31,000 plus (5)15,000	
(Exclusive of amortization & depreciation)	less (3) 10,000 =	36,000
Earnings before interest, taxes, depreciation and amortization		$ 39,000
Amortization and depreciation expense	10,000 + (2)8,910 =	18,910
Earnings before interest and taxes		$ 20,090
Interest expense	4,000 + (3)1,604 =	5,604
Income before tax		$ 14,486
Tax expense	4,500-(6)514 =	3,986
Net Income		$ 10,500

Table 4 shows the impact of the conversion to IFRS.

Question 6: Prepare a Balance Sheet under IFRS for Year 1.

Solution 6: Table 5 shows IFRS Balance Sheet for ACE Corp at 12/31/2011

Table 5: IFRS Balance Sheet for ACE Corp at 12/31/2011

ACE Corp Balance Sheet (in 000's) 12/31/2011			
Intangible Assets		**Equity**	
Goodwill	7,000	Share capital	$50,000
Trademark	5,000	Retained earnings	60,000
Total intangible assets	12,000	Total equity	$110,000
Property, Plant and Equipment		**Non-current Liabilities**	
Plant assets (cost)	$100,000	Bonds payable	$50,000
Leased asset	(1) 26,730	Minimum lease obligation (4)	$9,434
		Noncurrent liabilities	$59,434
Accumulated depreciation		**Current Liabilities**	
30,000 plus (2) 8,910=	38,910	Minimum lease obligation (4)	$8,900
Net plant assets	$87,820	Taxes payable 5,000-(6)514=	4,486
Current Assets		Accrued expenses	15,000
Inventory (FIFO)	50,000	Accounts payable	$20,000
Investments	10,000	Total current liabilities	$48,386
Accounts receivable	25,000	Total liabilities	$107,820
Cash	$33,000	Total equity and liabilities	$217,820
Total current assets	$118,000		
Total assets	$217,820		

IFRS Balance Sheet after conversion.

Table 4 shows the IFRS Balance Sheet after conversion. Where adjustments were necessary, they are indicated next to the account. Note that IFRS recommends listing accounts in reverse order of liquidity. The common stock is shown as share capital.

Question 7: Ratio Calculations:

Solution 7: Tables 6 shows GAAP and IFRS Ratios

Tables 6 shows GAAP and IFRS Ratios

	GAAP	IFRS
Current Ratio=current assets/current liabilities	2.95	2.44
118,000/40,000 118,000/48,316		
Quick Ratio=current assets-inventory/current liabilities	1.70	1.41
18,000-50,000/40,000 118,000-50,000/48,316		
Cash Ratio=cash/current liabilities	0.83	0.68
33,000/40,000 33,000/48,316		
Times Interest Earned =EBIT/ Interest Expense	8.5	3.58
34,000/4,000 20,090/5,604		
Debt to Capital Ratio=Total Liabilities/Total Assets	0.45	0.50
90,000/200,000 107,820/217,820		
Debt to Shareholder Equity Ratio=Liabilities/Shareholder' Equity	0.82	0.98
90,000/110,000 107,820/110,000		

Question 8: Comments

Solution 8: The ratios clearly indicate that IFRS rules result in more conservative ratio results with respect to the current and long-term creditor when compared to US GAAP. Every liquidity ratios is lower under IFRS and the differences are significant. Similarly, all long-term ratios are also more conservative when compared to US GAAP. The implications here is that IFRS will have far greater negative implications on bond covenant agreements as well as other long and short-term creditor legally binding agreements than US GAAP.

CONCLUSION

IFRS is the future of worldwide financial reporting and should be included as a major part of any accounting and/or business curriculum in the US, as well as the rest of the world. This case illustrates a situation where a Balance Sheet and Income Statement is prepared using GAAP as a basis and converted to IFRS for comparison purposes, with the focus being from the creditor point of view. In this case study, IFRS rules are discussed, and key lease GAAP and IFRS accounting similarities and differences are addressed and the implications on the corporation's creditors.

BIOGRAPHY

Peter Harris is a Professor and Chair of the Accounting and Finance department at the New York Institute of Technology. Previously, he has worked for Ernst and Young LLP. He is an author of over 40 refereed journal articles and over 100 intellectual contributions. He has presented and continues to present seminars to nationally and globally audiences on topics relating to financial reporting and taxation. He is a member of several professional organizations. He can be reached at pharris@nyit.edu and by phone at 516-695-6707.

Bill Stahlin is an Affiliate Associate Professor at Stevens Institute of Technology. He has over 30 years of teaching experience and 10 years in public accounting. He is both a CPA and CGMA. He is the mid - Atlantic regional coordinator for the American Accounting Association's teaching, learning and curriculum section. He has made numerous presentations on teaching pedagogy and co-authored an instructor training course while at Coopers & Lybrand. He can be reached at the Howe School of Management, Stevens Institute of Technology, Hoboken, NJ 07030 or wstahlin@stevens.edu.

Liz Washington Arnold is an Associate Professor of Accounting at The Citadel. She has over 25 years of corporate accounting experience and is an active member of various community and professional organization. Her research on Corporate Accounting Malfeasance and other topics appears in journals such as Accounting and Taxation, the Southeast Case Research Association Journal, and Business Education Innovations. She can be reached at The Citadel, 171 Moultrie Street, Charleston, SC 29445, liz.arnold@citadel.edu.

Katherine Kinkela is an Assistant Professor at the New York Institute of Technology. She is an attorney and holds an LL.M degree in addition to the JD. Prior to teaching, Katherine has worked at Deloitte and Touche, LLP and currently serves as a tax consultant. She has published a number of papers, and has presented accounting, auditing, legal and taxation topics in national conferences. She is a member of several professional organizations.

PAC.NW TRAVEL ONLINE

Lynda S. Livingston, University of Puget Sound

CASE DESCRIPTION

Michael Powers licensed a series of domain names that he thought would allow him to create a profitable set of online tourism marketing sites. The case asks students to evaluate the feasibility of the business, given Michael's projections. Given what they find, students are then asked to assess how reasonable are two of his current arrangements with stakeholders. The case allows students to practice fundamental valuation techniques on a cutting-edge business model. It is targeted toward MBA and advanced undergraduate corporate finance courses.

JEL: G10, G11

KEYWORDS: SEO, SEM, Internet Marketing, Private Firm Valuation

CASE DESCRIPTION

"A*fter* fees?!" Michael Powers could not believe was he had just heard. ViewIT—the company he was hiring to do the actual *work* on his supposedly "passive-income" internet venture—was now demanding that it receive half of whatever was left after Michael paid their costs. As if half of revenues *before* costs was not bad enough! This 11th-hour demand could send 60% of Michael's revenues straight to ViewIT. How was he supposed to make any money? If could not figure out a way to counter this demand from ViewIT, maybe he could renegotiate the perpetual 10% of revenues he had promised his dad (his "venture capitalist"). He would have to think of something fast, or give up on the ticket to his future—his internet start-up, Pac.NW Travel Online.

MICHAEL POWERS

Michael Powers was a risk-taker, but not a fool. He was a black-diamond freestyle skier ("chutes, cliffs, and trees"), competitive downhill mountain biker, and avid longboarder. Whatever the game was, he wanted to win—assuming he liked the odds.

Michael graduated in 2006 from a small, liberal-arts college in Washington state, where he was a standout in his honors business program. In his junior year, he decided to give up varsity soccer for an internship, where he was fortunate enough to meet an experienced real-estate entrepreneur. Michael realized he loved real estate, and immediately started lobbying his father to help him buy a house close to campus (a house he still kept as a rental).

After graduating (and after a year as a ski instructor—fun, but not professionally challenging), he applied for a job as marketing coordinator for which he was not remotely qualified. Surprisingly, he got it; perhaps not surprisingly, he succeeded brilliantly.

The job was to market a town and manage its rental business. The town, Neweston, Washington, was the brainchild of fellow college alum and new-urbanist visionary Kelvin C. Rolf. Kelvin was a developer whose dream had always been to found a new town along the Washington coast. He started Neweston in 2002 on an unplatted pile of sand. The town would eventually be a walkable blend of retail and residential areas, with 1,000 homes all carefully designed to ensure a consistent New England-style look. Homeowners could rent their homes to vacationers, and one of Neweston Land Company's jobs was to manage those rentals. That is where Michael came in.

Michael started as Neweston's marketing coordinator in early 2007, working under the director. Within a year, he was the only person in the entire marketing department. As the credit crisis of 2008 ground the real estate market to a halt, he quickly spearheaded the company's push online; in three years, he reduced online ad spending tenfold, while increasing the e-commerce "capture" by 35% every year. In 2010 he was promoted to director of sales and marketing. He continued developing online platforms—implementing systems to manage rental reservations, home-sale prospects, and web-generated lead data—increasing Neweston's revenues by 58%/year. His efforts paid off in accolades: one of Neweston's multimillion-dollar homes was named the "ultimate beach house" by *Coastal Living* magazine, and Neweston itself beat out 400 other competitors to become "residential project of the year." Kelvin recognized Michael's contributions, and in 2011 promoted him again, this time to Vice President of Business Development.

All was not all wine and roses for Michael and Neweston, however. He was in the very highest echelons of the company, but he was also probably as high up as he could go. Kelvin ran the company. The CFO, who had been with Kelvin since the beginning, was not going anywhere. There really were no other jobs above Michael's. Added to his lack of mobility were the tensions of the job he did have. Michael oversaw the sales team, but the majority of that team came from Kelvin's immediate family. Some of them were great salespeople; others were impervious to Michael's suggestions for improvement, and Kelvin was apparently unwilling to encourage them. Kelvin also seemed less than enthusiastic about Michael's career development goals. Kelvin had acted betrayed when Michael enrolled in law school to learn more about real estate law. (For Kelvin, it was bad enough that Michael—the Director of Sales and Marketing!—had decided to sell his Neweston house, which, unlike the campus-area rental, was not generating sufficient income.) Michael managed to convince him that Neweston would benefit from having legal expertise in-house, but the rift in their relationship persisted.

Michael excelled in law school, even starting a real estate club there. However, full-time school and full-time work (work that required a six-hour round-trip commute from Seattle to Neweston every weekend) took its toll. Faced with the prospect of adding a required law-clerking position his first summer, Michael reluctantly took a leave from school.

However, there was still his day job, which was not getting any better. Michael began to think more often about being his own boss. He had already taken steps to start his own online travel business—securing what he thought were nearly bullet-proof internet domain names. He wanted to use them to leverage his expertise in internet marketing, creating a business that could almost run itself: Pac.NW Travel Online.

PAC.NW TRAVEL ONLINE

Michael formed Pac.NW in the summer of 2011 after obtaining rights to 90 destination and real estate domain names. These domain names contained valuable keywords that would perform well in Google's search algorithm. He wanted to develop the sites to provide tourism information—lists of hotels and restaurants, publicity for local events—for towns along the west coast. He believed his business plan would capitalize on the growing demand for "hyper-local" content, publishing user reviews and local vendor content for highly targeted locations (like Coos Bay, Oregon, a town of 16,000 people).

Michael believed that the time was right for hyper-local tourism sites. The bad economy had forced many states to cut back or eliminate their own tourism spending. Tourists increasingly were looking to the web for trip planning, but local businesses did not have the type of search engine optimization (SEO) expertise that would allow them to promote themselves effectively. Pac.NW could step into the void left by the state tourism boards and provide small businesses with a user-friendly advertising platform—all facilitated, of course, by Michael's expertise in internet marketing.

Michael identified numerous possible revenue streams from Pac.NW. These are summarized in Table 1 and discussed briefly below.

Table 1: Summary of Revenue Sources for Pac.NW

REVENUE SOURCE	CATEGORIES	TYPES OF FEES
Business Listings	hotel/motel B&B RV & camping food & drink activities shopping services	monthly listing fee based on term of ad: Semiannual Annual
Vacation Rentals		monthly listing fee based on term of ad: semiannual annual *plus* per-unit fee
Events	premier basic	monthly fee
Display Advertisements	small-market mid-market major-market	monthly listing fee based on term of ad: Monthly Quarterly Semiannual annual *and* on ad intensities: awareness leader exposure

The "revenue sources" listed above are the four primary sales generators for Pac.NW: business listings, vacation rentals, events, and display advertisements. The types of fees associated with each revenue source are listed in the third column.

REVENUE

Business Listings

Pac.NW would allow local businesses to list in a directory, with categories like "hotel/motel" and "food & drink." Michael estimated monthly listing fees ranging from $7.20 to $19.76, based on fees charged by another site. (See Table 2.) For example, a 1-year listing for a hotel in Lincoln City, Oregon (a very popular tourist destination, featuring a large casino) was $37.60/month; a similar listing in Tillamook, Oregon (home of a cheese factory) was only $12.00/month. Six-month listings were slightly more expensive, so, to be conservative, Michael used the 1-year rates in his projections.

Although Michael had seven business listing categories, incorporating them all into his expected revenue projections gave him "growth that seemed way too fast." He decided to "fix" this result by using an average listing rate. Thus, Michael's adjusted estimates account for business listing revenue as if he had only one type of listing—priced at an average rate—instead of the actual seven. He expected to start in month 4 with 3 listings at tiers I and III, and 2 at tier II. (Tiers are discussed below).

Vacation Rentals

Pac.NW also would list properties available for rent. Rental listings required property managers to pay two types of fees: one for the business listing itself, and another for each unit listed (the per-unit fee). Each fee could be based on a 1-year or 6-month contract. As with the business listings, the 1-year contract was less expensive; again, Michael used the annual term for his projections. His month-4 estimate was for 1 business listing with 5 per-unit fees at all tiers.

Table 2: Monthly Fees for Business Listings

	Average	Maximum	Minimum	Mode	Median
Hotel/Motel					
Semiannual	$24.71	$47.00	$15.00	$16.00	$20.00
Annual	$19.76	$37.60	$12.00	$12.80	$16.00
B&B					
Semiannual	$10.47	$12.00	$9.00	$10.00	$10.00
Annual	$8.38	$9.60	$7.20	$8.00	$8.00
RV & Camping					
Semiannual	$9.47	$16.00	$9.00	$9.00	$9.00
Annual	$7.58	$12.80	$7.20	$7.20	$7.20
Food & Drink					
Semiannual	$9.00	$9.00	$9.00	$9.00	$9.00
Annual	$7.20	$7.20	$7.20	$7.20	$7.20
Activities					
Semiannual	$12.00	$12.00	$10.00	$10.00	$10.00
Annual	$8.00	$9.60	$8.00	$8.00	$8.00
Shopping					
Semiannual	$9.00	$9.00	$9.00	$9.00	$9.00
Annual	$7.20	$7.20	$7.20	$7.20	$7.20
Services					
Semiannual	$9.00	$9.00	$9.00	$9.00	$9.00
Annual	$7.20	$7.20	$7.20	$7.20	$7.20
All 7 Listing Types					
Semiannual	**$11.73**				
Annual	**$9.38**				

The monthly fees for various listings used in the Pac.NW projections are averages of destination-specific charges for 17 specific northwest destinations. For example, the $19.76/month used to price the hotel/motel listings is the arithmetic average e of the actual charges for hotel/motel listings for the various destinations (assuming an annual contract), which range from $12.00/month for Tillamook, OR, to $37.60/month for Lincoln City, OR. The underlying fees were estimated by ViewIT. Michael used the annual-term average of all seven listing types, $9.38, to estimate his business-listing revenues.

Table 3 gives Michael's five-year estimates for these first three revenue streams.

Table 3: Estimates for Growth in Business Listings, Vacation Rentals, and Events for First Five Years

		Months				
		5-12	**13-24**	**25-36**	**37-48**	**49-60**
TIER I	business listings (7 types)	15%	10%	5%	5%	2.5%
	vacation rentals (both fees)	15%	10%	5%	5%	2.5%
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%
TIER II	business listings (7 types)	15%	10%	5%	5%	2.5%
	vacation rentals:					
	annual fee	15%	10%	5% through t=26, then flat at 10 units		
	per-unit fee	15%	10%	5% for t=25, then flat at 50 units		
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%
TIER III	business listings (7 types)	15%	10%	5% through t=30, then flat at 40 units		
	vacation rentals:					
	annual fee	15%	10% through t=17, then flat at 5 units			
	per-unit fee	15%	10% through t=14, then flat at 20 units			
	events (both basic & premier)	15%	10%	5%	2.5%	1.25%

This table presents Michael's estimates for business listings, vacation rentals, and events. The entries give either the number of units (e.g., 10 vacation-rental annual fees per month for tier II after t=27) or percent growth (e.g., 15% per month for months 5 through 12 for tier-I business listings).

Display Advertisements

Display advertisements would allow businesses to post special ads on the sites—like billboards along the highway—giving much more information than a simple business listing. Pac.NW would offer three display ad products, based on the intensity of the ad: "awareness," "leader," and "maximum exposure." "Awareness" was the least expensive, but offered the least space; "maximum exposure" was, as its name suggested, the top-of-the-line option. The products' cost depended on the size of the advertiser's market segment (small, medium, or "major"). Larger markets demanded higher fees.

The company Michael was considering to manage his sites, ViewIT, had recommended prices for each ad product, based on rates charged by their current customers in Spokane, Washington. Michael found the pricing structure reasonable, compared to what he was used to. For example, the "pencil ads" he placed on the *Seattle Times*' website cost $6,000 per *week*. (Pencil ads were as wide as the webpage—450 pixels—and 10 pixels tall, or about the size of a pencil.) Print ads were also as expensive as always: $100,000/month for a full page in *Sunset* magazine, or $50,000/month in *Coastal Living*.

The pricing structure was the same for all three of Pac.NW's tiers, or website groupings. (See Table 4.) Prices were based on an ad term of one month. If an advertiser chose a longer term, he got a discount: quarterly ads cost 95% of the monthly rate, semiannual ads 90%, and annual ads only 80%. Michael had chosen to use the annual rate for all of his projections. His estimates for the number of ads he can sell at each tier are shown in Table 5.

Table 4: Prices for Display Ads

SMALL MARKET	Awareness	Leader	Exposure
Monthly	$195	$495	$995
Quarterly	$185	$470	$945
6 months	$175	$445	$895
Annual	**$155**	**$395**	**$795**
MID MARKET	**Awareness**	**Leader**	**Exposure**
Monthly	$295	$695	$1,295
Quarterly	$280	$660	$1,230
6 months	$265	$625	$1,165
Annual	**$235**	**$555**	**$1,035**
MAJOR MARKET	**Awareness**	**Leader**	**Exposure**
Monthly	$395	$895	$1,795
Quarterly	$375	$850	$1,705
6 months	$355	$805	$1,615
Annual	**$315**	**$715**	**$1,435**

This table gives ViewIT's suggested prices for the various market/intensity combinations for display ads. As the term of the ad got longer, the monthly fee fell. Exposure ads were the most expensive intensity option; for market segments, major-market ads were the most expensive.

There were two other ways the company could make money besides those listed In Table 1: affiliate marketing and real estate commissions. Pac.NW would earn affiliate revenues if a visitor to one of its sites clicked through to an affiliate's site (for example, to the travel booking site Kayak); each click-through meant 20¢ for Pac.NW. Google helped here, too. Its content network automatically tracked available space on webpages and placed its own ad inventory there; the rates it paid on click-throughs depended on the popularity of the original search term. (Michael considered these payments his "last ditch" way to make money.) For the real estate listings, Pac.NW would earn 25% of the commission on any house sold to a buyer who was referred through its sites. Pac.NW would forward contact forms completed on its sites by interested buyers to local brokers. When a broker closed the sale, Pac.NW would get its commission. Michael thought there was a lot of potential in these commissions and in the affiliate revenues, but—to be conservative—he left them out of his initial revenue estimates.

EXPENSES

Pac.NW had a fairly simple cost structure. (See Table 6.) There were start-up costs, ongoing maintenance costs, and monthly payments to Michael's "venture capitalist" and his license holder. The licensing fees would go to Larry Carter, who actually owned the domain names. Michael had promised him a monthly payment, plus a percentage of the firm's revenues, for 20 years. His VC—also known as his father, Joseph—would get 10% of monthly revenues in return for paying the start-up costs. Those costs, plus the monthly variable maintenance costs, were specified in Michael's contract with ViewIT (a company that sold content management systems and services to site owners)—the contract he needed to renegotiate.

Table 5: Estimates for Display Ad Sales

		Month						
		4	5	6	7	8	9	10+
TIER I								
small:								
	awareness				3 for all			
	leader	2	3	4	5	6	6	6
	exposure				1 for all			
mid:								
	awareness	1	3	5	5	5	5	5
	leader	2	4	6	8	10	11	11
	exposure	1	2	2	2	2	2	2
major:								
	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	12	15	17
	exposure	1	3	4	4	4	4	4
TIER II								
small:								
	awareness				3 for all			
	leader	2	3	4	5	6	6	6
	exposure				1 for all			
mid:								
	awareness	1	3	5	5	5	5	5
	leader	2	4	6	8	8	8	8
	exposure	1	2	2	2	2	2	2
major:								
	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	10	10	10
	exposure	1	3	4	4	4	4	4
TIER III								
small:								
	awareness	2	4	6	8	8	8	8
	leader	2	5	7	10	12	15	17
	exposure	1	3	4	4	4	4	4

This table gives Michael's estimates for the number of display ads for the three tiers for all 60 months.

<u>Licenseholder Fees</u>

Larry Carter owned Michael's domain names, but was willing to license them for a fee. Larry had a mini-empire of domain names—having purchased as many tourism-related URLs as he could in the mid-90s—but had let all but one, *Washington waterfronts*, languish. He launched that one in 1998, and it rewarded him with 15 years of solid real estate leads. However, by 2010, Larry admitted to himself that he lacked the passion to build a comprehensive marketing platform using his other names. He was familiar with Neweston Land Company, though, so he knew Michael. Michael was the man to build his URL empire.

Larry agreed to license the sites to Michael in return for monthly payments plus a share of the sites' revenues. There were three sets of sites. "Tier I" sites were the potentially most valuable domains: *Visit Oregon*, *Washington Waterfronts*, and *California Waterfront*. Michael thought that these three domain names alone would be enough to make Pac.NW profitable. "Tier III" sites were "small-market" sites (e.g., *Visit San Juan Island*). In between were Michael's "broad-scope sites"—*Visit King County*, *Visit Pierce County*, and *Visit Bellevue.* (King and Pierce counties are the homes to Seattle and Tacoma, Washington, respectively; Bellevue is a large, wealthy city across Lake Washington from Seattle, near the home office of Microsoft.) For tier I, Larry wanted $5,000 per month (or 50% of revenues, whichever was lower), plus annual payments of 2% of the prior year's revenue. (These annual payments were due in months 15, 25, 37, 49, and 60, at 2% of revenue from months 4-12, 13-24, 25-36, 37-48, and 49-60, respectively.) For both tiers II and III, he asked for a monthly fee of 18% of revenue, with no minimum, maximum, or additional annual fee.

Table 6: Pac.NW's Cost Structure

FEE TYPE	CATEGORIES	FEE STRUCTURE	
Licenseholder Fees	tier I	monthly fees based on tier::	
	tier II	tier I:	lower of $5,000 or 50% of revenues
	tier III		*plus* 2% of prior year's revenues
		tier II:	18% of revenue
		tier III:	18% of revenue
"Venture Capitalist" Fees		10% of monthly revenue	
Start-up Fees	CMS	$95,000 for CMS	
	area-specific modules	*plus* $20,000 per module	
Management Fees	costs	ViewIT's monthly costs	
	revenue share	*plus* 50% of remaining revenues	
		(up to 60% of monthly revenues)	

This table describes Pac.NW's four types of costs. Most are percentages of revenue, although there is a minimum payment for the license holder.

Monthly Payments to "Venture Capitalist"

Michael's VC was his father. Joseph had recently retired from his job as senior VP of human resources for a multibillion-dollar international manufacturing firm. He was already Michael's business partner, since he owned half of both the university-area rental house and the vacation house at Neweston. Joseph was ready to invest in Pac.NW, too, and had agreed to borrow $155,000 from his retirement fund (paying LIBOR for the privilege) to launch the first set of sites. In return, Michael had promised him 10% of monthly revenues, indefinitely. Even at that rate, Joseph acknowledged that it might take ten years to get his money back (telling Michael, "if the world ends tomorrow, this is the amount of money I'd be willing to kiss goodbye…and don't expect an inheritance!").

Start-up Costs

The most significant initial capital expense for Pac.NW was the content management system (CMS). This system would allow Michael to control each site's content and appearance without a web designer. The CMS also integrated the sites with social media, so that Michael could take a snippet of a published article and distribute it widely with just the click of a mouse. ("Just another cheap way to drive traffic and subsequently advertising dollars!") Perhaps most importantly, the CMS would provide the statistics (click-throughs, page views, impressions) that tracked the sites' activity.

Michael would buy the CMS from ViewIT for $95,000. ViewIT also charged $20,000 for each customized module that provided area-specific information like local weather. Michael needed three of these modules for his first three tiers, so his total initial payment to ViewIT would be $155,000. Michael knew that these costs were standard for the business. Nonetheless, he had been negotiating with ViewIT about the timing of this payment. He wanted to defer 30% of the cost, $46,500, for twelve months.

Monthly Fees to ViewIT

ViewIT would manage the sites, and also would be responsible for selling all display ads, business listings, vacation rental ads, and event ads. (This is why Michael considered Pac.NW to be a "passive-income" business.) In return, ViewIT wanted 50% of the monthly revenues generated from these four sources. (ViewIT got no payments from affiliate marketing or real estate referrals.) Michael initially thought this meant that he and ViewIT would share the sites' revenues equally, but had just learned—during their ongoing negotiations—that ViewIT wanted 50% of the revenue that was left *after* Michael paid their costs. Thus, ViewIT not only wanted payment for the costs it incurred in managing Pac.NW's websites, but half of the remaining revenue as well; its total monthly compensation for month t would therefore be: $\text{costs}_t + .50*(\text{revenue}_t - \text{costs}_t)$. The contract specified that compensated costs could not exceed 20% of revenues, so ViewIT could take, at most, 60% of Pac.NW's monthly revenues. Michael was extremely uncomfortable ViewIT's last-minute (in Michael's opinion) demand for a 60/40 split. He had floated the idea of making payment contingent on some (unspecified) performance-based metrics, but ViewIT rebuffed him. Michael was afraid Pac.NW would not pencil-out at 60/40; he thought his dream of being his own boss was evaporating before his eyes. He had to find some way to renegotiate *something*—the start-up fees, ViewIT's monthly payments, his dad's take—in order to salvage this business.

THE RENEGOTIATIONS

Michael thought that the domain names he had licensed from Larry Carter were "money." His dad had been ready, willing, and able to give him the start-up funds. Then came ViewIT's eleventh-hour demand that they be paid 50% after costs, not just 50% off the top. Michael thought ViewIT should prove itself before he handed over 60% of his revenue; he wanted to work out a deal to defer some of the start-up costs or to reduce their percentage. They seemed unwilling to deal, though—they had plenty of work.

Michael reluctantly began to confront the fact that his only leeway might be with his father. He had promised Joseph 10% of revenues because 10% was a round number and sounded fair. But was it *too* fair? Was he giving away the store? Michael felt he needed to come up with several alternative proposals that would compensate his father equitably but still allow Pac.NW to succeed—even if ViewIT would not deal.

Michael was sick of the long commute to Neweston and the drama he had to deal with when he got there. He wanted to go back to law school. The clock on that was ticking; pretty soon, he would have to start all over. His dad needed a decision, too; he had other opportunities for his money. Michael had to make a move now. Pac.NW could be his golden ticket, but only if it did not collapse under the weight of the upfront costs and revenue-sharing arrangements. He had to figure out how to rework his financial deals, and soon—preferably before school started again in the fall.

APPENDIX: INTERNET MARKETING BASICS

The internet opens new worlds to marketers. Instead of beaming commercials out to anonymous viewers, advertisers can monitor and analyze—in real time—user interaction with messages, tracking every click and page view. Social network data can instantly tailor ads to a specific user. This is "true psychographic advertising" (Ruxin, 2008): "Nearly instantaneously, …companies can log your visit [and] place ads tailored for your eyes specifically… The websites you visit reshape themselves before you like a carnivorous school of fish" (Madrigal, 2012). The downside: there is *so much* material. Even back in 2008, eight hours of video were uploaded to YouTube every minute (Ruxin, 2008). In this environment, money alone is not enough to guarantee exposure—advertisers have to earn "eyeballs" by offering compelling content.

Advertisers also have to exploit Google's search algorithm. Google rules search—over two-thirds of U.S. internet queries are "Googled" (Catan and Efrati, 2011). It manages this process using algorithms to determine which results will be the most useful to the searcher ("organic" results). Useful results mean money for Google. Unless searchers actually click on an ad ("click-through"), Google does not get paid.

Click-through depends on where an ad is displayed on the search results page. One way to score a premium top position is to create "landing pages" that Google's algorithm deem high-quality. (As Michael put it, "Content = search traffic = revenue.") Although the algorithm is proprietary, marketers know that older domains are preferred. "Exact-match domains" are given special consideration in the algorithm: in a correlation study of the relationship between "on-site/on-page" features and search rankings, no other factor "even came close" to explaining relative rankings. (In fact, the preference for exact matches was so strong—perhaps because Google wants to ensure that people searching for specific businesses find them easily—that there is a backlash brewing. Many in the search community expect Google to introduce more "subtlety" to their algorithm by mid-2011; Fishkin, 2010.) Of course, exact matches are not required: having search terms in the title, header, or URL tags makes a page appear relevant to someone searching on those words. (Header tags are section headers on a webpage; title tags are displayed in the top bar of a webpage. URL tags allow search engines to identify "duplicate" content on associated webpages.) Experienced optimizers know to use critical keywords (like "Washington" and "oceanfront") in tags. Managing content with an eye toward performing well in the organic search is called "search engine optimization" (SEO).

Marketers can also pay for exposure through "search engine marketing" (SEM). Michael put it like this: "SEM is like crack: you pay to satisfy your fiend. SEO, though, is like rehab: you don't immediately satisfy your fiend; instead, you figure out what's driving it."

Successful SEM depends on mastering Google's keyword auctions. These auctions allow advertisers to bid to have their ads displayed at various positions on the results page. Each position has an assumed average "conversion rate" (rate of click-throughs). (See Figure 1.) For example, an ad at the top of the page gets more clicks than one on the right-hand side; it might also be distributed among the engine's syndication partners, bringing even more clicks (Efficient Frontier, 2007). Nonetheless, an advertiser might choose to bid to a lower position, hoping to get his ad in front of the user for free (this is the "billboard effect"—getting an impression without cost).

Position was just one dimension of a bid. The keywords themselves were also critical. Online marketers made daily bids on keywords they predicted would be used in searches by their potential customers. Words like "beach," while frequent search terms, were also bid on by more advertisers. ("Beach" marketers also had to consider words like "beech," since there was no guarantee that their potential customers were good spellers.) Longer strings of keywords—like "Washington waterfront vacation rentals"—had better click-through rates, but required magnitudes more bids than single keywords. Marketers also had to decide how many search engines to use (Google's, Microsoft's, Yahoo's…), the number of geographic regions to target, the seasons or times of day on which to focus, the amount they could afford to spend, and the return on investment they wanted. Even a relatively simple scheme of twenty keywords targeted to twenty geographic markets on two search engines translated into 800 bids a day (Efficient Frontier, 2007). Given the complexity of the system, e-marketing was not for the faint of heart. Michael Powers was a proven competitor, and he expected Pac.NW to allow him to profit from his expertise. However, the market he knew was starting to change dramatically.

Figure 1: Stylized Results Page

Google		Oregon Coast Vacation Rentals		
Everything	1	**Oregon Vacation Rentals** Ads	Ads	
Images			Ribbon **Vacation Rentals**	4
Videos	2	Lincoln City Vacations - Luxury Beachfront **Vacation Rentals**		
News			**Oregon Coast** Getaway	5
Shopping	3	**Oregon** Beach Home **Rentals**		
Books			**Oregon Coast Rentals**	6
More				
			OR **Coast Cabin**, Manzanita	7
Sammamish, WA		Oregon Vacation Rentals | **Oregon Coast Vacation Rental** Home		
Change location			Lincoln City **Vacation**	8
		Beach House **Rentals - Oregon** & Washington		
Any time			**Oregon Coast Vacation**	9
Past hour		**Oregon Coast Vacation Rentals**		etc.
Past 24 hours				

This figure presents a stylized version of the screenshot from a search results page. The links in the grey box at the center of the figure (labeled #1 through #3) and those along the right-hand edge (labeled #4 through #9) are ads; the numbers indicate the position element of an online marketer's Google Adwords bid. Positions 1, 2, and 3 are in premium positions at the top of the page, where they should generate higher conversion (click-through) rates.

THE INTERNET ENVIRONMENT IN MID-2011

Michael was considering launching Pac.NW at a time when investors were spurning old tech companies for new "darlings," and as the internet itself underwent significant transformations.

In mid-2011, investors seemed bored with older technology stocks. For the first time since 1992, the forward P/E ratio for technology stocks (about 12.1 times) was lower than the multiple for the S&P500 (12.4). Apple was at an even 12, Google at 13.8, and Microsoft and Intel were less than 10 (Cheng, *et al.*, 2011).

In contrast, the new-issue market was sizzling. The second quarter of 2011 was the highest-grossing quarter for internet IPOs since fall, 2000 (Ovide, 2011). One internet investor compared the internet IPO market of mid-2011 with the 1995-1996 period, when Netscape and Yahoo—firms with actual business models, not just "dot-com" names—went public. However, other investors deemed the market "frothy." As the *Wall Street Journal* put it:

> In its stock market debut this past quarter, LinkedIn briefly had a market value that on a similar sales multiple would value Apple at $3 trillion. Groupon had a $420 million operating loss last year, yet the daily-discounts website may leapfrog Google as the biggest U.S. internet-related initial public offering ever, based on money Groupon is expected to raise. Facebook is shooting for a stock-market value of more than $100 billion, a price tag boasted by fewer than three dozen U.S. companies. (Ovide, 2011)

Groupon's IPO filing appeared to value the firm at $20 billion, over 31 times its first-quarter 2011 revenue of $644.7 million—this despite the "proliferation" of daily-deal clones (Chon and Woo, 2011; Raice and Woo, 2011). LinkedIn, which had three sources of revenue—job search, ad sales, and premium subscriptions, "each showing some healthy growth"—was priced at 16 times prior year's revenues and 100 times EBITDA (Jaffe, 2011). It closed its first day of trading at double those numbers, or 592 times earnings. "Even if you think it's a great business model, the feeling is that the valuation is way beyond what even the most bullish guys were hoping for" (Conway, 2011). Online radio company Pandora successfully priced its IPO at 12 times projected revenues (compared to a multiple of six times for internet giants Google and Apple). Many analysts were skeptical that such valuations reflected fundamental value.

The market for internet search—and the internet itself—was also evolving. (This section draws heavily on Holmes and Rhodes, 2011). In June 2011, the international body that coordinated domain names, ICANN (Internet Corporation for Assigned Names and Numbers), loosened the restrictive naming system that had previously governed web addresses. Originally, there had been 22 "generic top-level domain" names (the words coming after the "dot," like "dot-net" or "dot-org"). Almost 45% of the more than 211 million global web addresses used the most popular of these top-level domain names, the suffix "dot-com." ICANN's new system allowed *anything* to follow the dot, creating an infinite number of new web-address possibilities. ICANN believed that this system would help protect firms' brands by ensuring that counterfeiters could not use deceptively similar domain names; businesses owning their own "dot-firm" name (like "dot-PacNW") could allow only licensed distributors to use that suffix. The system would also allow firms unable to get attractive "dot-com" addresses to create comparable "dot-web" sites.

Of course, there were downsides. The new system could lead to customer confusion, as domain names proliferated. Registration of the new suffixes was expensive: the application alone—the guidebook for which was 352 pages long—cost $185,000. Some businesses had already concluded that the hassle was not worth it: "For us [Electronic Arts], the domains seem expensive and offer negligible value" (Holmes and Rhodes, 2011). The former chairman of ICANN warned that the new scheme would create work for lawyers and web marketers, but would "put large companies in a position like that of a farmer forced to carve up his land into tiny parcels and pay to retain ownership of each one…ICANN's offer to help companies safeguard their plots—for a fee—seems like a protection racket" (Dyson, 2011). Nonetheless, businesses like Pac.NW banking on "dot-com" addresses had to be aware of the potential complications arising from the new system.

There were also some changes in search in mid-2011. Google's search dominance had made it an antitrust target. Rivals continually complained that "Google's anticompetitive practices include using other companies' content without their permission, deceptive display of search results, manipulation of search results to favor Google's products, and buying up competitive threats to dominance" (Catan and Efrati, 2011). In 2011, the complaints were about Google's new "Places" service. Google launched Places in April 2011 to aggregate reviews of local businesses from other sites. It displayed snippets of those reviews on special pages. Instead of running Places pages through its usual algorithm, it often simply put them near the top of the search page—above results for competitors like TripAdvisor. Although Places included links to the original content, competitors nonetheless accused Google of "stealing our content to create a competitor." Google's response was that Places was just pointing users toward the best information, and that this "stealing" was protected by fair-use doctrine. Nonetheless, in June 2011, the pressure—combined with an antitrust investigation by the Federal Trade Commission, "the biggest showdown between regulators and Silicon Valley since the government took on Microsoft"—became too much, and Google announced it would display only reviews written by its own users (Streitfield and Wyatt, 2012; Efrati, 2011b). The rivals were gratified, although they complained that "it's too bad it took an antitrust investigation for them to do something" (from Yelp) and "I'd love for them to come out with a statement that 'we promise not to do it again'" (from TripAdvisor).

Google had been expanding in other areas, also. Given that 20% of its searches were related to local businesses, it bought Zagat, the restaurant review company, hoping to attract more local ads (Efrati, 2011c). Also, at almost the same time it was backing off on its Places approach, it was acquiring Admeld, a "supply-side platform" that helped large publishers sell advertising space on its webpages. Analysts believed that Admeld would help Google strengthen its ad exchange (essentially a stock market for advertising) by adding high quality ad-space inventory (Efrati, 2011a).

Adding space for display ads was an important part of Google's growth strategy. The company hoped that its display-ad business eventually would be as important as its $30B/year search business.

eMarketer, a digital research firm, expected the display market to grow 24.5% in 2011 (Peers, 2011), and, given growth like that, Google projected that the market would need only a few years to hit a total of $100B. The Admeld deal itself would help spur that growth. However, others were skeptical. Rivals noted that with over 1,000 competitors in the market, even a Google/Admeld combination faced significant headwinds. Yahoo had already been buffeted: its revenue growth rate fell from 10% to 5% in the second quarter of 2011, a "drastic deceleration of display advertising revenue growth" that some attributed to inroads by Facebook and Google (Peers, 2011). Even worse, the competitors may have been scrabbling over an unprofitable market. Sir Martin Sorrell, a British advertising executive with "a better handle on the fractured, panicky state of the media business than almost anyone else," believed that consumers were already bombarded with too many messages. There was too much internet content: "more means less." Worse: "[a]dvertising-only models don't work. There isn't enough advertising to go around. Period" (Lipman, 2011). If Sorrell were right, there could be significant ramifications for Michael Powers and Pac.NW Travel Online.

QUESTIONS

1. Perform a SWOT analysis of Pac.NW.
2. Evaluate Pac.NW's capital structure and leverage.
3. Determine the value of the Pac.NW project to Michael, using his initial understanding of ViewIT's compensation (i.e., 50% of revenue, *not* 50% after ViewIT's costs).
4. What are the most important drivers of Pac.NW's business?
5. Evaluate Michael's arrangement with his father, Joseph. Could Michael offer him a less "rich" deal and still offer Joseph a fair return?
6. Given your analysis of Pac.NW's business model, how should Michael address ViewIT's revised proposal that it receive 50% of revenues *after its fees*?

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PAC.NW TRAVEL ONLINE

Lynda S. Livingston, University of Puget Sound

TEACHING NOTES

CASE DESCRIPTION

Michael Powers had licensed a series of domain names that he thought would allow him to create a profitable set of online tourism marketing sites. The case asks students to evaluate the feasibility of the business, given Michael's projections. Given what they find, students are then asked to assess how reasonable are two of his current arrangements with stakeholders. The case allows students to practice fundamental valuation techniques on a cutting-edge business model.

GENERAL COMMENTS

The case supports the several learning objectives. First, it introduces students to a new business model. Online marketing is a rapidly expanding business replete with its own strategies, platforms, and acronyms. Consider the following recent quotes from a mainstream (print) news publication, *The Week*: "Having a great social-media strategy is part of what makes your business more robust" ("Finding Value in Tweets," 2/17/12); "A one-star increase on review site Yelp improves a restaurant's revenue by 5 to 9 percent." ("The Bottom Line," 10/21/11); "[W]hile there are many antecedent forms of advertising, never before in the history of human existence has so much data been gathered about so many people for the sole purpose of selling them ads." ("My Digital Shadow," Madrigal, 2012); "The best minds of my generation are thinking about how to make people click ads." ("My Digital Shadow," Madrigal, 2012). Students of marketing must become familiar with the jargon and strategies of online marketing. Second, the case allows students to apply cash-flow and discount-rate estimation to a small, private business. Finally, it allows them to evaluate alternative schemes for providing an adequate return to equity funders.

SOLUTIONS

Question 1: Perform a SWOT analysis of Pac.NW.

Solution 1: Table 7 outlines some salient aspects of a SWOT analysis of Pac.NW. In summary, evaluating Pac.NW on value, imitability, and organization, we find that its services would add value for tourists (strength). However, while the domain names themselves are unique, the sites are highly imitable; Michael would need to focus on creating unique content (weakness). In addition, the organization is dependent upon a third party, who provides the same services to all comers (weakness).

Question 2: Evaluate Pac.NW's capital structure and leverage.

Solution 2: Pac.NW has several claimants: Michael, the true residual stakeholder; his father, Joseph, who will be paid 10% of firm revenues; and the license holder, Larry Carter, who has several different arrangements, all of which have some percentage link to revenues. (For tier I sites, Larry gets both 50% of revenue or $5,000/month, whichever is lower, and 2% of the prior year's revenues. For tiers II and III, he gets 18% of revenues.)

Table 7: SWOT Analysis of Pac.NW

STRENGTHS
Michael is a capable and highly competitive person. His family is supportive of his business idea. Michael considered his domain names to be extremely strong. Google's emphasis on "exact-match domains" in searches enhanced the value of domains like *California waterfronts*. Control of these domain names was the primary advantage of Pac.NW. The *Washington waterfronts* site has been running since 1998. This means that it has a sustainable competitive advantage over potential competitors for organic search results, given Google's algorithm's emphasis on the age of a domain name. Michael is an expert at search engine marketing (SEM: structuring <u>bids</u> for good placement in search results, leading to high click-through rates) and search engine optimization (SEO: creating <u>content</u> that will score well on search engine's algorithms, leading to good "organic" placement). His work at Neweston has proved his capabilities in this area. Google's expansion into display advertising could stimulate the growth of that market, creating opportunities for Pac.NW's primary business line.
WEAKNESSES
Michael was dependent upon the content management system of ViewIT. He also relied on that company to sell the business listings and display ads, the heart of his revenue model. Pac.NW's results were driven almost exclusively by display ads. However, some commentators believe that "advertising-only models don't work," given the massive proliferation of internet media sites. Michael needs to be able to create unique, valuable content in order to draw visitors, and that content must draw an audience from web users who are already supersaturated with messages. He therefore cannot treat Pac.NW as a purely "passive" business; he must write (or find someone to write) material that not only exploits search engine algorithms, but that also draws users (and clicks). ViewIT uses the services of inventory distribution platforms like Admeld. If Google's acquisition of Admeld makes these services less competitive, Pac.NW could face higher costs.
OPPORTUNITIES
Investors' current excitement with new internet companies might give Michael a pool of potential capital beyond the sources he had currently identified. It also could help maintain the enthusiasm of his current investors. For example, seven months after a $200 million funding round, Twitter Inc. planned a new round of private financing that valued the firm at $3.7 billion. Discussions surrounding the follow-up round suggested a revised valuation of up to $7 billion, an increase some commentators tied to the "soaring" valuations for firms like Zynga, Groupon, and Facebook (Efrati and Ante, 2011). The cutback of state and federal funds to support tourism left a void that Pac.NW could fill. Vacationers were increasingly using the internet to research and plan their trips. They needed timely and accurate information, which Pac.NW would provide.
THREATS
If Google changed its algorithm to become more "subtle," reducing its reliance on exact-match domains, Pac.NW's sites could see worse organic search placement. The new ICANN system for generic top-level names could be a threat. There was a two-pronged threat here: first, that consumers came to trust the "dot-vacation" (or suitable alternative(s)) for their vacation-planning needs, bypassing older "dot-com" sites; and second, that a competitor used the new suffix(es) to mimic the same addresses that Pac.NW had. A rival could, for example, register a "dot-vacation" suffix, then sell "California_waterfront.vacation" or "Visit_Bellevue.vacation." This threat was mitigated by the expense involved with the new suffix registration. There were already multiple sites that provide user-generated reviews of local businesses: the case mentioned TripAdvisor, for example, not to mention Google's "Places" service. (There are others: UrbanSpoon, Yelp, and CitySearch, for example.) Places, in particular, had already raised competitors' ire for "stealing" content from other sites' pages. Pac.NW's pages would be as tempting a target as any of the other sites'. (Google had promised no more stealing, though.) Although tourists need quality information, they may have no loyalty to any particular site. Michael had no way of creating that loyalty, beyond developing a reputation for useful content. Google's expansion into display ads (e.g., through its purchase of Admeld) could result in its being the dominant player in the market. This could make it more difficult for ViewIT and Pac.NW to get the best ads and/or the best prices.

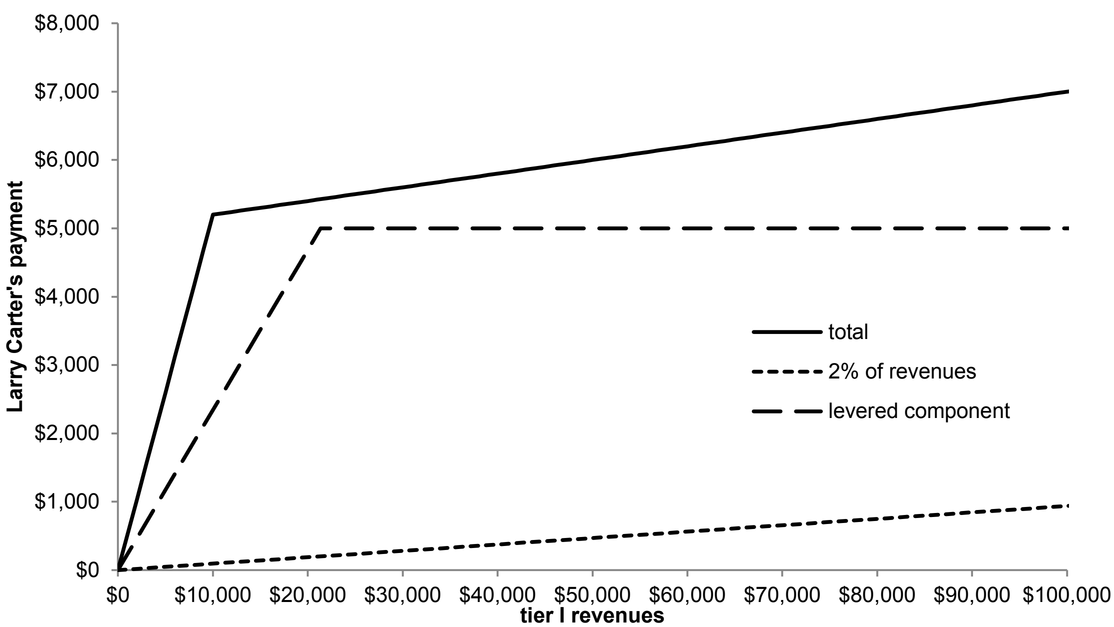
This table outlines the strengths, weaknesses, opportunities, and threats for Michael's online travel service.

We could also consider ViewIt a claimant in the same sense as the three gentlemen. Assuming that ViewIT receives 50% of revenues (the initial understanding), then its claim is effectively no different from Joseph's. However, the nature of ViewIT's payments is conceptually different, since ViewIT's payments are operating costs, not payments for the use of capital. We do note that, given the structure of ViewIT's payments, Pac.NW has no operating leverage.

What about financial leverage? Using the cash flows from question #3 below, we find that Joseph's payments are perfectly positively correlated with revenues (as they always will be). Given the timing issues, Larry's annual revenue sharing payments have only a .76 correlation with revenues, but—given the relatively small size of this part of his payments—the annual sum of his payments from all sources has a correlation of almost .98 with revenues. Similarly, Michael's payments, assuming no horizon value and ignoring the start-up costs, have a .98 correlation with revenues. Thus, there does not seem to be a lot of financial leverage, either.

There is a bit, though, driven by the arrangement with Larry Carter for tier I. We can see this below in Figure 2, which graphs Larry's tier I payments for a range of total income values. (These revenues are assumed to consist of display ad payments only. The share of revenue attributed to each tier is based on the proportions from Michael's initial estimates: 47% from tier I, 37.5% from tier II, and 15.5% from tier III.) The bottom line is the 2%-of-revenues payment (which is assumed to be paid immediately). The dashed kinked line is the tier-I conditional payment, equal to the minimum of 50% of tier-I revenue or $5,000. The top kinked line, Larry's total tier-I payment, is the vertical sum of the two other curves.

Figure 2: License Holder's Arrangement for Tier I



Figures 2 and 3 illustrate the leverage inherent in Pac.NW's financing arrangements, using hypothetical revenues produced solely by display ads. Figure 2 illustrates the source of the leverage, which is Larry's arrangement for tier I.

The leverage for Pac.NW comes from Larry's conditional payment. The middle curve in Figure 2 is the same as that for a corporate bond: the flat piece corresponds to income levels sufficient to pay the bond as promised; the steeper piece at the left is the default region. For the corporate bond application, Brealey, Myers, and Allen (2006) describe the blue curve as "the position diagram for a default-free bond *minus* a put option on the assets with an exercise price equal to the face value of the bonds" (emphasis original).

This put is Michael's "default put," which allows him to pay less than a fixed dollar amount ($5,000) if revenues of the firm are below a certain threshold.

In Figure 3, we can see the leverage inherent in Michael's position. Joseph's position is purely a function of revenue, so it, like revenue, is simply a straight line from the origin. The same is true for the line called "Michael if 29.5% of revs"; this illustrates a hypothetical situation in which Michael's payoffs were simply (100% of revenue – 50% of revenue to ViewIT – 10% of revenue to Joseph – 10.5% of revenue to Larry) = 29.5% of revenue. This is what Michael would face if Larry's tier-I payments were simply 2% of revenues. (Based on the relative proportions of revenues we have used for the three tiers, getting 2% for tier I and 18% for tiers II and III would give Larry a weighted average of 10.5% of revenue.) However, since Larry's actual payoff curve is kinked, so is Michael's. Once Larry's steady state is reached (that is, once tier I revenues are sufficient to make Larry's payment $5,000 instead of 50% of revenue), Michael's actual payoff curve rises parallel with the 29.5% curve. (Before Larry reaches the steady state, of course, the reverse is true, and Michael is worse off. Michael really does not derive the benefit of leverage—the magnified payoffs at high revenues—since the "leverage" here is so minute.)

Figure 3: Michael's Residual Claim

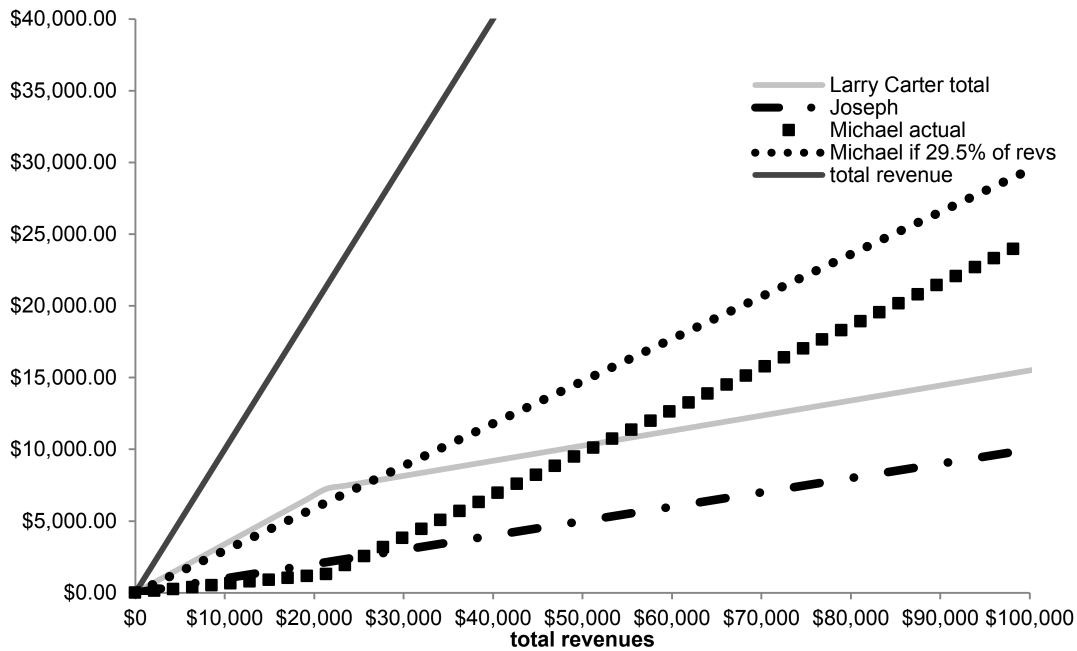


Figure 3 charts the implications of Pac.NW's leverage, and show that Michael's residual claim, shown by the kinked dotted line, rises more slowly at low levels of revenue, before Larry's "steady-state" is reached.

Thus, Larry's tier-I payment scheme introduces some leverage. However, as the correlation values given earlier attest, and as can be seen from Figure 3, there is really no leverage over the relevant range of income. Pac.NW essentially has neither operating nor financial leverage.

Question 3: Determine the value of the Pac.NW project to Michael, using his initial understanding of ViewIT's compensation (i.e., 50% of revenue, *not* 50% after ViewIT's costs).

Solution 3: To find the Pac.NW project's value to Michael, we must calculate the free cash flows to Michael attributable to the project. We will first determining these cash flows, then discount them at the cost of equity.

Detailed revenue and expense calculations are available from the author. Summary cash flows are presented in Table 8. Data for these tables comes from Tables 2 through 6 in the case.

Table 8: Value of Pac.NW to Michael

Year:	0	1	2	3	4	5
Revenue		$519,311	$869,766	$886,517	$902,609	$917,048
Operating Costs (50% of Revenue$_t$ to Viewit)		($259,656)	($434,883)	($443,258)	($451,304)	($458,524)
Operating Income		$259,656	$434,883	$443,258	$451,304	$458,524
Total Monthly Fees to Licensor		($95,056)	($143,351)	($145,917)	($146,396)	($147,503)
Total Annual Fees to Licensor (2% of Revenue$_{t-1}$)		$0	($8,861)	($14,622)	($14,851)	($30,464)
Fees to Venture Capitalist (10% of Revenue$_t$)		($51,931)	($86,977)	($88,652)	($90,261)	($91,705)
Income after Licensor and VC		$112,669	$195,694	$194,069	$199,796	$188,852
Capital Expenditures	($155,000)					
Horizon Value						$0
Total Free Cash Flow to Michael	($155,000)	$112,669	$195,694	$194,069	$199,796	$188,852
PV(Cf$_t$) At 13.88%	($155,000)	$98,937	$150,898	$131,405	$118,795	$98,602
Total PV	**$443,636**					
% Change in Revenue			67.48%	1.93%	1.82%	1.60%
% Change in Income after Licensor and VC			73.69%	-0.83%	2.95%	-5.48%
% Change in CF to Michael			73.69%	-0.83%	2.95%	-5.48%
Michael as % of Revenue		21.70%	22.50%	21.89%	22.14%	20.59%

This table provides summary cash flows and PV calculation for Michael. This table assumes a horizon value of $0 and a discount rate of 13.88%. Various summary percentages are shown at bottom.

We use a discount rate of 13.88% to discount Michael's cash flows. This was determined using the Capital Asset Pricing Model, assuming a beta of 1.2 (based on leverage-adjusted publicly traded comparables Expedia and Priceline), a risk-free rate of 4.28% (the contemporaneous 30-year Treasury bond rate), and a market risk premium of 8%. (Details on this calculation can be found in Livingston, 2013.) As Michael specified, business listings are priced at the average cost of the seven business lines (hotel/motel, B&B, etc.). The line costs stay constant throughout; these are found in Table 2 (e.g., $19.78 for hotel/motel listings). The number of listings for a particular month can be determined using Table 3. For example, for month 5 in tier II, there will be [(# of listings for month 4 in tier II)*(1 + growth rate from month 4 to month 5 for tier II)] = (2)*(1.15) = 2.3 listings. The average business listing cost is ($19.76 + $8.38 + $7.58 + $7.20 + $8.38 + $7.20 + $7.20)/7 = $9.38. Month 5's business listing revenue for tier II is therefore (2.3)*($9.38) = $21.59. Again, note that this is calculated *as if* there were only one business listing category instead of seven; this adjustment was specified by Michael, in the name of conservatism.

Students should recognize that there are ways other than Michael's to price the business listings. For example, by choosing to use a simple average of the rates charged for various towns, he is assuming that all destinations contribute equally to Pac.NW's revenue. However, listings for larger, more popular towns (like Lincoln City, Oregon) may have more listings than smaller towns. Michael could capture the relative contributions of the different destinations by using a weighted average price instead of the arithmetic average. However, this would add yet another level of estimation and potential error. Using the arithmetic average is also consistent with Michael's desire to be conservative in his analysis.

The calculation in Table 8, and in many of the sensitivity checks below, we assume a t=60 (year 5) horizon value of $0. This assumption obviously decreases our estimate of Pac.NW's value to Michael (assuming that he would not have to incur a cost to abandon the business). To properly value the business, however, we would need to address the question of what the firm would be worth after 5 years. There are two traditional approaches to estimating horizon values: discounted cash flow (DCF) models and multiples.

The simplest approach to DCF modeling is to assume the firm enters constant growth at year 5. We can then estimate horizon value as [FCF_5*(1+g)/(k_e - g), where FCF_5 is the cash flow to Michael at year 5, and g is the sustainable growth in that free cash flow (which starts at year 5). Given the values for growth of the various series shown in Table 8, we will use 1.5% as our g. Thus, we have horizon $value_{year\ 5}$ = [$188,852*(1.015)/(.1388 - .015)] = $1,548,342. (For some private firms, assuming infinite lives is problematic. However, given the passive nature of Pac.NW, we expect no issues with ownership transition that should cause such problems. See Damodaran, 2009.)

If we wanted to be more sophisticated, we could use a multi-stage model, allowing growth to stabilize later than year 5. (See, for example, CFA, 2007, Vol. 5.) However, given the stabilization of the series in Table 8 at "reasonable" (sustainable, given the growth in the overall economy) rates, this does not appear warranted.

For the multiple approach, we should have an idea about the multiples that are traditionally used in the relevant market. This is an especially salient point for internet businesses, which have often traded at huge multiples of traditional metrics. For example, as noted in the case, Pandora's IPO was priced at 12 times projected revenue. LinkedIn closed its first day of trading at 592 times earnings (Conway, 2011), after being priced at 16 times 2010 revenues and more than 100 times EBITDA (Jaffe, 2011). For these sorts of firms, analysts often resort to novel metrics instead (e.g., number of page views). (There is at least one unique measure used in the internet world: Groupon measures its success using a "profit-before-cost" measure, excluding its expenses for online marketing. This measure turns its loss into a profit, a "patina of profitability" that a *Wall Street Journal* analysis calls "bizarre." See Winkler, 2011.) However, since we have no information on what sorts of specific metrics would be appropriate for Pac.NW, we will resort to using the price/sales data for comparable firms. Choosing 2.5 (just a bit higher than Expedia's, a public comparable for Pac.NW, and much lower than the possibly "frothy" IPO values), we find a horizon value of [($917,048)*(1.015)*(2.5)] = $2,327,009. (We have assumed that revenues grow at 1.5%, as before, and have applied the multiple to year-6 sales. See Brealey, Myers, and Allen, 2011.) The problem with this method, however, is that this value applies to the entire firm, not just to Michael's interest. It is therefore not directly comparable to the $1,548,342 found above. We have used the latter value when using a horizon value.

Question 4: What are the most important drivers of Pac.NW's business?

Solution 4: Pac.NW's results are driven by display ad revenue. Display ads generate well over 90% of the expected revenue for the first 5 years. Of this, the "major" market ads are most important, accounting for half of total display ad revenue. The "leader" intensity ads dominate each market size; in aggregate, "leader" ads generate 58% of revenue. Tier I and tier II markets contribute about equally to major category revenues, except for the "leader" ads (where tier I is more important). Tier III markets contribute only to the "small" ad categories.

This revenue depends on two inputs: Michael's estimates of the number of ads in each category, and ViewIT's recommendations for the prices for each ad. These are the variables around which a sensitivity analysis must revolve, and these are the inputs Michael must estimate with exceptional care.

Given the extreme dependence of Pac.NW's results on display ad revenue, it is critical to appreciate the effect that changing ad prices or ad sales will have on Michael's results. Table 9 below shows the effect on Michael's total PV (the quantity initially calculated in question #3, $443,636, which assumes that horizon value is $0) from decreasing one display ad category's price by 10%. (If Michael's cash flow were perfectly positively correlated with revenue, there would be no difference between the with- and without-horizon cases. As it is, the with-horizon percentage changes in PV are slightly lower than the without-horizon PVs.) The top panel gives the revised PV, and the corresponding cell in the lower panel gives the percent change in PV. For example, changing the "leader"-intensity price in the major markets from $715 to $644 decreases PV by 5.21%, to $420,531. This is the largest effect from price changes in an individual ad category—which is not surprising, given that this category is the largest single contributor to ad revenue.

Table 9: Sensitivity Analysis

New Total PV for Michael with 10% Change in Monthly AD Price			
	Awareness	**Leader**	**Exposure**
Small	$441,519	$432,847	$439,114
Mid	$440,892	$431,128	$438,755
Major	$437,796	**$420,531**	$430,186
		% CHANGE IN TOTAL PV	
	Awareness	**Leader**	**Exposure**
Small	-0.48%	-2.43%	-1.02%
Mid	-0.62%	-2.82%	-1.10%
Major	-1.32%	**-5.21%**	-3.03%

This table gives the results of a sensitivity analysis assuming 10% decreases in prices of each category of display ads. Each cell in the upper panel gives the new PV to Michael after decreasing the price of the associated ad category by 10%. The corresponding cell in the lower panel translates that new PV into a percent change from the original.

A single category's price decrease does little to reduce Pac.NW's PV to Michael. But what if there were multiple price decreases? Table 10 below presents the results of several such scenarios.

Table 10: Scenario Analysis

CHANGE	NEW PV	% CHANGE IN PV
ad prices:		
all decline by 10%	$363,678	-18.02%
all major + small awareness = $0	**$197**	**-100%**
units:		
10% decline, tier I only	$362,641	-18.26%
10% decline, all tiers	$304,451	-31.37%
50% decline, all tiers	$190,752	-57.00%
price & units:		
all decline by 10%	$242,891	-45.25%

This table gives the results of a scenario analysis. The various scenarios are described in the leftmost column; the next two columns give the present value of Pac.MW to Michael under these scenarios and the percentage change in PV from the base case from Table 8. PV is strongly affected if both price and units decline by 10%. The second row shows one "break-even" scenario.

In the first two rows of results, we show the new PV and the percent change after decreasing multiple prices at once. The next three rows switch the focus to units, decreasing them while leaving ViewIT's estimated prices unchanged. Finally, the last row changes both inputs—both prices and units.

If all prices decrease by 10%, PV falls by 18%. This is approximately the same result we get if we decrease tier I's units by 10%. (The units were not uniformly decreased by 10%. Instead, for each ad category, we used the smaller of either a 10% decrease in units or a decline of one unit from the initial estimate: revised units = min{[initial units*(1-.10)], [initial units -1]}.) Thus, in some cases we decreased units by much more than 10%.

Thus, we see again that tier I is the most important of the website groupings. Decreasing the units for all tiers decreased PV by 31%; a 50% decline across all tiers cut PV by more than half. Decreasing both prices and units by 10% cut PV by 45%.

Finally, we see in the second row that PV falls essentially to $0 if we have no sales in all tiers for the "small awareness" category and in any major-market category. This is one of Pac.NW's break-even scenarios.

Question 5: Evaluate Michael's arrangement with his father, Joseph. Could Michael offer him a less "rich" deal and still offer Joseph a fair return?

Solution 5: We have already estimated Joseph's required return to be 13.88%. Given the cash flows that we expect Joseph to receive (shown in Table 8), we can find the following:

year:	0	1	2	3	4	5
cash flows to venture capitalist	($155,000)	$51,931	$86,977	$88,652	$90,261	$91,705
PV(CF_t) at 13.88%	($155,000)	$45,602	$67,067	$60,027	$53,667	$47,880
total PV	**$119,242**					
IRR =	39.77%					

Thus, even if Joseph's cash flows ended at year 5, he would be earning an extremely high return. (Of course, it still may be less than required if we have underestimated the systematic risk of the project.)

Thus, there does appear to be some room for renegotiation. There are several possible frameworks. For example, Michael could offer Joseph a bond-like payment stream of (13.88%)*($155,000) = $21,514/year for five years, plus a return of $155,000 principal at year 5. He also could offer to structure the payments like a perpetuity, offering Joseph (13.88%)*($155,000) = $21,514/year forever, with no return of principal. Michael could also suggest an equivalent annual payment. Assuming inflation is 2%/year, we would find Joseph's real required return as (1.1388)/(1.02) – 1 = 11.65%. The equivalent annual payment would then be found as $155,000/{(1/.1165)*[1-(1/1.1165)^5]} = $45,019/year. This real payment would be adjusted annually for inflation ($45,019 for year 1, $45,109*(1.02) for year 2, and so on; see Brealey, Myers, and Allen, 2011).

Each of these three approaches makes the present value of Joseph's investment $0—so that he is getting a fair economic return of 13.88%. Structuring the payments in any of these ways does not imply that Michael is substituting a debt claim for an equity claim; these payments would not be promised (or else they would not justify the 13.88% return). Instead, Joseph's claim could be seen more as a preferred equity stake, simply in terms of priority of payment (Joseph before Michael). (Given the amount of estimation here, we should not need to worry about any decrease in required return from this reconceptualization of Joseph's claim.)

Another approach Michael could take is to offer Joseph a lower percentage of the firm. The table below shows the cash flows after ViewIT and Larry are paid (these numbers come from Table 8). We have also included a terminal value here (using the DCF approach, as described and calculated in question #3). These cash flows have a present value of about $1.7M at 13.88%. Joseph's $155,000 contribution is about 9% of that value. Michael could therefore offer Joseph 9% of the equity of the firm. This is the type of approach that Michael decided to take. He and Joseph agreed that Joseph would get 10% of revenue until he had been paid a flat $400,000, which would reimburse him for the amounts he had lent Michael for the campus-area house and the Neweston house. After that, Joseph would get 5% of revenue.

year:	0	1	2	3	4	5
income after licensor	$0	$164,600	$282,671	$282,720	$290,057	$280,557
terminal value						$1,548,342
PV(CF_t) at 13.88%	$0	$144,538	$217,965	$191,432	$172,462	$954,888
total PV	**$1,681,285**					
VC contribution	$155,000					
VC %	9.22%					

Question 6: Given your analysis of Pac.NW's business model, how should Michael address ViewIT's revised proposal that it receive 50% of revenues *after its fees*?

Solution 6: In Michael's worst-case scenario, ViewIT would get 60% of revenue, as derived in the case. The table below recreates Table 8, assuming that ViewIT gets 60% of revenue instead of 50%. The PV falls dramatically, from $443,636 to $169,394 (a decline of almost 62%). Clearly, this arrangement would make the success of Pac.NW much more vulnerable to lower display ad sales.

Table 11: Value if ViewIT Receives 60% of Revenues

year:	**0**	**1**	**2**	**3**	**4**	**5**
Revenue		$519,311	$869,766	$886,517	$902,609	$917,048
operating costs (60% of revenue$_t$ to ViewIT)		($311,587)	($521,860)	($531,910)	($541,565)	($550,229)
operating income		$207,725	$347,906	$354,607	$361,044	$366,819
total monthly fees to licensor		($95,056)	($143,351)	($145,917)	($146,396)	($147,503)
total annual fees to licensor (2% of revenue$_{t-1}$)		$0	($8,861)	($14,622)	($14,851)	($30,464)
fees to venture capitalist (10% of revenue$_t$)		($51,931)	($86,977)	($88,652)	($90,261)	($91,705)
income after licensor and VC		$60,738	$108,718	$105,417	$109,536	$97,147
capital expenditures	($155,000)					
horizon value						$0
total free cash flow to Michael	($155,000)	$60,738	$108,718	$105,417	$109,536	$97,147
PV(CF_t) at 13.88%	($155,000)	$53,335	$83,831	$71,379	$65,128	$50,722
total PV	**$169,394**					
% change in revenue			67.48%	1.93%	1.82%	1.60%
% change in income after licensor and VC			78.99%	-3.04%	3.91%	-11.31%
% change in CF to Michael			78.99%	-3.04%	3.91%	-11.31%
Michael as % of revenue		11.70%	12.50%	11.89%	12.14%	10.59%

This table summarizes Michael's worst-case scenario with ViewIT, in which the content management firm receives 60% of revenues.

Michael has considered several ways to mitigate the risks of ViewIT's influence on his results. As mentioned in the case, one idea was to defer payment of 30% of the start-up costs, $46,500, for twelve months; presumably, this deferral would give Michael some leverage in case ViewIT was not performing up to expectations. (The *ability* to withhold any part of this payment was not made explicit in the case, however, and would need to be part of the revised contract with ViewIT.)

Another approach would be to proceed in stages, taking advantage of the "real option" to expand. If the first stage produced good enough results, Michael could choose to expand. If the results are not good, he could choose to abandon the project. Both of these options have value, and neither is considered in our initial analysis.

For example, assume that Michael chose to start only the tier I sites at t=0. The PV of this smaller project is $180,364, as shown below in Table 12:

This is less than half of the original value, which is not surprising: tier-I sites provide about half of the expected revenue, but the start-up costs fall by only $40,000 (26%), since only the marginal $20,000/tier is avoided.

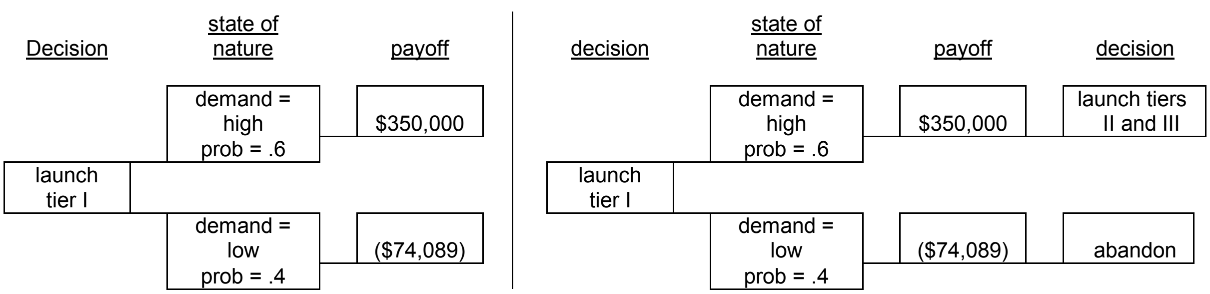
Now, consider that this PV is our expected value, given a 60% chance high demand and a 40% chance of low demand, with the associated payoffs shown in the left-hand panel below. (These probabilities and payoffs are just illustrations; there was not sufficient information in the case to make more informed estimates.) As shown in the right-hand panel, we can easily expand this simple decision tree to incorporate options, such as launching the other two tiers if initial response to tier I is positive, or abandoning the project if demand is poor. Although we do not have the information we would need to go farther with this type of analysis, students should nonetheless appreciate that Michael's decision is not all-or-none at t=0; they should be encouraged to consider what sorts of real options might exist in a project of this type.

Table 12: Revised Results Assuming Only Tier-I Sites Launched

year:	**0**	**1**	**2**	**3**	**4**	**5**
Revenue		$235,691	$406,704	$414,039	$422,629	$430,918
operating costs (50% of revenue$_t$ to ViewIT)		($117,846)	($203,352)	($207,020)	($211,314)	($215,459)
operating income		$117,846	$203,352	$207,020	$211,314	$215,459
total monthly fees to licensor		($44,004)	($60,000)	($60,000)	($60,000)	($60,000)
total annual fees to licensor (2% of revenue$_{t-1}$)		$0	($4,714)	($8,134)	($8,281)	($17,071)
fees to venture capitalist (10% of revenue$_t$)		($23,569)	($40,670)	($41,404)	($42,263)	($43,092)
income after licensor and VC		$50,273	$97,968	$97,482	$100,771	$95,296
capital expenditures	($115,000)					
horizon value						$0
total free cash flow to Michael	($115,000)	$50,273	$97,968	$97,482	$100,771	$95,296
PV(CF$_t$) at 13.88%	($115,000)	$44,145	$75,542	$66,006	$59,916	$49,755
total PV	**$180,364**					
% change in revenue			72.56%	1.80%	2.07%	1.96%
% change in income after licensor and VC			94.87%	-0.50%	3.37%	-5.43%
% change in CF to Michael			94.87%	-0.50%	3.37%	-5.43%
Michael as % of revenue		21.33%	24.09%	23.54%	23.84%	22.11%

This table outlines the results of Michael's choosing the option of starting only with his most valuable sites.

Figure 4: Considering Real Options



This figure presents a simple way to begin to visualize the real options inherent in Michael's project opportunity. For example, if demand for his service is high, he may choose to expand (a call option), whereas he may choose to abandon the project completely if demand is low (a put option).

Another approach to renegotiating with ViewIT is the one Michael actually took: renegotiate the percentage split. They agreed to launch all three sites, with no deferral of any start-up costs, but to split the revenue 55/45 instead of 60/40.

EPILOGUE

Michael was able successfully to negotiate revisions with both Joseph and ViewIT. As noted in the answer to question #5, Michael and Joseph agreed that Joseph would get 10% of revenue until he had been paid a flat $400,000, which would reimburse him for the amounts he had lent Michael for the campus-area house and the Neweston house. After that, Joseph would get 5% of revenue. As for

ViewIT—as just noted in the answer to question #6—they agreed to launch all three sites, with no deferral of any start-up costs, but to split the revenue 55/45 instead of 60/40.

Michael's newly revised *Washingtonwaterfronts.com* site went live in 2011.

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This case was written in close consultation with "Michael Powers," who was a coauthor on an early version of the case. Mr. Powers met numerous times with the case author, provided all cash-flow and other company-specific data for the case, and provided the updates about the ultimate outcome of both the "ViewIT" and "Joseph Powers" negotiations. Mr. Powers identified the comparable companies used in the IM, and identified critical aspects of the online marketing world which are highlighted in the case appendix. Data on the internet environment came from secondary sources, some of which were suggested by Mr. Powers.

BIOGRAPHY

Lynda S. Livingston is a professor of finance and the Nat S. and Marian W. Rogers Professor at the University of Puget Sound. She is also the founder of Four Horsemen Investments, a not-for-profit corporation focusing on finance education. She can be reached at the School of Business and Leadership, University of Puget Sound, 1500 North Warner #1032, Tacoma, WA 98416, llivingston@ups.edu.

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