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SAME SONG, SAME DANCE: EVIDENCE OF PATTERNS IN SECURITIES AND EXCHANGE COMMISSION FUNDING

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ABSTRACT

The actions of Congress and the Securities and Exchange Commission subsequent to a financial crisis appear to follow a predictable set of steps. Each tries to position itself to gain the resources it needs to survive by couching its actions in terms of legitimacy. One outcome is a predictable dance that culminates with the annual funding process. The events surrounding the financial collapse of Lehman Brothers and the resulting scrutiny of the Securities and Exchange Commission are hardly unique. In fact, they appear to be the predictable result of a period of boom and bust. These predictions are based on the historical behavior of politicians in funding the Commission. This paper uses an institutional theory perspective to examine the funding patterns in the wake of the collapse of Enron in 2001 and the global financial crisis precipitated by the collapse of Lehman Brothers in 2008. Implications for the Securities and Exchange Commission are provided.

JEL: M41, M48, M49

KEYWORDS: SEC, Institutional Theory, Regulation

INTRODUCTION

What experience and history teach is this-that people and governments never have learned anything from history, or acted on principles deduced from it. Hegel, (2004) Those who cannot remember the past are condemned to repeat it. Santayana (2011) A large Wall Street firm collapses. A post-bankruptcy investigation reveals the firm to be a house of cards. A public outcry threatens the very fabric of the accounting profession. Are these headlines from today's financial press? Hardly! The events being described occurred in the late 1930's. The collapse of the firm of McKesson, Robbins, Inc. sounds eerily familiar to those following recent financial headlines. The McKesson's collapse elicited a public outcry that placed the Securities and Exchange Commission (SEC) and the accounting profession under the spotlight of a Congressional investigation. In the end, however, the SEC emerged from the affair with renewed legitimacy.

Today's financial scandals have once again focused attention on SEC oversight. Congress and the public are outraged over events such as the bankruptcy of Lehman Brothers and the bailouts given to many large banks. What will be the result of the public outcry? Will the SEC survive or be replaced with another watchdog? While no one knows the ultimate outcome, lessons can be learned from historical events. This paper uses an institutional theory perspective to examine the budgetary interactions between the SEC and the Congress. The end result is hypothesized to be an outcome that has the SEC positioning itself in terms of taking steps to "improve" itself and hence, being able to do a better job at oversight of the financial industry. At the same time, politicians will attempt to garner favor from the voters since they have acted to protect the public from financial frauds. In short, the relationship among the parties is in reality a highly predictable set of behaviors that will allow all of the participants to demonstrate their legitimacy to their external constituents. The result will allow each party to secure future resources.

The remainder of this paper is organized as follows. The next section reviews work in the area of institutional theory, with specific applications to SEC behavior, shortly after its creation. Following the literature review, a discussion of SEC funding and how it adheres to the institutional theoretic framework is presented. The paper ends with some concluding comments about possible future behaviors on the part of both the SEC and those responsible for funding the agency.

LITERATURE REVIEW AND BACKGROUND

A basic premise of institutional theory is that an organization's survival requires it to conform to social norms of acceptable behavior. It follows that the better an organization is able to gain legitimacy in the eyes of its external funders, the more resources that it will secure. Tschopp, Wells and Barney (2011) state, "Unlike efficiency-based theories that focus on profit maximization and the interactions between markets and governments, Institutional Theory considers a wider network of variables that influence the decision making process." Eisenhardt (1988) found that institutional theory is applicable to complex, dynamic settings. A regulatory agency, such as the SEC does not operate in a vacuum. It must interact with its external constituents in order to survive. In this respect, specific organizational practices and structures may be displayed as symbols to external groups, in order to demonstrate that it is acting in a highly rational, stable and predictable manner. These legitimating activities takes place in order to gain support from external constituents, particularly in highly institutionalized settings, such as in agencies of the state (DiMaggio and Powell, 1983). Scott (2008) found that organizations are not passive actors and can respond to reshape institutional pressures. This result has been supported by authors, such as Phillips and Malhotra (2008) and Suddaby and Greenwood (2005), who have found that rhetoric plays a key role in creating, maintaining and repairing legitimacy.

Ritti and Silver (1986) specifically examined a regulatory agency's use of a predictable set of actions in its interactions with the industry it regulates. The resulting interactions between agency and funder allowed the regulatory agency to gain budgetary resources from its governmental funders, while the regulated entity submits to the regulation so that it may emerge as being "improved". Bealing (1994) and Bealing, et al. (2001) have quantitatively examined the applicability of the institutional perspective to the SEC. The results of these studies appear to bolster the idea that the SEC's behavior is consistent with an organization seeking to gain legitimacy from external constituents in order to gain resources.

Bealing, et al. (1996) specifically examined early SEC behaviors and found them to be consistent with the institutional perspective. Other authors, such as Meyer (2010), Drori, Meyer and Hwang (2006) and Drori, Meyer and Hwang (2009), have found that institutional rules may act as scripts defining the roles of actors with legitimate actions and purposes for particular social domains. That is to say, actor identities emerge in particular historical contexts. It is against this backdrop that the origins of the SEC will be examined. The call for strict federal regulation of the securities markets ebbs and flows with the times and appears to be somewhat predictable. During good economic times, there is little incentive for strict regulation. However, bad times bring renewed efforts at "protecting the investor". For instance, the Volstead Bill of 1919 and the Denison Bill of 1922 were designed to prevent the sale of fraudulent securities. Times were good and both measures failed to pass.

There were virtually no voices raised until after the debacle of 1929 to contest the virtues of participation in this best of all possible markets. As one writer pointed out, big business was not an object of distrust when the purchaser held its soaring stock. (de Bedts, 1964, p. 7). Contrast this to aftermath of the stock market crash of 1929. In a direct response to the crash, the Democratic party's 1932 platform called for the protection of the investing public. Shortly after his election, Democrat, Franklin Roosevelt, sent to

Congress a message urging passage of legislation that included the principle of “let the seller beware”. This message was accompanied by a bill that, after several modifications, eventually became the Securities Act of 1933 (Cherrington, 1942).

The Act of 1933 was to be administered by the Federal Trade Commission (FTC). However, nine months after its creation, the 1933 Act was soundly criticized by someone who eventually would become a future SEC Chairman. William O. Douglas called the Act a failure because, “it presupposes that the glaring light of publicity will give investors needed protection” (Karmel, 1982, p. 42). As it turned out, the Securities Division of the FTC only enforced the provisions of the Act between May 27, 1933 and September 4, 1934. On the later date, administrative responsibilities were transferred to the SEC, which was created by the Securities Exchange Act of 1934. This newly created agency faced many strong adversaries. President Roosevelt named Joseph P. Kennedy as the agency’s first Chairman.

The justification for this appointment was that Kennedy understood the questionable practices of the trade and could get the job done because he was a Wall Street operator. Kennedy’s objectives were to make the SEC acceptable to Wall Street and restore investor confidence in the capital markets (Karmel, 1982, p. 47). In the 1930’s, the firm of McKesson & Robbins, Inc. (McKesson) was acquired by F. Donald Coster. Coster, was the alias used by twice convicted swindler, Philip Musica. One of the first actions taken by Musica after the acquisition of McKesson was that of selecting auditors for the firm. He knew that in order to acquire financing for his planned “expansion”, the firm would need some credibility. Coster made several inquiries of various bankers and financial acquaintances as to the “finest auditors in the country”. He finally settled on Price, Waterhouse & Co. (PW) (Brief, 1982).

PW was widely recognized to be the largest public accounting firm in the United States and indeed, the world. In addition to its size, PW enjoyed one of the best reputations of all accounting firms. Several directors of MR referred to PW as, “the Blue Ribbon firm of America”, “they were tops”, and “I just took it that when you put Price, Waterhouse on the bottom of the statement, it was Sterling Silver and everything went”. (Brief, 1982). On December 6, 1938, the NYSE suspended trading of McKesson securities due to rumors that the firm would file for receivership. On December 8, 1938, McKesson became the first major corporation to enter reorganization under Chapter X of the Chandler Act . (Keats, 1982) The McKesson scandal made front-page headlines from coast to coast. There were six federal probes into the affair, one of which was undertaken by the SEC. The agency filed charges against several officers for violating Section 32 of the Securities Exchange Act of 1934: filing false financial information with the SEC. During the SEC investigation, it was determined that approximately $19,000,000 of the assets included in the 1937 financial statements audited by PW, were entirely fictitious. The fictitious items were comprised of approximately $10 million of non-existent inventory and $9 million of bogus accounts receivable. The SEC eventually concluded that the work of PW was deficient. The SEC stated,

While the appointment of Price, Waterhouse & Co. and the method of determining the scope of the engagement in this case was in accord with generally accepted practice, we do not feel that it insures to the auditor, in all cases, that degree of independence which we deem necessary for the protection of investors (Brief, 1982, p.5).

In response to the fact that the accounts receivable balance contained approximately $9 million of fictitious items, the Commission indicated that PW had conformed to generally accepted auditing procedures in effect at the time of the audit, even though confirmation of receivables was not carried out. With respect to the conduct of the audit of inventory, the SEC concluded that PW’s audit program basically conformed to generally accepted practice at the time of the audit. However, as a result of the hearings, several previously “optional” auditing procedures became required. The SEC now considered observation of inventory and confirmation of receivables to be part of generally accepted auditing standards. Both of these procedures had already been put into place by the accounting profession during the course of the McKesson investigation. The end result of the McKesson debacle was that the SEC severely reprimanded the accounting profession, but allowed the accounting profession to continue to determine appropriate auditing standards rather that have the Commission usurp this responsibility.

The SEC's ability to oversee the accounting profession was now beyond question. The accounting profession made mandatory, several previously optional auditing procedures. As a result, the profession was also able to proclaim itself as improved by virtue of its ability to conduct more thorough audits. The outcome was mutually beneficial to both the regulator and the regulatee.

Enron came into existence in 1986. It was the result of shareholders voting their approval for a name change by the Houston Natural Gas Corporation. Jeffrey Skilling would become the chief executive officer of Enron Corp. in 2001. Six months later, he would resign this position and have his responsibilities assumed by Kenneth Lay. In December of 2001, Enron would file for Chapter 11 bankruptcy bringing with it a massive public uproar. As a result of the public outcry over the bankruptcy of such a large public corporation, politicians seek to gain legitimacy in the eyes of their external constituents, the voters. Predictably, Congressional hearings into Enron's collapse (the WorldCom and Global Crossing debacles also took place during this time period) began less than two weeks after public disclosure of its bankruptcy filing and within six months, Congress had enacted H.R. 3763, the Sarbanes-Oxley Corporate Accountability Bill, widely referred to simply as the Sarbanes-Oxley Act of 2002.

Also predictably, the SEC engaged in its own legitimacy seeking behavior after the collapse of Enron. In March 2002, the SEC announced plans for completing reviews of auditor independence as well as establishment of controls over the "Final Four" accounting firms. It had effectively begun seeking legitimacy from its external funders (Congress) in order to justify the $776,000,000 of additional resources in fiscal year 2003 granted to it in conjunction with the Sarbanes-Oxley Act of 2002 (Law, 2002). One of the main ways the SEC can demonstrate legitimacy is by "getting tough" in its oversight of the accounting profession. A tough stance is seen by Congress as a legitimate response to the financial scandal. The SEC can expect additional resources to strengthen its oversight capabilities, while Congress (politicians) can expect to bank political capital by being seen by voters as funding efforts to protect the small investor. This scenario is very predictable and consistent with findings by Ritti and Silver (1986).

Discussion

In the wake of the perceived closer scrutiny of the Sarbanes-Oxley era, the SEC itself changed. Starting in 2004, the SEC began submitting its financial statements to the audit process. What better way for the agency that is responsible for the oversight of the financial industry to gain legitimacy than to submit to the same process it requires of all the publicly traded companies it oversees? According to William H. Donaldson, the Chairman of the SEC, Because we oversee the accounting and auditing profession, in order to avoid any perceived conflict of interest, the U.S. Securities and Exchange Commission (SEC) chose to have its financial statements audited by the U.S. Government Accountability Office (GAO). I am pleased to report that the GAO has affirmed that the SEC's financial statements were presented fairly in all material respects, in conformity with U.S. generally accepted accounting principles. This outcome is an impressive achievement considering that this was the first-ever audit of the SEC's financial statements. (SEC, 2004, p2) There was one slight problem. The SEC's auditor, the Governmental Accountability Office (GAO) has reported a material weakness existed in the SEC's system of internal controls. Hence, the GAO concluded,

"…SEC did not have effective internal control over financial reporting (including safeguarding of assets), but had effective control over compliance with laws and regulations that could have a material effect on the financial statements as of September 30, 2004…". (SEC, 2004, p105) For most of the public companies the SEC oversees, such a finding would prove devastating. Not so for the SEC. The agency was given lemons and it made lemonade. The agency stated it was, "…taking appropriate steps to begin to address all weaknesses that GAO and we have identified, including three material weaknesses in internal controls." (SEC, 2004) "It is quite an achievement for the SEC to receive an unqualified audit opinion on its financial statements as this is the first time the agency has prepared statements, a full PAR (Performance and Accountability Report), and undergone a financial statement audit." (SEC, 2004, p76) The SEC also revamped the format and title of its annual report beginning the very same year (2004). For fiscal years 2003 and prior, the document produced by the SEC was simply entitled, "Annual Report". Beginning in fiscal year 2004, the name changed to, "Performance and Accountability Report". The SEC began reporting more than twenty new "performance measures" in 2004. According to the agency,

Many of the measures presented in this report were derived from the SEC's "dashboards" initiative. These "dashboards" comprise a set of internally-generated indicators, which provide information regarding the SEC's timeliness in completing certain tasks, its changing priorities, and the scope and breadth of its activities. (SEC, 2004, p 54) In addition, the agency indicated that it had "improved". Its 2004 report states, The SEC has initiated efforts to improve its ability to "look over the hills and around the corners" for the next emerging problem by creating a new Commission-wide risk assessment and management program, featuring a new Office of Risk Assessment, as well as a new program of comprehensive risk identification throughout the agency. (SEC, 2004, p 3). The funding result for the SEC? "For FY 2004, the SEC received the authority to spend $811.5 million and maintain 3,550 full-time equivalents (FTEs) and 4,090 positions. These figures represent an 83 percent increase in dollars and a 21 percent increase in FTEs from FY 2001 levels." (SEC, 2004, p 12)

Funding levels rose approximately 13% again FY 2005. Not a bad outcome given investor outcry over the failures of companies such as Enron, WorldCom and Global Crossing. Politicians legitimate themselves by acting to "protect" investors by funding the watchdog agency. The SEC, even while admitting problems of its own, legitimates itself by undergoing a financial audit for the first time and touting itself as an improved agency. Between 2004 and 2007 the financial markets had stabilized, along with SEC funding levels. The S&P 500 index increased approximately 9%, 3%, 14% and 5% during this time period. Corresponding SEC funding levels for fiscal years 2005-2008 actually declined by approximately 3%, 2% and 3%. Apparently there is less need for Congress to take visible actions to "protect the investing public" when markets are rising.

But what became of the agency's promise to be able to "look over the hills and around the corners" for potential problems? It clearly did not foresee and prevent the financial crisis which occurred when the financial markets collapsed in 2008. What became of the SEC and its funding in the wake of the financial market meltdown? The music may have had a new beat to it, but it was the same old song and dance on the part of Congress and the SEC. Congress immediately responded by taking actions that demonstrated it was protecting investors. Probably the most prominent example of this was the introduction of "The Wall Street Reform and Consumer Protection Act of 2009". This legislation was later passed and signed into law by President Obama in 2010. It is most commonly referred to as the Dodd-Frank Act. This highly visible piece of legislation helped to legitimate politicians in the eyes of their constituents. As a result, lawmakers can be thought to be more likely to receive resources (votes) they need to win re-election. Notice the pattern? There is some sort of crisis in the financial markets. Congress then takes steps to legitimate itself in the eyes of its "funders", the voters, by passing Dodd-Frank. It return, the SEC can now say to Congress, we need more funding to do your bidding. In response to the calls of a few Congressional budget hawks to be fiscally responsible and cut the SEC budget, none other than Barney Frank who came to the defense of the SEC when he stated,

This is a serious threat to financial reform…What you get is a disproportionate assault on our ability to regulate the financial industries. (Wyatt, 2012)

Even President Obama got involved in the legitimation dance. Under fire for the lack of significant prosecutions related to the 2007-2009 financial and housing market meltdowns, he has supported adding about $55 million to the Justice Department's proposed budget to prosecute financial crimes.

In the aftermath of the financial market collapse in 2008, the SEC wasted no time in its attempt to legitimate itself in the eyes of both the public and its Congressional funders. None other than SEC Chairman, Christopher Cox paid homage to its Congressional funders and delivered the agency's case in the Message from the Chairman portion of the agency's 2008 performance report when he stated,

The mortgage meltdown and ensuing global credit crisis during the past year have confronted our markets with unprecedented challenges. The government's response to the financial turmoil has been equally unprecedented: the Federal Reserve and the Department of the Treasury have together committed over one trillion dollars in taxpayer funds to support insurance companies, banks, thrifts, investment banks, and mortgage giants Fannie Mae and Freddie Mac.

The Emergency Economic Stabilization Act (EESA) signed into law in October 2008, gives the Chairman of the SEC a formal oversight role with respect to the Troubled Asset Relief Plan administered by the Department of the Treasury. In addition, the Housing and Economic Recovery Act of 2008 gives the SEC Chairman similar oversight and advisory responsibilities with respect to the conservatorship of Fannie Mae and Freddie Mac supervised by the Federal Housing Finance Agency. These duties come in addition to the new responsibilities the SEC is already discharging as the statutory regulator of credit rating agencies, and the mandate that the EESA has given the agency to report by January 1, 2009, on the results of a congressionally-mandated study of fair value accounting. (SEC, 2008, p2) Later in the same message, Chairman Cox made the SEC's case when he said,

I told the Congress that when SEC regulation is backed up with statutory authority, it is strong and successful—and that voluntary regulation of businesses the SEC does not regulate by statute does not work. (SEC, 2008, p 4) Predictably, SEC funding levels increased in years following the crisis. They rose by 6% from the previous year in FY 2009 and soared by 22% FY 2010, largely due to provisions contained in the Dodd-Frank Act. SEC legitimating actions appear to be independent of its Chair. After Christopher Cox stepped down as SEC Chairman, he was replaced by Mary Schapiro. Chairwoman Schapiro was quick to point out that the agency needed even more resources in order to carry out the provisions of the Dodd-Frank Act, which was passed by Congress in response to a public outcry for more oversight of financial institutions. Confidence in the markets is important to economic growth and demands a strong investor protection agency. This additional funding will allow us to continue strengthening our enforcement and examination programs.

(Schapiro-contained in Doering and Lynch, 2012) There is one interesting fact about the budget of the SEC that makes the preceding "legitimation dance" all the more interesting. The agency has a long history of being a <u>net contributor</u> to the United States Treasury. In 2010, it collected $300 million more fees from the financial industry than it cost to run the SEC…the difference went into the Treasury (Wyatt). If funding of the SEC were merely a rational process, Congress would simply let the agency keep all the money it collects and bypass the budget appropriations process entirely. Under the present situation, cutting the SEC's budget has no effect on the deficit and wouldn't save any taxpayer money. It could, however, cost millions in terms of lost fees and penalties. Even the Dodd-Frank Act contained a provision that prevents the fees collected by the SEC from exceeding the amount budgeted to it! (Wyatt, 2012). In the world of governmental budgeting, appearance (legitimacy) is everything.

To demonstrate to external constituents that it is fulfilling its role as a public watchdog, the SEC appears to be focused on taking cases where it has a high probability of success. During the 2012 fiscal year, the SEC filed 734 cases and obtained 714 settlements. Out of the 15 cases it took to trial, it lost only two.

(Raymond, 2013) However, despite the SEC's claimed 85% success rate in trials during 2012, critics have said the commission's win rate has been poor when it comes to the financial crisis. The SEC's habit has been to allow defendants to settle cases without admitting or denying wrongdoing. This may be changing. In June, 2013, SEC Chair, Mary Jo White, said the agency is moving toward requiring defendants to admit liability. This increases the likelihood of a high profile trial and verdict. In July of 2013, one of the first high profile verdicts was handed down when a Goldman Sachs trader nicknamed "Fabulous Fab" Tourre was found liable in six of seven SEC fraud claims. (Hays, 2013) In a second highly visible case involving a "big fish", J.P. Morgan agreed to pay $920 million in penalties and admitted violating securities laws. This settlement was the result of the investigation into the so called "London Whale". While it may appear that the SEC has embarked on a new regulatory course, the agency may simply have put a new spin on an old regulatory style. One of the basic tenets of institutional theory states that both the regulator and the regulatee will engage in highly visible actions. The outcome of which will allow both parties to eventually emerge claiming they are "new and improved".

Thus both parties now have a legitimate claim to further resources. This is similar to Price Waterhouse's claim after the SEC got involved in the matter of McKesson & Robbins back in the 1930s. It is looking increasingly likely that it will be the same today. Specifically, there is a distinct possibility that the large fine against J.P. Morgan may lack any real bite. While J.P. Morgan engaged in a "pattern of misconduct" by maintaining poor internal controls, the fines may eventually be deemed to be tax deductible to the bank. This is because some fines and penalties may be "viewed as remedial (and thus deductible) rather than penal in nature." (Woods, 2013) Even the idea of not allowing defendants to "neither admit nor deny" any allegations against them may not be what it seems. In November 2013, JP Morgan reached a record $13 billion settlement with the government over, among other things, its packaging and reselling of mortgages to investors. According to Bloomberg,

The Justice Department wasn't about to go down that path when it unveiled its big, not-really-$13 billion deal this week… So the government made a few sly tweaks. The result is a mutant offspring of the no-admit genre that may be even less satisfying than the parent. JP Morgan didn't have to admit to any violations of the law. And here's the rub: The Justice Department didn't allege any, either. According to the settlement agreement, the bank will pay a civil penalty "pursuant to" a statute called the Financial Institutions Reform, Recovery and Enforcement Act. However, the Justice Department didn't lodge any claims against JP Morgan for breaking that law or any other. …The agreement did incorporate an 11-page statement of facts that explained in vague terms what JP Morgan did. Yet none of the acknowledgments by JP Morgan in that document hurt the bank. JP Morgan didn't admit liability or even any mistakes. That's no better than the old "neither admit nor deny" boilerplate. (Weil, 2014) And so it goes, the more things change, the more they stay the same. Different circumstances, different SEC chairman, but the same old song and dance.

CONCLUDING COMMENTS

Letting past history be our guide, several predictions can be made. Past response to financial scandal and Congressional hearings has been the passage of additional accounting standards or financial regulations. In the wake of the McKesson, Robbins affair, it became mandatory for auditors to observe inventory and confirm accounts receivable. The Moss, Metcalf, and Dingle hearings of the 1970s and '80s yielded similar outcomes. The Dingle hearings, which grew out of the collapse of the Savings & Loan industry, resulted in a package of accounting standards known as the response to the "Expectations Gap". The failures of Enron and WorldCom yielded the Sarbanes-Oxley Act which contained many provisions aimed directly at problems related to auditor independence and CEO responsibilities. In the aftermath of the failure of Lehman Brothers and the ensuing great recession, the Dodd-Frank Law was enacted. The pattern appears to be clear. During times of prosperity and a growing economy there is little incentive to upset the status quo…let the good times roll. However, during times of a perceived crisis, the various actors all assume their familiar positions on the dance floor of public perception and do the steps they know so well. Indeed, when it comes to the funding of the SEC, the music may sound different, but the beat is the same. During periods of good economic health, there is little in the way of regulatory oversight actions. During challenging economic times, the SEC will engage in symbolic actions which legitimize the agency in the eyes of its various constituent groups. At the same time, those organizations submitting to SEC oversight may claim that they have emerged from the process as being stronger and "improved". The result appears to be the same song, and the same dance.

This paper has used an institutional theoretic approach to analyze SEC funding patterns and behavior. Institutional theory was selected because several authors had previously applied it to explain the behavior of governmental regulatory agencies. Specifically, amounts allocated to the SEC during the federal budgetary process were identified and analyzed in light of SEC advocacy efforts. The result was a pattern that is consistent with the basic premise of institutional theory. That is, the SEC will try to legitimate its existence in the eyes of its external funders (Congress and the President) in order to obtain resources.
There are several limitations with respect to generalizability of results. First, only one agency, the SEC, was selected for analysis using one framework for analysis, institutional theory. As a result, the findings of this paper, while consistent with previous findings, may not be applicable to other settings. Second, there may be other theories which could be used to explain SEC funding patterns. To enhance the possible generalizability of this paper's results, future research is needed. Institutional theory could be used to analyze the funding patterns of other regulatory agencies.

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DOES INTERNET INFORMATION INFLUENCE FUND INVESTORS' PURCHASE INTENTION?

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ABSTRACT

The Internet is now one of the most popular channels for investors to acquire investment related information. It raises a question: Will Internet information richness increases mutual fund investors' perceived quality and decreases their perceived risk, which in turn influences investors' perceived value and purchase intention? This paper investigate the relationships between Internet information richness, perceived quality, perceived risk, perceived value, and purchase intention through a questionnaire format. Results of his study can provide a reference for Internet information providers and mutual fund investors. Limitations and suggestions for future research are also provided.

JEL: G1, M1, M5

KEYWORDS: Information Richness, Perceived Quality, Perceived Risk, Perceived Value, Purchase Intention

INTRODUCTION

The advancement in Internet technology has helped facilitate the acquisition of information. The Internet is now one of the most popular channels for investors to acquire information, because they can easily find a huge amount of investment-related material online. This raises a question: Does information richness increase mutual fund investors' perceived quality and decrease their perceived risk, which in turn influences investors' perceived value and purchase intention?

Most information richness studies have focused on communication media choices (Daft, Lengel, and Trevino, 1987; Lo and Lie, 2008), information security awareness (Shaw, Chen, Harris, and Huang, 2009), or determinants of the acceptance of virtual stores (Chen and Tan, 2004), with limited research targeting the relationship between Internet information and fund investor's purchase intention. Therefore, this paper investigates the relationships between Internet information richness, perceived quality, perceived risk, perceived value, and purchase intention through a questionnaire format. The study's results provide a reference for fund industry practitioners, Internet information providers, and mutual fund investors.

The rest of this paper is organized as follows. Section 2 reviews previous research on information richness, perceived quality, perceived risk, perceived value, and purchase intention. Section 3 describes the data and method we employ. Section 4 reports the empirical results, and section 5 concludes the paper.

LITERATURE REVIEW

Lengel (1983) first proposed the concept of information richness. Daft and Lengel (1984) then defined information richness as "the ability of information to change understanding within a time interval". If uncertainty and equivocality can be reduced in a timely manner, then it means high information richness. On the contrary, low information richness implies the receiver's understanding changes more slowly. Information richness is also defined as the amount of information that can be conveyed through a communication medium (Lo and Lie, 2008). Daft, Lengel, and Trevino (1987) used a four-dimensional scale to measure information richness: speed of feedback, multiple cues, language variety, and social-emotional cues.

Perceived quality is the consumer's judgment about a product's overall excellence and superiority, not the actual quality of a product (Zeithaml, 1988; Aaker, 1991). Consumers often judge the product quality via a variety of informational cues. They form their beliefs on the basis of these informational cues (intrinsic and extrinsic), and then they judge the quality of a product and make their final purchase decision based upon these beliefs (Olson, 1977). Petrick (2002) developed a four-dimensional scale to measure the perceived quality of a product: consistency, reliability, dependability, and superiority.

Bauer (1960) first proposed perceived risk to include two dimensions: uncertainty and adverse consequences. Dowling and Staelin (1994) defined risk as a consumer's perceptions of the uncertainty and adverse consequences of engaging in an activity. Perceived risk was also defined as the unfavorable outcomes related to a product or service (Engel, Blackwell and Miniard, 1995), the subjective perception of possibility and severity of a wrong purchase (Sinha and Batra, 1999), or the uncertainty a consumer perceives about the outcome of his or her purchase (Hoyer and Macinnis, 2010). Jacoby and Kaplan (1972) defined perceived risk to include five components: financial, performance, social, psychological, and physical risk. Peter and Tarpey (1975), and Murray and Schlacter (1990) expanded the components to include time risk.

Perceived value represent a trade-off between buyers' perceptions of quality and sacrifice, and it is positive when perceptions of quality are greater than the perceptions of sacrifice (Monroe and Dodds, 1985). Zeithaml (1988) defined perceived value as "the consumer's overall assessment of the utility of a product, based on perceptions of what is received (e.g., quality, satisfaction) and what is given (price, nonmonetary costs)". Perceived value has been argued to be the most important indicator to forecast purchase intentions and has been viewed as one of the most important measures for gaining a competitive advantage (Zeithaml, 1988; Dodds et al., 1991; Cronin et al., 2000).

Purchase intention is the likelihood that a customer will buy a particular product (Fishbein and Ajzen, 1975; Dodds et al., 1991; Schiffman and Kanuk, 2000). A greater willingness to buy a product means the probability to buy it is higher, but not necessarily to actually buy it. On the contrary, a lower willingness does not mean an absolute impossibility to buy. Bagozzi and Burnkrant (1979) defined purchase intention as personal behavioral tendency to a particular product. Spears and Singh (2004) defined purchase intention as "an individual's conscious plan to make an effort to purchase a brand". Purchase intention is determined by a consumer's perceived benefit and value (Xu, Summers, and Bonnie, 2004; Dodds et al., 1991; Zeithaml, 1988).

Information richness is higher when uncertainty and ambiguity can be reduced in a timely manner (Daft and Lengel, 1984), or when more information can be conveyed within a time interval (Lo and Lie, 2008). In other words, when information richness is high, uncertainty and ambiguity can be reduced more, and thus a consumer's perception about risk will be lower. Moreover, when information can be conveyed in a greater amount and more rapidly, then investors' judgement about Internet information's overall excellence and superiority and their overall assessment of the utility of Internet information will also be higher - that is, their perception about the quality and value of Internet information will be higher. Results from Dowling and Stealin (1994) indicate that perceived risk increases when information that consumers possess is less complete. Kim and Lennon (2000) also found that the amount of information perceived by consumers is negatively related to their perceived risk and positively related to their perceived value. Accordingly, we note the following hypotheses.

H1: Internet information richness has a significantly positive impact on investors' perceived quality.
H2: Internet information richness has a significantly positive impact on investors' perceived value.
H3: Internet information richness has a significantly negative impact on investors' perceived risk.

Monroe & Krishnan (1985), Zeithaml (1988), Dodds et al. (1991), and Petrick (2004) stated that a higher perception of quality improves consumers' perceived value and then strengthens their purchase intention. Sweeney, Soutar & Johnson (1999) and Snoj, Korda & Mumel (2004) showed that perceived risk plays an important role in the perceived quality-perceived value nexus. Faroughian, Kalafatis, Ledden, Samouel, & Tsogas (2012) found perceived risk has a significant impact on perceived value. Chen & Chang (2012) and Beneke, Flynn, Greig, & Mukaiwa (2013) also proved that perceived risk is negatively influenced by perceived quality. Many scholars have considered that perceived value is relevant to the emotional responses and consumption experiences of consumers, which can further influence their purchase behavior (Dumana & Mattil, 2005; Petrick, 2004; Sweeney & Soutar, 2001). When other things remain unchanged, purchase intention is positively related to perceived value (Beneke, Flynn, Greig, & Mukaiwa, 2013; Della, Monroe & McGinnis, 1981; Zeithaml, 1988; Chen & Chang, 2012; Tih & Lee, 2013; Yee & San, 2011). Accordingly, we propose the following hypotheses.

H4: Perceived quality has a significantly positive impact on investors' perceived value.
H5: Perceived quality has a significantly negative impact on investors' perceived risk.
H6: Perceived risk has a significantly negative impact on investors' perceived value.
H7: Perceived value has a significantly positive impact on investors' purchase intention.

DATA AND METHODS

According to the research framework, we design the items of the questionnaire for the five dimensions: information richness, perceived quality, perceived risk, perceived value, and purchase intention. These items are measured on Likert's seven-point scale, ranging from 1 point to 7 points, denoting "strongly disagree", "disagree", "a little disagree", "neutral", "a little agree", "agree", and "strongly agree", respectively.

Using random sampling, we administered the questionnaires to investors living in Taiwan from March 1, 2013 to June 1, 2013. A total of 550 responses were distributed, and 500 usable responses were collected, for an acceptable response rate of 90.91%. We perform data analyses on SPSS 19.0 and AMOS 20.0, with the adopted methods including descriptive statistics analysis, reliability and validity analysis, correlation analysis, and structural equation modeling (SEM) analysis.

The gauging scales are selected from the literature. Information richness is gauged by 4 items taken from Daft, Lengel, and Trevino (1987) and Lo and Lie (2008). Perceived quality is measured by 5 items taken from Petrick (2002). Perceived risk is measured by 5 items by means of Dowling and Staelin (1994), Sinha and Batra (1999), and Hoyer and Macinnis (2010). Perceived value is gauged by 3 items taken from Monroe and Dodds (1985). Purchase intention is gauged by 3 items taken from Zeithaml (1988) and Dodds et al. (1991).

ANALYSES AND RESULTS

Through descriptive statistics analysis in Table 1, we found that the basic attributes of major group are female (54.0%), unmarried (72.8%), 21-30 years old (63.8%), university education level (72.0%), monthly income below NT$40,000 (87.0%), and students (39.6%).

As presented in Table 2, all the dimensions have a Cronbach's α greater than 0.7, which complies with the criterion proposed by Nunnally (1978) and Wortzel (1979). Hence, the reliability coefficient (Cronbach's α) of the questionnaire is within the acceptable level. Factor analysis is also taken as a tool to verify the convergent validity of the questionnaire. This study adopts principal component analysis and uses the Varimax to maximize the sum of the variance of the loading factors. We extract factors with an eigenvalue greater than 1, a cumulative explained variation greater than 50%, and a factor loading greater than 0.5 (Kaiser, 1958). According to the results in Table 2, the questionnaire has convergent validity. In addition, it has content validity, because our scale and item contents are constructed according to the literature review and passed the questionnaire pre-test. The questionnaire also has discriminant validity, because the correlation coefficient of each of the two factors in Table 3 is lower than the Cronbach's α of each dimension.

Table 1: Descriptive Statistics Analysis of Sample

	Items	No. of respondents	Percent (%)
Gender	Male	230	46.0
	Female	270	54.0
Marital status	Unmarried	364	72.8
	Married	136	27.2
Age group	Younger than 20 years old	29	5.8
	21-30 years old	319	63.8
	31-40 years old	82	16.4
	41-50 years old	44	8.8
	Older than 50 years old	26	5.2
Education level	Junior high school	17	3.4
	Senior high school	60	12.0
	University	360	72.0
	Graduate school	63	12.6
Occupation	Service industry	117	23.4
	Financial industry	33	6.6
	Information technology	33	6.6
	Manufacturing industry	29	5.8
	Public servants & teachers	28	5.6
	Students	198	39.6
	Others	62	12.4
Monthly income	Below 20,000	223	44.6
	20,001-40,000	212	42.4
	40,001-60,000	50	10.0
	60,001-80,000	10	2.0
	More than 14,000	5	1.0

This table shows descriptive statistics analysis of the sample. The first two columns represent demographic variables and their items considered in this research. The third and fourth column reports the number of respondents and its corresponding percent, respectively.

This section conducts structural equation modeling (SEM) analysis to test the fit of the factors (dimensions) of Internet information, perceived risk, perceived quality, perceived value, and purchase intention. For a model with good fit, GFI (goodness of fit) should greater than 0.8 (Browne and Cudeck, 1993). AGFI (adjusted goodness of fit) should be greater than 0.8, and CFI (comparative fit index) should be greater than 0.9 (Doll, Xia, Torkzadeh, 1994; Hair et al., 2009; Gefen et al., 2000). RMSEA (root mean square error of approximation) should be under 0.08 (Brown and Cudeck, 1993), and the ratio of the chi-square value to degrees of freedom ($\frac{x^2}{df}$) should be no greater than 5 (Wheaton et al., 1977). The goodness-of-fit indices of the model are as follows: GFI is 0.882, AGFI is 0.848, CFI is 0.907, RMSEA is 0.078, and $\frac{x^2}{df}$ is 4.007. All these indices are within the acceptable range, meaning that the overall model fitness is good.

Figure 2 presents the path analyses from SEM. According to the estimated values of the standardized parameters of the relationship model in Figure 2, we find that Internet information has a significantly positive influence on perceived quality (H1 is supported), perceived value (H2 is supported), and perceived risk (H3 is not supported). With regard to the influence of perceived quality on perceived value and perceived risk, we find that perceived quality has a significantly positive influence on perceived value (H4 is supported) and has a significantly negative impact on perceived risk (H5 is supported). Besides, perceived risk also has a significantly negative impact on perceived value (H6 is supported). Finally, perceived value has a significantly positive effect on purchase intention.

Table 2: Reliability and Validity Analysis

Dimension		Factor loading	Eigen value	Explained variance	Cronbach's α
Internet information	IN1	0.684	2.535	63.381%	0.801
	IN2	0.807			
	IN3	0.797			
	IN5	0.591			
Perceived quality	QU1	0.847	3.547	70.933%	0.895
	QU2	0.891			
	QU3	0.811			
	QU5	0.676			
	QU6	0.759			
Perceived risk	PR1	0.513	3.131	62.613%	0.848
	PR2	0.787			
	PR3	0.888			
	PR4	0.803			
	PR6	0.646			
Perceived value	PV1	0.510	1.902	63.392%	0.708
	PV2	0.751			
	PV3	0.739			
Purchase intention	PI1	0.637	2.253	75.094%	0.830
	PI3	0.889			
	PI4	0.859			

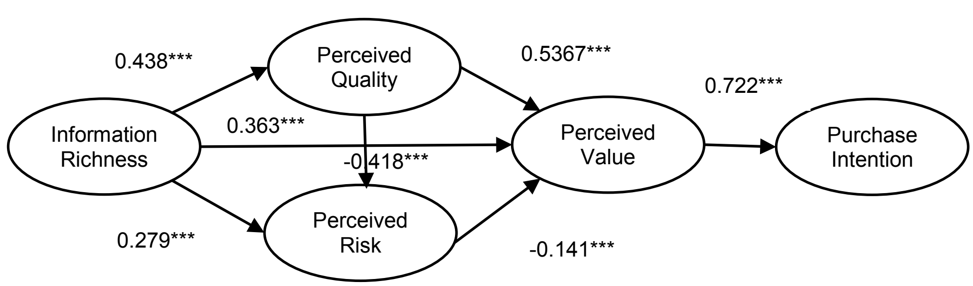
This table shows reliability and validity analysis. Explained variance represents cumulative explained variation by each factor. Cronbach's α represents the reliability coefficient in each factor.

Table 3. Correlation Analysis

Dimensions	**Information richness**	**Perceived quality**	**Perceived risk**	**Perceived value**	**Purchase intention**
Information richness	1				
Perceived quality	0.412***((0.000)	1			
Perceived risk	0.046(0.307)	-0.281***(0.000)	1		
Perceived value	0.508***(0.000)	0.582***(0.000)	-0.147***(0.001)	1	
Purchase intention	0.378***(0.000)	0.467***(0.000)	-0.175***(0.000)	0.579***(0.000)	1

*This table presents the correlation analysis. The figures on the non-diagonal represent Pearson correlation coefficient between two factors. The figures in parentheses represent p-value. ***, **, and * indicate significance at the 1, 5 and 10 percent levels respectively.*

Figure 2: Path analysis from SEM



CONCLUSIONS

The Internet is now one of the most popular channels for investors to acquire investment-related information. This raises a question: Does Internet information richness increase mutual fund investors' perceived quality and decrease their perceived risk, which in turn influences investors' perceived value and purchase intention? Therefore, this paper investigates the relationships between Internet information richness, perceived quality, perceived risk, perceived value, and purchase intention through a questionnaire format.

Using random sampling, we administered the questionnaires to investors living in Taiwan from March 1, 2013 to June 1, 2013. A total of 550 responses were distributed, and 500 usable responses were collected, for an acceptable response rate of 90.91%. We perform data analyses on SPSS 19.0 and AMOS 20.0 with the adopted methods including descriptive statistics analysis, reliability and validity analysis, correlation analysis, and structural equation modeling (SEM) analysis.

The research findings herein show that Internet information richness can improve fund investors' perceived value directly and indirectly, but the indirect effect of Internet information on perceived value is mainly via perceived quality, not via perceived risk. Perceived quality can also increase investors' perceived value directly and indirectly via perceived risk. Finally, perceived value has a significantly positive impact on investors' purchase intention.

Therefore, we suggest that Internet information providers should devote more efforts to increasing investors' perceived quality in order to enhance their perceived value, which in turn increases their purchase intention. Internet information providers can further strengthen the consistency, reliability, dependability, and superiority of the information they provide.

The primary limitation of this study is that we only considered perceived quality, perceived risk, and perceived value. There are still other determinants of the purchase intention of mutual funds. Future research can include these other variables in more comprehensive models that have possibly higher explanatory power.

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"THE YOUNG AND THE RESTLESS": GRAPPLING WITH THE YOUNG CHINESE CONSUMER MINDSET

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ABSTRACT

China will boast a population of almost 500-million young people under age 30 by 2015. The sheer size of the Chinese youth market and young people's discretionary income make this market one of the most sought-after in the world. The status and continuing development of Chinese youth culture is especially interesting to marketers and scholars worldwide. Recent media reports depict Chinese youth as "restless" and as experiencing an internal psychological conflict between "private selves" and "public selves," between "private identity" and "public identity"(Griffiths, 2012). Few studies have provided analysis of the causes of this seemingly "bi-polar" psychological state. The paper explores this situation by delving into the "core" values of Chinese tradition in the context of China's contemporary socioeconomic realities—focusing on the paradoxical, conflicting, and even opposing cultural values that are rooted in China's past and present. Among the dilemmas are "standing out and fitting in," "individual freedom and society's demands," and *"soaring aspirations and limited opportunities." This paper demonstrates that the "restlessness" of contemporary Chinese youth is the logical results of feeling trapped and directionless at the seismic boundaries between the culture's unshakable Confucian values and group orientation, and the ever-shifting trends in individual consumerism that China is embracing.*

JEL: M31, M37, M38

KEYWORDS: China, Advertising, Global Marketing, Youth Culture

INTRODUCTION

The past three decades in China have witnessed the most rapid changes in society and the most drastic adjustments in China's social structure. Consumption has become one driving force behind the country's economic development. Having been banned for almost three decades, Chinese commercial advertising was resumed in the wake of the country's economic reforms that started in late 1978. Since the ideological debates in the early 1980s on the "shoulds" and "should nots" in the so-called Chinese "socialist commercial advertising" advocated by the Chinese government, the advertising industry in China has grown to become the world's second largest after the United States, in terms of ad spending. With the changes in societal values, Chinese masses, especially young people, follow their own paths to pursue their dreams of happiness and success in different fields, from business to sports, from fashion design to entertainment, investing new meanings in their sense of self. Collectively, they have ushered in a multifaceted new Chinese identity. In taking on this new identity, Chinese youth perhaps are one of the most interesting groups, in terms of their cultural characteristics and their social, economic, and political impact on Chinese society. The significance of the impact of Chinese youth culture on society is multidimensional, but most prominently seen in the following three areas: First is the vibrant Chinese youth market. According to the report, China will boast a population of almost 500-million people under age 30 by 2015 (Bergstrom, 2012). Currently, in the explosive growth of consumption, the 400-million-plus Chinese young people who were born after the 1980s and 1990s have stood out as targeted groups for global marketers. Approximately a third of these young people are urban and are from households with relatively high income.

<u>The Rise of Chinese Youth Culture</u>

The "one-child policy" enforced by the Chinese government in 1979 has resulted in a situation in which the only-child in the family, nicknamed "little emperor," or *xiao huangdi* in Chinese, has become the focus of family spending. The sheer size of the Chinese youth market and young people's discretionary income makes this market one of the most sought-after in the world. Second is the complexity of the Chinese youth culture. Penetrating the gigantic Chinese youth market requires deep understanding of the youth culture. The first generations of Chinese young people have experienced the country's unprecedented economic boom, open markets, and capitalism (with "Chinese characteristics"). Similar to young people in Japan, the United States, and other Westernized societies, these Chinese young people grew up drinking Coca-Cola, listening to Rock and Roll, watching Hollywood movies, and wearing blue jeans. In other words, to many people, present-day Chinese youth are "Westernized." But close studies reveal there is no easy equation between the Chinese youth culture and that in other countries influenced by Western cultures. Chinese young people may look and act like their contemporaries in other Western-influenced consumer societies, and share certain cultural values. The paper will show later that Chinese youth, at heart, are still *Chinese*. Featured by interactions between Western ideals and native cultural origins, Chinese youth culture provides insights for understanding trends in the global youth culture. This young Chinese market demographic is exerting, and will continue to exert a powerful influence in shaping global business and marketing strategies in the foreseeable future.

The third area of impact is the Chinese youth workforce. In 2010, nearly 30 percent of the 550-million industrial workers in China were under age 30 (Moore, 2011). The size of the Chinese youth workforce is affecting Chinese society as a whole and shaping the direction of China's economic development. Currently, China has about 150-million migrant workers. Among them, an estimated 100-million-plus were born after 1980 (Cingcade, 2008). They build China's glittering skylines, highways and fast-speed train railway, serve at restaurants, hotels, and clubs visited by the newly rich and international travelers, and make fashions and sports-ware products sold around the world.

Chinese youth's contributions to the country's economy are far beyond the construction and the service sectors. It is well known that the Chinese youth population is savvy in technology. In 2005, then Chinese Premier Wen Jiabao announced a new and far-reaching strategy by the Chinese government in building a "comprehensive national strength" to identify technological innovation as the nation's top priority. Afterwards, Internet users in China increased from 33.7 million to 513 million at the beginning of 2012. Among them, 256 million were young people (Bergstrom, 2012). Being the main labor force in science and technology, Chinese youth have become the pillar of China's high-tech industry, information networks and e-commence, and other cutting-edge economic domains, thus playing a more and more important role in China's social and economic advancement.

The present study intends to facilitate further understanding of Chinese youth culture. Following this introduction, the paper will provide a literature review of existing scholarship, highlighting the main characteristics of Chinese youth culture. Then the paper will closely examine the mindset of contemporary Chinese youth in the complex interplay between the persisting values of Chinese tradition and the realities of a society going through rapid changes. Finally, the paper will conclude with a summary of the causes of the restless mindset of the young Chinese consumer. The concluding statements also will discuss the limitations of the present paper and ideas for future research on this important subject.

LITERATURE REVIEW

The emerging Chinese youth culture has drawn studies by scholars and business professionals both in China and abroad. To date, studies on Chinese youth mainly focus on examining Chinese youth's cultural characteristics. The research method, in general, is data analysis based on observations by the researchers, and on responses to the surveys conducted by the researchers. It has been noted that the market economy introduced by China's economic reform in the late 1970s has brought about awareness of the material benefits and economic gains among Chinese consumers. Western commercial ideas, such as individuality, luxury, freedom of choice of products, success, and modernity, have replaced Communist ideology. Similar to the young people in societies influenced by Western consumerism, present-day Chinese youth are generally characterized as being "open,' "free," and "individual" (Guo, 2006, Rosenthal and Feldman, 1992). A survey by the Gallup Organization confirms this trend.

The Gallup survey shows that over the past decades, Chinese people have displayed changing tastes and wants: an increasing number of Chinese say that their personal goals have shifted. Goals that involve "a taste of life," "self-satisfaction," and "self-expression" have more than doubled in the past decades (William McEwen, et al. 2006). More recent studies suggest that this trend continues. The World Value Survey conducted by Jiaming Sun and Xun Wang reveals the younger generations in China have shifted "from traditional values to modern values in a recent social transformation." The responses to the survey show that among the younger generations born after the 1980s, 40.98 percent rate "self-development" as the most important value in life, and 54.5 percent rate "individualistic values" as the most important. On the other hand, among the older generations born before and during the 1950s, the percentage is only 14.83 percent and 21.7 percent, respectively (Sun and Wang, 2010).

Kindled by the increasingly affluent material world, Chinese youth have turned from being ideology-oriented to being practical, and from valuing spiritual fulfillment to valuing material gains. This is evidenced by the data shown in the Sun and Wang study: "materialist values" in China rank the highest (51 points on a scale of 100) of any country in the world (The United States: 16; Japan: 29; Britain: 20; India: 40; and South Korea: 46) (Sun and Wang, 2010). Chinese young people want to live their lives according to their own ideas and dare to pursue success, excellence, and material wealth. According to Yan Wang, Chinese youth's salient self-value orientation, practical behaviors, and independence are the results of the realities in contemporary Chinese society. Mobility and changeability, guided by the market economic mechanism require youth constantly make adjustments in order to adapt to social changes. The one-child policy greatly increases the sense of self-direction and independence among contemporary Chinese youth (Wang, 2006).

Research by business professionals examines Chinese young consumers' consumption behaviors. Chinese young people have stood out as a group targeted by global marketers for their excessive spending. The post-1980s generations are typically trend-conscious, impulsive, and relatively wealthy. Many youngsters shop to explore sensations of consumption (*xunzhao xiaoshou ganjue*). Their purchase decision is based on how much they like the product (*wo xihuan de, jiu shi hao de*), rather than on how much they need it (Doctoroff, 2005). In 2012, China overtook Japan to become the world's largest consumer of luxury goods. What merits attention is that, compared with Japan and the United States, Chinese consumers of luxury goods are younger—the majority are aged twenty-five to forty. According to the consulting firm McKinsey & Company, 80 percent of Chinese luxury goods buyers are under 45, compared with 30 percent of luxury goods buyers in the United States and 19 percent in Japan ("China Still Has an Appetite for Luxury Goods," 2009).

Some studies have called attention to the multidimensional nature in Chinese youth culture. Tom Doctoroff alerts global marketers that Chinese college students seek brands that will help them say "I am unique" without making them look weird or socially unacceptable (Doctoroff, 2012). Seeking to belong, as a value among Chinese young people, has been noted by John Solomon of Enovate, a consumer insights and design firm. According to Solomon, China's "one-child" makes decisions based on a sense of belonging and social acceptance while seeking individuality from their peers ("Branding China Youth: Uncovering Vital Trends Among Emerging Chinese Consumers," 2013).

Others point out that this tendency to seek acceptance explains Chinese young people's fanaticism in joining clubs and online shopping. Cultural clubs have mushroomed in today's China. Music clubs are popular in China's first- and second-tier cities. However, according to Jian Wang, most Chinese youth see music first as an entertainment rather than as a channel for serious self-expression. Young people use clubs as a networking venue where they party for fun and for a quick build-up of human capital (Wang, 2005). Online shopping is another new phenomenon in present-day Chinese consumer culture, with about 300-million new shopping choices online. For Chinese youth, exploring the online marketplace goes beyond the practical need to cut through the clutter in making purchase decisions. Online shopping is an emotional need to fit in and feel that one's choices connect one to the right group of people, even as one tries to stand out with a style of his/her own. For young consumers in China, "the starting point for shopping is shifting from advertising, brands, and retailers … to people" (Caplan and Yu, 2012).

A number of studies show that despite the value changes in China, there is a persistent emphasis on family as a prevalent value in Chinese society. Xi and Xia have observed that the group-orientation is rooted in Chinese young people's value for family and country. The results in their survey show that while Chinese youth aspire toward "independence" and "individualism," 35 percent of respondents name their parents, rather than cool celebrities, as their "idols." Other young participants in the survey say that their life goals are to "contribute to the country" and to have "a happy and harmonious family" and a "successful career" (Xi and Xia, 2006). In addition to studies on Chinese youth's cultural behaviors, other research explores the psychological conditions of Chinese young people. The documentary film, *Young and Restless in China: Nine Stories*, profiles a group of young individuals from diverse backgrounds. The film tells stories of those individuals, showing mixed desires, opportunities, and courage, on the one hand, and anxiety, hopelessness, making sacrifices for their families, on the other hand (Cingcade, 2008). One readily discernable anxiety among Chinese young people is the burden of taking care of aging elderlies, as China is aging rapidly (Xi and Xia, 2006).

In conclusion, scholars seem to agree that Chinese youth culture has undergone an evolution from being inconspicuous on the margin to being at the center, from being an incidental phenomenon to becoming the primary outlook on values and the nucleus of culture, and from being a group sub-culture to being a social mainstream culture (Xi and Xia, 2006). Therefore, one cannot overestimate the importance of understanding the trends in Chinese youth culture.

A Shift in Chinese Cultural Values

As displayed in the research summarized in the "literature review" section, China has experienced a shift in its cultural values, especially among Chinese youth. A 2008 survey conducted by a group of business professors, headed by King-Metters and Metters, shows significant changes in the degree to which individuals are integrated into groups, as compared with the findings of the study of different cultures conducted by Geert Hofstede some twenty-five years before. Hofstede's research showed Chinese cultures were very collectivist in the 1980s, while the later survey by King-Metters and Metters indicates that China today is very individualist (King-Metters and Metters, 2008). This pendulum swing in Chinese cultural values, from emphasis on collectivism to individualism, is because of China's "one-child policy" and the economic reforms simultaneously introduced by the Chinese government in the late 1970s. As a step toward population control, the Chinese government enforced a policy limiting families to one child per family. This "one-child policy" has resulted in the situation in which the only-child has become the focus of family spending. The little emperors grew up to become the first generation of consumers in China's market economy following the country's economic reforms. The book *Advertising to Children in China* begins with a vivid description of the shopping behavior of contemporary Chinese "little emperors" portrayed in a drawing by a nine-year-old when he is asked to draw what comes to his mind when he thinks about going shopping:

The youngster's drawing shows him stepping boldly up to the toy counter of a department store with a five-Yuan note in his hand. It's his money, and he is attracted to the sign above the salesperson that reads, "Ship models on sale." The sign to his right beckons him with "Welcome. Visit Our Store." What this youngster is saying in his drawing is that he has money and he wants to spend it, in this case, on play items (Chan and McNeal, 2004).

What the authors of the book try to tell the reader here is that Chinese youngsters today have the privilege to spend their "own" money on their "own" wants. The "one-child policy" makes Chinese youth of special value in China's consumerism. One survey shows that being the focal point of Chinese families with the structure of 4-2-1—four grandparents, two parents, and one child—this only-child constitutes a large share of present-day Chinese families' consumption, resulting in a shift in China's cultural values from traditional values of frugality to the values of a modern consumer society (Sun and Wang, 2010). To them, life is about "me." Different from the older generations in China, they often say "I" instead of "we." Self-realization is one striking characteristic of the new "Me Generation." The 1996 national survey of youth by Chinese Youth and Children Research Center reveals that 77.5 percent of the youth consider realizing self-value as their life goal. The sentiments of "what I want, what I like, and who I am" are rising among Chinese young people. They ooze confidence and a sense of superiority. Youngsters engage the world in new ways and pursue a "good life." They search for personal fulfillment, enjoying a lifestyle their parents could not have imagined. The sense of individuality and self-consciousness of this highly "liberated" young generation is acutely reflected in the expressions of "personal taste," "personal expression," and "personal identity" (*shihe wo, zhanxian wo, wo jiu shi wo*) that are popular among contemporary Chinese youth (Guo, 2006).

<u>"The Young and the Restless": the Complexity of the Young Chinese Consumer Mindset</u>

Yet, underneath the façade of being open, free, and individualistic, recent media reports depict Chinese youth as "restless" and as experiencing an internal psychological conflict between "private selves" and "public selves," between "private identity" and "public identity" (Griffiths, 2012). While the phenomenon of "restlessness" among Chinese young consumers has been noted in general, few studies have provided in-depth analysis of the causes of this phenomenon. The present study delves into the "core" structures of Chinese traditional beliefs and values in the context of present-day social-economic realities, and will show, in the sections to follow, that Chinese young people's "restlessness" can be explained by the paradoxical, conflicting, and, sometimes, even opposing cultural values deeply rooted in Chinese tradition and its current realities. Among the dilemmas facing Chinese youth are "standing out and fitting in," "individual freedom and society's demands," and "soaring aspirations and limited opportunities." "Standing out" is explicitly depicted in an advertisement, titled "Just Want to Stand Out," published in *Modern Advertising*, a major advertising magazine in China. In the advertisement, a doggerel is printed on the T-shirt over a young man's robust body. Faceless, the young body, however, is full of life and energy, with a flock of thick black hair anxiously growing out from the collar of the T-shirt. The doggerel reads:

Just Want to Stand Out!
Use your head, night after night.
Apply yourself, head down, buried between your shoulders.
Creativity trampled, you bow your head, with secret hate.
Are you willing to capitulate forever?
Are you willing to work yourself until your head turns gray?
Come, seize the opportunity to hold your head high,
While you are still young.
("Just Want to Stand Out," 2006)

The advertisement captures the "young and eager to emerge" mentality of contemporary Chinese young people and their psychic need to find identity. According to Jib Fowles, most advertisements can be understood as having two orders of content. "The first is the appeal to deep-running drives in the minds of consumers." The second is information regarding the goods or service being sold—such as the product's name, its manufacturer, and its functions. Fowles asserts that by giving form to people's deep-lying desires, and by picturing states of being that individuals privately yearn for, advertisers have the best chance of arresting attention and affecting communication (Fowles, 1998). Successful advertising plays with a product's "emotional" functions for the consumer by associating commodities with feelings and emotions that the Chinese consumers find attractive.

In anticipation of emerging customer needs, smart marketers search for the soul of Chinese young consumers in order to sell their products by interweaving the actual and the imagined, and perpetuating the myth that consumption would make one's dreams come true. Feeding on the eagerness of Chinese youth to "stand out," modern Chinese advertising offers a world of success through consumption: The product is depicted as a symbol of wealth and status. The advertisement assures the audience that purchasing the product would bring power and self-worth and would provide a navigational guide for the voyage from the tortuous present to the ideal future. For example, an Audi's television commercial depicts an Audi car smoothly pulling in on a seemingly endless red carpet. A sartorially splendid man steps out of the car, striding down the carpet. He is greeted by people waiting along the carpet, applauding. The advertisement's body copy at the bottom says: "Audi-luxury, car for great leaders." Bombarded by such advertising messages, a migrant worker who cleans office buildings in Shanghai emotionally tells the interviewer in the documentary film *China Revealed*: "If only…I had a car…, I would be someone… People would recognize me" (Harrison, 2006).

Chinese love to win and admire big winners. Climbing society's ladder to the top is the ultimate goal in life for contemporary Chinese, especially for Chinese young people. However, seeking advancement in society and being successful are by no means new aspirations for Chinese people. In fact, success and advancement in society have been a primary drive for Chinese under Confucianism, and a noble calling by the government under Mao Zedong's regime. However, the definitions and concepts of "success" have undergone changes over Chinese history. In Confucianism, being successful originally meant mastering Confucian classics and passing the civil service exam to secure a position at the imperial court. Under Mao's regime, Communist ideology, however, advocates adhering to Communist doctrines to serve the people and the country. Since the economic reforms, mandated by Deng Xiaoping's proclamation to "let some people prosper first," acquisition of wealth has become the newest and most worthwhile pursuit for Chinese men and women. Being held back for decades under Mao's dictatorship, contemporary Chinese are eager to become the first to enter the brave new world of material wealth.

Yet, despite the changes in the definitions of success, the Chinese characteristic of seeking to become established in society as a primary purpose in life remains unchanged. Desire for attainment and a sense of urgency depicted in the "Just Want to Stand Out" advertisement mentioned earlier echoes Confucius accounts of his own progress and attainment as Man: "At fifteen, I set my heart on learning; at thirty, I stood firm; at forty, I had no doubts; at fifty I understood the Decree of Heaven; …" (*The Analects*, Book II). Likewise, life's purposefulness and urgency are explicitly expressed in Mao Zedong's *ci* poem composed in 1963: "Ten thousand years are too long. Seize the day, seize the hour!" (Mao, 1963) What merits attention, however, is that the urge to "stand out" is not all we see in Chinese youth's psychic search for identity and success. "Fitting in" is equally important. While the attribute of being ambitious and competitive is a Confucian virtue mandated by society, Chinese people, on the other hand, are expected to adhere to another set of Confucian ideals, which are also of the utmost importance for Chinese—harmony in society and in human relationships. For harmony to be achieved, individuals must conform and comply, and be humble. Confucius defined human relationships as "Ruler-Subject, Father-Son, Husband-Wife, Big Brother-Younger Brother, and Friend-Friend." In these Five Relationships, the senior and the male set rules for the junior and the female, while the junior and the female must respect the senior and male, and must be obedient. In other words, Chinese are social beings and must know their places in society, their boundaries and duties, and must co-exist with each other in harmony.

As the Japanese say, "the nail that sticks up gets hammered down"; the Chinese wisdom says, "birds at the head of the pack get shot first." Daoism is another school of philosophy in China and has significant influence on the Chinese way of life. The Daoist idea of non-action, or *wuwei* in Chinese, may cast a light on the phenomenon of Chinese young people feeling impelled to go with the flow. According to Daoism, the supreme Way of the Universe is to follow the course of Nature. "Water travels in its own way when it arrives at the head of the bridge." Forcing things to happen will destroy the balance in Nature and will be catastrophic. This philosophical view is admired even by Chinese *linglei* youth, or society's radical outcasts. In Jing Wang's study, an interviewee, Jian Cui—an idol of Chinese *linglei* youth—contradicts himself during the interview, saying "… Too much self-exposure is not good," after he has expressed his confidence in, and bragged about, his music talents. Another young music fanatic sees himself in a similar way, saying "Those who are content are happy. I don't like big ups and downs." Still another wants to learn "how to position himself in the middle for perfect balance" (Wang, 2005). Being small is virtuous and beautiful, and looms large in Chinese culture in the past or at present. "My humble self," or "my humble surname" are expressions commonly used by Chinese to refer to themselves, even by the imperial emperors and by Mao Zedong.

In his book *What Chinese Want*, Tom Doctoroff, the North Asia director and Greater China CEO for the advertising firm J. Walter Thompson, succinctly points out that Chinese individuals "are driven by an ever-present conflict between standing out and fitting in, between ambition and regimentation" (Doctoroff, 2012). As mentioned earlier, Chinese youth show a strong sense of belonging and social acceptance by their peers while seeking individuality. Research conducted by the students in my Chinese visual culture class in 2009, based on the advertisements in the Chinese version of *International Advertising*, 2007-2009, found that the three most frequently appealed desires to Chinese during this period were: need for prominence or achievements, need for affiliation, and need for security.

Another dilemma facing Chinese youth is individual freedom in the face of regimented social structures. Contemporary Chinese young people often are perceived as "free spirits." Themes of "dreams," "power and self-worth," and "freedom and happiness" prevail in contemporary Chinese advertisements. One can see individuality stressed in the catchy marketing slogan of Li Ning Corporation, China's largest sports-ware products company, "It's better to be yourself than to be someone else." Ambition is inspired by Nike's "Just do it," Adidas' "Impossible is nothing," and PepsiCo's "Dare for more"; freedom is evoked in the slogan "There is no boundary between you and freedom" seen in ads for IBM ThinkPad (T40).

However, closer examination of China's reality today shows that new paths are hard to break. One daunting challenge for Chinese young people is how to balance their individual ambitions with their sense of family responsibilities and society's demands. Tom Doctoroff has pointed out, "[Chinese] individuals have no identity apart from obligations to, and acknowledgement by, others" (Doctoroff, 2012). In pursuing success and self-satisfaction, China's individuals cannot shake off regimented social structures. Ambitions are intertwined with individuals' irrevocable responsibilities to family and society. Contemporary Chinese—man, woman, old, and young—are, as ever before, under enormous pressure to bring honor to the family, or *guangzong yaozu* (glorify the ancestors). This Chinese "characteristic" has not changed. Parents are mandated to provide their children a bright future. A survey in 2001, carried out by the Economic Situation Monitoring Center under China's National Bureau of Statistics, revealed that education had become a significant part of household expenses, consisting of 10 percent of a Chinese family's total household expenses (Xi and Xia, 2006).

Little emperors fear being a disappointment to their families when they grow up. They eventually have to face challenges in the real world and to balance their individual interest with their family responsibilities. To glorify the family name, young students bury themselves in books, studying day and night to pass the college entrance exam. The PBS *Frontline*'s documentary film *Young and Restless in China: Nine Stories* tells a story of the emotional dilemma of a young market executive who comes from an affluent Beijing family. Being renowned scholars, her parents put pressure on their daughter to succeed academically. This successful business woman tells the interviewer that for years, she has struggled to move out of the shadow of her parents and to sort out who she is and what her values are (*Young and Restless in China,* 2008).

At Marietta College, where I teach, many international students from China feel equally oppressed, even though they are thousands of miles away from home. Quite a number of them come to Marietta College to fulfill their parents' dreams. The family provides financial support for the young person's education. A young student chooses his/her major and career based on the parents' wishes. One student told me that his academic interest was in the humanities, but, to please his parents, he majored in accounting, then switched to finance, then to international business—only to feel miserable. Recently, he decided to follow his heart and declared his major in Asian Studies, but without his parents' knowledge. Some female Chinese students at Marietta College are depressed because they are under pressure to drop out of college before they receive a college degree, and return home to marry and help with their family business.

To an extent, education for young Chinese women is a double-edged sword. Girls still are distinctly second-class citizens, particularly in rural areas. When families with limited resources have to decide which child to send to school, it is always the son, because, traditionally, when young women marry, they leave their natal families to live with their husbands' families. Young women are expected to sacrifice their own interests to support their families. On the other hand, many women who do hold higher education degrees face a different problem: they are difficult to marry, because most Chinese men do not want to marry a "strong woman," or *nü qiangren* in Chinese. To put it in another way, many Chinese young women have their lives complicated several ways: first, they are facing the pressure (like their brothers) to be successful and to bring honor to their families. Second, in family decisions, young girls are more likely to be asked to make sacrifices and give the opportunities of education to their brothers, in the name of the family interest. Third, those who do get the chance to become educated, face the danger of becoming "unmarriable," which is equally unacceptable by China's norms today.

According to Confucianism, filial piety is the root of all virtues. No matter how spoiled China's little emperors are, they must learn filial piety by heart at a young age. However, taking care of aging elderlies has become increasingly challenging for Chinese young people. Aging population is a pressing problem in China and will have significant impact on Chinese youth, urban or rural. China is aging rapidly, largely because of the "one-child policy." It is reported that by 2030, China will have more people over age 65 than the entire population of the United States. China joined the world's aging countries in the late 1990s, with those over age 60 reaching 126 million, accounting for 10 percent of the country's population. It is predicted that by 2020, the percentage of China's senior population will rise to 11.8 percent. In 1990, the percentage of the Chinese working population caring for the aged was 13.7 percent; in 2000, it rose to 15.6 percent; in 2025, it is estimated to grow up to 19.46 percent; and by 2050, 48.49 percent. In other words, the per capita burden on working population has risen from 20 to 25 percent in the past to the present 50 percent; and will rise to 100 percent by 2050 (Xi and Xia, 2006).

As a release from the pressure cooker of social attainments and family responsibilities, Chinese young people spend time finding relief. Marketers promote products as relief of anxiety. Emotions are evoked in advertisements to offer the consumer a world of imagination, a utopia, or a world of spiritual transcendence and freedom from anxieties. Li Ning Corporation positions sports as relaxation, not a platform for competition. In their Television commercials, text floats across the screen: "Goodbye fatigue, goodbye toil, fear and fat…Yesterday's worries are over" (Doctoroff, 2005). Pizza Hut's advertisement asserts that Pizza

Hut provides the number-one place for pastimes and for entertainment. Starbucks promotes the idea of its coffeehouse as a Third Space, or *di san kongjian* in Chinese.

This *di san kongjian* position plays with the word *kong* in Buddhism, which means "emptiness." The Buddhist "emptiness" invokes detachment or being free from desires or worries. Thus the motif of Starbuck's Third-Space aims to create peace and tranquility: a cup of Starbucks coffee drunk *in situ* will set free one's spirit from the mundane. Furthermore, Chinese young people are oppressed by the reality in contemporary Chinese society: aspirations outstrip opportunities. With the importation of Western-style advertising and foreign goods to China, life for the Chinese has been a dizzying whirl. China's new middle-class consumers have enough disposable income to purchase non-essential goods. In other words, they can afford to make purchases based on what they "want," not just on what they "need." During the 1990s, China's elites liked to gather on the Bund in Shanghai for Western food, outdoor cafés, bistros, and boutiques that had a foreign cachet. They did not hesitate to show off their newly acquired Western-brand products, such as Armani and Louis Vuitton. Commercial advertisements further validate Chinese youth's belief that immediate success and luxury are consummated with goods and labels. In his book *Foreign Advertising in China*, Jian Wang describes a visual confrontation of an "upscale" and "cool" Hennessy brandy commercial displayed in downtown Beijing:

Displayed on the billboard are three "heroes"—a Caucasian man, a Caucasian woman, and a Hennessy bottle set against the backdrop of a peaceful blue sea. The dark-suited man, glass in hand, is posed in the middle of the background. In the left foreground, barely visible in the scene, the woman is showing only a shoulder draped in a beautiful scarf. On the right is the big Hennessy bottle, with its shape and texture occupying almost a quarter of the billboard space. Between the back and the front is a row of Greco-Roman arches. The ad caption written in Chinese characters reads, "Hennessy. The original X.O." (Wang, 2000).

A report in *The Wall Street Journal* predicts "a wave of development in China's luxury sector—rich Chinese are seeking a greater appreciation of what their newly minted wealth can bring" (Ernst & Young, 2006). With the liberation of retail law, China's luxury market has ballooned to more than US$2 billion in annual sales in the first decade of the twenty-first century, with 20 percent annual growth through 2008. Major luxury retailers, such as LVMH Louis Vuitton, Moët Hennessy, and Prada Group NV, operate their own stores in China. In 2012, China surpassed Japan to become the world's largest luxury goods consumer ("Chinese Buy Most Luxury Goods in the World," 2013).

The phenomenon of excessive and competitive consumption, or *dou fu* in Chinese, can be explained by the Chinese belief in the role of luxury spending in social construction and class distinction. Consumption in post-Mao China symbolizes modernity. Acquiring and consuming material goods *tastefully* has become an intrinsic part of modern living in China and a validation of one's high social standing. To a certain extent, youth are encouraged to demonstrate their role as consumers. As previously explained, the 4-2-1 family structure has resulted in the situation that six family members overindulge the only-child to consume luxury goods.

As China is transforming itself from a production-centered Communist society to a Capitalist consumer society, youth are encouraged to explore definitions of modern *Chinese-ness* by demonstrating their powers in consumption. When private cars, real estate, and luxury brands become available, youth are quick to claim them as their own status markers. Marketers explore ways in navigating young Chinese consumers in their move to the psychic haven of consumption so as to ensure that they are in the driver's seat in Chinese youth's "Consumer's Happy Express Train" (*xiaofeiqun de xingfu banche*), as characterized by a Chinese critic (Guo, 2006).

However, excessive consumption crashes head-on, not only with China's tradition of frugality, but with China's reality today: not everyone can afford the price of success. The surreal world of tranquility, luxury, and sophistication depicted in the Hennessy commercial is a dreamland for millions of Chinese. To be more accurate, it is a land that is beyond the imagination for ordinary Chinese men and women. While many Chinese are benefiting from the country's booming economy, many are not. China's highly competitive, consumption-driven environment inevitably forces many to the bottom. A Gallop survey shows that while Chinese buyers are many, and incomes are rising, most citizens remain too poor to purchase what they want. China today is a country that has the world's widest chasm of "haves" and "have-nots." At the time of the survey, 1.2 billion out of the 1.3 billion Chinese led a modest life, struggling through sweat and toil to cover just the basics (McEwen, et al., 2006).

Underneath the façade of glory, freedom, and happiness portrayed in contemporary Chinese advertisements, there is tension between big dreams and lack of opportunities. Disparity and identity crisis are effectively captured in the following "Save the Children" public-service advertisement: The ad depicts a shoe-shine boy shining shoes outside of a subway station in Beijing, and another boy having his shoes polished. The two boys in the ad are identical, showing the same age and the same face. The legend on the ad says: "Same life, different fate." One boy appears wealthy, confident, and privileged while the other is poor, hopeless, and enduring life's hardships. Reading the advertisement metaphorically, the ad illustrates the psychology of Chinese youth in a highly competitive commercial society. The wealthy boy can be seen as presenting an enviable image for the shoe-shine boy, enjoying wealth, privilege, and power. On the other hand, the shoe-shine boy presents a fearful image for the rich boy: if the rich boy fails, he will turn into a shoe-shine boy ("Save the Children," 2005).

CONCLUSION

A typical Western fairy tale conclusion is "… and they all lived happily ever after." The happy-ending conclusion of the modern Chinese consumers' fairy tale, however, remains to be seen. China's reality seems to allude to another type of fairy tale—the Cinderella story. When the clock chimes at midnight, the coach will give way to a pumpkin; the beautiful princess in elegant attire will be dressed in rags and return to scrubbing floors on her hands and knees. Ambitions outstrip opportunities. How to survive in a very competitive society preoccupies the Chinese mind. A survey conducted by the Northwest University of China shows that 88 percent of the respondents agreed that "there is no mercy in competition; only those who can adapt to it will survive" (Wang, 2006). In this brave new world, millions of contemporary Chinese find that their privileges, values, education, and work ethics—the honor that they used to find in their lives and behaviors—are disappearing. Under these circumstances, all segments of Chinese society have been "restless"—struggling to find a new identity that will provide a new source of societal and personal stability and a new source of societal and personal purpose.

The Chinese youth segment of society has experienced this restlessness primarily as a struggle to define their larger social role ("public identity") and to define their individual selves ("private identity"). China's "one-child policy"—under which, typically, six adults become the economic and social underpinnings for the launch of each new child into the society—has provided the impetus for the creation of contemporary Chinese youth culture. Chinese youth culture is grounded along two dimensions: the search for personal expression of individual identity, and the need to find one's place in the larger society—"standing out" and "fitting in." The dynamic created by the interaction of these two forces at work on the psyche of young Chinese has enabled a shift in cultural values among Chinese youth, away from traditional Confucian and Maoist values toward the values of a modern consumer society: knowing one's social position by what one can afford to display, and knowing one's self by the consumer products one *chooses* to acquire. However, it has been argued that there are elements of any culture that are central and invisible (e.g., cultural values) and there are elements that are peripheral and visible (e.g., behaviors). A culture's core values are likely to be more resistant to change than behaviors, which change constantly (Rosenthal & Feldman, 1992). In other words, a culture's "core" values and an individual's cultural identity may be less likely to change than the individual's behavior, such as his or her hobbies, taste in food and fashion, or consumption behavior.

This situation has resulted in a phenomenon in which Chinese young people find that while they relinquish some behavioral elements of their cultural origin with increasing acculturation to the Western consumerism, the "essence" of Chinese culture, or Confucianism, as represented in such characteristics as filial piety, family, and conformity persists over time. Often, the young people feel their individual desires overshadowed in their real-life situations and their voices silenced. Chinese youth's "core" Confucian self demands that Chinese young consumers be "collectivist" rather than "individualist," and "interdependent" rather than "independent."

The present study is an in-depth analysis of Chinese young people's "restless" state of mind resulting from two forces working on the psyche of Chinese young people. The two forces under study are the invisible, but unshakable, Confucian values, on the one hand, and the visible and ever-shifting values in individual consumerism, on the other. One point should be made, however, is that Chinese youth, though they share some commonalities, are not a unified entity, but have diverse interests, needs, and concerns; this divergence is a result of their diverse backgrounds, such as regions (rural or urban), education (domestic or foreign), professions (migrant workers, professionals, or government employees), and economic levels. Similarly, young people's "restless" psyche manifests differently among the different groups. One limitation of this paper, which seeks to generalize about Chinese youth across particular backgrounds and experiences, is the lack of close exploration of the mindsets of each of the individual groups. For example, could the effects of the two forces mentioned above on the young people with a domestic university diploma differ from the effects on those who returned to China with a degree of higher education abroad? How do these two groups of youth differ in their search for the meaning of existence in an ever-changing Chinese society? Why do they differ?

To answer these questions, investigation by means of focus groups may help to capture the pluralistic trend of Chinese youth in the diversification of values, concerns, and "restlessness." For my future research on this subject, I will carry on focus-group studies of young people who were born after the 1990s. The focus groups will include: 1) migrant workers, 2) Chinese university degree holders, 3) people with advanced degree returned from overseas, 4) small business owners, and 5) enterprise elites. I believe that, together, these groups are the key to China's economic development and play a decisive role in China's future. Another limitation of the present paper is the lack of insight from business professionals in addressing Chinese young people's so-called "bi-polar" psyche.

International consumer-goods companies—and more recently, their Chinese domestic counterparts—have recognized this psychic state in the Chinese youth demographic, and increasingly, have focused on exploiting it. Future research needs to look into the points of view of marketers and advertising professionals. How do they address the issue of Chinese young people's psychological complexity? What marketing strategies will they use to evoke emotional responses among Chinese youth? The acculturation and identity crisis that Chinese young people are experiencing also are seen in young people of other global emerging markets. The analysis of young Chinese consumers' mindset and their struggle between the influence of Western consumerism and the values of their native cultural tradition, and the lessons learned in the Chinese consumer market will be applied, with appropriate modifications, to other developing markets, and other Asian markets in particular.

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INDIA'S SATYAM SCANDAL: EVIDENCE THE TOO LARGE TO INDICT MINDSET OF ACCOUNTING REGULATORS IS A GLOBAL PHENOMENON

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ABSTRACT

This paper examines the capture of government regulators using the case of Satyam Computer Services Ltd., one of India's largest software and services companies, which disclosed a $1.47 billion fraud on its balance sheet on January 7, 2009. The firm, which traded on the New York and Bombay Stock Exchanges, was required to file financial reports with the SEC. Price Waterhouse of India, the local member of PricewaterhouseCoopers (PWC), served as its auditor. After news of the scandal hit the airwaves, Price Waterhouse of India issued a press release and stated that its audit was conducted in accordance with applicable auditing standards and was supported by sufficient audit evidence. Because Satyam shares were quoted on Wall Street, SEC rules prohibited auditors from having business relations with their clients. U.S. regulators failed to take action against PWC. Is this lack of enforcement related to PWC's size and the impact that the failure of a Big 4 firm would have on the global financial marketplace? We question whether government regulators have been captured by the key market players in the auditing services market. One outcome of this "capture" is moral hazard, which implies that the Big 4 accounting firms, or their local affiliates, may place less emphasis on quality audits. Such an approach to the audit function places the self-interests of the audit firm above the public interest. We also question whether foreign companies that are listed on US Stock Exchanges fall under the purview of US Laws and if these companies and their auditors face the same regulatory scrutiny as publicly-traded US Corporations. In addition, the paper provides suggestions to protect the public interest while citing lessons learned from this scandal.

JEL: M42, M48, M41

KEYWORDS: Auditing, Capture Theory, Accounting Regulation

INTRODUCTION

Regulation of business has always been a topic of considerable debate. Regulatory proponents call for more regulation of the private sector in order to protect the public good, while regulatory opponents claim that additional regulation further damages a free-market economy by unduly constraining business. The *theory* of regulatory *capture* posits that regulators, including government bureaucrats who oversee the regulatory process and legislators who write the regulations, are routinely and predictably "captured" and manipulated to serve the interests of those who are supposed to be subject to them.

For public choice theorists, regulatory capture occurs because groups or individuals with a high-stakes interest in the outcome of policy or regulatory decisions can be expected to focus their resources and energies to gain their preferential policy. Meanwhile, members of the public, each with an insignificant individual stake in the regulatory outcome, will either ignore or pay scant attention to the regulatory process altogether. Regulatory capture results when this imbalance of focused resources devoted to a particular policy outcome is successful at "capturing" influence with elected officials or regulatory agency bureaucrats so that the preferred policy outcomes of the special interest(s) are implemented. A captured regulatory agency serving the interests of its invested patrons and wielding the power of the government behind its decisions is often worse than no regulation. Galbraith (1955) posited that captured regulators were part of the problem rather than the solution. He suggested that regulators were vigorous in their youth, moving to complacency in middle age, until they became in old age either senile or arms of the sector they are supposed to regulate.

Ample evidence suggests that regulatory *capture* is indeed widespread and takes a variety of forms. The Big 5 accounting firms were reduced to the Big 4 with the criminal indictment of Arthur Andersen in 2002 and the firm's ultimate collapse. The vacuum created by the demise of Arthur Andersen and, ironically, the constraints of the Sarbanes-Oxley Act of 2002 (SOX), i.e., the unlinking of audit and consulting services, have contributed to increased market power for the remaining Big 4 firms. One negative aspect of this increased market power is the reluctance of government regulators to indict any of the Big 4 for criminal actions, creating moral hazard. Corporate executives, government regulators and politicians have all expressed concerns about the lack of choices that large public companies have when selecting a public accounting firm. In response to these concerns, the U.S. Congress, as part of the Sarbanes-Oxley Act of 2002, required the General Accounting Office, now the General Accountability Office (GAO), to examine the effects of the consolidation on competitive forces, audit costs and quality, and audit independence in the public accounting industry.

Since the initial charge by Congress for the GAO to examine the market structure of audits for large public companies, the GAO has issued two reports, the first *Public Accounting Firms: Mandated Study on Consolidation and Competition* (GAO, 2003) and a second *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* (GAO, 2008). Among other findings, both of these reports stated that the Big 4 audit 97% of all public companies with sales between \$250 million and \$5 billion dollars (GAO, 2003, 2008). Dominance by the Big 4 is global in scope, not just a U.S. phenomenon. Affiliates of the Big 4 are also the largest auditing firms in Turkey, South Korea, India and the Philippines. The Big 4 audit all of the Financial Times Stock Exchange (FTSE) 100 companies in England (Simms & Oram, 2002). They also audit more than 80% of the public companies in Japan and two-thirds of those in Canada. According to the International Accounting Bulletin, they hold over 70% of the European market by fee income (The Economist, 2004). Although the collapse of one of the Big 4 firms could have dire consequences for participants in the financial markets, it appears that the GAO has discounted the impact of not only the current lack of competition facing the Big 4 but also the possible capture by the Big 4 of government regulators charged with the oversight of the accounting profession. We posit that the reluctance of government regulators to punish the Big 4 accounting firms is not just a U.S. phenomenon, rather a global regulatory failure. We use the collapse of India's Satyam and the questionable audit its auditor, PWC, as an example of accounting regulators being "asleep at the wheel" and giving little more than a slap on the wrist to PWC and its Indian affiliates, in spite of the egregious audit failure at Satyam.

The remainder of the paper is organized into five sections. In Section 2, we provide literature review and a brief background on regulation. In Section 3, we review the Satyam fraud and PWC's failure to detect Satyam's accounting shenanigans. In Section 4, we discuss the societal implications associated with a "too big to fail" mentality and the moral hazard of such a mindset. A conclusion is provided in Section 5.

LITERATURE REVIEW AND BACKGROUND

When the U.S. government deems that a company's failure would have significant ramifications for the national economy, elected officials make the argument that the company is "too big to fail." This reasoning is used to justify government bailouts and, in some cases, the loosening or repeal of regulatory policies.

The bailouts of Chrysler in the late 1970s and Long Term Capital Management in the late 1990s provide examples (Cunningham, 2006). More recently, the U.S. Treasury loaned in excess of $700 billion to several of the nation's largest financial institutions and other large non-banking companies such as American Insurance Group, General Motors and Chrysler (Young, 2013). Once again, government officials argued that the failure of these large corporations, either together or individually, would have a dire negative impact on the economy. Once the "too big to fail" mentality becomes the modus operands of government, large firms may get a "leg up" on their smaller competitors. In other words, government regulators give the special interests favorable differential treatment.

In July of 2002, the Financial Economists Roundtable met to discuss the crisis in corporate governance, auditing and accounting that followed the scandals at Enron, Adelphia and WorldCom. As part of their deliberations, the attendees asked…"might they [the Big 4] perceive that they were 'too-big-to-fail' and, consequently, have incentives to engage in moral hazard behavior?" (*Journal of Applied Finance*, 2002) Perhaps the engagement in moral hazard behavior came sooner rather than later.

Recently, global financial markets were sent into a tailspin by the subprime mortgage crisis. One of the first investment banks to fail as a result of this crisis was Lehman Brothers. On December 21, 2010, Andrew Cuomo, New York Attorney General, filed a lawsuit accusing Ernst & Young (E&Y) of helping Lehman Brothers hide its declining financial health for several months before its implosion in September 2008. Cuomo's suit against E&Y is a civil suit, not a criminal indictment like the one brought against Arthur Andersen, and may, as many suggest, be settled out of court. E&Y responded by stating that the Lehman bankruptcy resulted from a series of unprecedented adverse events in the financial markets. A spokesman stated that E&Y stood by its December 31, 2007 audit of the company (Frean and Spence, 2010).

A couple of observations are in order. First, the Arthur Andersen (AA) effect appears to be impacting regulators. Once AA was served with a criminal indictment, SEC rules prohibited the firm from auditing SEC registered companies. As a result, most of its large clients and some partners left AA in search of one of the other four international audit firms. Regulators learned their lesson. Repetition of this scenario with E&Y would create turmoil in global financial markets which are just now beginning to show signs of recovery from the subprime mortgage crises. Regulators have decided to bring a civil indictment against E&Y rather than a criminal indictment, allowing the firm to continue auditing its SEC clients. Second, the disintegration of one of the remaining Big 4 firms would result in an audit services market that would be even more concentrated than it is today. An increase of just 50 points in the Herfindahl-Hirschman Index (HHI) would put the accounting industry in violation of antitrust guidelines (Sloan, 2010). Feldman (2010) estimated that the failure of E&Y would add 733 points to the HHI, unacceptable to the Department of Justice's Antitrust Division. Regulators may punish E&Y with significant monetary fines and perhaps suspend them from accepting new clients for a short period of time, but regulators and those clients seeking the services of one of the Big 4 accounting firms want E&Y to survive. Once again, it appears that one of the Big 4 accounting firms is too big for a regulator to protect the public interest, i.e., serve E&Y a criminal indictment.

GLOBAL PHENOMENON: THE SATYAM CASE

The Satyam scandal highlights the importance of securities laws and accounting regulation in emerging markets. It provides insight into the problems that emerging markets face when they transition from locally controlled corporations to globally traded corporations. There is wide consensus that emerging markets must strive to create a regulatory environment in their securities markets that fosters effective corporate governance. India has managed its transition into a global economy well, and although it suffers from corporate governance issues, it is not alone as both developed countries and emerging countries experience accounting and corporate governance scandals (Winkler, 2010).

In October 2009, the World Bank accused Satyam of installing spy systems on its computers and stealing assets and issued an eight-year ban against the company. In December 2008, Ramalinga Raju, the Chairman of Satyam, announced that Satyam would spend $1.6 billion to purchase Maytas Properties and Maytas Infrastructure, two companies unrelated to the information technology field. Efforts in this direction were withdrawn under pressure from shareholders who viewed the transactions as an attempt to siphon money out of Satyam into the hands of the Raju family since the Raju family held a larger stake in Maytas Properties and Maytas Infrastructure than it did in Satyam. On December 30, analysts with Forrester Research advised clients to stop doing business with Satyam because of the fear of widespread fraud. Satyam hired Merrill Lynch to advise it on ways to increase shareholder value. On January 7, just hours before Mr. Raju disclosed the fraud, Merrill Lynch sent a letter to the stock exchange indicating that it was withdrawing from its engagement with Satyam because during the course of its representation it learned of material accounting irregularities (Winkler, 2010).

Mr. Raju claimed that he overstated assets on Satyam's balance sheet by $1.47 billion. Nearly $1.04 billion in bank loans and cash that the company claimed to own was nonexistent. Satyam also underreported liabilities on its balance sheet. Satyam overstated income nearly every quarter over the course of several years in order to meet analyst expectations. The results announced on October 17, 2009 overstated quarterly revenues by 75 percent and profits by 97 percent (Winkler, 2010). For the third quarter, Satyam reported 50.4 billion rupees ($1.03 billion) of cash and 3.76 billion rupees of earned interest that were fictitious. Receivables were overstated and liabilities were understated by 4.9 billion rupees and 12.3 billion rupees, respectively (The Economist 2009).

Numerous bank statements were created to advance the fraud, and bank accounts were falsified to inflate the balance sheet with balances that did not exist. The income statement was inflated by claiming interest income from the fake bank accounts. Fake salary accounts were created, and the money in them was appropriated after the company deposited the salaries. The company's global head of internal audit created fake customer identities, generated fake invoices against their names to inflate revenue, forged board resolutions and illegally obtained loans for the company. It also appeared that the cash that the company raised through American Depository Receipts (ADRs) in the United States never made it to the balance sheets (Kahn, 2009).

Global auditing firm PWC audited Satyam's books from June 2000 until the discovery of the fraud. PWC signed Satyam's financial statements and was responsible for the numbers under Indian law. Cash is one of the easiest accounts to audit. The question of how the audit of a cash account failed to disclose a shortage of $1.03 billion dollars remains unanswered. The auditors also did not independently verify with the banks in which Satyam claimed to have deposits (Winkler, 2010). Suspiciously, Satyam also paid PWC twice what other firms would charge for the audit, which raises questions about whether PWC was complicit in the fraud. Furthermore, PWC audited the company for nearly 9 years and did not uncover the fraud, whereas Merrill Lynch discovered the fraud as part of its due diligence in merely 10 days. Missing these red flags implied either that the auditors were grossly inept or in collusion with the company in committing the fraud. PWC initially asserted that it performed all of the company's audits in accordance with applicable auditing standards (Winkler, 2010).

Immediately following the news of the fraud, Merrill Lynch terminated its engagement with Satyam, Credit Suisse suspended its coverage of Satyam, and PWC came under intense scrutiny and its license to operate was revoked. Coveted awards won by Satyam and its executive management were stripped from the company (Agarwal and Sharma, 2009). Satyam's shares fell to 11.50 rupees on January 10, 2009, their lowest level since March 1998, compared to a high of 544 rupees in 2008. In the New York Stock Exchange, Satyam shares peaked in 2008 at US$ 29.10; by March 2009 they were trading around US $1.80. Thus, investors lost $2.82 billion in Satyam (Bhasin, 2012). Criminal charges were brought against Mr. Raju, including: criminal conspiracy, breach of trust, and forgery.

Although Mr. Raju initially asserted that he acted alone in perpetrating the fraud, the Indian authorities also charged Mr. Raju's brother, the company's CFO, the company's global head of internal audit and one of the company's managing directors. Indian officials acted quickly to try to save Satyam from the same fate that met Enron and WorldCom, when they experienced large accounting scandals. The Indian government appointed a new board of directors for Satyam to try to save the company. The Board worked diligently to bring stability and confidence back to the company to ensure the sale of the company within the 100-day time frame assigned by the Indian Government. The Securities and Exchange Board of India (SEBI) appointed a retired Supreme Court Justice, Justice Bharucha, to oversee the process of an auction for Satyam and instill confidence in the transaction. Several companies bid on Satyam on April 13, 2009. The winning bidder, Tech Mahindra, bought Satyam for $1.13 per share—less than a third of its stock market value before Mr. Raju revealed the fraud—and salvaged its operations (Dagar, 2009).

There were also several civil charges filed in the U.S. against Satyam by the holders of its ADRs. Both civil and criminal litigation cases continue in India and civil litigation continues in the United States. The SEC and the Public Company Accounting Oversight Board (PCAOB) fined the affiliate, PW India, $7.5 million in what was described as the largest American penalty ever against a foreign accounting firm (Norris, 2011). According to President of the Institute of Chartered Accountants of India (ICAI), "The Satyam scam was not an accounting or auditing failure, but one of corporate governance. This apex body had found the two PWC auditors prima-facie guilty of professional misconduct." (The Economic Times, 2009). The Central Bureau of Investigation (CBI – India), which investigated the Satyam fraud case, also charged the two auditors with "complicity in the commission of the fraud by consciously overlooking the accounting irregularities" (Business Standard, 2011). The Registrar of Companies report in India, stated that the directors and senior officials at Satyam, sold shares ahead of the fraud revelation by Mr. Raju (IBNLive, 2009).

The firm, which trades on the New York and Bombay Stock Exchanges, is required to file financial reports with the SEC. After news of the scandal hit the airwaves, PW India issued a press release and stated that its audit was conducted in accordance with applicable auditing standards and was supported by sufficient audit evidence. In 2008, the PCAOB had inspected selected audits of PW India, but the PCAOB's findings were not released (Bloomberg, 2009)

The Big Four – Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP – have long distinguished themselves from second- and third-tier assurance services firms by marketing themselves as global entities with specific-industry skills that international companies need in highly competitive markets. The Big Four boast of their numerous global affiliates and tout the efficiency and responsiveness of these affiliate offices to current and potential clients. These global professional services firms state that their affiliate offices provide a global network with tens of thousands of employees who can meet the accounting, auditing and consulting needs of the world's largest companies. In essence, the Big Four sell the idea of a global affiliate network as "we are family," with each affiliate office working together to take care of the needs of their international clients.

Ironically, the Big Four quickly disavow this "we are family" concept when a problem surfaces in one of their affiliate offices. When an audit failure occurs, the international offices of the Big Four issue public statements reminding accounting regulators that the numerous firms which comprise their affiliate networks are legally independent. In Satyam's case, the PWC affiliate was PW of India. When news of the Satyam scandal broke, PWC's international headquarters office in London quickly distanced itself from PW of India and stated that local Indian affiliate offices had conducted the Satyam audit. These PW India affiliates were Lovelock & Lewes, Price Waterhouse Bangalore, Price Waterhouse & Co. Bangalore, Price Waterhouse Calcutta and Price Waterhouse & Co. Calcutta. The US Securities and Stock Exchange Commission (SEC) eventually sanctioned these five PWC affiliates and fined them $10 million, the largest fine the SEC has ever issued to a foreign-based accounting firm (The Indian Express, 2011). Upon payment of the fine, PW India stated that it neither admitted nor denied wrongdoing in the Satyam case. The PWC affiliate emphasized that no American accounting regulator “found that PW India or any of its professionals engaged in any intentional wrongdoing or was otherwise involved in the fraud perpetrated by Satyam management.” The PCAOB barred two PW India accountants from taking part in audits of American companies but said it did so because they had refused to cooperate with its investigation (The Firm, 2013).

The $10 million fine, however, pales in comparison to the losses suffered by Satyam investors and creditors. PWC’s affiliate gladly paid the fine. PWC still has its Indian affiliates in spite of the fact that “PW India failed to conduct even the most fundamental audit procedures” (The Indian Express, 2011). PWC still advertises the expertise and skill set of its global affiliates found in 159 countries and 776 cities. Given the “slap on the wrist” that PWC received from accounting regulators, a skeptic might ask if PWC and its global affiliate network, which comprise the world’s largest professional services firm, have become too big of an international player to indict for its audit of India’s Enron.

Further compounding PWC’s troubles, was the business relationship between PWC and Satyam in the U.S. Both firms worked on a major IT contract for Idearc, a spinoff of telecom firm Verizon. Because Satyam shares are quoted on Wall Street, SEC rules prohibit auditors from having business relations with their clients. U.S. regulators have yet to take action against PWC. Once again, is this lack of enforcement related to PWC’s size and the impact that the failure of a Big 4 firm would have on the global financial marketplace?

MORAL HAZARD BEHAVIOR: SOCIETAL IMPLICATIONS

One form of moral hazard behavior may be less quality audits. The absence of quality audits increases the probability of audit failures. Auditor silence in the face of inordinate corporate risk taking may also imply moral hazard behavior on the part of auditors. Such actions by auditors are more than a social issue such as the environment or sustainability. The failure of one large, publicly traded bank or brokerage house may set up a chain reaction that brings global financial markets to the brink of ruin (Roth, 2008). The collapse of The Bank of Credit and Commerce International in 1991, Barings Bank in 1995, and Bear Stearns and Lehman Brothers both in 2008 provide examples. Each of these collapses rattled the financial markets and spurred global anxiety. Governments and financial regulators around the world coordinated their efforts to prevent panic and to resolve the financial crisis (Nanto, 2009).

The attitude of the Big 4 toward their social responsibility for quality audits or alerting a board of directors to an unhealthy level of financial management risk is more than just about the reputational capital of the Big 4. It has implications for world-wide financial stability. Writing on the great financial crash of 1929 in the United States, J.K. Galbraith saw the crash as a symptom of a wider problem. Galbraith believed that the world of finance was incapable of expressing even the most basic and necessary self-criticism. “The sense of responsibility in the financial community for the community as a whole is not small,” he observed, “it is nearly nil” (Galbraith, 1955). Turner (2006) noted the fact that Big 4 firm-on-firm peer reviews never resulted in a negative or qualified report on one of the major international accounting firms, and had engrained a culture in which one firm had agreed not to tell on the other. When Galbraith’s observation is combined with Turner’s statement, marketplace stakeholders could question if the Big 4 view audit quality with a critical eye.

Neither the global community nor government regulators can afford for the Big 4 to disregard legal, regulatory and ethical standards. Galbraith (1955) also posited that regulators were part of the problem rather than the solution. They were, he thought, vigorous in their youth, moving to complacency in middle age, until they became in old age either senile, or arms of the sector they are supposed to regulate.

A major concern in the marketplace is over the possible demise of one of the remaining Big 4 firms, especially if one of the firms faces a criminal indictment. Friedland (2004) noted that the break-up of Arthur Andersen unfolded in a relatively smooth manner. With this in mind, the authors posit that rather than forming the mentality of "too concentrated to indict," government agencies, particularly the SEC, should inform the Big 4 and large corporations that the agency has formed a mentality of "here is the plan" in case one or more of the Big 4 are brought to court on criminal charges.

CONCLUSION

The purpose of this study is to use the tepid reaction of accounting regulators to PWC's audit failure at Satyam as evidence that the "too big to fail" mindset is a global phenomenon, not isolated only to the U.S. The facts associated with PWC's audit at Satyam are troubling for the investing public. From June of 2000 until January 2010, PWC audited Satyam. During this time period, Satyam overstated its earnings in almost every quarter. PWC never voiced any concerns about these revenue overstatements. In year 10 of PWC's audit work for Satyam, PWC missed a cash shortage of $1.03 billion. Merrill Lynch, a non-audit firm that Satyam hired late December 2009 to help the company find ways to increase shareholder value, notified the New York Stock on January 7 that it was withdrawing from its Satyam engagement because of accounting irregularities. Merrill Lynch uncovered evidence of fraud in less than 10 days. PWC either failed to uncover or ignored the same fraud symptoms for ten years.

Accounting regulators fined PWC's five Indian affiliates a paltry $10 million while Satyam investors lost $2.82 billion. The PCAOB banned two accountants at the PWC Indian affiliates from working on the audits of any American company. The ban was the result of those individuals refusing to cooperate in the regulators' investigation, not because of reckless audit work. This slight slap on the wrist by accounting regulators reinforces the idea that the regulated have captured the regulator. Such a condition creates a moral hazard environment for audit quality, which, in turn, has negative consequences for global investors and efficient capital markets.

One limitation of our paper is the number of Big 4 audit failures that we examine at the global level. Future research could extend the number of Big 4 audit failures associated with firms in mature or emerging markets and determine if regulatory actions were consistent with a "slap on the wrist" or if they resulted in more serious consequences.

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PROFIT RETURN IN CIVIL AVIATION AND FLEET INSURANCE: GAAP, FINANCIAL REPORTING AND TAX APPLICATIONS

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ABSTRACT

In the civil aviation market, unique insurance types are available. This market encompasses a small number of insurers who have the capacity to insure large fleet portfolios. Profit return is the portion of the insurance premium returned to the insured depending on the insurance contract. This paper examines the concept of profit return as used by civil aviation companies along with the scrutiny of accounting and tax applications implemented by Turkish civil aviation companies regarding aviation insurance premia. This work has particular implications on International Accounting Standards, Generally Accepted Accounting Principles (GAAPs) and Financial Reporting for a particular setting.

JEL: M40, M41, M48, M49

KEYWORDS: Recognition, Disclosure, International Accounting Standards (IASs), International Financial Reporting Standards (IFRSs), Financial Reporting, Civil Aviation, Profit Return

INTRODUCTION

There are various types of insurances applicable in civil aviation depending on the requirements of different authorities. These include aircraft hull insurance, hull resistance, aviation hull war, terrorism risk insurance, spare parts, total loss insurance and financial liability insurance. *Hull insurance* secures the entire hull and equipment of an aircraft, regardless of the owner during flights, when landed, when moving or parked. *Exemption insurances* (as in the hull exemption) lower the limits of exemption. *Liability Insurances* secure the passengers, baggage, cargo and the third persons against losses and damages from the check-in procedure until the passenger leaves the apron. *Total Loss Insurance* provides insurances to be used in the extra premium payments that will be undertaken due to the rise in the premium rates in the following insurance periods when an aircraft becomes completely unserviceable. Finally, *Loss of License Pilot Insurances* covers pilots' financial commitments if their licenses are suspended within the framework of international regulations, either permanently or temporarily, for the purposes of medical reasons.

In the event that payments made for losses during the insurance period do not exceed a specific ratio of the premia paid, or to be paid, by the company which has purchased an insurance policy, the insurance company can return part of the paid premium back to the insured company. Alternatively, it can appropriate the undue premium given the insurance contract made between the two. This practice is called profit return. The subject of this paper is investigation of the concept of profit return as used by civil aviation companies and the examination of accounting and tax applications implemented by Turkish civil aviation companies regarding aviation insurance premia.

In the first section of this paper literature related to aviation insurance markets are reviewed. The second section explores the literature along with scope and framework. In particular, the legal framework considering aviation insurances is investigated. In the third section, accounting and tax applications on aviation insurances are studied. In the fourth section an evaluation of the subject within the sphere of Turkish Accounting Standards (TASs) is presented. The fifth section discusses potential problems which might be encountered in the course of recognizing aviation insurance premia. Finally, the fifth section concludes this paper.

LITERATURE REVIEW AND BACKGROUND

The relevant literature is silent on the issue of profit return in the civil aviation and fleet insurances. There exists neither scholarly nor professional works to date. This paper aims to examine the subject of profit return in civil aviation and fleet insurances, given the context of generally accepted accounting principles (GAAP), financial reporting as well as tax applications. This paper is, to the best of our knowledge, the first scholarly investigation of these issues. Before delving into technical specifics this paper puts forth, we start with a discussion of the relevant prior studies.

Consideration of aviation insurance in the literature is not new. Holland (1927) discusses the evolving issue of aviation insurance. The scholar presents a history on insurance of transportation, the possibility of a single (catch-all) aviation insurance coverage, pricing, types as well as causes of losses covered in addition to the influence of protection on flying. He concludes the paper highlighting the critical importance and relevance of and a fast growing necessity for extensive aviation insurance policies to cover the immediate needs for the sector agents.

W. R. B. (1947) explores the relevance and importance of mandatory aviation insurance. The scholar advocates that aviation insurances are more than a must. He argues that protection of the public should be well provided and the level of compensation against the occurrence of the hazard itself should be kept at a reasonably decent level. The scholar further states that a rigorous set of regulatory mechanisms should be developed to mitigate risks involved. Enforcement of mandatory insurance policies would do indeed a good job of lessening the costs of having a system of damage control and management practices.

Tuan (1965) discusses the emergence and the evolvement of aviation insurance in the U.S. He argues that a strong backup from the American insurance market and willingness to assume the underlying risks are among the leading factors in the insurance development. These factors are suggested to be contributing to the further advancement of the aviation industry and insurance businesses together.

Margo (1996) discusses several aspects of insurance in aviation finances. The scholar argues that since motives differ, financiers of aviation insurance business price the risks involved differently than the way the insurers do. Margo conjectures that insurance financiers might reap certain financial advantages on the right way to exploit the insurance deal. This entails asset protection as well as assurance of lease/loan payment flows. The scholar concludes that since the insurance market has a flexible structure and players in this market are eager to embed motives the financiers have, the existing dialogue between the financiers and the insurers would prove to be more intense than it is now.

Pricing risks and hence coming up with an accurate number to capture the right amount of compensation on aviation insurance are pretty demanding. It is suggested that, no matter what schemes of varying pricing and premia might be considered, insurance underwriters must fairly price the risks and consider all the possibilities involved. Among these are drivers leading to pricing differences as insurance/reinsurance and temporal dimensions with respect to the coverage of premia and the lag between incidence of loss and reimbursement of claims (Anonymous, 2006; Lane, 2005).

Lin and Chang (2008) study drivers underlying the aviation insurance business. They sample Taiwanese Airline Carrier enterprises. They set the degrees of hull and liability types of aviation insurance premia as their dependent variable which is regressed on a broad vector of regressors. These regressors include fleet profile, operations, losses, flight crew performance and financial stability. Employing gray relation analysis (performance assessment) and risk analysis matrix (loss severity and frequency), the scholars find that two factors mainly determine the rates applicable to aviation insurances. These are the quantities of fatalities as well as the claims due from prior periods and the level of a given airline company's loss history. They further conjecture that the given factors not only guide pricing practices of risks associated with the damage potentiality and thereby the level of the compensation, but also the overall performance.

Mann (2009) investigates the finances of aviation activities as a source of capital. The author discusses the aviation financing market in light of a number of determinants. These involve (a) airlines, (b) aircraft lessors, (c) values underlying aircrafts, (d) EETC markets (Enhanced Equipment Trust Certificates), (e) debt structuring, (f) pooled lease securitizations which are alternate aircraft financing instruments, (g) export credit agencies (ECAs), and (h) the bank markets as premier financiers of capitals in the aviation industry. The bank markets are also suggested to be encompassing ExIm banks (Export-Import) as well. Mann further indicates that there will be arising many financing opportunities in the near future which are the probable expansions for instance in the level of (i) banks' lending capacities, (ii) guarantees to be offered by ECAs or ExIms and (iii) issuances to be led by EETC markets.

Flouris *et al.* (2009) examine some notable implications of recent developments in the aviation insurance industry business. They investigate market risk shared by the insurers, treatment of insurers on intentional violence acts, and risk pricing. They argue that many things in aviation insurance have changed following the 9/11 crashes, which mainly harmed the existing market stability, but also led to involving agents to redesign their insurance structures and layouts. The scholars advocate that pricing terms and conditions applied to the aviation insurance business have well adapted in the post-9/11events-period. This closely implies that current aviation insurance industry is now working differently than the one before the 9/11 incidents, depicting a more conservative (risk-averse) yet prudential picture. The scholars conclude that players in the aviation insurance markets have an improved insurance oversight at the expense of a higher cost of coverage.

Jackson (2011) recently investigates prospects the aviation insurance businesses encapsulate. The author argues that reinsurers, insurance underwriters and the financial markets are all integrated in these businesses. He further advocates that this close linkage is one major reason accounting for the floating changes in the degrees of the risk pricing and therefore the premium costs.

Anderson *et al.* (2012) recently examine fraud of insurance in the aviation industry while presenting implications on liabilities and losses along with the considerations of catastrophic events like September 11. This is a fine case study. The scholars examine the case of insurance fraud connected to Fortress Reinsurance Corporation. They argue the given company has deceived its stakeholders in making them believe that they are financially safeguarded in the events of huge disasters. Following the September 11 occasions, it was realized that this was not the case. Due to this deception, the ruined stakeholders of Fortress had immediately filed legal proceedings against not only the company owners (insider shareholders) but also its auditor, which ranks in the big four at present.

<u>Aviation Insurance Markets</u>

An aircraft in a fleet is insured against different "aviation risks" under a compound policy which covers not only damages and losses to an aircraft but also damages and losses it would cause passengers and third parties. A single insurance company does not have the financial resources adequate to insure a large airline company. Except for countries where laws require regional insurance, a great deal of insurers and reinsurers participate in each insurance stage (Hayes *et al.*, 2010).

Llyod's market in London is a worldwide recognized aviation insurance market. Although there are other markets such as the German Market, French Market, US Domestic and GAUM, most of the markets with the exception of Llyod's are relatively small (Chappell, 2010). Small markets are not capable of assigning lead underwriters for companies with large fleets. This brings forth the risk of incomplete placement. It is also important to note that in the insurance market, reinsurers who guarantee compensation for damages are called *underwriters*. However, the reinsurers who make transactions in markets other than Llyod's can also participate in the placements performed at Llyod's. Although there are many companies registered in the Llyod's market, only a small fraction happen to be capable of reassuring the companies with high fleet values (Hayes *et al.*, 2010).

The Llyod's market has a unique working method such that underwriters in this market do not deal with airline companies on financial issues such as premia and compensations. Therefore, bargains for premia and compensations are carried out by means of financial intermediaries called brokers who are authorized by airline companies to do so (www.llyods.com, 2010). Airline companies struggle to achieve scale economies and thus to pay lower premia (a) by incorporating the fleets of all the companies under the roof of airline associations such as Star Alliance and (b) by creating huge portfolios and hence increasing their marketing power.

In calculating the premia for insurance policies various criteria such as: (a) the value and age of the fleet, (b) estimated number of passengers, (c) number of departures, (d) passenger gain per kilometers, (e) number of seats, (f) premium damage statistics (history) of the company in the last few years, (g) premium trends in aviation insurance and (h) risk coefficient defined by the underwriters for airline companies are all taken into consideration. Therefore pricing is a sophisticated process.

<u>Profit Return in General</u>

Profit commission is a double-edged sword. When exercised properly it provides the opportunity for a consistent and profitable partnership by allocating profit and risk between the risk holder and the insured. Profit commission is a contingent commission defined over the profitability of the portfolio included in the insurance line. The payment of a profit commission is made from the party who undertakes the risk, or from the insurer (the reinsurer, insurer or the insurance agent in general) to the producer/distributor (an insurer, insurance agent, broker or the agency in general). It is also known as profit share commission, bonus commission or sliding scale commission. Different from the other flat commissions (that are collected with the sale or renewal of a single policy) profit commissions are calculated over the financial results of a group of policies (Weaver, 2010).

In each profit commission agreement the following arrangements can be made depending on the nature of the agreement (Weaver, 2010): (a) the parties to the agreement, (b) the subject of the business and whether there is a single pool or multiple sub-pools, (c) the term of the agreement, (d) how the profit commission will be calculated and paid, (e) whether the profit commission will be paid at once or in installments, (f) whether there will be a minimum portfolio or a profitability threshold before the profit commissions begin to be paid, (g) whether the losses can be compensated with the future profit commissions and if it is so agreed the period for its validity, (h) the conditions of termination and the profit commission payments after the termination of the agreement, (i) arbitration arrangements, and (j) profit commission calculation formula.

In the profit commission formula there may be a great number of variations – there is not a single best and correct definition for it. However the following formula is widely applied (Weaver, 2010): $X\%*(P - C - E)$. Therein, *X%*: profit rate to be paid to the party who is to receive profit commission (this rate may be contingent or variable); *P*: Premia earned; *C*: Payments for the incurred losses (which encompasses the provisions reserved for such losses), and *E*: Expenses (which encompasses all types of costs, taxes, financial expenses, etc.).

Legal Framework

The responsibilities of carriers in civil aviation (on the issues of the passengers, baggage and cargo) remain settled back in the 12 October 1929 agreement called the Warsaw Convention. Although the main text has been amended, the convention listed the financial responsibilities of the airline companies and mentioned their obligations to carry insurance.

According to article 15 of the 03.06.2007 dated and 5684 dated Insurance Law vehicles used in civil aviation (excluding the exceptions) should be insured by insurance agents located within the borders of Turkey and are in service in Turkey. According to the aforementioned article: "Persons resident in Turkey are obliged to have their insurable interests insured by the insurance companies carrying out business in Turkey. However when such persons buy credit for aircrafts, ships or helicopters they can apply for insurance abroad providing that the scope of the insurance be limited with the amount of foreign debt and until the foreign debt is paid." Legal basis of the insurance types used in civil aviation in Turkey are provided below:

a-Hull Insurance: Although it is not compulsory for civil aviation companies to purchase hull insurance they are required to buy hull insurance for the aircrafts bought through leasing, pursuant to the articles 14 and 17 of the 28.06.2005 dated and 3226 numbered Law on Financial Leasing. In the abovementioned articles it is stated that "the leaseholder is responsible for the losses and damages accrued within the term of the agreement. This responsibility is limited with the amount that cannot be met by the insurance paid… The leasing company is obliged to have the good in his property subject to the lease insured for the period of the agreement. The leaseholder shall pay the insurance premia." Besides, there are also provisions in the financial leasing agreements which require aircraft hull insurance.

*b-Liability Insurance**:*** In the articles 132 and 138 of the 19.10.1983 dated and 2920 numbered Turkish Civil Aviation Act it is stated that "carriers authorized to perform domestic and international carriage of passengers, freight and mail are required to have an insurance against financial liability within limits determined at least according to the principles of article 124, covering compensation claims for damages that may occur under the transportation contracts… The insurance contract to be executed by carriers operating in domestic and international routes and the risks it covers shall be approved by the Ministry of Commerce taking into account international standards and the opinion of the Ministry of Transportation and Communications. Aircrafts not complying with the insurance requirement prescribed by this article shall be prohibited from flight by the Ministry of Transport and Communications… Operators of Turkish and foreign civil aircraft to fly in Turkish airspace are required to execute an insurance contract as surety for damages that may be caused to third persons. Aircrafts not complying with the insurance requirement prescribed by this article shall be prohibited from flight by the Ministry of Transport and Communications." It is also required to execute financial liability insurance contracts according to financial leasing agreements and civil aviation regulations.

c-Exemption Insurance: There is no a legal arrangement which necessitates exemption insurance; however it is possible to increase the level of compensation to be met by insurance companies through exemption insurance. The next section generously presents the accounting (financial reporting) along with the tax implementations on insurance premia and profit return subject-matters. The steps on financial recognition/reporting transcending the incurring and payment of the insurance premia as well as the accrual and receipt of the profit returns are presented in detail therein.

ACCOUNTING AND TAX APPLICATIONS

Although it is legally required that companies execute the covenants of insurance when carrying out business in Turkey, companies are compelled to buy foreign insurance policies. This is mainly because no insurance system to execute direct insurance transactions is available in Turkey. This is likely because of expensive policy coverage. Payments to foreign insurance companies are made by means of an established domestic insurance company. When payment is made to the established insurance companies in Turkey, Banking and Insurance Transactions Tax is included in the payment and the established company transfers the payment collected with a certain amount of commission to the foreign insurance company. It is stated in article 28 of the 23.07.1956 dated and 6802 numbered Expenditure Tax Act that the Banking and Insurance Transactions Tax is money banks and insurance companies receive under any title either in cash or in account resulting from transactions they have performed. This happens regardless of the methods they would have applied.

Premium payments prescribed in aviation policies which are arranged to cover a calendar year (between January and December) are generally made in periods of 3 months. One fourth of 90% of the amount of the insurance premium which is calculated depending on estimated values is paid in advance to the insurance company. The period of insurance is one calendar year in application. Agreement procedures with the foreign company may only be concluded a few months after the insurance period ends. Under some conditions, determination on the cost of damage might take long periods of time. The appropriate accounting entries are as follows:

180 – Prepaid Expenses for Future Months Account (dr.)
    320 – Accounts Payable Account (cr.)

Description: Become indebted for ¼ of the insurance premium before the insurance period begins

320 – Accounts Payable Account (dr.)
    102 – Banks Account (cr.)

Description: Payment of the ¼ of the insurance premium before the insurance period begins

740 –Expenses of Provision of Service Account (dr.)
180 – Prepaid Expenses for Future Months Account (dr.)
    320 – Accounts Payable Account (cr.)

Description: Charges for the premium payment to be made in April and advance payment records for the premia of May and June

320 – Accounts Payable Account (dr.)
    102 – Banks Account (cr.)

Description: Payment of the premia of April, May and June

740 – Expenses of Provision of Service Account (dr.)
    180 – Prepaid Expenses for Future Months Account (cr.)

Description: Charges for the premium payments to be made in May and June

The abovementioned records are also applicable for the period between July and December. The insurance premium paid by the airline company within the insurance period and the agreed amount of premium to be paid at the end of the period is compared for the purposes of reconciliation. Should the amount paid during the insurance period be less than the due amount (considering that the fleet value has not increased, 90% of the estimated premia of some policies is paid during the period which in return brings forth the opportunity of extra payment at the end of the period), one would have the following records:

740 – Expenses of Provision of Service Account (dr.)
373 – Provision for Expense Accruals Account (cr.)

Description: Though not finalized yet, recording the residual insurance premium in the related period according to the requirements of periodicity

373 – Provision for Expense Accruals Account (dr.)
320 – Accounts Payable Account (cr.)

Description: Becoming indebted for the payment of the residual insurance premium

320 – Accounts Payable Account (dr.)
102 – Banks Account (cr.)

Description: Payment of the residual insurance premium

120 – Accounts Receivable Account (dr.)
649 – Other Ordinary Income in relation to The Business Activity and Profit Account (cr.)

Description: Taking back the overpaid amount of insurance premium

102 – Banks Account (dr.)
120 – Accounts Receivable Account (cr.)

Description: Collection of the overpaid premium

If it is found that the amount of premium paid during the insurance period is more than the amount of insurance premium to be paid, one would have the right above-presented records. In summary, when making agreements about insurance premium payments to be made at the end of the period, the amount calculated at the beginning of the period is compared to the difference to be figured out with the calculations made after the insurance period. If the paid amount is determined to be low it is paid to the insurance company. Should it be considered overpaid it is returned to the insurance holder. After these procedures are finalized the profit return operation is performed if the amount of the damage/premium remains under a certain rate (critical mass). The accounting records are as follows:

120 – Accounts Receivable Account (dr.)
649 – Other Ordinary Income Related to The Business Activity and Profit Account (cr.)

Description: Accounting record of the profit return

102 – Banks Account (dr.)
120 – Accounts Receivable Account (cr.)

Description: Collection of the profit return

TURKISH ACCOUNTING STANDARDS (TASs)

TAS 37: "Provisions, Contingent Liabilities and Contingent Assets" Standard

We know that TASs are extensions of International Accounting Standards (IASs) alongside with concepts derived from their implementations to Turkey –International Financial Reporting Standards (IFRSs). Profit commissions, when examined in terms of the Turkish Accounting Standards, may be dealt with under TAS 37, the "Provisions, Contingent Liabilities and Contingent Assets" standard. According to this standard a contingent asset is "a possible asset that arises from past events and whose existence would be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity." The following issues are indicated in the related sections of the same standard:

> An entity shall not recognize a contingent asset on its financial statements (Paragraph 31).
>
> Contingent assets usually arise from unplanned or other unexpected events that give rise to the possibility of an inflow of economic benefits to the entity (Paragraph 32).
>
> Contingent assets are not recognized in financial statements since this may result in the recognition of income that may never be realized. However, when the realization of income is virtually certain, then the related asset is not a contingent asset and its recognition is therefore appropriate (Paragraph 33).
>
> A contingent asset is disclosed, as required by paragraph 89, where an inflow of economic benefit is probable (Paragraph 34).
>
> Contingent assets are assessed continually to ensure that developments are appropriately reflected in the financial statements. If it has become virtually certain that an inflow of economic benefits will arise, the asset and the related income are recognized in the financial statements of the period in which the change occurs. If an inflow of economic benefits has become probable, an entity discloses the contingent assets (Paragraph 35).
>
> Where an inflow of economic benefits is probable, an entity shall disclose a brief description of the nature of the contingent assets at the end of the reporting period (as of the balance sheet date), and where practicable, an estimate of their financial effect, measured using the principles set out for provisions in paragraphs 36-52 is suggested (Paragraph 89).
>
> It is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising (Paragraph 90).
>
> Where any of the information required by paragraphs 86 and 89 is not disclosed because it is not practicable to do so, that fact shall be stated (Paragraph 91).

Briefly TAS 37 states that if the inflow of contingent asset to the entity is probable that fact should be disclosed in the financial statement while the profit returns should be included in the financial statements from the beginning of the reporting period. Again, as can be understood from the explanations provided above, if it has become virtually certain that an inflow of economic benefits will arise, the change should be recognized in the financial statements.

<u>TAS 10: "Events after the Reporting Period" Standard</u>

Recognition of possible effects of profit return, which is to be agreed at the time of the signing of the contract, in or out of the financial statements not only demonstrates the size of the expected damages or the condition of no-claim, but also plays an important role in terms of the time such damages occurred. TAS 10 states that:

> An entity shall not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the reporting period (Paragraph 10).
>
> If an entity receives information after the reporting period about conditions that existed at the end of the reporting period, it shall update disclosures that relate to those conditions, in the light of the new information (Paragraph 19).
>
> In some cases, an entity needs to update the disclosures in its financial statements to incorporate the information received after the reporting period, even when the information does not affect the amounts that it recognizes in its financial statements (Paragraph 20).
>
> If non-adjusting events after the reporting period are material, non-disclosure could influence the economic decisions that users make on the basis of financial statements. Accordingly, an entity shall disclose the following for each material category of non-adjusting event after the reporting period: (a) the nature of the event; and (b) an estimate of its financial effect, or a statement that such as estimate cannot be made (Paragraph 21).

The reporting period indicated above is meant to take effect as of the balance sheet date. Briefly in the TAS 10 it is stated that no adjustment shall be made in the financial statements for the non-adjusting events after the reporting period. However, considering that the non-adjusting events are important they should be disclosed in the financial statements as in the example of the total loss of an aircraft within the insurance period.

There is another important standard worth mentioning, i.e. TAS 32. TAS 32 is entitled: "Financial Instruments: Presentation" Standard. This standard states that a financial asset and a financial liability be offset, and the net amount be presented in the statement of financial position (balance sheet) if and only if, an entity: (a) currently has a legally enforceable right to set off the recognized amounts; and (b) intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously… financial assets and financial liabilities are rather presented separately from each other in line with their unique characteristics as either economic resources or financial obligations of the entity (Paragraphs 42 and 43).

POTENTIAL PROBLEMS

The problems civil aviation companies might encounter in the recognition of the aviation insurance premia may be listed as follows: First; contrary to TAS 37, non-disclosure of the profit returns [in balance sheet disclosures] that are in the status of contingent assets when they remain likelihood as well as non-recognition of the profit returns in the financial statements when their realization is highly likely. Second; contrary to TAS 10, failure to make the necessary disclosure in a timely manner regarding the changes that might occur after the reporting period meaning the balance sheet date.

And third; contrary to TAS 32 again, in the agreements made between the insurance company and the airline company at the end of the reporting period if it is determined that the airline company may receive profit return after the amount of the premium to be paid by the airline company is figured out and when the "amount of damage / amount of premium" rate gets at a certain value, making the mutual settlement on the gross basis instead of net basis. Since this would decrease the assessment of the Banking and Insurance Transactions Tax it would lead to tax loss.

CONCLUDING COMMENTS

In the civil aviation market, unique insurance types are available. This market encompasses a small number of insurers who have the capacity to insure large fleet portfolios. Profit return is the amount of the insurance premium returned to the insured depending on the insurance contract. This paper xamines the concept of profit return as used by civil aviation companies along with the scrutiny of accounting and tax applications implemented by Turkish civil aviation companies regarding aviation insurance premia. This is an original research in the area as the relevant literature is silent on this subject.

This paper has special implications on (International) Accounting Standards, Generally Accepted Accounting Principles (GAAPs) and Financial Reporting for a particular setting. In order to satisfy the main objective, we provide a generous presentation of the literature. In exploring the literature a broad picture of background was also given. Thereafter, accounting and tax applications were discussed. That section was specifically attributed to showing the financial recognition and reporting implementations that results from the incurring and payment processes of insurance premia as well as the accrual and collection processes of profit returns.

We note that even though it is legally obligated, for firms to execute insurance contracts with firms carrying out business in Turkey, enterprises are compelled to buy foreign insurance policies. This was suggested because no insurance system to perform direct insurance transactions is available in Turkey. It has also been stated that payments to foreign insurance companies are made by means of an established domestic insurance company. Once a payment is made to the established insurance companies in Turkey, Banking and Insurance Transactions Tax (BITT) would be involved within the payment and the established company would transfer the payment it has collected with a certain amount of commission to the foreign insurance company. The foreign insurance company is the one writing the main insurance contract.

In the above discussions, it has been advocated that when construing agreements about insurance premium payments to be made at the end of the period. The amount calculated at the beginning of the period would be compared to the difference after the insurance period. If the paid amount is low it would then be paid to the insurance company. Should it be overpaid it would then be returned to the insurance holder. Once these procedures are finalized, profit return operations would be performed.

Following the discussions on accounting and tax implications, applicable Turkish accounting standards (TASs) were technically investigated. That section is particularly relevant as TASs are extensions of International Accounting Standards (IASs) that lead performance and oversight of International Financial Reporting Standards (IFRSs). These investigations entailed: (a) TAS37 which is a Standard stipulating the Provisions, Contingent Liabilities And Contingent Assets, (b) TAS10 which is a Standard stipulating the Events After The Reporting Period, and (c) TAS32 which is a Standard regulating the Financial Instruments. In this, among the others, it has been suggested that once it has become virtually certain that an inflow of economic benefits would arise, the change should then be recognized in the corporate financial statements. It has also been proposed that since non-adjusting events prove to be of importance they should be disclosed in corporate financial statements as is the case of the total loss occurrence of an aircraft within the insurance period.

This paper has also discussed the possibilities of some specific (firm or industry wises) problems civil aviation companies might encounter especially in the course of financial recognitions of the aviation insurance premia. Despite the law and spirit of TAS37, it might yet be possible to have a (a) non-disclosure of the profit returns -in balance sheet disclosures- that are in the status of contingent assets when they remain probable *as well as* (b) a non-recognition of the profit returns in the corporate financial statements when their realization is even highly likely. Second; despite the law and spirit of TAS10, there might happen a failure to make the necessary disclosure in a timely manner regarding the changes that might occur after the reporting period (i.e. the balance sheet date). Third; despite the law and spirit of TAS32 again, in the legally binding deals made between the insurance company and the airline company at the end of the reporting period it should it be determined if the airline company may receive profit return. This is done after the amount of the premium to be paid by the airline company is identified and when the amount of damage/amount of premium rate gets at a certain value. Among the other advantages, it would decrease the value of the Banking and Insurance Transactions Tax, which in turn implies a tax loss by definition.

All the above points highlight the significance of recognition and disclosure practices. They combined to conclude that profit return should be better considered as having the status of a contingent asset. For this reason, it is required to be disclosed in the corporate financial statements and at times when its payment becomes virtually certain it has also to be recognized in the corporate financial statements. The former and latter requirements might be respectively called the disclosure and recognition obligations. Moreover, in the case that events that occur after the reporting period do not require any amendment prove to be (significantly) important they should also be disclosed in the financial statements. When the premium payment and profit return is to be made in the same period collection on account would not be appropriate according to present accounting and tax regulations.

Last but not least, this paper is not without its limitations. First, this study is a country-specific investigation where the structure of aviation industry as well as the insurance and taxation practices among the others is unique. This might give a rise to impairment of generalizability of our results and implications worldwide. Perhaps the backbone of this scholarly investigation relies rather on the international accounting standards and principles (i.e. IASs and IFRSs) and thus retains generalizability. Thanks to the standardization, we believe that once our examination is replicated in some other outlets, similar results as well as implications are likely to obtain to a significant degree.

Opportunities are available for future studies in this area. Even though the examinations made throughout this study are specific and technical, it would be interesting to see if the same context is replicated in another venue with differing reporting, accounting and taxation regimes and practices. The probable results would vary if the given venue implements its own GAAPs rather than an internationally-driven-GAAP such as that of IASs and IFRSs. The results and implications would also read differently if the given venue has a completely different kind of insurance structure.

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THE INTERNATIONALIZATION OF CHINESE MULTINATIONALS IN THE MIDDLE EAST AND AFRICA: THE CASE OF HAIER

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ABSTRACT:

This article investigates the internationalization strategy of the Chinese firm Haier in Africa and the Middle East and addresses strategic implications in Haier's successful entry strategies in these difficult regions. It also draws some useful lessons for the industry incumbents willing to enter these markets. A case study approach of Haier in Africa and the Middle East with an emphasize on the Algerian market is used to shed more light on the striking internationalization patterns of the firm's entry strategy in these developing regions of the globe. The results of this study suggest that, despite the hardship associated with doing business in Africa and the Middle East, Haier unlike its incumbent peers from developed nations and given its international entrepreneurship mindset, political and market acquaintances with these developing nations, seems to follow (1) an accelerated and early internationalization, (2) a dual-entry mode − entry simultaneously in developed and developing countries − and (3) an increased commitment and localization toward these markets.

JEL: M160

KEYWORDS: Internationalization, Haier, China, Africa, The Middle East, Algeria, Emerging Markets MNEs

INTRODUCTION

The last decade witnessed overwhelming growth of the Chinese Multinational Enterprises (MNEs) worldwide, with Haier at the forefront of these firms, in the home appliance industry. In a period of no more than two decades, under the impulsion of its emblematic CEO, Ruimin Zang, the firm from Qingdao transformed its nearly bankrupted firm in 1984 to China's number-one home appliance maker in 2001. In addition, it has constantly maintained its leadership since then. Globally, Haier ranked 3rd among home appliance manufacturers in terms of sales volume, with $23 billion revenue in 2011, trailing only Whirlpool and Electrolux (Euromonitor International, 2010).

China's adherence to the WTO in the late 1990s led to the accelerated internationalization of Chinese MNEs and a growing number of outbound investment projects. Under the 'Go Global' government-led initiative instigated in 1999, the central government aimed to further enhance Chinese firms' international competitiveness by reducing or eliminating foreign-exchange-related, fiscal, and administrative obstacles to international investment activities (Sauvant, 2005). In the following years, a sharp and steady surge in the Chinese outward foreign investments (OFDI) occurred. From a modest US$ 28 billion recorded in 2000, the Chinese OFDI stock worldwide reached US$ 317 billion in 2010, and more than 13,000 domestic companies established 16,000 foreign affiliates, spreading throughout 178 countries (The Chinese Ministry of Commerce, 2010).

Within the context of this globalization rush among the Chinese MNEs, in 1997 Haier developed a formal internationalization strategy, at which point CEO Ruimin Zhang announced the "three one-thirds" goal, which asserted that, out of all Haier products, one-third is made and sold domestically, another one-third is made domestically but sold overseas, and the last one-third is both made and sold overseas (Yi & Ye, 2003: page 187). The company has since relentlessly set up subsidiaries, joint ventures, or sales arms virtually in every part of the globe, even in the most difficult and remote regions. By 2011, the firm had a presence in 160 countries, with 29 manufacturing bases and 16 industrial parks in the U.S., Europe, Asia, The Middle East and Africa (See Table 1).

Unlike its established incumbents in the industry in Africa and the Middle East, Haier has been over the last 20 years harnessing the potentially vast and untapped markets of these countries, establishing sales networks and manufacturing facilities in more than 30 countries within these regions. In effect, over the last decade, Africa and the Middle East's economic growth has quickened, benefiting from growing raw material revenues and market liberalization policies, opening up new business opportunities in a market of 1.4 billion people. The two regions were the fastest growing in the world in terms of GDP (+5.1% in Africa and +4.5% in the Middle East), trailing only the emerging Asian countries (+8.6%) during the period of 2000-2010 (McKinsey Global Institute, 2012). In Africa, for instance, the population will increase from 965 million to 1,996 billion by 2050, and the real GDP rose 5.1 percent from 2000 to 2010. The continent's households spent a combined $860 million in 2008, more than those in India or Russia. This figure is projected to rise to $1.4 trillion over the next decade if the real GDP continues to grow at its current pace (Mckinsey and company, 2010). The Middle East as well, with a population of 380 million, has demonstrated steady economic performances between 2000 and 2010 as the real GDP rose 4.5 percent on average. This growth was especially strong among oil and gas exporter countries, where surging export volumes and prices enabled them to accumulate the area's current account surpluses of about US$440 billion in 2012 (IMF, 2013).

However, these economic growth and opportunities come with a great deal of uncertainty and a harsh business environment for MNEs. This environment is typically characterized by mercurial economic policies, instable political systems, risk of popular revolutions, foreign companies' ownership regulation (the 51/49 rule), red tape, corruption, limited intellectual property protection, lack of various infrastructures, and failure to enforce contracts. Facing such extreme business conditions, foreign multinationals are less likely to make investments because assets face greater transactional hazards, and returns are less predictable and certain (Williamson, 1996). Thus, the international business literature suggests that, in more externally uncertain and volatile environments, firms tend to lower their ownership structures and reduce their commitment in host countries with greater risks (e.g. Anderson & Gatignon, 1986; Hennart, 1988; Hill et al., 1990).

However and despite the hardship associated with doing business in such environments, in recent years Haier has stood as a fast-moving pioneer investor in Africa and the Middle East. The company's activities in the region can be traced back to 1993, when it started appliance exports across the region. By 2005, the firm had opened its first industrial park in Jordan and started plants in Algeria, Iran, Nigeria and Tunisia (see Table 2).

This article investigates Haier's internationalization strategy in Africa and the Middle East and addresses strategic implications from Haier's experience with its successful entry strategies in the region. It also draws some useful lessons for industry incumbents willing to enter these markets. From a more general prospective, it documents the strategies used by the Chinese MNEs in the extreme business environments of Africa and the Middle East and to which extent they diverge/converge with those models applied by advanced economies' MNEs. Relying upon a series of interviews with the former CEO (2002 to 2010) of Haier Sodinco Algeria and other executives of the firm in China in charge of the two regions, a case study of Haier in Africa and the Middle East with a special emphasis on the Algerian market is also used to shed light on the striking internationalization patterns of the firm's entry strategies in these developing regions. To date, many case studies have been published documenting Haier's internationalization strategies in different parts of the globe, but none specifically focus on the African and Middle Eastern markets; we therefore try to bridge this gap through the present research. The paper proceeds as follows. In the first section, we introduce the framework of the Chinese MNEs expansion in Africa and the Middle East. In the second section, we present the internationalization strategies of Haier worldwide in general, and then in section three, we discuss the company's methods applied in the African and Middle Eastern regions in particular. We present in section four the case of Haier in the Algerian market, and finally in section five, we discuss the results and draw conclusions.

Table 1: Haier Global Operations in 2011

Regions/Type of Operations	Trading Company	Industrial Park	Manufacturing Facility	R&D Center	Sales Network
Americas	3	1	2	1	12260
Europe	4	-	-	2	15100
East Europe	1	-	2	-	2390
Mediterranean	1	1	3	-	2660
Africa	-	-	4	-	2520
West Asia	-	-	2	-	2380
South Asia	1	1	6	-	3560
Southeast Asia	5	1	3	-	2670
East Asia	3	-	1	2	1650
China	42	12	5	3	13000
Australia	1	-	-	-	610

This table shows Haier's global network of operations (Trading companies, R&D centers, Manufacturing facilities, Industrial parks and sales networks) across the globe and by region. Source: Haier corporate data

FRAMEWORK OF THE CHINESE EXPANSION IN AFRICA AND THE MIDDLE EAST

China's frenetic economic growth has brought about an insatiable thirst for natural resources over the past two decades and pushed the Chinese central government to increasingly orient its OFDI policy toward resource-rich countries to fuel its economic and demographic expansions. In 1998, a white paper from the Chinese Ministry of defense was issued, proclaiming energy security as a critical part of China's overall security. The country's global economic, foreign, and security policies became closely interconnected (Hill, 2004: page 56). Although it was historically low until the 2000s, the Chinese economic engagement in Africa and the Middle East is completely reshaping these regions' geopolitical landscape, given its impressive scope and scale, especially in Africa, which foreign investors had passed over and marginalized for decades (Tull, 2006: page 459). In 2009, China overtook the U.S. as Africa's first trade partner, and trade volumes reached US$ 126 billion in 2010 (Christopher & Hanson, 2012). China was also the Middle East's top trade partner, with a trade value of US$ 190 billion in 2010 (Chinadaily, 2011). In terms of FDI, Chinese OFDI stocks in Africa grew by 1349% to US$ 13 billion in the period of 2004-2010 and by 509% to US$ 3,5 billion in the Middle East during the same period (The Chinese Ministry of Commerce, 2010). China's growing economic commitment toward Africa and the Middle East in recent years has been positively welcomed by these area's leaders, as it offers an alternative to the involvement of former colonial powers and western countries perceived as imperialistic or neocolonialist. Unlike its western counterparts, the Chinese economic cooperation and aid do not hinge on any specific political or economic conditionalities such as human rights, democracy, or market liberalization (Tull, 2006; Yetiv & Luo, 2007). China's non-interference principle in the internal affairs of a state and its ability to maintain political relationships with "pariah" states helped to grow its interests and sphere of influence in countries such as Sudan or Iran. Throughout Africa and the Middle East, Chinese MNEs are gaining a strong foothold in not only the oil industry but also in a wide range of other sectors. In Algeria, a Chinese consortium was granted the construction of the longest highway in the continent; in Nigeria, HUAWEI technologies won a $750 million contract with the operator Globacom to upgrade its network infrastructure; and in Iraq, the government awarded five separate contracts to Chinese oil companies (Chen, 2011). These examples illustrate the clear progression of Chinese corporations into these regions and the outperformance of their western competitors. We analyze in the following discussion the origin of the Chinese corporations' competitive advantages in these two regions (based on Alden & Davies, 2006).

Political acquaintance advantage: Since most Chinese MNEs investing abroad are state owned or closely tied with China's central government, they usually enjoy strong inter-governmental political support when investing in fellow communist or ideologically similar states (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007). Their willingness to work with any state regardless of its governance practices helped to consolidate their position in some African and Middle Eastern countries such as Sudan, Angola, or Iran. In order to establish itself in the long term, Beijing has been providing financial assistance (through aid or debt cancellation), infrastructure building, or technological transfer cooperation programs to these countries in order to secure their sympathy and trust. Although not profitable in the short term, these initiatives enable China to gain political influence and privileged access to the local market and natural resources extraction rights (Pan, 2006; Evans & Downs, 2006).

Comparative economic advantage: Within several African and Middle Eastern cities, attentive observers will notice Chinese goods on every street corner. With cheap textiles and clothing, consumer electronics, and even automotive goods and services, Chinese brands are claiming an increasing share in these regions' consumers' shopping carts. Low-cost goods of variable quality as well as higher-end products such as refrigerators, TVs, or smartphones are gaining growing popularity amongst consumers, as they appeal to the modest revenues of the middle-class citizens of these countries. Companies such as Huawei, TCL, and Cherry are becoming major household names, with extensive distribution networks and comfortable market shares throughout the area. Additional aspects of the Chinese firms' dominance include low-cost bidding strategy in public projects centered on lower skilled labor, lower managerial costs, and strong governmental support that helps them win public contracts.

Non risk aversion and first-mover advantage: In addition to the aforementioned distinguishing characteristics, Chinese corporations appear to be less risk averse than western ones in difficult environments. This attitude toward hazardous countries might be effectively explained by the home country capital market imperfections and institutional factors such as an active support from the Chinese governments (through soft loans, for instance), or strong political ties with countries in these regions (See Buckley et al., 2007 and Buckley, Tan, & Xin, 2008). This is especially true in countries torn by war or under closed political systems such as Sierra Leon, Angola, Sudan, or Iran. This low risk aversion attitude helps Chinese investors to see beyond the risks to establish profitable businesses earlier than their industrialized economies' competitors. First-mover advantage usually grants pioneering and risk-taking investors various competitive edges over late entrants such as higher market shares, possibilities to preempt key assets, establishment of entry barriers, or better relationships with local governments.

Market acquaintance advantage: Chinese MNEs' knowledge of operating in difficult environments characterized by centralized economies, weak institutional framework, or deficient market structures may well have equipped them with ownership advantages that enable them to compete efficiently in settings similar to their domestic market (See Buckley et al., 2007, Buckley et al., 2008; Cross et al., 2007; Erdener & Shapiro, 2005). The fact that, until very recently, the Chinese domestic market was very similar to these emerging and least-developed markets has helped the Chinese firms to gain a competitive edge vis-à-vis developed countries' companies. This market acquaintance and familiarity are said to be important competitive advantages, as they reduce the liability of foreignness and thus the transaction costs incurred with operating in unfamiliar settings.

METHODOLOGY OF THE CASE

This study employs a case study approach in order to generate fine-grained findings that would be difficult to retrieve with larger quantitative studies. The case study is “a research strategy which focuses on understanding the dynamics present within single settings” (Eisenhardt 1989: page 534). We selected the company Haier because it is the largest and most successful Chinese consumer electronics company internationally, while the electronics industry offers a good setting in which to study the issue of MNEs’ internationalization, as it is one of the most globalized industries (Li, 2007). Haier was selected also because it is the most localized international home appliance firm in Africa and the Middle East. Data for this case study was gathered from face-to-face, phone, and mail interviews with Haier Sodinco Algeria’s CEO and executives (between September 2010 and August 2012) as well as with a Haier executive in charge of the Middle East and African departments of the company in China. Interviews consisted mostly of open questions regarding the firm’s internationalization strategy in the two regions. To complement the primary data, we used supplementary data, including published case studies, books, company brochures, corporate reports and website content, and various media articles. In the following sections, we present cases involving Haier’s internationalization patterns first worldwide, second in the Middle East and Africa, and then in Algeria for a more in-depth analysis.

HAIER’S GLOBAL EXPANSION

The ultimate goal of Ruimin Zhang, Haier’s CEO, has always been to expand globally and become a major industry player like GE, Panasonic, Samsung, and Sony. Therefore, his aspiration to internationalize and become one of the Global 500 has played an important role in Haier’s rapid internationalization (Comprehensive published studies on Haier include Bonaglia, Goldstein, & Mathews, 2007; Liu & Li, 2002; Muroi, 2005; Child & Rodrigues, 2005; Palepu, Khanna, & Vargas, 2005; Palepu, Khanna, & Andrews, 2012 and Yi & Ye, 2003). In 1984, shortly after Zhang was appointed as the plant director, Haier introduced technologies from the German company Liebherr to produce refrigerators in China through a technology licensing agreement. Haier then started an original equipment manufacturer (OEM) partnership with Liebherr as a way of entering the German market in 1991 (Liu & Li, 2002). Later, Haier imported freezer and air-conditioner production lines from Darby of Demark and Sanyo of Japan. Joint ventures with Japan’s Mitsubishi and Italy’s Merloni provided Haier with new design and technological capabilities. The early 1990s also marked the beginning of Haier’s overseas activities in the United Kingdom, France, and Italy through OEM agreements with local manufacturers to enter rapidly these advanced markets (Palepu, Khanna, & Andrews, 2012).

After Haier had built a strong brand in China and became a quality capable manufacturer, Zhang felt that Haier was ready to embark on a global venture expansion to build its own brand in the global scene. As he put it, “*The objective of most Chinese enterprises is to export products and earn foreign currency. This is their only purpose. Our purpose in exporting is to establish a brand reputation overseas. We have created an important brand in China, and we are taking that brand to other markets*.”(Zhang Ruimin quoted in Wu, 2003). In its quest for globalization, the firm intended to follow a “three in one” strategy. Haier found it crucial to extend and develop its competencies by localizing its networks for design, production, distribution, and sales in the host countries. According to Zhang’s approach to localization, wherever there is a market for Haier, there must be a strong presence locally and, in fine, a manufacturing facility. This approach has enabled the company to bypass various trade barriers and encounter the possibility to bid for government purchases in the United States and the European Union, for instance.

Haier initially focused on Southeast Asia in the first phase of internationalization, with investments in Indonesia, the Philippines (1996), and Malaysia (1998). This was followed by a few more FDI projects in emerging countries before the company launched its operations in the U.S. in 1999. It established a design center in Boston, a marketing center in New York, and a manufacturing center in South Carolina, with a total investment of US$30 million (Liu & Li, 2002). Haier became the first Chinese company to operate a U.S. manufacturing facility, and a plant worth US$100 million was announced in 2006 for further expansion of the current one. The firm achieved the number-one market share in compact refrigerators in 2001 and in 2005 became the number-two seller of air conditioners in the U.S. market. In its effort to build a strong brand in the U.S., Haier signed a marketing partnership with the NBA league in 2006 and became a major sponsor of the league.

Haier also invested €80 million in Europe between 2001 and 2004. In 2001 it purchased for $8 million the Meneghetti refrigerator plant, one of the largest manufacturers of built-in appliances to match kitchen cabinetry. By 2004, the company's European headquarters coordinated logistics through four distribution centers in Italy, Netherland, Spain, and the U.K. to serve 17 European markets. In 2004, sales in Europe accounted for 17% of the Haier Group's total revenue (Bonaglia, Goldstein, & Mathews, 2007; Palepu, Khanna, & Andrews, 2012). In Japan, Sanyo Electronics (a Panasonic subsidiary with 23% of Japan's white-goods market) launched a joint venture with Haier in 2007 to develop and sell refrigerators in the Japanese market. Shortly after, in 2011, Haier acquired Sanyo's washing machine and consumer-use refrigerator businesses in Japan, and washing machine, consumer-use refrigerator, and other consumer electric appliance business in Indonesia, Malaysia, the Philippines, and Vietnam (Haier's corporate website).

From the initial stage of Haier's globalization in 1995, when the company's overseas sales amounted to just over 3% of its sales prior to 1999, revenue grew steadily throughout the decade and accounted in 2010 for over 27% of Haier's total sales, worth $5.4 billion in value (Palepu, Khanna, & Andrews, 2012).

<u>Haier in Africa and the Middle East</u>

Haier's operations in Africa and the Middle East trace back to 1993, when the firm started refrigerator exports across the region. With growing demand for home appliances in the region and the apparition of the wealthy middle class, the firm established Haier Middle East in 1999 in Dubai, The United Arab Emirates, to promote Haier's products in the country and the neighboring Gulf region. In Saudi Arabia, the firm established in 1998 a distribution agreement with local group Al Jabr Electronics, a diversified trading company, to aggressively promote its products through an extensive network of dealers and special stores. In 2001, Haier introduced new color TVs at an exhibition held in Saudi Arabia featuring 21 models especially designed for Middle Eastern consumers. Haier appliances and after-sale service reached even the most remote villages in the desert (Yi & Ye, 2003).

In December 2001, the Haier Middle East trading company was established in Jordan (HMT) as a joint venture with South Electronics Company (SEC) and Syrian and Lebanese partners. The division worked to expand Haier's market share and raise the brand's reputation in Middle Eastern countries including Jordan, Lebanon, Syria, Palestine, Egypt, Iraq, and Kuwait. Haier also invested in Jordan to build an industrial park, the first in the Middle Eastern and African regions. The park construction project started in June 2002 and was ready for operation in December 2004, with strong political support from the local authorities, including King Abdullah II, who in a five-minute telecom-satellite conversation assured CEO Zhang that his government will work to provide Haier with a "good and steady environment for Haier's development in Jordan." With a total annual production capacity of 150,000 refrigerators and air conditioners, 150,000 washing machines, and 150,000 televisions, this project required a $10 million investment (of which Haier's contribution amounted to $2 million). Benefiting from mutual tariff exemption agreements signed between Jordan and the surrounding Arab countries, appliances produced in the Jordan industrial park have entered surrounding countries such as Syria, Lebanon, Egypt, and Palestine at competitive prices (Haier Middle East and Africa corporate data).

By the early 2000s, the company had established with local partners in Africa 3 manufacturing joint ventures in Algeria, Nigeria, and Tunisia to produce washing machines, refrigerators, and air conditioners. In Nigeria, the most populated African country and largest market for Haier in the African region in term of sales, Haier Group and the UK PZ Cussons Group signed a joint venture agreement in May 2001 to build up a factory for the assembly and sales of refrigerators, freezers, and air conditioners marketed under the brand Haier-Thermocool. Within 5 years of its operations' beginning in the country, the company achieved a number-one ranking for refrigerators and freezers. It now has 5 distribution centers and a total of 23 service outlets across the country (Rubicon Strategy Group, 2012). Haier's sales in Nigeria reached $150 million in 2009 and $200 million in 2010.

In Tunisia, Haier and the Group Hachicha, a large and diversified Tunisian group, signed an exclusivity representation contract in 1997 for Haier brand production and distribution in North African countries. The contract granted the Tunisian group the exclusive rights to Haier's white goods production and commercialization in Algeria, Tunisia, Morocco, and Libya for a 20-year-term contract. In 2000, Haier and the Tunisian group set up Hachicha Haier Worldwide (HHW), a joint venture factory in the capital city Tunis, to produce 30,000 air conditioners, 25,000 refrigerators, and 50,000 washing machines each year. The factory project was launched in November 2001 and put into operation in October 2002. HHW presently produces a wide range of home appliances for the Tunisian market, operates the subsidiary Haier Sodinco in Algeria and exports appliances to Libya and Morocco. HHW achieved in the Tunisian market an annual sales volume of more than US$ 21 million in 2010, with an increase of 42% over that of 2009.

Presently, according to the company's data, Haier operates with local partners an industrial park in Jordan; 3 manufacturing plants in Algeria, Tunisia, and Nigeria; and two trading companies in the Middle East and Africa, and the company's products have been sold in more than 30 countries within these regions (See Table 2 for Haier's major steps in the region). In order to meet the specific local needs in these regions, Haier launched several products tailored to the specific conditions; for example, it created a refrigerator that can operate through 100 hours of power failure and an air conditioner designed for desert and tropical conditions. Based on information feedback from its Middle Eastern branch in 2001, Haier developed an air conditioner combining strong heat-resistance capability with unique exterior materials to increase its anti-erosion abilities. When the sample was on the market, the whole orders for 2002 were fully taken by customers from Middle East and African countries (Liu & Li, 2002).

Table 2: Haier's Major Steps in Africa and the Middle East 1997-2012

1997	20 years exclusivity contract signed with Tunisia Hachicha Group to distribute Haier's products in Tunisia, Algeria, Libya, and Morocco.
1999	Haier Middle East was established in The United Arab Emirates*; Haier Sodinco Algeria was incorporated as a subsidiary of the Tunisian Group Hachicha to serve the Algerian market.
2000	Haier Sodinco Algeria Factory started operations in Algeria; Haier and the Tunisian group set up Hachicha Haier Worldwide (HHW), a joint venture factory in Tunisia.
2001	Haier Middle East trading company was established in Jordan (HMT) as a joint venture with South Electronics Company (SEC) and Syrian and Lebanese partners; Haier Group and the UK PZ Cussons Group signed a joint venture agreement to build up a factory in Nigeria; Tunisian plant construction plant started in November.
2002	Industrial park construction project started in Jordan; Tunisian factory put into operation in October.
2005	Jordan Industrial park officially opened.
2010	Sales in Nigeria reached $200 million: $21 million in Tunisia and $17 million in Algeria.
2012	Exclusivity contract signed with IBS to distribute Haier's appliances in Egypt.

*This table shows Haier's most significant milestones in the Middle East and Africa between 1997 and 2012 including market entries, manufacturing facilities opening, importa*nt partnerships with local firms and some sales figures. Source: Prepared by authors based on official corporate data, unless indicated otherwise. *: Yi & Ye (2003).

In 2005, to promote its brand further on the African continent, in collaboration with the International Department of the Communist Party of China, Haier invited a delegation of 17 members of ruling parties in Africa to visit the Haier Qingdao facilities. The delegation included politicians from Cameroon, Djibouti, Guinea, Equatorial Guinea, Madagascar, Niger, Rwanda, Seychelles, and Togo (China Xinhua News

Agency, 2005). After the visit, impressed by Haier's technologies, they promised to become volunteer spokespersons for Haier activities in Africa. In 2010, Haier was awarded as among the "Top 10 Chinese Enterprises that Moved Africa", rewarding its contributions to the China-Africa friendship and cooperation.

Haier in Algeria

In October 1999, Haier Sodinco Algeria was established as a Haier Tunisia (HHW) wholly owned subsidiary. After the Tunisian Group Hachicha obtained Haier brand exclusivity for the North African region, HHW identified Algeria as the first market to enter in the region. In association with U.K.-based General Mediterranean Holding Group, Haier Sodinco Algeria Ltd. was established near Algiers, the capital city. After more than a decade of political and economic troubles during the 1990s, Algeria had resumed economic growth in the 2000s under the impulsion of economic deregulation policies and a significant surge in oil and gas revenues. In the period of 2000-2009, public investments programs worth $250 billion were carried out to build 1.5 million houses and infrastructures and modernize the economy. The country, home to the 4th African economy in terms of GDP, counted 37 million people in 2012.

Following the initial establishment of the firm in 1999, Haier Sodinco's manufacturing plant started its operations in June 2000, specializing in air conditioner (central and split-system air conditioners) and washing machine assembly. In this phase, the company began to produce appliances utilizing relatively mature technologies under the "completely knock down" (CKD) assembling system and benefited from a reduced 5% tariff on appliances imports, in a move from the Algerian government to encourage the installation of manufacturing facilities in the country.

In the early 2000s, air conditioners were still considered luxury products among Algerian consumers, and they were priced at around US$1500 at the cheapest, and very few local and foreign firms invested in manufacturing facilities at that time. Haier Sodinco chose to focus its effort toward the corporate and domestic air conditioning market, a highly profitable and untapped market, in a country where temperatures easily reach 40 degrees Celsius in the summer. According to Mr. Hicham Doubabi, Haier Sodinco CEO between April 2002 and May 2010 and current member of the board, "*When we first launched our air conditioners in the market, we didn't expect such a commercial success; we were overflowed by orders from both companies and distributors. The Algerian consumer was demanding of good quality appliances, reasonable prices and a good after-sale service, Haier was able to satisfy these needs, and that's the reason why our air conditioners are so appreciated by the consumers*."

Haier Sondinco's sales reached US$ 17 million in 2010, with a yearly 25% growth since 2005. In 2008, air conditioner, refrigerator, and washing machine sales represented 76%, 12%, and 12% of sales, respectively. Air conditioners' contribution to the gross margin of the firm accounted for 88% of the total gross margin during the same year. The firm claimed a 14% market share in the white good industry in 2010 and a leadership position in the central air conditioning system in the corporate and office building segment (Haier Sodinco Algeria Internal documents). As the competition intensified over the years, Haier Sodinco started to offer more technologically advanced and higher-end appliances such as eco-friendly air conditioners and refrigerators or antibacterial washing machines.

In the absence of structured and specialized distribution networks, Haier Sodinco had to build its own network within Algeria and relied as well on the existing, more informal distributors and regional wholesalers. By 2009, the company had 30 regional distributors, 107 licensed dealers, and 7 regional after-sale service centers located throughout the country. "*At first, we had to heavily rely on informal distribution network in the absence of specialized chain stores such as Best Buy or Darty. It was a problem for us, since such wholesalers like the ones in the Hamiz appliances market near Algiers usually operate under their own rules of the game and are reluctant to use invoices or any official contractual documents. But after we* *started to gradually build our own network and gained a good brand reputation in the market, it was much easier for us to properly work in the country*" said Mr. Doubabi.

Haier Sodinco staff is almost fully composed of locals (170 employees). Teams of engineers and executives from China often visit the plant for technical trainings, production line installation, and technological transfers. In April 2002, Haier Sodinco appointed Mr. Hicham Doubabi, a former high executive and director of several banks both in the public and private sectors, as its chief executive officer. He retired for his function in 2010 and is currently member of the company's board.

DISCUSSION AND FEATURE OF THE CASE

The case study of Haier in Algeria in particular and Africa and the Middle East in general provide us with valuable information on the striking pattern the firm exhibited when entering these difficult regions of the world. The entry sequence and process the firm followed fit, to a certain level, its internationalization strategies in other regions of the world but diverged in other regards. We discuss in the following section the most notable features of the case.

First-mover advantage: In the late 1990s and the beginning of the 2000s, Haier made strategic entries in numerous African and Middle Eastern countries including Algeria (See Table 2) before its established industry competitors did. The firm started rapidly building its production and distribution network, brand reputation, and positive relationships with these countries' local authorities. At that time, foreign investors were very reluctant to set up manufacturing facilities locally and rather preferred the export mode of entry to reduce various risks incurred with doing business in difficult business environments. Haier in contrast chose to enter these markets early, and rapidly increased its commitment in the two regions.

Numerous empirical studies have demonstrated strong evidence of the existence of positive effects of being the first mover (e.g., Kerin, Varadarajan, & Peterson, 1992; Mascarenhas, 1992; Robinson, Kalyanaram, & Urban, 1994) and supported the hypothesis that early movers can capture various kinds of competitive advantages, such as higher market shares over time, technological leadership, preemption of key assets (such as distribution channels or joint venture partners), and establishment of entry barriers for follower firms; in other words, early movers are in the best position to determine the rules of the game.

In developing market contexts, early-mover advantages might be amplified by the low competitive pressure at the early stage of market liberalization, an important pent-up demand for foreign brands and the absence of various infrastructures. Potential foreign entrants tend to adopt a wait-and-see strategy because of the tremendous uncertainties in the market, which enable early entrants to establish brand loyalty and shape consumers' perceptions more easily than late entrants (Carpenter & Nakamoto, 1994). Additionally, local governments in these regions often treat early foreign investors more favorably. Where such differential treatment is critical for success, foreign firms may have better incentives to move sooner rather than later (Isobe, Makino, & Montgomery, 2000). In Jordan, for instance, King Abullah 2 welcomed Haier industrial park with open arms and made sure that the firm would enjoy strong support from the Jordanian government following a discussion with CEO Ruimin Zhang. In Algeria, the government often excludes foreign appliances manufacturers from public purchases in favor to those who have established manufacturing facilities in the country. Finally, the choice of the right local partner is critical in developing economies, where often large and diversified groups with already established distribution networks, sufficient financial resources, and market knowledge and inroads into the local political system are particularly scarce assets. In such economies, early-mover companies like Haier can preempt such assets and built upon them in order to secure a long-lasting competitive advantage, and thus raise entry barriers for follower firms.

Entry motives and modes: Unlike in advanced economies, where Haier usually holds majority shares, we saw that, in the Middle East and Africa, Haier often holds minority shares or even chooses to license its brand or technology with its local partners without direct or formal shareholding. The market-seeking motives might well explain this expansion pattern in these regions. Whereas in developed markets such as the U.S., European countries, or Japan, where Haier enters to learn and build up new capabilities (technological, managerial, and marketing capabilities) via its subsidiaries with high ownership structures or Greenfield investments, Haier in less sophisticated, and developed markets choose to transfer more simple, mature, and undifferentiated technologies that suit well the local conditions in terms of products' need and price levels (see Table 3). This entry mode is very typical of latecomer companies, especially Chinese firms in less codified and structured environments. Rather than opting for full internationalization, these latecomer firms tend to chose external modes of entry such as technology licensing or non-equity alliances (Li, 2003; Mathews, 2006). These entry modes enable Chinese firms to access the local market quickly, reduce entry costs, reduce various risks, and gain valuable complementary assets from their local partners (e.g., market knowledge, access to distribution channels or political networks).

Table 3: Haier's Entry Mode in the Middle East and Africa Compared to Advanced Economies

The Middle East And Africa	Mode of Entry	Advanced Economies	Mode of Entry
Algeria	Non-equity mode of entry in association with the Tunisian Group Hachicha	France	Wholly Owned Subsidiary
Jordan	Joint venture with local group SEC electronics (minority share holding)	Germany	Wholly Owned Subsidiary
Nigeria	Joint Venture with PZ Cussons group (minority share holding)	Italy	Wholly Owned Subsidiary
Saudi Arabia	Non-equity mode of entry with local group Al Jabr Electronics	Japan	Wholly Owned Subsidiary
Tunisia	Joint venture with Hachicha Group (Minority share holding)	USA	Wholly Owned Subsidiary

This table shows Haier's ownership structures in a selected sample of countries in the Middle East and Africa compared to those in industrialized economies. Source: Prepared by Authors.

Increased Localization and adaptation to the local conditions: As noted earlier, Haier adapted several product lines to match the specific market conditions of Africa and the Middle East under the request of its local distributors and consumers. The refrigerator that can run through 100 hours of power failure, a high-capacity washing machine, and the air conditioner for desert and tropical conditions are good examples of this adaptation strategy. Haier Sodinco Algeria also reported numerous collaborations with the head office's R&D team in China to adapt different generations of its popular MRV1, 2, 3, and 4 central air conditioning systems.

Zhang firmly believes that, by focusing on its customers' differentiated needs and satisfying them through tailored products, Haier will gain a competitive edge over its competitors. Zhang mentions the following: *"…. large companies are established and slow moving, and we see an opportunity to compete against them in their home markets by being more customer focused than they are. To win over those consumers, we have two approaches: speed and differentiation—speed, of course, to satisfy the consumers' needs as quickly as possible, differentiation to introduce brand-new products or products with features to meet different needs."(*Zhang Ruimin quoted in Wu, 2003).

The firm's commitment to more than 30 countries of the region − often disregarded by other more established multinationals − through sales and manufacturing networks suggest that the firm considers Africa and the Middle East as important market areas. As the CEO of Haier Sodinco Algeria noted, "*Establishing an industrial plant in Algeria, whereas all our competitors were massively importing their products was a proof of our long-term commitment to the Algerian market. Despite the difficult environment and the heavy administrative procedures incurred with investing in the country, we felt that it was very important to produce as much as we could in the country and in the region in order to ensure our competitiveness.*" This localization strategy fits well within Haier's internationalization framework, which involves three steps: first, raise Haier's brand awareness; second, localize design, production, and sales; and third, leverage the local resources of capital and human potentialities. CEO Zhang has often been quoted stressing the importance of localizing Haier's value chain as close to the market as possible by saying, "Globalization equals localization."

Market acquaintance: Despite extreme business conditions, Haier has reached a high level of performance in the region compared with its industry counterparts from developed countries. This might stem from the fact that, when Chinese enterprises operate in developing or least developed markets such as the African and Middle Eastern markets, they see market opportunities and a means of doing business that are similar to the conditions found in their home markets, rather than threats. The Chinese firms' experience dealing with difficult environments characterized by centralized economies, weak institutional framework, or deficient market structures may have equipped them with ownership advantages that enable them to compete efficiently in settings similar to their own domestic market, whereas in contrast, companies from industrialized nations might find it more difficult (e.g., Buckley et al. 2007, Buckley et al., 2008, Cross et al., 2007; Erdener & Shapiro, 2005). In this context, Boisot and Child (1996) argued that Chinese firms have a cultural preference for operating in less-codified regimes typified by fiefs and clans networks rather than by formal and codified rules. From another perspective, MNEs in developing countries possess mature technologies that are particularly suited for other developing nations (Kumar, 1982; Kumar & Kim, 1984; Wells, 1977). Firms in developing countries may also have a better ability than industrialized countries to customize particular technologies, products, and processes by simplifying them or downscaling production, for instance, in order to make them more suitable for the contexts of developing countries (Shenkar & Luo, 2004).

This was the case for Haier in Africa and the Middle East, where the firm transferred and adapted its mature technologies in most of the countries in which it set up manufacturing facilities through, for example, transferring CKD production systems.

Political acquaintance: Haier's intense operations in the region can also be partly explained by the political acquaintance factor. As argued by Buckley et al. (2007), the Chinese FDI stocks in states with higher risk profiles may have been promoted by political affiliations and connections between China and its fellow developing or ideologically similar countries. The bargaining position of the Chinese government and firms may have been strengthened vis-à-vis governments in these host countries that attract limited FDI inflows from industrialized nations, thus reducing significantly the hazards to which the Chinese FDIs are exposed. In the African and the Middle Eastern contexts, given the market failures and institutional voids in these regions, affiliation with political actors or powerful business groups might not only protect MNEs against opportunism from powerful actors and institutions, but also provide them with preferential treatment and access to highly valuable political resources (Mellahi et al., 2011).

As discussed earlier in this paper, Haier built upon political acquaintances with local politicians to ensure its activities in the two regions. Examples include the 2005 invitation by Haier in collaboration with the International Department of the Communist Party of China to a delegation of 17 members of ruling parties in Africa to visit the Haier facilities in China, the support the Chinese firm received from Jordanian King Abdullah 2, and the meeting between Cote d'ivoire's minister of ICT with the Haier representative over operations in the Middle East and Africa − Zhang Qingfu.

CONCLUSION

This article has sought to enhance understanding of the internationalization of Chinese companies in developing nations by presenting the experience of Haier's successful entry strategy in Africa and the Middle East. The results of the case study suggest that, despite its so-called policy of "hard markets first and easier second," the company entered almost simultaneously developing and developed nations. In 1999, when Haier established a manufacturing plant in the U.S. market, it entered several African and Middle Eastern markets as well, including Algeria, The United Arab Emirates, Jordan, and Tunisia, by establishing sales arms or manufacturing plants. The firm formed Haier Middle East in 1999 even before Haier Europe was established in 2000. By localizing its operations in the two regions, the firm adapted its product to meet the very specific needs of these markets, such as a refrigerator that can withstand power failures and air conditioners that can function in desert and tropical conditions. We also saw that, despite the minority shares in the joint ventures or alternative entry mode through licensing partnership, Haier is a fast, early, and proactive investor in these difficult regions of the world. Pioneering in an emerging region carries many advantages, such as the possibility for early mover companies to preempt distribution channels or joint venture partners. The latter advantage can be especially determinant in an emerging market, where local partners with critical financial and knowledge capabilities are scarce. Therefore, by preempting such key strategic assets, the company not only builds a competitive advantage over its competitors but also raises entry barriers for potential foreign new entrants.

The market acquaintance factor was also critical to Haier's success in these regions. The familiarity and the relative ease the firm exhibited in dealing with difficult environments characterized by centralized economies, institutional voids, or deficient market structures stem from the fact that the firms had to deal with these difficulties in its very home market and therefore gained a unique ownership advantage in operating similar environments. The firm's political acquaintances and networking capabilities also helped it access valuable political resources and gain strong support from these regions' local authorities. In times during which foreign investors were reluctant to invest in the manufacturing sectors of these countries, Haier was one of the few exceptions and was consequently welcomed with opened arms by the local authorities of Africa and the Middle East.

Thus, managers from both developing and developed countries' multinational companies should consider in their entry mode, timing and level of commitment decisions in Africa and the Middle East in terms of not only the risks and limitations but also the opportunities in these developing parts of the world. Their success will lie in their ability to treat the local environment as an opportunity rather than a threat and to turn first-mover disadvantages into advantages. Zhang's international entrepreneurship orientation played a determinant role in Haier's pursuit of global expansion, as he views the world as one market and deeply believes that, wherever there is a market for Haier, the firm should have a local presence in these markets, regardless of their development stage. Companies seeking to enter the African and Middle Eastern markets should also look closely at the features of Haier's entry strategies, as it is the most localized international home appliances company in these two regions with presences in more than 30 countries, including an industrial park in Jordan; 3 manufacturing plants in Algeria, Tunisia, and Nigeria; and two trading companies in the Middle East and Africa.

Although this study enabled us to access detailed information about Haier's strategy in the two regions, we also acknowledge the fact that it carries some limitations as well due to the method it employed. The case study's approach, though rich in terms of findings provided about a single firm (Haier), produces implications that would be hard to generalize and apply to other Chinese corporations operating in Africa and the Middle East. Therefore, we call for more case studies on Chinese firms operating in these regions as well as for larger quantitative and cross-industry investigation on the subject.

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USING OPTIONS PRICING THEORY TO VALUE SAFETY & ERGONOMICS PROJECTS: A CASE STUDY

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ABSTRACT

This paper applies option pricing theory to value an investment in safety & ergonomics. Utilizing both traditional and perpetual call option frameworks, we quantify project value overlooked by traditional discounted cash flow techniques. In a case study format, it is shown that delaying investment allows the firm to reduce uncertainty associated with safety & ergonomic interventions; with increased costs of delaying encouraging speedier implementation.

JEL: G30, G31, G32, G39

KEYWORDS: Capital Budgeting, Options Pricing, Case Study

INTRODUCTION

The application of options pricing theory to investments in tangible assets is commonly known as real options analysis and provides a method for quantifying the value of flexibility in investment timing, while considering the impact of uncertainty. Real options analysis allows investment managers to value project abandonment, delay, expansion, and development.

Real options analysis is most appropriately applied to business decisions dependent on the value of additional information, investment timing, and cash flow uncertainty. Uncertainty is inherent in the evaluation of all safety and ergonomics (S&E) interventions; consequently, making accurate economic evaluations of such decisions can be rather difficult. Numerous sources of uncertainty exist. In particular, experts are unable to predict the precise number of workers who will develop work-related musculoskeletal disorders (WMSD) or suffer work-related injuries. In addition to the frequency of occurrences, accident severity is an important driver of costs which cannot be readily predicted. Further, no intervention is completely effective in preventing injuries. As such, the extent to which a given intervention is effective within a target population is unknown. At best, the intervention will reduce the probability an accident or WMSD will occur. This scenario of partial effectiveness introduces additional uncertainty regarding the number and severity of accidents or WMSDs that may be prevented due to an intervention.

Both accidents and WMSDs have direct and indirect costs associated with them. The most significant direct costs are medical expenses for the treatment of injuries, monies paid to employees such as disability and replacement wages, and expenses associated with rehabilitation. Generally, these expenses are translated to the company through worker's compensation insurance. The company pays an insurance premium, which is based to a varying extent on the actual injury rate experienced by the company internally. Indirect costs include expenses such as the worker's pay for the remainder of the day, lost productivity, mechanical repairs, supervisor/administration time, etc. Additional expenses include costs related to relief staffing, absenteeism, and employee turnover. Understanding these costs and their sources will allow companies to more accurately evaluate potential opportunities for avoiding or reducing costs by taking steps to prevent the accidents or WMSDs.

The purpose of this paper is to provide a detailed economic analysis of safety and ergonomics interventions similar to Lanoie and Trottier (1998). However, instead of using traditional discounted cash flow techniques, we utilize an options pricing approach to evaluate investment in S&E.

This paper is organized as follows. Section 2 reviews the literature. Section 3 lays out the principles of option pricing theory and real options. Section 4 uses a practical case study to illustrate the applicability of real options analysis techniques to investment decision making in the area of S&E. Section 5 provides concluding remarks.

LITERATURE REVIEW

The idea that discounted cash flow analysis may be insufficient to capture the true value of investment opportunities has been around for several decades. Myers (1977) was one of the first to examine this and suggest the application of option pricing theory to real investments. Dixit and Pindyck (1994) show that the ability of the firm to delay investment can affect the decision to invest, hence exposing the weakness of the net present value rule. Dixit and Pindyck espouse the use of real option analysis to capture and account for uncertainty, hence creating flexibility. They evaluate the mathematical techniques of dynamic programming and contingent claims analysis and use these techniques to model investment decisions under uncertainty. Botteron (2001) provides a general introduction to the use and benefits of real options theory by walking the reader through the practical application of the theory. The survey paper of Triantis and Borison (2001) examines the experiences of companies across different industries in the United States to better understand how real options analysis is actually applied. The authors find varying degrees of use in different industries, but overall find that real options are used as both a way of thinking and as an analytical tool.

Newton and Pearson (1994) specifically apply real option analysis to a research and development project, illustrating the value of flexibility provided by R&D. Palmer and Smith (2001) also study an application of real options, but to the health care sector, to show that although the firm incurs a loss from delay of implementation, this loss is actually more than offset by the gain of information. Block (2007) surveys Fortune 1000 companies to determine what percentage of managers actually utilize real options. Block finds 14% of respondents use real options in some form. Kyrchowski and Quelin (2010) apply real options analysis to a case study in the telecommunications industry to examine the gap that exists between theory and practice. Krychowski and Quelin find value in the option to defer investment, contrary to discounted cash flow rules.

There are a number of economic studies evaluating the costs and benefits of ergonomic interventions. However, many focus on shorter term payback periods and the development of predictive cost-benefit analysis models (Goggins, Spielholz, Nothstein, 2008). Tompa, Dolinschi, Oliveria, and Irvin (2009) found evidence that ergonomic and other musculoskeletal injury prevention interventions in manufacturing and warehousing are worth undertaking in terms of financial merits, but methodological quality of these economic evaluations could be improved. Further, Tompa, Dolinschi, and Oliveria (2006) identify a need for economic expertise in the multidisciplinary research teams evaluating workplace-based occupational health and safety interventions. Haddix, Teutsch, and Corso (2003) provide discussion in the public sector of the need for specific decision analysis and economic evaluation approach in prevention effectiveness. Niven (2002) identified problems with valuing benefits in health and safety because they frequently take many years to emerge and are difficult to measure. Additionally, healthcare managers and economists have not traditionally worked together and have inherent misunderstandings of each other's roles. This paper fills a void in the literature by providing a contemporary economic analysis technique, namely options pricing theory, to the difficult task of evaluating longer term S & E intervention investment.

DATA AND METHODOLOGY

Option Pricing Theory and Real Options

An option, broadly speaking, provides the holder with an opportunity to take a specific action, but does not require or obligate them to do so. A simple example is the financial call option on a stock, which gives the holder the option to purchase a given stock at a specified price (the exercise price) within a set time period. Hence, if conditions are favorable for the holder of the option and the trading price of the stock exceeds the exercise price of the option, the holder can choose to exercise the option to receive the net value given by:

$$C = Max[S - X, 0] \tag{1}$$

where:

C = Value of the Call Option
S = Value of the Asset (i.e. Stock Price)
X = Exercise Price

Derivatives are a class of securities in which the value of the security is derived from an underlying asset. Options are type of derivative. While options pricing theory has traditionally focused on financial securities as the underlying asset, more recently researchers have applied options pricing theory to the evaluation of real assets involving timing flexibility and uncertainty (Trigeorgis, 1996). The options pricing methods used for valuing these real opportunities have become known collectively as real options analysis. Table 1 lists the components of financial options and their corresponding interpretations under real options.

Table 1. Relating Financial Options and Investment Decisions

Stock Call Option (C)	↔	Option to Invest in a Future Project (C)
Current Value of Stock (S)	↔	Expected Present Value of the Project's Cash Flows (V)
Exercise Price (X)	↔	Expected Investment Cost (I)
Expiration Date (T)	↔	Time Horizon of the Investment Opportunity (T)
Volatility (σ)	↔	Volatility of the Project's Returns (σ)
Dividend on Stock (δ)	↔	Opportunity Cost of Delaying the Investment (δ)
Risk-free Interest Rate (r)	↔	Risk-adjusted Interest Rate (r)

Table 1 relates the components of traditional financial options to those of real options. The left hand side details the variables used in the calculation of financial options, while the right hand side of the table lists their corresponding interpretations under real option theory.

The methodology used to value financial options can be translated to real options by regarding the option as the right, but not the obligation, to invest in a future business project. The current value of the stock is analogous to the present value of the project's cash inflows. The exercise price corresponds to the investment amount to initiate the project. The expiration date represents the point in time when the investment opportunity ends due to license expiration, competitor influences, or other factors. The volatility of the stock price corresponds to the projected volatility of returns for the project. With respect to a call option, dividend payouts decrease the value of the stock thereby reducing the value of the call option. Thus, the dividend can be thought of as the income opportunity which the investor foregoes by delaying the investment.

Case Study Background

Consider the implementation of a new manual material handling (MMH) system at Société des Alcools du Québec (SAQ), the only authorized distributor of wine and liquor in Quebec, to help reduce work-related injuries. SAQ employees primarily perform order-picking activities. Cases of wine and liquor are retrieved from storage shelves and assembled into different orders for distribution to retail locations. The costs and benefits of the new MMH are highlighted in Table 2.

Table 2: Costs and Benefits of New MMH System

COSTS	BENEFITS
Forklift trucks (to move through alleys in shelving units)	**Direct cost savings** (reduced premium paid to Quebec's worker compensation board, which covers lost wages and medical expenses
Pallet trucks (to pick orders from shelves)	**Indirect cost savings** (cost of lost days in terms of lost productivity, mechanical repairs, supervisor/administration time)
Complete redesign of shelving system	**Labor Savings** (tasks eliminated by increased productivity of the MMH system)
Automatic pallet distributor (installs pallets on pallet trucks)	**Broken bottle savings** (annual costs decreased 66%, in constant dollars)
Modifications to the facility (additional room for battery storage and charging)	
Time spent for ergonomics training (teaching employees lifting/handling techniques to prevent back-related injuries)	

Table 2 details the costs and the benefits (cost savings) of the implementation of the new manual material handling (MMH) system at Société des Alcools du Québec. These costs and benefits are then quantified and used in the real option framework to determine the value of delaying the project.

RESULTS AND DISCUSSION

Traditional Call Option Framework

Using data from 2012, we began by framing the MMH investment as a real call option. V_0, is estimated by calculating the present value of the projects benefits at the appropriate discount rate, which in this case equals to \$2.6 million. The investment cost, I, is the present value of the costs associated with the intervention, or \$1.65 million. Consistent with the cost and benefit projections, the time to make a decision, T, is assumed to be 5 years. The risk free rate, r, is assumed to be 5.5%. The parameter used to model project uncertainty is volatility, σ. Dixit and Pindyck (1994) suggest estimating σ by using the stock price volatility of a pure play company in the specific project of interest. In this case, we utilize Columbus McKinnon Corp. (CMCO) because they specialize in manufacturing and selling the type of equipment employed in this intervention (i.e., material handling equipment including trucks and lifts). The CMCO stock price volatility and thus implied project volatility, σ, was estimated to be 64%. The table below lists the real option variables and the corresponding values associated with this project.

Table 3: Traditional Call Option Framework

Real Option Variable	Description	Value
V_0	Present discounted value of the benefit of the project	\$2.6 million
I	Present value of the costs of intervention	\$1.65 million
T	Time to make a decision	5 years
r	Risk-free rate	5.5%
σ	Uncertainty, as measured by comparable stock price volatility	64%

Table 3 lists the real call option variables, the description of each variable within the real option framework, and the associated project value. These values will then be utilized in Black-Scholes equation to determine the value of the call.

Using the above parameters, the value of the call option to invest in this project can be determined using the Black-Scholes (1973) equation.

$$Call = V_0 N(d_1) - Ie^{-rT} N(d_2) \qquad (2)$$

Where

$$d_1 = \frac{\ln\left(\frac{V_0}{I}\right) + \left(r + \frac{\sigma^2}{2}\right)}{\sigma\sqrt{T}}$$

$$d_2 = d_1 - \sigma\sqrt{T}$$

V_0 = Present value of cash inflows
I = Investment cost
T = Time to make a decision
□ = Project value uncertainty due to cash flow volatility
r = Risk-free rate

Using Equation 2, the value for SAQ to delay their MMH investment decision is $1.7 million. The real options literature often refers to this value as the Flexible Net Present Value (FNPV). When compared to the project's net present value (NPV) of $0.94 million, this analysis suggests the flexibility to postpone the investment decision for five years is worth the difference between the FNPV and the traditional NPV, or $0.84 million. As a result, even though there is a positive net present value to the project, the company may be better served to delay investment in order to acquire additional information about the project's costs and benefits.

Perpetual Call Option Framework

An irreversible investment decision, delayed over an infinite time horizon, may be valued using the perpetual call option framework found in Dixit and Pindyck (1995). The value of this perpetual call option, $F(V)$, is shown to be:

$$F(V) = AV^{\beta} \; for \; V \leq V^*$$
$$F(V) = V - I \; for \; V > V^* \qquad (3)$$

where:

$$A = \frac{(\beta-1)^{(\beta-1)}}{\beta^{\beta} I^{(\beta-1)}} \qquad (4)$$

and

$$\beta = \frac{1}{2} - \frac{(r-\delta)}{\sigma^2} + \sqrt{\left(\frac{(r-\delta)}{\sigma^2} - \frac{1}{2}\right)^2 + \frac{2r}{\sigma^2}} \qquad (5)$$

r = risk-free rate
□= volatility
δ = opportunity cost factor

where δ represents the opportunity costs associated with delaying the investment decision
The critical value, V^*, is determined to be:

$$V^* = \frac{\beta}{\beta - 1} I \qquad (6)$$

In the absence of risk, V^* will be equal to I, and the NPV rule would apply. However, the presence of uncertainty implies that $\beta / (\beta - 1) > 1$, and thus $V^* > I$. In other words, when risk is present and $V^* > I$, the NPV rule is no longer appropriate and investment should be deferred until $V > V^*$. When $V > V^*$, the value of the option to invest is simply given by $V - I$ since the decision to invest would be implemented immediately.

When contemplating investment in S&E, the cost of delaying investment must be taken into account. The opportunity cost associated with injuries and accidents that could otherwise have been prevented by investing immediately in the intervention must be considered before making a decision to delay. This opportunity cost of delaying the investment, δ, may be incorporated into the real options analysis and is based on the foregone benefits of the project; that is, the costs of injuries which would be avoided by implementing this intervention, but which will continue to be incurred by the firm each year the intervention is delayed. The total benefits provided in the case study are worth $2.6 million over 4 years. For simplicity, if we assume the $2.6 million in benefits are evenly distributed over the 4 year period, then there is an opportunity cost of $650,000 for each year the investment is delayed. As an overall fraction of the project's value, δ can thus be expressed as 0.25.

With many safety and ergonomics interventions there is not a preset timetable to make an investment decision. Management could choose to delay the investment for one year or ten years, without losing the option to invest later. As such, the perpetual call options framework is an appropriate model.

Using equations 3-6 yields a value for β of 2.08, with a V^* of $3.2 million. Since the expected net present value of the project, V_0, does not exceed the critical value, V^*, the optimal decision is to delay investment rather than invest immediately.

Figure 1 shows the critical value V^* at the point where the flexible net present value (FNPV) and traditional net present value (NPV) converge. Note for all project values $V > V^*$, the FNPV and NPV are equal.

Figure 1: Project Value, V, vs. F(V), (FNPV) and Traditional NPV

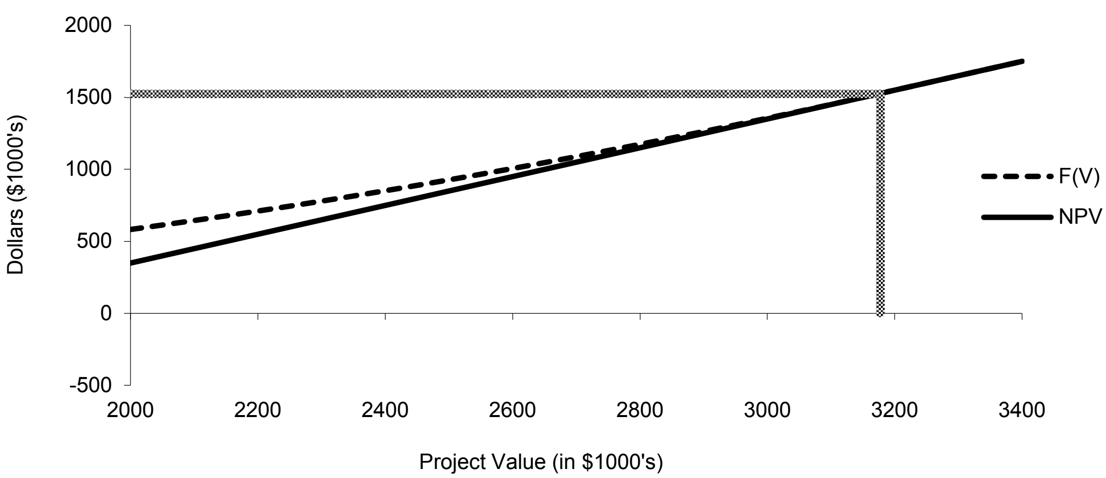

Figure 1 plots the value of the perpetual call option, F(V), (FNPV) and the value of the traditional net present value, NPV. It is shown that the two converge at the critical value, V^*=$3.2million. For expected net present value, V_0, less than the critical value, V^*, the value of the call option is greater than the traditional NPV.

In the following sensitivity analysis, the input parameters are changed, with the corresponding response to the FNPV discussed. In Figure 2, we examine the sensitivity of the option value, F(V), to changes in the initial project value. Note F(V) increases gradually with the project value until it reaches the critical value, as is represented by the vertical line in the figure. In other words, if V0 > $3.2 million, then the benefits of implementing the MMH system today outweigh the value of delaying to gather additional information.

Figure 2: Sensitivity of F(V) to V0

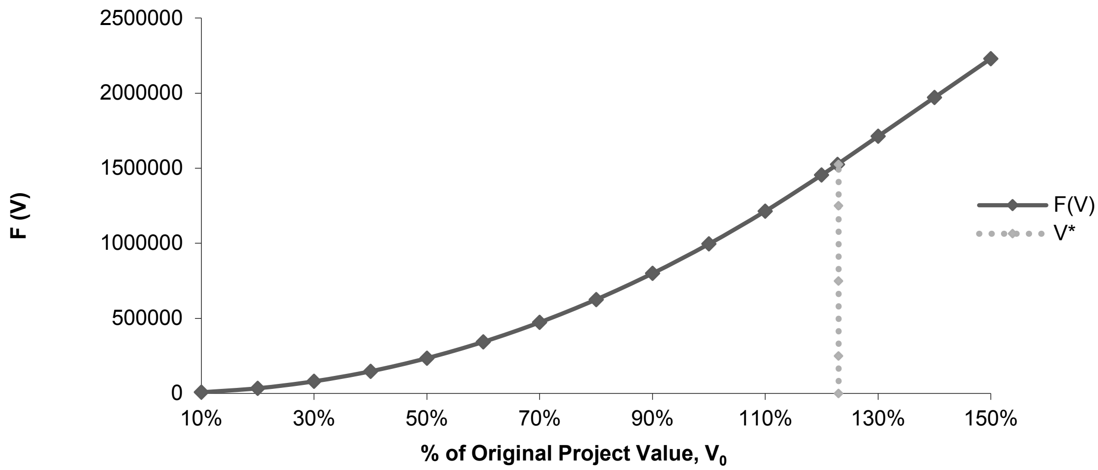

Figure 2 examines the sensitivity of the option value, F(V), to changes in the original project value, V_0. As original project value is changed, F(V) increases gradually, until it reaches the critical value, V*, at which point it increases linearly.

In Figure 3, we examine the effect of the dividend yield, or opportunity cost parameter on the option's value. As one would expect, an increasing opportunity cost reduces the option value. This continues until δ reaches 40%, at which point the value of the project exceeds the critical value, and the project would be implemented. Thus, if the work-related injury costs exceed $1 million per year, then SAQ should implement the MMH system immediately.

Figure 3: Sensitivity of F(V) to δ

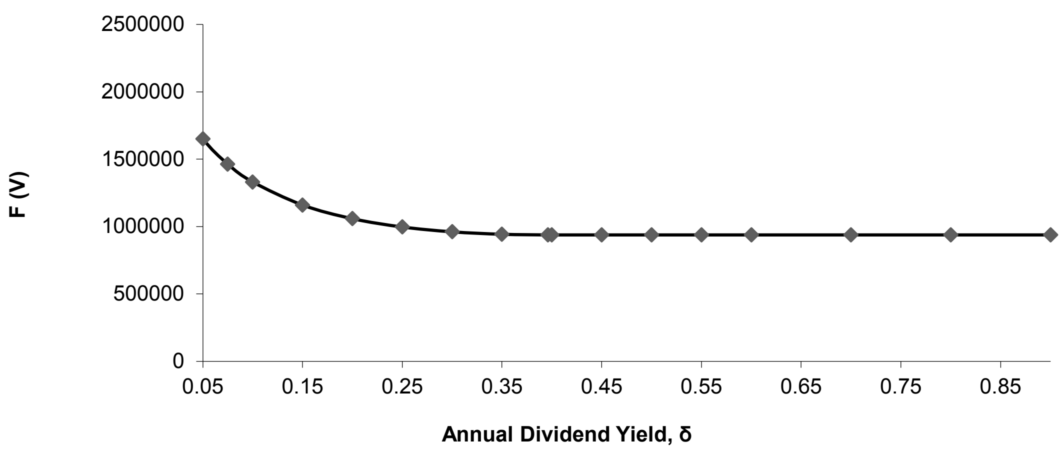

Figure 3 examines the effect of the dividend yield, or opportunity cost parameter, on option value. The increasing opportunity cost reduces the option value until the point that δ reaches .40, at which point V_0 exceeds V, indicating that the project should be implemented.*

Figure 4 shows that F(V) increases with volatility. If the volatility drops below 50%, then V > V* and SAQ should implement the MMH system. In other words, once uncertainty in the MMH benefits are reduced, management should protect its workers with appropriate interventions.

Figure 4: Sensitivity of Option Value to Volatility

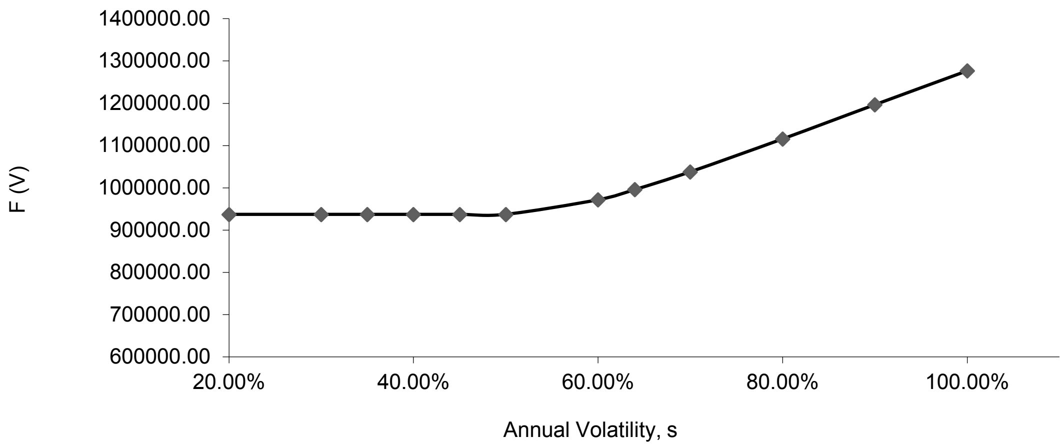

Figure 4 illustrates that option value, F(V), increases with volatility. However, if the volatility drops below 50%, then $V_0 > V^*$ and the project should be immediately implemented.

CONCLUDING COMMENTS

Traditional capital budgeting techniques are often insufficient to justify investment in S&E projects. Further, when these projects can be justified, questions often arise regarding the optimal timing of the investment decision. Using real options, the decision maker has another tool to evaluate these issues.

In the case of S&E projects, it may be especially valuable to view the option value as a measure of the worth of gathering additional information. More specifically, if analysis results in a delay decision, information should be actively collected during this delay to obtain better estimates of benefits or to reduce uncertainty. In terms of S&E intervention, this means further risk analysis, attempting to more accurately characterize the effectiveness of an intervention, and/or developing better estimates of the cost savings per prevented accident or injury. Often, this information is not freely available. As such, the decision maker should invest in additional resources to acquire this type of information and reduce the level of uncertainty. These activities may include (a) hiring outside consultants or experts, (b) developing in-house expertise regarding hazard recognition and mitigation, and/or (c) training of employees regarding unsafe work practices and conditions. Thus, the option value may be viewed as the economic worth of these investigative activities. This investigation should reduce the level of uncertainty, and potentially lead to the discovery of additional or alternative S&E interventions to protect workers.

Further, it should be noted that delaying investment in safety projects may result in additional workers being injured. Although a delay in investment may appear optimal in the short run, it does not alleviate a company from its responsibility to the health and safety of its employees. During a delay, the firm should actively investigate the proposed intervention as well as potential intermediate steps to protect workers. The investigation may yield information that will improve the efficacy of a particular intervention.

Benchmarking from financial option pricing techniques, real options are becoming a practical tool for investment decisions. However, one key difference does exist between financial versus real option valuation. The end goal of financial option pricing is to sell a marketable security, whereas, the culmination of real options should be to improve decision-making. Acquiring precise prices for financial options is a necessary condition for market makers to profitably market and sell derivative products to firms. In addition, firms need to understand more accurately how the option prices were derived, if the derivative product will mitigate targeted risks, and whether or not the market price of that derivative is justified given its potential benefits. On the other hand, real options should be viewed as just another decision-support tool to be used in combination with payback period, return on investment, net present value, and internal rate of return. The real ‘bang for the buck’ for real options is identifying an appropriate decision framework, recognizing the implicit/explicit real options, and calculating an enhanced project value. In other words, real options results should guide decision-makers to choose the best course of action, not necessarily to provide an ‘exact’ option price.

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UTILIZATION OF VALUE STREAM ANALYSIS TO IMPLEMENT REDEFINED VALUE: A SOCIAL BUSINESS PERSPECTIVE

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Khan Muhammad Saqiful Alam, North South University, Bangladesh
Iftekhar Mahfuz, Independent University, Bangladesh
Towhid Khan, University of Hawaii at Manoa

ABSTRACT

The premise of value focuses on the customer while the integration of social and environmental value along with customer value holistically is missing. This paper redefines the conceptualization of value as a three dimensional construct encapsulating customer, social and environmental (CSE) value. Furthermore, in operations management, value stream analysis (VSA) has been utilized as an implementation tool of customer value only. However, this study addresses a gap in the literature by employing VSA as an implementation tool to execute the redefined CSE value in a social business setting. An exploratory research driven by semi-structured interview sessions with the employees of a social business in Bangladesh were conducted while embracing a qualitative research strategy to build new insights and theories. In consequence, this study offers strategic suggestions to existing social businesses as to how the redefined conceptualization of value can be implemented for the betterment of customer, society and environment.

JEL: M00, M1

KEYWORDS: Value Framework, Customer Value, Social Value, Environmental Value, Process Analysis, Strategic Process Mapping

INTRODUCTION

Various scholars such as Zeithaml (1988), Woodruff (1997) and Holbrook (2005) have stressed on the significance of value in business management. For instance, Zeithaml (1988) elucidated value in terms of what a customer gains in consequence of a cost. The aforementioned authors conceptualized value from a functional and tangible viewpoint. However, scholars such as Butz and Goodstein (1998) and Kotler, Armstrong, Agnihotri and Haque (2010) conceptualized an additional intangible antecedent of value in terms of emotional value. Hence, value can be defined as the summation of benefits (functional and emotional) that a customer receives at a given price.

The authors of this paper conducted an in depth literature review of previously published research papers on the significance of value. In consequence, wide arrays of scholarly articles were found where researchers conceptualized value from the perspective of the customer. Hence, value has been widely accepted as a uni-dimensional construct which incorporates the benefits a company provides to its customers (Albrecht, 1995; Day, 1990; Huber, Herrmann and Morgan, 2001; Slater, 1997; Zeithaml, 1988). However, the authors of this paper believe that the principle of value needs to evolve from a mere uni-dimensional construct into a multi-dimensional paradigm. Hence, this research paper conceptualizes value by encapsulating customer value along with social and environmental value.

Furthermore, from the perspective of operations management, value stream analysis (VSA) has been widely used as an implementation tool of customer value whereby, business processes are diagnosed and re-engineered to enhance value for the customers(Womack and Jones, 2003 and Bicheno, 2008). However, this research paper utilizes VSA to implement value not only for the customers – but for the environment and the society holistically. The novelty of this research paper addresses a gap in the literature by conceptualizing value as a three dimensional construct (customer, social and environmental). Moreover, previous scholars in the milieu of operations management have only utilized VSA to implement customer value (e.g. Browning, 2003, Kocakulah and Upson, 2005, Barber and Tietje, 2008, Doyle, 2009, Chen and Meng, 2010). However, this research paper addresses a gap in the literature by being the first to utilize VSA to implement a redefined value encapsulating the impact business processes can have on the customers, the society and the environment.

Moreover, this research is conducted in the context of social business. The social business paradigm conceptualizes the significance of addressing social and environmental problems in a sustainable set-up (Yunus, 2010). It provides entrepreneurs a novel school of thought to commence a business to facilitate social and environmental transformation. A social business integrates the dynamism of sustainability rooted in conventional profit maximization firms with the social and environmental conscience of non-governmental organizations (Yunus, 2010). Social business elevates the social and economic positions of the under privileged (Yunus, Moingeon, and Ortega, 2010). It is designed to encompass the under privileged to equally participate in the market based economic activities (Rahman and Hussain, 2012). According to the pyramid of economic prosperity, very few business enterprises target the bottom of the pyramid because it comprises of people with limited or no purchasing power (Prahald and Hammond, 2002). However, the social business paradigm includes the bottom of the pyramid and addresses their needs (Rahman and Hussain, 2012).

This paper first reviews the extant literature on the premise of value comprising of customer, social, and environmental value in the process of formulating the CSE value framework. Subsequently, a critical review of the literature encompassing value stream analysis is prepared. Furthermore, the methodological foundations of this research paper encapsulating the philosophical stance, the research approach and purpose, research strategy, and primary data method is explicated. Results are generated by utilizing value stream analysis as a tool examine the existing process map of the organization under study while also utilizing the aforementioned tool to implement CSE value in the process of generating a proposed process map. Lastly, the authors of this paper reveal areas for further study while also offering recommendations and concluding statements.

LITERATURE REVIEW

Customer Value

Customer value is a significant source of competitive advantage for businesses (Porter, 1985). Identifying and creating customer value is regarded as an essential prerequisite for long-term company survival and success (Porter, 1986; Woodruff 1997; Payne and Holt, 2001; Huber, Herrmann and Morgan, 2001). Scholars such as Heskett, Sasser, and Schlesinger (1997) and Kotler et al., (2010) revealed the importance of providing superior customer value through the implementation of the service profit chain as a thrust to enhance financial performance of the firm. In consequence, scholars in the milieu of marketing have published various research papers to empirically examine the value that companies create for their customers while providing key insights into how marketing practices should be customer centric (e.g. Graf and Maas, 2008; Sheth, Sisodia and Sharma, 2000).

Customer value signifies the benefits received by the customers as a result of purchasing a product or service at a given price (Evans, 2002). Fundamentally, benefits can be categorized under functional and emotional benefits. Functional benefits are derived from the attributes of the product which satisfies the utility needs of the customer (Keller, 1993). On the contrary, emotional benefits are the positive feelings customers get from the purchase of a product (Keller, 2008). Such emotions are evoked via advertising and have been a significant element in the brand management literature (Clow and Baack, 2012). Hence, customer value can be defined as the summation of function and emotional benefits received by the customers at a given price. Furthermore, the general consensus encompassing the customer value literature reveals that customer value is determined by the customer and not the company (Belasco and Stayer, 1993; Woodruff and Gardial, 1996; Zeithaml, 1998). Hence, understanding the customer needs and wants is an essential parameter for businesses to determine what value customers are looking for (Kotler et al., 2010). In consequence, businesses can design products or services which satisfy the needs of the customers by delivering superior customer value (Kotler and Keller, 2009). This in turn will result in profitable exchange relationships between the company and the customer.

<u>Social Value</u>

As this research paper is prepared in a social business setting, the authors of this paper have reviewed the literature encompassing social business to signify the importance of social value. A social business cultivates *social value* which involves the pursuit of societal improvement by eliminating obstacles that thwart social development (Austin, Stevenson, and Wei-Skillern, 2006; Smith and Stevens, 2010). Hence, social value signifies the fulfilment of the basic and long standing needs of the bottom of the pyramid (Certo and Miller, 2008). Such needs encompass education, health, water, food, and etcetera that yield social wealth enhancement (Drayton, 2002).

The key distinguishing feature between a social business and conventional business is the pursuit of *value*. In a conventional business, *financial value* maximization for the shareholders remains the chief motive. Even though the advocates of corporate social responsibility (CSR) have proposed businesses to encapsulate social, environmental and financial value in a triple bottom line measurement approach, ultimately financial value matters most (Yunus, Moingeon, and Ortega, 2010). Hence, the reconciliation of the triple bottom line approach is rather challenging. Scholars such as Burke and Longsdon (1996) and Husted and Allen (2007) have in fact established affirmative results suggestive of CSR in producing social and financial value. In consequence, conventional businesses are keen to launch CSR activities to address social issues. However, such projects require businesses to devote capital and human resources. Therefore, in the process of enhancing social welfare by means of CSR projects, profits for the shareholders may dwindle resulting in profit oriented shareholders feeling resentful unless corporate managers can demonstrate a healthy return of CSR investment in terms of financial value (Yunus, Moingeon, and Ortega, 2010). Hence, this necessitates a change in shareholder philosophy to enhance social welfare – from being a '*profit oriented shareholder'* to a '*social oriented shareholder'*. In consequence, the chief motive of investors of a social business is to eradicate a social problem. Hence, social businesses cultivate *social value* in the quest to realize a world without poverty (Yunus, 2009). This impetus has given rise to various social businesses striving to address the most pressing needs of the society.

<u>Environmental Value</u>

The conceptualization and implementation of environmental management practices has received significant importance in the milieu of business management (Aragon-correa and Sharma, 2003; Banerjee, 2002; Vachon and Klassen, 2008). However, many corporate managers do not appreciate the importance of operating an environmentally conscious business. Some even believe that allocating company resources towards protecting the environment will reduce company profitability and competitiveness (Gingrich, 1995; Walley and Whitehead, 1994). In consequence, various stakeholders of a business such as the clients and the governments are demanding for environmentally conscious business practices (Vidal-Salazar, Cordon-Pozo, and Ferron-Vilchez, 2012). This calls for organizations to modify and re-engineer their business processes to cultivate *environmental value*. The authors of this paper signify environmental value as *"the ability of an organization to have a zero impact on the environment"*. Furthermore, we suggest businesses to be proactive and *not* reactive in establishing environmental strategies in the quest to cultivate environmental value (Aragon-Correa and Sharma, 2003; Christmann, 2000). In other words, businesses should no longer integrate environmental strategies just to comply with environmental regulations and stakeholder requirements - but should encapsulate dynamic environmental practices that extend beyond industry standards, foresee future changes in social trends and regulations, and re-engineer business processes to prevent negative environmental impacts (Aragon-Correa, 1998; Aragon-Correa and Sharma, 2003; Hunt and Auster, 1990; Sharma and Vredenburg, 1998). Therefore, *environmental value* should become one of the strategic pillars of an organization whereby all the departments of the firm are accountable to cultivate environmental value in a proactive manner.

Various scholars such as Judge and Douglas (1998) and Klassen and McLaughlin (1996) have empirically established affirmative relationships between proactive environmental strategies and financial performance. In fact, most corporate managers who pursue environmental strategies promote their actions to establish a positive corporate image in the customer mindset (Chang, 2011). Scholars such as Russo and Fouts (1997) have confirmed that this in turn results in higher profitability for the firm. However, the authors of this paper suggest a mutually exclusive approach towards the establishment of environmental value. We suggest that, the **motive** of the business towards the creation of environmental value should be uni-dimensional towards protecting the environment, and **not** improving financial performance.

Figure 1: CSE Value Framework

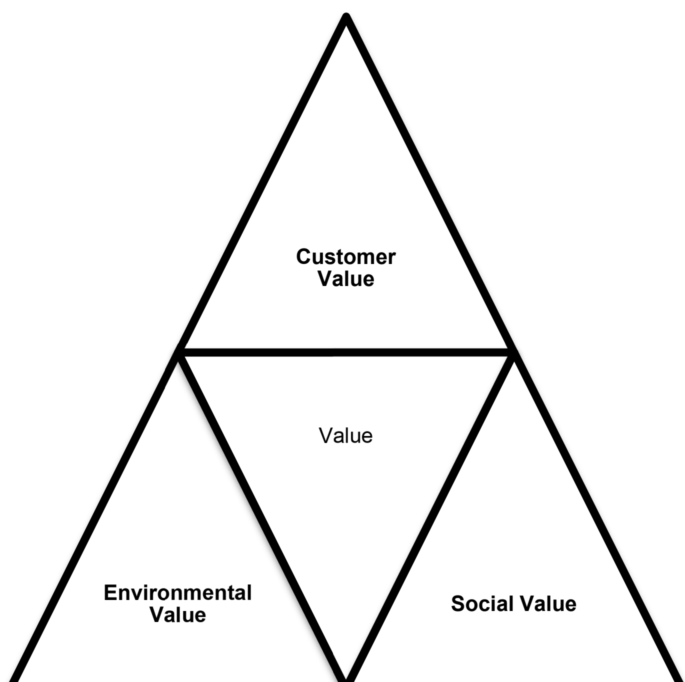


Figure 1 illustrates the CSE (customer, social, environmental) framework

Figure 1 above illustrates the CSE (customer, social, environmental) framework of value which signifies the re-defined value established in this research paper. As a result, social businesses should pursue customer, social, and environmental value in an integrated manner to address humanity's most pressing needs. Subsequently, the authors of this paper review the literature encompassing value stream analysis (VSA) to implement and support the novel CSE framework as a strategic pillar for social businesses.

Value Stream Analysis

The concept Value Stream Analysis (VSA) was coined by the works of Womack and Jones (2003) who suggested VSA as an effective tool for the implementation of lean. It became popular through the books: *The Machine that Changed the World* and *Lean Thinking*. After its conceptualization, various studies have been done on the significance of VSA. It was the works of Bicheno (2008), Womack and Jones (2003) and Lian and Van Landeghem (2007) that established the concept of using VSA as an implementation tool. In consequence, their work demonstrated the effectiveness of the implementation of lean in different business scenarios. The versatility of VSA could also be seen from the works of Chen and Meng (2010) which showed its use in a Chinese business context. Moreover, scholars such as Seth, Seth and Goel (2008), Vinod, Arvind and Somanaathan (2010) and Seth and Gupta (2005) utilized VSA in different business contexts in India – including cottonseed manufacturing and camshaft operations. Furthermore, VSA has been utilized in process improvement in Electrical Manufacturing Systems (EMS) (Shen and Han, 2006), pipe manufacturing and supply industry (Arbulu, Tommelein, Walsh and Hershauer, 2003), upholstery furniture engineering process (Wang, Quesada-Pineda, Earl Kline, Buehlmann, 2011), house construction industry (Yu, Tweed, Al-Hussein, Nasseri, 2009) and even in health management systems (Kocakülâh and Upson, 2004; Kim, Spahlinger, Kin, Billi, 2006; Tischler 2006; Barber and Tietje, 2008). However, the VSA tool has not been utilized in the context of a social business. Hence, this research addresses a gap in the literature by employing VSA in a social business set up.

In its very essence, VSA looks into identifying and then removing all those activities that are not adding any value to the end customer, the user, or the product or service (Womack, Jones and Roos, 1990; Rother and Shook, 1998; Hines, Howleg and Rich,2004). Thus, as discussed in the work of Braglia, Carmignani and Zammori(2006), the heart, or the core attribute of the tool is the understanding of what customer value actually is, because only after the appropriate definition and scope of the value can the tool be used to increase value for the customer. According to Rother and Shook (1999), the concept of value stream comes whenever there is a product for a consumer involved. The surface level effectiveness of VSA can be seen from the better understanding of the concept of value in terms of flow of product and services throughout the production line and the supply chain and also the increased detectability of flaws all throughout the value chain (Bicheno, 2008). But the benefit of VSA does not stay limited to the production flow only. The flow improvements also extend to the flow of information among the stakeholders (Braglia et al.,2006). Due to these advantages, the understanding of the processes and the improvement suggestions that arise from VSA cannot only be used to implement lean, but can be used in product designing and redesigning exercises (Serrano, Ochoa and Castro, 2008) and also in future strategic planning for an organization (Gregory, 2003; Lasa, Laburu and de Castro Vila, 2008).

Furthermore, due to the versatility and effectiveness of the use of VSA, a good deal of work has been carried out in improving its conceptualization and implementation power. Such improvements can be categorized as backward integration to the core concept of value, and the others as forward integration towards the implementation phase. It was the works Hines et al., (2004), which, also after basing itself on the previous works of Browning (2003), suggested that one of the biggest problems of VSA was its focus on defining value only on the foundations of the cost parameter, and thus making VSA a cost minimizing tool. This tool was further brought into light by the work of Agyapong-Kodua, Ajaefobi, Weston and Ratchev (2012) as well. One of the means of countering this drawback was to go back to the very roots of VSA and look for what exactly creates 'customer' value (Braglia et al.,2006).

Other than the focus on the customer's perception of value, Kocakülâh and Upson (2004) suggested that the concept of value for the customer will also take into consideration the flow of information all along the supply chain/value chain. There have been indeed quite a few other works, which suggested that the improvement of VSA can be effectively done through redefining the concept of concept of value – namely value for the customer (Doyle, 2009; Allen, 1993; Huber, Herrmann and Morgan, 2001; Piercy and Morgan, 1997). The other category of research related to the improvement of VSA, as mentioned in the outset of paragraph, was about forward integration, looking into improved means of implementation of VSA. The work of Agyapong-Kodua et al. (2012) suggests improvements in VSA tailored towards the quantitative aspects of the process in concern, and a similar stand is taken by the work of Braglia et al. (2006) and Serrano et al. (2008), both of which suggests the collaboration of VSA with the engineering tools to give a more concrete set of results. Finally, the work of Zokaei and Simmons (2006) summarizes the improvements on VSA that have been done so far, and it is evident from their work that most of improvement efforts of VSA have been directed towards the redefinition of value, mostly customer.

Based on the critical review on VSA, the effectiveness of VSA as a good implementation tool depends on the concept of value, and although various studies have been carried out in order to modify the concept of value, the final concept of value in VSA has always circled around the customer. However, this research paper will change the lens of VSA from *customer value* to *CSE value*. In consequence, an examination of business processes will be conducted not only to implement customer value, but to enhance social and environmental value in a cohesive manner. Hence, adding to the academic literature of VSA a completely new and strategic area of study. Such an approach has not been previously conducted by scholars, which further augments the novelty of this research paper.

DATA AND METHODOLOGY

This research paper strives to redefine the conceptualization of value in the milieu of social business. Furthermore, this study explores whether value stream analysis can be utilized to improve business processes while considering the redefined concept of value. Hence, from a philosophical standpoint, this research undertakes a subjectivist ontological stance as the authors of this paper believe in the continuous creation and re-creation of theory (Bryman and Bell, 2007). Furthermore, considering the sociological paradigms developed by Burrell and Morgan (1982), this research paper encapsulates the interpretive paradigm while considering the regulatory perspective. In consequence, this study will strive to offer strategic suggestions to existing social businesses as to how the redefined conceptualization of value can be implemented within the framework of the way things are done at present (Saunders, Lewis, and Thornhill, 2009).

This research utilizes the inductive research approach as the authors of this paper look to build theory which will crystallize during the data collection phase (Johnson and Clark, 2006). Furthermore, the purpose of this research is exploratory in nature as it is a valuable means to seek new insights and assess a phenomenon in a new light (Robson, 2002; Saunders et al., 2009). Hence, considering the nature of the research questions, the philosophical stance, the research approach and purpose, this study embraces a qualitative research strategy whereby primary data is collected via interview methods. The reason for the choice of interview methods as compared to case study analysis was due to the fact that case studies normally cover two sets of scenarios – i) learning from the challenges faced by an organization and generalizing the best possible solutions that the organization have either taken or could have taken and ii) learning from the success story of an organization in a context, and then generalizing the critical success factors so that they can be applied by other organizations in a similar scenario (Yin, 2008 and Dul and Hak, 2012). However, given the fact that this research is exploratory in nature, neither of the aforementioned scenarios fit into this context. Hence, a qualitative research conducted by interviewing experts is a better choice compared to case study analysis. Consequently, considering the research rationale and philosophical stance of this study, the action research methodology could also be executed. However, due to the limited access to the organization chosen for primary research (in terms of managerial control of implementing the recommended changes) or any consulting capacity relationship with the organization, the cyclical approach of analyzing the impacts of the research in order to validate the initial set of recommendations cannot be carried out (Costello, 2003 and Stringer, 2007).

The authors of this research have chosen "Mpower" which is a social business in Bangladesh to collect primary information. Furthermore, the employees of Mpower were approached and a non-standardized, semi-structured in-depth interview method was capitalized. This is because, this research being exploratory in nature, will require in-depth interviews to seek new insights in the milieu of operations management and social business (Cooper and Schindler, 2008; Robson, 2002). Moreover, a semi-structured interview method will help us probe answers which will add significance and depth to the data we obtain to address the research questions (Saunders et al., 2009).

To ensure the quality of the primary data, the authors of this paper incorporated the triangulation method which has been extensively utilized by various scholars (e.g. Gillham, 2000; Myers, 1997; Patton, 2002; Stake, 1995; Yin, 1994) to strengthen the data credibility in a qualitative research strategy framework. This research will utilize *data triangulation* and *investigator triangulation* approach (Stake, 1995). Hence, interviewing different employees of the organization will enhance the validity of the data (Yin, 1994). Furthermore, all the three authors of this paper will be involved in the data collection process. In consequence, at the end of the data collection process, the authors will compare the findings to develop a deeper and broader understanding of the study. This in turn will heighten the confidence of the findings provided that all three authors arrive at the same conclusion (Denzin, 1970).

The organization under study is Mpower Social Enterprise which sprung from ClickDiagnostics Inc., a company founded by graduate students of Harvard University and MIT in 2008. Its journey began in Egypt and eventually spread out in countries like Botswana, Bangladesh, Ghana and Uganda. Mpower harnesses the power of information and mobile technologies to revolutionize the impact of development. Their services and products package consists of process analysis and information optimization, technology customization and development and mining and analysis of real-time data.

RESULTS

This section of the research paper utilizes the VSA tool to reveal the existing process map of the social business under study. In consequence, the existing process interfaces are discussed where value is being created. Furthermore, an improved strategic process map encompassing the CSE value framework is suggested. Lastly, a comparative discussion is prepared in order to signify the effectiveness of the proposed framework compared to the present value maximizing scenario of the firm.

The existing strategic process map of the organization under study is presented in Figure 2. Through semi-structured interview methods, the authors of this paper interviewed the top management officials at M-power and determined all the business process steps executed in the organization. As a result, a strategic process map could be established as shown in Figure 2 which sheds light on the details of every business process currently pursued at M-power to achieve their organizational goals and objectives.

The first step of the Mpower's business process involves the pre-sales step. This step involves identifying prospective projects which strategically aligns with the organization's core values. The next step involves an in-depth analysis of the client's existing business process. At this stage, the weaknesses and gaps of the client's business process are identified. In consequence, a basic structure of the proposed solutions – (the *'to be'* process) are outlined whereby Mpower suggests how their strength in information and mobile technology can enhance the client's business process in order to boost their impact on development programs. Subsequently, Mpower and the client go through a series of discussion sessions whereby the proposed improvements of the client's business process are fine-tuned based on the requirements of the client, the capacity of Mpower and the costs involved. In consequence, after all the requirements from both parties are addressed, the project contract is signed. The next step involves the design phase whereby Mpower designs the information system solution product needed to enhance the business process of the client. Consequently, a pilot run of the product is implemented in order to signify the actual performance of the product while identifying and troubleshooting any problems. Subsequently, a performance report from the pilot run is generated and shared with the client. Furthermore, if the client requires any further modifications, then according to the client's requirements, further adjustments to the product specifications are employed. As a result, the product is finalized and implemented in the client's business process. However, parallel implementation is utilized in order to ensure a smooth transition while implementing the new product in the client's business process. Parallel implementation involves real time debugging and troubleshooting, training of the staff and the measurement of the impact of the new product. In the final stage, Mpower remains an operational partner of the client by managing and monitoring the new product they implemented in the client's business process.

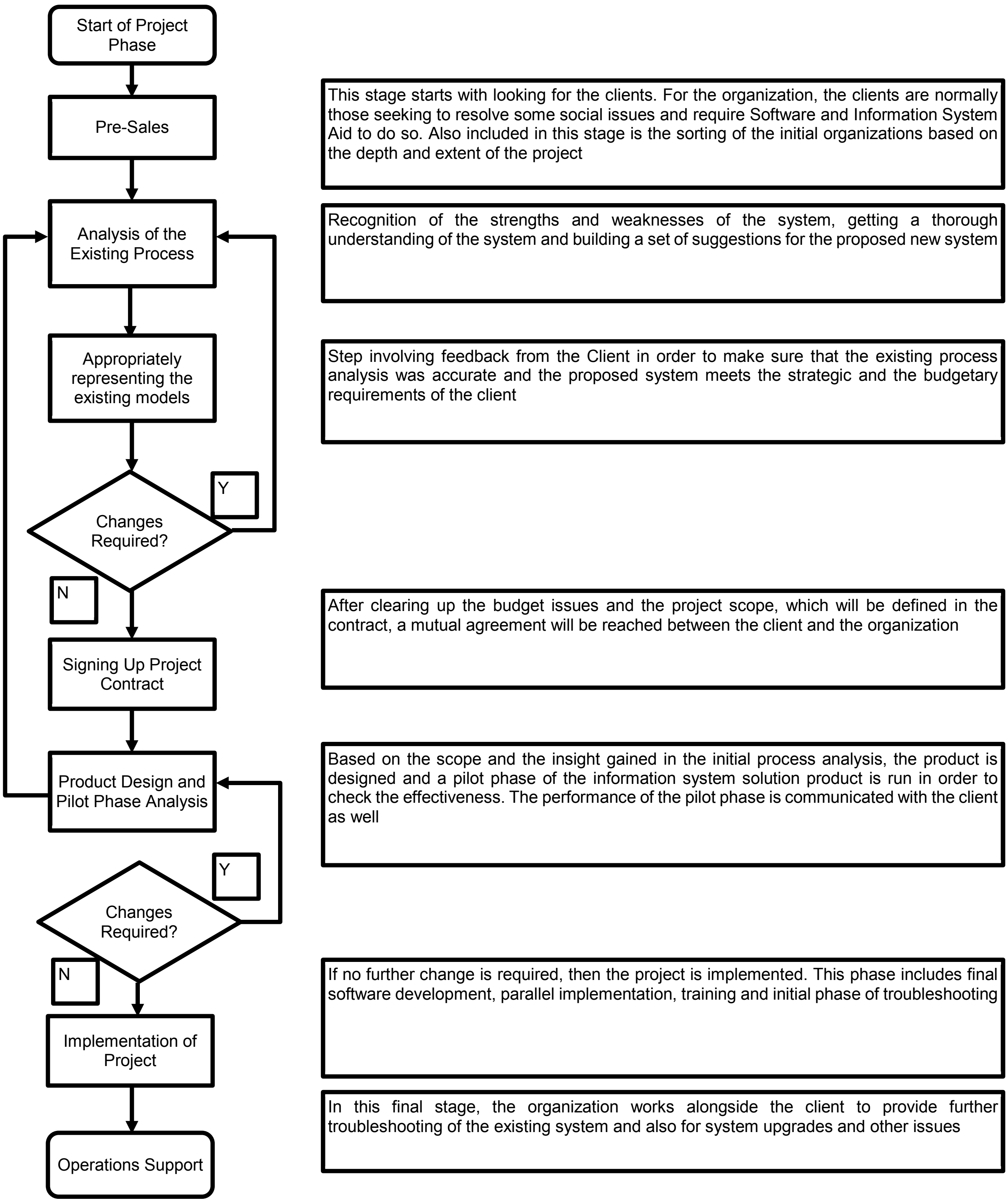
Based on the above description of the existing business process of Mpower, the following process map illustrated in Figure 3 presents the value created in each phase of Mpower's business process. The authors of this paper have chosen a social business in order to explore the effectiveness of the CSE value framework because of the fact that one of the core objectives of a social business is to create social value. Hence, it is eminent that for a social business, the end value in terms of customer will lead to social value.

After initially determining the strategic process map of the organization under study, the authors of this paper investigated the value created in each phase of the business process as shown in Figure 3. This investigation was done through the utilization of value stream analysis. As a result, this research verifies whether in each step of the business process, M-power creates customer value, social value, environmental value or a combination of the values under study.

The stages where Mpower stresses on social value are pre-sales, existing business process analysis of the client, product design and pilot run, and finally the implementation and operational support stages. In the pre-sales phase, while choosing a project, Mpower picks the one which focuses on addressing social problems. Hence, Mpower's product encompassing information and mobile technology by function will be adding social value for the client. Subsequently, in the existing business process analysis of the client phase, Mpower focuses on social value that is to be enhanced in the existing system. In consequence, Mpower proposes resolutions by identifying and eliminating processes that are redundant and non-social value adding while introducing processes that will maximize social value. At this stage, Mpower communicates the significance of social value to the client. Therefore once a contract has been signed, the product design phase starts whereby an information or mobile technological product is designed to enhance social value in the business process of the client's organization. Afterward, a pilot run phase is employed to test the actual performance of the product in terms of its ability to maximize social value in the business process. At this stage, Mpower identifies and troubleshoots any problems which thwart the product's ability to enhance social value. In consequence, a performance report from the pilot run phase is generated which signifies how the product has enhanced social value throughout the business process of the client's organization. During the parallel implementation phase, Mpower executes the product in the client's business process while also troubleshooting, debugging and training the employees of the client's organization in order to realize the maximization of social value. Finally, in the operational support phase, Mpower provides further assistance to ensure consistency of the performance of their product in providing social value.

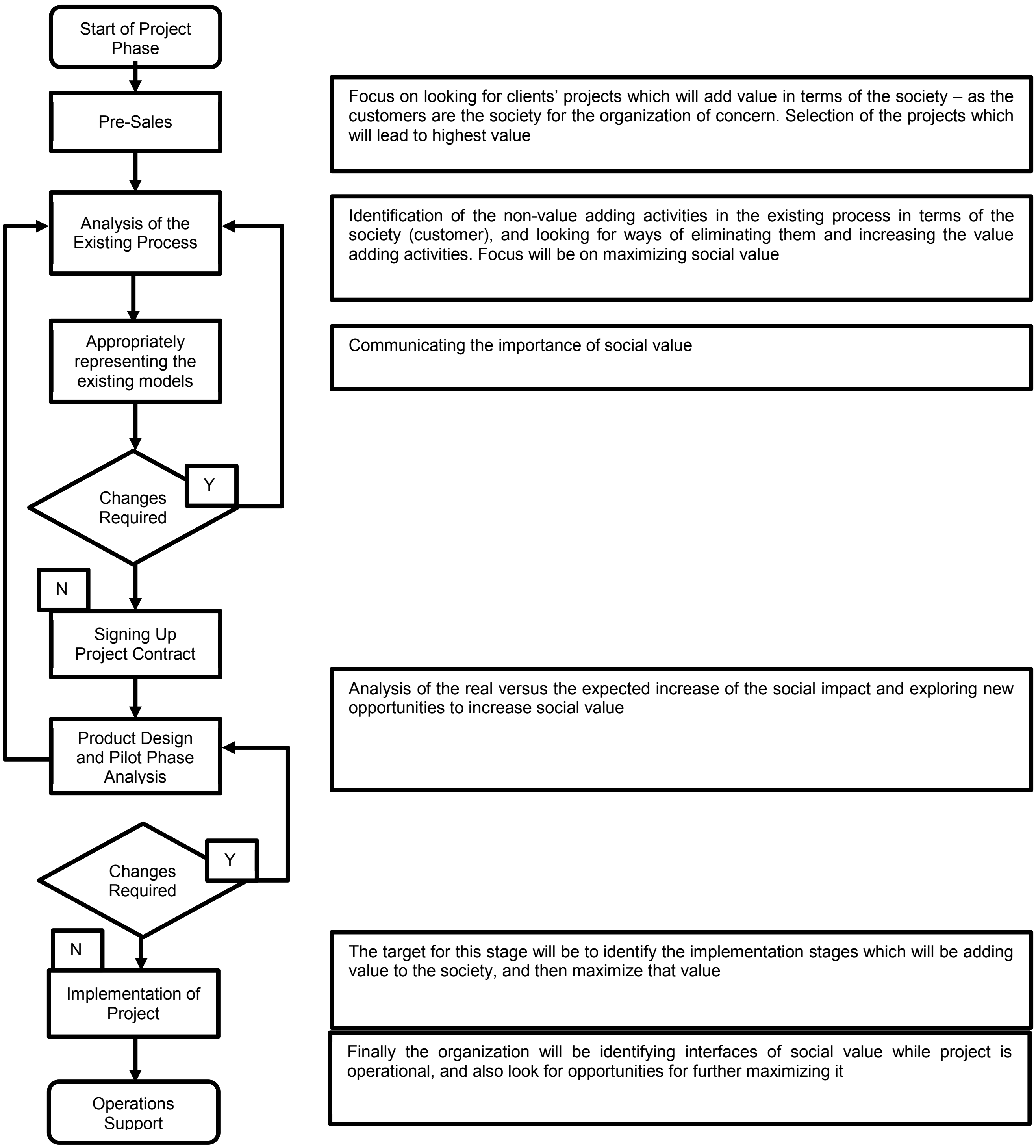
Hence, the above discussion presents how value is created in the existing business process of Mpower. In the subsequent section, this research paper utilizes value stream analysis and presents how the CSE value framework maximizes customer, social, and environmental value in the business process of Mpower. Figure 4 illustrates the proposed business process map whereby CSE value has been incorporated.

Figure 2: Existing Strategic Process Map of the Organization under Study



Figures 2 illustrates the existing strategic process map of the organization under study

Figure 3: Value Created in Each Phase of the Business Process of the Organization under Study



Figures 3 presents a process map illustrating the value created in each phase of Mpower's business process.

Figure 4: Proposed Business Process Map with the Incorporation of CSE Value

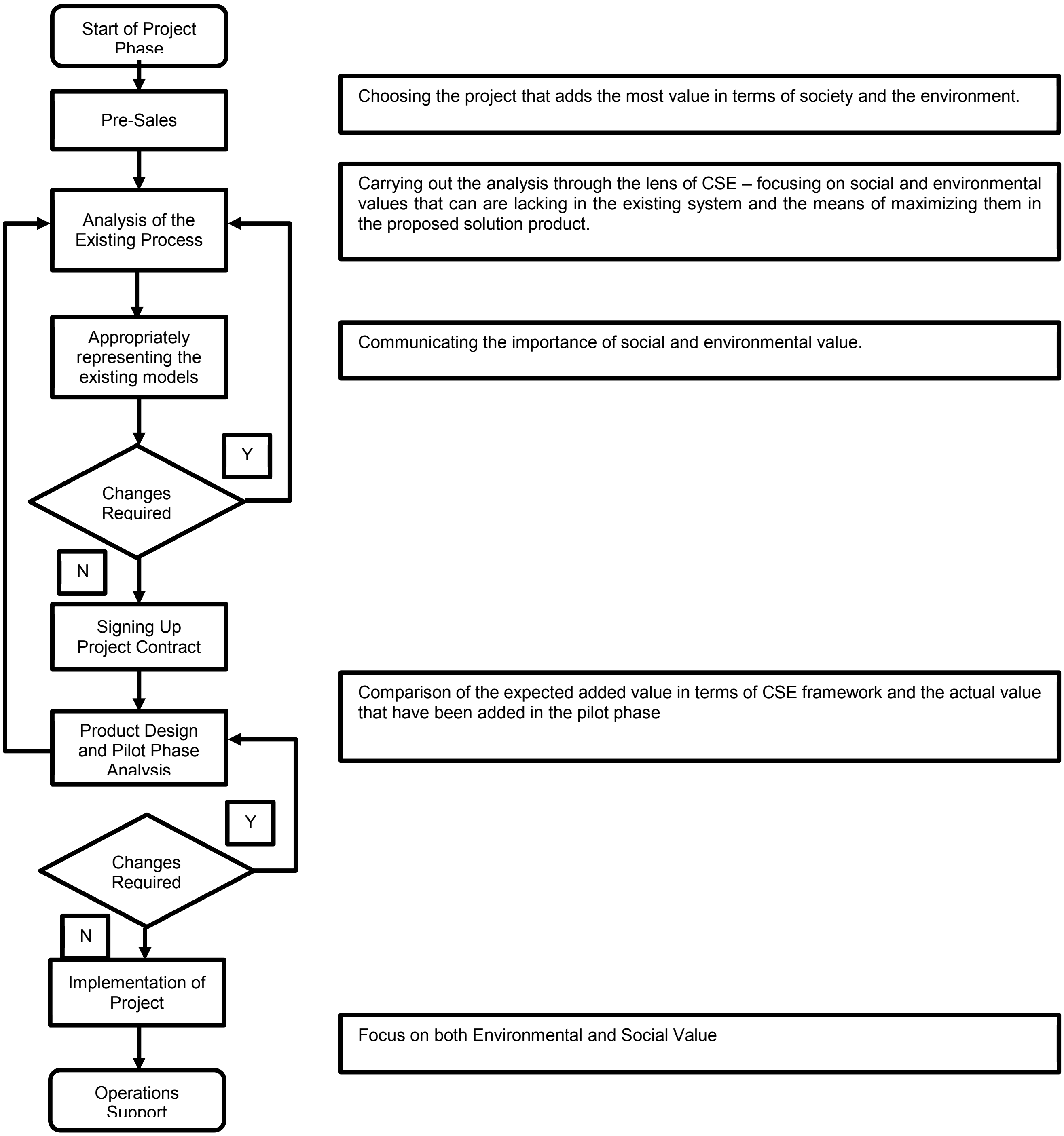


Figure 4 illustrates the proposed business process map whereby CSE value has been incorporated.

Once the values created in the existing phases of the business process at M-power was determined, the authors of this paper pursued a gap analysis and established a proposed business process map through the utilization of value stream analysis as shown in Figure 4 by implementing CSE value in each step of the business process in the organization under study.

The steps and the means of cultivating CSE value are similar to that of the existing process, which means that the changes necessary will not be radical in nature. Accordingly, in the pre-sales phase, Mpower should look for projects which can address social and environmental problems. Subsequently, during the analysis of the existing business process phase of the client's organization, Mpower should identify weaknesses and gaps of the client's business process in terms of social and environmental value. Accordingly, Mpower should formulate proposed solutions by identifying and eliminating processes that are unnecessary and non-value adding in terms of social and environmental value while proposing resolutions that will maximize social and environmental value. At this stage, Mpower should communicate the importance of social and environmental value to the client. Once a contract has been signed, Mpower should design a product that will not only enhance social value but also encompass environmental value as well. Consequently, during the pilot run phase, the actual performance of the product should be measured in terms of its ability to maximize social and environmental value in the business process of the client's organization. During this stage, Mpower should address any technical problems that prevent the product's ability to maximize social and environmental value. Furthermore, as far as the performance report generated from the pilot run is concerned, Mpower should illustrate how their product will enhance social and environmental value in the existing business process of the client's organization. During the parallel implementation phase, while installing the product in the client organization's business process, Mpower should troubleshoot, debug, and train the employees of the client's organization to effectively cultivate social and environmental value in the client organization's business process. Finally, in the operational support phase, Mpower should provide continuous support to ensure the reliability of the product in maximizing social and environmental value.

Hence, this research paper effectively utilized the VSA tool to implement the redefined CSE value in a social business. In consequence, a strategic "to be" process map incorporating the three dimensions of the CSE value framework has been suggested. This in turn will work as a strategic guideline for the organization while conducting its business operations to create value for the customer, the society and the environment holistically. As a result, this research paper has addressed a vital gap in the literature by effectively utilizing VSA to implement not only customer value but also social and environmental value in an integrated approach.

CONCLUSION

This paper effectively implemented the redefined CSE value in a social business through the utilization of the value stream analysis tool. Through semi-structured interview methods, the authors of this paper generated the existing process map of the organization under study. In consequence, a proposed process map was produced while executing the CSE value in the organization's business process. As a result, the CSE value framework proposed in this research paper provides a novel strategic thought process for social businesses. Furthermore, for existing and potential social entrepreneurs, the CSE value framework provides a lens through which business processes should be examined and improved to provide customer, social, and environmental value through the utilization of the value stream analysis tool.

The authors of this paper propose scholars to further examine the implementation of the CSE value framework through action research. In consequence, knowledge and practicality being the nucleus of action research will further present strong guidelines for businesses to implement the CSE value framework (Coghlan and Brannick, 2001). Furthermore, another area for future research is to quantitatively measure the impact of the CSE value framework. Lastly, the implementation of this framework should be examined in the context of a conventional profit maximization firm.

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CHANGING PERSPECTIVES OF POLITICS MARKETING IN NIGERIA

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ABSTRACT

Politics marketing in recent years has attracted increasing attention from politicians all over the world, though not much from academia. Politics is about power and the distribution of scarce resources has created more politics marketing. For a third world economy like, Nigeria the challenges are enormous, and can play a major role on how good leaders can be elected and invariably, how scarce resources of the nation are distributed to achieve voter/consumer satisfaction and overall economic development. The paper looked at politics marketing from the perspective of more developed economies. The model of a market-oriented party thus involves: use of market intelligence; adaptation of behavior; organizational implementation; and conveyance of new behavior, and its implications for Nigeria. The paper also examined evolution and development of party politics in Nigeria. The political structure, with ethnic and religious slant, were handed over by the British Colonial masters, leading to instability, military intervention and an evolving political culture, after over 53 years of independence. The paper recommends an independent electoral body; an incorruptible judiciary; enlightened electorate and deregistering of mushroom political parties.

JEL: L8, L89

KEYWORDS: Politics, Marketing, Electorate, Market-Oriented Party, Democracy

INTRODUCTION

The current interest in politics by marketers may not be unconnected with the recent definition, importance, world view of politics in our daily life, and the misapplication of power politics by those in authority. Heywood (2007) defines politics as the activity through which people make, preserve and amend the general rules under which they live. However, looking at politics as power and the distribution of resources, he argued that at its broadest sense, politics concerns the production, distribution and use of resources in the course of social existence. Politics therefore is, in essence, power. It is the ability to achieve a desired outcome, through whatever means. From this perspective, Lasswell (1936), summed it up by arguing that, politics is about diversity and conflict, but the essential ingredient is the existence of scarcity. The simple fact that, while human needs and desires are infinite, the resources available to satisfy them are always limited. He also viewed the elite as primary holders of power. Politics can therefore be seen as a struggle over scarce resources, and power can be seen as the means through which this struggle is conducted. From the above one can easily understand why oyibosonline.com, quoting the former president of Nigeria, Chief Olusegun Obasanjo, described the 2007 general elections in Nigeria as a matter of life and death for the ruling party PDP, and likened it to a military warfare without weapons.

Marketing is increasingly becoming an inseparable aspect of politics since both marketing and politics have the identical ultimate goal of attracting, holding and sustaining customers (voters and consumers) to their specific product or brand. The infiltration of politics by business therefore, has attracted increasing attention of political commentators in recent years. According to Lee–Marshment (2001), research has been conducted into how politics marketing has permeated political communications with political parties making increasing use of professional advertising from the world of business as well as polling agencies to inform their campaign design. They equally use political marketing to inform all aspects of party behavior and not just campaigning. Political parties also use marketing instruments as part of their electoral campaign activities (Kotler and Kotler, 1999; Scammell, 1999). The literature on politics marketing has contributed considerable insight into how specific marketing instruments have been utilized to optimize tactical and strategic aspects of political campaigns (Newman, 1994; Kavanagh, 1995; Scammell, 1995; Wring, 1999; Wring, 2002b). Besides parties and individual candidates, the employment of political marketing instruments can be noted for grass–roots organizations within a party (Franklin and Richardson (2002), single–issues groups (Lindsay, 1999), or governments and executive bodies (Newman, 1995; Nimmo, 1999; Buurma, 2001; Newman, 2001; Harris, 2001a).

The rest of this paper reviews the related literature on politics marketing, first from the conceptual context and perspective of the developed economies of Europe and United States of America (USA). We focus specifically on how a party can achieve electoral victory, through the use of marketing techniques to become truly a market-oriented party. Next, the paper presents a model of market-oriented party, which suggests the process and socio-behavioral adaptations necessary for the enthronement of a market-oriented party. Furthermore, the evolution of party politics in Nigeria is reviewed and the political market opportunities, in the country are analyzed. Lastly, the implications of the study, as well as the conclusions and recommendations of the study are discussed.

LITERATURE REVIEW

According to Lees–Marshment (2001), marketing, is a form of management or approach used primarily by business organizations. It has evolved to include the design and promotion of a product to ensure that the goals of the organization, primarily making a profit in the case of a business, are met. However, marketing is not just about selling, or, in political terms, campaigning. Citing Levitt, (1960), Les-Marshment, observed the difference between marketing and selling is more than semantics. Selling focuses on the needs of the seller, while marketing is focused on the needs of the buyer. Selling is preoccupied with the seller's need to convert his product into cash. Marketing is concerned with satisfying the needs of the customer by means of the product and the cluster of things associated with creating, delivering, and consuming the product. The current marketing philosophy focuses on how firms can satisfy customers and adopt a market orientation, as this is deemed the most effective way to meet the firm's goals and also applies to politics marketing and political parties.

Lees-Marshment further explored the potential of political marketing on a theoretical level, integrating both management and political science literature to create a model of how a political party can use marketing and become market oriented. She also examined the extent to which Thatcher and the Conservatives in 1979 exhibited behavior in line with this model and compared this with Blair and Labour in 1997. It showed how Thatcher used marketing to inform policy design, a model which Blair followed but to a great extent, using results from market intelligence to push for changes in the role of party membership and further centralization of power to ensure a clear organizational structure within the party.

Nkamnebe (2003), reviewing Gamble (1990) noted, particularly in a developing country context like Nigeria, marketers are often occupied with increasing demand for basic needs to an extent they forget to think about the synergistic potentiality of studying marketing as a veritable tool for productive political process. Most importantly perhaps is the general weak political behavior occasioned by frequent truncated democracy, which is characterized by military dictatorship and pseudo military democracies. He further discussed similarities of marketing and politics on the basis of the obvious interface between the two, mentioning attempts made to conceptualize their semblance. He then identified and discussed some obvious similarities between marketing and politics under the following themes: market problems; product development; purchasing; distribution and market communications. The differences include market, structure market periodicity and organizational objective. He also identified some factors that influence the development of politics marketing in third world countries like Nigeria to include: illiteracy; poverty; corrupt bureaucracy; and sit-tight syndrome.

Citing (Beard, 2000; Chang and Park, 1998), Opeibi (2006) argued that political advertising in the past two decades in Nigeria has assumed a new dimension with an increasing use of negative political advertising during electioneering campaigns. Continuing, he noted that prior to this period in Nigeria, political candidates concentrated more on selling themselves and their programmes to the people with very few instances of negative advertisements. However, with the resuscitation of democratic activities in 1998, leading to elections in 1999, the competitive nature of electioneering campaigns and the 'winners-take-all-syndrome' that characterized that election and especially the 2003 elections changed. Many political candidates abandoned positive, issue-focused, image-building advertisements for direct attacks on their opponents. Concluding, he said that based on data taken from selected Nigerian newspapers, factors such as: level of education of voters; political literacy; content and structure of advertisements; personality of the sponsor (and/or the political candidate) among others may influence the effect of negative campaign on the electorate. Hennerberg (2003), used two perspectives of instrumental and functional views to analyze political marketing management. The analyses used existing instrumental (means-oriented) interpretations of political marketing activities and drive, as an alternative to 'managerial' orientation, an ends oriented categorization of generic functions that provide a new way of describing and characterizing political marketing management. The analysis also used Henneberg's (2004) political marketing theory: hendiadyoin or oxymoron.

Other researches who attempted to apply the theoretical basis of marketing for business to politics include (Niffenegger, 1989; Newman, 1994; O'Shaughnessy, 1990; Wring, 1995), among others, even though they focused more on marketing functions of communications and selling. According to Kotler, Armstrong, Saunders, and Wong (1999), the selling concept is practiced in the non-profit area. A political party vigorously sells its candidate to voters as a fantastic person for the job. The candidate works hard at selling himself or herself by shaking hands, kissing babies, meeting donors and making speeches in addition to the use of public media like radio and television advertising, billboards, posters and mailing. Bovee and Thill (1992) may have been thinking in that direction when they posit that, a political party markets its candidates and its ideas. It produces candidates with distinct political points of view, and it promotes them through a variety of advertising techniques. The target market is registered voters, and the marketing goal is to sell voters on the politician and the kind of re-presentation he or she would provide. The price is a vote.

Lees–Marshment (2001) toes this line of marketing concept in politics marketing by arguing that if a political party implemented the marketing philosophy, it will seek to meet voters' needs and wants, thus producing voter satisfaction, and in doing so, satisfies its own goals. A market–oriented party is not concerned with changing peoples' mind, but rather, in following them. They invest heavily in advertising, to convince voters their party is the best one, or engage in arguing their particular ideology. A party would act in line with the rational-choice notion put forward by Downs (1957) that, parties need to move to a median position to win enough electoral support to get into office. The organizational focus of the party is on voter needs and wants, and on the best way to satisfy those needs and wants. A major party in Britain for instance would design its product or determine its behavior in a way that will attract support from those it needs, enough of the electorates to win office in a general election.

MODEL OF A MARKET-ORIENTED PARTY

Lee – Marshment identified four main activities that a party attempting to use marketing in determining all aspect of its behavior would engage in. These include: use of market intelligence; adapting its behavior to suit those whose support it seeks; implementing this new behavior at all levels of the party organization; and conveying this to the electorate.

(i) Use of Market Intelligence: A party will invest significant efforts in discovering the needs, wants, behavior and the demands of the voters whose support it seeks. It is concerned with party-voter communication in its broadest sense, and can be derived from many sources and in different ways. All or any of these research methods formal/informal, quantitative/qualitative, primary/secondary may be employed by parties. The party leadership might create committees or task-forces to examine the party's problems, and look into what marketing could offer. This includes both hiring professionals with marketing expertise or outright Integrated Marketing Communication (IMC) Consultants. Today's, marketing is leaning towards seamless communication (viz, polling and advertising agencies, direct mail consultants, market analysis/statistical experts). These could either be outsourced, completed from within the party or a mixture of both. This will help ensure acceptance and thus the success of marketing as party members can also be made aware of the results of research by professionals. In seeing results of opinion polls, party members will accept that, despite the perceived value of the party's current policies, voters will not support them, if such policies do not match voter satisfaction, needs and wants.

(ii) Adaptation of Behavior: The party would then adapt its behavior, or design its 'product', according to the findings from its market intelligence. A party's product would include more than just the slogans and posters it produces in a campaign. It should also include all aspects of its behavior at all times (not just at election time), and at every level of the party (not simply the leadership).

A party is a more complicated entity than a business and thus needs not to simply follow voters but adjust this new product design to take into account various factors. First it considers whether the product design is achievable. A market-oriented-party would not "promise-heaven on earth", but as much as possible; ensure that it can 'deliver' its promised product especially where policy proposals are concerned. Compare this with the ruling party Peoples Democratic Party (PDP) in Nigeria that promised zero power outages after six months. It won an election in 1999. Eight years thereafter power outages had gotten worse, but the party still contested and won elections in 2007 and 2011, and is preparing to contest in 2015. Interestingly, what is akin to a party adapting its behavior or designing its product according to the findings from its market intelligence is evident. The PDP, Nigerian ruling invested significant effort and financial resources in electric power generation and distribution, to achieve zero power outage in 2014, before the 2015 general election. Power supply is critical to winning electoral votes in 2015. Secondly, a party should estimate what likely reaction of internal support will be to the proposed changes in behavior.

A political party will normally engage in competition and support analysis. It will take into account the strengths and weakness of opposition parties and should alter its design to ensure that it has strength where the other party/parties are weak. The party may also adopt target marketing, if it already has long-term, loyal support from one section of society, it may then reduce the aspect of the product design that suits its demand and alter its behavior to suit another section of the society. This other section makes different demands but whose support the party does not yet have but needs to win power. It does so as long as it can make these changes without alienating its existing support base. This is true for any party wanting to win electoral votes in the South-South/Niger-Delta region of Nigeria in all elections. One of Nigeria's political parties, the Action Congress of Nigeria (ACN), which has now merged with other opposition parties, to form the All Progressive Congress (APC), probably had this in mind due to the strategic nature of the South-South or Niger-Delta, where the party does not seem to have electoral strength. The alternate party promised to set up a ministry of the Niger-Delta to more effectively tackle problems of this region that produces more than eighty percent (80%) of the nation's resources in terms of crude oil reserves.

(iii) Organizational Implementation: The party then ensures the new product design is implemented at all levels of the party. This is essential to be effective and attract support from voters, but requires careful organizational handling. The greater the degree of change in behavior required, the harder the task for the party leadership to attract support for such change. Thus the party leadership will be aware of potential problems and either take measures to avoid it or be ready to respond to such problems, while planning to carry the electorate or voters along in the implementation. Failure of organizational implementation is evident in the zero tolerance for corruption or anti graft policy and due process of the ruling party in Nigeria the PDP. It is rather embarrassing that a top party hierarchy, in fact the fourth in government could not adapt to such strategic and important party policy as was the situation some time ago, in the lower National Legislative House. How then can the party intend to carry the electorate along in future behavior adaptation. However, the emergence of APC has changed the political landscape and the need for all parties, especially the ruling party, to adapt a market-oriented party policy as the 2015 election approaches.

(iv) Conveyance of New Behavior: A party should naturally communicate its new behavior or new product design in a positive way to voters. Kotler and Andreasen (1987), argued that everything about an organization–its products, employees, facilities and actions communicate something. Not only could the nature of the leaders, but the behavior and rights of party members are influential in attracting or propelling voters. Shaw (1994), contended that the British labor party failed to win the 1992 general election because (among other factors), despite policy changes, Kinnock (party leader) lacked the time and support to transform the party itself… its ethos, its language and rituals, and its close association with the unions, all alienated the electorate. So a party using marketing would attempt to display behavior in line with the new product design at all levels and at all times.

Generally speaking, if a party engages in these four activities, the model contends that the party will win power, and would also deliver the product to voters. Thus carrying out its promise through into government. This is arguably the most important and difficult part of marketing, though still a subject of much debate due to varying levels of success. From a pragmatic point of view, there are arguments as to whether the use of marketing in this way can help increase party standings. Thatcher's Conservative Party successfully used the four models to win election in Britain in 1979. However by 1997, Blair's Labour Party, through the use of a more effective combination of the four models, took over the government from conservatives. The Democratic Party in the USA, also effectively used the model to win the last two presidential elections.

EVOLUTION OF PARTY POLITICS IN NIGERIA

Serious party politics started in Nigeria in the 1950s in anticipation of independence from Britain in 1960. Then politics revolved around major tribal leaders. Though there were other parties, the three major tribes Hausa, Igbo and Yoruba, formed the three major parties. The Northern Peoples Congress (NPC) with Alhaji Ahmadu Bello as leader was the major party in the north. The National Congress of Nigeria Citizens (NCNC) with Dr. Nnamdi Azikiwe as leader was the dominant party in the east. After some realignments Action Group (AG) with Chief Obafemi Awolowo as leader was the major party in the west.

As the nationalists' struggle for political power gathered momentum in the 1950s, Omoweh and Boom (2005), noted it was obvious that sooner rather than later, Nigeria would become politically independent. Consequent upon this, the colonialist handed over the reign of government to a class of politicians believed to be capable of protecting its economic interest in the post-colonial period. It was a political class not groomed for political administration of the country, explaining its preference to continue with colonial policies, politics and structures of exploitation instead of changing them. Once in power, the dominant political class exhibited features of the colonial state, relying on violence, repression and coercion to manage. They thereby attached too much importance to political power, since their security and survival depended largely on it. Political competition then became deadly, and those who had political power defended it at all cost and by all means. Those seeking to replace current holders of political power deployed all means within their reach. That was the foundation on which Nigerian politics was built and eventually saw it through a series of military intrusions, civil war and few years of civilian administration since independence in 1960.

ANALYSING POLITICAL MARKET OPPORTUNITY

Having evolved through stages of colonial, military and civilian administrations, the current dispensation is the longest democratic administration the country had experienced since the 1960 independence. This political period tagged the 4th Republic came into being in 1999 following a keenly contested presidential election between the Peoples Democratic Party (PDP) and the merged party, Alliance for Democracy (AD) and All Peoples Party (APP). Since then, three successive elections have been held and political observers have opined that each successive election was an improvement on the previous one. The 2011 election was especially improved with international observers acknowledging it to be credible. The PDP emerged the winning party in the 1999 election, and has remained the leading party since. They control in all instances, more than 50 percent of vital political positions in the nation. Table 1 below presents a picture of the results of presidential elections since 1999.

Table 1: Analysis of Voting Results and Voters Participation during Various Presidential Elections in Nigeria (1999 – 2011)

	1999	2003	2007	2011
Number of registered Political Parties	3	28	63	63
Percentage of votes won by:				
Leading Political Party	62.78 (PDP)	61.94 (PDP)	69.82 (PDP)	58.89 (PDP)
2nd Leading Political Party	37.22 (AD/APP)	32.19 (ANPP)	18.72 (ANPP)	31.98 (CPC)
3rd Leading Political Party	-	3.29 (APGA)	7.49 (AC)	5.41 (ACN)
Total Percentage of votes controlled by the three (3) leading parties	100	97.42	96.03	96.28
Turn out rates of voters	52.3	N.A	57.5	53.7

Source: Authors' compilation from various public sources. This table shows the number of approved political parties in the various electioneering years from 1999 to 2011. It further shows the distribution of the share of votes cast, among the three (3), leading political parties in the country. Lastly, it shows the percentage of registered voters that actually cast their votes at the various elections.

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Although the PDP has remained the leading party through this period but its market share, from the percentage of electoral votes has not been stable. It declined by more than 10 percent in the 2011 election which was adjudged the fairest of all elections thus far. More interesting is the performance of the challenging parties. ANPP which had 32.19% in 2003 declined to 18.72% in 2007. It is clear that while PDP is likely to retain its leadership position in 2015, but its share of the market is likely to reduce to the advantage of other contending parties.

More than 60 political parties are registered in Nigeria but not all participate in National elections. For instance, in 2011, only 56 out of the 63 registered political parties participated in the general election, and only 20 parties contested in the presidential election (INEC, 2011). Table 1 shows also the number of participating political parties not-withstanding. Three parties control more than 95% of the votes cast in all the presidential elections. In fact, only six of the parties are represented in the National Assembly as well as occupy governorship position in the States as shown in Table 2.

Table 2: Percentage of Political Party Control of Seats in National Assembly and State Governorship Positions in 2011

Political Party	Senate	House of Representative	Governorship position
PDP	66	59	64
ACN	17	19	17
ANPP	6	9	8
CPC	6	8	3
LP	4	2	3
APGA	1	-	5
Others	-	3	-

Source: INEC records This table shows the percentage seats occupied in the Senate, House of Representatives and Governorship positions by political parties. The table shows that only two parties on the average control about 80% of the seats or positions in the nation during the 2011 elections.

IMPLICATIONS OF THE STUDY

It is evident from the above presentation that the political environment is growing in maturity and competitiveness. This is a clear sign that the nation is likely to experience yet another keenly contested 2015 general election, especially with the merger of ACN, ANPP, CPC and a faction of APGA, to form the APC, (see appendix 1). As in other strong competitive situations, only the fittest survive. In a marketing environment, companies that adopt a marketing orientation usually survive and perform better than others. Consequently, for any party to survive and remain active in Nigeria, the party must understand in content and context the principles guiding Market-Oriented-Party (MOP); and deliberately adopt and operate it as its organizational culture. As in a conventional market, where the consumer through his power of choice determines which manufacturer remains in the market, the political market has the power to reshape or prune out undeserving political parties, leaving only those that can dance to the tune of the marketplace. Presently, some parties are merging with others, while some are being reorganized for better results. Others who cannot attune themselves to cope with realities of the time have no choice but to face natural extinction.

Doghudje (1992:19) studied factors likely to influence voting decisions of voters in their choice of candidates during 1993 general election and reported that 70% would be influenced by tribe and religion and only 5% by party manifesto. Current development in the environment shows that people are gradually rejecting ethnicity and religious influences and are giving more rational consideration to the candidates' attributes and party programmes. This means that a political campaign that emphasizes tribe and religion may not get much attention. The implication is that parties need to carefully package their brands for effective delivery to the market (the electorate). This will require parties to develop a market oriented manifesto and a candidate who can display a high degree of commitment to the party's manifesto. By doing so, parties would be developing their own brands rather than just accepting and supporting any person who thinks he has what it takes to contest an election.

The environment of marketing is ever changing but astute marketers continually adapt to and exploit opportunities presented by the contemporary environment as they skillfully develop their marketing program based on strengths and weaknesses of the organization in the context of opportunities and threats of the environment. In the same vein, political marketers should have a strategic team that analyzes the market with a view to discovering opportunities and strategies for winning them. For instance, Table 1 shows that turn out rates of voters during previous elections were less than 60%; leaving more than 40%

of an untapped market each time. A creative and innovative party can target that opportunity and convert at least a portion of it to become its customers. Also there is high rate of brand switching in the politics market both among the political candidates and the electorate. Creative exploitation of these opportunities can significantly improve the returns (number of votes gained) of the political party.

The use of political advertising is high in Nigeria given the level of various types of advertising displayed during political campaigns. Studies have shown that quality of message content is important and critical to the effectiveness of the message. This means that political advertising messages, rather than based on attacks on political opponents; should be based on trustworthy, relevant and realistic information correctly packaged and delivered to the target audience. This will likely generate acceptance and build better customer loyalty for the party than messages filled with empty promises and irrelevant bickering.

CONCLUDING COMMENTS

The Nigerian Political Market is due for change. Change, they say, is constant but it behooves the players in the market to follow this change in order to remain relevant. The challenge is that parties and political institutions who do not appreciate this changing political scene, and think that it is 'business as usual,' will have so much to lose. The country is witnessing structural changes in legal/regulatory frameworks as well as the infrastructure to put the next general election on a good pedestal. For example, the electoral commission (INEC) and electoral system, as well as the judicial systems, are being strengthened. This obviously is an opportunity for market oriented parties that would focus on the needs of the market rather than on the selfish ends of individuals. Parties should therefore set up machinery to analyze, develop and implement strategies in accordance with the current market perspective. This will help them compete strongly in the next election.

Professional institutions like the National Institute of Marketing of Nigeria (NIMN) as an umbrella Marketing Body in Nigeria has a pioneering and vital role to play in all this. The CNN, the Internet and other Interactive Media have changed the world of Politics Marketing in the USA and the other advanced economies of Europe. The last American election was virtually won during the live debate by the CNN. The live broadcast by, Nigeria's, African Independent Television (AIT), greatly influenced the shaping of Politics Marketing in Nigeria, especially during the National Assembly's Constitutional debate and tenure elongation of the former government of President Obasanjo. NIMN leadership, should partner with AIT and other virile media to put this issue on the front burner. NIMN should present a position paper/conference on: 'Politics Marketing and Election Process'. Anybody who wants to be President, Governor, etc, must face Nigerians and tell them where he is coming from. The resources of this country are so enormous, and since politics is about power and distribution of resources, it cannot be left in the hands of just anybody.

Mergers and acquisitions are common practices in the business environment and can be adopted in politics. The current trend towards mergers or some kind of fusion of political parties to present a common formidable offer to the target market is generally welcome, provided the terms of such partnership is clearly spelled out and respected. Such re-engineered party, and in fact any party that desires to survive, should build itself into a strong and vibrant party, rather than using all sorts of tactics, at times unethical, just to win in the 2015 general election. A more sustainable approach is the concept of market-oriented party which will build a party of tomorrow.

This study reviewed the political conditions in the country overtime, based on the trend and records, and also, analyzed opportunities in the politics market, it however, did not emphasize the procedures for developing good political product, nor predict the impact of the switching behavior on market share. Also, the analysis and opinion is base on secondary sources. A survey on the other hand would have disclosed voters' intention or expectations that can help in molding a virile market-oriented political party. This is an area for future research, given the strength of the new opposition ahead of the 2015 Nigeria general election.

APPENDIX

Appendix 1: Full Names of Major Political Parties, in Nigeria

1	AD	Alliance for Democracy
2	CAN	Action Congress of Nigeria. (Formerly AD)
3	ANPP	All Nigerian Peoples Party. (Formerly APP)
4	APGA	All Progressive Grand Alliance
5	APP	All Peoples Party
6	CPC	Congress for Progressive Change
7	LP	Labor Party
8	PDP	Peoples Democratic Party.
9	APC	All Progressive Congress. (A new party registered in 2013, which is a merger of ACN, ANPP, CPC, and a faction of, APGA).

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