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# **JOURNAL OF BUSINESS ISSUES**

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- ◆ **The Imposter Phenomenon's Impact on Citizenship Behavior and Employee Commitment: Flying Under the Radar**  
W. Lee Grubb III and William C. McDowell
- ◆ **The Global Financial Crisis: Implications to Financial Reporting in the Banking Industry**  
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## Author Bibliographies

**Paul E. Bayes** is Professor of Accountancy at East Tennessee State University located in Johnson City, Tennessee. His email address is bayes@etsu.edu

**Bea Chiang** is an Associate Professor of Accountancy at The College of New Jersey located in Ewing, New Jersey. Her email address is bchianga@taenj.edu.

**D. Keith Denton** is Professor of Management at Missouri State University located in Springfield, Missouri. His email address is dkdenton@missouristate.edu.

**Omar A. Esqueda, Ph.D.** is an Assistant Professor of Finance at Tarleton State University located in Stephenville, Texas. His email address is esqueda@tarleton.edu.

**W. Lee Grubb III** is an Associate Professor of Management at East Carolina University. His email address is grubbw@ecu.edu.

**Dave O. Jackson** is an Associate Professor of Finance at University of Texas-Pan American located in Edinburg, Texas. His email address is dojackson@utpa.edu.

**Bridget Kennedy** is at The College of New Jersey located in Ewing, New Jersey. Her email address is bridget.alice.kennedy@gmail.com.

**Clifford M. Koen, Jr.** is Professor of Business Law at East Tennessee State University located in Johnson City, Tennessee. His email address is koencm@etsu.edu.

**Shari Lawrence** is an Associate Professor of Finance at Nicholls State University in Thibodaux, Louisiana. Her email address is shari.lawrence@nicholls.edu.

**Yongli Luo** is an Assistant Professor of Business Administration at Wayland Baptist University located in Plainview, Texas. His email address is luoy@wbu.edu.

**William C. McDowell** is an Associate Professor of Management at East Carolina University located in Greenville, North Carolina. His email address is mcdowellw@ecu.edu.

**Shawn Mauldin** is Dean of the College of Business Administration and Professor of Accounting at Nicholls State University in Thibodaux, Louisiana. His email address is shawn.mauldin@nicholls.edu.

**Amy Menerick** is a student in the MACC program at East Tennessee State University located in Johnson City, Tennessee.

**Robert G. Morgan** is Professor of Accountancy at East Tennessee State University located in Johnson City, Tennessee. His email address is morgan@etsu.edu.

**James G. S. Yang** is Professor of Accounting at Montclair State University located in Montclair, New Jersey. His email address is yangg@mail.montclair.edu.

**John Wang** is Professor of Information and Operations Management at Montclair State University located in Montclair, New Jersey. His email address is wangj@mail.montclair.edu.

## THE IMPOSTER PHENOMENON'S IMPACT ON CITIZENSHIP BEHAVIOR AND EMPLOYEE COMMITMENT: FLYING UNDER THE RADAR

W. Lee Grubb III, East Carolina University  
William C. McDowell, East Carolina University

**Abstract:** The purpose of the study is to examine the impostor phenomenon in the workplace for influence on organizational citizenship behaviors and organization commitment. Staff employees at a large university in the southeastern United States were invited to participate in a confidential study aimed at examining employee evaluations and attitudes. A total of 588 usable surveys were received. The respondents were 79% White, 14% Black, 1% Asian and the rest of the sample was listed as "other". 77% of the respondents were males and the average age was 45. The mean total years worked for the sample was 24 years with an average of 10 years at the university. Using correlation analysis, the results of this study indicate that there is a statistically significant negative relationship between those who have feel high impostor phenomenon and each of the citizenship behavior constructs. Significant findings were reported for the relationship between the imposter phenomenon and commitment as well. Specifically, the study found that those who suffer from the impostor phenomenon are significantly less likely to engage in citizenship behaviors and are more likely to have lower affective commitment, the commitment most desired by organizations. Additional implications and future research suggestions are recommended.

### INTRODUCTION

They say it is lonely at the top. If you are a high achiever you may have wondered if you were smart enough or good enough to actually justify and maintain your current level of success, you may fall prey to what has been termed the Imposter Phenomenon (Clance and Imes, 1978). The Imposter Phenomenon (IP) is used to describe feelings of anxiety, uncertainty and a lack of confidence successful people may have despite their public appearance of success. In addition, there may be a lingering internal fear that the individual will be recognized or "found out" as not being good enough or smart enough and that they actually do not deserve their current position (Clance and Imes, 1978).

Initially, the IP was used to describe a sample of high-achieving women who, despite their public success, felt like they were imposters (Clance and Imes, 1978). Since then the IP has been used to help explain many of the different feelings of anxiety, depression, and phoniness that outwardly successful people may experience (Harvey and Katz, 1985; Kumar and Jagacinski, 2006; McGreggor, Gee, and Posey, 2008; Thompson, Foreman, and Martin, 2000). Currently, however, there is a dearth of research that has transitioned the study of the IP from its association with other psychological constructs to the applied managerial setting using employee samples. The purpose of this paper is, in response to McDowell, Boyd, and Bowler (2007), to help advance the IP literature by using an employee sample and testing the impact of the IP on management related constructs. McDowell, et al., (2007) developed a theoretical framework for the IP in organizations. It is the purpose of this paper to specifically investigate the impact of the IP on citizenship behaviors and both affective and continuance commitment.

It is important to note that the study of IP has distinguished itself as being a related, but different construct from other constructs such as self-esteem, self-monitoring, and social anxiety

(Chrisman, Pieper, Clance, Holland and Glickauf-Hughes, 1995; Cozzarelli and Major, 1990; Edwards, Zeichner, Lawler and Kowalski, 1987). Although other constructs regarding the self involve one's perceptions of one's self, IP has identified six different characteristics that come together to a greater or lesser degree and create self-doubt in successful individuals. The six different characteristics identified in the IP by Clance and Imes (1978) are: 1) feelings of intellectual phoniness; 2) a belief that one's success is attributed to luck or hard work and not ability; 3) a lack of confidence in one's ability to repeat past achievements; 4) a fear of being evaluated by others and failure; 5) the inability to derive pleasure from past achievements and 6) a fear that one's incompetence will be discovered by others.

We have learned a great deal about the IP over the last 30 years. Although the theory was initially developed using predominantly white female samples, the literature now confirms that these feelings of phoniness can be experienced to varying degrees across gender, race, age, and other demographic variables (Bernard, Dollinger and Ramaniah, 2002; Clance and O'Toole, 1988; King and Cooley, 1995; Kolligian and Sternberg, 1991; Lin, 2008; McGregor et al., 2008; September, McCarrey, Baranowsky, Parent and Schindler, 2001). In addition, we have come to understand that the IP can in part explain differences in academic performance, personality, perceptions of the self, and depression (Bernard et al., 2002; McGregor et al., 2008; September et al., 2001). One of the next logical steps in studying the IP is to explore the relationship IP has with management related constructs such as organizational citizenship behaviors and affective and continuance commitment.

## **IMPOSTER PHENOMENON AND ORGANIZATIONAL CITIZENSHIP BEHAVIORS**

The IP may well influence different employee behaviors in the workplace. Employees generally have some discretion regarding the different extra-role behaviors they engage in while at work. Organ, 1988 defined organizational citizenship behavior as "individual behavior that is discretionary, not directly or explicitly recognized by the formal reward system, and that in the aggregate promotes the effective functioning of the organization." Further, these citizenship behaviors can be broken down into different types of prosocial behaviors (Organ, 1990). Of the many different types of organizational citizenship behaviors that have been proposed, we have decided to examine three: civic virtue, sportsmanship, and general helping behaviors. Civic virtue refers to the type of behaviors associated with being a good citizen of the organization and exhibiting an active interest in the life of the organization (Podsakoff, MacKenzie, Paine and Bachrach, 2000). Sportsmanship behaviors refer to one's acceptance and tolerance of the inevitable inconveniences and impositions of the organization without whining, grievances or complaining (Podsakoff et al., 2000). General helping behaviors include behaviors that are directed more specifically at helping, or acting courteously towards other individuals at work (Organ, 1988). These behaviors can involve assisting coworkers or being kind and generous to others.

Over the last two decades the amount of research that has been conducted regarding organizational citizenship behavior has firmly rooted it in the organizational behavior and management literature. A comprehensive meta-analysis solidifies the assertion that these different citizenship behaviors have significant positive relationships with both individual and organizational level consequences related to absenteeism, productivity, turnover, customer satisfaction and long-term success (Podsakoff, Whiting, Podsakoff and Blume, 2009).

A host of individual characteristics have been studied as antecedents to citizenship behaviors. Some of the various characteristics that serve as antecedents to the different citizenship behaviors include trust in supervisor, employee attitudes, dispositional variables,

demographic variables, personality variables, affectivity, and prosocial orientation (Organ, 1994; Penner, Midili and Kegelmeyer, 1997; Podsakoff et al., 2000; Wat and Shaffer, 2005). Again, the purpose of the current paper is to investigate the impact that IP may have on different management constructs.

Because employees that suffer from the IP will likely have feelings of phoniness and question their ability or intelligence, we believe that they will be more likely to engage in the prosocial citizenship behaviors. One's lack of confidence and concern about being branded as a phony may encourage them to engage in the citizenship behaviors to appear more likable and more involved with the success and well being of the organization. Because employees suffering from the IP will be uncertain about their ability to continue contributing to the success of the organization in the task role arena, they are presumed to direct additional efforts at contributing to the organization through other less direct, but noticeable prosocial activities. This is consistent with the previously proposed relationship between the IP and Organizational Citizenship Behaviors (OCBs) (McDowell et al., 2007). Thus, we propose our first hypothesis:

*Hypothesis 1a: The imposter phenomenon will be positively associated with organizational citizenship behaviors.*

Although we believe that the overall relationship between the IP and OCBs will be positive, we do not believe it will be positive for each of the individual behaviors. Sportsmanship behaviors involve not complaining or whining about the negative situations at work and tolerating less than ideal circumstances. However, when one scores high on IP and they are concerned about their ability to continually succeed, they may take advantage of less than ideal situations and complain about negative circumstances at work to create a plausible excuse for the potential lack of future success. Thus, we offer the following hypothesis:

*Hypothesis 1b: The imposter phenomenon will be negatively associated with sportsmanship organizational citizenship behaviors.*

Next, the phony feeling employees will want to elevate their social status in the workplace to offset any future failures based on their "lack of intelligence or talent." An easy way to do this would be to participate in civic OCBs to overtly support the organization and to engage in overt helping behaviors with individuals in the organization. Thus, we offer our next two hypotheses:

*Hypothesis 1c: The imposter phenomenon will be positively associated with civic organizational citizenship behaviors.*

*Hypothesis 1d: The imposter phenomenon will be positively associated with helping organizational citizenship behaviors.*

## **IMPOSTER PHENOMENON AND COMMITMENT**

Organizational commitment has long been studied because it also has many desirable relationships with organizational outcomes such as productivity, absenteeism, turnover, turnover intentions, and citizenship behaviors (Mathieu and Zajac, 1990; Organ and Ryan, 1995; Riketta, 2002; Martin, 2008). Historically, three types of commitment have been researched, affective, continuance, and normative. We are primarily concerned with affective commitment and continuance commitment.

Affective commitment speaks to one's level of commitment to an organization based on one's attachment and loyalty to the organization (Meyer and Allen, 1991). Further, affective commitment is related to one's attachment to, identification with and personal fulfillment in the organization (Allen and Meyer, 1990). As we consider the thought process, affect, and confidence levels of employees that experience the IP, we must understand that they experience a lack of confidence and most likely negative perceptions about their ability to perform and succeed in the workplace. These feelings of self-doubt and insecurity will likely inhibit their ability to form a strong attachment to the organization for a number of reasons. First, they may not want to form a strong emotional attachment to the organization for fear that they will not likely be able to remain in the organization because of their perceived lack of intelligence or ability. As well, it has been shown that employees that are confident in their abilities are more likely to develop a commitment to the organization. Finally, based on equity theory, high IP employees experience a perceived dissonance in their inputs to the organization and the outcomes they receive (Adams, 1963). This dissonance may also decrease one's sense of worth and negatively affect one's desire to commit to the organization. Based on these thoughts we arrive at our next hypothesis:

*Hypothesis 2: The imposter phenomenon will be negatively associated with affective commitment.*

The second form of commitment we chose to investigate, continuance commitment, is based largely on the costs associated with leaving an organization (Meyer and Allen, 1991). With continuance commitment, one's commitment to the organization is based on the perceived loss one would incur if one left the organization. For example, leaving an organization would likely cause the individual to forfeit the benefits and perks associated with their current position such as status, title, pay, and other premiums attributed to the organization. High IP employees, because of their insecurity and lack of confidence in their ability to find a comparable position in another organization, are likely to sense that they have more limited opportunities than employees that are confident in their abilities. Powell and Meyer (2004) showed that employees who believe they lack employment opportunities report higher levels of continuance commitment. Therefore, we posit our final hypothesis:

*Hypothesis 3: The imposter phenomenon will be positively associated with continuance commitment.*

## **METHODS**

### **Sample**

Staff employees at a large southeastern university were invited to participate in a confidential study aimed at examining employee evaluations and attitudes. They were provided a link to an internet based survey to complete at their convenience. A total of 588 usable surveys were received. The respondents were 79% White, 14% Black, 1% Asian and the rest of the sample was listed as "other". 77% of the respondents were males and the average age was 45. The mean total years worked for the sample was 24 years with an average of 10 years at the university.



## Measures

### --Impostor Phenomenon

The impostor phenomenon was measured using Clance's (1985) 20 item scale (previous  $\alpha = .92$ ; Chrisman et al., 1995) consisting of 20 items that included statements such as "I have often succeeded on a test or task even though I was afraid that I would not do well before I undertook the task," "It's hard for me to accept compliments or praise about my intelligence or accomplishments," and "I'm afraid people important to me may find out that I am not as capable as they think I am." These items were assessed with a five point Likert-type scale ranging from not true at all (1) to very true (5).

### --Organizational Citizenship Behaviors

Organizational citizenship behavior was measured using Podsakoff and Mackenzie's (1994) 11 item scale (previous  $\alpha = .92$ ). This scale included three areas of OCBs that included Helping (previous  $\alpha = .89$ ), civic virtue (previous  $\alpha = .82$ ), and sportsmanship (previous  $\alpha = .84$ ). These items were assessed using a five point Likert-type scale ranging from strongly disagree (1) to strongly agree (5).

### --Commitment

Affective commitment and continuance commitment were measured in this study using a scale developed by Meyer and Allen's (1991) using 16 items. Affective commitment (previous  $\alpha = .87$ ) consisted of eight items and continuance commitment (previous  $\alpha = .75$ ) consisted of 8 items. These items were assessed using a five point Likert-type scale ranging from strongly disagree (1) to strongly agree (5).

## Measurement Evaluation

Each of these scales have been widely used and accepted in previous research on these constructs. The scale analysis did result in findings that were consistent with previous research with the only deviation being the reliability estimate for the civic virtue aspect of OCB. The reliability estimate for this scale resulted in a Cronbach's alpha of .67, which was low. However, the results of factor analysis and the reliability estimates for all other scale items were as expected and since these questions were taken from a pre-existing study and have been used with great success, we went ahead with further evaluation using the scale as is. We do note that this is a limitation of this study. The reliability means, standard deviations, and reliability estimates can be seen in Table 1.

## ANALYSIS AND RESULTS

The purpose of this study was to examine the impostor phenomenon in the workplace for influence on organizational citizenship behaviors and organization commitment. The hypotheses indicated that IP would positively relate to OCB combined, and that it would negatively relate to OCB civic virtue and OCB sportsmanship. It was expected, however, that IP would negatively relate to OCB helping behavior. In addition, it was hypothesized that IP would negatively relate to affective commitment and positively relate to continuance commitment.

Using correlation analysis, the results of this study indicate that there is a statistically significant negative relationship between those who have feel high impostor phenomenon and

the each of the OCB constructs which include the combined OCB measure (H1a:  $-.32, p < .001$ ), the measure of OCB civic virtue (H1b:  $-.17, p < .001$ ), the OCB sportsmanship (H1c:  $-.37, p < .001$ ) and the OCB helping behaviors (H1d:  $-.22, p < .001$ ). Thus, the results for IP with OCB do not support H1a, H1b, or H1c. However, the results do indicate support for H1d, the helping behaviors aspect of OCB.

Table 1

Means, Standard Deviations, Reliability Estimates, and Correlations									
Item	Mean	S.D.	1	2	3	4	5	6	7
Impostor Phenomenon	2.20	.62	(.89)						
OCB Total	4.24	.48	-.32**	(.84)					
OCB Civic Virtue	3.92	.84	-.17**	.72**	(.67)				
OCB Sportsmanship	4.31	.65	-.37**	.68**	.25**	(.78)			
OCB Helping Behavior	4.40	.53	-.22**	.86**	.46**	.38**	(.83)		
Affective Commitment	3.44	.85	-.11*	.32**	.26**	.27**	.22**	(.82)	
Continuance Commitment	3.64	.95	.20**	.00	-.01	-.03	.03	.04	(.85)

\*\*  $p < .001$

\*  $p < .01$

Cronbach's Alphas on the Diagonals

Additionally, using correlation analysis, the results indicate that there is a statistically significant negative relationship between IP and affective commitment (H2:  $-.11, p < .01$ ). This does support the expected outcome for H1. Also, there was a statistically significant positive relationship between IP and continuance commitment (H3:  $.20, p < .001$ ). This also supports H3. The means, standard deviations and correlations can be found in Table 1.

## DISCUSSION AND IMPLICATIONS

The findings above support only two of the original 6 hypotheses forwarded in this paper. McDowell et al. (2007) had originally proposed that the impostor phenomenon would be positively related with organizational citizenship behaviors. Based heavily on social exchange theory (Blau, 1964), they proposed that employees experiencing the impostor phenomenon would have a sense of obligation based on favorable treatment of having a job that they did not feel qualified. The hypotheses presented above expected this same result using a combined scale for OCBs as well as the civic virtue and sportsmanship behaviors. A different outcome was expected for helping behaviors, however, in that it was expected that helping behaviors would be negative based on the impostor's desire to not be overly involved in the organization. What we did find was that all of the relationships between the impostor phenomenon and organizational citizenship behaviors were in fact statistically significant in a negative direction. While this only supports Hypothesis H1d, the findings do seem to be reasonable. OCBs all include some degree of inserting one's self into the organization beyond just doing an assigned task or job. They include things such as "willingly gives of his or her time to help," "attends functions that are not required," and "attends and actively participates." Each of these examples of positive behavior does seem to be contrary to statements from the IP scale that states "I avoid evaluations" and "Sometimes I'm afraid others will discover how much knowledge or ability I really lack." While it was expected that one who experiences the impostor phenomenon will engage in these citizenship behaviors, it could very well be that they instead try to avoid all extra contact with those who they feel are ready to judge, criticize or "find out" about them. Thus, impostors do their best to live under the radar.

The expected relationships concerning commitment were indicated by this study. Affective commitment, which signifies a desire within the individual to be a part of the organization, was negatively related to the impostor phenomenon. Thus, those who do not feel that they are qualified or able in their current position do not feel comfortable in their job or organization and therefore do not have these affective feelings towards their work or workplace. Additionally, continuance commitment, which is attributed to staying with a job because you have no better alternatives, was positively related to impostor phenomenon. This relationship was expected in that those who feel they are in a position that they do not deserve, or are capable of, are not enthused about the prospects of leaving because of their perceived lack of better alternatives.

## **FUTURE RESEARCH**

The above findings do present interesting directions for future research, especially in the area of organizational citizenship behaviors. Again, according to social exchange theory (Blau, 1964), one would expect a sense of obligation stemming from the sense of being in a position that is better than one deserves. So questions remain when one experiences a favorable condition that may in fact be too favorable. Can favorable treatment, which may or may not be reality but rather a perceived reality on the part of someone such as a self-perceived impostor, actually have an unexpected negative effect on an individual within the workplace?

Another area that may need to be examined in light of these findings includes determining what other types of feelings individuals who perceive themselves to be impostors feel? For example, could someone who is afraid of being caught as an impostor experience feelings of being a servant rather than an employee? Do these individuals feel a sense of being trapped or do they consider themselves to be second-class citizens that are not worthy of fully interacting with others? The results indicate a sense of continuance commitment, but can this commitment be perceived as entrapment by their situation and surroundings, and if so, what are the implications or additional behaviors that may result?

There are implications for practice in this study as well. Clearly, those individuals who perceive themselves to be impostors, whether rightly so or not, are not fully engaged in the organization. Thus, the organization may be benefiting from their work or expertise, which in many cases concerning the impostor phenomenon has been shown to be good and relevant, but not from the additional benefits of having fully engaged and contributing members to the organizations climate and culture. This lack of involvement can have negative implications should this be seen by other employees, perhaps new hires, as the way that both business and interactions should be done. If this is indeed the case, an organization could have these impostors negatively influencing employee connections or important relationships.

In addition, those who suffer from the impostor phenomenon may sit in key networked positions with others outside of the organization that may be beneficial to the impostor's organization. If these individuals do not have a sense of connection with their organization, they may not "help with recruiting or training new agents" or "help the agency/company image" in the presence of that outside individual or company representative. The implications of these types of problems may result in the loss of potential clients, loss of potential qualified hires, or even the deterioration of existing external interorganizational relationships.

## **CONCLUSION**

In conclusion, research has shown the existence of the impostor phenomenon within individuals. This study has taken steps to examine the impostor phenomenon in the workplace utilizing a sample of employees and found that it does exist within the workplace and it is significantly related to potential outcomes, namely organizational citizenship behaviors and organizational commitment. We found that those who suffer from the impostor phenomenon are significantly less likely to engage in citizenship behaviors and are more likely to have lower affective commitment, the commitment most desired by organizations. Also, it is presumed that these impostors are more likely to remain within an organization because of the lack of perceived alternatives. This research has opened the door for future research and hypothesis development into the role that the impostor phenomenon plays in practical management settings.

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## THE GLOBAL FINANCIAL CRISIS: IMPLICATIONS TO FINANCIAL REPORTING IN THE BANKING INDUSTRY

Bea Chiang, The College of New Jersey  
Bridget Kennedy, The College of New Jersey

**Abstract:** The purpose of this paper is to uncover the various implications and possible insights into the causes of the subprime financial crisis related to financial reporting standards. The adoption of International Financial Reporting Standards (IFRS) will significantly affect the banking industry and financial institutions around the world. Adjustments to accounting standards will need to be made when considering the current implications of the financial crisis. The largest issue of the subprime crisis in relation to the banking industry and reporting standards is measurement and classification of debt securities that are held to maturity without a current market for valuation. Standardizing valuation practices will be of great significance for the global financial markets and the financial institutions in the United States who are recovering from the subprime crisis. Apprehension among professionals for adopting IFRS is that the banking industry will suffer collectively and the adoption will be detrimental to the corresponding global markets as a result.

### INTRODUCTION

The purpose of this paper is to expose the implications and insights into the causes of the subprime financial crisis related to financial reporting standards. The need for a unified set of accounting standards to increase transparency and consistency has been a topic of concern. The subprime financial crisis has further indicated the need for a single set of global accounting standards that can be applied throughout various industries and sectors. Financial analysts and accounting professionals argue that the subprime financial crisis was intensified by inadequacy of financial reporting standards. The accounting community and financial institutions will be affected by the choices made during the current International Financial Reporting Standards (IFRS) convergence. The final standards will change the operations of various financial institutions and furthermore create reporting issues and challenges for top management, executives, private auditors, and public CPA firms. The severity of the subprime financial crisis has forced the financial community to analyze the implications and insights into the financial crisis and their effect on the convergence between US Generally Accepted Accounting Principles (GAAP) and IFRS. Both the Financial Accounting Standard Board (FASB) and International Accounting Standard Board (IASB) are committed to creating a single set of high quality global financial reporting standards, focusing on the need for increased transparency and global comparability.

The valuation of debt securities was one of the contributing factors of the financial crisis. Regulators and accounting professionals allowed companies to move large volumes of debt off of their balance sheet, which misstated the financial position of Bank of America, JPMorgan, Citigroup, and other large financial institutions in the United States. The adoption of IFRS has become a topic of concern based upon the current financial position of the United States and the economic recession. Standards must be created with intense scrutiny for the implications on the current economic position of the global market and the United States specifically. In addition, the FASB and IASB must remain committed to proposing standards that will not allow for another financial crisis of this magnitude.

The cause of the crisis can be attributed to many factors. The areas of particular importance to the accounting standard setters are mark-to-market accounting, off-balance sheet financing and reporting, and poor regulations for the accounting activity. The government involvement in accounting standards regulating has proven to be a detriment to the quality and transparency of the financial statements of banks in the United States. The subprime financial crisis further perpetuates the overall goal of creating transparency of financial reporting and creating a consistent application of these standards.

Another point to consider is that the financial crisis and quality of reporting standards affect the public opinion of auditors and their credibility. Accounting has become a new exercise in creative fiction, with the result that banks are carrying a lot of “sludge” assets clogging up the balance sheet”. (Sikka, 2009) This is a clear example of how the reliance upon accountants, primarily auditors, has been maimed by the financial crisis. The auditing practice will continue to lose its credibility if the standard setters do not correct the errors that were brought to public forum by banking industry.

### **FINANCIAL CRISIS**

Olsen and Weirich stated that “In their characterization of effect financial reporting, the group reiterated that financial reporting plays an integral role in the financial system, and for financial reporting to be effective it should provide unbiased, transparent, and relevant information to investors and other financial market participants for making resource allocation decisions” Financial reporting is of increased importance as the Financial Crisis Advisory Group (FCAG) discusses the future of financial reporting and avoiding another financial crisis. The article then states “Further user confidence in the transparency and integrity of financial reporting is critical to global financial stability. These observations are important because in the heat of the financial crisis these seemingly fundamental objectives became obscured” (Olsen and Weirich, 2010). During the financial crisis, the trust of financial reporting and regulations to insure users with accurate documentation was lost. The global markets became unstable and the financial institutions took a devastating hit. The financial crisis opened the eyes of standard setters and regulators that reporting issues needed to be addressed. Financial reporting quality is central to a thriving economy, both nationally and globally. The banking industry lost confidence from investors when major financial institutions declared bankruptcy and either were granted government bailouts or collapsed as a result. Employees lost their jobs, compensation plans, retirement savings, and some investors lost majority of their life’s savings. The FASB and IASB need to consider the risk factors at stake while constructing proposed guidelines and proposal drafts for standards that will be in convergence of US GAAP and IFRS. Additionally, governing bodies and regulators across the globe must be diligent in enforcing standards that are proposed.

The financial crisis was not solely caused by the lack of high quality valuation reporting standards, but there are key issues regarding financial reporting that contributed to the intensity of the effects. The lack of consistency between multiple reporting standards within the same industries has led to misstatement of assets and balance sheets that are not an accurate representation of the overall performance of a company.

The global financial crisis emphasized deficiencies of the current financial reporting standards. Two areas of concern were intensified: fair value accounting and the valuation of financial instruments with no liquid market. The debate on the limits of fair value accounting was put on spotlight because of the financial crisis. In addition, the valuation of financial instruments without a liquid market forces institutions to perform valuation methods of internal models rather



than by using observable market prices. As third parties review documentation and procedures for the internal models, there is no way to insure the accuracy of these valuations that there is when using market prices. During times of increased stress, these type of valuations raise uncertainty in both investors and financial statement auditors. (Ackermann, 2008)

Fair value accounting and the reduction of impairment guidance had an effect on the gravity of the subprime financial crisis. The banking industry took the blame because their assets use fair value and impairment rules constantly. Because the FASB and IASB released statements lessening the strict guidelines required for impairment and fair value and allowed for manager's discretion, the assets were misstated which aided in the subprime crisis.

Previously, EITF 99-20 required the use of market participant assumptions about future cash flows in determining "other-than-temporary impairment" (OTTI), not allowing for managerial judgment in the determination of the probability regarding the collection of the previously projected cash flows. Thus, applying EITF 99-20 in an illiquid/distressed market can *automatically* result in an OTTI when the fair value is less than the cost basis, even though the management may have current information suggesting that the underlying assets are still expected to fully perform. FSP EITF 99-20-1 provided guidance to establish that it is inappropriate to automatically conclude that every decline in fair value represents an OTTI. It requires further analysis and allows managerial judgment to assess whether a decline in fair value suggests an OTTI, thereby allowing for more managerial discretion in recording OTTIs. This event clearly relaxed impairment rules and gave managers the opportunity to avoid some OTTIs. (Bowen, Kahn and Rajgopal, 2009)

As a result of reducing guidelines on accounting practices, managers had the opportunity to avoid other than temporary impairments. As the global economy begins to adopt IFRS and the standards move towards more judgment based guidelines, there is only more room for misstatement and avoidance of proper accounting practices. Managers given the legal opportunity to avoid a practice that will negatively affect the company's financial performance cannot be blamed for following the accounting standards. The auditors cannot be expected to correct a practice that is following an accounting statement. Furthermore, fair value accounting and the relaxation of impairment rules emphasizes the need for industry and practice guidelines that must be regulated and implemented by financial governing bodies in respected countries across the globe.

There are various deficiencies to adopting IFRS and leaving behind the rules based system of US GAAP. Four European banking industry groups have critiqued a discussion paper from the IASB on a one-size-fits-all approach to fair-value measurement. These groups have stated that fair value should be defined and applied consistently across IFRS as it is with US GAAP. They contend that fair value under IFRS has been devised to meet a specific objective under each standard; while under US GAAP, the requirement of using an exit price is used in every case. This is an aspect of the two standards that has not converged; many believe that this leaves an uneven playing field as IFRS provide less guidance. (Christian and Kohlmeyer, 2009)

Another core deficiency in reporting standards in relation to the financial crisis is the volume of securities that did not occur on the balance sheet. Because it is not required that certain securities be included on the balance sheet, the transparency of the financial documents is further impaired. According to the *IFRS Briefing Sheet Report of the FCAG*(FCAG, 2009), there are four areas of weaknesses in accounting standards and their proper application that were brought to attention by the financial crisis. The weaknesses include (1) the difficulty in

applying fair value measurement in illiquid markets, (2) the delayed recognition of losses on a variety of instruments measured at amortized cost, (3) issues with off balance sheet financing vehicles, (4) the complexity of accounting standards with regard to financial instruments and the multiple approaches to recognizing impairment.

### **IFRS vs. US GAAP**

There is urgency for converged accounting standards and a need for a single set of global standards with regard to the global financial markets. The differences between IFRS, US GAAP, and other country-specific reporting standards were highlighted by the global financial crisis. The differences of IFRS and US GAAP regarding the comparability and the competitive neutrality between financial institutions raised questions. An area of specific concern is the extent that it is possible to reclassify assets between different accounting categories.

Deficiencies among accounting reporting standards have existed for years prior to the subprime financial crisis. The future of accounting standards is moving towards a convergence of US GAAP and IFRS. There is a general debate over rules based system and principles based system and how this will affect the global financial market. Historically, the reasons that a rules based system was essential to success was because it prevented fraudulent practices, misstatement of assets, improper valuation, and a plethora of accounting issues that need guidance for both internal and external auditors, managers, and executives. There is a need for a single unified set of reporting standards that can be applied across the globe, but the regulation of these standards imposes a challenge for the FASB and IASB.

A rules-based system is black and white; either someone breaks a rule or they do not. However, with a principles-based system, accountants must exercise their own professional judgment using accounting guidelines to determine how to account for a particular transaction. Benzacar (2008) commented that the intention of a principles-based system is to focus on presenting the business reality of business transactions. However, since a principles-based system relies on the professional judgment of those applying the standards, it may be possible for two well-qualified accountants to apply the standards differently.

Professional judgment exercised over principles based standards is a concept that increases anxiety over the comparability and consistency of financial statements in the same industry. The performance of one company can be greatly altered by the judgment of auditors and high level executives and managers. The distinction, measurement, and classification of transactions will be based upon the judgment of its internal associates. The United States historically has manipulated rules to falsify documents and to misstate assets. If a system was principles based the temptation of executives to use their judgment in the favor of the company's financial performance seems like an obvious consequence. Performance based bonuses account for the majority of high level management's compensation and with the greed that exists among the financial industry, a principle based system will have to be under high scrutiny and constant regulation by governing bodies in the United States and internationally to insure consistency and accuracy.

The banking industry must commit to changes and start to work with comparative financial statements to provide information to financial statement users and auditors that will be compliant with the timeline to transition smoothly to IFRS. This will pose challenges to the banking industry because the financials of the past four years are not going to be necessarily comparable and the various financial institutions are in recovery and may not be able to afford

the costs to reconstruct a system for these requirements.

The banking industry and financial institutions are subjects of high scrutiny after the subprime crisis. The accounting standards boards are concerned with the proper implementation of proposed standards and the overall effect on the financial markets and the health of the United States unstable economy. The adoption of IFRS presents challenges for regulation, reporting, and implementation for the financial industry and the benefits of adopting IFRS may not outweigh the costs and possible risks associated with the adoption of these practices. There are significant areas of concern involving the convergence of accounting standards and the implications for the financial industry. Several areas in financial reporting can affect financial institutions, the following sections will elaborate on related issues.

- Financial Instruments
- Hedge Accounting
- Impairment
- Consolidation of Special Purpose Entities
- Leases
- Debt Vs. Equity Valuation
- Presentation and Disclosure of Financial Statements

### **Financial Instruments**

Financial Instruments are of significant concern to the banks and financial institutions because of the nature of their business. The financial instruments make up majority of the financial institution's assets and liabilities; the accounting standards are generally authorized based on long term standing. Because standards are not rigid and descriptive, there are issues concerning implementation. In the banking sector, financial instruments are initially measured at fair value. The initial fair value is generally the transaction price and then after the initial recognition the financial instruments are measured at fair value, amortized cost, or cost. The practice of amortized cost involves spreading fees, transaction costs, and discounts or premiums over the lives of the instruments which adjust the balance sheet accordingly. The use of amortized cost is generally limited to debt instruments held to maturity and the financial instruments not quoted in an active market. In addition to debt instruments, derivatives and equity investments are usually accounted for using fair value measurement. The challenges that face the area of financial instruments and IFRS convergence is the implementation and regulation of the corresponding proposed standards.

In the release of IFRS 9 *Financial Instruments*, the initial two parts covers both the classification and measurement for financial assets and liabilities. IFRS 9 will become effective on January 1, 2013, for accounting periods starting on and after that date, although adoption of the standard can begin prior to the effective start date. Essentially, IFRS 9 removes the cost option from the valuation model and requires that financial assets be recorded at amortized cost only if they are held with the object to collect contractual cash flows and give rise to cash flows that are either payments of principal or interest. Any financial assets that do not meet the criteria for amortized costs must be valued at fair value with the corresponding gains and losses recognized in profit or loss.

## Impairment

Impairment of financial assets is a complex area of measurement for financial instruments. Divisions in companies including risk management and advisory boards are involved in the process of measuring impairment of financial assets. These risk management teams and advisory boards have an immense task ahead in order to successfully avoid another financial crisis. According to the IASB "One of the FCAG's recommendations was to explore alternatives to the incurred loss model that use more forward-looking information." The IASB proposes that the incurred loss approach be replaced with an approach that is based specifically on expected losses. Because of the nature of impairment losses, this area of accounting standards is under scrutiny. The IASB and FASB must work diligently to create standards that will insure investors and the financial community that a crisis of this magnitude will not be experienced again.

The global financial crisis has led to criticism of the incurred loss model for presenting an initial, overly optimistic, assessment of no credit losses for new loans, which is then followed by a large adjustment. Pressure from regulators following the global financial crisis has been pronounced within the industry and the standardsetters agree that change to the current financial instrument accounting methodology is required. The impairment and amortized cost will affect the financial industry most significantly because financial institutions have significant investments in loans and receivables. Credit risk is the most crucial material judgment that a bank must make on their balance sheet. The IASB's exposure draft entitled *Financial instruments: Amortized Cost and impairment* from November 2009 will create changes for the industry. According to PwC (2010), "The proposal will change both the way the judgments are made and how investors learn of the judgments by the disclosures in the financial statements. The proposals also have the potential to require changes that could create significant income statement volatility and a high degree of dependency on prevailing market conditions. There is a sense within the banking and capital markets industry that the changes proposed will be significant and far reaching" Market conditions continue to be a significant factor in the adaptation of proposed accounting standards. Dependency on market conditions is not a positive attribute of financial reporting standards. High quality standards should not be contingent on the performance of an outside factor. Measuring and reporting cannot be comparable across industries and countries if one industry relies almost exclusively on the market conditions for accurate measurement of its assets.

## Hedge Accounting

Hedge accounting is often used to minimize profit or loss fluctuation arising due to volatility in foreign exchange, interest rates, and other changes in fair values of certain financial instruments and other non-financial items. As under IFRS generally all derivatives have to be accounted for at fair value, with gains and losses recognized in profit or loss. Hedge accounting aims to mitigate profit or loss impact in respect of the portion of the hedge that is effective. Hedge accounting rules under IFRS are incredibly strict and require complete documentation on the process and procedures of the hedge. The applicability of hedge accounting is dependent on the proper documentation and risk analysis associated with the future hedges. The banking industry will need to budget for the various resources necessary to begin the hedging process and insure its completion. The systems and processes associated with hedge accounting will be a topic of great concern if the convergence of IFRS and US GAAP or the total adoption of IFRS becomes a reality. The IASB is continually revising proposal drafts and statements to ensure that the final draft will be implemented correctly and efficiently.

Disclosures will be increased in volume and specificity to validate judgment decision on accounting practices. The financial statement users will need to be diligent in their use of the disclosures because IFRS will involve more judgment calls.

### **Consolidation of Special Purpose Entities**

The banks will need to be mindful of their Special Purpose Entities (SPE) and the potential changes that will occur as a result of the convergence to IFRS. IFRS has strict guidelines to evaluate whether there is control of an SPE and if consolidation is appropriate. KPMG (2009) commented that, "Banks often use SPEs, for example to securitize loan receivables, design investment products for customers, or effect certain leasing transactions. Some banks are party to many hundreds of SPEs that may not be consolidated under the local accounting rules. The resulting structures can be complex and are likely to require review of each individual transaction in order to determine whether consolidation under IFRS is appropriate." The definition of a subsidiary and the concept of control will be of great concern to bank when converging to or adopting IFRS. Each individual SPE will need to be reviewed and if it meets the guidelines to be consolidated based on the parent company's level of control; it will be introduced in consolidated financial statements. This change will prove incredibly costly to implement for financial institutions that have SPE's in the triple digits and will change the performance of the company. The performance of the parent company will be reflected by the SPE in the consolidated financial statements. If the SPE is performing well then it can be beneficial to the parent company and alternatively if the SPE is not then it could become an immense liability for institutions that have many SPE's, particularly the financial sector. The disclosures for this change will need to be detailed and thorough to ensure that the proper procedure was put in place regarding the details of the parent-subsidiary relationship. As a result of this change, documentation will become revised and increase in length which can be a cause of concern for investors and financial statement preparers and users.

### **Leases**

The main difference between US GAAP and IFRS regarding leases is that the amount of lease transactions on the balance sheet will significantly increase from the current practice. Classification of a lease as either operating or capital leases is what allows for the operating leases to remain off the balance sheet. The current proposal requires banks to make regular assessments as to whether they will take up renewal options. The executives must consider when planning out the necessary budget to make the regular assessment of renewal options on leases. The reporting standards concerning leases will affect the financial industry and banks especially because most financial entities have lease arrangements within the current time frame of the leasing standard, banks are regularly entering new lease arrangements and finally banks have current operating leases that will extend beyond the expected mandatory conversion date. Operating leases will be reviewed and potentially included on the balance sheets by its classification. The financial statements of banks will be altered by length, constant reassessment, and value and must be a consideration of top executives, auditors, and financial statement users alike.

### **Debt vs. Equity**

Defining a financial instrument as either debt or equity has an impact on the banks financial performance, key statistics and analysis, and the bank's level of equity and its corresponding ratios. Investors and analysts rely on the ratios to make judgments on a company's position in a market and its ability to be successful in the future. An instrument is

classified as a financial liability if it contains a contractual obligation to transfer cash or another financial asset, or if it can be settled in a variable number of the entity's own equity instruments. An equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Instruments that coincide with the prescribed definitions are classified simply, but there are exceptions to these definitions and slight nuances of difference that create an area of uncertainty. Bialkowska and Martin (2011) states "An exception to the rules are puttable instruments, which give the holder the right to put the instruments back to the issuer for cash or another financial asset or instruments imposing an obligation on an entity only in liquidation. If certain criteria are met, then such instruments are classified as equity. Some contracts may contain both equity and liability components, which may have to be accounted for separately. An example is a convertible bond that comprises a debt instrument and an equity conversion option. The equity conversion option would require analysis to determine whether it meets the definition of equity. This is an example of another area that requires contract-by-contract analysis during the IFRS conversion process."

Because this area of accounting practice can determine the performance of a financial institution, the definition of either debt or equity can become an area of great concern for standard setters. Judgment calls made in this area of accounting can determine the overall performance of a company. The financial statements of banks will be changed as a result of this final standard and its final guidelines for measurement. The IASB and FASB should make recommendations for financial statement users and auditors on how to perceive the changes in financial statements and position of companies that will be affected by this standard.

### **Presentation of Financial Statements and Disclosure of Financial Instruments**

An ongoing concern with presentation of financial statements among industries having complex data and the length of annual reports in excessive numbers is that the ordinary financial statement users do not have time to sift through data that they do not understand. The information presented on complex financial statements might not be useful to help users to identify risk associated with valuation.

According to Humphrey, Loft, and Woods (2009) "A live problem for the visibility of the audit is the vast length of corporate annual reports in the banking sector, with annual reports in excess of 300 pages being commonplace. The reports are filled with a range of complex disclosures, the bulk of which lie outside the formal financial statements and are audited only for their consistency with those statements." Readers are not given the details on what specifically was tested for consistency and how those processes were controlled. The standard external audit report does not help the reader for solving these issues. The report has general and standardized statements regarding the audit and very little information about specific procedures used by auditors. Disclosures could vary by industry and sector with regard to what levels of audit risk and materiality are included, the errors that are detected by auditors, and the information about scale, nature, and results of tests done to verify the valuation of assets.

As the convergence of IFRS and US GAAP becomes a reality there is reasons to believe that these complex disclosures that are used in the financial institutions will become more complex and difficult to understand. Readers must be able to use the financial statements and creating more complex disclosures for management's judgment calls will not solve the deficiencies in the presentation of financial statements that were uncovered as a result of the financial crisis.

The primary concern with the presentation of financial statements and disclosure of financial instruments is the power given to management to make judgment on which line items appear on financial statements. The format of financial statements will be made on entity's business needs and extensive disclosures for decision making will be required. "IFRS is not prescriptive as to the format of the statement of comprehensive income, the balance sheet or other primary statements. However, this means that the format has to be carefully developed to appropriately reflect the activities of each entity. Disclosures in many areas, for example for financial instruments, can be extensive" (Bialkowska and Martin, 2011). Although extensive disclosures may be time consuming and costly, these disclosures will provide financial statement users and investors with the necessary information to make educated decisions about a company and its performance. The global financial crisis could have been avoided if there was complete transparency of financial instruments, their measurement, and what the instruments were being used for and how they were being used. With extensive knowledge of the company's practices and level of risk, the magnitude of the global financial crisis could have been avoided or lessened.

A publication from Ernst and Young (2008) entitled "IFRS 7 in the Banking Industry" discusses the changes of disclosures regarding risk management and its implications on financial statement preparers. The publication states: "IFRS 7 requires an entity to make both qualitative and quantitative disclosures of the risks arising from its financial instruments. The qualitative disclosures include the types of risk to which the entity is exposed and how they arise, the entity's objectives, policies and processes for managing risks, the methods used to measure the risks, and any changes made from the previous period. The quantitative disclosures include summary data about the exposure to risk as at the reporting date. These disclosures must be given either in the financial statements or incorporated by cross-reference from the financial statements to other disclosed information, such as management documentary or risk report, that is available to users of the financial statements on the same terms as the financial statements and at the same time."

Disclosures regarding risk management have become more important within the past three years and will only become an area of increased magnitude as studies and documents regarding the effects of the global financial crisis. Requiring both qualitative and quantitative disclosures regarding risk should be a global standard. A goal of the IASB is to provide transparency to financial statement users. By disclosing all types of risk and the levels and implications it will have on a company can only be a positive addition to reporting standards. The argument of cost efficiency to implement proposed standards cannot be considered an issue with regard to disclosure of risk management.

## **CONCLUSION**

Despite the results and consequences of the financial crisis, there is still a need for change in achieving high-quality global reporting standards. Globalization is inevitable and the financial markets will become one unified financial market that will need reporting standards applicable across borders and industries. Challenges face standard setters and local governments to apply and regulate proposed standards and the financial crisis further increased those challenges. Progress was halted and recovery became the priority among government officials and financial institutions. The banking industry must be carefully monitored as new changes are implemented. Financial reporting standards affected the outcome of the financial crisis and will continue to be an area of concern for various industries, specifically the banking industry.

Valuation of assets in the banking industry is of utmost priority in relation to proposed standards and application across the globe in foreign markets. The commission continues to move forward to make a determination of adopting IFRS while simultaneously dealing with the financial crisis. The standard setter must keep in mind the mission that standard-setting process must result in high-quality standards; that is, a comprehensive set of neutral principles that require consistent, comparable, relevant, and reliable information that is useful for investors, lenders, and creditors, and others who make capital allocation decisions.

The commitment to adopting IFRS is strong in the United States. The SEC understands the importance of a set of global financial reporting standards and more importantly understand the impact that the financial crisis had on the smooth adoption of those standards. When the United States adopts IFRS it will change the global expectation of IFRS. The SEC and other regulatory bodies within the United States will provide the economy and US investors with the assurance that the standards are implemented with the proper guidelines and principles intended.



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## PROFITABILITY OF FOREIGN FAMILY-CONTROLLED FIRMS: THE CASE OF AMERICAN DEPOSITORY RECEIPTS

Omar A. Esqueda, Tarleton State University  
Dave O. Jackson, The University of Texas-Pan American  
Yongli Luo, Wayland Baptist University

**Abstract:** We analyze the relative operating performance of Family Business' list of the largest family-controlled firms versus non-family-controlled firms listed in the S&P 500. Our cross-sectional data includes over 400 firms and eleven years of data. We provide empirical evidence to demonstrate that family-controlled firms are more profitable than non-family-controlled firms. However, this is limited to family-firms trading as American Depository Receipts (ADR). We show that foreign family-controlled firms that trade as ADRs outperform U.S. family-controlled firms. It appears that family-owned firms have taken advantage of the reduction in capital barriers when they access U.S. stock exchanges. We conclude that foreign family-controlled firms are better able to exploit their growth opportunities compared with a sample of large U.S. firms.

### INTRODUCTION

Despite their current size, most firms were originated by families or lone founders and as such, have had a high degree of ownership concentration at some point in time. However, a large number of firms lose this characteristic as they progress through their business cycle, particularly when they become publicly traded. However, a substantial share of firms with ownership concentration continues to be controlled by founding families which makes a comparative analysis of their performance *vis-a-vis* firms with dispersed ownership interesting.

We examine the relative performance of family-controlled firms by analyzing the operating and stock-price performance of Family Business Magazine's (FBM) list of the 250 largest Family Firms (FF). FBM's most recent list includes data for family-controlled firms at the end of 2003. The list includes firms from 28 countries (with the U.S. accounting for more than half with 130 firms) and with revenues of at least 1.2 billion (by Fall 2003). Of the 120 foreign family-controlled firms, 62% are public (75) and 24% trade on U.S. stock markets through ADR (29). In addition to the global publication, FBM also lists the 150 largest American family firms, which are considered more complete in regard to the sample of American family-controlled firms with fifty-three percent (68) of the companies listed being publicly traded by 2007.

For business scholars, it has always been a topic of debate whether concentrated ownership promotes improved financial performance. Family-controlled firms are perceived by some theorists as less efficient than firms with dispersed ownership because there is the tendency to tunnel resources to the controlling family (Jensen and Meckling, 1976). On the other hand, some researchers point to the presence of agency problems when there is a separation of ownership and control (Eisenhardt 1989). In order to address this issue, we investigate the relative operating and stock-market performance of family- and managerially-controlled firms. Our analysis also includes a discussion of foreign family-controlled firms that trade in the U.S. market via American Depository Receipts (ADR). Our analysis indicates that foreign family-controlled firms are significantly more profitable than non-family-controlled firms and U.S. family-controlled firms.

This paper is presented as follows. The next section describes the literature review and

main research questions. Section 3 describes the data. Section 4 covers the methodology used to address our hypotheses. Section 5 describes the results and Section 6 concludes.

## LITERATURE REVIEW AND HYPOTHESES

### Definition

Family firms have been defined in several ways in the literature.<sup>1</sup> However, the general consensus is similar to the definition of Shanker and Astrachan (1996) and Lansberg (1999) which indicates that a family firm is an organization controlled and usually managed by multiple family members. Since we use the data provided by Family Business magazine, we use their definition which lists as family firms those firms that have one or more of the following characteristics: a single family controls the company's ownership, the controlling family's members are currently active in top management, and the family has been involved in the company for at least two generations, or seems likely to be.

### Performance

Previous researchers such as Miller et al. (2007), Barth et al. (2005), and Anderson and Reeb (2004) find negative, or insignificant, effects in firm's profitability when comparing family-controlled firms with managerially-controlled firms. Conversely, other researches find a positive effect in companies' financial performance when families govern them (e.g. Habberson et al., 2003; Anderson & Reeb, 2003; Barontini & Caprio, 2006). Hence, there is little agreement in the literature, and some authors offer arguments to support both results (Anderson and Reeb, 2003, 2004). Miller et al. (2007) argues that the results of these comparisons are highly sensitive to sampling and may not be correctly attributing the result to a particular governance type.

Li (1994) argues that in line with agency theory ownership concentration should improve the financial performance of the firm, ultimately benefitting shareholders. However, in many cases, large shareholders tend to expropriate the firm's resources to the detriment of smaller shareholders. In classic literature, Myers and Majluf (1984) present a theoretical paper that exemplifies the potential unwillingness to buy stock from a firm with concentrated ownership at fundamental value because potential investors tend to acknowledge asymmetric information and consequently are only willing to buy at a discount. Jensen and Meckling (1976) state that; "...the price which they (outside investors) will pay for shares will reflect the monitoring costs and the effect of the divergence between the manager's interest and theirs". They point out that there is a potential reduction in rents for atomistic shareholders when large shareholders act as managers and do not synergize their goals with those of the firm, and large shareholders are likely to divert resources to non-pecuniary expenses. It is clear that controlling shareholders bear only a fraction of the cost, proportional to their share of the firm, of non-pecuniary benefits, yet they will receive the entire non-pecuniary benefits. Hence, family-controlled firms sometimes might have to offer shares at a discount to lure new investors. La Porta et al. (1999) also point out that the level of protection offered to minority shareholders will influence the number of widely-held corporations, implying that atomistic shareholders acknowledge the risk of large shareholder expropriation.

Shleifer and Vishny (1997) favor this view and argue that one of the greatest costs paid by businesses with large shareholders might be that controlling shareholders remain active

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<sup>1</sup> For further information on the various definitions of Family businesses, Miller et al. (2007) presents an aggregate table of the definitions available in the literature from top-tier Finance and Management journals from 1996 to 2006.

within the firm when they are no longer capable of successfully managing the firm. Nevertheless, the costly internal controls and monitoring costs of firms with dispersed ownership can be detrimental for atomistic shareholders as these excessive costs are reflected in stock prices. Yet, the benefits of being managed by professional outsiders are assumed to exceed monitoring costs. Family-controlled firms should have lower monitoring costs and this is another reason to expect this corporate structure to outperform non-family-controlled firms, likely increasing shareholders' wealth. Owner-managed firms eliminate the costly control mechanism commonly used to limit the agency problem in the separation of ownership from management (Schulze et al., 2002).

Another strand of the firm-performance literature focuses on the relative performance of founding chief executive officers (CEO) versus those hired subsequently. For example, Kim (2007) finds that founder-CEOs' ownership has a positive effect on firm performance when their ownership is between five and twenty percent. Kim attributes his findings to the ownership hypothesis, which implies that an owner will more likely align the firm's interests to that of his own.

Wang (2006) examines the effect of family ownership by focusing on founding-family owners. He finds that, on average, founding-family ownership is associated with higher earnings quality. The improved earnings quality includes lower abnormal accruals, greater earnings informativeness, and less persistence of transitory loss components in earnings. Ali et al. (2007) examines S&P 500 firms and find evidence that family-controlled firms report better-quality earnings and are more likely to warn for a given magnitude of bad news, in support of Wang's (2006) findings. Ali et al. (2007) attribute their findings to family-controlled firms facing less severe agency problems. They point out however, that family-controlled firms tend to make fewer disclosures about their corporate governance practices since there are more severe agency problems that arise between controlling and non-controlling shareholders. Wang (2006) and Ali et al.'s (2007) findings imply that family-controlled firms should outperform comparable non-family-controlled firms.

We therefore aim to answer whether firms controlled by families are more profitable than other types of governance structures. According to Habberson et al. (2003) and Fama and Jensen, (1983), when a family controls a firm, the firm tends to improve its efficiency and gain a competitive advantage over its rivals. According to Burkart et al. (2003), there are three broad benefits for controlling shareholders of family-controlled organizations. First, there is the "amenity potential," that encompasses non-monetary benefits, direct or indirect, such as personal satisfaction or self-actualization. Second, there is an increase in positive reputation that can be used externally, e.g. to promote a political career. Third, there are monetary benefits as well as the possibility for expropriation (or tunneling) by the insider family, as described by Jensen and Meckling (1976).

We hypothesize that monetary benefits are, in most cases, the most important reason for a family to control a firm. Burkart et al. (2003) points out that "a crucial factor shaping the attractiveness of delegated management is the degree of legal protection of outside shareholders from expropriation by the insiders". Earlier research shows that such protection varies widely across countries, and this variation predicts the differences in financial development and ownership structures.

Given the potential impact of controlling structure on firm performance, this area warrants further attention in the literature. Anderson and Reeb (2003) indicate that the ownership structure of family-controlled firms tends to be less efficient than widely-owned firms.

On the contrary, Li (1994) points out that ownership concentration and board of directors are factors that tend to improve any firm's performance. Performance incentives are common expenses utilized to overcome the agency problem. However, these types of incentives can occasionally cause a moral hazard dilemma; managers will be more likely to authorize riskier projects than what may be acceptable to a rational investor. Schulze et al. (2001) note that family-controlled firms are more likely to stick with their strategies through various scenarios and pursue results over longer periods than non-family-controlled firms. Since family-controlled firms might have a longer time horizon, opportunistic behavior might be reduced.

## Hypotheses

We test whether family ownership concentration provides the foundation for a more profitable performance. Our initial analysis involves a comparison of the relative performance of domestic family-controlled firms with that of domestic non-family-controlled firms, which generally have more fragmented ownership, or if ownership concentration exists, it is believed to affect performance differently than when a controlling family is present. Given the expected lower agency costs associated with family-controlled firms, we hypothesize that:

*H1: Family-controlled firms are more profitable than publicly traded non-family-controlled firms.*

We acknowledge that the industrialization level and regulatory environment of the firms' home country might have an effect on financial performance. Developed common-law countries usually offer the best legal protection to minority shareholders. Even large shareholders have lower expectation of being expropriated if they ever lose control of the corporation (La Porta et al., 1999). We expect some nations to have less strict supervision on fiscal legislation and accounting regulations. Usually, accounting regulations are correlated with internal controls. Less than efficient internal controls might lure managers and controlling shareholders into tunneling, less than optimal use of resources, and misrepresentation of the firm's financial condition. Loose enforcement of existing regulations might allow managers to misrepresent profits. There is also a possibility that foreign companies do not have mature corporate governance mechanisms, which might increase block-shareholder expropriation. Hence, we endeavor to investigate whether domestic firms are more profitable than foreign family-controlled firms. We test the following hypothesis:

*H2: Domestic family-controlled firms are more profitable than foreign family-controlled firms that trade as ADRs on U.S. stock exchanges.*

## DATA

We collect the sample of family-controlled firms from the Family Business Magazine's list of the 250 largest family firms.<sup>2</sup> The list includes firms from 28 countries with annual revenues of at least USD \$1.2 billion at the end of 2003.<sup>3</sup> The list includes 120 foreign family-controlled firms from which 62 percent (75 firms) are publicly traded, and 24 percent (29 firms) are trading in U.S. stock markets through ADRs. We supplement our list of U.S. family-controlled firms, from the Global list, with the Family Business Magazine's list of the 150 largest American family-

<sup>2</sup> Family Business Magazine (Autumn 2003) "The World's 250 Largest Family Businesses" is available at: <http://familybusinessmagazine.com/topglobal.html>. The list includes the 250 largest family firms at the end of the year 2003.

<sup>3</sup> The countries include The U.S. with 130 firms, France with 17 firms, Germany with 16 firms, Italy with 11 firms, and Mexico with 10 firms, and 23 more countries with less than 10 firms.

controlled firms.<sup>4</sup> The list includes 68 American firms that are publicly traded by 2007. For our comparative analysis, we use a representative sample of the American economy, non-family firms listed in the S&P 500 at the end of 1997 (474 companies).

**Table 1: Descriptive Statistics**

<b>Panel A. All</b>						
	N	Mean	Median	S.D.	Min	Max
Operating	3328	0.148	0.143	0.075	0.004	0.337
Leverage	3379	0.613	0.609	0.197	0.205	1.063
Revenue	3358	1.022	0.878	0.666	0.107	3.244
Size	3344	8.916	8.894	1.466	5.376	12.029
Book-to-Market	3328	0.544	0.353	0.724	0.009	3.979
<b>Panel B.</b>						
	N	Mean	Median	S.D.	Min	Max
Operating	832	0.142	0.136	0.064	0.004	0.337
Leverage	854	0.569	0.563	0.181	0.205	1.063
Revenue	843	1.097	0.896	0.753	0.107	3.244
Size	827	8.503	8.515	1.489	5.376	12.029
Book-to-Market	811	1.007	0.482	1.243	0.009	3.979
<b>Panel C. US</b>						
	N	Mean	Median	S.D.	Min	Max
Operating	643	0.145	0.143	0.064	0.004	0.337
Leverage	665	0.563	0.558	0.184	0.205	1.063
Revenue	843	1.097	0.896	0.753	0.107	3.244
Size	652	8.404	8.388	1.499	5.376	12.029
Book-to-Market	652	0.520	0.400	0.457	0.009	3.979
<b>Panel D. ADRs</b>						
	N	Mean	Median	S.D.	Min	Max
Operating	189	0.130	0.126	0.060	0.004	0.337
Leverage	189	0.588	0.570	0.171	0.205	1.063
Revenue	189	0.842	0.693	0.516	0.107	2.838
Size	175	8.873	8.856	1.393	5.376	11.812
Book-to-Market	159	3.004	3.979	1.436	0.009	3.979

N represents the number of firm/year observations. *Operating Income* equals earnings before interest taxes depreciation and amortization divided by total assets. *Leverage* is the amount of total liabilities divided by total assets. *Revenue* is the total operating revenue divided by total assets. *Size* is the log of the firms' Market Capitalization. *Book-to-Market* is the book value of equity divided by its market value. Variables are in billions of US dollars except *Size* and *Book-to-Market* ratio.

<sup>4</sup> Family Business Magazine (2002) "America's 150 largest family businesses" can be accessed on the website: <http://familybusinessmagazine.com/top150.html>.

We use firm-level data over an eleven-year period, from 1997 to 2007. The initial sample includes 4,417 firm/year observations in fifty industries. Industries without domestic or foreign family-controlled firms are removed from the sample (1,014 observations), which results in a final sample that includes thirty-five industries, with 3,403 firm/year observations. We report descriptive statistics in Table 1.

**Table 2: Frequency Table**

	N	Yes / No	Mean	%
<b>Panel A. Relative to All Firms</b>				
Family-Firm	3382	Yes	854	25.25%
		No	2528	
US-family	3382	Yes	665	19.66%
		No	2717	
ADR-family	3382	Yes	189	5.59%
		No	3193	
<b>Panel B. Relative to Family-Firms</b>				
US-family	854	Yes	665	77.87%
		No	189	
ADR-family	854	Yes	189	22.13%
		No	665	

N represents the number of firm/year observations. Panel A shows the frequency of categorical variables relative to all firms. Panel B shows the frequency relative to Family-Firms only. *Family-Firm* equals to 1 if the firm is a family-controlled firm and zero otherwise. *ADR-family* is a dummy variable equals to one if the firms is family-controlled and foreign-owned. *US-family* is a dummy variable that equals one if the firm is family-owned in the U.S.

## METHODOLOGY

We first estimate Pooled OLS regressions with industry and year effects. We estimate one-way and two-way dimension Petersen's (2009) clustered standard errors. We control for firm size, leverage, revenue, market to book value, and family ownership structure. *Operating-Income* is our measure of operating performance, which is used as the dependent variable in model 1. We show the calculation of our dependent and control variables in section *Operating-Income* and control variables *Size*, *Leverage*, *Revenue*, and *Book-to-Market* are Winsorized at the 2% and at the 98% to avoid the influence of outliers.



## Multiple Regression Model

We estimate the following equation to determine the relative effect on operating income:

$$OperatingIncome_{ij} = \alpha + \beta_1 Size_{ij} + \beta_2 Leverage_{ij} + \beta_3 Revenue_{ij} + \beta_4 BooktoMkt_{ij} + \beta_5 OwnerType_i + \varepsilon_{ij} \quad (1)$$

Where:

*Operating Income* = EBITDA divided by total assets for firm *i* in year *j*.

*Size* is the natural logarithm of market capitalization for firm *i* in year *j*.

*Leverage* is computed as liabilities divided by total assets for firm *i* in year *j*.

*Revenue* is the total operating revenue deflated by total assets for firm *i* in year *j*.

*Book-to-Market* is the book value of equity divided by its market value.

*OwnerType* is a set of dummy variables for Family-Firm, ADR-family-firm, and U.S.-family-firm, with a value of 1 if the firm is in the corresponding category and zero otherwise.

## RESULTS

We show descriptive statistics in Table 3. Non-family-controlled firms have better operating performance when no control variables are included. This group has higher mean and median values for *Operating Income*. On the other hand, family-controlled firms have lower *Leverage*, greater *Revenue*, yet they appear to be smaller and with higher book-to-market value.

We report the results of the estimation of equation 1 in Table 4. Models 1 and 2 include a dummy variable indicating whether the firm is family-controlled. This dummy variable is positive and significant indicating that, on average, family ownership increases operating performance. The control variables have the expected sign. *Revenue* is positive and significant, whereas *Book-to-Market* value is negative and significant, indicating that larger/growth firms tend to be more profitable than small /value firms. In models 3 to 6 results indicate that family firms outperform non-family-firms only if they are foreign family-firms, rather than U.S.-based family firms. The coefficients for *ADR-family* are positive and significant, whereas the coefficients of *U.S.-family* are negative and significant, which indicates that family ownership has a positive effect *only* when the firm is domiciled overseas. This result is surprising given the relatively lower shareholder protection outside the U.S. However, it appears that the fact that these family firms are listed on U.S. exchanges, as level 2 and level 3 ADRs,<sup>5</sup> has improved their corporate governance as implied by the bonding hypothesis (Coffee, 1999, 2002; Stulz 1999; Doidge et al., 2004). This group of family firms appears to be bonded to the stricter regulations existing on U.S. exchanges, compared to those of their home countries. The control variables remain with similar coefficients in the rest of the model specifications.<sup>6</sup>

<sup>5</sup> There are four levels of ADR; however, only levels 2 and 3 trade on U.S. stock exchanges. Level 1 is traded over-the-counter, and level 4 is limited to private offerings to qualified investors.

<sup>6</sup> The results were tested for robustness by dividing the sample into two groups, manufacturing and non-manufacturing and by cross-validation, random sampling of two groups 60% and 40%. The main findings remain unchanged.

Family firms seem to outperform non-family firms; however, the effect is nonexistent within domestic firms. It appears that the combination of family and foreign ownership improves operating performance, compared with a sample of large U.S. firms. However, one limitation of our study is that we are not able to separate the effects of the cross-listing treatment from the family-ownership effect. Hence, the different performance may be due to external factors such as a temporary improvement in performance after cross-listing or the existence of more growth opportunities in their home countries compared to the U.S. We limit our findings to the synergy created between family owners and being cross-listed in the U.S.

**Table 3: Univariate Tests**

	N	Group	Mean	Median
Operating	832	Family-Firms	0.142	0.136
	2496	Non-Family-	0.150	0.145
		Difference	-0.008***	-0.009**
Leverage	854	Family-Firms	0.569	0.563
	2525	Non-Family-	0.628	0.625
		Difference	-0.059***	-0.062***
Revenue	854	Family-Firms	1.097	0.896
	2515	Non-Family-	0.997	0.871
		Difference	0.099***	0.025***
Size	827	Family-Firms	8.503	8.515
	2517	Non-Family-	9.052	9.002
		Difference	-0.549***	-0.487***
Book-to-Market	811	Family-Firms	1.007	0.482
	2517	Non-Family-	0.395	0.327
		Difference	0.612***	0.155***

Significance levels are from *t*-tests of means and from Wilcoxon paired signed rank tests, respectively for mean and median values. \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels respectively. N represents the number of firm/year observations. *Operating Income* equals earnings before interest taxes depreciation and amortization divided by total assets. *Leverage* is the amount of total liabilities divided by total assets. *Revenue* is the total operating revenue divided by total assets. *Size* is the log of the firms' Market Capitalization. *Book-to-Market* is the book value of equity divided by its market value. *Operating Income*, *Leverage*, and *Revenue* are in billions of US dollars.

**Table 4: Results of Panel Regression Analysis**

$$OperatingIncome_{ij} = \alpha + \beta_1 Size_{ij} + \beta_2 Leverage_{ij} + \beta_3 Revenue_{ij} + \beta_4 BooktoMkt_{ij} + \beta_5 OwnerType_i + \varepsilon_{ij}$$

	(1)	(2)	(3)	(4)	(5)	(6)
Size	0.014*** (0.000)	0.009*** (0.000)	0.011*** (0.000)	0.011*** (0.002)	0.013*** (0.002)	0.011*** (0.002)
Leverage	-0.085*** (0.008)	-0.099*** (0.007)	-0.088*** (0.008)	-0.088*** (0.022)	-0.090*** (0.024)	-0.086*** (0.022)
Revenue	0.036*** (0.002)		0.036*** (0.002)	0.036*** (0.008)	0.036*** (0.009)	0.036*** (0.008)
Book-to-Market	-0.023*** (0.002)	-0.027*** (0.002)	-0.049*** (0.004)	-0.049*** (0.009)	-0.022*** (0.004)	-0.049*** (0.009)
Family-Firm	0.004* (0.002)	0.008*** (0.002)				
US-family			-0.005** (0.002)	-0.005 (0.008)	-0.010 (0.008)	
ADR-family			0.114*** (0.011)	0.114*** (0.036)		0.116*** (0.036)
Const	0.051*** (0.009)	0.143*** (0.009)	0.091*** (0.008)	0.091*** (0.029)	0.062** (0.030)	0.087*** (0.030)
<i>N</i>	3253	3274	3253	3253	3253	3253
<i>Year Clusters</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Industry Clusters</i>	No	No	No	Yes	Yes	Yes
<i>R</i> <sup>2</sup>	0.276	0.184	0.320	0.320	0.278	0.320
<i>F</i>	462.41	199.05	515.24	106.17	116.75	123.25

Models 1-3 include controls for year clusters. Models 4-6 include industry and year clusters. The symbols \*, \*\*, and \*\*\* indicate statistical significance at the 10%, 5%, and 1% levels respectively. Standard errors in parentheses. The coefficients are robust standard errors, given the potential autocorrelation of panel data. *Operating Income* equals earnings before interest taxes depreciation and amortization divided by total assets. *Leverage* is the amount of total liabilities divided by total assets. *Revenue* is the total operating revenue divided by total assets. *Size* is the log of the firms' market capitalization. *Book-to-Market* is the book value of equity divided by its market value. *Family-Firm* equals to 1 if the firm is a family-controlled firm and zero otherwise. *ADR-family* is a dummy variable equals to one if the firms is family-controlled and foreign-owned. *US-family* is a dummy variable that equals one if the firm is family-owned in the U.S.

## CONCLUSION

Many researchers argue that the primary disadvantage of the modern corporate form of firm governance is weakened by agency issues. Hence, some posit that a possible way to improve firm performance is to align the interest of managers and owners of the firm. One way this is evidenced is by having families that own large blocks of shares also control the day-to-day management of the firm. We examine financial data relating to the largest family-controlled firms based on Family Business Magazine's list of the largest family-controlled firms to observe whether their financial performance is better than those of non-family-controlled firms in the S&P 500. We find evidence that controlling for relevant factors, family-controlled firms have superior operating performance than other U.S. firms. However, this relationship is limited to foreign family-controlled exchange-traded ADR firms. Further, family-controlled ADRs outperform the sample of U.S. firms, whether family-controlled or non-family-controlled. It appears that family-owned firms have taken advantage of the reduction in capital barriers when they access U.S. stock exchanges to better exploit existing growth opportunities.

Perhaps the underlying reason for our finding is that managers of family-controlled firms are more likely to have their personal interests more closely aligned with the firm's goals, and this may be further strengthened when firms chose to cross-list in the U.S. and embrace stricter regulations. An additional contributing factor could be that since many family-controlled firms still have in place the founders of the business, they may be more knowledgeable about their businesses; hence, their expertise is reflected in the firms' performance.

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## APPLICATIONS OF BUSINESS ANALYTICS IN CONTEMPORARY BUSINESS ISSUES

**John Wang**, Montclair State University  
**James G. S. Yang**, Montclair State University

**ABSTRACT:** This paper points out some contemporary business issues, such as audit quality, financial fraud, risk management, and corporate social responsibilities. It offers some business analytics techniques to mediate these problems, such as data mining, business intelligence, simulation techniques, theory of constraints, logistic regression, simultaneous equations system, and content analysis. There is a huge body of literatures on this subject. This paper reviews quite a few of them.

### INTRODUCTION

We are facing and witnessing a new age, which is highly data-driven (“Big Data”). Data is the driver and motivator of business analytics research and practice. These developments pose huge challenges, present new opportunities, and demonstrate the importance and role of business analytics in responding to and aiding in this new economy. Business Analytics consists of four overlapping areas: Data Mining, Business Process Optimization, Applied Business Statistics, and Business Intelligence/Information systems. Business Analytics focuses on developing new insights and understanding into business performance as a result of different methods and techniques. This has been increasingly recognized by organizations for their potential value and is considered a new path towards transforming insights into action (Wang, 2013).

“It’s a revolution,” says Gary King, director of Harvard’s Institute for Quantitative Social Science. “We’re really just getting under way. But the march of quantification, made possible by enormous new sources of data, will sweep through academia, business and government. There is no area that is going to be untouched” (Lohr, 2012). As businesses grow, the amount of information that is collected over time through its operations can be a key success factor when properly analyzed through Business Analytics techniques. The workplace is changing and as technology advances the pressure to adapt to environmental change to staying ahead of the competition becomes more rigorous. In order to stay ahead of the competition, businesses must capitalize on its own resources while embracing the influence of technology.

This paper attempts to identify the contemporary business issues today. They include audit quality, fraud detection, corporate social responsibilities, risk management, quality of accounting information, etc. This paper then offers applications of Business Analytic techniques to solving these problems, such as data mining, business intelligence, simulation techniques, theory of constraints system, logistic regression analysis, simultaneous equation system, content analysis, etc.

### AUDIT QUALITY

Financial information is the basis for investment decision and the auditor is the guardian to protect its integrity. Unfortunately, the audit failure by Author Anderson, LLP, in Enron debacle has tarnished its value. What went wrong? It was the issue of audit quality. There have been many studies since then.

Amid heightened concerns for systemic risk in the global audit and credit rating markets, Hu (2011) takes a departure from the silo approach of the current debate on audit and credit rating by exploring the potential benefits of convergence of audit and credit rating practices, such as going concern (GC) rating (or audit rating) with notching relationship to issuer credit rating, an alternative practice platform for auditors and credit rating agencies (CRA) to form strategic alliances, and use of innovative insurance solutions to mitigate catastrophic litigation risks in order to facilitate the capital formation for such audit-credit rating alliances. If successfully implemented, the convergence would lead to potentially seven global audit-credit rating alliances (the Big 7) in the financial reporting industry, instead of an audit market dominated by the Big 4 and a credit rating market by the Big 3.

Francis (2011) presents a general framework for studying factors associated with engagement-level audit quality. The framework is intended to sharpen their thinking about conducting audit-quality research, and to help scholars, professional accountants, regulators, and policy makers to better understand the multiple drivers of audit quality. While the framework has a broad scope, the research implications will focus mainly on archival-based audit research. Research on the relation between accounting firms and audit quality is severely limited by the availability of data on characteristics of accounting firms. To date, research on this topic has relied on variables that can be constructed from public disclosures such as client-based measures of industry expertise and office size. However, these measures do not go inside the "black box" of the accounting firm's organizational structure and operations, and several studies have collected private data to pursue these questions.

Omer, Shelley, and Thompson (2012) examine investors' response to the disclosure of prior-period waived misstatements under Staff Accounting Bulletin (SAB) No. 108, "Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in the Current Year." Misstatement correction decisions typically are not observable, and financial statement users have little insight into the disposition of identified misstatements, a dimension of audit and financial statement quality. The authors find that investors respond negatively to the disclosure of SAB No. 108 misstatements, and this response is associated with the current-period auditor initially waiving the misstatement and client importance. Although SAB No. 108 misstatements were waived under prevailing materiality guidance, their findings suggest that investors interpret SAB No. 108 misstatements as indicating lower perceived audit quality.

The above literatures clearly points to the problem of audit quality. Investors heavily rely on the audit report for investment decision, but the current auditing techniques and capabilities do not catch up with the modern technology and technical competence. Data mining is one of the business analytics that can be employed to improve the audit quality.

## **DETERRING FRAUD**

Nowadays, financial fraud is inevitable. It has become a serious issue in corporate financial management. The worse it becomes, the more sophisticated techniques are required. Many studies offer such caviar approaches.

In line with Bouwer (2010), by understanding the so-called 'fraud triangle' (of pressures/opportunities and rationalization), one really understands (and can internalize) the reason why there are dishonest people venturing in our world. Prevalence of fraud in challenging economic times has resulted in greater incentive and pressure on individuals to make ends meet. The accounts payable function within business environments is no exception and is falling prey to fraudsters. The surprising absence of documented policy,



which should outline robust and embedded accounting controls, has been an emerging and growing concern, particularly in the investigation of perpetrated frauds in the accounts environment. Too few organizations deploy sound pro-active strategies in respect of fraud deterrence. This includes intelligence such as staff and supplier vetting that is robust and not just one-off initiatives, fraud and corruption auditing and importantly, training initiatives in the identification of fraudulent trends and practices. The use of data analytics is also a key investigative and fraud deterrence tool that is growing in demand and sophistication.

Doinea and Lapadat (2012) make conceptual and methodological contributions to the role of the external auditor in detecting and deterring fraudulent or misleading financial reporting, increased globalization of financial and product markets, the pervasiveness of technology within the corporate financial data transmission structure, and management's involvement in the fraudulent financial reporting activity. The mainstay of the paper is formed by an analysis of the relationship between the importance of Related Party Transactions (RPTs) in auditing and in detecting fraud, the widespread adoption of Web-based financial and business reporting, the risk of fair value accounting fraud, the process of detecting fraud, and opportunities for fraudulent financial reporting based on misapplication of fair value accounting concepts.

As was appropriately observed amid the Great Depression, the performance of securities markets affects economic activity. Congress passed the federal securities laws to ensure the safety and reliability of the public capital markets. The Securities Exchange Commission (SEC) is the regulatory body that is charged with implementing these laws and it fulfills this obligation by actively pursuing its mission to protect investors, maintain fair, efficient, and competitive markets, and facilitate capital formation. The proper implementation of its mission is absolutely necessary because the markets are inextricably linked to the health of the national economy. Accordingly, Martin (2012) argues that the sophisticated investor exemption is no longer a reliable mechanism for separating private and public investment companies. The author broadens this analysis by examining the extent to which the sophisticated investor exemption has undermined the SEC's ability to fulfill its mission to protect the public capital markets, and whether this failure has left the general public inadequately protected.

At one of the forensic and investigative accounting panels at the American Accounting Association's 2011 Annual meeting, panelists discussed some of the common misconceptions about fraud, the dearth of articles related to fraud examination and forensic accounting published in the mainstream accounting journals, and the many opportunities for future research in these areas. They also discussed the publication process as it relates to articles on fraud examination and forensic accounting topics. Brody, Melendy, and Perri (2012) summarize their discussion, and also draw upon some of the relevant published literature to highlight some of the fraud topics that are still largely unexplored and thus ripe for academic research. An emerging area of research is in the fraud and forensic accounting area. As a result of increased interest in fraud and forensic topics, journals (both new and old) are interested in manuscripts.

The above literatures reveal that financial frauds are pervasive and widespread in business world today. They undermine the operating efficiency and quality of financial information. The fraud problem has become more serious today due to digitalization of accounting data. Analysis of massive amount of data has become critically important. Data mining technique can also be employed to detect frauds.

## RISK MANAGEMENT

Any business operation involves risk. The real task of business management is actually the risk management. The most disastrous example of failure in risk management was mortgage lending by banks in 2009. Citi Group and Bank of America were at the brink of collapse due to losses on mortgage. At that time many other conglomerates are on the same boat, such as American Insurance Group and General Motors. It costs the Federal government at least \$100 billion to rescue them. The government cannot afford to let them fail - "Too big to fail." This financial crisis points to the importance of risk management. Risk management is not only a matter a company's internal control system, but also government regulations. Federal Reserve Bank, Securities and Exchange Commission, and many other government agencies all step in regulating the risk management of a corporation. Many academic studies also turn attention to this risk aspect of management. It has become a contemporary business issue since then.

Legal scholarship has been silent about a phenomenon with profound implications for governance: the automation of compliance with laws mandating risk management. Regulations - from bank capitalization rules, to Sarbanes-Oxley's provisions on financial fraud and misrepresentation, to laws governing information-privacy protection -- frequently require regulated firms to develop internal processes to identify, assess, and mitigate risk. To comply, firms have turned wholesale to technology systems and computational analytics that measure and predict corporate risk levels and "force" decisions accordingly. Bamberger (2010) explores these developments and the failure of risk regulation to address them. While regulators have lauded the turn to technology, they have ignored its perils. By contrast, the author investigates the accountability challenges posed by these and other technologies of control, and suggests specific reform measures for policy makers revisiting the governance of risk. The author argues for more activist regulator oversight backed by sanctions before disaster has occurred.

Stanley (2011) hypothesizes a link between observed audit prices and future reported changes in clients' economic condition. As predicted, results from a traditional audit fee model, estimated using a large sample of U.S. public company engagements spanning from 2000 to 2007, reveal a significant inverse relation between audit fees and the one-year-ahead change in a measure of clients' operating performance. Additional analysis indicates that the relation extends to more forward-looking changes and is stronger for negative versus positive changes in performance. Results also indicate that audit fees reflect future changes in clients' earnings that are unaccounted for by analysts' forecasts. In contrast, the findings reveal little evidence of a relation between audit fees and future changes in clients' solvency, including bankruptcy status. Collectively, the study's results provide initial evidence suggesting that the audit fee disclosure is a leading indicator of the operating performance dimension of clients' business risk.

Hammersley, Myers, and Zhou (2012) study a sample of companies that fail to remediate previously disclosed material weaknesses (MWs) in their internal control systems and, thus, disclose the same MWs in two consecutive annual reports. Their failure to remediate is surprising given that regulators, credit rating agencies, and academics contend that the remediation of MWs is important. The authors form a control sample of companies that initially disclosed MWs in their internal control systems, but subsequently remediated these weaknesses, and investigate the characteristics of the remediated and unremediated MWs, the characteristics of remediating versus non-remediating companies, and the consequences to non-remediating companies. Regarding the characteristics of companies failing to remediate,

the authors find that companies are less likely to remediate previously disclosed MWs when the weaknesses are more pervasive and when their operations are more complex. In addition, companies with smaller audit committees are less likely to remediate. Regarding the consequences, the authors find that companies failing to remediate MWs experience larger increases in audit fees and a higher likelihood of auditor resignation as the number of MWs increases. The authors also find that non-remediating companies are more likely to receive modified audit opinions and going-concern opinions. Finally, the authors find that companies failing to remediate are more likely to miss filing deadlines and experience increased cost of debt capital.

The above studies indicate that the auditors are required to disclose the management's efforts in remediating its risk control weakness. Auditing fees bear reverse relationship with management success in risk control. The more the success, the lower is the auditing fees. One study points out Sarbanes-Oxley Act as an evidence of government intervention on a corporation's risk management. Business Analytics technique can identify where the management risk and weakness are and offer remedies.

### **CORPORATE SOCIAL RESPONSIBILITY**

Corporate social responsibility (CSR) has been a dilemma for corporate management for a long time. Should a corporation's stakeholders be its shareholders or the society? There is a conflict between them. The issue seems unsolvable. In recent years many studies attempt to break the deadlock by using Business Analytics techniques.

In Biology, symbiosis describes two unlike organisms living together, and one can distinguish between parasitism and mutualism. In the former only one organism benefits at the expense of the other, while in the latter both organisms benefit from the symbiosis. Langella, Carbo, and Dao (2012) show how corporations and business, once expected to provide a benefit to society, have evolved into organizations whose only concern is to maximize shareholder profits, often at the detriment of stakeholders (e.g. employees and communities) and the environment. Several recent particularly significant examples are used in order to illustrate this point. The authors also provide a thorough but accessible overview of corporate social responsibility and sustainable management theory in order to show how businesses and management education are responding to recent events.

Relatively little research has examined the effects of ownership on the firms' corporate social responsibility. In addition, most of it has been conducted in the Western context such as the U.S. and Europe. Using a sample of 118 large Korean firms, Oh, Chang, and Martynov (2011) hypothesize that different types of shareholders will have distinct motivations toward the firm's CSR engagement. The authors break down ownership into different groups of shareholders: institutional, managerial, and foreign ownerships. Results indicate a significant, positive relationship between CSR ratings and ownership by institutions and foreign investors. In contrast, shareholding by top managers is negatively associated with firm's CSR rating while outside director ownership is not significant. The authors conclude that different owners have differential impacts on the firm's CSR engagement.

The financial crisis of 2007-2009 was preceded by a period of financial firms seeking short-term profit regardless of long-term consequences. Numerous market participants engaged in myopic behavior. Contrary to the efficient market hypothesis, market prices of subprime mortgage-related securities failed to reflect underlying risk in the wake of a massive decline in lending, underwriting, and rating standards and over reliance on the risk reduction

capacities of derivative transactions and on models that failed to account, among other things, for low-frequency economic shocks. Dallas (2012) provides a comprehensive exploration of why financial and nonfinancial firms engage in short-termism and how to mitigate it. It explains how market and internal firm dynamics contribute to short-termism by considering various structural, informational, behavioral, and incentive problems operating within firms and in markets. Structural explanations include consideration of how biases in financial firms cause them to incur ever-increasing debt levels during periods when the economy is strong and interest rates low, leading such firms to a state of financial fragility.

Sustainability is concerned with the impact of present actions on the ecosystems, societies, and environments of the future. Such concerns should be reflected in the strategic planning of sustainable corporations. Strategic intentions of this nature are operationalized through the adoption of a long-term focus and a more inclusive set of responsibilities focusing on ethical practices, employees, environment, and customers. A central hypothesis, that Ameer and Othman (2012) test is that companies which attend to this set of responsibilities under the term superior sustainable practices, have higher financial performance compared to those that do not engage in such practices. The target population of this study consists of the top 100 sustainable global companies in 2008 which have been selected from a universe of 3,000 firms from the developed countries and emerging markets. The authors find significantly higher mean sales growth, return on assets, profit before taxation, and cash flows from operations in some activity sectors of the sample companies compared to the control companies over the period of 2006-2010. Furthermore, their findings show that the higher financial performance of sustainable companies has increased and been sustained over the sample. Notwithstanding sample limitation, causal evidence reported in this paper suggests that, there is bi-directional relationship between corporate social responsibilities practices and corporate financial performance.

The above literatures demonstrate the conflict between a corporation's desire to maximize the shareholder's profit and its responsibility to protect the benefits for the society as a whole. The typical example is the recent financial crisis in subprime mortgage. The theory of constraint can detect where the conflicts are. It can help promote harmony between a corporation's financial performance and its social responsibilities.

## **INTERDISCIPLINARY STUDIES**

### **Data Mining/Data Analytics**

The technique of data mining is a branch of operation research. It enables the manager to search information through database and find a pattern of correlation among variables. It leads to management decision in minimizing cost, maximizing profit, and promoting operating efficiency.

In the field of accounting and auditing there is a vast amount of information. Data mining technique proves to be an effective tool in analyzing the data.

There are three methods in data mining analysis. First, the mathematical-based method is based on neural networks which are similar to human brain. It can be used in auditing profession in assessing risk, detecting errors and fraud, determining a company's going concern, and evaluating financial stress and bankruptcy. Second is the distance-based method clustering approach. It classifies large clusters of data into groups according to attributes. This method is most useful in marketing segment, but it can also be applied to auditing environment.

Third, the logic-based method is using decision tree approach in organizing data. This method is most useful in the analysis of credit risk, business bankruptcy, and bank failure. In any method, data mining can make auditing function more efficient in organizing data.

There are many studies in data mining. Steinhoff and Terry (2012) state that smart use of data mining is good business and good government. In its simplest form, data mining provides automated, continuous feedback to ensure that systems and internal controls operate as intended and that transactions are processed in accordance with policies, laws, and regulations. Leading organizations tend to take a measured approach initially when embarking on a data mining initiative, starting small and focusing on particular "pain points" or areas of opportunity to tackle first -- such as whether only eligible recipients are receiving program funds. Similar to procurement analytics, purchase card analytics enable management to target risk and prevent problems on the front end. This article is written for management from the perspective of an auditor, who has seen firsthand the power that forensic auditing holds in advancing government accountability. The techniques used by auditors are equally applicable to management, who should always be the first line of defense against fraud, waste and abuse.

Cheh, Lee, and Kim (2010) tried to find the financial and nonfinancial variables which would be useful in identifying companies with Sarbanes-Oxley Act internal control material weaknesses (MW). Using the decision tree model of data mining, this paper examines the predictive power of the variables used in each paper in identifying MW companies and compares the predictive rates of the three sets of the variables used in these studies. In addition, an attempt is made to find the optimal set of the variables which gives the highest predictive rate. Their results have shown that each set of the variables is complementary to each other and strengthens the prediction accuracy. The findings from this study can provide valuable insights to external auditors in designing a cost-effective and high-quality audit decision support system to comply with the Sarbanes-Oxley Act.

According to Sabau (2012), given the current global economic context, increasing efforts are being made to both prevent and detect fraud. This is a natural response to the ascendant trend in fraud activities recorded in the last couple of years, with a 13% increase only in 2011. Due to ever increasing volumes of data needed to be analyzed, data mining methods and techniques are being used more and more often. One domain data mining technique, suspicious transaction monitoring, has emerged for the first time as the most effective fraud detection method in 2011. Out of the available data mining techniques, clustering has proven itself a constant applied solution for detecting fraud. The author surveys clustering techniques used in fraud detection over the last ten years, shortly reviewing each one.

All these studies show that data mining technique is nowadays widely used in almost every area of business information analysis. It can enhance operating efficiency and make a better-informed decision.

## **Business Intelligence**

In addition to data mining technique, another business analytics is business intelligence.

Business Intelligence is a technique to identify the source of data that are relevant to decision. For example, an auditor needs to determine whether the company can go on in its operation as a "going concern."

Where are the data to support such a decision? The task involves financial ratio, market share, credit rating, source of raw material, customer relations, competition in the industry, etc. Business Intelligence provides such relevant information.

Nastase and Stoica (2012) show the benefits that evolve from reporting to Business Intelligence for auditors who perform their work in Information Technology (IT) environments. Business Intelligence is a key factor which contributes to making successful business decisions and supporting not only managers but also auditors who need to perform their work as efficiently as possible in an IT environment. Business Intelligence provides auditors an easy way to make all the data stored within a company meaningful in order for them not to waste time searching for the desired information, but focusing more on performing high-quality audits which can add value to their work and to their client's business.

Spreadsheet applications, and in particular Microsoft Excel, are now ubiquitous. Even though, many large organizations heavily rely on them for data analysis, management reporting, and decision making, limited research regarding their potential impacts on organizational information quality has been published. Baskarada (2011) aims to bridge that gap in the literature by identifying key factors - inherent to spreadsheet applications as well as related to their use - which may have significant negative effects on information quality in organizations. The findings presented in this paper have been identified as a part of a broader ethnographic study on information quality, which was conducted in a large telecommunications company over a period of six months. The author shows that the diffusion of spreadsheet applications is driven by reporting limitations inherent in existing transactional and Business Intelligence (BI) systems. However, while the use of spreadsheets may often be justified from the operational perspective, it frequently leads to significant negative effects on the quality of relevant information.

These studies show that different decision requires different data. Different data come from different environments. In order to make a decision more efficient, the data must be more relevant. Business Intelligence is one of the Business Analytics.

### **Simulation Techniques**

Another Business Analytics is the use of simulation techniques. Sometimes a decision may not have actual data. For example, a company has a current profit with a good internal control system; what would have been the profit without this system? It cannot give the system an actual test. The only way is to find out the variables for the company's profit, and then feed into different data where there is no such good internal control system. The difference in profits between a good and a bad system would measure the value of a good internal control system. Although this is only a hypothetical question it has practical use. For instance, a good internal control system requires a certain amount of cost. It would not be beneficial to engage in such an endeavor unless it can yield a greater amount of benefits. A simulation technique is designed to tackle such a situation. There are several studies below demonstrate how it is used.

Budescu, Peecher, and Solomon (2012) use simulation to investigate the joint effects of materiality, evidence extent, evidence nature, and misstatement type on achieved audit risk, i.e., the risk of undetected material financial statement misstatement due to error or fraud. Their primary results are fourfold. First, contrary to conventional audit wisdom, the authors show that elevating the extent of testing decreases achieved audit risk only under certain conditions and may well increase it. Second, reducing materiality (attempting to perform a more precise audit) can either enhance or jeopardize audit effectiveness. Third, learning about the quality of the

internal controls over financial reporting not only can help the auditor to perform an integrated audit, but also help the auditor reach better judgments about the extent to which and how evidence from the auditee organization's management and/or information systems may be distorted as a result of misstatement, reducing the risk that the auditor would be misled by such evidence. Fourth, when financial statements are biased intentionally due to fraud, it is especially important for the external auditor to supplement more traditional audit tests with tests that produce evidence that is less likely to be biased by management. Auditors who do not understand these four results run a heightened risk of compromising audit effectiveness.

IT governance - and its related assurance activities - is important knowledge for information systems students to obtain. This teaching tip describes a six-week simulation involving IT assurance professionals from a major certified public accounting firm who lead students in an IT risk and assurance class through a mock IT audit. Merhout, Newport, and Damo (2012) completed the first semester using this case. One significant lesson the authors learned is that students will have varying levels of interest in IT audits and will need to be coached through the significance of the case even if they are not planning to pursue a career in audit.

The above two scenarios are fictitious. They do not actually exist. They are used only to test what results it may be under different situation. The authors employ simulation techniques for this purpose.

### **Theory of Constraints System (TOC)**

Many business management decisions involve constraints. Each constraint must be satisfied. For example, what is the optimal production unit to maximize profit? The decision invariably encounters many limitations. Notably, the production activities cannot exceed a certain number of machine hours. The production units must reach a minimum level so as to be break-even for a desired amount of profit. Due to market share, the production volume cannot be greater than other products. The Business Analytics can formulate an objective equation with these constraints. In fact, this is known as "linear programming." The following study illustrates the use of it.

Krishnan, Mistry, and Narayanan (2012) inspect the attitudes, use, and acceptance of a new accounting system in a pharmaceutical corporation that switched from an activity-based costing system to the Theory of Constraints System (TOC). Using structuration theory as a framework to understand the dynamics of the change process, the authors posit that user responses and attitudes toward TOC are influenced not only by the technical features of the system and the potential economic benefits, but also by the fit between TOC and existing structures, modes of mediation, and agency of the users' environment. When users interact with TOC on an ongoing basis, they form interpretations of the new system, and, based on such interpretations, they exhibit actions with respect to the use of TOC ranging from championship to rejection of the system. The authors explore cross-sectional variations in the use of the system and link such variations to the practical features of the new system, as well as the social structures of the users' environments.

This example applies the constraint theory to a pharmaceutical company when it attempts to change a cost accounting system. The change involves many constraints. The study shows the effects of these constraints.

## Logistic and Ordinal Regression Analyses

A business decision involves many variables. More often than not, it is necessary to know the cause-effect relationship between two variables. How does change in one variable affect the outcome? For example, when the selling price per unit is increased by 10% while the cost per unit is decreased by 15%, what is the profit under this strategy? The answer requires information on the relationship between the profit, the selling price, and the cost. The following example demonstrates the use of relationships.

Farag and Elias (2011) scrutinize the stability or loyalty in the auditor-client relationship. It explores the association between audit fees and auditor loyalty. Specifically, it investigates whether clients paying less audit fees relative to other companies in their industries are more likely to be loyal to their auditors. Logistic and ordinal regression analyses are used to compare loyal clients to clients that switched audit firms after controlling for factors that are expected to be associated with client loyalty. Results show that relative audit fees have a significant effect on the degree of loyalty of clients to their audit firms. Additional analysis shows that the loyalty of clients that pay higher audit fees relative to similar clients in their industry are highly affected by increases in audit fees. However, the loyalty of clients who pay lower audit fees compared to similar clients in their industry is not affected by further increases in relative audit fees. It is cost effective for clients to stay with the same audit firm. Audit firms should be careful when adjusting their audit fees from one period to another, as there is a higher probability of losing a client when increasing the audit fees, especially if this client is already paying higher audit fees relative to similar clients.

This study attempts to determine how the client loyalty is affected when the auditor raises the auditing fees. The answer is negative. The higher the auditing fee, the lower is the client loyalty. Many clients leave as the auditing fee increases. The results require regression analysis.

## Simultaneous Equation System

Still another business analytics technique is the simultaneous equation system. In many situations the decision variables are related to each other. Take consolidation of financial statements as an example. Two companies own each other. One company's profit depends on the other, and vice versa. What is each company's profit after taking other company's profit into account? Consolidated financial statements need such information. The solution is a system of two simultaneous equations with two unknowns. Actually, it is not too hard to solve. In the event that there are three companies that own one another, it would be a system of three equations with three unknowns. That problem would be much harder to solve. Business Analytics provide such a technique.

Boone, Khurana, and Raman (2011) observe the relation between auditor litigation risk and abnormal accruals over the 1989-2007 time periods. The authors address potential endogeneity in prior studies by jointly modeling abnormal accruals and litigation risk in a simultaneous equation system. Their findings suggest that client-specific litigation risk affects auditor incentives to acquiesce to client demands for earnings management, i.e., the higher the risk of auditor litigation, the greater the auditor's restraining influence on the abnormal accruals reported by the client. The authors also find evidence that abnormal accruals increase the likelihood of auditor litigation. The authors also document that the 1995 Public Securities Litigation Reform Act (PSLRA) lowered the client-specific risk of auditor litigation. Litigation reform remains a topic of ongoing interest. Their findings contribute to a better understanding of



the effects of litigation reform (and related changes in legal exposure) on auditor incentives and earnings management.

This study attempts to find out the relationship among client's abnormal accruals, earnings manipulation, and auditor litigation. It is surprising to observe that all three variables have a positive relationship.

### **Content Analysis**

Still another Business Analytics is content analysis. Content analysis concerns the question as to whether a report can be biased and distorted from its truth. For example, is a corporation's annual report true in measuring its performance? Is a stockbroker's recommendation on hold, buy, or sell honest to an investor? Many studies cast serious doubts. Content analysis is one of many Business Analytics techniques that investigate this issue.

Prior accounting research views impression management predominantly through the lens of economics. Drawing on social psychology research, Merkl, Brennan, and McLeay (2011) seek to provide a complementary perspective on corporate annual narrative reporting as characterized by conditions of "ex post accountability". These give rise to impression management resulting from the managerial anticipation of the feedback effects of information and/or to managerial sense-making by means of the retrospective framing of organizational outcomes. A content analysis approach pioneered by psychology research is used, which is based on the psychological dimension of word use, to investigate the chairmen's statements of 93 United Kingdom listed companies. Results suggest that firms do not use chairmen's statements to create an impression at variance with an overall reading of the annual report. It was found that negative organizational outcomes prompt managers to engage in retrospective sense-making, rather than to present a public image of organizational performance inconsistent with the view internally held by management. Further, managers of large firms use chairmen's statements to portray an accurate, albeit favorable, image of the firm and of organizational outcomes. The approach makes it possible to investigate three complementary scenarios of managerial corporate annual reporting behavior: self-presentational dissimulation, impression management by means of enhancement, and retrospective sense-making.

Abhayawansa and Guthrie (2012) explore what and how intellectual capital information (ICI) conveyed through analyst reports varies by the type of stock recommendation. ICI draws on the theory of impression management. Content analysis is used to investigate ICI in the full text of sell-side analysts' initiating coverage reports. It categorizes ICI by type and three qualitative characteristics: evidence, time orientation, and news-tenor. It explores how the extent, types and qualitative characteristics of ICI found in analyst reports vary by the type of stock recommendation accompanying the analyst report. Given the conflicting interests facing analysts and relative amenability of ICI, it was found that analysts use ICI to manage perceptions. In particular, analysts attempt to use ICI in their reports to subdue the pessimism associated with an unfavorable recommendation, increase credibility of favorable recommendations, and distinguish sell from hold recommendations. The paper contributes to the literature on impression management by extending its application to the study of sell-side analysts' decision processes and it alerts future researchers to the wider role played by ICI beyond its use in generation of forecasts and valuations. The paper's findings have implications for consumers of analyst reports, as the level of negativity/positivity of forecasts and recommendations may be altered as a result of the semantics associated with ICI. This paper explores analysts' use of ICI conditional on the type of stock recommendation accompanying the report. Findings are explained using the theory of impression management.

These two studies demonstrate that “intellectual capital information” always plays a rather important role in deciding how the report should be presented. In other words, a pre-conceived desire dictates the report. If this is true, it would be beneficial to investigate what that “intellectual capital information” is in each report and decision. Content analysis provides such an insight.

## **CONCLUSION**

This paper points out some contemporary business issues and offers Business Analytics technique as a solution. Financial data are crucial in making decisions, but it has been tainted by the recent financial crisis. Financial data failed to convey correct information. The Auditing profession is supposed to protect the investors' interest, but it is tarnished by the debacle of Arthur Anderson, LLP, in Enron case. It failed to detect the financial frauds. It did not meet its mission. The recent financial crisis was actually rooted on the financial institutions' desires to pursue short-term interest rather than long-term financial health. As a consequence, it took too much risk in mortgage loan. The management failed to manage its risk properly. Corporations pursue profits for their stockholders at the expense of social responsibility, such as environmental protection. These are some of the issues confronting the business management today.

This paper then offers some Business Analytics techniques as an interdisciplinary measure to remediate the problems. Data mining is a framework to analyze massive amount of data in identifying the business operating pattern. It also can serve to detect frauds. Business intelligence is a technique to identify relevant data in making a better decision. Simulation technique is a method to tackle the situation where there are no actual data available for making a decision. Theory of constraints is a model to maximize the objective and yet meet many limitations at the same time. Logistic regression is a technique to find relationship among many variables. Simultaneous equation is a system to solve the problem of complex relations among many variables. Contents analysis is a foundation to investigate and improve quality of a financial report.

Each field of business operation has its own problems. However, integrating insight from other discipline can certainly find solution. This paper provides an example.

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## **Employment Application Forms: Do Potential Illegal Questions Remain?**

**Clifford M. Koen, Jr.**, East Tennessee State University  
**Robert G. Morgan**, East Tennessee State University  
**Amy Menerick**, East Tennessee State University  
**Paul E. Bayes**, East Tennessee State University

**Abstract:** This study was conducted using 31 randomly selected on-line employment applications to determine if they asked any questions that would be considered inappropriate. A review of the on-line employment applications found 124 potential problems. This paper describes the problem areas and makes some suggestions concerning questions a company should not be ask on employment applications.

### **INTRODUCTION**

Generally, the body of law that governs pre-employment questioning and screening has been relatively well-settled in recent years. However, errors in judgment by employers continue to be all-too-common and often are very costly.

In a January 11, 2012 press release, the Equal Employment Opportunity Commission (EEOC) provided a prime example of what can happen when an employer treads on thin ice with respect to fundamental principles of employment law. Pepsi Beverages agreed to pay \$3.13 million, make a major change in its screening policy and provide job offers and training to resolve a charge of race discrimination.

The federal charge was based on Pepsi's policy of denying employment to applicants who had been arrested or convicted of certain minor offenses and also denying employment to individuals who had been arrested pending prosecution even if they had never been convicted of any offense. The EEOC's investigation revealed that Pepsi's criminal background check policy adversely affected more than 300 African Americans who had applied for employment. The press release noted that an employer's "...use of arrest and conviction records to deny employment can be illegal under Title VII of the Civil Rights Act of 1964, when it is not relevant for the job, because it can limit the employment opportunities of applicants or workers based on their race or ethnicity". The EEOC further advised that employers who contemplate instituting a background check policy should "...take into consideration the nature and gravity of the offense, the time that has passed since the conviction and/or completion of the sentence, and the nature of the job sought in order to be sure that the exclusion is important for the particular position. Such exclusions can create an adverse impact based on race in violation of Title VII". Generally, employers should consider only job-related convictions and not the applicant's arrest record when screening for employment.

### **PRIOR RESEARCH**

Research studies conducted by (Koen, 1984) and (Bayes et al, 1989) identified employment application questions that were potentially illegal and provided guidance for developing employment application questions that would meet the guidelines established by the various employment discrimination laws. Other research studies, such as Miller (1980), Jolly and Frierson (1989) and Wallace and Vodonovich (2004), have reviewed employment applications and found questions that would be considered illegal. In the intervening quarter century, since the initial studies conducted by Koen and Bayes, there have been numerous

court cases and rulings that have interpreted and clarified the questions that employers are allowed to ask potential employees. The objective of this study is to evaluate on-line employment applications to determine if they are currently in compliance with the laws.

This study was conducted by reviewing 31 randomly selected on-line employment application forms. Collectively, the review discovered 124 potential problems contained in the 31 employment application forms. The most common problems encountered involved questions concerning the applicant's criminal record (22), citizenship (17), and either social security numbers or age information (9). Additionally, one firm had 10 potentially impermissible questions. Of the 29 categories the authors identified as containing possible problems, eleven of the categories had only one firm asking for information that could potentially lead to legal problems.

Analysis of the 31 on-line application forms revealed that there are still questions that are being asked that are not appropriate. First, companies should ensure that questionable items are not included as part of their application processes. Second, companies can provide a valuable service to their clients by making them aware of potential illegal questions that they may have on their employment applications. The purpose of this article is to identify items in employment application forms that, if used incorrectly or at wrong stages in the employment process, could lead to legal problems.

This article does not attempt to address all the issues that may arise concerning employment application questions, but instead addresses the more pertinent issues employers must consider. Nothing in this article should be construed as legal advice. Employers should seek the advice of a knowledgeable attorney when resolving issues concerning what is "legal" in a particular situation. A question that is "illegal" in one jurisdiction or for one job may be deemed "legal" in another jurisdiction or for another job. The information contained in this article is based on sound management advice and fundamental concepts of employment law.

## **LEGISLATION**

There are numerous federal and state laws that apply when determining what pre-employment questions may be asked. Among the federal laws, those that generally have the greatest impact on this issue are Title VII of the Civil Rights Act of 1964, the Equal Pay Act of 1963, the Age Discrimination in Employment Act of 1967 (ADEA), and the Americans with Disabilities Act of 1990 (ADA). All states have some type of protection against employment discrimination and virtually all have enacted statutes very similar to the various federal laws mentioned.

Title VII generally prohibits an employer from discriminating on the basis of race, sex, color, religion, or national origin. The Equal Pay Act prohibits discrimination based on sex in rates of pay for men and women working in the same or similar jobs. The Age Discrimination in Employment Act prohibits discrimination against individuals who are 40 years of age or older. The Americans with Disabilities Act makes it unlawful for employers to discriminate against a person because of a disability. It also requires employers to make a reasonable accommodation to a qualified person who has a disability unless doing so would impose an undue hardship on the employer.

A review of the specific provisions of each of these laws is beyond the scope of this article. However, some general observations concerning who is covered by each law would be helpful. Title VII and the ADA cover private employers that employ 15 or more employees for 20

or more weeks per year, educational institutions, state and local governments, employment agencies, labor unions, and joint labor-management committees. The ADEA covers private employers with 20 or more employees for 20 or more weeks per year, labor organizations, employment agencies, and state and local governments. The Equal Pay Act covers all employers who are covered by the Fair Labor Standards Act, and virtually all employers are covered. These federal laws are enforced by the Equal Employment Opportunity Commission (EEOC).

The number of formal complaints filed by victims of discrimination has increased in recent years. This increase has no doubt been due in large part to the poor economy as workers have been hurt by layoffs, pay cuts, and difficulty seeking employment. (See chart for charges filed with EEOC FY2002-2011.)

The number for total charges reflects the number of individual charge filings from the years 2002 to 2011. Because individuals often file charges claiming multiple types of discrimination, the number of total charges for any given fiscal year will be less than the total of the eight types of discrimination listed.

The data are compiled by the Office of Research, Information, and Planning from data reported via the quarterly reconciled Data Summary Reports and compiled from EEOC's Charge Data System and, from FY 2004 forward, EEOC's Integrated Mission System. (See Table 1)

**TABLE 1<sup>1</sup> - US EQUAL EMPLOYMENT OPPORTUNITY COMMISSION  
CHARGE STATISTICS FOR FY 2002 – FY 2011**

	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011
<b>Total Charges</b>	84,442	81,293	79,432	75,428	75,768	82,792	95,402	93,277	99,922	99,947
<b>Race</b>	29,910 35.4%	28,526 35.1%	27,696 34.9%	26,740 35.5%	27,238 35.9%	30,510 37.0%	33,937 35.6%	33,579 36.0%	35,890 35.9%	35,395 35.4%
<b>Sex</b>	25,536 30.2%	24,362 30.0%	24,249 30.5%	23,094 30.6%	23,247 30.7%	24,826 30.1%	28,372 29.7%	28,028 30.0%	29,029 29.1%	28,534 28.5%
<b>National Origin</b>	9,046 10.7%	8,450 10.4%	8,361 10.5%	8,035 10.7%	8,327 11.0%	9,396 11.4%	10,601 11.1%	11,134 11.9%	11,304 11.3%	11,833 11.8%
<b>Religion</b>	2,572 3.0%	2,532 3.1%	2,466 3.1%	2,340 3.1%	2,541 3.4%	2,880 3.5%	3,273 3.4%	3,386 3.6%	3,790 3.8%	4,151 4.2%
<b>Color</b>	1,381 1.6%	1,550 1.9%	930 1.2%	1,069 1.4%	1,241 1.6%	1,735 2.1%	2,698 2.8%	2,943 3.2%	2,780 2.8%	2,832 2.8%
<b>Retaliation - All Statutes</b>	22,768 27.0%	22,690 27.9%	22,740 28.6%	22,278 29.5%	22,555 29.8%	26,663 32.3%	32,690 34.3%	33,613 36.0%	36,258 36.3%	37,334 37.4%
<b>Retaliation - Title VII only</b>	20,814 24.6%	20,615 25.4%	20,240 25.5%	19,429 25.8%	19,560 25.8%	23,371 28.3%	28,698 30.1%	28,948 31.0%	30,948 31.0%	31,429 31.4%
<b>Age</b>	19,921 23.6%	19,124 23.5%	17,837 22.5%	16,585 22.0%	16,548 21.8%	19,103 23.2%	24,582 25.8%	22,778 24.4%	23,264 23.3%	23,465 23.5%
<b>Disability</b>	15,964 18.9%	15,377 18.9%	15,376 19.4%	14,893 19.7%	15,575 20.6%	17,734 21.4%	19,453 20.4%	21,451 23.0%	25,165 25.2%	25,742 25.8%
<b>Equal Pay Act</b>	1,256 1.5%	1,167 1.4%	1,011 1.3%	970 1.3%	861 1.1%	818 1.0%	954 1.0%	942 1.0%	1,044 1.0%	919 0.9%

### POTENTIALLY ILLEGAL INQUIRIES

<sup>1</sup> Chart and Data available from 1997 (along with other historical data) at <http://www.eeoc.gov/eeoc/statistics/enforcement/charges.cfm>

To compile an all-inclusive, detailed list of specific questions that may potentially be deemed “illegal” would be a difficult, if not impossible, task. However, based on the previously mentioned review of the employment application forms the following are topics and inquiries that should be avoided as screening criteria is helpful to prevent potential legal problems. Generally, an employer should avoid:

Inquiries regarding names:

1. Inquiries about preferred title: Miss, Mrs. Ms.
2. Inquiries about name that would indicate an applicant’s lineage, ancestry, national origin, or descent.
- 3.

Inquiries regarding marital & family status:

1. Any inquiry indicating whether an applicant is married, single, divorced, engaged, etc.
- 2.
3. Information on childcare arrangements.

Inquiries on Age

1. Requirement that applicant state age or date of birth.
2. Requirement that applicant produce proof of age.

Inquiries on sex:

1. Sex of the applicant.
2. The applicant’s sex cannot be used as a factor for determining whether or not an applicant will be satisfied in a particular job.
- 3.
4. Employers may not request information from female applicants that is not requested from males (such as marital or family status).
- 5.

Inquiries about disabilities:

1. Except in cases where undue hardship can be proven, employers must make “reasonable accommodation” for the physical and mental limitations of an employee or applicant, including altering duties, altering work schedules, transferring the employee to a vacant position, altering the physical setting, and providing job aids.
2. Prior to making a job offer, the employer may not ask questions about whether the individual is disabled, what kind of disability it is, or the severity of the disability.

Inquiries regarding race and color:

1. The applicant’s race
2. Color of the applicant’s skin, eyes, hair, etc. or other questions directly or indirectly indicating race or color.

Inquiries regarding address or duration of residence:

1. Specific inquiry into foreign address that would indicate national origin.
2. Names and relationship of people with whom the applicant resides.
3. Whether the applicant rents or owns home.

Inquiries regarding place of birth:



1. Birthplace of an applicant
2. Birthplace of an applicant's parents, spouse, or other relatives.
3. Requirement that an applicant submit a birth certificate before employment.
4. Any other inquiry into national origin

Inquiries regarding religion:

1. An applicant's religious denomination or affiliation, church, parish, pastor, or religious holidays observed.
2. Any inquiry to indicate or identify religious denomination or customs.  
Note: Generally, this ban on discrimination does not apply to religious institutions

Inquiries regarding military records:

1. Type of discharge.

Inquiries regarding photographs:

1. Requirements that the applicant affix a photograph to his/her application.

Inquiries regarding height/weight:

1. Questions about an applicant's height or weight, unless demonstrably necessary as requirements for the job.

Inquiries regarding citizenship:

1. The Immigration Reform and Control Act of 1986 (IRCA) prohibit employers from knowingly hiring aliens not authorized to work in the United States. After being hired, an employee must provide the employer with proof to establish identity and eligibility to work in the United States.

Inquiries regarding national origin:

1. Inquiries into the applicant's lineage, ancestry, national origin, descent, birthplace, or native language.

Inquiries into Education:

1. Inquiry as to how a foreign language ability was acquired.

Inquiries regarding arrests, convictions, and court records:

1. Any inquiry regarding an arrest.
2. Any inquiry into or request for a person's arrest, court or conviction record if not related to functions and responsibilities of the particular job in question.

Inquiries regarding relatives:

1. Name or address of any relative of an adult applicant.

Inquiries regarding notices in case of emergencies:

1. Names and addresses of relatives to be notified in case of accident or emergency.

Inquiries regarding organizations:

1. List of all organizations, clubs, societies, and lodges to which an applicant belongs, if such information would indicate through character or name the race, religion, color, or ancestry of the membership.

Inquiries regarding references:

1. Requiring the submission of a religious reference.

Miscellaneous Inquiries:

1. Concerning financial status (such as credit rating, charge accounts, or ownership of a vehicle or home).

Generally, all of the foregoing inquiries should be avoided unless the information sought is related to the duties associated with the job sought by the applicant.

### **PERMISSIBLE INQUIRIES**

There are a number of other inquiries which may appear suspect, but generally are permissible under the law. Some of these often-seen inquiries and topics are discussed below.

Individuals are frequently advised to give their social security number to nobody without a compelling reason. The most apparent reason for an employer to need an applicant's social security number would be to verify work and academic records. There is no reason legally why an employer cannot request this number and use it for verification purposes.

Requesting other names previously used, could also be helpful to verify employment and academic credentials. Asking an applicant to designate a prefix and marital status would generally not be job-related and should not be asked.

Asking for birth date or age is generally indefensible and should be avoided. However, no problem is created by asking "if you are under 18, do you have a work permit?" or similar questions that would not discriminate against individuals who are 40 or older.

Generally, it is permissible to ask if an applicant has been convicted of any crimes. If this question is asked, an employer should request that details be provided. To determine if a particular conviction may be used to disqualify a candidate, an employer should consider the nature of the job desired, nature of the offense, and length of time since the conviction.

Asking an applicant if he/she has ever been fired is not likely to result in a claim of employment discrimination. However, like all inquiries, they must be asked of all applicants with standards consistently applied.

Employers may not ask questions about an applicant's disability or if the applicant will need an accommodation. However, prior to making a job offer, an employer may ask all applicants if they can perform job related functions in a safe manner, or ask them to describe how they would perform job tasks. On the other hand, in situations where an applicant's disability is obvious or disclosed, the employer may obtain information about the types of accommodations needed by an applicant. It is generally acceptable to ask applicants if they can meet attendance requirements of the job. After a conditional job offer is made, employers may ask disability-related questions if these questions are asked of all employees who enter into that job, and they can require a medical exam if all applicants for that job category are required to take such an exam.

Employers may ask individuals to state the highest rank obtained while serving in the military. An employer may also ask applicants to describe the type of education and experience obtained while in military service.

### **FINAL THOUGHTS AND ADVICE**

There are some fundamental rules that employers should keep in mind when determining what inquiries are appropriate in a given set of circumstances. Generally speaking, if the information at issue is not specifically forbidden by federal, state, or local law and it is directly related to the job desired by an applicant, it is a permissible inquiry. If the information sought is not job-related, an employer should not use it to determine who will be hired, and if the information is not going to help select the best qualified applicant, just don't request it. Why invite an applicant to sue?

For those employers who may consider using resumes in lieu of an application form, a few words of advice may help the unwary---don't do it---for several reasons. Applicants often include information on a resume (e.g., age, marital status, religion or health-related information) that should not be used by an employer in the hiring decision. The employer is legally in a better position if such information is never revealed by the applicant. Using an application form helps to ensure that all applicants are providing the same information and are being judged by the same standards thereby reducing the likelihood of claims of bias against the employer. Also, in this struggling economy, some applicants will do whatever it takes to get a job including stretching the truth on such items as length of time previously employed, level of responsibility in prior jobs, and academic credentials. An employer can greatly reduce instances of such falsification by having an applicant sign a statement on the application form that says "I affirm that all information contained in this form is true and complete, and I understand that information contained in this form will be verified. I also understand that any falsification, misstatement, or omission may be sufficient grounds for my disqualification as an applicant or, if hired, may be sufficient grounds for my termination."

Certain questions that may be used to complete records for the Equal Employment Opportunity Commission (e.g. age, number of dependents, race, and gender) can legally be requested after the individual has been hired. This information should be kept separate from the applicant's application form and kept separate from the employment file after the individual is hired.

### **CONCLUSION**

Although laws protecting employees and applicants from discrimination to have been in existence for nearly fifty years, many employers have not applied the laws to their application forms. Some of the information requested on employment applications should be obtained only after someone has been offered employment. Prior to offering employment, many questions currently being asked are considered illegal. While not comprehensive, this paper provides guidance to the most commonly asked questions that are considered impermissible.

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## BALANCING WORK AND FAMILY

D. Keith Denton, Missouri State University

**Abstract:** Americans work longer hours than other cultures, but long hours do not necessarily relate to greater productivity. Looking for a better balance between work and home? Much of the problem is of our own making. America is a society of consumers. It never crosses our minds to work less and have less. It really is a matter of setting personal priorities. The first step is to make a list of what is essential. If you seek a more well-balanced work and life, focus on what is really important. Decide what is critical and what is trivial. Here are some suggestions.

### INTRODUCTION

Franklin Delano Roosevelt's New Deal poured government money into job creation and encouraged consumption. World wars and lesser wars created plenty of jobs, plenty of money, and plenty to buy. Did you know that in 1933 the Senate passed a bill that would have mandated a 30-hour workweek and was only narrowly defeated in the House? People like W. K. Kellogg had workers in cereal plants in Battle Creek, Michigan experiment with 6-hour workweeks. It is a time long since passed: a time of less work, more free time. Good grief, have things changed! But, then again, the world has changed; it's a 24/7 world. Busy, busy, busy!

The voter reaction within many countries has generally been pretty negative with regards to strategies of addressing the labor shortage by increased workforce participation or the opening of borders. Obviously, the developed countries of the world will require a significant change in business and society's approach to education and skills training. China is already graduating three times as many engineers as the United States (Camden, 2005). It also means we will need to get more out of what we already have. We will need people to work harder or more intelligently if they are not going to work more.

The answer for most is not to work more. This seems especially critical for senior managers whose 60-hour week, once considered the path to fame and fortune, is now often considered part-time. Spouses, family, friends, and leisure time are all being squeezed. Xerox CEO Anne Mulcahy observes, "Businesses need to be 24/7, individuals don't" (Miller and Miller, 2005).

A Fortune survey found that even though most senior-level men want better options than simply working more, nearly half believe that talking about it with their boss would hurt their career (Miller and Miller, 2005). Flextime, always touted as a solution, seems to come up short. Flexible work schedules can create needless bureaucracy on managers instead of addressing the real issue: how to work more efficiently in an era of transcontinental teams and multiple time zones. Flextime stigmatizes those who use it (the reason so few do) and keeps companies acting like the military (fixated on schedules) when they should behave more like MySpace (social networks where real-time innovation can flourish). If people can virtually carry their office around in their pockets or pocketbooks, why should it matter where and when they work if they are crushing their goals (Conlin, 2006).

**THINK OUTSIDE THE CORPORATE BOX**

Gary Newman and Dave Walden are co-presidents of 20<sup>th</sup> Century Fox Television. It is not a job share; they are **both** responsible for the performance of the entire company. They are two people with complementary skills for a complex job. Both say it has been great for their family lives. Newman says he has greater freedom to be a participant in life. There is no meeting that one or the other of them cannot cover. They can have a flexible schedule. When Walden's daughter broke her arm, Walden did not come in on Monday. The company did not skip a beat (Miller and Miller, 2005).

At Fleet Bank in Boston, Cynthia Cunningham and Shelley Murray shared the job of vice president for global market's foreign exchange for six years. Each worked three days a week on a trading desk. They had one set of goals and one performance review. They used weekly meetings and constant voicemails throughout the day. In previous jobs, each had worked 50 to 60 hours a week, but in their shared roles, they dropped this figure by 20 to 25 hours each. The result was that they felt "totally on" at the office because work was no longer consuming their lives.

When Dean Baquet became editor of the Los Angeles Times, he divided the managing editor position into three jobs. Now there are two managing editors and an associate editor to oversee the 1,000-person newsroom. Baquet felt the complexity of the job could cause a solo manager to miss or ignore some things. An example he gave was that the sports section was getting short-shifted; the job was just too big for one person to handle. There is no one perfect solution for everyone. High wage earners may want to trade income for time. The point is to create a human-sized job.

Working longer hours does not actually mean you are working more effectively. Americans have the most productive economy in the world, but in 2002, they were actually **less** productive per hour worked than countries many think of as slackers—Belgium, France, Germany, Norway, and the Netherlands. U.S. output per person is more, but only because a bigger share of Americans worked, and many Americans worked longer hours. The moral is individual choice: Americans don't have to work as hard as the Indians and Chinese, or like they did in their own country in the 19<sup>th</sup> century as factory workers.

Everyone has a different approach to work. Indian engineers are mostly specialists. They tend to seek out other team specialists to solve problems. This mutual commitment leads to long hours. Chinese engineers never really speak to each other. Instead, requests are put through to project leaders. It makes them highly dependent and locks them into the manager's hours. In Hungary, when an engineer has a problem, they go to whoever is free. As a result, many people help each other, and it is not as important for everyone to be in the office all the time. Each nation thinks its approach is the only way to do it.

## **BALANCING WORK AND HOME**

Are you looking for a better balance between work and home? Look at what is happening at Best Buy. Chap Achen, who oversees online orders at Best Buy Co., shut down his computer, stood up from his desk, and announced that he was leaving for the day. It was around 2 p.m. "See you tomorrow," said Achen. "I'm going to a matinee." At Best Buy's Minneapolis headquarters, similar incidents of strangeness were breaking out all over the ultramodern campus. Steve Hance had suddenly started going hunting on workdays, a Remington 12-gauge in one hand, a Verizon LG in the other. In the retail-training department, e-learning specialist Mark Wells was spending his days bumming around the country following rocker Dave Matthews. Single mother Kelly McDevitt, an online promotions manager, started

leaving at 2:30 p.m. to pick up her 11-year-old son Calvin from school (Conlin, 2006).

Best Buy, the nation's leading electronics retailer has embarked on a radical experiment to transform a culture once known for killer hours and herd-riding bosses. The program called ROWE, for "results-only work environment," seeks to dispel the dogma that equates physical presence with productivity. The goal is to judge performance on output instead of hours (Conlin, 2006). Best Buy is not alone in experimenting with new work arrangements. At IBM, 40% of the workforce has no official office; at AT&T, Sun Microsystems Inc. calculates that it is saving \$300 million a year in real estate costs by allowing nearly half of all employees to work anywhere they want. A recent Boston Consulting Group study found that 85% of executives expect a big rise in the number of unleashed workers over the next five years (Conlin, 2006).

Why the change? Best Buy was afflicted by stress, burnout, and high turnover. The hope was that ROWE, by freeing employees to make their own work-life decisions, could boost morale and productivity and keep the service initiative on track. It seems to be working. Best Buy notes that productivity is up an average 35% in departments that have switched to ROWE. Employee engagement, which measures employee satisfaction and a gage for retention, is way up too, according to the Gallup Organization, which audits corporate cultures (Conlin, 2006). Hopefully, other companies will recognize how essential happiness of their workforce impacts their bottom line and start converting talk into actions. But if not, there is still a lot we can do to create a more contented life.

### **WHAT EXACTLY DOES MAKE PEOPLE HAPPY AT WORK?**

Thirty-five years ago, the Gallup Organization started researching why people in certain work groups, even within the same company, were so much more effective than others. From those interviews, Gallup developed a set of 12 statements designed to measure employees' overall level of happiness with their work, which Gallup calls "engagement." Questions include items like, "Do you have what you need to do your job?"; "Do you know what's expected of you at work?"; "Do you have a best friend at work?"; "Does your supervisor or someone else at work care about you as a person?"; and so on. Gallup started the survey in 1998, and it now includes 5.4 million employees at 474 organizations. The polls paint a picture of a rather disaffected U.S. work force. In the most recent poll, from September 2004, only 29% of workers said they were engaged with their work. More than half, 55%, were not engaged, and 16% were actively disengaged. Still, those numbers are better than in many other countries. James Harter, a psychologist directing that research at Gallup, says many companies are simply misreading what makes people happy at work. "It isn't pay or benefits; it's strong relationships with co-workers and a supportive boss." Statements like, "I have a best friend at work," is a powerful predictor for engagement at work and is correlated with profitability and connection with customers. Harter says, "It indicates a high level of belonging" (Thottam, et al., 2005). So the message seems simple, familiar but true. Keep it simple! It is a message that can be applied within a larger context.

### **SIMPLIFY YOUR LIFE**

Remember when there was not much to do after about 9 o'clock. Everything was closed on Sunday. You just stayed home. Today everybody is Internet shopping at all times of the day and night. Life used to be a lot more physical, now we just sit. So we go "work out" after work; we go to the grocery at 10 p.m. At work, it just seems like it never ends. There is always something that needs to be done.

Mary Ellison, a forty-something person, is a Health Education and Wellness Coordinator for a mid-size, mid-Western city. She says, "I think time is an issue, that we (my generation) think we need to be busy and we need to work and we're not taking enough time to just enjoy life and to learn new things or relax. I think we're too tied up in trying to get ahead or we have to do this or that, without taking stock. Sometimes it is OK to just say, it's a beautiful day and just go outside and sit, kind of a 'stop and smell the roses' type of thing." So, is it also just a bit of forty-something whining, too?

Dana Walden, President of 20<sup>th</sup> Century Fox television, was asked, "If you had six hours per week, how would you use it?" She said, "I'd spend afternoons with my kids, in particular my older daughter who just started elementary school. I'd love to discuss the things she's learning at school when they are fresh in her mind" (Miller and Miller, 2005).

So what is the root cause of all of this "busyness"? In 1970, the world's 50 biggest companies averaged \$29 billion in revenue (in 2003 dollars), now it's around \$100 billion. The number of consumer products manufactured each year has experienced a 16-fold increase over the same time period. Companies are working 24/7, competing across different industries and geographies. All of this is compounded by **runaway inefficiency**. A 2003 study by Marakon Associates and the Economist Intelligence Unit found up to 80 percent of top management time was devoted to issues that accounted for less than 20 percent of the company's long-term value (Miller and Miller, 2005).

Many owners and managers are often rightly frustrated with the younger worker entering the workforce. They wonder how they are going to motivate them. What employers probably do not realize is that they are often out of touch with the seasoned employees as well. Corporate executives often are so out of touch with the normal working staff. They often wrongly assume that you and I just need a bigger stake in the action, like stock options, so we will work harder. A study by Yanelovich Partners, Inc. shows that, given the choice between two weeks of extra pay and two weeks of vacation, we take the vacation by a margin of 2 to 1. People just feel overloaded (Brady, 2002).

Owners and managers often complain about the attitude of people at work. But, in terms of pure hours worked, there can be no doubt that Americans work a lot. In fact, Americans work longer hours than their counterparts in any industrial country. Much of the developed world has cut back the annual hours worked per person over the past decade; but Americans are headed in the other direction by adding 58 hours to their yearly total. Contrast this to the Japanese who have cut 191 hours (Brady, 2002). A 2001 Family and Work Institute survey shows that both men and women wished they were working about 11 hours less a week. There is a lot of peer pressure not to say how you really feel at work or to your supervisors. It is a bit of that Protestant work ethic thing. Ellen Galinsky, the institute's president, says a lot of people believe if they work less they'll be seen as less committed (Curry, 2003).

### **SEE HOW IMPORTANT I AM!**

America is a society of consumers. It never crosses our minds to work less and have less. Business people, advertisers, and politicians all tell us there is never enough stuff. Those things that used to be "wants" become "needs." Our society is continually driven to invent new things that we just have to have. Advertisers instill a desire; we encourage people to want, so work will continue indefinitely. We sell our time and exchange leisure for work and accumulating material wealth.



The highest paying jobs show us working more while the lowest jobs show working less. It has not always been that way. At the end of the 19<sup>th</sup> century, the less you worked the higher up you were. Back then, the lowest paid 10 percent of employees worked two hours more a day than the richest 10 percent (11 hours versus 9 hours). Interestingly, a century later the best paid actually worked an hour more a day than the poorest paid at 8.5 hours to 7.5 hours. Well, it is a different world today. Keeping busy seems to have become a mark of prestige. Busy means we are important. We can even be disillusioned about it. C. Garry Betly, Chief Executive Officer for Earthlink, says, "I am not a workaholic, but I don't enjoy myself if I am not working" (Androschick, 1999).

We admire the rich and famous, dream of dream houses, and want the latest technological marvel. Many seem to live for work, but secretly long for a balanced life. But in American society, dysfunctional behavior of excessive consumption and excessive work is often seen as something to be admired. Microsoft's Bill Gates says he works long hours, but does not expect others to work as hard as he does. He is proud today that he does not work more than 12 hours a day. On weekends, he boasts, he rarely works more than 8 hours. There are weekends he takes off and even takes vacations. He says his job is the best job in the world because it has a lot of variety and he gets to travel around to see customers (Gates, 1997). I hope so because he has no variety in his life. No life but work. Life for the rich and powerful is like a giant game of monopoly, careers or money. They are obsessively concerned with power and a God-like desire to create a world in their own image.

According to a new Ipsos-Reid poll, about 43 percent of workers say they bring work home or are "on call." On the other hand, 30 percent admit using the Internet or e-mail at work for play or personal matters (Samuelson, 2001). High technology was supposed to help free people from the office. It did, but it also eroded the natural boundaries between work and leisure. E-mails and high-speed Internet give you no excuse to work any hour of the day. Unfortunately, important bonding rituals like the family dinners are rapidly disappearing. Ringing cell phones, faxes, and e-mails have blurred the lines between work and home. There is no escape. Work needs to be 24/7, but people do not function well 24/7. We need boundaries, we need balance, or else our family and non-work life suffers.

### **DO LESS, SUPERVISE MORE**

Dr. Peter Richardson, an industrial/organizational psychologist, discusses what kids often see today. "Sexual related issues, drugs, various kinds of behaviors and, maybe not deviances, there is all of this stuff out there. It's the kind of things that adults dabble in, or an adult is going to see, but kids don't have the intellectual, the emotional development, or the experience knowledge. They don't have the capacity to deal with that kind of information and that kind of knowledge. But they've got it all of a sudden. So, they get all of this information and have access to it. In the past, there would have been only a few sleazy people sliding around alleys trying to find that out. You know they could get on an anarchist Website; a 12-year-old can get on there and find out how to make a bomb. It's right there. He asks, 'Did you know how to make a bomb when you were 12 years old, or did you even think about it?' Firecrackers, maybe, bombs no. They know everything about every kind of drug. There is just so much of it."

David White, a school guidance counselor at McBride Elementary, has some advice for today's busy parents. He says one of his biggest concerns is TV, video games, and movies. He says, "Those are the issues that I am extremely concerned about. I see kids, they watch movies, see things on TV, and they play video games that are just so inappropriate for them. Surprisingly, parents let them do it. That's the thing that really shocks me, is that they allow it. I

wonder why, and I think well maybe it's because they are too busy. I know personally with my kids, trying to keep them entertained and do things with them takes a lot of work. It's easy just to say go watch the movie, play that video game, or go with your friends to the movies. I really think that it's messing our kids up. The things that they know about, they shouldn't know about, and they would never know about if they didn't watch inappropriate movies and television or play some computer games. They come to school with this baggage in their mind, and I feel it causes them to do and say things that would never, ever cross their mind."

Richardson would agree, and points out, "A lot of younger kids know an awful lot more about things they shouldn't have any idea. You're not at home 24 hours a day and they've got friends that are in to all that kind of stuff, and it's just not that hard to access. The point is just that because of technology and the way the world is set up. I think a lot of kids have more information and more access to things that they don't have the capacity and experience to really know how to handle. We were better off when they didn't find that stuff out earlier, where they couldn't really get involved in those things until later."

They kind of want the same experiences and, in some ways, have almost the same outlook on life as a 30-year-old. A 13-year-old is basically kind of where a 30-year-old used to be, but he's still got a 13-year-old brain, and he still only has 13 years of experience. It's like we've ratcheted them up and put them 15-20 years ahead of their maturation level.

Some parents do a good job monitoring, but I think a lot of parents today, particularly the younger parents, really have kind of relinquished some of their responsibilities as parents, and do not provide a lot of supervision. They have got their own stuff to deal with, they are so busy, and they do not want to hassle with it.

White believes many parents do have the time; it's just a lack of priorities. He says, "I would agree that it's a lack of parental supervision. Many parents don't realize—they have no clue—what their kids are watching a lot of the time. Sometimes I hear a student say that Mom, Dad and I sat down and watched this together, and that makes me feel a little better in a way, because if there is something inappropriate, I hope they're explaining it. They should say, 'Oh, we don't do that, or we don't say that'. But, unfortunately, I think a lot of times parents don't have a clue. I think about my teenage daughter. We are very protective, and we supervise, and we really watch what she does, and even then there is no guarantee she is going to turn out perfect. We do the very best that we can, but I see children that are very, very young that parents just let go by themselves."

White says, "When I first worked at this school we lived in this neighborhood and kids were running up and down the streets, just little kids. I wondered, where's mom and dad? Good supervision starts when they're little. They say, can I go down to someone's house, and they'll go, and then on the way there they may go here, there, and there. They just run around, and there are a lot of kids whose parents weren't home, and the kids were out running around, too. It's like, can we go with our friends to the mall? Sure, we'll just drop you off. Young kids running around the mall by themselves. Well, that doesn't work, that's where things begin, and they meet somebody from somewhere else, and troubles will start. You know even just dropping a kid off at a ballgame by themselves can be a real risk. Personally, we are just now starting to let our 15-year-old do that because there are a lot of things that happen at ballgames, and if you're not there, there are a lot of things that your child can get into. That's where a lot of the temptations begin. Some of the friends we have tried to reach out and help, but the parents just don't want to know. We try to say, I think your daughter or your son is getting into this, but it is as if they are saying like, 'Don't judge me, I don't want to hear that'. They want to pretend it's

not happening. And you know there's not a lot you can do when they don't want to know."

### STAY CONNECTED

So how do we produce better workers, better citizens, and a better world? White says, "It often seems as if we subconsciously think, 'If I don't know it, then it'll be okay.' Xanga and MySpace are blogs that the teenagers are really into. Blogs are basically where your kids get on the computer; it's kind of almost like a diary that anybody can read that wants to read it. You get on there and you type—well, today we did this, this, and this. And then friends can comment on it, and say oh you did that—there's a little comment space. But really anybody can get on it, it's the Internet thing, and anybody can see your picture on there and start talking to you and then make conversation. Lots of relationships, inappropriate ones, can start there. It's a lack of supervision that leads to this. The parents have no clue what their kids are doing, and maybe the parents are too busy working, too busy playing, I don't know what they're doing."

White said when his daughter is on a blog, that he and his wife supervise her. "Most parents, they just let the kids get on it. We started when she first got on it. We know her password. We read it everyday. We monitor what she says, what everybody else says, and there's a lot; MySpace is in the news right now a lot." White remembers he saw an article about how lots of troubles start because the blogs are where these kids are making connections to each other.

As a guidance counselor, White's advice to busy parents is simply to know what they are doing at all times. Know what they are doing and be there with them. Most importantly, spend time with them. Do not just drop them off here, there, and there. Be there with them, and check out the friends they are going to be with, talk to their parents, know them. He says, "If you don't know somebody that's there, you know, then you probably need to say no. Say, I don't know this person, so you're not going to go there. That's my advice and I know a lot of people would say that's strict, but I've seen too many kids just go by the wayside because parents don't know what's going on. They don't have a clue until it's too late. Kids spill their guts on these Xanga blogs. If only parents would look at those. If they'd take the time to look at them, they're going to learn a lot about their child. There are some kids that have been on that Xanga and MySpace, and they say, you know they have these things called confessions."

Jim Snell, an envoy for the Salvation Army, says he feels many lose their perspective about what is really important. He says many parents seem to feel like 'we've got to keep up with the Joneses; mom and dad work a lot. That means somebody else has to take care of the kids, and that person is not necessarily where they should be in their life. Often these kids are resentful because mom and dad are not there as much and there is stress from work and they pick up on all of that. This filters out to the kids and by the time they reach adulthood, this pattern is replicated where they're really involved in themselves, they're involved in a lot of things that are not really contributing to the overall of society, the good of society, so in a sense, taking away from society. They are so consumed with self that the son does not have a problem going and drinking with the boys, but one night he has a few too many and runs over somebody, and nobody is there so he drives off. The police do not know, there's no eyewitnesses, there's just this horrendous wreck, and it's quite some time down the road where he goes to get his car fixed that they finally figure out who and what and how this all came about. Things like that where they are buying into the standard, he would not have gone out drinking and gotten behind the wheel of a car, he thinks, "I'm not going to do that because I need to be responsible to my fellow human being and not run the risk of hurting or endangering them as well as myself."

It really is a matter of **setting personal priorities**. The first step is to make a list of what is essential. Perhaps 80 percent of what we do is not essential. Isolate the 20 percent that is critical to you and your family. White has noticed that parents seem to think that the kids have to be involved in everything they can possibly find – every sport, every dance lesson, piano lessons. He says, “I know they feel like they are being really good parents when they do that, because they’re spending lots of money. But the thing is when they are doing all of that, you have no interaction with them. You drop them off at piano lessons, drop them off at ballet, you drop them off here and there. You’ve got a little bit of car, but you know they think these are good things for kids.”

### WHAT YOU CAN DO

White emphasizes, “My personal opinion is that it would be better to go home and play a game of monopoly than to drop your kid off at piano lessons. Your kid is going to get more out of it and see what life’s all about, and build a close relationship. And I just use piano lessons as an example—it could be anything. Many seem to think, and I think the fear of the parent is that if I don’t do it, what if they’re good at that, and I don’t let them try it. They need to try everything, because what if that’s their talent. That’s how they get to the Olympics, or that’s how they get here or there. Parents, it seems, often feel like they need to try everything, and then they just spend so much time at it. They lose that family relationship, family time together, which is, I think, a factor that can save us all. Just like that, one kid that was a bit religious and the boyfriend shot the parents. There was stuff going on there that the parents had no clue about, and I don’t try to judge them or anything, but I wonder if they are just so busy doing stuff, taking their kids here and there that they really have no clue what’s going on there.”

White firmly believes there are just too many activities. “I think it’d be better to set the limits and to spend family time. We struggle with that in my family. We’re really involved in church, and I think church is really important, but I get frustrated because I want to do family stuff, I want to be together as a family and do things. That’s what makes your kids have stability. When the times are tough, they know they can go back to their families because they’ve had that family. A lot of times kids—they don’t have that family.” Today’s kids are into sports and other activities, but ask yourself, do you spend much time together at home just hanging around?

### SMELL THE ROSES

In other words, if you seek a more well-balanced work and life, focus on what is really important. Often families spend so much time coming and going that parents do not really develop the quality of relationship. Busy is not the same thing as being a good parent. White says, “Its okay, you don’t have to do all that stuff to be a good parent, just relax. Enjoy your children at home, do stuff at home, play games at home, and its okay. I want to tell parents this because I don’t think many parents think it’s okay. I think that they feel the pressure to keep their kids busy, and often they seem to believe, if I don’t get my kid into some program, then I am not a good parent. And I’d just say its okay, **you don’t have to keep them busy, just stay involved.**” Make a list of the things you do, look at how much time is devoted to each category, and is it appropriate. Look at how much time you really spend just talking. Most importantly, decide just how much time you want to spend in buying and having stuff. Nice cars, a nicer house, a nice vacation — what is the cost of having more stuff? There is a big difference between needing something and having to have it. You need insurance, you need food, and you need shelter; that is about it. It is a message increasingly being heard by today’s executives, and some corporations are responding. It is just a matter of deciding what is really

important and keeping a perspective. Sometimes it is the simple things that matter the most.

### **KEEP A SENSE OF PERSPECTIVE**

We all want a better balance between life and work. We want to be happier. Americans work longer hours than other cultures, but long hours don't necessarily relate to greater productivity.

We need to establish boundaries for work, set aside one-on-one time with the family, and for ourselves. We need to eliminate some opportunities, pick out a few critical activities and experiences. Decide what is critical and what is trivial. **Make a list.** Whether it is 15 things or 50 things, you do focus 80 percent of your effort on a few critical things. It might be engaging the children or attending a function, it will vary for everyone. The important point is to not treat everything the same. Make a list of your 3 or 4 most important issues in your family or work life and stay connected, keep a balance to your life.

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## Providing Investment Advice to Clients: An Overview for CPAs

**Shari Lawrence**, Nicholls State University  
**Shawn Mauldin**, Nicholls State University

**Abstract:** Due to an in depth understanding of their clients financial affairs, CPAs are often viewed as financial advisors and are asked to provide input on the status of financial markets. This is especially true in the current investment environment. Although CPAs possess a wealth of knowledge related to their clients' financial affairs, many lack the skill set to adequately provide perspective on historical returns of alternative investments that can provide information for a more effective allocation of assets in the future. There is a need for CPAs to be able to help their clients make proper investment decisions. Accordingly, the purpose of this paper is to provide an overview of historical rates of returns of various types of investments, investor psychology, and alternative asset allocation models.

Specifically, historical rates of return are analyzed for equities as well as corporate and government bonds. The results indicate that, for the first time in history, corporate bonds actually outperformed stocks during a ten year period: the last decade. The authors discuss historical trends and propose rationale for optimal portfolio allocation going forward based on clients' risk tolerance and time horizon. Finally, the registration requirements for CPAs to provide financial planning services are discussed.

### INTRODUCTION

Due to an in depth understanding of their clients financial affairs, CPAs are often viewed as financial advisors and are asked to provide input on the status of financial markets. This is especially true in the current investment environment. Although CPAs possess a wealth of knowledge related to their clients' financial affairs, many lack the skill set to adequately provide perspective on historical returns of alternative investments that can provide information for a more effective allocation of assets in the future. There is a need for CPAs to be able to help their clients make proper investment decisions. Accordingly, the purpose of this paper is to provide an overview of historical rates of returns of various types of investments as well as alternative asset allocation models. In addition, the psychology of investing and risk tolerance is discussed so that CPAs will have a better understanding of how clients' underlying emotions can influence their financial decisions. Finally, the registration requirements for CPAs to provide financial planning services are discussed.

### HISTORICAL MARKET RETURNS

The average returns for the last 30 years and last 10 years were calculated for the Dow Jones Industrial Average (DJIA), the S&P 500, the NASDAQ, 3 month treasury bills, 10 year treasury bonds, and corporate bonds (see Exhibit 1). As illustrated in Exhibit 1 below, the DJIA has had the highest returns for the past 30 years at 9.17 percent, followed by the NASDAQ at 9.00 percent and the S&P 500 at 8.06 percent. Since the NASDAQ consists of firms that have a higher risk premium compared to the DJIA and the S&P 500, the expectation is that equities in the NASDAQ will yield a higher return. However, the 9 percent return on the NASDAQ clearly has not adequately rewarded investors for their risk compared to the 9.17 percent they could have received from DJIA stocks or the 8.06 percent on the S&P 500. This is largely the result of a 67 percent decline in the NASDAQ from 1999 to 2002 as this index was the hardest hit by the dot.com bubble. Furthermore, an investor could have achieved an average return of 7.59

percent in long term corporate bonds (Vanguard's long term corporate bond index fund was used as a proxy for corporate bond returns). Even the most conservative investor who chose to invest in government issued securities would have made average returns of 5.15 percent or 6.47 percent depending on term to maturity preferences.

Exhibit 2 illustrates the value of \$10,000 invested in each of the respective allocations over the past 30 years as well as the past 10 years. While it is clear that investing in stocks versus government bonds during the past 30 years yielded significantly higher returns, one could argue that the risk reward payoff for stocks versus corporate bonds during this time period was negligible at best. For example, the difference between an investment of \$10,000 in a basket of stocks in the DJIA versus corporate bonds would have equaled \$49,000 at the end of the 30-year time period. Some analysts argue that the S&P 500 is a better indicator to true equity performance in the market since this index consists of 500 companies versus only 30 companies in the DJIA. Thus, comparing a \$10,000 investment in the S&P 500 to a \$10,000 investment in corporate bonds for the last 30 years yields a difference of approximately \$12,000. Finally, if we average the corporate and government bond totals in Exhibit 2 and compare them to the average totals for the equity investments, the average difference is about \$58,000 of additional investment returns over the last thirty years for an initial \$10,000 investment.

Another way to compare the 30-year historical returns in bonds to the historical returns in stocks is to look at the average percentage returns during this time period. The average return for the three bond investments in Exhibit 1 for the last 30 years is 6.40 percent compared to the average return for stocks, 8.74 percent. This is a difference of 2.34 percent. While this higher average return in equities will clearly add up over time, one must question if the additional 2.34 percent return for investing in equities is sufficient to compensate the investor for the additional risk associated with stocks versus bonds. The traditional view of a "risk premium" compares government bonds (viewed as a risk free rate), to average equity returns. This is generally believed to be about 5.5 percent. However, as illustrated is Exhibit 1, the risk premium or difference between government bonds and stocks over the last 30 years has only been between 3 and 4 percent. Therefore, whether one factors corporate bonds into the equation or not, it is clear that the actual returns investors have received from equities over the last 30 years has not adequately compensated them for the market risk since as investors should be earning closer to 5.5 percent more on average in equity investments. It is up to the individual investor to decide if he or she is comfortable with the actual risk/return tradeoff in the equity markets.

#### **Exhibit 1: Historical Returns**

Time Period	DJIA	S&P 500	NASDAQ	3MO T-Bill	10YR Treasuries	Long Term Corp. Bonds
1982-2011	9.17%	8.06%	9.00%	5.15%	6.47%	7.59%
2002-2011	1.98%	0.90%	2.93%	2.23%	3.70%	7.82%

#### **Exhibit 2: Value of a \$10,000 Lump Sum Investment**

Time Period	DJIA	S&P 500	NASDAQ	3MO T-Bill	10YR Treasuries	Long Term Corp. Bonds
1982-2011	\$139,027	\$102,317	\$132,677	\$45,111	\$65,587	\$89,775
2002-2011	\$ 12,166	\$ 10,937	\$ 13,348	\$12,468	\$14,381	\$21,232



Finally, the historical returns for the last decade have been miserable for investors in the equity markets, with bonds generally outperforming stocks. Indeed, for the first decade of this century, the return on equities was flat, resulting in the return on bonds outpacing stocks during a consecutive 10-year period for the first time in history. Although the equity markets have not had negative returns in 2010 or 2011, bond performance has still outpaced equity performance since the year 2000.

While past returns are not a predictor of future returns, it is worthwhile to analyze the macroeconomic factors contributing to the disparity between historical returns of bonds versus stocks. Note that the average return on equities during the past 80 years is approximately 12% versus about 3.5% for government bonds. The reason for the narrowing of the returns gap between stocks and bonds over the last 30 years is two-fold. First, interest rates were at historical highs during the first part of the 1980's as inflation continued to be a problem. Therefore, bond yields were relatively high. Second, the dot.com bust that began in the equity markets in April 2000 marked the beginning of a volatile and disappointing period for the equity markets. Many individual investors left the equity markets and dollars poured into bonds, thereby raising total return due to increased demand for these instruments even though interest rates were at historical lows.

CPAs' knowledge of historical returns, and their ability to effectively communicate this information, adds value and perspective to their clients understanding of the investment environment. In addition, a basic understanding in investor psychology, discussed below, can assist CPAs in providing meaningful advice to their clients regarding investment allocations in today's markets.

### **UNDERSTANDING INVESTOR PSYCHOLOGY**

One of the main tenets in understanding investor psychology is that one must accept the fact that individuals may not behave rationally when making financial decisions. Emotions as well as cognitive errors may cause investors to make bad decisions. This problem has become more pronounced in recent years as technological advancements in investing and a barrage of information has caused the increased turnover of investment account allocations, but not increased returns. Some common psychological pitfalls of investing are outlined below.

- **Loss Aversion** – The pain of losing money is much worse for investors psychologically than the elation of making money. As a result, after a market downturn investor sentiment is generally one of extreme conservatism. For example, after suffering losses in equities, investor sentiment is usually to sell out of losing positions and go into safer investments with potentially lower but more stable returns. All this strategy accomplishes is to lock in losses while eliminating the potential for adequate future gains. This issue is particularly relevant given the market volatility in recent years. If caught in a market downturn, the best option for an investor is to have patience and stay the course.
- **Market Timing** – Now that virtually anyone with a computer and a brokerage account can become a trader, many investors have tried to time the equity markets by buying low and selling high. The problem is that psychological biases often result in just the opposite. There seems to be a herd mentality in investing. That is, investors tend to buy equities that are rising in price and sell equities that are declining in price when they should be doing just the opposite. In addition, trying to time the market may result in an investor selling too soon (and foregoing potential earnings), then getting back in the market when prices are too high.

- Keeping Losers too Long, Selling Winners too Fast – Another psychological bias with investing is that investors may be reluctant to sell out of a losing equity as this is an admission of failure. Conversely, investors tend to sell their winners too fast due to the temptation to take profits.
- Overconfidence – Investors typically remember their stock market gains more vividly than their losses. As a result, investors may become overconfident in which they overestimate their knowledge. This can cause investors to misinterpret information or overestimate their analytical skills, resulting in excessive trading, risk taking, and ultimately, financial losses.
- Recency Bias – The tendency for investors to place more importance in recent events. For example during the great bull market of 1995-1999, many investors assumed that the market would continue its enormous gains, forgetting the fact that bear markets have tended to occasionally happen in the more distant past.
- Anchoring – This is when investors cling to a fact or figure that should have no bearing on their decision making. For example, in a volatile market investors may count their losses from the market highs which is irrelevant to investment decisions.

### **ADVICE FOR CLIENTS**

If one looks at historical returns since 2000, one would be tempted to abandon the stock market in lieu of investing 100% in bonds. However, many analysts suggest the opposite. The logic is that the markets tend to overreact. That is, there is such a negative sentiment toward the equity markets that overall, equities are currently undervalued. Likewise, there has been such a rush into bonds, that their prices have been drive up. In addition, bonds have, in general, outperformed stocks over the last 12 years - an event not likely to be repeated.

Even though recent returns in the stock market have painted a bleak picture, one must not forget that historically, equity investments have outperformed bonds in the long term. In addition, diversification is the key to maximizing returns with the minimum amount of risk. Therefore, the best thing for CPAs to do is be cognizant of investor psychology, and identify their client's risk tolerance level and time horizon for investing before providing advice on an optimal portfolio allocation.

**Risk Tolerance** – While CPA's desire their clients to achieve the best possible investment returns, the most important thing to consider is a client's peace of mind. Investors must be able to sleep at night and not be constantly worried about their financial future. Therefore, by assessing a client's risk tolerance, CPAs can make informed decisions about a client's optimal investment allocation. There is a plethora of information available online to measure risk tolerance. Therefore, CPA's may want to have their clients complete one of the many short questionnaires available online to get an idea of how much investment risk they are comfortable with.

**Portfolio Allocations** - While there are no hard and fast rules for optimal portfolio allocation, the two most important items to consider are time horizon and risk tolerance. Below are some basic rules of thumb that may be followed depending upon how much risk a client is willing to take as well as where they are in their life cycle.

- Just Starting Out – Individuals in this phase range from ages 25-40. They may have just graduated from college and are beginning careers or have been established for a while. Regardless, these investors have a very long time horizon. The suggested portfolio allocation at this phase is 80-90 percent equities and 10-20 percent bonds, depending on risk tolerance. A 100% equity allocation should be recommended only in cases where there is a very high willingness and ability to tolerate risk.
- The Maximum Earning Years – In this phase, the age range is 41-55. Ideally, individuals should be maximizing their earnings potential as well as their savings potential during this phase. Their time horizon is considered long term and the suggested portfolio allocations range from 65-75 percent equities to 25-35 percent bonds.
- Preparing for Retirement – This phase is for investors ranging from 56-65 years of age. The recommended allocation ranges from 50-60 percent stocks to 40-50 percent bonds. The primary reason for the near 50-50 equity/bond allocation is to help protect the investor from a sudden downturn in the equity markets similar to what occurred in 2008. The logic is that if investors in this age group have a high exposure to equities and get caught in a market downturn, they will not have enough time to recoup their losses.
- Retired – This phase is for individuals who are 65 and older. Even though, many people can expect to live well into their 80's or even 90's potential investment growth must be balanced with capital preservation. Thus, the optimal portfolio allocation for an individual in this life stage is a mixture of 30/60/10 or 40/50/10 equities, bonds and cash. It should be noted that within the equity framework investors may further refine their allocations by choosing among individual equities, stock mutual funds or exchange traded funds (ETFs) of varying degrees of risk. In addition, within the bond allocation, investors may choose among government bonds for the most conservative investor or corporate bonds for those seeking a little more return. There are many mutual funds and ETFs on the market in which investors may select varying grades and maturities of bonds.

Exhibit 3, below, illustrates the potential future value of \$2,400 contributed annually over varying time horizons and portfolio allocations. The rates of return were calculated by averaging the equity and bond returns, illustrated in Exhibit 1, over the last thirty years. Thus, assuming that the equity portion of the portfolio consists of an equal weighting among the DJIA, S&P 500, and NASDAQ, the average annual return from 1982-2011 is 8.74%. Likewise, considering an equal weighting of corporate bonds, three month T-bills, and 10 year treasuries from 1982-2011 yields an average return of 6.40%

### **Exhibit 3: Value of \$2,400 Contributed Annually Over Varying Time Horizons and Portfolio Allocations**

Equity/Bond Allocation	Ave. Annual Rate of Return	20 Years	25 Years	30 Years	35 Years	40 Years	45 Years
100/0	8.74%	\$119,259	\$196,606	\$311,680	\$488,156	\$756,462	\$1,164,385
90/10	8.51%	\$116,234	\$189,081	\$298,668	\$463,524	\$711,526	\$1,084,608
80/20	8.27%	\$113,169	\$182,528	\$285,718	\$439,243	\$667,656	\$1,007,486
70/30	8.04%	\$110,317	\$176,483	\$273,883	\$417,260	\$628,319	\$939,009
60/40	7.80%	\$107,426	\$170,411	\$262,104	\$395,588	\$589,910	\$872,799
50/50	7.57%	\$104,735	\$164,810	\$251,338	\$375,964	\$555,464	\$813,999
40/60	7.34%	\$102,120	\$159,415	\$241,058	\$357,398	\$523,180	\$759,415
30/70	7.10%	\$99,470	\$153,995	\$230,826	\$339,090	\$491,648	\$706,619
20/80	6.87%	\$97,004	\$148,994	\$221,472	\$322,509	\$463,361	\$659,715
10/90	6.63%	\$94,504	\$143,971	\$212,160	\$306,156	\$435,727	\$614,337
0/100	6.40%	\$92,177	\$139,337	\$203,646	\$291,343	\$410,932	\$574,011

Although the difference in rates of return between the 100% equity portfolio and the 100% bond portfolio is only 2.34%, the difference in account value is dramatic over a long time horizon. As illustrated in Exhibit 3, an individual in an all equity portfolio would have nearly \$600,000 more in his or her account versus a 100% bond portfolio, over a period of 45 years. Furthermore, this chart illustrates the magic of compounding. For example, extending one's time horizon from 40 years to 45 years, yields an increase in account value of over 50%. This realization may induce clients to make a concerted effort to begin saving for retirement earlier, or they may see the benefits of working a bit longer.

### **BECOMING AN ADVISOR**

Many CPA firms have become increasingly interested in providing investment advice to their clients as a way to better serve their clients' needs as well as expand their practice. The requirements for CPAs to provide investment advice to their clients depends upon the level of financial services being provided. CPAs who are providing financial planning advice that is "solely incidental" to their profession are excluded from the definition of investment advisor under the Advisors Act, section 202(a)(11)(B) and therefore are not required to register as an investment advisor. Many CPAs may want to begin in this fashion to test the waters with regard to providing investment advice to clients. Those wanting to go a step further may want to partner with a securities broker/dealer who would be responsible for the buying and selling of securities. In this case, the CPA firm would not be required to register as an investment advisor and would negotiate some type of commission arrangement with the broker/dealer. Finally, CPAs interested in providing advice (beyond incidental) as well as selling securities under their roof are required to become registered investment advisors (RIAs). Effective, July 2011, advisors with less than \$25 million of assets under management are required to register with their respective states. Advisors with \$30 million or more under management are required to register with the SEC. Those with assets between \$25 and \$30 million may choose between the SEC or a state.

CPAs should carefully consider how involved they want to become in the field of financial planning. While it can be lucrative and expand their practice, stringent account practices must be adhered to if one registers as a RIA. Regardless of the level of involvement, however, many CPAs may find it beneficial to become certified financial planners (CFPs) or personal financial specialists (PFSs) in order to expand their knowledge base of financial planning.

### **CONCLUSION**

The market volatility in recent years has caused angst for many investors. CPAs with proper knowledge of historical returns and investor psychology should be in a better position to advise their clients on proper asset allocations during uncertain times. This paper provides evidence that depending on risk tolerance and time horizon a diversified portfolio consisting of stocks in sound companies, investment grade corporate bonds, and possibly government bonds is likely the best way to navigate a sound financial course.

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