The European Journal of Management and Public Policy

VOLUME 2 • No.1 (2003)
ISSN 1726-6475

EUROPEAN CENTER FOR PEACE AND DEVELOPMENT
UNIVERSITY FOR PEACE ESTABLISHED BY THE UNITED NATIONS

The European Journal *of* Management *and* Public Policy

VOLUME 2 • No.1 (2003)
ISSN 1726-6475

Contents

published by:

ECPD

EUROPEAN CENTER FOR PEACE AND DEVELOPMENT
OF THE UNIVERSITY FOR PEACE ESTABLISHED BY THE UNITED NATIONS

European Journal of Management and Public Policy
Academic Journal and Professional Forum on Interface between Business and Society

Published by the European Center for Peace and Development of the University for Peace established by the United Nations

For the Publisher: **Prof. dr Negoslav P. Ostojić**, ECPD Executive Director

ISSN 1726-6475

The European Center for Peace and Development (ECPD) is a regional, international and research organization. The ECPD represents a unique institution in Europe and has special significance to countries of South-Eastern Europe. The ECPD was established in 1985, with the main tasks and objectives "to organize and carry out postgraduate studies, research projects and dissemination of knowledge, which contribute to the promotion of peace, development and international cooperation". Following its mission defined in its Statute, the ECPD "…brings together the intellectual potentials from all parts of the world for the benefit of implementation of the programs of education and research project devoted to the fulfillment of the ECPD aims and objectives". Dr. Simonida Marjanovic, Ambasador Paul-Marc Henry (long serving UN Under-Secretary Genaral and President of the OECD Development Center) and Dr. Pierre Maries-Gallois served as president, while Professor Norman Scott CMG, Professor Shinichi Ichimura and Professor Takehiro Togo chaired the ECPD Council.

The Basic tasks and objectives of the ECPD have been incorporated into its program structure, which feature:

(A) Studies leading to postgraduate degrees and specialist training in Management, European Union, European Union Law and International Business Law, Diplomatic Studies, Banking and Finance, Sustainable development issues,

(B) Interdisciplinary research on sustainable development issues, regional development, multicultural, multi-confessional and inter-ethnic relations and international relations;

(C) Organizing international meetings, conferences, round tables, symposia, and workshops on topical issues from its programme;

(D) Publishing conference, proceedings, professional and scientific texts, research papers, case-studies, textbooks, etc.

The ECPD organizational structure is based on its Executive Staff, consisting of the Executive Director and the ECPD Secretariat as well as professors core and expert team. The ECPD Executive Director represents the ECPD in public, national and international organizations, coordinates the ECPD activities and manages the ECPD Secretariat.

In focusing its activities on education and research that foster sustainable development and the promotion of peace, the ECPD has a very well-developed educational network in various countries, a number of research units and an extensive publication program (with more than 200 books published).

printed in Belgrade by Graficom-uno

Editorial Policy

The *European Journal of Management and Public Policy* publishes original scholarly papers across the whole spectrum of disciplines encompassing Management and/or Public Policy (widely defined). The areas of interest include Accounting, Finance, Human Resource Management, Organisational Behaviour, Industrial Organisation, Marketing, Public Administration, Public Policy, Transformation and Transition Studies, etc. but this list is by no means exhaustive. The Journal aims to be eclectic and pluralistic and, consequently, multidisciplinary work and work endorsing different (even conflicting) schools of thought is welcome. The Journal desires to be an influential policy forum and therefore the submissions must be primarily policy oriented and capable of influencing the policy processes at both the micro and macro levels. However, good quality theoretical papers, which may also be considered for publication, should clearly demonstrate the potential for replication and further extension by the professionals and policy-oriented scholars. Each paper submitted for publication will be judged, based on its own merit and international standards of excellence. The editors and referees will pay particular attention to the originality of the topic, the quality of the methodological approach, the paper's relevance for future developments of and within the discipline and the overall quality of exposition. Although the Journal promotes high quality, original empirical and theoretical work, high quality review articles are also welcome, especially if they demonstrate excellence to the extent that they may influence the directions of further research on the particular topic or in the focus area. All published papers must be accessible to both academics and practitioners, who should be able to understand papers published without being experts on the particular topic or area of research. All papers submitted will be judged in the first place by the Editor. If the paper is initially judged to be suitable for publication in the Journal, the Editor will send the paper to *at least* two anonymous referees. The referees can recommend a paper for publication without revision, publication with minor revisions, publications with major revisions and to reject publication of a submitted paper. In all cases where they recommend some changes to be made, the referees must provide a detailed report listing all the changes that are recommended. Based on the referee reports, the Editor will decide on the status of the submitted paper. The decision of the Editor is final and cannot be disputed.

The Journal aims to publish contributions of the highest quality possible that can be of interest to the wider international professional public. However, the research topics should preferably reflect research interests and traditions of Europe, notwithstanding the comparison of different approaches existing in other parts of the world.

The prospective authors may contact the Editor and respective Regional Associate Editor (if appointed) with questions regarding the suitability of the paper for publication in the Journal. However, the final decision can only be made on the submitted full paper. The editors can assess submissions that are incomplete, using their discretion, but their comments are not binding regarding any decision on a later submitted full paper. The editors will not provide detailed comments on papers prior to formal submission to the Journal. The Editor reserves the right to return manuscripts to the authors without the full refereeing process if, in his professional and academic judgement, the paper is not of a quality acceptable to the Journal, or for any other reason. However, the Editor or his nominee will provide a prospective author with reasons for such a decision, especially if the paper falls outside the editorial policy or the authors seriously disregarded the Notes to the Contributors, published on the back cover of the Journal.

The Journal is committed to best publishing practices and emphasises that the full referee procedure will be completed within 16 weeks from the date of submission to the Journal. The Editor will personally confirm receipt of the submission in writing and keep authors informed on the progress of their submission. Every effort will be made by the Editorial Board to inform the author of the decision within the committed 16 weeks from the date of submission. No submission fee is currently being charged.

Editorial Board

MERVYN K. LEWIS

Private infrastructure in European transition economies

Abstract

In this paper, the role of public private partnerships (PPPs) for infrastructure development in Europe is examined, with particular reference to the transition countries in Central and Eastern Europe. One of the major barriers to the entry of foreign investors in transition economies is the lack of infrastructure. PPPs have facilitated the development of infrastructure in other European countries. However, their implementation gives rise to difficult contractual, financial, legal and accounting issues, which are the subject of this paper. Following a review of the conceptual basis of PPPs, and their evolving market in European countries, the paper outlines a framework for dealing with PPPs appropriate for the situation of the transition economies.

1. The role of partnerships

Given the lack of budgetary resources and the enormous infrastructure needs in transition economies, public private partnerships (PPPs) are an attractive policy option. In fact, the United Nations (2002) describes them as a 'strategic necessity rather than a policy option', representing 'a unique and flexible solution to implement infrastructure projects' (p3). Certainly, the United Nations has become increasingly prominent as an advocate of PPPs on economic, social and environmental grounds as reflected in the Global Compact, the Millenium Summit and Rio +10. Earlier, in January 1996, the United Nations Economic Commission for Europe agreed to establish the Build, Operate, Transfer (BOT) Expert Group, to provide information to its member states on new project finance techniques for countries in Central and Eastern Europe and the CIS.

However, a common misconception about PPP projects is that they are principally about private sector financing of public infrastructure. This is not strictly true. Financing is only one element of the calculation. The very essence of a PPP is that the public sector does not primarily buy an asset; it is purchasing a service under specified terms and conditions. This feature provides the key to the viability (or not) of the transaction if it is indeed the case that the involvement by the private sector can reduce inefficiency and respond effectively to user demands. It is in this sense that governments can acquire extra resources; PPPs can release public sector resources which can be used for other purposes.

There are many different meanings of public private partnership (Rosenau, 2000). Since any relationship involving some combination of the private, voluntary and public sectors is prone to be labelled a 'partnership', it may be useful to clarify what is meant here by a PPP.

Collaboration. PPPs involve a sharing of both responsibility and risk in a collaborative framework. They seek to draw upon the best available skills, knowledge and resources, whether they are in the public or the private sector, and deliver value for money in the provision of infrastructure.

Focus on services. Emphasis is on services received by government, not government procurement of infrastructure. Government pays for services provided by the private party, which are delivered through privately owned or rented infrastructure as part of the service package.

Length. The service provision needs to be long-term and relational. A short-term transactional contract for the provision of goods or services is not a partnership.

Trust. A partnership is built on trust. Underpinning the arrangement will be a framework document which sets out the 'rules of the game' and provides the partners with some certainty. While this PPP contract provides the basic architecture of the arrangement, it does not (and cannot) specify all components and allow for all outcomes. *Whole-of-life costing.* With a PPP there is the opportunity for a complete integration – under one party – of up-front design and construction costs with ongoing service delivery, operational, maintenance and refurbishment costs.

Innovation. A PPP approach focuses on output specifications, providing enhanced opportunities and incentives for bidders to fashion innovative solutions in meeting these requirements.

Risk allocation. Risk retained by government in owning and operating infrastructure typically carries substantial, often unvalued, cost. Transferring some of the risk to a private party which can manage it at less cost can substantially lower the overall cost to government.

Accordingly, for our purpose, PPPs can be defined as agreements where public sector bodies enter into long-term contractual agreements with private sector entities for the construction or management of public sector infrastructure facilities by the private sector entity, or the provision of services (using infrastructure facilities) by the private sector entity to the community on behalf of a public sector entity. But what is infrastructure?

2. What is infrastructure?

As John Kay (1993) noted, infrastructure is easier to recognise than to define. Investment in infrastructure is thought to provide "basic services to industry and households", "key inputs into the economy", and "a crucial input to

economic activity and growth", although what is "basic", "key" and "crucial" varies from country to country and from one period to another. The litmus test used to be that infrastructure had to be provided by government-owned enterprises (the predominant approach in Europe) or by privately owned utilities subject to rate of return regulation (the approach in much of the United States). This conviction was derived from a number of inherent features, such as the existence of:

- network services, providing integrative activities which bind economic activity together;
- public goods, from which it is difficult (and perhaps not desirable) to exclude non-payers (the non-excludability principle);
- externalities, whereby benefits and costs are conferred upon those not a party to the transaction (e.g. spillovers);
- natural monopolies, for which scale economies make it efficient to have only one provider (for example, of an electricity grid).

The trend away from public to private provision of infrastructure has been underpinned by a marked change in thinking and practice on these matters. There has been the perception, for example, that a move from 'taxpayer pays' to 'user pays' (i.e. from ability-to-pay to the benefit principle) in the provision of infrastructure services (water, power) is likely to be associated with a better economic use of the services. Many industries considered to be natural monopolies, e.g. electricity generation and telecommunications, have been broken up geographically into different regional firms or, with deregulation, separated into competitive (or potentially competitive) sectors vis-à-vis those sectors that remain natural monopolies (the distinction between power supply and high-voltage transmission and between railway operation and rail track services). In those activities which have natural monopoly characteristics, substitution of price-cap regulation for rate-of-return regulation (i.e. fixing of maximum prices rather than the mark up over costs) has created strong incentives to reduce costs, while third party access to certain facilities that are not economic to duplicate has widened competition in the upstream and downstream markets served by the facilities.

Such changing attitudes on the public-private contribution and a re-assessment of what is really a 'core' public service constitute one set of factors that has led to the development of PPPs. A PPP is simply a method of procurement (although of infrastructure services rather than the infrastructure itself) and as such, falls into the privatisation literature and what has become known as the 'new public management' or 'marketisation' of the public sector (Starr, 1988; Domberger and Rimmer, 1994; Hood, 1995; Parker and Gould, 1999; Manning, 2002). These terms embrace the corporatisation, privatisation, commercialisation, managerialism, outsourcing and downsizing of public sector activities. PPPs are one exemplification of these trends.

Another important factor in the development of PPPs is the refinement of the private financing model (Haley, 1992; Hodgson, 1995; Stewart-Smith, 1995; Forshaw, 1999). The PPPs with which we are primarily concerned involve supplying whole-of-life infrastructure services to the private sector and utilise project financing techniques in order to deliver the required private finance in a form that meets the risk-reward requirements of private financiers and suppliers or risk capital. PPPs draw on the experience of using DBFO/BOT techniques for highways and other transport schemes. These structures are devised to spread risks across a number of participants (sponsor, constructor, suppliers, and financiers) including the government, which typically provides the site, reduces legal uncertainties and purchases the output.

Table 1. – CLASSIFICATION OF INFRASTRUCTURE BY TYPE

	Hard	Soft
Economic	roads motorways bridges ports railways airports telecommunications power	vocational training financial institutions R & D facilitation technology transfer export assistance
Social	hospitals schools water supply housing sewerage child care prisons aged care homes	social security community services environmental agencies (EPAs)

A further factor can be seen from the distinction made between the different types of infrastructure (see Table 1). Infrastructure can be classified into 'economic' or 'social' and within these into 'hard' or 'soft'. Roads, airports, telecommunications are 'hard economic', while 'soft economic' embraces vocational training, R & D facilitation and technology transfer. 'Hard social' involves water treatment, housing, child care and prisons, whereas social security, community service and environmental agencies are 'soft social'. When PPPs began in the UK, they were largely confined to 'hard' economic infrastructure projects such as roads, bridges, ports etc. They then spread to social infrastructure such as schools, hospitals, prison and detention centres, sewerage and so on. Now the 'hard hats' have become providers of 'soft services' (D & P, 2001). Instead of being interested only in the construction contract and the first two years of a project, the facilitators are now servicing the asset throughout its life. Major UK construction companies, for example, have become more like facilities management companies, reinventing themselves as project operators and service providers. Much the same trend is occurring

across Europe. This is an indication of the flexibility of the PPP arrangement, a topic to which we now turn.

3. The conceptual framework of PPPs

PPPs are arrangements wherein private parties participate in, or provide support for, the provision of infrastructure, and can thus take many different forms, including:

- contracting out or management contracts, where the private sector is only partially involved, for example it provides a service or manages without taking any risk;
- joint ventures, where the private and public sector jointly finance, own and operate a facility;
- leasing, where part of the risk is transferred to the private sector;
- BOT (Build Operate Transfer), where the private sector takes primary responsibility for funding, designing, building and operating the project. Control and formal ownership of the project is then transferred back to the public sector;
- BOO (Build Own Operate), where the control and the ownership of the projects remain in private hands.

The PPP model that we have in mind is that developed in the UK, Australia, Canada, South Africa (Allen, 2001; Commission on Public Private Partnerships, 2001; Partnerships Victoria, 2001) under which a PPP project results in a contract for a private entity to deliver public infrastructure-based services. The fundamental elements of this model are as follows:

- The public sector defines the service it requires over a long-term period (typically 15 – 30 years) by reference to an output specification and closely specified performance criteria. The payment mechanism relates to the performance standards specified.
- The design risk, in terms of the decision on the type of specification of assets required to deliver the services to the required standard for the long-term period, is left to the private sector entity.
- The assets are owned and operated by the private sector.
- The public sector provides no funding during the construction phase, and the risk of cost overruns, delays, etc rest with the private sector.
- The public sector has to devolve control to the private sector over the assets and resources needed to deliver the service to such an extent that the private sector reasonably affects the appropriate risk transfer.

Whether or not a service should be delivered by means of a PPP project depends on the answer to three questions. First, which (if any) part or parts of

the proposed service is a service which government itself should deliver to its citizens? (the core services question). Second, for all other aspects of the service and supporting physical infrastructure, what is the project model that delivers the best value for money? (the value for money question). Third, do the outcomes of the value for money question satisfy the public interest criteria articulated in the policy and if not, can the public interest be satisfied by either building safeguards into the contract or through regulatory measures? (the public interest question). The combined response to the three central questions – core services, value for money and public interest – determines the underlying framework for the project.

Obviously if the whole service is considered to be core, there will be no scope for a PPP arrangement. Nevertheless, one merit of a partnerships agenda is to determine the point at which the core ends and ancillary services begin. Not all public services provided to the community are necessarily core in the sense that government needs to provide these services itself. Moreover, core services are usually delivered in a context which does not preclude participation by private parties. The services performed by doctors and nurses within public hospitals, teachers within government educational facilities and judges within courts are widely regarded as ones which are a function of government to provide. However, there is no reason, in principle, why supporting infrastructure and ancillary services within those service areas cannot be delivered by the private sector. In this respect, PPPs can allow for a range of roles for the parties and Table 2 summarises the range of service delivery models available.

'Related ancillary services' encompasses a number of operational services including information technology services, accommodation services arising out of the infrastructure, building related services such as maintenance and some support services. Notably, in all cases, whether involving the construction of a hospital, road, courthouse, school or sporting facility, land and property are required for the delivery of the PPP service. From a property point of view, it may seem that the analysis of a PPP project involves many of the same principles as a joint venture/development arrangement in an open commercial environment. Perhaps the main difference between the PPP and the various property-based public/private joint ventures which have preceded it, lies in the fact that the PPP requires participants to view the arrangements as the delivery of a service. This contrasts with the more traditional view of regarding the assets *per se* as having intrinsic value. When a government agency enters into a long-term PPP contract for infrastructure, senior management is freed from the everyday issues of infrastructure ownership and management and the delivery of related ancillary services. Management's focus on service delivery is not distracted by construction time and cost overruns, maintenance needs, an infrastructure that is not quite fit for the purpose, and staff and client unrest that could be resolved by a refurbishment, if only funds were available. This leads into the issue of finance.

Table 2. – RANGE OF PARTNERSHIP MODELS

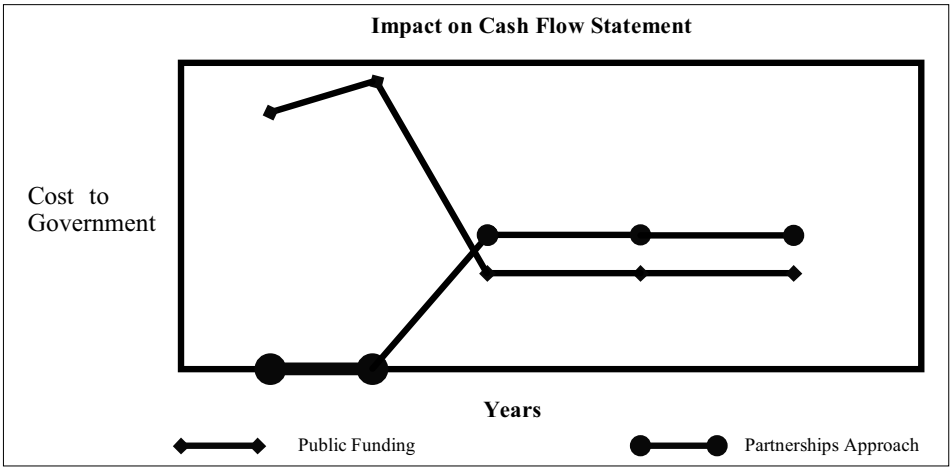
Role of the private sector increasing				
Private party role	Infrastructure services only	Infrastructure and ancillary services	Infrastructure and partial private-to-public service delivery	Infrastructure and service delivery to users
Government role	All public-to-public services	Delivery of core public services	Delivery of core public services	No operational role
Example	Public buildings	Non-core hospital services, non-judicial court services	Community facilities linked to educational facilities (e.g. after-hours usage)	Rail, roads, port facilities, car parks

Governments frequently have been motivated into entering into PPP arrangements by the desire to reduce debt (and contain taxation), while facing pressure to improve and expand public facilities. However, the argument that PPPs are the only way of delivering the public infrastructure (and the services) that the community wants is exaggerated, for PPPs still draw on public funds. What differs is that the public payments are made over a very different time frame. When infrastructure is provided under a PPP, the government does not own the asset but, instead, enters into a contract to purchase infrastructure and related ancillary services over time from the private sector. These operating payments must cover operating costs as well as giving a return on capital. Therefore, a project delivered under a partnership's approach will have a similar (although not identical) effect on the Government's annual operating surplus to that if the asset was publicly funded.

Figure 1 illustrates the cash flow differences between public funding and a PPP project. From the public sector side, PPPs require little or no upfront capital expenditure but involve a larger operating expenditure over time to purchase the services. By contrast, the public asset approach requires a large upfront capital funding commitment and relatively lower operating expenditure over time. Thus, the PPP route may, on these grounds hold some attractions to a government with a backlog of infrastructure projects and facing an uncertain fiscal climate – a not unimportant consideration for many transition countries. But the major merit is in terms of the predictability of costs and funding. A PPP ensures that whole-of-life costing and budgeting are considered, providing infrastructure services to specification for a significant period and including any growth or upgrade requirements. This provides budgetary predictability over the life of the infrastructure and reduces the risks of funds being diverted (for example, away from scheduled refurbishment) during the life of the project, impacting upon residual value risk to the asset.

Yet financing is only one element of the calculation. The very essence of a PPP is that the public sector does not just buy an asset; it is purchasing a service under specified terms and conditions. Infrastructure procurement has traditionally been viewed as asset procurement. When assets are procured from

Figure 1. – COMPARISON OF PUBLIC FUNDING AND PARTNERSHIPS ON CASH FLOWS



private sector contractors, their responsibilities are limited to the construction of the asset and the risks associated with the operation and maintenance of the facility remain with the public sector. With a PPP, the emphasis is upon the purchase of services, not the procurement of an asset and the allocation of risks in the transaction are quite different.

In theory, the conception of risk allocation as a result of this emphasis on service purchase and delivery is straight-forward. The government frees itself entirely from asset-based risk (including design, construction, operation and residual value risk), and becomes the purchaser of a product that is risk-free in the sense that government does not pay if the service is not delivered or not delivered to the specified standards. That is, the public sector is purchasing the long-term provision of a service of a guaranteed standard, as well as the security that if the service is not provided at the right time, or to a satisfactory quality, then reduced payments are made or compensation is received.

That is the underlying philosophy. In practice, risk allocation in a PPP is more complex. Rather than shifting all risk to the private sector, the policy aims at allocating risk to the party that is best suited to manage it. These are those who can do so at the lowest price. Unloading inappropriate forms of risk onto the private entity merely adds unnecessary cost to a PPP agreement. Driven by the requirement for 'value for money', the government may agree to assume some risks for which the private party would charge too dearly if the risk transfer to the private party were to remain complete. Only 'efficient' levels of risk should be transferred to the private party, reducing individual risk premiums and the overall cost of the project.

Thus the conceptual framework underlying PPPs is that, because the government is a service recipient providing full payment only on satisfactory deliv-

ery of these services, it initially transfers all project risk to the private party. It is then a matter for government to determine, on a value for money basis and having regard to the cooperative framework of the partnership, what risks it should 'take back' to achieve an optimal risk position. Taking back means a deliberate decision by government to assume or share a risk that would otherwise lie at the door of the private party.

4. The structure of a PPP

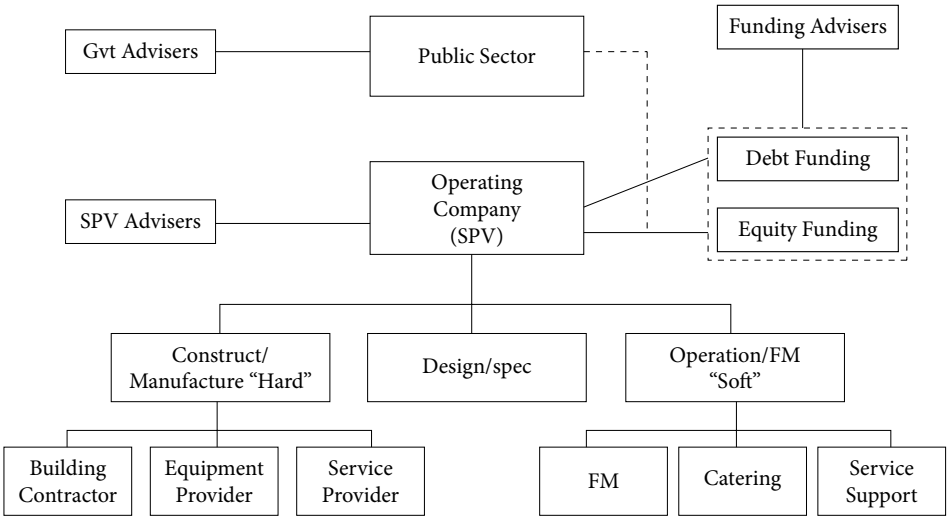
The upshot of this risk reallocation is that a PPP contract differs from a standard procurement contract because it is not part of a traditional product supplier/buyer relationship. Under a PPP, the parties allocate risks between them and work together in an ongoing relationship to meet project objectives. From a government point of view, the risk transfer is most effective if there is a 'whole of cycle' contract with a single private party, to give that party the strongest possible incentive to ensure that the design and construction phase converts into a highly effective operation. Behind the private party, however, there may be a number of private sector interests seeking to be represented through the private party. The distinctive feature of current PPPs is the bundling of finance, design, construction, operations, and maintenance. Because these functions are highly specialised, private sector providers tend to be consortia consisting of engineering and project management firms, construction companies, financial underwriters, and operating enterprises that come together to develop a particular facility. Typically, this has been in the form of a 'special purpose vehicle' created specifically for the purposes of the project. Figure 2 illustrates the possible complexity of the private party and the differing interests that may underlie its objectives. Grimsey and Lewis (2002a) document this complexity in a case study of a PPP project involving a water treatment facility in Scotland.

Hence the key participants in a PPP include:

- the public sector procurer (the government, local governments and agencies, state-owned entities);
- equity investors, who normally create a special purpose vehicle (SPV or project company) through which they contract with the public procurer and the principal subcontractors;
- financiers;
- subcontractors; and
- other involved parties such as advisors (legal, financial, technical), insurers, rating agencies, underwriters etc.

All, obviously, have defined roles, and Abdel-Aziz and Russell (2001) suggest a framework for analysing them that revolves around rights, obligations and

Figure 2. – TYPICAL PRIVATE SECTOR CONSORTIUM



liabilities. This three-fold classification encompasses key features of any PPP project. Under the agreement, various rights are ceded to the private entity in return for it taking on and undertaking a specified set of obligations. One set of rights relates to possession, when the public sector transfers ownership of land and property in its possession to the private sector. The other right refers to revenues when the government entity gives the private sector body access to revenues during the operational stage of the contract. In return, the private firm is obliged to undertake certain functions. These relate to planning, design, construction, improvements, operation, maintenance, financing, environmental aspects (biophysical), labour issues and regional and other business impacts. Finally, the liabilities dimension refers to the actual and potential liabilities and risks shared or assumed by parties under the agreement. Included under this heading are: general liability (tort, third party and facility damage); liability for taxation and risk liabilities. The latter arises from the risk allocation process, and the risk 'take back' by the public sector, described earlier.

Notably, under a PPP, while the responsibility for many elements of service delivery may transfer to the private sector, the public sector procurer remains responsible for:

- defining the business and the level of services that are required and the public sector resources which are available to pay for them;
- specifying the priorities, targets and outputs;
- executing a carefully planned procurement process that reflects the above;

- determining the performance regime by setting and monitoring safety, quality and performance standards for those services;
- managing the contract by enforcing those standards, taking action if they are not delivered;
- managing community expectations;
- providing the enabling environment
- reacting, in cooperation with the private sector, to changes in the project environment while remaining focused on pre-defined objectives.

PPPs consequently place considerable demands upon the public sector. One of the key barriers to the implementation of PPPs has been the lack of government skills in identifying and bringing forward projects to the market. All European countries have gone through a substantial learning curve in the process of putting a PPP policy into place, and we now consider these developments.

5. PPPs in Europe

While our discussion above has focused on the UK model of PPPs, this is not the only approach to the private financing of infrastructure in Europe. Table 3 summarises the approach to PPPs in seventeen European countries. Ireland has followed the UK lead. By contrast, countries such as France and Spain have a history of co-operation between the state and the private sector but use concessions rather than the UK-style PPPs. In essence, the governments own the asset and give to a private sector agent a concession to operate the asset. Even if it is not possible to identify a common European PPP model, the role of partnerships seems to be expanding in most European countries.

The Dutch and the French experiences are significant examples of alternative PPP approaches. Both are based around the concept of a fixed-term concession, one of the oldest forms of public private partnership. They use various combinations of private sector resources to design, construct, finance and operate facilities, although there are significant differences in the contractual arrangements in the two countries.

Netherlands. Despite the fact that a PPP is not a recognised concept under Dutch law, the Netherlands has put in place a framework for PPPs including a dedicated PPP unit, the 'Kenniscentrum' or Knowledge Centre, which was set up in 1999 within the Ministry of Finance (Linklaters and Alliance, 2001). The Centre is a point of contact and advisor for government agencies interested in PPP and also supplies general information to the private sector. It regards the 'concession' model as offering the best opportunity to realise added value with PPP (especially with respect to central government projects). In the concession model, the private sector (i.e. a consortium) is responsible for

all elements of a public project as a package, including design, construction, maintenance and financing (and sometimes operation).

The PPP Knowledge Centre expects the PPP-concession model to have the following characteristics:

- the public sector offers an integrated public project, involving design, construction, maintenance and financing (and sometimes operation);
- the public sector focuses on output, not the product, so that the services to be delivered are essential;
- concessions will be offered by way of EU public procurement;
- comparative methods are used to ensure that the best model for a certain project is selected;
- risks must be taken by the party which is best equipped to manage such risks;
- transfer of risk must be achieved by integrating financing in the concession; and
- remuneration is to be based on output rather than product.

Three major PPP projects have reached the procurement stage: HSL (the high speed train line between Amsterdam and the Belgian border), the A59 (between Oss and Den Bosch) and Delfland (new Hamaschpolder waste water purification installation by DBFO). For

Table 3. – NATIONAL EXPERIENCE OF PPPS IN EUROPE

Country	**Experience with PPPs**
Bulgaria	The Sofia Water and Wastewater Concession Project is the major municipal infrastructure concession in Bulgaria and one of the first water concessions to be financed on a limited recourse basis in Eastern Europe, via a special purpose vehicle. International Water is the majority shareholder and private sector operator. This 15-year project reached financial closure in October 2000.
Croatia	The government's policy is favourable to the use of BOT schemes for transport (Istrian toll road), energy (Lukovo Sugarje power project) and water (wastewater treatment plant for Zabreb). New legislation is designed to facilitate concessions.
Czech Republic	Joint ventures have taken place between public institutions and private entities in the energy sector, telecommunications and water and waste water treatment, mainly as a result of privatisation. Toll roads have been rejected with two BOT projects not realised. A task force was created in 2000 to develop PPPs, in order to complete the road network.
Finland	The Helsinki-Lahti motorway, conceived in 1995 and begun in 1997 is the first and largest PPP in Finland, involving equity from the UK, Sweden and local entities. There are schemes underway e.g. a pilot PPP project to build a 6th form college specialising in IT.

Country	Experience with PPPs
France	France has a long-established tradition of public-private cooperation (especially in sectors such as water) using the concession structure. PPPs are not permitted in a social infra-structure area. The tunnel Prado-Carrenage in Marseille was toll-financed. Three major road projects have been launched under PPPs since 2000 (Millau Viaduct, the A19 and the A28) and cross-border projects such as the Perpignon-Figueras high speed link and the Lyon-Turin high speed link have involved recourse to PPPs.
Germany	Germany has no formal PPP programme although it has, in the past, involved private sector contractors in road projects (e.g. the Wanow tunnel) some of which did involve risk transfer to the private sector under a concession framework. A BOT law has been passed, although specific taxation issues complicate the procurement process.
Greece	Some projects (e.g. the 2004 Olympic stadium) have been started but not completed. Those completed include Spata Airport and the Athens ring road. The government launched a PPP programme in 2000, as well as setting up a central PPP Unit. Nevertheless, some legal issues remain to be resolved.
Hungary	Some transport projects have been developed by PPPs (eg the M5 BOT project), but others have not been realised or transferred to the National Highway Agency (eg M1). The *Szechenyi* Plan seeks to expand PPPs, but there is no government authority specially assigned to deal with PPPs.
Ireland	In 1999, a pilot PPP road programme including three roads and a light rail system was initiated. Toll bridges, government offices and prisons have been designed, built, financed and operated by the private sector. There is a strong commitment to a formal PPP programme. A clear legislative framework is in place, a dedicated PPP unit has been set up and central committees facilitate PPPs.
Italy	The Merloni Bill in 1994 and 1998 set the framework for using private sector contractors and later a special PPP taskforce, UFP, was created and its powers reinforced in 2001. There have been projects in the water and power sectors in particular, which involve the private sector on a concession-style basis. However, new PPP projects are discouraged, perhaps due to the administrative complexity associated with the civil code.
Netherlands	*Kennis-centrum PPPs* was set up in 1999 and a major pilot project (the high speed rail) was started. Projects underway since then include road, railway harbours and water projects, ie *Zuiderzeelijn/Randstad Circle Line,* (magnetic levitation technique), 2nd *Maasvlakte* (enlargement harbour Rotterdam).
Poland	The A4 Katowice-Krakow is the first toll highway in Poland. The government is anxious to facilitate PPPs and two bridges have been identified as PPP projects. The legal, accounting and taxation system hinder the implementation of PPPs.
Portugal	Under the *SCUT* programme, 3 toll roads have reached financial closure and one syndicated. Around a dozen other road projects are being implemented, six of which involve shadow tolls. Motorways, railways, airports, water, parking, subways, local transportation and museums involving PPPs are under consideration, although union resistance and constraints on issuing project bonds hinder implementation.
Romania	Concession-based financing techniques are favoured. In 2000, the French utility company Vivendi was awarded a twenty-five year concession to provide water and pipeline rehabilitation services to Bucharest, in the form of a new treatment system and modernising the existing water system. Commercialisation of road maintenance activities is being investigated, and PPPs are being promoted for infrastructure development as part of Romania's preparations for accession.

Country	Experience with PPPs
Slovenia	An EBRD-assisted project is investigating private investment in the maintenance of the national road network. Development of a private finance concession-based highway maintenance scheme is a planned pilot for PPPs.
Spain	The government has a road programme using the shadow toll structure. Private sector involvement is sought in three new rail lines and other initiatives. PPP projects are also planned in the health and waste management sector. However, the legal framework is not supportive, and there is no law to cover concessions.
United Kingdom	The British Government launched its PPP development policy in 1992 under the 'Private Finance Initiative'. Since then, the technique has been applied systematically to virtually every area of significant department capital spending in the UK. Partnership UK was established in 2000 to promote PPP/PFI concepts. It also works on local authority projects.

Sources: D & P (2001), American Chamber of Commerce (2002), United Nations (2002), von Hirschhausen (2002).

the HSL the government opted to 'unbundle' and separate transport and infrastructure. With respect to the infrastructure, different tendering procedures have been adopted for the substructure (Design and Build Contract) and superstructure (PPP style Design Build Maintain and Finance Contract).

France. The French approach differs from the UK and the Netherlands. The French government has not launched an official Public-Private Partnership development policy due to the fact that PPPs are considered an 'old concept'. The French PPP model goes back more than a hundred years in the form of *Societés d'Economie Mixtes* and *Concessions*, and the concession system remains one of the most popular modes of constructing and managing 'commercial' public services and public infrastructure in France.

Public services and infrastructure in France remain divided between two opposite systems: the PPP-based private concession system known in France as *délégation de service public* and the *dirigiste* system of *gestion directe,* where the infrastructure or service is built and/or operated directly by a public or state-owned body. A large amount of infrastructure remains managed and developed under the form of a concession contract granted to a public concessionaire. State monopolies also remain strong. Purely private concessions, however, have never disappeared. They have survived under various contractual forms, especially in the municipal services sector. Water supply, sanitation, urban heating, waste management, urban transportation and contracted food services have generally been operated in France under PPP schemes. Since the end of the 1990s, the use of PPP schemes to finance and design infrastructure projects has made a strong comeback and French utilities such as Vivendi, Suez Lyonnaise, Bouygues, Vinci, SAUR, Sodexho and Connex have taken advantage of this new climate.

There is no specific legislative framework for PPPs in France, and public law-related legal constraints remain strong. However, there is a long-standing tradition of PPPs in France and the administrative courts have drawn the lines

of a coherent legal framework, in particular concerning the breakdown of responsibilities between the operator and the public bodies. This framework, elaborated by the Council of State (*Conseil d'Etat*) is based on the following principles:

- the contract remains subject to the principles governing public services activities, i.e. the supremacy of the general interest over private interests;
- the public entities are therefore placed in a position of superiority vis-a-vis the private partner;
- infrastructure and buildings necessary for the provision of the public service, even if financed, designed and operated by the private sector, are placed under the regime of public properties which means that they are the property of the public entity *ab initio* and must be returned (*biens de retour*) to them at the end of the contract;
- as a counterpart to these powers given to the public entity, the French courts have awarded the private partner the right to be indemnified when its situation is affected by unilateral decisions founded on the general interest and the right to be indemnified when unforeseeable circumstances (*imprévision*) affect the financial balance prevailing at the date of the signature of the contract.
- contracts have to be submitted to the general principles of French public law and to the jurisdiction of the administrative courts.

The effect of the last principle is that as soon as a PPP contract involves the general interest or the management of an activity considered to be a public service, it is generally subject to French public law. French public law has strict rules concerning the use of public funds and public properties, which have a strong impact on the nature of the legal and financial schemes available to design a PPP project. In particular, rules pertaining to public properties (*domaine public*) render difficult, if not impossible, the implementation in France of Build, Own, Operate and Transfer (BOOT) contracts, in which the property of the infrastructure is to be private, at least during the contract, or of long-term leases.

In general, however, the flexibility of case-law and the realism of the Council of State and the administrative courts, make possible the adoption of the new structure of PPP projects, allowing a precise and adequate breakdown of risks, funds and responsibilities between the project's main parties. For instance, most of the Anglo-Saxon rules concerning project finance schemes can be implemented under French law. Nevertheless, the French administrative courts sometimes seem reluctant to admit innovative forms of PPP schemes outside the traditional concession contract. The Council of State has adopted a strict position concerning the possibility of admitting private financing schemes for railways, in order to protect the public properties.

These difficulties are echoed to a greater or lesser extent in most European countries and are complicated at the European Union level by the rules on public procurement. However, a quite different set of obstacles arise when we consider the situation in the transition economies.

6. PPPs in transition countries

Based on the experiences of other European countries, PPPs in the transition economies seem likely to be concentrated initially in the transport, defence and energy sectors. PPPs can be employed for the construction or development of municipal transport systems, municipal infrastructure such as water, heat distribution, wastewater and sewerage, as well as the health, education and prison sectors (United Nations, 2002; American Chamber of Commerce, 2002).

PPPs are structured to maximise the use of private sector skills, where these are needed to supplement the existing skills of the public sector, while ensuring clear accountability and risk transfer for both project delivery and operation. Activities should be performed by those most capable of managing them and the associated risks. This allocation translates into better value for money spent by the public sector.

A valuable aspect of a PPP is that it can be designed to achieve both social and commercial goals. The potential benefits include:

- infrastructure in the shortest possible time from the outset of the PPP contract resulting primarily from the whole-of-life costing principle;
- limited risk of delay or stoppage of construction caused by lack of public funds, but it is possible to limit that risk, for the private sector will be determined to finish the works on time due to properly constructed incentives and/or penalties;
- value for money, achieved through the efficient allocation of risk between the public and private sectors;
- operational savings arising out of innovative capital build solutions, a benefit derived from combining the operational and capital phases of the project;
- undertaking made without reliance on public debt;
- public sector skills released from financial constraints and utilised to maximise efficiency.

In addition, there can also be a set of benefits related to social gains, such as:

- ensuring that the PPP transaction facilitates technology transfer from the foreign investors to the local public sector;

- selecting projects that promote competition and market-based conduct, skills and innovation;
- having the private sector share its learning experience with the public sector (perhaps through training sessions); and
- reforming the public sector as a result of gaining new commercial skills, freeing ideas from capital constraints, and working with the latest technological know-how.

If these benefits are to be realised, then there are obstacles that have to be overcome in the PPP market of the transition countries. Some of these are inherent in the concept of a PPP itself. A PPP is not an easy process to implement. It is complex in terms of the interactions with all the parties involved and in the impact on the agency's objectives. The preparatory work and implementation process of a PPP are time-consuming, so until any project can demonstrate the benefits of the PPP approach, strong political support is required.

While political support (and stability), along with the active involvement of different ministries, is seen as an essential 'enabler' for PPPs, other barriers come from the commercial and legal environment and these need to be addressed to enable legislative and policy changes. Amongst the barriers to PPPs we can list the following.

Legal framework. In many countries, there is no legal framework for PPPs. Ideally a robust system of commercial laws needs to be put in place. Private sector interests have to be protected under the existing laws. Government agencies have also to facilitate the involvement of the private sector in infrastructure projects or public utilities. Restrictions on public procurement may adversely affect the implementation of PPPs. For example, in Poland, entering into a public procurement agreement for a period of more than three years requires the prior consent of the President of the Public Procurement Office. A similar approval must be obtained for applying a procedure other than an unlimited tender process in the case of large public procurement contracts (American Chamber of Commerce, 2002). In addition, PPP projects are usually complicated, and require a number of permits, consents and administrative decisions. The partners of the public entity are often foreign companies, the operations of which sometimes face additional restrictions in the host country.

Finance. The perception of high risk attached to project financing in regions such as South East Europe is difficult to overcome. It deters the private commercial banks from lending to the region. Risk is made up of several components (i.e. political, commercial, price, etc) some of which can be covered by international financial institutions. Country credit risk is also an important factor. Private commercial banks are frequently reluctant to enter due to the general legal and regulatory weakness that characterises certain transition countries. Global finance limits applied to the amount of indebtedness of lo-

cal government entities may inhibit or even prevent local governments from incurring the long-term commitments typical of PPPs.

Taxation. A good appreciation of the taxation ramifications is needed in any dealings with private sector entities. The very complexity of PPPs creates many points where an unhelpful taxation system can impose itself. For example, are direct grants from the public sector to pay for a portion of the PPP asset taxable? Is the hand back of the asset to the public sector assessed for tax? Is property used in the PPP exempt from taxation? Can infrastructure assets be depreciated for taxation purposes? The existing taxation system, as with the legal system, may be ill-equipped to deal with PPPs.

Accounting. Determining the appropriate accounting treatment of PPPs has proven to raise complicated and controversial issues (Grimsey and Lewis, 2002b). The main problem consists of providing a correct answer to the question: in whose books should the assets covered by a given agreement be reported? Recognising a given asset in the balance sheet also means recognising a related liability in the accounts. Assets covered by a given agreement should be recognised in the accounting records of the party, which is not only exposed to the greatest extent to the economic risk associated with using those assets, but which is also able to make use of related economic benefits to the greatest extent. A detailed analysis of each individual case must be conducted in order to determine this, focusing on the variability over time of the revenue and costs connected with using a given asset and the parties exposed to the greatest risk. International standards largely accept this point, but not all national systems do, creating ambiguities as to the conditions when PPP payment obligations can be treated as off balance sheet transactions by the public sector. The chief premise behind the concept of a PPP is for the public sector not to have to procure the capital asset by paying for it up front through a direct public sector loan. Instead, the effect of a typical PPP structure is to create a single stand-alone business, financed and operated by the private sector.

Public acceptance. A broad public consensus as to the involvement of the private sector in infrastructure is required, especially for implementing project financing models based on user charges. For example, most attempts to finance the building of new East European transport infrastructure by means of toll revenues have been abandoned or put on hold, although two exceptions are the M5 highway in Hungary and the A4 (Katowice-Krakow) highway in Poland (von Hirschhausen, 2002). The legacy of free socialist infrastructure has made it difficult to jump immediately to private project financing based on user charges, while a combination of low traffic volumes, low capacity to pay and the availability of free alternative routes means that private concession models based on user tolls are likely for some time to be less profitable in transition economies than in Western Europe and other industrialised countries.

Public administration. The capacity and skills of public administrations have to be improved to manage and negotiate successful projects. The difficulties in implementing private financing for transport infrastructure, for example, revealed a lack of administrative competence in the development and control of private project financing, as well as a lack of knowledge of future traffic flows, willingness to pay and other determinants of demand side risk (von Hirschhausen, 2002). There may be the potential to pool the knowledge base. The United Nations (2002) suggests that for PPPs to be promoted and used in the reconstruction of areas such as South East Europe, interested government units and departments could be involved in a regional network to improve governments' capacity to facilitate projects.

7. A WAY FORWARD

Clearly, a number of significant elements ('enablers') have to be in place to allow PPPs to develop (see Table 4). Many of these matters must be tackled at the individual nation level. Others seem likely to require European-wide initiatives. For example, financing support for the accession countries will rely on assistance provided by the EIB and the EBRD. Purely private infrastructure financing may not be a feasible option for many projects in the transition countries, but that does not exclude expanding private sector participation. Some financing might come from the private sector under different arrangements if the market for PPPs evolves from project finance to corporate finance.

D & P (2001) argue that an investor with a portfolio of 20-30 infrastructure projects has an asset or income stream that can be borrowed against or se-

Table 4. – KEY 'DRIVERS' AND 'ENABLERS' FOR PPPS

Drivers	Enablers
• Financial need e.g. budget deficit	• Political framework: stability, explicit political will or commitment, e.g. a dedicated unit, ability to push schemes through, creative and willing local government
• Ageing or poor infrastructure	• Legal framework: no roadblocks, and documentation not excessively complicated
• Growing demands or expectations on public sector services	• Public acceptance: acceptance of private sector involvement and specific impacts e.g. environmental impact of new roads
• Search for greater efficiency and creativity	• Quality practitioners: good quality, experienced project sponsors and lenders
• Desire to introduce competition	• Readily available finance: including EU and EIB funding in some cases; mature or sophisticated banking sector and capital markets culture
• Shortage of domestic experience or skills	
• Desire to educate national contractors and remain competitive	
• Bandwagon effect	

Source: European PPP Survey 2001 – D & P Report

curitised. Project bonds are attractive to pension funds when credit wrapped (when an insurer credit rates a project to give it a higher credit rating), and may even be sold to retail investors. As high quality infrastructure assets are placed in this way, there might develop an appetite for more risky infrastructure assets in portfolios, bypassing to some extent, the reluctance of banks to lend.

However, it is not sufficient to design a credible framework to attract funds from the capital markets. Those who use the infrastructure services need to accept the legitimacy of the public-private arrangements that attract and allocate resources to infrastructure projects and be convinced that they are paying appropriate prices for the services they receive. Incentives must also be put in place to promote cost containment and economic efficiency. Berg, Pollitt and Tsuji (2002) identify these three factors – credibility, legitimacy and efficiency – as central to sustaining public-private collaboration in infrastructure.

The United Nations (2002) and the American Chamber of Commerce (2002) emphasise the necessity for transition economies seeking to introduce and expand PPPs to attend to the following matters:

- an appropriate legislative framework must be enacted;
- government needs to take a leading role;
- public trust has to be established;
- public acceptance is required at local political level;
- experienced practitioners are needed;
- financing needs have to be met.

All of these are important preconditions. Since PPP contracts engage many parties and their resources in the long-term, there is a need to support them by suitable legislation, firmly embedded in the legal structure of the country. This relates not only to legal acts but also to any procedures and administrative rules. Private partners seek the elimination of any legal ambiguities and expect clear legal statements. On the other hand, with such legislation in place, the public sector possesses an effective tool for PPP implementation. The private sector seeks the opportunity for long-term cooperation and achievement of this goal requires political support from the public side. Political stability is important as bidding costs are high, while clear public sector policy regarding PPPs is vital in resolving contractual issues. A constant dialogue needs to exist between the public sector and the private sector bodies to establish a wider PPP framework and subsequently to create a foundation for true partnering between the two sectors.

Such factors relate to the general environment for PPP implementation and underpin the development of a PPP strategy. But, in order for transition economies to achieve the benefits that PPPs can bring, considerable detailed preparatory work is required. There is evidence that PPPs can bring efficiency

gains and cost savings compared with traditional procurement (some of the evidence is examined in Grimsey and Lewis, 2004), but not all PPPs are successful. Like any other project, successful PPP projects must satisfy their own objectives and meet processes from the creation and managing of the contractual process. The key factors to be considered include project objectives, contract terms, the scope of activities, contract management, performance measurement, risk management, accounting and tax treatment, resourcing, infrastructure, probity and accountability, political policy. A successful PPP is one in which each of these and other relevant factors are addressed, along with the inter-relationships between them.

Because the PPP is a relatively new concept in transition economies, it is necessary to draw on the experiences of other countries in their implementation of PPP schemes, identifying weaknesses in their PPP methodologies and considering whether certain solutions used in other countries can be adapted to suit local circumstances. What this experience shows is that PPPs can achieve value-for-money for the public sector, but that the PPP process is more complex than traditional procurement and requires all PPP parties to understand the issues characterising it. The public sector procurer, for one, needs to be able to negotiate and manage individual project contracts and access the appropriate financial, legal and technical expertise. Creating a mechanism by which PPP expertise can be captured, retained, shared and used within the public sector is invaluable to work out the PPP model best tailored to the public sector's objectives, local requirements, the enabling environment and public acceptability.

It is here that a central PPP unit assumes significance. A central policy unit or taskforce has underpinned the successful implementation of PPPs in the UK, Australian states, Ireland and the Netherlands, for example. They have been invaluable in:

- signalling government commitment to the approach;
- defining and developing best practice, structuring policy development and providing guidance to project teams;
- establishing or clarifying the legality and powers of public authorities to enter into PPP style contracts (one of the main challenges faced by government in transition economies is to identify the agency or ministry that has sole negotiating authority for concession projects);
- removing tax anomalies which can weigh against PPP approaches; and
- refining public expenditure control regimes to accommodate PPPs.

Another important factor is the selection of pilot programmes. Public sector procurers need to identify those sectors and projects that should take priority in the PPP process. Project prioritisation helps to reduce the incidence of unsuccessful procurements and avoid the associated bidding costs that would otherwise be incurred. Providing working examples of PPPs rather

than theoretical models, as early as possible, is desirable if the confidence and trust of public sector procurers and private sector bidders is to be established. Given that the expertise for PPP concepts will typically be scarce at the outset of a programme, focusing such resources on a small number of representative projects, such that each is well served, is likely to be the most effective approach for the long term commitment and sustainability of a PPP programme.

Finally, it should be emphasised that a PPP is a partnership. Partnerships represent the second generation of policies to bring competitive forces and market disciplines to bear on government provision of goods and services. Unlike the first generation of outright privatisation, PPPs involve a sharing of both responsibility and risk in a collaborative framework. They seek to draw upon the best available skills, knowledge and resources, whether they are in the public or the private sector, and deliver value for money in the provision of infrastructure. Mutual understanding of each party's goals is essential in PPPs. Rodinelli (2002) argues that the success of PPPs depends on mutual trust between government officials and private sector entities and on public confidence in the integrity of the partnerships. Therefore, a partnership approach is required at each stage of PPP implementation. Discussing each party's interests enables them to reach agreements which are best from both the public and private parties' perspective, whilst not forgetting that the aim is to provide society with the highest possible quality of services.

REFERENCES

Abdel-Aziz, A M and A D Russell (2001), 'A structure for government requirements in public-private partnerships,' *Canadian Journal of Civil Engineering,* 28, 891-909.

Allen, G (2001), *The Private Finance Initiative (PFI),* House of Commons Research Paper 01/117, House of Commons Library, December.

American Chamber of Commerce (2002), *Public-Private Partnership as a Tool to Develop Infrastructure in Poland,* White Paper, American Chamber of Commerce in Poland.

Ball, A (2001), 'Discovering its own relevance? Reflections on the 'new' management accounting in the public sector,' *Accounting Forum*, 25 (3), 292-299.

Berg, S V, M G Pollitt and M Tsuji (2002), *Private Initiatives in Infrastructure*, Cheltenham: Edward Elgar.

Commission on Public Private Partnerships (2001), *Building Better Partnerships*, London: Institute for Public Policy Research.

D & P (2001), *European PPP Survey 2001*, D & P Secretariat, Brussels, May.

Domberger, S and S Rimmer (1994), 'Competitive Tendering and Contracting in the Public Sector: A Survey,' *International Journal of the Economics of Business,* 1 (3), 439-453.

Forshaw, A (1999), 'The UK revolution in public procurement and the value of project finance,' *Journal of Project Finance,* 5 (1), 49-54.

Grimsey, D and M K Lewis (2002a), 'Evaluating the risks of public private partnerships for infrastructure projects,' *International Journal of Project Management*, 20, 107-118.

Grimsey, D and M K Lewis (2002b), 'Accounting for Public-Private Partnerships,' *Accounting Forum,* 26 (3), 245-270.

Grimsey, D and M K Lewis (eds) (2004), *The Economics of Public Private Partnerships,* Cheltenham, Edward Elgar (forthcoming).

Haley, G (1992), 'Private Finance for Transportation and Infrastructure Projects: A View', *International Journal of Project Management*, 10 (2), 63-68.

Hodgson, G J (1995), 'Design and build – effects of contractor design on highway schemes,' *Proc. Civil Engineers,* 108, May, 64-76.

Hood, C (1995), 'The "New Public Management" in the 1980's: Variations on a Theme,' *Accounting, Organizations & Society,* 20 (2/3), 103-109.

Kay, J (1993), 'Efficiency and Private Capital in the Provision of Infrastructure,' in *Infrastructure Policies for the* 1990s, Organisation for Economic Co-operation and Development, Paris, 55-73.

Linklaters & Alliance (2001), 'PPP in the Netherlands,' Linklaters & Alliance, Amsterdam, April.

Manning, N (2002), 'The new public management in developing countries,' in Kirkpatrick C, R Clarke and C Polidano, *Handbook on Development Policy and Management,* Cheltenham: Edward Elgar.

OECD (1993), *Infrastructure Policies for the 1990s,* Paris: OECD

Parker, L and G Gould (1999), 'Changing public sector accountability: critiquing new directions,' *Accounting Forum*, 23 (2), 109-135.

Partnerships Victoria (2001), *Guidance Material,* Melbourne: Department of Treasury and Finance.

Rondinelli, D (2002), 'Public-private partnerships,' in Kirkpatrick C, R Clarke and C Polidano, *Handbook on Development Policy and Management,* Cheltenham: Edward Elgar.

Rosenau P V (2000), *Public – Private Policy Partnerships*, Cambridge, Mass: The MIT Press.

Starr, P (1988), 'The Meaning of Privatization', *Yale Law and Policy Review*, 6 (6), 6-41.

Stewart-Smith, M (1995), 'Private Financing and Infrastructure Provision in Emerging Markets,' *Law and Policy in International Business,* 26 (4), 987-1011.

United Nations (2002), 'A Review of Public-Private Partnerships for Infrastructure Development in Europe,' Economic Commission for Europe, Working Party on International Legal and Commercial Practice, 11-13 March.

von Hirschhausen, C (2002), Modernizing Infrastructure in Transformation Economies, Cheltenham: Edward Elgar.

ENO L. INANGA
WM. BRUCE SCHNEIDER

Accounting Research And Accounting Practice: An Uneasy Relationship

Abstract

There is anecdotal evidence to support the assertion that accounting research, or what is alleged to be research, is of little or no value to the practice of accounting, nor to the development of accounting as an academic discipline. The problem is not that efforts have not been made to conduct research, but rather there is a fundamental flaw in the accounting research process itself.

Tricker suggests that the research process can be understood using two models. One is a set of relationships which "feed-forward". That is, a known theory suggests a hypothesis, which is tested through the accumulation of data. If the hypothesis is proven to be true, it is added to the body of knowledge, enhancing the legitimacy of the underlying theory. The second model is intended to provide "feed-back". That is, the real world is observed and a model of it is proposed, based on known theory. Data is collected and processed and the model is refined. When the model is consistent with the real world and known theory, it is added to the body of knowledge. These research models depend on the existence of known theory for their usefulness.

1. Introduction

This paper is based on two fundamental premises. The first premise is that most, if not all, of what purports to be research in accounting is, in fact, a trivial pursuit. We will demonstrate that accounting is not a science and that the mere use of scientific methodologies does not change the basic facts. We also contend that the reported research is nothing more than correlation analysis, rather than the testing of theories and related hypotheses. Moreover, the "decision usefulness theory of accounting" (Staubus 2000) is no more than a rationalisation of observed activities. We contend that the assumptions inherent in "decision usefulness theory" have not been researched. Thus, without appropriate theory, accounting cannot be the subject of scientific research because, as a discipline, it lacks a basic requirement of a science. Researchers are thus unable to raise and research fundamental, non-trivial questions.

The second basic premise is that accounting research is not significantly linked to accounting practice because the issues and methods of interest to academic researchers are of little or no consequence to practitioners and, moreover, are not focused on fundamental questions. Additionally, it is important to note that in the university, at the undergraduate level, the "educational" process

and curricula are based on a strong bias towards training for practice, rather than on education and the development of an appreciation for research. At the graduate level, the bias is towards pseudo-scientific research constrained by Generally Accepted Accounting Principles (GAAP), resulting in the failure to discover new knowledge and develop relevant products to serve user needs. Several highly respected members of the academic community have addressed these issues (Albrecht and Sacks 2000, Demski 2001, Selto and Widener 2001).

2. Organisation of Paper

In the light of the two basic premises above, the remainder of the paper has been structured to develop our argument and recommendations in five main sections based on a discussion of:

- The Nature of Research
- Theory – An Essential Ingredient of Research
- The Historic Role of Research in Accounting Education and Practice
- The Causes for the Failure of Accounting Research
- Accounting Research : Re – conceptualisation and Re-modelling

In the section titled *Accounting Research: Re-conceptualisation and Re-modelling*, we will suggest two models intended to provoke thinking about new directions and possibilities for research and its relationship with accounting education, training and practice. The paper then concludes with a brief reflection on the current situation and the importance of research as a social activity.

3. The Nature of Research

In the context of this paper, we may define research as a theory-based systematic investigation of, or enquiry into, a specific phenomenon either for the purpose of discovering new facts or critical exposition of existing knowledge. The findings that emerge are normally expected to contribute to knowledge and bring about positive social change.

Ijiri (1975) identified three necessary attributes of research findings that contribute to knowledge in this manner. The first is novelty, to distinguish creative activities essential to research from production activities. For example, while production activities can be subjected to a certain routine, creative activities are full of uncertainties and often require unconventional approaches. Thus, research that replicates an experiment would be valued much less than the original experiment, because the outcome of such replication tends to

add much less to knowledge than the original experiment. Furthermore, the repeated experiment could follow previously programmed procedures by the original effort. For example, since the first successful human heart transplant by the late Christian Barnard, a South African surgeon, subsequent successful similar transplants have not received as much publicity as the first. The same is true of the successful cloning of a sheep, Dolly, by two Scottish scientists. As Polanyi (1964) observed, no solution of a problem can be accredited as a discovery, if it is achieved by a procedure following definite rules.

But while the cloning of Dolly is novel and constitutes a significant research breakthrough, the vast majority of research is, at best, a marginal increment to existing knowledge. Just how large an increment needs to be in order to constitute a worthwhile and novel piece of research, is debatable. Thus, two highly skilled researchers may take very different views of the same research due to either personal biases or current research climate.

Defensibility, either through logical proofs or empirical verification, is another attribute of research findings. Defensibility, according to Ijiri, facilitates reproduction and verification of findings by other researchers. Reproduction and verification make research findings usable by anyone, independently of the original researchers. Research findings are thus distinguished from personal opinions, which cannot be evaluated without references to those expressing the opinions.

However, in reality, lack of data access, proprietary rights to databases, and lack of incentive may make replication difficult, especially as few publishers may be interested in publishing replications. Furthermore, many researchers invest valuable hours and much money in developing their extensive database in a given area. Such researchers may see the database as a comparative advantage and be very reluctant to share their database with others. In accounting, a more fundamental problem is the inability of subsequent researchers to develop new accounting data comparable to that in the original study. Therefore it may be impossible to corroborate independently the findings and conclusions originally reported. There are, therefore, constraints to defensibility of research findings on the basis of their potential for reproduction by other researchers for independent verification.

The third characteristic of research findings, according to Ijiri, is dissemination. Research findings that are not, or cannot be disseminated, cannot contribute to knowledge. No matter the important the discovery, it will not benefit knowledge if the researcher locks up the findings or is systematically prevented from reporting them. Both the researchers and those who control the reporting context must be adequately motivated to make the results known as widely as possible. However, there could be problems where researchers and the "gatekeepers" of research dissemination have different perceptions about the importance of research findings (Demski 2001).

4. Theory – an Essential Ingredient of Research

The above characteristics of research findings suggest that research is a theory-based social activity in which observed phenomena are tested with reference to known theory, or a theory is tested with reference to observed phenomena. The results, whatever they are, contribute to knowledge. The contribution, however, may or may not be significant. We assert, therefore, that theory is an essential element in research. It provides "a set of interrelated constructs, definitions, and propositions that present a systematic view of phenomena by specifying relations among variables with the purpose of explaining and predicting the phenomena." Kerlinger (1964:1). The purpose of research as a theory-based social activity is to create and document knowledge of relationships and phenomena. Research is then designed and intended to use theory as a reference for the investigation.

In general there are two types of theory – positive and normative.

• Positive theories attempt to describe real world situations as they are.

Research based on positive theories involves empirical observations of the relevant phenomena from which a problem is defined. Data relevant to the problem are then collected and hypotheses formulated and tested by independent process. If the theory that results is an accurate representation (description) of the empirical phenomena, such a theory can be used for predictive purposes. Induction follows empirical observation and takes the form: "If event Y takes place, then the outcome will be Z". The greater the number of empirical observations, the better supported the related induction will be.

• A normative theory is a goal-oriented theory that represents real-world situations, not as they are, but as they should be. It is prescriptive rather than descriptive theory that explains and sets out, principles of what ought to be. Normative theories are characterised by goal assumptions and deduction.

Each type of theory has its strengths and weaknesses. Positive theories can take various descriptive forms. One form is the verification of the accuracy of its representation through logical deduction. Another is appraisal of the extent to which observations agree with deductions. Checking the size and selection method of observations and the induction process itself is yet another form of defence of descriptive theory.

A major strength of positive theory is its predictive ability. It also enables hypotheses to be tested against observations. But if the observations are biased, there can be prediction errors. Furthermore, if the observations are partial or relate to samples with characteristics unrelated to the population, it will be difficult to generalise conclusions from findings.

The strength of normative theories is their feasibility, and ability to demonstrate convincingly, that a specific event should take place if a specified goal is to be attained. The inductive process of descriptive theory and the deductive process of normative theory are interrelated in that the deductive proc-

ess may also be applied to empirical observations, if reality is to be changed to a more preferred state as indicated by the assumed goals (Ijiri 1975). As also argued by Ijiri, a normative theory need not be counter-empirical. This is particularly so where the existing system is optimal. The outcome, under such circumstances, would be a convergence of both positive and normative theories.

The goals on which normative theory is based need not be actual. The researcher need not accept or subscribe to these goals. But since the goals may depend on personal judgments, the researcher may find it difficult to exclude personal biases. Attainment of the assumed goals may be difficult where they are ambiguous or lack detailed operational specifications.

Some qualitative researchers in the social sciences have advocated a "grounded theory" as an alternative to positive and normative theories. Miles and Huberman (1991), and Patton (1990), are among such advocates. Straus and Corbin (1990: 23) define grounded theory as one "derived from the study of the phenomenon it represents". It thus has some elements similar to positive theory. However, instead of starting with a theory and then proving it empirically, grounded theory-based research "begins with an area of study and what is relevant to that area is allowed to emerge" (ibid.). Conceptually, grounded theory can be viewed as a technique for building theory based on observed social science phenomenon, using data derived from the research activity. Cynically, it is based on the idea of data in search of a rationalisation. It would be difficult to establish, convincingly, the superiority of a grounded approach to either positive or normative approaches. For example, the determination of relevance in a study phenomenon would still be a matter of personal judgment and subject to personal bias. The existing "decision usefulness" theory of accounting which underlies the Concept Statement of the Financial Accounting Standard's Board (FASB) is a classic example (see Staubus 2000).

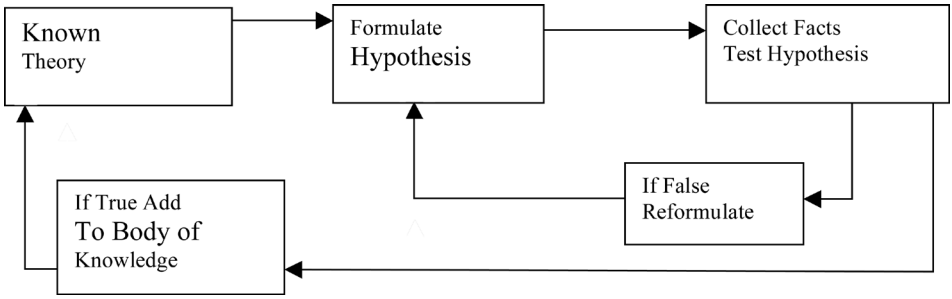
Indeed, since the 1960s, accounting research has increasingly moved away from normative (e.g. Chambers, 1966) to positive (e. g. Watts and Zimmerman, 1986). This development, according to Watts and Zimmerman (1986), has been attributed to the introduction of large-scale empirical studies that use economics and finance concepts to analyse the behaviour of capital markets, and which led to the development of efficient market hypothesis with significant impact on accounting research. Subsequent studies, such as Ball and Brown (1968) produced findings that were inconsistent with the prescriptions of normative accounting researchers.

5. Tricker's research models:

Two accounting research models presumably intended to achieve the purpose of research as a theory-based social activity, were suggested by Tricker (1978).

The first, shown in Figure 1, is the classical model that Tricker labels a "feed forward" model.

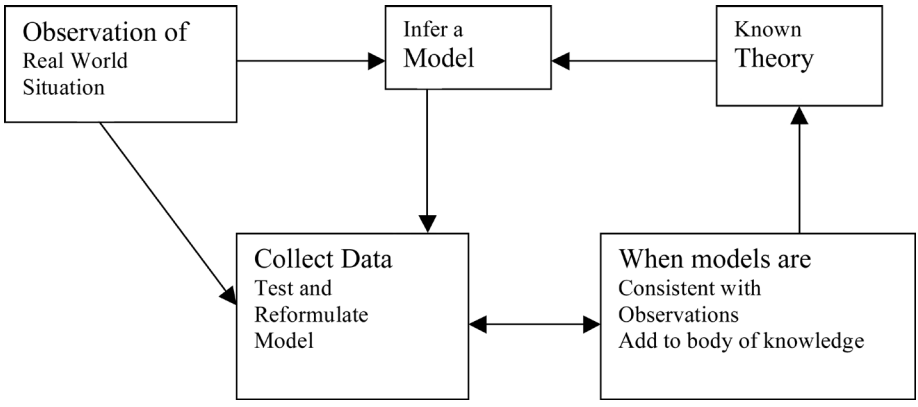
Figure 1. – TRICKER'S CLASSICAL RESEARCH MODEL.



Starting from known theory, the researcher formulates a new hypothesis and collects facts to test the hypothesis. If the hypothesis is false, the researcher reformulates the hypothesis. If the hypothesis is proven to be true, then a new theory emerges and adds to the body of knowledge.

The second approach is one that adopts a feedback as different from the "feed-forward" process of the classical method in Figure 1. This approach is shown in Figure 2.

Figure 2. – TRICKER'S FEEDBACK MODEL OF ACCOUNTING RESEARCH.



In the above approach, the researcher observes the real world situation and, in the light of known theory, formulates a model, checking the generality of its application. If the model is found consistent with observations of the real world, the findings of the research are added to the body of knowledge.

6. Problems with Theory in Accounting Research

The role of theory as an essential ingredient of any research was discussed earlier in this section. Its centrality in accounting research is further underlined in Tricker's models, both based on "known theory", shown in Figures 1 and 2. The basic problem in applying either of the models in practice is identifying what is "known theory" in accounting.

Traditionally, what constitutes accounting theory has evolved over time as a set of rules and principles, strictly utilitarian in function, aimed at guiding accountants in financial reporting, i.e., GAAP. The principles are essentially pragmatic, describing the structure of accounting practice, having evolved from observations of existing practice. The essential ingredients of a "good theory" are conspicuously absent in these principles. These ingredients, as agreed by Ryan, Scapens and Theobald (2002), are predictive ability, internal and external consistency, ability to generate implications that can be refuted by empirical testing and provision of focus to guide and direct research into empirical problems. Thus, the "decision usefulness theory" is unsupported, untested, and un-testable by known theory. It is a grounded theory.

The consequence of a lack of "known theory" in accounting satisfying these requirements has been the emergence of fragmentary accounting theories that tend to preclude the development of conceptual standards by which existing and proposed practices can be evaluated. The practical outcome has been the existence of numerous alternative practices, according to Caplan (1972), each capable of producing substantially different results, all of which are considered acceptable. In the absence of basic accounting theory, practising accountants are incapable of evaluating effectively what they are doing and providing innovation in response to new demands as they arise, e.g. accounting for the effects of changing price-levels and "intellectual capital".

Another result of the lack of a basic accounting theory is what Ijiri (1975) has described as "accounting theorising", which exists in the form of dogmas. Dogmas, according to him, are authoritative statements of opinion that must be accepted on faith. Such statements are, however, useful for the accounting profession by enabling respected leaders to exercise influence over accounting practice, thereby providing a unifying and coherent force in the profession. Ijiri goes on to argue that dogmas will remain effective so long as members of the profession are willing to accept and be bound by respected opinions. But because such statements are sometimes internally inconsistent, they lack the logical and convincing framework required for empirical testing and verification. Positive and normative accountings theories are needed to facilitate an evaluation of existing and proposed accounting practices as well as identify appropriate areas of further research.

In spite of these problems, much effort has been directed, in recent years, towards developing a general theory, a conceptual framework (Macve, 1981), a

statement of principles by the UK Accounting Standards Board (ASB), which has attracted criticism by Baxter (1999), and Bromwich (2001), to guide accounting practice. Different categories of empirical research have also been carried out. These include predictive ability research examining the relevance of historical financial reports to investors in making estimates of the future. Research has also been carried out on the behaviour of users of accounting information, using concepts from the behavioural sciences. Efficient markets research, using concepts in economics and finance, has also been carried out examining how accounting information affects share price movements in the stock market.

Empirical research, which is concerned with facts, is often preferred to *a priori research* that tends to focus mostly on abstractions. In 1992/93 the American Accounting Association (AAA) set up a committee to locate and publish the types of research methodologies and data bases currently being used by international accounting scholars and explain the methodologies, data bases, as well as research questions, for which they are appropriate (American Accounting Association, 1993).

The committee's report, which was published in July 1993, advised against any impression, such as implied in Tricker's models, that the research process is a strictly linear "scientific" sequence of hypothesis statement, data collection, data analysis, refutation or support of initial hypothesis, followed by a research report and discussion of findings. They argue that rather than take this straightforward route, the researcher, requiring multiple interventions and difficult questions, often takes a more intricate approach. The committee suggested that the potential researcher could ask known and experienced researchers to describe how they conducted the research that resulted in publication. However, this approach leads to more of the same type of research, i.e. replication not innovation.

7. The Historic Role of Research in Accounting Education and Practice

Both positive and normative theories discussed earlier should provide a framework for evaluating current and developing new accounting practice. Accounting practice emerging from such a framework would have been tested for logic, consistency and relevance. But evidence seems to show that this is hardly ever so in accounting practice.

The picture painted by Sterling (1973) in his characterisation of the relationship between accounting education and accounting practice, also cited by Arnold (1989), accounts for the generally observed, historic lack of linkage among them and is reflected in Figure 3.

Figure 3. – HISTORIC RELATIONSHIP BETWEEN EDUCATION AND PRACTICE.

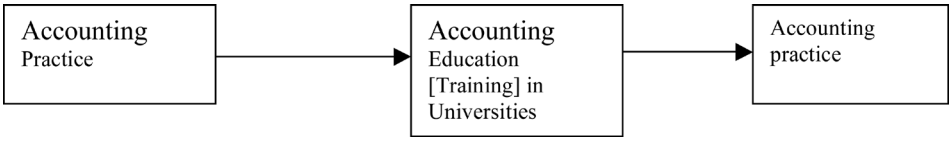


Figure 3 reflects the tendency for accounting educators in universities to concentrate on teaching what is practised, so that students can go out to practise what has been taught. Essentially the employers of recent graduates are more concerned about how quickly the recruit will be billable, rather than how well educated the person is. The education / training paradigm is thus driven by the requirements of employers, not the education needs of students (Demski 2001). Faculty research, if any, plays virtually no role in the students' educational process. Indeed, very limited accounting research is currently going on in many universities, due to a lack of funds and instruction oriented toward the requirements of practice. Moreover, issues related to evaluation of research productivity of accounting academics have tended to limit research output (Brinn, Jones and Pendlebury 2001, Bublitz and Kee 1984, Parker, Guthrie and Gray 1997).

In recognition of the above problems, Albrecht and Sacks (2000) have highlighted the need for greater focus of university accounting on generic skills, such as problem solving and communication and the broadening of the accounting curricula. These ideas were initiated by the Accounting Education Change Commission (Sundem 1999). More recently, the American Institute of Certified Public Accountants (AICPA) Vision Project identified five similar competencies that should be developed in the university education process (AICPA 2000). As explained in the Final Report (AICPA 2001), these core competences are aimed at providing value and results to the user through a unique combination of human skills, knowledge and technology. Interestingly, none of these suggests an emphasis on technical accounting training, or accounting research.

Demski (2001) attributes the present practice-orientation of accounting curriculum to four contributory factors:

- Employers whose focus is on immediacy and tend to expect universities to produce students with well-equipped skills for immediate employment as professionals.
- Administrators and accreditation bodies who respond to employers' demands for technical content.
- Publishers who publish only books developed with the aid of focus groups and which are compilations of technical pronouncements.

- Academics, who instead of giving intellectual leadership, tend to ask employers what should be included in the curriculum.

There is also the misleading tendency to assess the quality of the university curriculum in accounting by how many and how well, students are able to pass the professional accounting examinations with minimum attempts. The contents of accounting syllabuses in many universities are more often than not influenced by the technical content of qualifying examinations of professional accounting bodies. It appears that academia has lost sight of the fact that the professional relevance of a university accounting degree is not an exclusive function of the extent to which the degree curriculum replicates current professional techniques and practice, which forms the basis for the profession's qualifying examinations.

Thus, the initial bias in both the UK and American accounting education had been towards practice rather than research. In the eyes of many American accounting academics and university administrators, even today, the single most critical measure of the quality of accounting education is student success on the uniform CPA examinations. It is a statistic which is easy to obtain, but it measures technical training in accounting, not education.

Speaking of his experience as an articled clerk in a UK firm of chartered accountants, Professor Tricker (1978:5), at the first Arthur Young Lecture he delivered at the University of Glasgow in Scotland, confessed:

> I cannot remember accounting research ever being mentioned. In five years of practical and very valuable experience, not once did I recognise the subject as one with frontiers and with unknowns waiting to be explored. On the contrary, I was trained in a methodology which I saw as precise, accurate, quantitative, and relevant, a way to capturing the transactions of the real world truthfully. I was dealing with facts and we knew what we were doing.

The personal work experience of one of the authors of this paper in a US-based "big 5" accounting firm is consistent with Tricker's experience. Several recent informal interviews conducted by one of the authors with current employees of large firms and sole practitioners in the US reveal that academic research in accounting is of little or no value or interest to practitioners. This view was further confirmed at the 2001 Annual Conference of The Accounting Association of Australia and New Zealand (AAANZ) in Auckland, New Zealand. The keynote speaker, Frank Selto (from the University of Colorado in Boulder), reported results from a very recent study into the link between accounting research and practice. He found significant gaps between what is currently of interest to practitioners (as reported in professional journal articles) and what is being researched by accounting academics (as reported in academic journal articles).

Tricker's experience and recent anecdotal evidence show that research was not considered relevant to the training of UK chartered accountants in Trick-

er's time, or to individuals in practice today, both in the US and countries of Western Europe.

Sir Bryan Carsberg[1], who began his academic career as a Lecturer in Accounting at the London School of Economics and Political Science (LSE) in 1964, shares Tricker's views. Reflecting on his experience, in a foreword to Cooke and Nobes (1997), Sir Carsberg (1997:xi) observed that "…an enormous and regrettable gulf [exists] between accountants in practice and accountants in academia. Academia had little influence on practice. And there were differences of opinion about how to change that situation". Such differences of opinion existed, even among distinguished academics, before Sir Bryan Carsberg, as far back as 1948. (Parker 1995, Zeff 1997).

Serious academic study of accounting in UK universities started only at the beginning of the twentieth century, Hopwood and Bromwich (1988), Parker (1995), and Zeff (1997). The first full time Chair in Accounting in any British University was established in 1947 at the LSE – Professor W. T. Baxter. Prior to this he was at the University of Cape Town in South Africa. Now an Emeritus Professor of Accounting at the School, he retired in 1973.

Until Professor Baxter's appointment, accounting played only a subsidiary role at the LSE as a supporting subject in the B. Com. Degree programme (Dev[2] 1980). Similar views were held at Oxford and Cambridge Universities, the two oldest British Universities. At Cambridge, accounting was taught only as a part of the mathematics tripos until the nineteenth century (Ryan, Scapens and Theobald, 2002). At Oxford, accounting was "regarded as a pedestrian, commercial, workaday subject, quite unworthy of being admitted into those dignified halls…" (Boulding, 1977:86). A Chair in Finance and Accounting has since been established at Cambridge by the Institute of Chartered Accountants in England and Wales (ICAEW) in the Department of Applied Economics to which Professor Geoffrey Whittington, a former student of Professor Baxter at the LSE and a Chartered Accountant, was appointed as the first incumbent.

Academic study of accounting that subsequently followed, led to a growing demand for accounting courses and the establishment of accounting departments in several U.K. universities. Increasing demand for scholarly publica-

---

[1] Sir Bryan Carsberg had the distinction of being the first member of the Institute of Chartered Accountants in England and Wales to be appointed to a lectureship in a top British University without a first degree. He subsequently obtained, with distinction, the M.Sc. (Economics) degree of the University of London in 1967, specialising in Accounting and Finance. Appointed Professor of Accounting and Business Finance in the University of Manchester in 1969, he returned to the LSE in 1981 to occupy the Arthur Andersen Chair of Accounting. He was knighted by the Queen in January 1989 and is currently the Secretary – General of the International Accounting Standards Committee.

[2] Professor Susan Dev, an alumna of the LSE, was appointed in 1979 to the Chair, which had become vacant after Professor Baxter's retirement. Now an Emeritus Professor of Accounting at the School, Professor Dev was the first woman to be appointed Professor of Accounting in any British University.

tions in accounting, according to Hopwood and Bromwich (1988), led to the launch in 1970, of a research journal, ***Accounting and Business Research***, by ICAEW. Subsequently, Sterling (1973) proposed a normative model, including research that is illustrated in Figure 4.

Figure 4. – STERLING'S NORMATIVE RELATIONSHIP AMONG ACCOUNTING RESEARCH, EDUCATION AND PRACTICE.

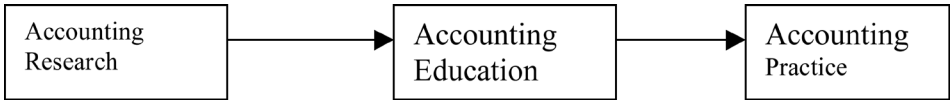


Figure 4 demonstrates that the content of education in accounting should be determined by research findings which students, after their education, should implement in practice. The model, however, tends to omit a possible feedback loop between accounting research and accounting practice. Such a feedback could have demonstrated how changes in accounting practice could influence accounting research and education in order to induce changes in accounting practice.

The history of the development of accounting education and research in the US is similar to Sterling's suggested models. Over time, graduate and Ph.D. accounting programmes in the US were established to provide a more traditional academic teaching cadre and presumably provide the man/woman power to do research. However, the public accounting profession's need for technically trained university graduates was not de-emphasised. In the UK, Ph.D. programmes in accounting are a recent development.

There is no doubt that substantial human and financial investments have been made in academic research in both the US and the UK. Yet, as the researchers of the Jenkins' Committee (1994) found, financial accounting statements in their current form and with their current content do not serve their intended audience well. This is a conclusion supported by the research reported by Epstein and Birchard (1999). One can only conclude that most of what has been done in the name of accounting research has not resulted in better practice. The discussion below will suggest and develop reasons for this apparent failure.

8. The Causes for the Failure of Accounting Research

The essence of research in any discipline is discovery. Without discovery, no research can make a significant contribution to knowledge. Bernal (1971) sees the essential feature of a strategy of discovery in terms of determining the sequence of the choice of problems to solve

Some scholars perceive accounting as lacking the paradigm necessary to qualify it as a normal science, a perception that has implications for the choice of research method. Sterling (1972) argued that research method cannot be chosen independently of the research question. The research question itself, in his view, cannot be formulated unless the researcher believes that the answer to the question is likely to be important. But this cannot be known until after the research has been performed. A researcher should therefore select his/her research question based on his/her perceived importance of the answer to the question that, in turn, will influence the choice of research method.

Sterling goes on to suggest that if the researcher's focus is the behavioural effects of accounting, he/she will select research methods of behavioural sciences. Methods of research in mathematical sciences will be appropriate if the researcher is interested in exploring the mathematical dimensions of accounting. He concludes that a meaningful appraisal of the appropriateness of a research method cannot be carried out without reference to the research question that is to be investigated. But, on the other hand, it may be argued that many research questions can be answered through a combination of behavioural and mathematical approaches. For example, if we were interested in discovering what factors drive firms to adopt a certain accounting treatment, we can study this by combining qualitative methods (such as case studies) with empirical approaches (such as stock price impacts and balance sheet characteristics).

Another perspective on the importance of a proper understanding of the context within which research is conducted is described by Goldratt (1990). He suggests the taxonomy presented in Exhibit 1, extended to include accounting.

Exhibit 1. – GOLDRATT'S TAXONOMY OF RESEARCH CONTEXT DEVELOPMENT
Research Contexts

Stage	Example	Contribution	Accounting
Classification Schemes	Astrology	Development of categories and vocabulary	Pacioli Model Vocabulary—e. g., assets, liabilities, etc. Operational process—rules of algebra
Correlation oriented research	Astrology	Test internal and external relationships implicit in the classification schemes	Virtually all published academic research
Science	Astronomy	Development and test of theories and hypotheses	GAAP (Normative)

Exhibit 1 provides support for the earlier assertion that accounting may lack a paradigm, (e. g., researchable theories and hypotheses), necessary to be considered a science. Goldratt suggests that a science is the last stage in a process of research context development. This sequencing is important to our discussions on the significance of accounting research. If accounting is not a

science, and we contend that it is not, then any research done is limited to correlation analysis. In the case of accounting research, there is a high probability that a high degree of auto-correlation exists because accounting data or derivatives of it, e.g. stock prices are used recursively.

Furthermore, there is a major risk in conducting research using normative theories, which assume that the desired state is known, but which is not tested and evaluated with research. Research conducted in this context is self-serving and self – fulfilling, i.e. trivial. Most, if not all, financial accounting research is tied to GAAP, which is, itself, based on the assumption that general purpose, historical cost financial statements are informative and useful because they are reliable. This assumption is based on a wrong premise of linearity (Demski 2001) and stability of measurement that simply are not part of the real world. Zohar and Marshall (1994) and Zohar (1990, 1997) suggest that the real world is a "quantum world" characterised by ever-changing relationships and measurements. The dynamics of quantum mechanics that are the basis of Zohar's position were set out earlier by Hawking (1988).

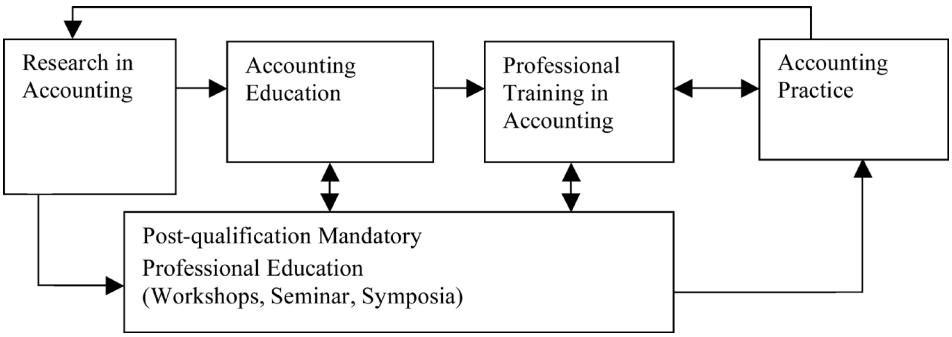
Professional accounting literature is full of criticism of current financial accounting and reporting practices. Probably the most notable, authoritative and frequently cited research findings were presented in the report of the Jenkins' Committee (1994). Essentially it was reported that most sophisticated users do not use the traditional financial statements, as they are prepared, to evaluate companies for investment or lending purposes, or for the prediction of future cash flows. These findings would seem to indicate that the desired goals of GAAP are not being obtained (Schneider 1997). The implication is that research based on GAAP is not advancing the achievement of the normative theories, which suggests that the research is trivial and/or the theories are faulty or both.

Research in accounting should aim at improving accounting practice in the same way, as the goal of medical research is to improve medical practice. The many breakthroughs today in medical practice would have been impossible without medical research. In medicine, there is a symbiotic relationship between medical research, medical education and medical practice. The picture is different in accounting. The relationship is disjointed, with wide gaps between accounting education, accounting research and accounting practice. Writers such as Carsberg (1997), Baxter (1988), Mautz (1978), Lee (1989), Hopwood (1988), Wallace (1997) Selto (2001) and Demski (2001) are among those who have commented on this gap and put forward reasons for its existence.

Accounting researchers, usually academics and practitioners have divergent interests. The perception is that most researchers are unconcerned with the immediate and short-term needs of the practitioners. While accounting practitioners are interested in short-term research results capable of providing an immediate solution to professional problems, the focus of researchers is on

academic career advancement and a professional reputation built on a publications record. Status is determined by the quality of the journals in which their research findings are published, not necessarily by the quality of the problem or findings. A comprehensive model is proposed in Figure 5 that provides for a more complex set of linkages, between and among, accounting research, education, training and practice (see also Arnold 1986, 1989). In the next section we will suggest an institutional context in which to make this model operational.

Figure 5. – PROPOSED LINKAGE BETWEEN AND AMONG RESEARCH, EDUCATION, TRAINING AND PRACTICE



Symptomatic of the failure of both the normative theory and related research is the observable response of the accounting establishment and of users. Each has responded differently. The Accounting Standards Bodies have reacted to the apparent communication problem by piling on more standards and disclosure requirements. This is the "standards overload" problem that is generally recognised by practitioners. Users have sought alternative sources of information to move from "reliable trivial" to "relevant substantive", meaningful and timely information that relates to the decision at hand. Thus, users have developed their own research paradigm based on *ad hoc* information needs, rather than abstract prescriptions and normative, positive or grounded theories.

It must also be remembered that some research findings, judged to be unacceptable by the reviewers of submissions and editors of "high quality" journals, may be so because it poses a challenge or threat to long held positions and values, i.e. the normative theory of GAAP. This was exemplified in a special edition (Vol.12 No.2, April 2001) of *Critical Perspectives on Accounting* with various commentaries that were quite critical of both the present structure of the AAA and how editors of some accounting journals review manuscripts submitted to them for publication. A previous study by Lee (1999) had also examined the membership of the AAA Executive Committee and

concluded that it had been dominated, throughout its history, by academics from three major US universities.

Findings of a recent study by Brinn, Jones and Pendlebury (2001) similarly explained why many UK accounting and finance academics, in general, do not publish in top US journals. The reasons given by the academics included "not being in the US network, working with non – US data, the existence of gatekeepers and constraints of US methodology". In support of constraints imposed by methodology, evidence shows that most of these journals, with very few exceptions, do not accept research papers using field research. Consequently, but not surprisingly, too few accounting researchers choose to employ field-based designs in their research, a point empirically proved by Young and Selto (1993).

Not infrequently, the gestation period of some of these research efforts is so long and results are so slow in coming, that accounting practitioners tend to consider them irrelevant to their short-term problem-solving needs. For example, it is generally conceded that major topics identified by the Financial Accounting Standards Board (FSAB) for research and pronouncement development frequently require seven years or more to bear fruit. The painstaking due process of the FASB led to the establishment of the Emerging Issues Task Force (EITF) to respond to practitioner needs on a timely basis. As Baxter (1988:3) puts it:

Practical men give plenty of reasons for ignoring, and sometimes disparaging, academic research. Thus, they find its subject matter remote. They shy away from its statistical tables, and mathematics. They regard its jargon as pretentious. They feel that the writers are excessively concerned to demonstrate familiarity with "the literature"; the many-bracketed references in the text are irritants, as is the end loading of full references. Research should be written up with brevity and clarity. It should possess clarity.… And, it could be added …and should be delivered in a timely, accessible manner.

Thus there is a lack of effective communication between accounting researchers and accounting practitioners. The situation is further exacerbated by the reality that relatively few people do accounting, while vast numbers of people with diverse backgrounds, interests and objectives use the work product of the accounting practitioners, (i.e. financial statements).

In essence, there is a double communication problem. Researchers and practitioners do not communicate with each other and the financial statements resulting from the practitioners' efforts do not communicate with users who do not effectively communicate their needs to either practitioners or academics. This situation exists because user needs are not known by practitioners, i.e. they are un-researched because the needs are assumed to be known. The environment is further exacerbated by various accounting regulatory agencies and the occasional brute force intrusion of political establishment to politicise accounting standards (Solomons 1983).

It is the disjointed nature of the interests and time frames that creates the gap between researchers, practitioners, and users. These gaps would not exist if accounting practice were to be broadly conceptualised as the primary objective of the study of accounting. Such broad conceptualisation would view accounting practice, not just in terms of how accounting information is prepared, but also in terms of the reaction of managers, investors, creditors and other stakeholders to whom such information is presented. Also included as part of accounting practice would be financial management, taxation, auditing and other institutional systems involved in the preparation and consumption of accounting information.

The researcher having this conception of accounting practice in mind would select and expand his/her research questions and methods with a view to controlling the empirical system within which accounting is practised, so as to improve its behaviour and make it more relevant to society. The researcher would also develop appropriate models of the system to move it towards intended goals. Inherent limitations in the current research environment are the assumptions of traditional, normative GAAP, which effectively constrain both the evaluation of posted goals and the conceptualisation of alternatives. In the next section we will suggest a different model for contemplating research related to accounting. .

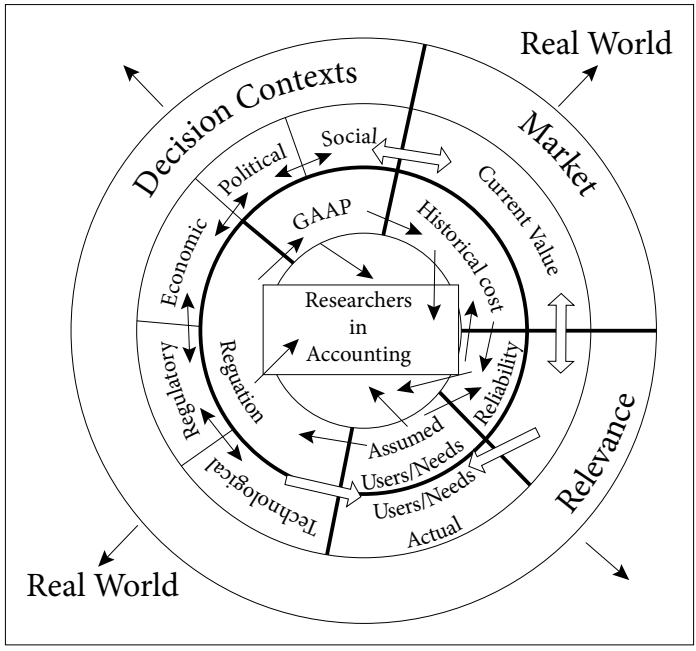
The discussion above leads to a number of conclusions. One of these is that accounting research tied to a normative theory expressed in terms of GAAP inhibits, rather than encourages substantive, meaningful research. Therefore, the context within which accounting is perceived, as a discipline worthy of research must be re-conceptualised as a means of communicating messages. Furthermore, the institutional context within which research is conducted and related to education and practice, must be understood and operationalised in a new way. Because of its algebraic structure and legalistic preoccupation, both in terms of what and how to report, accounting has imposed intellectual straightjackets on researchers. In the past, the result had been research of limited usefulness, except for the academic objective of establishing a publications record. Today, the world of the traditional researcher is imploding. These conclusions call for a re-conceptualisation of accounting, which we discuss in the next section.

9. Accounting Research: A Re-conceptualisation and Re-modelling

Joel Demski (2001), in his Presidential Address to the AAA Annual Meeting in Atlanta, Georgia, observed that accounting research has linearised everything. That is, most research methodologies are based on correlation analysis and the models have great rigidity limiting both the questions and the subsequent analysis. Essentially, this implies that accounting research is disconnected from the dynamic non-linear, non-objective real world. It must

be recognised that accounting is a social science discipline used to describe economic activity. The evidence, on the other hand, suggests that accounting research does not relate well to the social context. Figure 6 presents this situation graphically. It suggests the complex of forces operating on the accounting researcher and the clear need for effective communication.

Figure 6. – THE MACRO-ENVIRONMENT AND FORCES IMPACTING RESEARCHERS.



The space outside the circles represents the real social world. If it could be modelled mathematically, it would consist of an infinite number of interdependent, interrelated, highly correlated multivariate functions. The implication is that everything that happens in the real world is related to everything else. This is the "quantum world view" suggested by Zohar and Marshall (1994), and Zohar (1990, 1997).

The two outermost concentric circles identify a set of broad categories of variables and functions drawn from the "quantum world" that typically are associated with economics and business decision-making and which motivate the real needs of accounting information users: the social, political, economic, regulatory and technological forces. The information and data needs of users are simultaneously generic and situation specific. They, in large part, arise on an *ad hoc* basis at a point in current time, driven by information requirements and priorities unique to the decision at hand and the decision maker. This is the context of the real world: dynamic and kaleidoscopic, subject to both evolutionary and revolutionary change.

The inner two circles suggest the "pin wheel" of classic accounting research. It is bound and constrained by GAAP, accounting, regulations and law, which determine the set of variables contained within accounting and the way those variables are defined and quantified. Accountants assume, through the "decision-usefulness theory of accounting" that the needs of users are known to them and are generic. This gives rise to the idea that management-prepared general purpose historical cost (modified to increase assumed relevance) financial statements are useful. They may be, but they are static and legalistic, rather than dynamic and flexible. The research models built in this context are recursive and limited to correlation analysis. The boundary between the "pin wheel" and the real world – based circles is almost impermeable. It reflects the disconnection between the accounting domain and its related research activities and the real needs of accounting information and data users.

Thus the real world environment described by the space outside the circles and the two outside concentric circles, above is very unlike the assumed environment in the "pinwheel" circles. Inevitably, classic accounting fails to relate to and have a significant impact on meeting the real needs of accounting data and information users, because the "world view" of the accounting researcher is dramatically different from that of the user.

Not only is the usefulness and relevance of the output being questioned, but also the legitimacy of accounting as an academic discipline itself, especially in the US where it is also being challenged. Perhaps the lack of intellectual content has caused the "best and brightest" to pursue other disciplines. There is a widespread decline in the size of university accounting programmes in the US. Albrecht and Sack (2000), in their Report, have estimated the decline at more than 20 per cent. They suggest the factors responsible for this decline as a decrease in staff salary levels, increasing alternative career levels, and misinformation and lack of information about accounting and accounting careers.

Professional accounting bodies on both sides of the Atlantic have expressed concern about the future of the profession in the 21st century. It has been said that the challenges facing the profession in the US, for example, if left unchecked, could lead to the extinction of the profession. According to the AICPA, the extinction could be similar to that which consumed buggy-whip manufacturers or, more recently, typewriter repairers (Tilberg 1999). In the UK, the ICAEW is concerned about what the market for Chartered Accountants is likely to be in 2005 and whether the profession will develop at sufficient speed to meet market demands (Bruce 1998).

There are also threats to the profession. The mechanics and processing are now being taken over by computers, as raw accounting data becomes more easily accessible to users through data bases and communication protocols, as e-Business alters the way businesses interact and as the needs of the market place shift from valuing producers of accounting information (i.e. practitioners), to the users of it in decision-making contexts.

Figure 7. – POSSIBLE RESEARCH DISCIPLINES RELATED TO ACCOUNTING

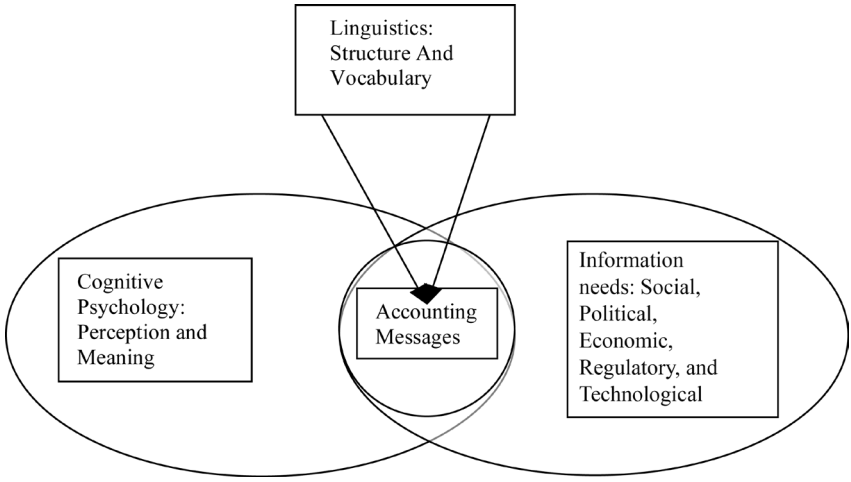


Figure 7 suggests that other disciplines provide means to enrich and improve the relevance of accounting research. They are part of the real world domains that are open to and seek evidence of change and the dynamics (i.e. the motivation) for and implications of change. They are all related to developing an understanding of what information is and how it is communicated, processed and used by people in the social context on a real time, dynamic basis. The three lobes and others could graphically be set in another Venn diagram with the space outside the lobes defined as the "real world" as in Figure 6. The significant differences are that accounting is understood as a way of structuring and communicating messages without the normative assumptions of GAAP and the self–serving, self–defined constraints of classic accounting research.

Figure 8. – THE INSTITUTIONAL CONTEXT OF ACCOUNTING RESEARCH, EDUCATION, AND PRACTICE

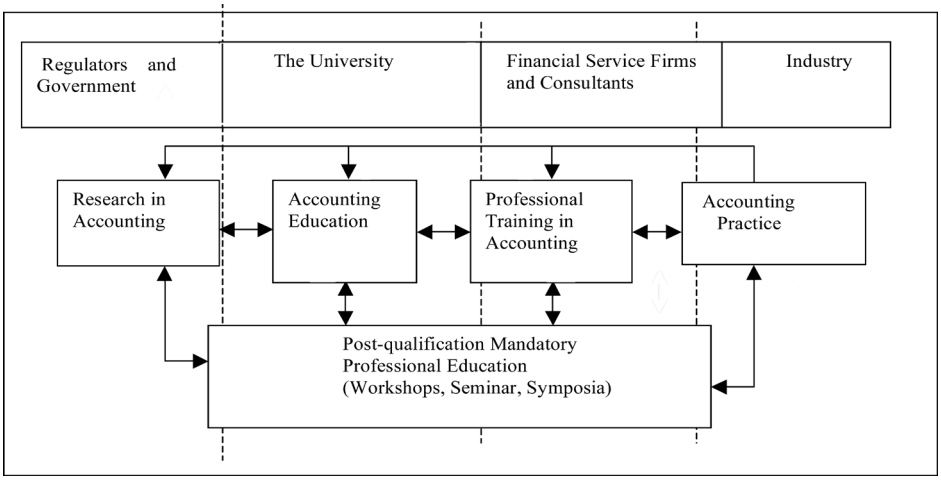


Figure 8 incorporates Figure 5 to make it operational in relevant institutional contexts. The linkages in the figure clarify the relationships between the elements presented and the enabling social environment that supports and makes demands on, accounting research, education and practice.

10. Summary and Conclusion

This paper is based on two fundamental premises. The first is that accounting research is largely trivial, because of the absence of referent theory for testing and evaluating accounting theorising. The second premise arises from the first. This is that accounting research is inadequately related to practitioner and user needs because of the lack of meaningful and constructive communication amongst researchers, practitioners and users.

The attributes of research suggested by Ijiri (1975) are not found in accounting research because of the lack of theory. There is a lack of novelty in research methods and questions; the conclusions and findings are not readily subjected to independent replication and, therefore, may not be defensible and academic researchers may be prevented from sharing controversial findings as a result of the self-protective tendencies of senior academics, some journal editors and reviewers. We have suggested that the "decision usefulness" theory of accounting, on which GAAP is based, is a grounded theory. It is normative, based on a set of assumptions that have not been tested. Accounting, as a discipline, is not a science and as suggested by Goldratt, research results in this context are limited to correlation analyses. The use of sophisticated scientific research methodologies does not change the basic situation.

Research is an important aspect of the development of both education and practice. Accounting "education" in most universities has been committed to training new accountants for practice. The more intellectual dimensions related to questioning and the evaluation of purpose and alternatives have not been emphasised. The questions of interest to academic researchers have been constrained by the domain of GAAP and the biases of research publication editors and reviewers. These questions have tended not to be the questions of practitioners or users. We suggest that the university training process has inculcated in the practitioners and users a disrespect, and disregard for intellectually motivated accounting research. Thus, there are different agendas being served, or not being served, by accounting research.

We suggest that accounting be understood as a communication activity required by society and the real world. Accounting researchers, therefore, must look outside of the self-defined "decision usefulness" theory to other disciplines/sciences for referent theories related to communications, economics, philosophy and quantum mechanics, for example. Researchers need to ask practitioners and users questions about issues of importance to them. The academic community must infuse the accounting curriculum with the in-

tellectual demands and benefits of research as a socially desirable objective. The "gatekeepers" of dissemination vehicles, e.g. editors, reviewers and theses supervisors, must be more tolerant and supportive of research that is novel and controversial.

Research must be considered in a complex environment of many constituencies with diverse interests and information needs. Each has its unique cognitive sets and world contexts. Accounting research, if it is to be relevant, must be tailored to a specific context, but not excluding appropriate interrelationships and interdependencies. Perhaps in time, some general theory of accounting as a communication process, capable of servicing a wide range of user needs, with generally accepted and understood constructs and models will emerge. The theory will relate to communication of information to diverse users. It will be sufficiently robust to provide a basis for global communication of economic events that have occurred and will be linked logically to the decisions of today and tomorrow.

REFERENCES

Albrecht, W. Steve and Robert J. Sack (2000), *Accounting Education: Charting the Course Through a Perilous Future*, American Accounting Association Accounting Education Series, and Vol. No. 18

American Accounting Association (1993), *Report on Research Methodologies in International Accounting*, The International Accounting Section.

American Accounting Association Financial Accounting Standards Committee (1999), Shaping IASC for the future. *Accounting Horizons*, 13 (December) pp.443-456.

American Institute of Certified Public Accountants (1994), *The Special Committee on Financial Reporting (The Jenkins' Committee) (1994) Improving Business Reporting—A Customer Focus*, New York, NY, AICPA.

American Institute of Certified Public Accountants (2000), *The AICPA Vision Project: Role of the CPA*, New York, NY, and AICPA.

American Institute of Certified Public Accountants (2001), *CPA Vision Project 2011 and Beyond*, New York, NY, AICPA.

Anya, A.O. (1982), *Science Development and the Future: The Nigerian Case*, University of Nigeria Press.

Arnold, J. (1986), *The Education of Accountants at the Crossroads, The Fourth Armitage and Norton Lecture*, Huddersfield Polytechnic.

Arnold, J. (1989) Accounting Education and Research: The Role of Universities, in G. Macdonald and B.A. Rutherford, eds. *Accountants, Accounting and Accountability*, London, Van Nostrand Reinhold (International and The Institute of Chartered Accountants in England and Wales.

Ball, R., P. Brown (1968), An Empirical Evaluation of Accounting Income Numbers, *Journal of Accounting Research*, 6, (Autumn) pp. 159-178.

Baxter, W.T. (1988), *Accounting Research – Academic Trends versus Practical Needs*, Edinburgh: The Institute of Chartered Accountants of Scotland.

Baxter, W. T. (1999), The ASB on Principles, *Accountancy*, October, pp.75-76.

Bernal, J.D. (1972), Science In History Volume 1, *The Emergence of Science*, Cambridge: The M.I.T. Press.

Blaug, Mark (1997), *The Methodology of Economics*, Cambridge: Cambridge University Press.

Boulding, K.E. (1977), Economics and Accounting: The Uncongenial Twins, in W.T. Baxter and S. Davidson (eds.) *Studies in Accounting*, London: The Institute of Chartered Accountants in England and Wales.

Brinn, Tony, Michael Jones, Maurice Pendlebury (1996), UK Accountants' Perception of Research Journal Quality, *Accounting and Business Research*, Vol. 26 No. 3, Summer, pp265-277.

Brinn, Tony, Michael Jones, Maurice Pendlebury (2001), Why do UK Accounting and Finance Academics not Publish in Top US Journals?, *The British Accounting Review*, Vol. 33 No.2, June.

Bruce, R. (1998), Traditional Route is Key to the Future, *The Times*, February 26, London.

Bromwich, M. (2001) Angels and Trolls: The ASB's Statement of Principles for Financial Reporting, *The British Accounting Review*, Vol. 33, No. 1, March 2001, pp.47-72.

Bublitz, B., R. Kee (1984), Measures of Research Productivity, *Issues in Accounting Education*, pp39-60.

Chambers, R. J., Accounting, Evaluation and Economic Behaviour, Englewood Cliffs, NJ: Prentice Hall.

Cooke, T. and C. Nobes (1997) (ed.) *The Festschrift in Honour of R. H. Parker*, London: Routledge.

Caplan, Edwin H. (1972), Accounting Research as an Information Source for Theory Construction in Robert S. Sterling (ed.) *Research Methodology in Accounting*, Houston, Scholars Book Co.

Carsberg, Bryan V. (1997), Foreword in T. Cooke and C. Nobes (eds.) *The Festschrift in Honour of R.H. Panker*, London, Routledge.

Cohen, Morris R. and Ernest Nagel (1934), *An Introduction to Logic and Scientific Method*, Harcourt, Brace and World Inc.

Demski, Joel S.(2001), Some Thoughts on Accounting Scholarship, Presidential Address, August 22.

Dev. Susan (1980), *Accounting and the LSE Tradition*, London, London School of Economics and Political Science Inaugural Lecture

Dev, Susan and E. L. Inanga (1979) Educating Accountants in Nigeria, Accountancy, *Journal of the Institute of Chartered Accountants in England and Wales*, Vol. 90, No. 1028.

Dyckman, T.R. and S.A. Zeff (1984), Two decades of the Journal of Accounting Research, *Journal of Accounting Research*, 22 (1)

Epstein, Marc and Bill Birchard (1999), *Counting What Counts*, Reading MA, Perseus Books

FSAB (2001), *Improving Business Reporting: Insights into Enhancing Voluntary Disclosures*, Business Reporting Research Project.

Goldratt, Eliyahu M. (1990), *What is This Thing Called Theory of Constraints*, Great Barrington, MA, North River Press

Hawking, Stephen (1988), *A Brief History of Times*, Bantam Books (Random House Inc.)

Hopwood, Anthony G. (1988), Accounting Research and Accounting Practice: The Ambiguous Relationship Between the Two, in Anthony G. Hopwood (1988) (ed.) *Accounting from the Outside*, New York and London, Garland Publishing Inc.

Hopwood, Anthony G. and Michael Bromwich (1988), Accounting Research in the United Kingdom, in Anthony G. Hopwood (op.cit.).

Ijiri, Yuji (1975), *Theory of Accounting Measurement*, American Accounting Association.

Inanga, E.L. (1991), *Accounting and Accountability*, Inaugural Lecture, Ibadan University Press.

Inanga, E. L. (1998), *Linking Research in Accounting and Finance with Accounting Practice*, MSM Research Papers, Vol. XVIII, 1998, Maastricht School of Management, The Netherlands. (Originally presented at a Research Awareness Workshop organised by the Institute of Chartered Accountants of Nigeria.)

Inanga, E. L. and Wm. Bruce Schneider (Forthcoming), The Failure of Accounting Research to Improve Accounting Practice: A Problem of Theory and Lack of Communication, *Critical Perspectives on Accounting*.

Kerlinger, F.N. (1964), *Foundation of Behavioral Research*, New York: Holt, Rinehart and Winston.

Lee, T.A. (1989), Education, Practice and Research in Accounting: Gaps, Close Loops, Bridges and Magic Accounting, *Accounting and Business Research*, Vol. 19 No. 75 pp.237-253

Lee, T.A. (1999), Anatomy of a professional Elite: The Executive Committee of the American Accounting Association, *Critical Perspectives on Accounting*, Vol. 10, No.2. pp. 247-264.

Lintner, J. (1965), The Valuation of Risky Assets and the Selection of Risky Investments in Stock Portfolios and Capital Budgets, *Review of Economics and Statistics* 47 (February) pp.13-37.

Macve, R.H. (1981), *A Conceptual Framework for Financial Accounting and Reporting: The Possibilities for an Agreed Structure*, London: Institute of Chartered Accountants in England and Wales.

Markowitz, H. (1992), *Portfolio Selection*, Second Edition, Basil Blackwell, Cambridge, Mass.

Mautz, P.K. (1978,) Discussion in A.R. Abdel-Khalik and P.F. Keller (eds.), *The Impact of Accounting Research on Practice and Disclosure*, Duke University Press.

Miles, M. B. and A. M. Huberman (1991), *Qualitative Data Analysis – A Source Book of New Methods Sage Publications*, Beverly Hills, CA.

Miller, M.H. and F. Modigliani (1961), Dividend Policy, Growth and the Valuation of Shares, *Journal of Business*. Vol. 34, pp. 411-433.

Modigliani, F. and M.H. Miller (1958), The Cost of Capital, Corporation Finance and the Theory of Investment, *American Economic Review*, 48 pp.261-297

Mossin, J. (1966), Equilibrium in Capital Markets, *Econometrica* 34.

Parker , L. D., James Guthrie, Rob H. Gray (1997), *Publish or Perish: The Social Construction of Quality in Accounting and Management Research*, Mimeo. Working Paper.

Parker, R.H. (1995), David Solomons and British Accounting, *Accounting and Business Research*, Vol. 25, No. 100 pp.311-314.

Patton, M. Q. (1990), *Qualitative Evaluation and Research Methods*, 2ndEdition, Sage Publications, Los Angeles, CA

Polanyi, Michael (1964), *Personal Knowledge: Towards a Post-critical Philosophy*, Harper and Row Publishers.

Ross, S.A. (1976), The Arbitrage Theory of Capital Asset Pricing, *Journal of Economic Theory*, Vol.13 pp 341-360.

Ryan, Bob, R.W. Scapens and Michael Theobald (2002), *Research Method & Methodology in Finance & Accounting*, London: Thomson.

Selto, Frank H and Sally K. Widener (2001), *Relevance of Management Accounting Research*, Mimeo. Working Paper.

Schneider, Wm. Bruce (1997), *The Jenkins' Committee Report: Where Do We Go from Here*, MSM Research Papers, Vol. XVII, June-December 1997, The Maastricht School of Management.

Scott, William R. (1997), *Financial Accounting Theory*, Saddle River: Prentice Hall Inc.

Sharpe, W.F. (1964), Capital Asset Prices: A Theory of Market Equilibrium Under Conditions of Risk, *Journal of Finance*, Vol 19, pp.425-442.

Solomons, D. (1983), The Political Implications of Accounting and Accounting Standard Setting, *Accounting and Business Research*, Spring.

Staubus, George J. (2000), *The Decision-Usefulness Theory of Accounting*, Garland Publishers Inc.

Sterling, Robert R. (1972), *Research Methodology in Accounting*, Houston, Scholar Book Co.

Straus, Anselm and Juliet Corbin (1990), *Basics of Qualitative Research*, Thousand Oaks: Sage Publications.

Sundem, Gary L. (1999), *Accounting Education Change Commission: Its History and Impact*, AICPA/ACEG

Tilberg, R. (1996), CPA Leaders Forge New Vision, *Accounting Today*, Faulkner & Gray Inc.

Tricker, R.I. (1975), *Research in Accounting: A Strategy for Further Work*, London: Social Science Research Council.

Tricker, R.I. (1978), *Research in Accounting*, Arthur Young Lecture No. 1, Glasgow University Press.

Upton, Wayne S.(2001) *Business and Financial Reporting, Challenges from the New Economy*, FASB Special Report No. 219-A, April.

Young, S.M. and F. Selto (1993) Explaining Cross-Sectional Workgroup performance Differences in a JIT Facility: A Critical Appraisal of a Field-Based Study, *Journal of Management Accounting Research*, Fall, 300-26.

Wallace, R.S. Olusegun (1997), The Development of Accounting Research in the UK, in T. Cook and C. Nobes, ed., (op.cit) pp 218-257

Watts Ross L. , Jerold L. Zimmerman (1986), *Positive Accounting Theory*, Saddle River: Prentice-Hall International.

Zeff, S.A. (1997) The Early Years of the Association of University Teachers of Accounting: 1947-1959; *The British Accounting Review*, Special Issue, Vol. 29, pp.3-39

Zohar, Danah (1990), *The Quantum Self*, New York: William Morrow & Company Inc.

Zohar, Danah (1997), *Rewiring the Corporate Brain*, San Francisco; Berret-Koehler Publishers

Zohar, Danah and Ian Marshall (1994), *The Quantum Society*, New York: William Morrow & Company Inc.,

METKA TEKAVČIČ
DARJA PELJHAN

Activity-based Cost Management: Evidence From Slovenia

Abstract

The purpose of this paper is to emphasise the importance of the use of activity-based costing (ABC) and activity-based management (ABM) in companies facing a rapidly changing business environment, in particular in transitional economies. The aim of the paper is to develop a better understanding of ABC and ABM presence in Slovenian companies by providing the final results of empirical research conducted in them. In particular, we have sought to explore the following questions: Is there a common understanding and use of ABC and ABM among Slovenian companies?; Is there any relationship between the size of the company and the use of ABC and ABM? and Does the use of ABC and ABM affect the performance of Slovenian companies?

1. Introduction

Today, companies focus on the continuous improvement of work and the pursuit of excellence in their daily operations. They use different improvement techniques e.g. the management of processes rather than resources, the elimination of waste, improvements to processes that result in better, faster and cheaper services to customers and the empowerment of employees to create change. Companies focus on work activities and the relationship thereof to products or services provided to customers.

Companies that adopt "process-based thinking" should identify and quantify which work activities (and related costs) make up the processes. In particular, they should focus on the operational or process view of costs and aim to answer the question "What causes costs to occur?" Thus, they can facilitate performance improvements, focus on activities that add value and try to avoid non-value adding activities. A significant number of companies worldwide are implementing activity-based cost management systems, especially activity-based costing (ABC) and activity-based management (ABM). These systems trace financial and operating information to significant activities of the company and use this information to focus efforts to achieve excellence in their performance.

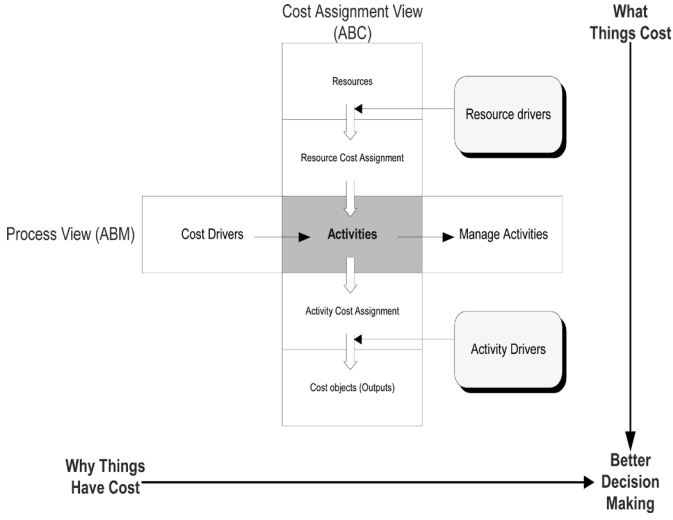
The purpose of this paper is to emphasise the importance of the use of activity-based costing (ABC) and activity-based management (ABM) in companies facing a rapidly changing business environment, in particular in transitional economies. In these economies, the recent business environment seems to have been, although less developed, very turbulent in some cases. For that reason,

the lack of managerial knowledge and absence of the use of modern cost management tools might be critical for the survival of companies operating in such circumstances. The aim of the paper is to develop a better understanding of ABC and ABM presence in Slovenian[1] companies by providing the final results of empirical research conducted in these companies. In particular, we have sought to explore the following questions: Is there a common understanding and use of ABC and ABM among Slovenian companies?; Is there any relationship between the size of the company and the use of ABC and ABM? and Does the use of ABC and ABM affect the performance of Slovenian companies? The aim of our research was to determine the current situation with regard to the number, size and performance of Slovenian companies familiar and unfamiliar with ABC and ABM, especially those implementing or using these concepts. The aim of this paper is to investigate the characteristics of companies familiar with ABC and ABM, focusing on those implementing or using them, by providing the final results of empirical research conducted in Slovenian companies. We also wish to point out some reasons why Slovenian companies fail to implement ABC and ABM by analysing companies' comments made in the open-ended questions at the end of our questionnaire.

2. Activity-based cost management

Activity-based cost management has two major views: a cost assignment view and a process view. The cost assignment (vertical) view and process (horizontal) view are pictorially represented in a CAM-I (Consortium for Advanced Manufacturing-International) exhibit reproduced as Fig. 1. Activities are at the centre of both views.

Figure 1. – CAM-I BASIC ABC MODEL



Source: Cokins, 1998.

[1] We chose Slovenia as an example of a transitional economy.

Activity based costing (ABC) is the cost assignment view. It answers the question: How much does the product or service cost? ABC assumes that activities consume resources and cause costs. Products or services do not cause costs; they incur costs by the activities that they require. ABC traces costs to products or services through activities. It provides a better costing method compared to traditional cost accounting methods by establishing a more direct link between the cost object and the resources that it consumes (Oliver, 2000). ABC is a methodology that measures the cost and performance of activities, resources and cost objects. Cost objects consume activities and activities consume resources. Resource costs are assigned to activities based on their use of those resources and activity costs are reassigned to cost objects (i.e. products) based on the cost objects' proportional use of those activities. ABC incorporates causal relationships between cost objects and activities and between activities and resources (Brinker, 2000). It is not our intention in this paper to discuss ABC in detail. Much has been already written on this theme (see for example Adler, 1999; Gunasekaran, 1999; Krumwiede, 1999; O'Guin, 1991).

Activity based management (ABM) is the process view. ABM focuses on the management of activities as the route to improving the value received by the customer and the profit achieved by providing this value (Ray, 2000). It analyses activities and determines how well these activities are being executed. It uses activity information to continuously improve processes and to provide value to the customer. ABM answers the questions: "How well are we doing?" and "Are we doing things right?" ABM draws on ABC as a major source of information. ABC supplies the information and ABM uses this information in various analyses designed to yield continuous improvement. ABM complements a continuous improvement philosophy by highlighting waste and opportunities for cost reduction (Oliver, 2000).

The use of ABM requires an analysis of activities. We have already mentioned process mapping, where the activities performed in making or doing something can be detailed on a flowchart called a process map. These maps should include all activities performed to accomplish a specific process, not just the obvious ones. By detailing all activities, process maps allow duplication, waste and unnecessary work to be identified. It is wise to indicate the time and cost spent on each activity from the beginning to the end of a process. We can then calculate total business process time and cost. Activity may be value-added (it increases the worth of a product or service to customers and is one for which customers are willing to pay), non-value added – NVA (it increases the time spent on a product or service but does not increase its worth to the customer; it creates unnecessary additional costs) or business-value-added (NVA activity that is essential to business operations; for example an audit in publicly held companies) (Raiborn *et al*., 1999).

Preparing process maps for each product or service would be quite time consuming. A few such charts, however, can quickly indicate where a company

is losing time and money through NVA activities. NVA activities' cost estimation allows managers to make more informed decisions about how much costs could be reduced if NVA activities were minimised or eliminated and, thus, how company profitability would be improved. So, we can improve a process' performance by activity improvement, for instance by eliminating duplication, eliminating causes of rework, combining fragmented activities, better scheduling, simplifying, training, automating, standardising, or changing the flow of a process.

ABM is also concerned with finding and selecting an appropriate number of activity cost pools[2] and then identifying the cost drivers that best represent the companies' activities and are the underlying causes of costs. The activities chosen by management are those judged to reflect the major and most significant processes. These activities normally overlap several functional areas and occur horizontally across the firm's departmental lines (Raiborn *et al.*, 1999).

Judging by the significant increases in both the number and scope of implementations since the early 1990s, the evidence indicates that companies have found ABM information valuable. Many companies have now begun to aggressively replace traditional information systems with process – or activity-based systems. Therefore, we decided to investigate whether Slovenian companies are following this example or not.

3. Empirical research in Slovenian companies

3.1. The Slovenian business environment in transition

Slovenia is a small transition economy with a population of about 2 million. It was founded in June 1991. It is a small country with a land area of 20,296 square km, neighbouring Italy in the West, Austria in the North, Hungary in the East and Croatia in the South. It had been a constitutional part of the former socialist republic of Yugoslavia during the period 1945-1991. The business environment in Slovenia has changed radically in the last decade. The country has been faced with a triple transition process: the transition to an independent state, the reorientation from former Yugoslavian to Western-developed markets and the transition to a market economy.

When Slovenia became an independent state in 1991, it lost the huge Yugoslavian market. Companies' markets began to change radically. Slovenian industry has succeeded in finding substitute markets. The Slovenian economy had some advantages because of the positive legacy of its Yugoslavian past that gave Slovenian companies a sizeable head start over the rest of the Cen-

[2] Activity cost pool is a grouping of all cost elements associated with an activity (Brinker, 2000).

tral-Eastern European (CEE) region when it came into transition. Slovenian companies had been exposed to a market economy for decades and had had traditional trade links with Western European companies. Slovenia has remained one of the most successful economies in Central and Eastern Europe. This fact is proven by the high GDP per capita at around € 10,500 which exceeds 70 per cent of the EU average. At the start of the transition period, state – (i.e. socially -) owned companies encountered a radically different business environment. Companies were facing privatisation and changes in top management, companies' strategic and tactical planning, activities and operations etc.

Slovenia is not the only CEE country facing transition period difficulties. Apart from Yugoslavia, some other countries were also split up (for example Czechoslovakia and the Soviet Union). Firms in these countries lost a significant portion of their domestic markets while their traditional export markets also disappeared. Companies in transitional economies were entering an open competitive environment. They had to face a deregulated and liberalised business environment. The problem was that many CEE companies were neither flexible nor customer – oriented. That was the reason why they had to rethink and/or change the basic management tools they were using, in order to survive in a turbulent business environment. What is more, some companies began to use these tools for the first time. Due to its successful transition process, Slovenia may be considered as a „benchmark" for the majority of transitional economies in the region. On May 1, 2004, Slovenia became a full member of the European Union. Companies are therefore faced with the intensive processes of deregulation and liberalisation of the foreign trade regime. They are being exposed to increasing foreign competition. The major changes in the business environment described above, strongly influenced the introduction of ABC and ABM in proactive and outward oriented companies. For this reason, we wanted to investigate the current state of the use of ABC and ABM in Slovenian companies.

3.2. Methodology

The aim of the research has been to develop a better understanding of the ABC and ABM presence in Slovenian companies. In particular, we have sought to explore the following questions: Is there a common understanding and use of ABC and ABM among Slovenian companies? Is there any relationship between the size of a company and the use of ABC and ABM? Does the use of ABC and ABM affect the performance of Slovenian companies?

The main source of data is the survey *Cost management in Slovenian companies* conducted during the winter of 2000/2001. The empirical research is based on an extensive questionnaire. After careful consideration, it was decided to conduct personal interviews with top managers or middle managers (responsible for the cost monitoring and analysing). A fully structured interview with pre-coded responses was prepared. We chose personal interviews because we

believe that they provided us with more complete and precise information than mail, telephone or e-mail questionnaires, especially in view of the long questionnaire. Personal interviews provided the opportunity for feedback in clarifying any questions put by a respondent about the instructions or questions. Other advantages of personal interviews are the moderate to fast speed of data collection, excellent respondent cooperation, low number of unanswered questions and the lowest possibility of respondent misunderstanding (Zikmund 2000: 212). We conducted personal interviews with 100 specially trained interviewers.[3] Each interviewer questioned 2-3 companies. Slovenia is a relatively small country (20,296 square km, 2 million inhabitants), so we could cover all geographical areas at a relatively low cost, which is usually not the case when carrying out personal interviews (Zikmund 2000: 212).

This study is based on a research sample of 264 companies. When choosing companies to be included in the sample, we had no intention of excluding any company. However, our sampling technique corresponds to judgemental or purposive sampling[4] as the population elements were selected based on the judgement of interviewers. Nevertheless, the sample is relatively big and offers a good representation of the whole population, as regards the size of companies, their geographical position and the industry (branch) they belong to.

3.3. Research findings

3.3.1. Knowledge and use of ABC and ABM in Slovenian companies

We attempted to find out whether there is a common understanding and use of ABC and ABM amongst Slovenian companies. Table 1 shows the results, according to the questionnaire results.

Table 1. – KNOWLEDGE AND USE OF CONTEMPORARY COST MANAGEMENT CONCEPTS IN SLOVENIAN COMPANIES (IN %)

Concept	Unfamiliar with the concept	Familiar with the concept, but do not use it or think that using it is not sensible	Think it is wise to implement the concept	Planning to implement it	Implementing the concept	Using the concept
ABC	34.1%	33.0%	11.7%	7.6%	5.3%	8.3%
ABM	46.2%	37.5%	6.4%	4.5%	1.9%	3.4%

Source: Research *Cost management in Slovenian companies*, Winter 2000/2001.

[3] Interviewers were properly trained because the research was part of their postgraduate course work. Moreover, internal checks of completed questionnaires were performed during their seminar work, when interviewers presented their findings with respect to interviewed companies, especially those based on open-ended questions (varying comments from the interviewed companies). We also controlled the variation among interviewers by checking the names of interviewed companies to avoid duplication of companies included in the sample.

[4] For more on judgement or purposive sampling, consult for example Churchill, 1999: 503; Malhotra, 335: 1999 or Zikmund, 2000: 351.

Slovenian companies are poorly acquainted with activity-based concepts, especially with ABM (46.2 per cent of the companies are unfamiliar with the concept). What is more, only 5.3 per cent of all companies are introducing or using ABM. 3 per cent of companies are implementing or using both ABC and ABM. These companies have the biggest potential to develop an activity-based cost management approach.

3.3.2. Relationship between the size of the company and the use of ABC / ABM

The sample consists of 33 per cent small, 23 per cent middle, and 44 per cent large companies. Companies are classified according to Slovenian legislation as follows: A small company is a company fulfilling two of the following criteria: average number of employees does not exceed 50, annual revenues are less than SIT 280 million (around € 1.25 million), average assets at the beginning and at the end of the financial year do not exceed SIT 140 million (around € 625,000). A medium company is a company fulfilling two of the following criteria: average number of employees does not exceed 250, annual revenues account for less than SIT 1,100 million (around € 5 million) and average assets at the beginning and at the end of the business year do not exceed SIT 550 million (around € 2.5 million). All other companies are classified as large companies.

We tried to find out whether there is any relationship between the size of a company and the use of ABC / ABM. In our research, we tested the following hypothesis: The familiarity with and the use of ABC/M is dependent of the size of the company. We tried to find out whether small, medium and large companies differ according to their knowledge and use of ABC / ABM. We analysed each concept separately. Companies were included in one of the following groups: (1) companies which do not know the concept; (2) companies which know the concept, but do not use it, or think that using it is not sensible; (3) companies which think it is wise to implement the concept or are planning to implement it and (4) companies which are already implementing or using the concept.

We used a chi-square contingency table to test the dependence within each concept, because we dealt with two non-metric parameters ("size of the company" is an ordinal parameter, "knowledge and use of the concept" is a nominal parameter). Our null hypothesis (H_0) is the following: There is no relationship between the size of a company and the use of ABC / ABM (when referring to the variable "use of ABC / ABM", we are actually addressing the variable "knowledge and use of ABC/M" throughout the article). On the other hand, the alternative hypothesis (H_1) states that there is a relationship between the size of the company and the use of ABC / ABM.

The research showed (see Table 2) that there is a relationship between the size of a company and the use of cost management concepts for ABC and ABM. Namely, a chi-square test managed to indicate statistical significance of the results within these two concepts (a significance level of 0.05 (alpha) was chosen for the test).

Table 2. – CHI-SQUARE VALUES AND SIGNIFICANCE LEVELS FOR EACH CONCEPT

Concept	Chi-square value	Significance
ABC	32.407	0.000
ABM	13.740	0.033

Source: Research *Cost management in Slovenian companies*, Winter 2000/2001.

A chi-square test was used for testing the statistical significance of the results. It is based on the comparison between actual and expected frequencies. The use of a chi-square test can be problematic if too many of the expected frequencies are small, because this makes results in the computed value proportionately inflated. Churchill (1999) states that it is generally agreed that only a few cells (less than 20 per cent) should be permitted to have expected frequencies of less than 5, and none should have an expected frequency of less than 1.

The research results also revealed the following: Companies that are unfamiliar with ABC/ABM are mostly small companies (they represent 47.8 per cent within ABC and 40.2 per cent within ABM). Companies that are familiar with a particular concept, but are not using it or think that using it makes no sense, are mostly large companies (they represent 43.7 per cent within ABC and 48.5 per cent within ABM). Companies that think it is wise to introduce a particular concept or are planning to introduce it are mostly large companies (they represent 26.7 per cent within ABC and 51.7 per cent within ABM). Further, companies that are already introducing or using particular concepts are mostly large companies (they represent 66.7 per cent within ABC and 57.1 per cent within ABM). This is quite understandable given that the introduction of the concepts is connected with a relatively greater need for knowledge, resources, and time.

We found out that companies implementing or using ABC / ABM are on average large companies, privately owned, operating in the production sector, selling mostly to the Slovenian market and facing a high or very high level of competition. The main conclusion was that companies introducing and using ABC / ABM are, on average, large companies. They account for the biggest share (44 per cent) amongst all companies interviewed. Large companies in the sample cover almost 13 per cent of all Slovenian large companies. As the results of this population are the most interesting, we would like to provide insights into those them.

Table 3 shows the distribution of large companies as regards their knowledge and use of ABC/M. Companies are divided into four groups: (1) Companies unfamiliar with the concept, (2) Companies familiar with the concept, but do not use it or think that using it is not sensible, (3) Companies thinking it is wise to implement the concept or are planning to implement it and (4) Companies implementing or using the concept. We can see from Table 3 that large Slovenian companies are poorly acquainted with ABM (38.8 per cent of companies are unfamiliar with the concept). We have already mentioned that this is true for all Slovenian companies except that percentage shares are much smaller as regards investigating large companies only. ABC is one of the best-known concepts among large Slovenian companies. 80.2 per cent of companies are familiar with ABC. The results were similar when considering all companies. However, we would like to emphasise that ABC is better known among large companies than amongst SMEs (small and medium-sized enterprises). Namely, only a good half of Slovenian SMEs know this concept. ABM is one of the least implemented concepts in Slovenia. Only 5.3 per cent of the companies are implementing or using it.

Table 3. – COMPARISON BETWEEN LARGE COMPANIES AND SMES CONCERNING THE KNOWLEDGE AND USE OF ABC / ABM (IN %)

Concept	Unfamiliar with the concept		Familiar with the concept		Implementing or using the concept	
	Large companies	SMEs	Large companies	SMEs	Large companies	SMEs
ABC	19.8	45.3	80.2	54.7	20.7	8.1
ABM	38.8	52.0	61.2	48.0	6.9	4.1

Source: Research *Cost management in Slovenian companies*, Winter 2000/2001.

It is quite understandable that there is such a big difference between large companies and SMEs as regards the use of ABC, because adequate resources and a sufficient budget allocated properly are important for the successful implementation of ABC. Furthermore, companies often have to cooperate with external consultants when they lack the required expertise and knowledge. For these and other reasons, large companies have a better potential to adopt ABC than SMEs. The reasons why particular types of companies use or do not use ABC/ABM are explained in Section 3.4 and will be defined in greater detail in our future research.

3.3.3. ABC / ABM and performance of Slovenian companies

We tried to answer the following question: Does the use of ABC/M affect the performance of Slovenian companies? Theoretical implications suggest that companies using ABC/M should have better performance, especially when faced with a highly competitive and complex business environment. Perform-

ance can be measured by financial and/or non-financial measures. Due to easier comparison amongst different companies, we chose financial measures. Some companies participating in our research do not use non-financial measures at all; those companies that do not use them, do not use the same non-financial measures of performance. For this reason, it would be impossible to compare all companies according to non-financial measures. We compared different companies (who know ABC/M) using the following financial measures of performance: net income (loss), ROA, ROE, and profit margin.

Research results suggest that companies differ according to the performance measures used. This finding was also tested with statistical methods. We used a One-Way ANOVA procedure to test the dependence of the performance of companies on the use of a particular concept. The One-Way ANOVA procedure produces a one-way analysis of variance for a quantitative dependent variable (in our case particular financial performance measures) by a single factor (independent) variable. Factor variable values range from 1 to 4, as the research was set up involving four types (groups) of companies: (1) Companies unfamiliar with the concept, (2) Companies familiar with the concept, but do not use it or think that using it is not sensible, (3) Companies thinking it is wise to implement the concept or are planning to implement it and (4) Companies implementing or using the concept. Analysis of the variance is used to test the hypothesis that several means are equal. One of the assumptions underlying the One-Way ANOVA procedure is that the groups should come from populations with equal variances. To test this assumption, we used Levene's homogeneity-of-variance test. According to this test, we find out that the assumption regarding equality of variances is not valid for the profit margin for all concepts. That is why, in the final findings, we do not refer to profit margin and other performance measures, for which the assumption regarding equality of variances is invalid. The final results are presented in Table 4.

Table 4. – F TEST VALUES AND SIGNIFICANCE LEVELS FOR EACH CONCEPT

Concept	Financial Measure	F test	Significance
ABC	Net income	11.601	0.000
	ROA	5.840	0.001
	ROE	5.703	0.001
ABM	Net income	2.104	0.101
	ROA	3.085	0.028
	ROE	5.178	0.002

Source: Research *Cost management in Slovenian companies*, Winter 2000/2001.

First, we found that net income is generally dependent on the use of ABC. Second, we found that ROA generally depends on the use of ABC and ABM. Third, we found that ROE is generally dependent on the use of ABC and ABM.

Since we found that companies implementing or using ABC / ABM are generally large companies, we decided to present final results by indicating what type of large companies have the highest performance measures (see Table 5). Companies are classified by three types: A – Companies implementing or using a particular concept, B – Companies thinking it is wise to implement a concept or are planning to implement it, and C – Companies familiar with a concept, but not using it or thinking that using it is not sensible. As we can see from Table 5,our research results suggest that companies differ according to performance measures. The main conclusion is that companies thinking it is wise to implement a particular concept, or planning to implement it, frequently have the best results according to financial performance measures, especially with regard to ROA and ROE. This implies that successful companies are, on average, more inclined to implement ABC / ABM. The implementation of ABC / ABM is connected with high initial investment. On the other hand, positive financial results can be expected in a few years' time. Thus, it would be appropriate to repeat the survey amongst the same sample units (including only those implementing or using ABC / ABM) in a sequence of at least 5 years to test the influence of ABC / ABM on the companies' performance.

Table 5. – TYPES OF LARGE COMPANIES WITH HIGHEST PERFORMANCE MEASURES

Concept	Net Income	ROA	ROE	Profit Margin
ABC	A	B	B	B
ABM	A	B	B	C

Source: Research *Cost management in Slovenian companies*, Winter 2000/2001.

3.3.4. Reasons why Slovenian companies fail to implement ABC/M

In the research, we also want to indicate some reasons why Slovenian companies fail to implement ABC and ABM based on companies' comments from open-ended questions at the end of our questionnaire. The reasons why Slovenian companies fail to implement ABC and ABM are as follows:

- Lack of top management buy-in,
- Lack of clear objectives in Slovenian companies,
- Lack of employee involvement,
- Lack of funding,
- Lack of information technology support, and
- Lack of knowledge and training in companies.

Reasons why Slovenian companies fail to implement ABC and ABM are discussed further in the next section.

3.4. Discussion

Until recently, a very small number of Slovenian companies had undertaken implementation of ABC / ABM. ABC and ABM are implemented and used mostly by large companies. This is quite understandable given that the implementation of these concepts is connected with relatively high requirements for knowledge, resources and time. However, there is a considerable pay-off, as we found out that companies using ABC / ABM, on average, perform better than those which fail to do so. Larger firms tend to know ABC / ABM better and use them more frequently than smaller firms because larger companies possess more financial and managerial resources, have greater production capacity and attain higher levels of economies of scale. Large Slovenian companies are poorly acquainted with activity-based management, whereas ABC is among the best-known concepts. ABM is also one of the least implemented and used concepts.

We believe that companies using only ABC should focus more on using ABC information to make better decisions regarding cost reduction, waste elimination, etc. to continuously improve their performance. For companies that are using only ABM, it would be easier and more accurate to trace costs to activities using ABC. We believe that Slovenian companies should use a process management approach to improvement which requires defining each activity as part of a business process that can be continuously improved. Activities defined in this way can be based on various techniques to decrease time, improve quality, and reduce the cost of those activities. According to Brimson and Antos (2000), process management is crucial to excellence because high levels of performance are possible only when activities are carried out to the best possible standards, the unused capacity is minimal, best practices are continually made better and the activities are executed perfectly.[5]

We found quite a big difference when comparing large companies with SMEs. It is true that SMEs on average do not possess the knowledge and resources of large companies. ABC/ABM should also be implemented in SMEs, at least to some extent, especially in Slovenian and other CEE companies operating in the turbulent transitional business environment and facing severe global competition. Larger firms tend to know ABC / ABM better and to use these methods more frequently than smaller firms because larger companies possess more financial and managerial resources, have greater production capacity and attain higher levels of economies of scale. Similarly, Krumwiede (1999) argues that according to a survey[6] conducted by the Cost Management Group of the Institute of Management Accountants (IMA) ABC adopters tend to be somewhat larger on average than non-adopters. Possible reasons for the size

[5] For more on process thinking and management, also in Slovenian companies, see Sink, Rant, 2002.

[6] The data cited in this paper come from two IMA surveys which were mailed in November 1995 and January 1996.

difference include availability of resources (human and financial) and economies of scale in implementing ABC at multiple sites.

Our research also indicated some reasons why Slovenian companies fail to implement ABC/M. First, the most important reason is the lack of top management buy-in. Despite top management's awareness of the potential benefits of the concepts, it is not willing to invest its own time or the funding needed to implement them. Top management buy-in is very important because management stimulates creativity, empowers employees, provides leadership and establishes a framework for providing resources. Countless case studies have shown that top management's commitment is crucial (Maguire, Putterill, 2000). For example, previously mentioned IMA survey results support the idea that ABC needs strong commitment from upper management. 58 per cent of the usage-level companies had a very high level of top management support (versus 40 per cent for the non-usage companies) (Krumwiede, 1999). Top managers must not only be committed, they must be seen to be committed. An effective way to do this is by being present at key gatherings, actively participating in them and supporting the initiatives both by word and in action.

Second, there tends to be a lack of clear objectives in Slovenian companies. Third, there is a lack of employee involvement. Employees are not involved in creating, implementing, and continuously improving ABC/M. Fourth, there is lack of funding. Companies (top management) are not prepared to invest great amounts of money into the implementation of projects. As a counter argument, we can say that according to a survey conducted by the Cost Management Group of the Institute of Management Accountants (IMA) 89 per cent of companies using ABC said it was worth the implementation costs (Krumwiede, 1999).

Fifth, a lack of information technology support was also mentioned. It must be emphasised that a company operates in a predetermined direction only by the use of an advanced information system that represents basic support to decision-making. Information has to be proper, accurate and timely and prepared in the most suitable way for those who use it. Under such circumstances, information supports good decision-making. It is extremely important that the benefits derived from information exceed the costs incurred by collecting it. According to a survey conducted by the Cost Management Group of the Institute of Management Accountants (IMA), it appears that improvements to the information system often precede both ABC adoption and reaching the usage stage. A high level of IT sophistication appears to be an important factor in getting to the usage stage for the majority of companies. Of the usage-stage companies, 61 per cent received an above-average IT score, compared to only 46 per cent of the non-usage stage firms.[7] In general,

[7] The 'IT score' was based on responses to questions relating to system characteristics such as subsystem integration, query capability, available data, and frequency of updates.

companies will have an easier time implementing ABC if their IT system has the following characteristics: good sub-systems (for example, sales system, manufacturing system, etc.) integration, user-friendly query capability, available sales, cost and performance data going back 12 months and real-time updates of all these types of data (Krumwiede, 1999). Sixth, there is a lack of knowledge and training in companies as neither the implementation team nor the people using ABC / ABM information are properly trained.

The aim of our research was to find out the current situation as regards the number, size, and performance of Slovenian companies familiar and unfamiliar with ABC / ABM, especially those implementing or using these concepts. Reasons why particular types of companies use or do not use ABC / ABM will be defined in greater detail in our further research.

4. Conclusion

Although customer satisfaction has become a top priority for a lot of Slovenian companies today, many management control systems over-emphasise throughput and short-term cost control (e.g. reducing scrap and re-work) within individual departments. These systems based on traditional accounting lead to goal inconsistencies and displacement problems. That is, maximising or minimising some measures in individual responsibility centres does not always lead to what is best for the company as a whole. Managers resort to managing the numbers instead of focusing on activities that would lead to higher quality and lower costs. These conditions cause losses in downstream processes and also losses to customers or society. This is obviously inconsistent with the goal of customer satisfaction and it is also a poor strategy in a globally competitive environment.

Our research showed that a very small number of Slovenian companies have undertaken implementation of ABC / ABM. However, there is a considerable pay-off, as we found that companies using ABC / ABM on average perform better than those which fail to do so. ABC and ABM are implemented and used mostly by large companies. Large Slovenian companies are poorly acquainted with ABM, whereas ABC is among the best-known concepts. ABM is also one of the least implemented and used concepts.[8] Reasons why Slovenian companies fail to implement ABC and ABM are the following: lack of top management buy-in, lack of clear objectives in Slovenian companies, lack of employee involvement, lack of funding, lack of information technology support and lack of knowledge and training in companies.

The proper use of ABC / ABM provides managers with the critical information they need to make proper business decisions related to costs and profitability, so companies can remain strong and efficient when faced with global

[8] The generality of our conclusions is constrained by the fact that we used judgemental sampling.

competition. Under normal conditions in the past, managers could often afford to be reactive. They could take actions that nested comfortably within their routine planning and control duties. However, for a business moving into a turbulent business environment, demands for information and analysis become imperative and more challenging. For this reason, it is important that companies learn about and start adopting ABC / ABM. The use of ABC / ABM in Slovenian companies for ensuring their effective performance is required due to the increasing complexity of economic and business processes. This is the reason why sophisticated cost management is extremely important, especially for Slovenian companies, which frequently incur excessively high costs and therefore have a poor competitive position in both national and international markets. We found out that many companies trying to succeed in transition economies and facing severe global competition tend to use traditional cost accounting, which does not provide a sufficient basis for effective cost management. Our recommendation to many Slovenian companies (and all other companies facing similar problems) is to tackle these barriers and try to overcome them by implementing at least some contemporary cost management concepts (e. g. ABC and ABM) as they support better performance through improved decision making based on more accurate cost information. This results in improved profitability, better understanding of products and services, improved pricing decisions, improved budgeting and planning processes and elimination of waste.

REFERENCES

Adler, R., (1999), *Management Accounting – Making It World Class*, Butterworth Heinemann, Oxford.

Brinker, B. (Ed.) (2000), *Guide to Cost Management*, New York: John Wiley & Sons

Churchill, G. (1999), *Marketing Research: Methodological Foundations*, 7th ed., Fort Worth: The Dryden Press

Cokins, G. (1998), *Using ABC to Become ABM*, ABC Technologies Inc.

Gunasekaran, A. (1999), A framework for the design and audit of an activity-based costing system. *Managerial Auditing Journal* 3, 118-126.

Krumwiede, K. (1999), ABC: why it's tried and how it succeeds. In: Edwards, J. (Ed.), *Emerging Practices in Cost Management*, Boston: WG&L/RIA Group, pp. I1-1 – I1-7.

Maguire, W. and M. Putterill (2000), Continuous improvement in turbulent times. In: Brinker, B. (Ed.), *Guide to Cost Management*. New York: John Wiley & Sons

Malhotra, N. K. (1999), *Marketing Research: An applied Orientation*, 3th ed. Upper Saddle River: Prentice Hall,

O'Guin, M. (1991), *The Complete Guide to Activity-Based Costing*. Englewood Cliffs.

Prentice Hall

Oliver, L. (2000), *The Cost Management Toolbox: A Manager's Guide to Controlling Costs and Boosting Profits*, New York: Amacom

Raiborn, C. *et al.* (2000), *Managerial Accounting*, 3rd ed., Cincinnati: South-Western College Publishing, Ray, M. (2000), New product development, In: Brinker, B. (Ed.), Guide to Cost Management, New York: John Wiley & Sons, pp. 47-67.

Sink, D., Rant, M. (2002), Implementing process improvements in companies in transition. In: Kumar, A. and V. Kandzija (Eds.), *Transitional impacts and the EU enlargement complexity*. Ljubljana, pp. 283-292.

Zikmund, W. (2000), *Business Research Methods*, Fort Worth: The Dryden Press.

INDRA ABEYSEKERA

Political Economy Of Accountng In Intellectual Capital Reporting

Abstract

Several factors shaping intellectual capital reporting (ICR) in the context of the political economy of accounting (PEA) theory were discussed in relation to a traditional accounting reporting system, intellectual capital and intellectual reporting definitions, techniques employed to report intellectual capital (IC) and the theoretical classification of IC. Reporting intellectual capital enables firms to report them in a fashion that best suits the relationship between the firm and its political, economic and social arrangement. Unregulated reporting can increase manipulation of ICR in a borderless reporting environment to reduce the tension between the firm and its political, social and economic arrangements.

1. Introduction

Contemporary accounting can be described as a regulated institutional process and a constructed model to report and communicate the impact of economic activity (due to temporal and spatial displacements) and associated regimes of accumulation. It is an external reporting mechanism for profit oriented firms (Boczko, 1997, p. 13). The regulated process secures capitalist reproduction through institutional collection (such as laws and agreements), and norms and cultural habits. These institutional collections support a capital accumulation regime by laws, state policy, political practice, rules of negotiation and bargaining, the consumption culture and social expectations (Amin, 1994, p. 8). Tinker (1985, p. 84) argues that accounting is a belief-making informational commodity that measures and appraises the terms of exchange between different social constituencies, helps to allocate resources and simultaneously determines a distribution of income. Accounting has become part of that exchange process by helping firms make decisions in relation to economic exchange. If the accounting practice did not take part in this way, competitive pressures would eradicate it as an unnecessary production cost.

Tinker (1985, pp. 14–15) argues that share prices do not reflect historical asset values, but rather the earnings that those assets are expected to generate. Therefore, it is to the advantage of the managers to convince capital providers that the management is capable of using those assets at the highest levels of

efficiency through news releases which include accounting reports such as company annual reports. In this context, intellectual capital reporting (ICR) presents two unique situations. First, unlike social and environment reporting, ICR is presently unregulated, offering firms the opportunity of choosing what to report, when to report and where to report. Second, ICR is proactive reporting since there is no need to meet any legislative or accounting requirements which enable firms to fictionalise ICR to maximise the market value of their firms to attract and retain capital providers.

This paper outlines the factors shaping ICR in the context of the political economy of accounting (PEA) theory. Section two of this paper reviews political economy and PEA and offers reasons why PEA is more applicable to ICR. The remaining sections outline the different variables and their impact on PEA: the role of traditional accounting; intellectual capital (IC) and ICR definitions; techniques for ICR and IC theoretical classification. The last section contains concluding remarks.

2. Literature Review

Firms are a focal point of economic, social, and political interactions in most market driven economies. They are places where the results of conflicts from the interactions leave their obvious marks (Grant, 1985 pp. 3-5). Therefore, it is necessary to comprehend the relationships between economic, social, and political forces to understand the changing characteristics of firms such as ICR in an unregulated reporting environment and thereby the influence they have on the lives of different people.

The corporatism represents an attempt to understand the reciprocal relationships that have developed between the state and major organised interest groups. It is the process of negotiating policy between state agencies and interest firms that has arisen due to the division of labour in society. The policy agreements are implemented by collaborating with interest firms (Grant, 1985: pp 3-5). These interest firms should be willing and have the ability to secure the compliance of their members to deliver support of their benefiting constituency (Chubb, 1983; p. 26). On that basis, the interest groups can be assumed to be big listed firms or big listed industry groups. These arrangements are led by both groups, which are state and interest firms, in seeking each other out (Schmitter, 1979; p. 7). This is because corporatist arrangements are an unintended outcome of different conflicts and policy crises where neither the state nor the interest groups were capable of imposing their preferred solution on the others (Grant, 1985; p. 7).

The incapability to impose preferred solutions upon others arises due to four reasons. First, interest groups cannot attain the status of monopoly constituents, or form comprehensive hierarchies of sectors without some degree of offi-

cial recognition or encouragement. Second, public officials should tacitly agree or actively promote interest groups to become regular, integral participants in making policies, or acquire direct responsibilities for policy implementation. Third, affected groups (interest groups or the government) may refuse to organise appropriately, or refuse to participate if they find the collaborating cost is too high. Fourth, relatively autonomous groups within the government form these arrangements. The government officials are much less enthusiastic to share the power of decision-making with interest groups, but on the other hand, are not fully in control of the leadership selection of the interest group to bring about the desired adjustments (Schmitter, 1985, pp. 35, 39).

For example, past research cites that unequal opportunity of employment (e.g. disabled, gender, and race) is a result of poor social or political power realising their economic needs as an interest group due to commodification of labour. This is because in a deregulated economic approach, productive capital is privately owned and they hold the right to decide to make capital available for the preferred type of labour (Russell, 2002). Another research found that firms influence the nature of training and wage structure, and in a competitive labour market, firms have little incentive to invest in general skills of their employees since they can take those skills on to other firms (Acemoglu & Pischke, 1999).

However, past case studies indicate several ways to enhance the capability of imposing a preferred solution by an interest group. The first way is to express all demands through only a few voices for negotiation and compromise. The second way is to centralise the internal structure of the interest group to increase consensus formation and member compliance. The third way is to modernise the interest group to increase its professionalism. The fourth way is to create 'modern' interest groups to play their role in corporatist co-operation (Marin, 1985,: pp. 97-100) and the fifth way is to have less distinction between private and public corporatists or forge partnerships between private and public interest groups in the delivery of products and services (King, 1985, p. 205).

Most of the discussion on corporatism is based on tripartite bargaining between capital (economic), labour (social), and government (political) at a national level. However, understanding the corporatist phenomena at below the national level enhances comprehension of how corporatism can flourish in particular sectors or locations, even when it is not apparent at the national level. The cumulative impact of such arrangements on society could be as important as weakly enforced tripartite arrangements of a nation (Grant, 1985, p. 4).

When attempting to enhance a socially optimum level or type of reporting of IC, it should examine the corporatist phenomena both at corporate sector level and at national level while enhancing the preferred level by an interest group such as the state.

The central importance of political economy theory is to promote the process of adjustment through the political capacity of the government (political) and is often pursued by working together with their economic (capital) and social (labour) representatives (constituents) (Zysman, 1983, p. 15).

The PEA theory views that accounting is a means of sustaining and legitimising the current social, economic, and political arrangements. Accounting information is used to support those groups who are currently powerful in society (Cooper, 1980; Cooper & Sherer, 1984). Accounting reports are a means to construct, sustain, and legitimise the economic and political arrangements in the private interests of the firm (Guthrie & Parker, 1990). It takes the view that there are two opposing forces or principles that create tension in relations with the constituents in the arrangement (Buhr, 1998). Firms proactively provide information from their perspective to set and shape the agenda of debate and to mediate, suppress, mystify and transform the conflict (Guthrie & Parker, 1990).

Based on the above characteristics, the PEA theory is relevant to ICR for the following reasons. First, adopting the PEA theory perspective to ICR can widen the researcher's focus of analysis, by explicitly attempting to introduce wider, systematic factors into the interpretation and explanation of ICR phenomena (Gray, Owens, & Adams, 1996, p. 47). These factors make the political, social and economic arrangement in which a business operates more important for its stability and continuity. Second, ICR is about proactive reporting. They are not reported to meet any regulatory requirements. The PEA theory focuses on proactive corporate disclosure provided from the management's perspective. It is designed to set and shape the agenda according to its own self-interest (Burchell, Club, Hopwood, Hughes & Nahapiet, 1980; Cooper, 1980; Cooper & Sherer, 1984; Tinker, 1980; Tinker & Neimark, 1987; Woodward, Edwards & Birkin, 2001). Third, the political economy perspective perceives accounting reports are social, political, and economic documents. They have been used as tools to construct, sustain, and legitimise economic and political arrangements, institutions, and ideological themes, which contribute to the firm's private interests (Guthrie & Parker, 1990). Firms use annual reports as a tool to ease tension in social relations between the firm and society, and stay away from any regulation. It can possibly use different reporting units to varying degrees and can use different reporting locations within the annual report for such purposes. This is because a political economy perspective critically focuses on themes, meanings and motivations implicit in voluntary disclosures.

Annual reports may not reflect the true position of the firm as empirical findings indicate that there was no systematic relationship between the quantity of disclosure in annual reports and IC performance (Williams, 2001). This is because most listed firms use the annual report as a promotional or marketing document rather than merely to comply with accounting standards and

the law (Abeysekera, 2002a). Fourth, the political economy approach takes the view that there are two opposing forces or principles that create tension in social relations (Buhr, 1998). In the area of corporate reporting, such tension can manifest due to the size of the firm, industry sector, ownership structure (such as diversity of share ownership or/and number of shareholders), ownership type (such as foreign or local), and difference between the market value and the net book value of the firm. Firms, in return, can use more disclosure in IC to ease such tensions. Fifth, specific previous research on ICR (Brennan, 2001; Guthrie & Petty, 2000) has shown that the frequency of IC reported voluntarily by large firms varies in their annual reports. These specific studies also demonstrated that IC items reported in annual reports could differ from country to country (Brennan, 2001; Guthrie & Petty, 2000; Olsson, 2001). The differences in reporting can be due to firms reporting to create harmony in social relations between the firm and its social, political and economic framework. Sixth, the knowledge economy facilitates propagation of thoughts, value, and power, by ultimately packaging and selling them in.

Past research on both IC and corporate social reporting confirmed that firms have used various reporting units both qualitative (i.e. charts, tables, photographs and narrative) and quantitative (i.e. non-fiscal and fiscal) in varying combinations. However, several authors have pointed out that narrative is the predominant mode used in reporting of corporate social reporting and IC reporting (Andrew *et al*., 1989; Collier, 2001; Brennan, 2001). The choice of reporting units can determine to what extent relations are maintained with their relevant constituents because narrative is a powerful way to make sense. Seventh, the reporting location within the annual report can have an impact on social relations between the firm and its social, political and economic arrangements (Choon, Smith & Taylor, 2000; Hughes, Anderson & Golden, 2001). Although, why a particular reporting location is preferred has not been completely resolved by any theory in the past, PEA theory can provide some helpful guidance.

3. ICR in the context of PEA

Several factors contribute to shaping ICR in a PEA context as outlined in Figure 1 and discussed in the following sections.

3.1. Role of traditional accounting

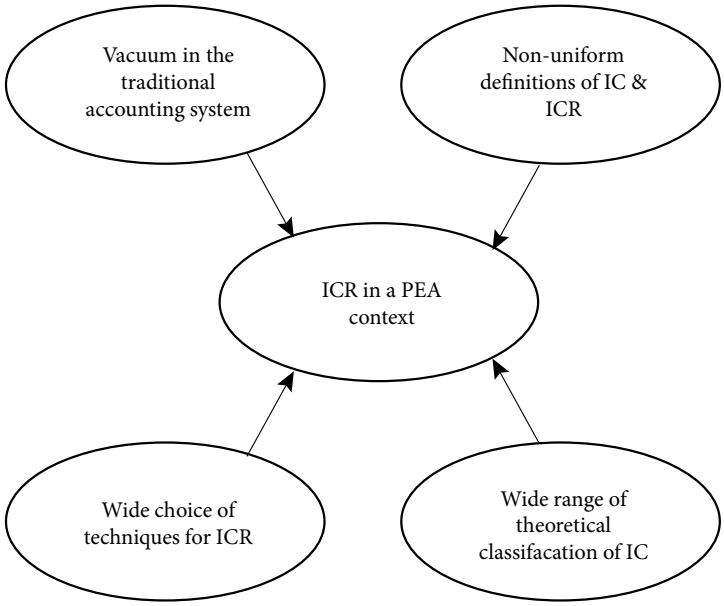
The empirical studies point out several limitations imposed by the traditional accounting system in ICR. First, there is the writing-off of intellectual assets as expenses (Backhuijs, Holterman, Oudman, Overgoor & Zilstra, 1999;

Lev, Sarath and Sougiannis, 1999). Authors have demonstrated that it leads to systematic under-valuation and a relatively adverse liquidity of firms (Boone & Raman, 2001a; Boone & Raman, 2001b; Ronen, 2001). Dunk and Kilgore (2001) in a questionnaire response, combined with telephone interviews of finance directors in Australia, indicated that firms are likely to cut R&D expenditure to focus on short-term financial performance when the emphasis in the marketplace is on cost more than on product innovation. The literature suggests two ways to overcome the deficiency: (i) Hoegh-Krohn and Knivsfla (2000) suggest that to overcome the anomaly within the traditional accounting system is to reverse the previously written-off intangibles once they meet the recognition criteria of an asset; (ii) Thompson (1998) suggests firms can add a supplementary set of reporting elements to acknowledge forms of capital and claims to capital that cannot be measured in financial terms. Others agree that it is more useful to measure them even if they are less exact with new rules of measurement (Heckmian & Jones, 1967).

Several authors hold the view that using accounting figures without IC in financial statements is a concern when seeking solutions to management problems (Dearden, 1960; Anthony, 1965 ; Moorhow, 1990; Buhner, 1997; Davies & Waddington, 1999; Petty & Guthrie, 1999; Rohwer, 1999; Copeland, 2000; Allen, 2001). This has resulted in the current reporting system not presenting objective reality (Wharton Alumni Magazine, 1997) and it has not been a meaningful indicator of the economic efficiency of a firm (Hansson, 1997; Graham & King, 2000; Zambon and Zan, 2000). This view is supported by others who argue that the present balance sheet records what has been spent, is silent on value addition to the firm (Swinson, 1998 pp. 4-5; Horney, 1999) and measures only the realisation of value rather than the creation of value of a firm (Romer, 1998; Brennan, 2001).

Second, accounting standards in most countries permit only recognition of purchase goodwill to be reported in their financial statements, which represents only a portion of IC (van der Meer-Kooistra & Zijlstra, 2001). At the extreme end are Austria and Germany, countries that do not recognise any intangible assets (Bornemann, Knapp, Schneider & Sixl, 1999). Japan recently amended their accounting regulations to record purchase goodwill in the consolidated accounts only (Okano, Okada & Mori, 1999). According to Unwin (1990) the outcome available for several countries is to amortise purchased goodwill. The literature also suggests that the lack of national homogeneity in accounting standards on intangibles may have given rise to a lack of international homogeneity on accounting standards on intangibles (Stolowy & Jenny-Cazavan, 2001). The International Accounting Standards (IAS) 38 which specifically prohibits recognition of start-up costs, training costs, and advertising costs, can be cited as an example. They also prohibit recognising internally generated goodwill (IAS38 1998, pp. 983-1031) and have failed to respond well to current market needs of reporting IC (Ravlic, 2000).

Figure 1. – ICR IN A PEA CONTEXT



Third, some suggest that accounting theorists compound the weaknesses in traditional accounting, by presenting theories that have little relationship to actual economic conditions (Merino, 1993). They have adopted a less pragmatic perspective by viewing it as a purely technical discipline and have failed to analyse the role that accounting plays in society. Chapman (1997) states that the failure to respond to the contingent nature of accounting has led to the loss of credibility in the accounting profession (Chapman, 1997). Further, the coexistence of several accounting approaches has also made it complex to verify the multi-dimensional character of ICR in a firm (Zambon & Zan, 2000).

The above-mentioned weaknesses of traditional accounting are believed to be responsible for the gap between the market value and the net book value of a firm. The gap has highlighted and questioned the relevance of accounting numbers reported to make economic decisions (Power, 2001; Tollington, 2001). However, it has become evident that the accounting profession in some countries is heading towards measuring and reporting assets in reference to the market value (Lashinsky, 1999) as shown by their recently published accounting standards (ASCPA, 1999, pp. 6677-6782).

The technology has enabled businesses to change their approach in reporting information to meet the market needs of users (Jenkins, 1998, p. 1; Swinson, 1998,:p.4; ICA E&W, 1998, pp. 2-3). Therefore, authors predict that the annual report of the future would recognise forward-looking information such

as IC (Roos *et al*, 1997, p. 21; Benjamin 1998, pp. 13-15). However, the profession is actively debating the issue of how to measure, manage, and report IC. Several authors agree that it is yet to gather a critical mass to achieve a significant change in the accounting profession (Benjamin, 1998, pp. 26-27; Brennan, 2001; Cook, 1998, p. 29; Fay, 1998, p. 28; Lipworth, 1998, p. 26). It is unlikely to see any major changes in the accounting standards followed by accountants mandated by the accounting profession to recognise IC in financial statements in the near future (Brennan, 2001). Several techniques have been developed to overcome the deficiency in ICR.

The limitations imposed by the traditional accounting system in ICR, the theories which have little relationship to actual economic conditions, and the decided reluctance of the accounting profession to recognise IC in financial statements have all encouraged firms to report IC in an ad-hoc fashion. These factors indicate that IC reporting will perpetuate for some time in an unregulated reporting environment allowing firms to manipulate the economic, social, and political arrangement through unregulated ICR.

3.2. Definitions of IC and ICR

Edvinsson and Sullivan (1996) and Petrash (1996) outline intellectual assets as synonymous to IC. Many of them take a strategic view but they vary in their meanings from one another (Edvinsson and Sullivan, 1996; Brooking, 1997; Edvinsson, 1997; Edvinsson and Malone, 1998; Stewart, 1997, p. X; Klein, 1998, p. 1; Nasseri, 1998; Saint-Onge, 1998; Ulrich, 1998; CMA, 1998, p. 3; ASCPA and CMA, 1999, p. 4; Knight, 1999). The Society of Management Accountants of Canada (SMAC), on the other hand, offers an accounting based definition (IFAC, 1998, p. 12). However, the SMAC definition conflicts with the assets definition of the International Accounting Standards Committee (IASC) and the Australian conceptual framework since SMAC defines assets using the criterion of owning the asset and others define using the criterion of controlling the asset (CPA Australia, 2000, pp. 49-69; IAS38, 1998). The diversity of definitions shows there is difficulty in arriving at a uniformity of definitions (ASCPA and CMA, 1999, p. 53) and a generally accepted theory of IC (Canibano, Garcia-Ayuso, Sanchez and Olea, 1999; Petty and Guthrie, 2000; van der Meer-Kooistra and Zijlstra, 2001).

ICR has not been defined in the literature. However, the Australian accounting handbook defines general purpose financial reporting as 'a financial report intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs' (ASCPA, 1999, p. 0005). Using the definition of general purpose financial reporting as a basis, this thesis defined ICR as 'a report intended to meet the information needs common to users who are unable to command the preparation of reports about IC, tailored so as to satisfy

specifically, all of their information needs' (Abeysekera and Guthrie, 2002). In doing so, the benefits should justify the cost incurred in reporting them. The availability of several definitions and a lack of a uniform definition of IC and IC reporting, enable firms to define them in an ad-hoc fashion for reporting purposes. The ad-hoc definitions can become the basis for justification of unregulated ICR which firms can manipulate to orchestrate their political, social, and economic arrangements.

3.3. Techniques for reporting ICR

Several techniques have been proposed to measure ICR as ratios and values (Montague Institute Review, 1998). The techniques could be classified into two broader categories, those that measure and report them at firm (macro) level for inter-firm comparisons and others that measure and report within firm level (micro) for inter-divisional comparisons (Abeysekera & Guthrie, 2002).

Six broad indicators are used for measuring and reporting IC between firms: (i) the market to net book value; (ii) Tobin's q ratio; (iii) calculated intangible value; (iv) direct IC; (v) Baruch Lev's knowledge capital valuation; and (vi) Paul Strassmann's knowledge capital valuation. Market to net book value (Roos, Dragonetti, and Edvinsson 1997, p. 2; Sveiby, 1997, pp. 3-18; Knight, 1999; Brennan, 2001) is the most popular and widely known indicator (Knight, 1999).

There are three ways to construct indicators to report IC within firms (Roos and Roos, 1997). These are: indicators as drivers of the vision; indicators to represent intellectual categories and indicators to represent inter-capital flows. The IC index is an indicator developed as a driver of the vision of a firm (Roos and Roos, 1997). The Intangible Assets Monitor™ is a model developed to report IC as an indicator in relation to growth and renewal, efficiency, and stability of a firm (Sveiby, 1997, pp. 163-184). The Intellectual Accounting Scorecard is another model that integrates ICR into mainstream traditional accounting reporting (Abeysekera, 2002b). The return on knowledge assets on IC items is another reporting approach (Dekker and de Hoog, 2000) constructed to report indicators to represent inter-capital flows.

As outlined in this section, IC performance can be measured and reported in six different ways for inter-firm comparisons, enabling firms to adopt the reporting measure that fits best their circumstances. The IC performance within the firm can also be reported in three broad methods, offering the firm a wider choice to select an appropriate indicator. The wide choice of ICR indicators to report performance both within and between firms enables firms to manipulate their political, social, and economic arrangements in an unregulated environment.

3.4. ICR via theoretical classifications

The theoretical classification of IC is simple and varied, but Canibano *et al*. (1999) argue that they are not exhaustive. The analysis of IC available in literature can be classified into five major frameworks: (i) Structures holding intellectual assets (Sveiby, 1997, pp. 93, 11-12, 165). This framework focuses on intellectual assets; (ii) Capital holding intellectual items (Edvinsson, 1997; Edvinsson & Malone, 1998; Roos *et al*., 1997; Edvinsson and Sullivan, 1996), which has been modified by others (Stewart, 1997, pp. 229-246; Roos and Roos, 1997). It discusses ICR in relation to intellectual assets; (iii) Assets representing IC (Brooking, 1996, pp. 13-15, 129; 1999, pp. 153-155) but it focuses on intellectual assets; (iv) Strategic root and measurement root (Roos *et al*., 1997, p. 15) and it focuses on the role of IC; (v) A combination of assets and capital representing IC (SMAC, 1998, p. 14; IFAC, 1998, p. 7). This framework is an extension of the assets representing IC. The organisational (structural) capital represents intellectual property and infrastructure assets.

As outlined in this section, five major theoretical frameworks are discussed in the literature offering a choice of frameworks to report IC.

4. Concluding Remarks

The inconsistent measurement rules to recognise accounting elements and the decided reluctance of the accounting profession to recognise IC in financial statements, and non-uniformity of treatment of accounting elements between countries, have enabled firms to report IC in an unregulated environment. Accounting theorists proposing theories that have little relationship to economic conditions has also confounded the reporting aspects of IC. The literature offers several strategic and one accounting-based definition on IC. There was also hardly any definition of ICR in the literature. The absence of a uniform definition of IC and ICR has widened the reporting definitions and thereby increased ICR choices of firms. A literature review also identified four methods of ICR. First, reporting as ratios, at both inter-firm and intra-firm level. Second, reporting as indicators to represent the vision of the firm, IC categories and return on IC items. Third, reporting via IC statements. Fourth, reporting via the IC framework. These choices offer firms the ability to select the best way to report IC in their favour. These choices of non-uniform ICR enable firms to use IC as a commodity to mediate their political, economic, and social arrangements. Although regulating ICR may not eliminate firms using IC as a commodity, unregulated reporting can enable firms to manipulate ICR to reduce tension between those firms and political, economic, and social structures, in a boundary-less environment.

REFERENCES

Abeysekera, I. 2002a, Annual reports-do they report the truth? *Business Today*, TW Networks, Colombo, March 6(11), pp. 104-105.

Abeysekera, I. 2002b, *Measuring intellectual capital - Intellectual accounting scorecard.* Australian & New Zealand Academy of Management (ANZAM) and the International Federation of Scholarly Associations of Management (IFSAM) 5th World Congress, Gold Coast, July 10-13.

Abeysekera, I. and J. Guthrie, 2002, *An updated review of literature on intellectual capital reporting.* 16th Australian & New Zealand Academy of Management (ANZAM) conference, Beachworth, December 4-7.

Amin, A. 1994, *Models, fantasies, and phantoms of transition,* ed. A. Amin, Post Fordism, London: Blackwell.

ASCPA (Australian Society of Certified Practising Accountants) 1999. *Members Handbook*. **1 & 4**, Update No. 58, December, Butterworths, Australia.

ASCPA and CMA (Australian Society of CPAs and The Society of Management Accountants of Canada) 1999, *Knowledge Management: Issues, practice and innovation.* Australian Society of Certified Practising Accountants, Melbourne.

Acemoglu, D. and J-S. Pischke, 1999, The structure of wages and investment in general training. *Journal of Political Economy*, **107**(3), pp. 539-572.

Allen, D. 2001, Hard Currency. *Financial Management (U.K.)*, January, p. 13.

Anthony, R. N. 1965, *Management Accounting Principles.* Richard D. Irwin Inc., Homewood, Illinois.

Backhuijs, J.B., Holterman, W.G.M., Oudman, R.S., Overgoor, R.P.M. and S.M. Zijlstra 1999,. Reporting on intangible assets. *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Benjamin, A. 1998, Prototype plc-The 21st century annual report. *The 21st Century Annual Report, Corporate Governance*, Institute of Chartered Accountants of England & Wales, London.

Boczko, T. 2000, A critique on the classification of contemporary accounting:towards a political economy of classification-the search for ownership. *Critical Perspectives on Accounting*, **11**, pp. 131-153.

Boone, J. P. and K.K. Raman, 2001a, Off-balance sheet R&D assets and market liquidity. *Journal of Accounting and Public Policy*, **20**, pp. 97-128.

Boone, J.P. and K.K. Raman, 2001b, On R&D capitalization and value relevance: a response. *Journal of Accounting and Public Policy*, **20**, pp. 255-261.

Bornemann, M., Knapp, A., Schneder, U. and K.I. Sixl, 1999, Holistic measurement of intellectual capital. *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Brennan, N. 2001, Reporting intellectual capital in annual reports: evidence from Ireland. *Accounting, Auditing & Accountability Journal,* **14**(4), pp. 423-436.

Brooking, A. 1997, The Management of intellectual capital. *Long Range Planning*, **30**(3), pp. 364-365

Brooking, A. 1999, *Corporate memory, Strategies for knowledge Management.* International_Thomson Business Press, London.

Buhner, R. 1997, Increasing shareholder value through human asset management. *Long Range Planning*, **30**(5), pp. 710-717.

Buhr, N. 1998, Environmental performance, legislation and annual report disclosure: the case of acid rain and Falconbridge. *Accounting, Auditing & Accountability Journal,***11**(2), pp. 163-190.

Burchell, S, Clubb, C., Hopwood, A., Hughes, J. and J. Nahapiet, 1980, The roles of accounting in organizations and society. *Accounting, Organizations and Society*, **5**(1), pp. 5-27.

Canibano, L., Garcia-Ayuso, M., Sanchez, M. and M. Olea, 1999, Measuring intangibles to understand and improve innovation management. Primary result. *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Chapman, C.S. 1997, Reflections on a contingent view of accounting. *Accounting, Organizations and Society*, **22**(2), February, pp. 189-205.

Chub, J. 1983, *Interest groups and the bureaucracy: The politics of energy.* Stanford university press.

Choon, H., Smith, M. and S. Taylor, 2000, What do Australian annual reports say about future earnings?. *Australian Accounting Review*, **10**(1), March, pp. 17-25.

CMA (The Society of Management Accountants of Canada) 1998, *The management of intellectual capital: The issues and the practice, Management accounting issues paper 16*. The Society of Management Accountants of Canada, Hamilton, Ontario.

Collier, P. M. 2001, Valuing intellectual capacity in the police. *Accounting, Auditing & Accountability Journal,* **14**(4), pp. 437-455.

Cook, A. 1998, *The 21st century annual report, Corporate governance.* Institute of Chartered Accountants of England & Wales, London.

Cooper, D. 1980, Discussion of towards a political economy of accounting. *Accounting, Organizations and Society*, **5**(1), pp. 161-166.

Cooper, D. J. and M.J. Sherer, 1984, The value of corporate accounting reports: arguments for a political economy of accounting. *Accounting, Organizations and Society*, **l9**(3/4), pp. 207-232.

Copeland, T. 2000, Cutting Costs without Drawing Blood. *Harvard Business Review*, September-October, pp. 155-164.

CPA Australia 2000. *Members handbook.* **1,** CPA Australia, Melbourne.

Davies, J. and A. Waddington, 1999, The management and measurement of intellectual capital. *Management Accounting (UK)*, September, p. 34.

Dearden, J. 1960, Problem in decentralized profit responsibility. *Harvard Business Review*, **38**(3), May-June, pp. 79-86

Dekker, R. and R. de Hoog, 2000, The monetary value of knowledge assets: a micro approach. *Expert Systems with Applications*, **18**(2), February, pp. 111-124.

Dunk, A. S. and A. Kilgore, 2001, Short-term R&D bias, competition on cost rather than innovation, and time to market. *Scandinavian Journal of Management*, **17**, pp. 409-420.

Edvinsson, L. and M.S. Malone, 1998, *Intellectual capital.* 1st edn. Judy Piatkus(Publishers), U.K.

Edvinsson, L. and P. Sullivan, 1996, Developing a model for managing intellectual capital. *European Management Journal*, **14**(4), pp. 356-364.

Graham, R.C. and King, R.D. 2000, Accounting practices and the market valuation of accounting numbers: evidence from Indonesia, Korea, Malaysia, the Philippines, Taiwan, and Thailand. *The International Journal of Accounting*, **35**(4), pp. 445-470.

Grant, W. 1985. Introduction. *The political economy of corporatism,* ed.W.Grant. Macmillan, Hong Kong.

Gray, R., Owens, D. and C. Adams, 1996, *Accounting & Accountability, Changes and challenges in corporate social environmental reporting.* Prentice Hall Europe, Hertfordshire, UK.

Guthrie, J. and L.D. Parker, 1990, Corporate social disclosure practice: A comparative international analysis. *Advances in Public Interest Accounting*, **3**, pp. 159-175.

Guthrie, J. and R. Petty 2000, Intellectual capital: Australian annual reporting practices, *Journal of Intellectual Capital*, **1**(3), pp. 241-251

Hansson, B. 1997, Personnel investments and abnormal return: Knowledge-based firms and human resource accounting. *Journal of Human Resource Costing and Accounting*, **2**(2), Autumn, pp. 9-29.

Heckmian, J.S. and C.H. Jones, 1967, Put people on your balance sheet. *Harvard Business Review*,**45**, Jan-Feb, pp. 105-113.

Hoegh-Krohn, N.E.J. and K.H. Knivsfla, 2000, Accounting for intangible assets in Scandinavia, the UK, the US, and by the IASC: Challenges and a solution. *The International Journal of Accounting*, **35**(2), pp. 243-265.

Horney, S. 1999, Speech delivered as the Chairman Lend Lease Corporation Ltd., Australia. *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Hughes, S.B., Anderson, A. and S. Golden, 2001, Corporate environmental disclosures: are they useful in determining environmental performance?. *Journal of Accounting and Public Policy*, **20**, pp. 217-240.

ICA E&W (The Institute of Chartered Accountants in England & Wales) 1998. Towards a market led reporting model. *The 21st Century Annual Report, Corporate Governance*, The Institute of Chartered Accountants in England & Wales, London.

IAS (International Accounting Standards) 38 1998. *Intangible assets*. International Accounting Standards Committee.

IFAC (International Federation of Accountants) 1998. *The measurement and management of intellectual capital: An introduction study 7*. October, IFAC, New York.

Jenkins, B. 1998. Chairman's introduction", *The 21st century annual report, Corporate governance.* The Institute of Chartered Accountants of England & Wales.

King, R. 1985. Corporatism and the local economy. *The political economy of corporatism,* ed. Wyn Grant. Macmillan, Hong Kong.

Klein, D.A. 1998. *The Strategic Management of Intellectual Capital*. ed. D.A. Klein. Butterworth-Heinemann, Woburn, MA.

Knight, D.J. 1999. Performance measures for increasing intellectual capital. *Planning Review*, **27**(2), March/April, pp. 22-27.

Lashinsky, A. 1999, Just What Are Earnings, Anyway? *Fortune*, **140**(5), p. 312.

Lev, B., Sarath, B. and T. Sougiannis, 1999, R&D reporting biases and their consequences. *2nd Intangible Conference in New York City, Intangibles Management, Measurement and Organization*, New York, May 27-28.

Lipworth, S. 1998, *The 21st century annual report, Corporate governance.* Institute of Chartered Accountants of England & Wales, London.

Marin, B. 1985, Austria-the paradigm case of liberal corporatism?. *The political economy of corporatism,* ed. Wyn Grant. Macmillan, Hong Kong.

Merino, B.D. 1993, An analysis of the development of accounting knowledge: A pragmatic approach. *Accounting, Organizations and Society*, **18**(2/3), pp. 163-185.

Montague Institute Review 1998. *Measuring intellectual assets* (online). January 1998. http://www.montague.com/le/le1096.html [Accessed on 12 January 2001].

Moorhow, M. 1990. Brands debate: wake up to the real world. *Accountancy*, **106**, July, p. 30

Nasseri, T. 1998. *Knowledge leverage: The ultimate advantage* (online). http://www.brint.com/papers/submit/nasseri.htm [Accessed on 18 December 2001].

Okano, H., Okado, E. and N. Mori, 1999, Implementing brand management in the Japanese companies: related with target cost management. *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Olsson, B. 2001, Annual reporting practices: Information about human resources in corporate annual reports in major Swedish companies. *Journal of Human Resource Costing and Accounting*, **6**(1), Spring, pp. 39-52.

Petrash, G. 1996, "Dow's journey to a knowledge value management culture. *European Management Journal*, **14**(4), pp. 365-373.

Petty R. and J. Guthrie, 1999, Managing intellectual capital from theory to practice. *Australian CPA*, cover feature, August, pp. 18-22.

Petty, R. and J. Guthrie, 2000, Intellectual capital literature review: Measurement, reporting and management. *Journal of Intellectual Capital*, **1**(2), May, pp. 155-176.

Power, M. 2001, Imagining, measuring and managing intangibles. *Accounting, Organizations and Society*, **26**, pp. 691-693.

Ravlic, T. 2000. The great intangible debate. *Australian CPA*, July, pp. 28-30.

Romer, P.M. 1998, Bank of America roundtable on the soft revolution: Achieving growth by managing intangibles. *Journal of Applied Corporate Finance*, **11**(2), Summer, pp. 8-27.

Rohwer, J. 1999, The Numbers Game (online). http://library.northernlight.com/PN19991109040000416.html?cb=13&sc=0, *Fortune*, **140**(10), pp. 263+ [Accessed 18 December 2001].

Roos, G. and J. Roos, 1997, Measuring your Company's intellectual performance. *Long Range Planning*, **30**(3), pp. 413-426.

Roos, J., Roos, G., Dragonetti, N.C. and L. Edvinsson, 1997, *Intellectual capital, navigating the new business landscape.* Macmillan Business, London.

Ronen, J. 2001, On R&D capitalization and value relevance: a commentary. *Journal of Accounting and Public Policy*, **20**, pp. 241-254.

Russell, M. 2002, What disability civil rights cannot do: employment and political economy. *Disability & Society*, **17(2), pp. 117-135.**

Saint-Onge, H. 1998, How knowledge management adds critical value to distribution channel management. *Journal of Systemic Knowledge Management,* January, (online). http://www.free-press.com/journals/knowledge/issue1/article1.htm [Accessed on 27 March 2000].

Schmitter, P.C. 1979. Still the century of corporatism?. *Trends towards corporatist intermediation,* ed. P. Schmitter and G. Lehmbruch. Sage, London.

SMAC (Society of Management Accountants of Canada) (1998). *The management of intellectual capital: The issues and the practice.* January, The Society of Management Accountants of Canada, Ontario.

Stewart, T.A. 1997. *Intellectual capital, The new wealth of organizations*. Nicholas Brealey, London.

Stolowy, H. and A. Jenny-Cazavan, 2001, International accounting disharmony: The case of intangibles", *Accounting, Auditing & Accountability,* **14**(4), pp. 477-496.

K-E. Sveiby, 1997. *The new organizational wealth, managing & measuring knowledge based assets*. 5th edn., Barrett-Koehler, San Francisco.

Swinson, C. 1998. Address by the President of the Institute. *The 21st Century Annual Report, Corporate Governance*, Institute of Chartered Accountants of England & Wales, London.

Thompson, G.D. 1998, Cultural capital and accounting. *Accounting, Auditing & Accountability Journal*, **12**(4), pp. 394-412.

Tinker, A.M. 1980, Towards a political economy of accounting: An empirical illustration of the Cambridge controversies. *Accounting, Organizations and Society*, **5**(1), pp. 147-160.

Tinker, T. and M. Neimark, 1987, The role of annual reports in gender and class contradictions at General Motors: 1917-1976. *Accounting, Organizations and Society*, **12**(1), pp. 71-88.

Tinker, A.M. 1985. *Paper prophets*. New York: Holt, Rinehart, and Winston.

Tollington, T. 2001, UK brand asset recognition beyond "transactions or events. *Long Range Planning,* **34**, pp. 463-487.

Ulrich, D. 1998, Intellectual capital = competence x commitment. *Sloan Management Review*, **39**(2), Winter, pp. 15-26.

Unwin, W. 1990, Its not bad on the goodwill front. *Accountancy*, **106**, p. 29.

Van der Meer-Kooistra, J. and S. M. Zijlstra 2001, Reporting on intellectual capital. *Accounting, Auditing & Accountability Journal,* **14**(4), pp. 456-476.

Walgemoed, J.H.J.A. 1999, Measuring and reporting intellectual capital: Experience, issues, and prospects, *OECD Symposium on Measuring and Reporting of Intellectual Capital*, Amsterdam, June 9-11.

Wharton Alumni Magazine 1997. Beyond bricks and mortar, accounting for intangible assets. *The Wharton School, University of Pennsylvania*, Winter, pp. 7-12.

Williams, S.M. 2001. Is intellectual capital performance and disclosure practices related?. *Journal of Intellectual Capital*, 2(3), pp. 192-203.

Woodward, D., Edwards, P., and F. Birkin, 2001, Some evidence on executives' views of corporate social responsibility. *British Accounting Review*, Sep., 33(3), pp. 357-397.

Zambon, S. and L. Zan, 2000, Accounting relativism: the unstable relationship between income measurement and theories of the firm. *Accounting, Organizations and Society*, 25, pp. 799-822.

Zysman, J. 1985. *Governments, markets and growth.* Oxford: Martin Robertson.

PRODROMOS CHATZOGLOU
DIMITRIOS KOUSENIDIS
CHRISTOS NEGAKIS

The Performance of Greek Closed-End Funds

Abstract

The present study examines the selectivity and market timing performance of listed and non-listed Greek Closed-End Funds. The study uses four alternative performance models that allow separating returns into selectivity and timing components. The results of the study show that there is an inverse relation between selectivity and market timing performance. Moreover, it appears that the return timing component is stronger for listed than for non-listed closed-end funds. Finally, the results indicate that both listed and non-listed closed end funds are unable to outperform the market. The poor performance, especially of the non-listed funds, explains why many of them face survival problems and bears important implications for regulators and policy makers in Greece.

1. INTRODUCTION

The increasing preference of investors for shares of managed funds is well documented over the past years and is justified by the belief that managed funds offer investors diversification and managerial skills. Managerial skills are usually interpreted as the ability of the management of the funds to display selectivity and timing. The term "selectivity" refers to the ability of the management to pick successful shares whilst "timing" refers to the ability of the management to foresee the movements of the market and adjust the risk of the funds' portfolio towards the right direction.[1]

In this context, the issue of performance measurement of managed funds has taken the form of identifying selectivity and timing performance measures. Many, if not all, of the models that have been developed are variants of the CAPM and have been tested on both mutual funds and closed-end funds. Although it is true that researchers display a preference to mutual funds[10],

[1] The existence of managerial skills does not contradict the efficient market hypothesis. Grossman and Stiglitz (1980) provide a version of EMH, which assumes that information is not free. Therefore, some managers may possess valuable private information that is not shared by the market as a whole. The excess returns of active managers are then presumed to concur with the information-gathering costs incurred. Lang, Litzenberger and Madrigal (1992) also observe that even if noise exists in the market, it does not completely dilute the information content of share prices. In this context they admit that their results describe an environment under which it is not contradictory to assume both traders' rationality and private incentives to acquire information.
[2] See Wermers (2000) for a review and an analysis.

studies on the performance of closed-end funds are not scarce in the finance literature. Dimson and Minio-Kozerski (1998) provide a thorough review of such studies in the area.

These studies mainly refer to the US, UK and the Australian institutional environments and reveal results which are not always consistent. For example, Connor and Korajczyk (1991), Coggin, Fabozzi and Rahman (1993), Fletcher (1995), and Hallahan and Faff (1999) find some evidence on selectivity but not on timing skills. Moreover, all these studies report that there is an inverse relation between selectivity and timing. On the other hand, Patro (2001) examines the performance of 45 US-based international funds and finds little evidence either on selectivity or on timing. Bangassa (1999) uses multifactor performance measures for a sample of UK unit trusts and argues that some of the funds exhibit superior selectivity performance. Again however, he is unable to observe any superior timing abilities.

Allen and Soucik (2000, 2002) trying to explain these contradicting results, test for the sensitivity of univariate and multivariate CAPM-based performance measures to different factors. They find that the use of different benchmarking portfolios is the major source of conflicting results. Moreover, they observe that some univariate versions of the CAPM exhibit a nontrivial degree of misspecification. Finally, they find little evidence on consistency in selectivity and timing across different time periods.

Kothari and Warner (2001) test for model misspecification by constructing portfolios from naively selected stocks. They then use a variety of both univariate and multivariate performance measures to test for selectivity and timing in managed funds and in naively constructed portfolios. Their results reveal abnormal performance even in cases of naïve portfolios where none is known to exist. Thus, they conclude that there is a high degree of model misspecification, although they admit that multivariate models exhibit a lesser degree of misspecification than univariate models.

Finally, Pedersen and Satchell (2000) argue that studies on the performance of closed-end funds usually employ a small amount of data. The small number of observations is likely to violate the assumption of normality and results in biased OLS regression estimates of selectivity and timing. They show that accurate performance rankings are obtained by using the Asymmetric Response Model (ARM), initially proposed by Bawa, Brown and Klein (1981). This model has the intuitive property that it captures non-normality in unconditional returns without demanding the use of specific distributional assumptions that incorporate skewness and kurtosis. Moreover, the ARM nests the one-factor mean-variance CAPM and the lower partial moment CAPM and produces positive and negative excess-return betas for up and down markets.

The present paper uses the ARM along with three alternative CAPM-based performance measures to evaluate the performance of Greek closed-end funds. Thus, the paper tests not only for selectivity and timing performance, but also for differences in performance across up (bull) and down (bear) markets. Moreover, the paper contributes to the literature by looking at two different samples of Greek closed-end funds. The first sample refers to the closed-end funds that are listed in the Athens Stock Exchange (ASE). The second sample refers to the closed-end funds that are not listed and are in the queue waiting for permission to conduct an initial public offering.

Under normal circumstances researchers are unable to use data for non-listed closed-end funds because soon after their formation, closed-end funds apply for listing the stock market. However, the Greek case offers a slightly paradoxical phenomenon. Although the first Greek fund was founded in 1973, closed-end funds in Greece were not very popular. By the end of 1998 there were only seventeen Greek closed-end funds, owned mainly by banks and insurance companies. The year 1999 was a very hot year for the Greek capital market. This offered the opportunity to many institutional investors and investment companies to form closed-end funds in order to facilitate their market-making activities. Thus, by the summer of 2000 there were approximately twenty newly formed closed-end funds in the queue for listing the ASE. However, since April 2000 the ASE exhibited a tremendous downward trend, a tendency that continues till now. Because of the significantly low volume of transactions following the continuous drop in stock prices, the Hellenic Capital Market Commission (HCMC) decided to limit the number of IPOs and delay the procedures of new listings. Thus many newly formed closed-end funds have found themselves waiting for more than two years to list their shares. In particular, by the middle of 2002, there were 22 listed closed-end funds and 17 non-listed funds. By the end of 2002, these numbers became 23 listed and 13 non-listed funds. These clearly show that many non-listed funds face serious survival problems and either they discontinued operations, or they are being acquired by larger financial institutions.

The unfortunate conditions that prevail in the Greek Capital Market provide an incentive to non-listed closed-end funds for successful active management. In fact if non-listed funds are to survive and eventually list their shares to the ASE, they should at least provide positive NAV returns. Therefore, an alternative hypothesis tested in the present paper states that if closed-end funds in Greece exhibit selectivity and timing performance, it should be more apparent to non-listed than to listed funds.

The results of the study vary across the models. In addition, one model is found to present some degree of misspecification. Overall, the results depict that both listed and non-listed closed-end funds in Greece display significantly negative selectivity performance. On the other hand, some inconsistency is observed as concerns timing performance. The ARM suggests that listed

funds display significant positive timing performance. Conflicting evidence on timing is, however, observed for the non-listed closed-end funds. Moreover, it appears that listed funds, on average, outperform the non-listed ones and market movements better explain the NAV returns of listed rather than non-listed closed-end funds in Greece.

The results on the poor performance of closed-end funds in Greece and especially of the non-listed, bear important implications for regulators and policy makers in Greece. First, it appears that the HCMC should impose stricter requirements in authorising fund managers to newly formed closed-end funds. Second, stricter requirements should also apply to the portfolio formation of closed-end funds prior to going public. The Greek experience shows that in times of recession, shifts from equity stocks to fixed income securities, is not something that is considered as the natural thing to do. Thus, regulatory authorities should apply rules that require the measurement of the funds portfolio downside risk, such as Value at Risk (VaR) measures. Finally, it seems that something must be done to facilitate the survival of the existing non-listed funds. For example some incentives can be provided for mergers and acquisitions. Certainly, however, the liquidation of their portfolios is not the appropriate solution, given the bad conditions that prevail in the Greek Capital Market.

The remainder of the paper is organised as follows. Section 2 describes data selection and some methodological issues. Section 3 presents and analyses the empirical results. Section 4 summarises conclusions and implications for further research

2. Data and Methodology

2.1. The Data Set

The present study uses monthly data for a sample of Greek listed closed-end funds and a sample of Greek non-listed closed-end funds over a period of 38 months from 11/1999 to 12/2002. Both sample sizes vary in the number of firms from month to month and amount to a total of 678 pooled firm-month observations for the listed funds sample and to a total of 648 pooled firm-month observations for the non-listed funds sample. Both samples contain young firms and firms that have discontinued operations. Thus, it can be argued that the samples do not suffer any survivorship bias[3].

For all listed and non-listed funds, the return metric considered is the monthly net asset value (NAV) return. These data are available through the website of the Association of Greek Institutional Investors (www.agii.gr). The excess

[3] Elton, Gruber and Blake (1996) provide a set of arguments on the importance of considering the impact of survivorship bias on portfolio performance.

NAV return, which is used in the performance models, is calculated by deducting the risk-free return from the raw NAV returns. In the context of the present study, the risk-free return is approximated by the monthly interest rate of the 3-months Treasury Bills of the Greek Government.

The market rate of return used is the monthly percentage change in the General Index of the ASE. Because NAV returns do not contain any dividends paid, no adjustment has been made to the general index for dividends. The excess market return is calculated by deducting the risk-free return from the market return. Data for the ASE General Index and for the 3-Months T-Bill rates have been extracted from the Global Financial Data database.

2.2. Models of Portfolio Performance Evaluation

As stated in the introductory section, the present study uses alternative models of portfolio performance. These models are:

2.2.1. The Jensen (1968) Model

This model is actually the standard CAPM, which advocates a linear relation between the excess NAV returns and the excess market returns:

$$R_{p,t} = \alpha + \beta R_{m,t} + \varepsilon_{p,t} \quad (1)$$

where $R_{p,t}$ is the excess NAV return on fund p in the month t; $R_{m,t}$ is the excess market return in month t; the slope of the regression equation β represents the systematic risk of the funds; the intercept of the regression equation α measures the selectivity performance of the funds; and $\varepsilon_{p,t}$ is a white noise process assumed independent of excess market returns.

2.2.2. The Treynor and Mazuy (1966) Model

This model is also known as the Quadratic CAPM and relaxes the linearity assumption of the CAPM reflecting thus, time-variations in beta. Specifically, fund managers who exhibit good timing skills are able to increase the systematic risk of the portfolio during market up-times and reduce it when the market falters. Hence the time dependent beta is expressed as:

$$\beta_t = \beta + \gamma R_{m,t} \quad (2)$$

A positive gamma thus shows a direct relation between beta and excess market returns, reflecting thus, the managers' timing ability. Substituting equation 2 into equation 1, leads to the quadratic definition of the CAPM:

$$R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^2_{m,t} + \varepsilon_{p,t} \quad (3)$$

In this model, the intercept alpha indicates the return specifically derived from stock selectivity and the slope gamma reflects the return component from market timing.

2.2.3. The Henriksson and Merton (1981) Model

This model is also known as the Dual Beta CAPM and adopts the same attitude towards time-varying betas as the Treynor and Mazuy model. Henriksson and Merton (1981) opted to separate the constant factor-beta from the changing timing-beta. This leads to the definition of a dual beta CAPM:

$$R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^+_{m,t} + \varepsilon_{p,t} \quad (4)$$

where $R^+_{m,t}$ equals $R_{m,t}$ when $R_{m,t}>0$ and zero otherwise. Once again, the intercept alpha reflects the return derived from selectivity while the slope gamma exposes the return from market timing.

2.2.4. The Asymmetric Response Model (ARM)

The ARM was initially developed by Bawa, Brown and Klein (1981) and was adopted by Pedersen and Satchell (2000) for testing portfolio performance. The ARM nests the one-factor mean-variance CAPM and the lower partial moment CAPM and can accommodate various degrees of non-normality in portfolio returns quite simply. The model captures asymmetry by producing positive and negative excess return slopes for up and down markets respectively:

$$R_{p,t} = \alpha + \beta R^+_{m,t} + \gamma R^-_{m,t} + \delta D_t^+ + \varepsilon_{p,t} \quad (5)$$

where $R^-_{m,t}$ equals $R_{m,t}$ when $R_{m,t}<0$ and zero otherwise; and D_t^+ is a dummy variable that takes the value of one when $R_{m,t}>0$ and zero otherwise, with all other variables being as previously defined. The intercept alpha, once again reflects the selectivity performance, whilst the slopes beta and gamma indicate the timing skills of the funds manager.

2.3. Specification Tests

In order to examine the possibility of misspecification in the selectivity-timing separation models, Jagganathan and Korajczyk (1986) suggested the application of exclusion-restriction specification tests (ERST). These tests have also been applied by Hallahan and Faff (1999) and by Allen and Soucik (2000) and require that the selectivity-timing model is augmented by additional variable(s) of higher order. If the original model is correctly specified then

the additional variables should not produce significant regression coefficients. The application of this argument to the Treynor and Mazuy and the Henriksson and Merton models, results to the following ERST-adjusted versions:

$$R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^2_{m,t} + \varphi R^3_{m,t} + \varepsilon_{p,t} \quad (6)$$

$$R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^+_{m,t} + \phi R^2_{m,t} + \varepsilon_{p,t} \quad (7)$$

Although the aforementioned studies do not consider any specification test for the ARM, following Jagganathan and Korajczyk, the ERST-adjusted version of the ARM could be as follows:

$$R_{p,t} = \alpha + \beta R^+_{m,t} + \gamma R^-_{m,t} + \delta D_t^+ + \phi R^2_{m,t} + \varepsilon_{p,t} \quad (8)$$

In this augmented version of the ARM, is considered to be the base variable. This is because both explanatory variables in the ARM are calculated by multiplying by a dummy variable.

In these adjusted versions of the three models, the regression coefficient should be statistically insignificant. The appropriate significance test proposed by Jagganathan and Korajczyk is the F-test although they argue that a heteroskedasticity-adjusted t-test performs equally well.

3. Empirical Results

The empirical analysis conducted in the context of the present paper involves testing the performance of listed and non-listed Greek investment trusts using four alternative performance models. The time horizon of the study covers a period of 38 months from 11/1999 to 12/2002. Some summary statistics for the variables are presented in table 1.

Table 1. – SUMMARY DESCRIPTIVE STATISTICS

	NAV Return		Market Return	Risk-Free Rate
	Listed	**Non-Listed**		
Mean	-3.88%	-3.83%	0.12%	0.38%
Median	-2.41%	-0.92%	1.28%	0.36%
Std. Deviation	10.65%	30.33%	6.20%	0.08%
Count	678	648	38	38

Notes:

The NAV return represents the percentage change in the monthly net asset value of the funds; the Market return represents the monthly return of the ASE General Index; the risk-free rate is the interest rate of the Greek Government's 3-Months T-Bills adjusted on a monthly base. The horizon of the study covers a period of 38 months from 11/1999 to 12/2002.

Numbers are rounded to two decimal points.

Table 1 tabulates mean raw NAV returns for the two samples of listed and non-listed closed-end funds as well as mean raw market returns and mean risk-free returns. It is clear that over the period examined, both listed and non-listed closed-end funds on average do not manage to outperform the market. Moreover, it appears that on average, there are no significant differences in the mean performance of listed and non-listed funds. However, the standard deviation of the returns of the listed funds is much lower than the respective non-listed funds. This implies a significant volatility in the returns of non-listed funds across firms.

The results of the regression models that examine the performance of non-listed closed-end funds are tabulated in table 2.

Table 2. – THE PERFORMANCE OF NON-LISTED CLOSED-END FUNDS EVALUATED BY FOUR ALTERNATIVE MODELS:

Model 1: $R_{p,t} = \alpha + \beta R_{m,t} + \varepsilon_{p,t}$

Model 2: $R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^2_{m,t} + \varepsilon_{p,t}$

Model 3: $R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^+_{m,t} + \varepsilon_{p,t}$

Model 4: $R_{p,t} = \alpha + \beta R^+_{m,t} + \gamma R^-_{m,t} + \delta D_t^+ + \varepsilon_{p,t}$

Model		***α***	***β***	***γ***	***δ***	***R²***	***Adj – R²***	***F-stat***
1	Coefficient	-3.984*	0.907*			0.034	0.033	23.014*
	t-stat	-3.398	4.797					
	p-value	0.001	0.000					0.000
2	coefficient	-6.917*	1.148*	0.078*		0.063	0.060	21.731*
	t-stat	-5.198	5.915	4.447				
	p-value	0.000	0.000	0.000				0.000
3	coefficient	-9.463*	-0.046	2.496*		0.062	0.059	21.461*
	t-stat	-5.561	-0.163	4.388				
	p-value	0.000	0.871	0.000				0.000
4	coefficient	-2.404	2.795*	0.637	-9.389*	0.071	0.066	16.321*
	t-stat	-0.706	6.625	1.577	-2.393			
	p-value	0.480	0.000	0.115	0.017			0.000

Notes:

Description of variables: $R_{p,t}$ is the funds monthly NAV return in excess of the risk free rate; is the monthly return on the market portfolio in excess of the risk free rate; $R^+_{m,t}$ is equal to $R_{m,t}$ when $R_{m,t}>0$, and zero otherwise; $R^-_{m,t}$ is equal to $R_{m,t}$ when $R_{m,t}<0$, and zero otherwise; and D_t^+ is a dummy variable that takes the value of 1 when $R_{m,t}>0$, and zero otherwise.

The sample size consists of 648 pooled firm-month observations.

* indicates significance at the 1 per cent level.

The first three models examined show that non-listed closed-end funds display a significant negative selectivity return component. The ARM also produces a negative intercept term, which however, is not statistically significant. On the other hand, all models reveal that non-listed closed-end funds display a significant timing ability, in the sense that they switch portfolio risk to higher levels during market up-times. The ARM, however, indicates that the

timing return component is significant only in up markets. The gamma slope of the regression that accounts for downside risk is found to be insignificant, indicating an inability of fund managers to lower portfolio risk when the market is going down. In addition, the extremely low values of the R-square depict that the market returns play a very small role in explaining the returns of the portfolios of non-listed closed-end funds in Greece. This finding clearly highlights the problems that the non-listed funds face. The urge for survival potentially forces fund managers to engage in high risk investments in order to generate high returns. If these investments fail to yield the expected returns, then the only problem that may arise is that the possibility of going bankrupt will appear sooner than anticipated.

The results of the regression models used to evaluate the performance of listed closed-end funds in Greece appear in table 3.

Table 3. – THE PERFORMANCE OF LISTED CLOSED-END FUNDS EVALUATED BY FOUR ALTERNATIVE MODELS:

Model 1: $R_{p,t} = \alpha + \beta R_{m,t} + \varepsilon_{p,t}$

Model 2: $R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^2_{m,t} + \varepsilon_{p,t}$

Model 3: $R_{p,t} = \alpha + \beta R_{m,t} + \gamma R^+_{m,t} + \varepsilon_{p,t}$

Model 4: $R_{p,t} = \alpha + \beta R^+_{m,t} + \gamma R^-_{m,t} + \delta D_t^+ + \varepsilon_{p,t}$

Model		***α***	***β***	***Γ***	***δ***	***R²***	***Adj – R²***	***F-stat***
1	coefficient	-2.114*	0.702*			0.260	0.258	237.465*
	t-stat	-5.712	15.409					
	p-value	0.000	0.000					0.000
2	coefficient	-2.075*	0.700*	-0.001		0.260	0.258	118.575*
	t-stat	-4.767	14.249	-0.167				
	p-value	0.000	0.000	0.867				0.000
3	coefficient	-1.958*	0.723*	-0.054		0.260	0.258	118.639*
	t-stat	-3.388	9.765	-0.035				
	p-value	0.001	0.000	0.726				0.000
4	coefficient	-2.459*	0.541*	0.675*	1.703	0.262	0.259	79.789*
	t-stat	-3.577	3.808	8.196	1.344			
	p-value	0.000	0.000	0.000	0.179			0.000

Notes:

Description of variables: $R_{p,t}$ is the funds monthly NAV return in excess of the risk free rate; $R_{m,t}$ is the monthly return on the market portfolio in excess of the risk free rate; $R^+_{m,t}$ is equal to $R_{m,t}$ when $R_{m,t} > 0$, and zero otherwise; $R^-_{m,t}$ is equal to $R_{m,t}$ when $R_{m,t} < 0$, and zero otherwise; and D_t^+ is a dummy variable that takes the value of 1 when $R_{m,t} > 0$, and zero otherwise.

The sample size consists of 678 pooled firm-month observations.

* indicates significance at the 1 per cent level.

It appears from the results of table 3 that listed closed-end funds exhibit significant negative selectivity performance. This result is demonstrated by all four models. However, the results vary when it comes to timing performance. Both the Treynor and Mazuy and the Henriksson and Merton models fail to prove any significant timing related abnormal returns. The ARM, however, presents results which highlight the notion that the managers of listed closed-end funds in Greece exhibit market-timing abilities. It appears that managers of listed funds adjust portfolio risk to market movements and that the downside risk measure (the gamma coefficient) is significant for listed funds. In essence, the results obtained by the ARM are consistent with the view that there is an inverse relation between selectivity and timing performance. Moreover, equally important in the results of table 3 are the values of R-square. In all four models the values of R-square are 26 per cent, indicating that the variation in excess NAV returns of listed closed-end funds in Greece is explained, to a large extent, by the variation in excess market returns.

By comparing the results of tables 2 and 3, we can clearly observe that on average, both listed and non-listed closed-end funds in Greece exhibit a negative selectivity return component. Moreover, three out of the four models indicate that in terms of selectivity, listed closed-end funds perform better than non-listed funds. The fourth model, the ARM, shows that both listed and non-listed funds perform equally well. In addition, in the non-listed funds case, we can clearly see that by moving from the Jensen Model to the Treynor and Mazuy Model and then to the Henriksson and Merton Model, the timing return component increases at the expense of the selectivity return component. This result, however, is not apparent in the listed funds case. Moreover, neither is it apparent in either sample, when the selectivity-timing separation model considered is the ARM. This perhaps indicates that the ARM captures in a better way the timing return component by considering information asymmetries across bull and bear markets.

The evidence on the timing ability, however, is slightly mixed. The Treynor and Mazuy and the Henriksson and Merton models show that non-listed fund managers display significant timing skills whilst listed fund managers do not. The regression coefficients, however, derived by the ARM indicate exactly the opposite. That is, listed fund managers adjust portfolio risk to up and down markets, while non-listed fund managers adjust portfolio risk only to up-moving markets.

The fact that the results of the study vary across the models employed enhances the need to perform model misspecification tests. However, table 4 shows that the somehow conflicting results, especially on the timing performance of the non-listed closed-end funds, cannot be attributed to model misspecification.

Table 4. – REGRESSION ESTIMATES OF THE ϕ COEFFICIENT (EXCLUSION – RESTRICTION SPECIFICATION TESTS)

		Model		
		T-M	**H-M**	**ARM**
Non-Listed	**Coefficient**	0.004**	0.051	0.064
	t-stat	1.996	0.845	1.051
	p-value	0.046	0.399	0.294
Listed	**Coefficient**	-0.001	0.007	0.006
	t-stat	-1.420	0.502	0.445
	p-value	0.156	0.616	0.657

Notes:

Regression test statistics are based on standard errors corrected for heteroskedasticityusing the method in White (1980).

** indicates significance at the 5 per cent level.

All models appear to perform relatively well with Greek data. The only exception is the Treynor and Mazuy (T-M) model, which for the non-listed funds sample, exhibits some degree of misspecification at the 5 per cent level. By looking at the results of the listed funds sample, we can see that across all three models the coefficient ϕ is very close to zero and statistically insignificant. The non-listed funds sample present slightly different results. The coefficient ϕ for the T-M model is found close to zero but significant at the 5 per cent level. For the other two models, the coefficients ϕ are found to be insignificant but larger than those observed in the case of the listed funds sample. Overall, however, the results of table 4 depict that all three selectivity-timing separation models perform relatively well in evaluating the performance of Greek closed-end funds.

4. Concluding Remarks

After the hot market of 1999, the Greek Capital Market has shown a significant downward trend. This situation has caused problems to many Greek companies but especially to closed-end funds whose performance is dependent on the returns of the portfolios they hold. Moreover, many closed-end funds that were formed in 1999 and in early 2000 had to postpone the initial offering, waiting for a reversal in the tendency of the market. However, till the present time, the situation has not altered and all the newly formed closed-end funds are facing severe problems. Some of them were faced with survival problems and eventually had to discontinue operations. Others have managed to survive, but they have never managed to conduct an IPO. Thus, for the first time in the history of the Greek Capital Market, there are available data for a large number of non-listed closed-end funds and over a long period of time. This gives the opportunity to examine the performance of closed-end funds in Greece by distinguishing the sample into listed and non-listed closed-end

funds. Thus, it is possible to study the investment behaviour of Greek funds prior to going public.

The results of the study are disheartening. Both listed and non-listed closed-end funds exhibit a negative selectivity return component, implying that active portfolio management cannot outperform the market. As regards the timing return component, the results of the study exhibit some degree of conflict across listed and non-listed funds. It appears that the listed funds' managers display some rational behaviour by adjusting the risk of their portfolios to higher levels when the market is up and to lower levels when the market is down. No such behaviour, however, is apparent to the management of non-listed funds. The risk of their portfolios adjusts only to upward market movements, whilst the downside risk measure is found to be totally insignificant.

These findings have certain implications for regulators and policymakers in Greece. First, the Hellenic Capital Market Commission (HCMC) should investigate on the reasons why the performance of non-listed funds is so poor. If the results of the study are indicative of opportunistic investment behaviour of the management of these funds, then some new legal requirements should be imposed in terms of portfolio formation. Moreover, more strict requirements should be applied concerning the qualifications of those who assume the responsibility of managing the portfolios of closed-end funds. On the other hand, there should be audits to all non-listed funds in order to ensure that management acts in the best interests of the equity holders of the funds. After all, we must not forget that the equity holders of non-listed funds are totally unprotected since they do not have the opportunity to sell their shares in the market.

Another measure that the HCMC should consider is the application of metrics that measure portfolio downside risk. As with other financial institutions in Greece and all over the world, closed-end funds should calculate and publish the Value at Risk (VaR) of their portfolios. If this happens, it will surely minimise the need for frequent audits and additional legal requirements on portfolio formation.

Finally, the HCMC should take some measures to prevent the discontinuance of operations of the existing non-listed investment trusts. Such measures could include facilitating mergers among small-sized non-listed funds that will help them to overcome potential problems with capital requirements. Moreover, the HCMC could facilitate the acquisition of non-listed funds from listed ones. This will prevent non-listed funds from waiting in the list for a public issue and will help their equity holders trade their shares in the market. The necessity of all these measures is made obvious when considering the effects of potential portfolio liquidation. Indeed, in the light of the current course of stock prices, the future potential of many of the non-listed funds is uncertain. Many of them will soon be forced to liquidate their portfolios

and discontinue operations. If this happens, needless to say, it will cause additional problems to the already turbulent Greek Capital Market.

REFERENCES

Allen, D. and V. Soucik (2000). 'In Search of True Performance: Testing Benchmark – Model Validity in Managed Funds Context', Working Paper, Edith Cowan University, Australia.

Allen, D. and V. Soucik (2002). 'Performance Benchmarking Managed Funds: Australian Fixed Interest Funds', Working Paper, Edith Cowan University, Australia.

Bangassa, K. (1999). 'Performance of UK Investment Trusts: 1980-1994', *Journal of Business Finance & Accounting,* vol. 26, pp. 1141-68.

Bawa, V., S. Brown and R. Klein (1981). 'Asymmetric Response Asset Pricing Models: Testable Alternatives to Mean-Variance', *Mimeo.*

Coggin, T., F. Fabozzi and S. Rahman (1993). 'The Investment Performance of US Equity Pension Fund Managers: An Empirical Investigation', *Journal of Finance,* vol. 48, pp. 1039-1055.

Connor, G. and R. Korajczyk (1991). 'The Attributes, Behavior and Performance of US Mutual Funds', *Review of Quantitative Finance and Accounting,* **vol. 1, pp. 5-26.**

Dimson, E., and C. Minio-Kozerski (1999). 'Closed-End Funds: A Survey', *Financial Markets, Institutions & Instruments,* vol. 8, pp. 1-41.

Elton, E.J., M.J. Gruber and C.R. Blake (1996). 'Survivorship Bias and Mutual Fund Performance', *Review of Financial Studies,* vol. 9, pp. 1097-1120.

Fletcher, J. (1995). 'An Examination of the Selectivity and Market Timing Performance of UK Unit Trusts', *Journal of Business Finance and Accounting,* vol. 22, pp. 143-156.

Grossman, S. and J. Stiglitz (1980). 'On the Impossibility of Informationally Efficient Market', *American Economic Review,* vol. 70, pp. 393-408.

Hallahan, T.A. and R.W. Faff (1999). 'An Examination of Australian Equity Trusts for Selectivity and Market Timing Performance', *Journal of Multinational Financial Management,* vol. 9, pp. 387-402.

Henriksson, R. and R. Merton (1981). 'On Market Timing and Investment Performance: Statistical Procedures for Evaluating Forecasting Skill', *Journal of Business,* vol. 54, pp. 513-533.

Jagganathan, R. and R.A. Korajczyk (1986). 'Assessing the Market Timing Performance of Managed Portfolios', *Journal of Business,* vol. 59, pp. 217-235.

Jensen, M.C. (1968). 'The performance of Mutual Funds in the Period 1945-1964', *Journal of Finance,* vol. 23, pp. 389-416.

Kothari, S.P. and J.B. Warner (2001). 'Evaluating Mutual Fund Performance', *Journal of Finance,* vol. 56, pp. 1985-2010.

Lang, L.H.P., R.H. Litzenberger and V. Madrigal (1992). 'Testing Financial Market Equilibrium under Asymmetric Information', *Journal of Political Economy,* vol. 100, pp. 317-348.

Patro, D.K. (2001). 'Measuring Performance of International Closed-End Funds', *Journal of Banking and Finance,* vol. 25, pp. 1741-67.

Pedersen, C.S. and S.E. Satchell (2000). 'Small Sample Analysis of Performance Measures in the Asymmetric Response Model', *Journal of Financial and Quantitative Analysis,* vol. 35, pp. 425-450.

Treynor, J.L. and K.K. Mazuy (1968). 'Can Mutual Funds Outguess the Market?', *Harvard Business Review,* vol. 44, pp. 131-136.

Wermers, R. (2000). 'Mutual Fund Performance: An Empirical Decomposition into Stock-Picking, Talent, Style, Transactions Costs, and Expenses', *Journal of Finance,* vol. 55, pp. 1655-1695.

White, H. (1980). 'A Heteroskedasticity – Consistent Covariance Matrix Estimator and a Direct Test for Heteroskedasticity', *Econometrica,* vol. 48, pp. 817-838.

ŽELJKO ŠEVIĆ

The Australian Financial System: An Ongoing Reform?*

1. INTRODUCTION

The problems of financial system infrastructure attracted the attention of scholars in the 1960s and 1970s, especially within the larger framework of Development Economics. However, despite the financial crisis in the 1980s and early 1990s, not very much attention has been paid to the issues of financial infrastructure and design. This situation began to change with the overwhelming changes in the political and economic system in central and eastern European countries (CEECs) after the failure of communism. Some recent works focus on the broad issues of financial system design (Allen and Gale, 2000). There is also a limited body of literature addressing the development of the financial system from the new institutional economics point of view. This is a normal consequence of financial theory having been mainly dominated by neo-classical scholars. Moreover, neo-classical theory introduced some good concepts to economic thought (principal-agent theory, rational expectations, theory of contracts), but with the passage of time, it became obvious that it was necessary to focus on the real economic problems from another, rather different perspective. This paper tries to contribute to that task.

2. Typology of Financial Systems: Some General Remarks

Financial systems differ amongst countries. However, some common characteristics can be found. The classical structure of the contemporary financial system comprises: 1) central monetary authority, 2) banking system (different kind of banks and other financial deposit taking intermediaries), 3) financial markets and 4) financial instruments (see: Šević, 1999). All these compo-

* The work on this paper started while the author was the Australian Bicentennial Senior Visiting Fellow at the University of South Australia in Adelaide, March-May 2000. The hospitality provided by Professor Mervyn K. Lewis, National Australia Bank Professor of Banking and Finance in the School of International Business and Professor Kevin O'Brien Pro-Vice Chancellor has been gratefully acknowledged, as well as financial support in the form of Australian Bicentennial Fellowship, provided by the Menzies Centre for Australian Studies at the King's College University of London. The author is also very grateful to the Reserve Bank of Australia, Australian National Library and the Australian Federal Treasury for providing additional documents and data utilised in the preparation of this paper and to three anonymous referees who commented on two earlier versions of this paper. However, the usual disclaimer remains.

nents have common theoretical characteristics although they are, generally, variously defined in a particular financial system. Depending on which component of the financial system has higher relative importance, the financial systems are classified into different groups.[1]

Theory generally recognises two types of financial system: 1) bank-based (banking-based), and 2) market-based (securities-based) (see: Marer, 1991). The first is connected with the German/Japanese experience and the latter with the Anglo-American practice. The strategic choice between these two possible alternatives is crucial for the financial structure design in a transitional economy, although in advanced economies the differences are sharper in theory than in practice. In a bank-based financial structure, greater attention is paid to financial intermediaries (especially banks), and their role is more important, while financial markets play a subsidiary role. In this model, the relationship between the supplier of funds and the user of funds, typically a bank or other financial intermediary, is much more direct and closer. The closer relationship usually strengthens the banks' sole equity holding in a firm which enhances control and commitment. It is believed that this kind of consolidation of ownership allows the bank to influence the management of the firm (Udell and Wachtel, 1995). This model allows a bank to invest funds directly in other economic subjects in the real or financial sector of the economy. Simply by performing this activity, banks, as a specialised financial agent, control closely the performance of enterprise management.

The bank-based system is characterised by the dominance of a few large universal banks involved in close relationships with industry. In this system, pension funds and similar types of institutional investors do not exist. From the organisational point of view, this concept is somewhat limited with regard to the set of participants. The limitation of information is simply a direct consequence of particular accounting rules and practices, as well as specific relationships between firms and banks. The concentration of ownership is extremely high and therefore, acquisitions and take-overs from outside investors are very rare and the stock market does not play an important role in corporate control. The banks' presence is visible everywhere: in the board of directors, supervisory board etc... In short, the bank-based financial system is highly concentrated, so the role of financial intermediaries, especially banks, is very important (Grosfeld, 1994, p. 6). Consequently, because the bank is simultaneously the lender and the investor, risk-shifting problems associated with debt financing might be less important (Chirinko and Elston, 1996). However, there are two major sub-groupings of the financial system, one following the German blueprint and another that can be found in Japan.

The German financial system, which is treated as a "blueprint" for the bank-based financial system, is really based on bank credit and thus, the stock mar-

[1] See institutional features and theoretical implications of different financial system concepts in Allen and Gale, 2000

ket is poorly developed. The German financial system centres itself around three large universal banks, which are closely linked to industry. As noted above, the banks own a substantial amount of individual equity, as well as acting as proxies for small investors. Investment banking enables enterprises to gain access to other sources of capital through the intermediary actions of banks. When the bank is also a shareholder, it is argued that the bank is more likely to pursue actions which enhance the overall return on capital. In this model, a bank controls managers on two main grounds: as a creditor, and as a shareholder. The "big three" (*Deutsche Bank*, *Dresdner Bank*, and *Commerzbank*) have 65 per cent of seats (Carson, 1990, p. 603) on companies' Supervisory Boards and Boards of Directors. The high degree of concentration of corporate control, together with legal safeguards written into company statutes, makes hostile takeovers extremely rare. Banks also finance new business initiatives and play an important stabilisation role. Other groups of banks can form consortia to rescue companies in financial difficulties. While there is a high concentration of banks at federal level, banking at local levels is extremely decentralised and it is relatively easy for SMEs to obtain funds from co-operative (3,151 banks), and regional banks (199).[2] The above arguments also hold true at the local level, i.e. local and regional banks participate intensively in the management of SMEs.[3]

The Japanese main banking system (Hoshi, 1995) can be seen as an alternative bank-based system. Japanese banks are severely constrained in their ownership of corporate stock and they own only about 5 per cent of the shares outstanding of any corporation. Large companies in Japan are members of *Keiretsu*[4], the industrial groups in which all elements have very strong mutual ties. *Keiretsu,* as an industrial group, constitutes a loose association of enterprises headed by a trade company, at whose centre a „Main bank" operates. These banks are closely involved with industrial enterprises. There is competition across these groups but co-operation within a group. The concentration is so high that nine of the leading trade companies control about 1,500 industrial enterprises. The main bank has great power in the management of group members. Japanese enterprises prefer a much more unified and interdependent mode of organisation.

The Anglo-American market-based model is rooted in a strong finance function and in the preference for internalising risk in the absence of close indus-

---

[2] For more information on the German banking system, see for instance: Stein, 1993; Francke and Hudson, 1984; Edwards and Fischer, 1993

[3] See: Bundesministerium für Wirtschaft, 1996; Šević, 2002

[4] Previously "*zaibatsu*". After 1882 most of the state property was sold to the private sector at extremely good prices. The sales were made especially to members of *Zaibatsu*, prominent Japanese families. Later on, the elements of *Zaibatsu* became large conglomerates, or holdings owning other firms. A *Zaibatsu* family had firms in many branches of economy, because it was not limited. "To some extent this *Zaibatsu* control is like a semi-national government". (Zhang, 1995, p. 130). On *Keiretsu*, see: Gilson and Roe, 1993

try-bank connections. Control is based on financial procedures and a reporting system which tends to treat each unit as a separate profit centre. Many corporations develop market-like relationships between their component parts. Given the dispersion of shares, an individual shareholder is not able to exert any major influence, so it seems that the most important *a posteriori* control is based on take-over.[5] With the debt/equity ratio in this system being relatively low, banks are unable to exert any major influence on the managerial structure. If the performance of an enterprise is not satisfactory, the price of shares on the market will decline as a result and shareholders will be increasingly inclined to sell them. In this situation, the interested investor will be in a position to put his/her hands on a controlling block of shares, so he/she will be in a position to acquire the enterprise and dismiss the current management.

In this model, the asset side of banks' balance sheets shows a combination of a small amount of cash and deposits at the central bank, some highly liquid assets such as governmental securities and a high proportion of non-marketable loans and advances, mostly of indefinite maturity. Their liabilities are overwhelmingly deposits, a fair proportion payable on sight. Also, the proportion of equity is quite small. The capital necessary for financing a company comes mostly from internal sources, such as, for example, retained profits and depreciation. External sources of capital include investors and creditors. The investors are buyers of various financial instruments issued by the corporation, and they buy diverse financial instruments expecting a profit. Currently in this model, financial institution investors predominate and the banks are only one group of players amongst several. The banking system is highly centralised and bank lending tends to be short-term and has not led to the establishment of close industry-bank relationships. The financial system has imposed constraints on industrial management of requiring high short-term returns on capital, without offering any support through a monitoring function.

In an Anglo-Saxon model, banking can be seen, up to the 1980s, as a comfortable, profitable and oligopolistic industry, with relatively little freedom, but enjoying stable long-term profits. This was a consequence of over-regulation and a widespread scheme for deposit protection (insurance). Currently, the banking industry in the Anglo-American model represents an industry of high concentration, while most of the large banks have been organised along the lines of holding companies. The main business within these banks includes deposit transactions and extending credits to firms and households.

It is important to notice the real sector – bank relationship is less dependant on capital volume than on the manner in which capital is obtained. Banks are the most conservative investors after depositors. They focus on short-term credit and have little interest in risk-sharing, or in corporate control. Banks

[5] See: Harvard Business Review, 1991; Journal of Economic Perspectives, 1988, pp. 3-82

are strictly interested in interest payments. In this framework, it is obvious that minimising the risk of bankruptcy cannot maximise the returns of shareholders. Finally, it is obvious why this system is market-based. The stock-market is the critical factor for overseeing company results and, through this, management results. Financial markets, especially the stock-market, provide the concept of external corporate control. In this model, the system relies „on wide dissemination of pubic information and the importance of firm reputation – as opposed to relying on control mechanisms associated with the debt instrument itself" (Udell and Wachtel, 1995, p. 41).

However, the recent (1980s) changes in the regulatory policy treatment of the financial sector brought these two theoretically different systems closer. Under the auspices of deregulation, new financial institutions (non-bank financial intermediaries) entered the banking sector (bank-market), increasing competition, reducing the price of banking (interest rate), but, as a by-product, increasing systemic risk. This type of risk cannot be avoided, only shifted to the other economic agent. Together with the deregulation came a great number of bank failures (Sheng, 1996, pp. 71–86). A direct link has not been established, but considering the market strategies of banks, it can be concluded that the management has been exposed to great pressure to be competitive, which often led to adventurous business strategy and policies. Undoubtedly deregulation was, by a number of financial agents, comprehended as the end of regulation. However, they forgot that in the well-established market, formal rules are often unnecessary, since the market introduced proper operating practices and codes of conduct. Often formal, legal rules can stop or hinder the development of new products and self-advancement of the system itself.

On the other hand, banks started to become involved in capital market operations. Explicit or implicit limits on the banks' participation in the capital (long-term) market has been gradually falling and, as a consequence, the volume of trade increased and banks started to be more seriously involved in financial engineering. A special boom has been noticed within the trade in derivatives, especially exotic ones.[6] They began to combine two or more classic financial instruments creating new ones, or even „banking" derivatives, amongst themselves. These factors began to change the balance sheet positions of banks. Previously, classical banks were interesting for the regulators because of the asset side of their balance sheet, i.e. they were a major producer of lending services and they pursued this function even in incomplete or failed market situations (Bernanke, 1983). Today, the borrower has a much wider choice: she/he can approach a financial intermediary (which, as a rule, is not necessarily a bank) or can raise money in the financial markets. Often,

[6] On derivative activity of financial intermediaries (from a central banker's point of view), see: Federal Reserve Bank of Atlanta, 1993

even if the debt is to the bank, debt can be transformed into securities and resold in the financial markets. This practice is quite common in the US.

This process of „*securitisation*"[7] caused a redefinition of classic financial instruments which were previously not tradable. Now, these non-tradable financial instruments (usually different kinds of loans) can enter the market and this allows the bank to change its liquidity policy. Classic banks pursued only so-called asset-side management, whilst now they practise both asset and liability management. However, innovation seriously affects the powers of supervisory authorities because accountancy procedures are not as transparent[8] (see: Šević, 2000).

Financial systems in developed countries are subjected to a periodic review of their performance even if they function well. However, if the problems emerge and show recurrent patterns, often a major enquiry is organised to assess the current situation and offer solutions to the problems faced. Often these commissions are organised under the auspices of parliament as the most widely democratically elected body in the country (see: Šević, 1996a) and which is ultimately responsible to the electorate for the overall state of the nation. This is generally true for a Westminster and European model of public governance, whilst in the US the responsibility can be seen as shared between the President and Congress. The Committee may suggest solutions to be considered by the government of the day, or simply point out the major directions for further development. In order to understand the need for change, how it is formulated in the ultimate public arena and what is to be done to manage the process well, we have to look at the public policy process in a democracy.

3. Setting the Stage for Change: Pretext to and for the Reform

In the public policy arena certain policy actions are often – fashion. Some are initiated by the real needs of society, whilst others are initiated by powerful societal groups that are in the process of driving their own agendas. Australia, together with a number of other industrialised countries, applied a wide policy of deregulation of the financial system in the 1970s and 1980s. With failure to deliver what was expected and the number of failures in the 1980s, industrialised nations have questioned the quality of their regulatory framework and what has to be done to ensure that the regulatory framework is – sustainable (another fashionable term that became factual somewhat later in the late 1990s) and that the financial system can be marked as stable. Financial stability became a major concern for central monetary authorities, which increasingly are released of their supervisory functions,

[7] On this issue, see for instance: P. W. Freeney, 1995

[8] See, for instance: Study Group Report, 1994

are transferred to para-government semi-independent agencies charged with licensing banks, monitoring their operations and undertaking necessary corrective actions when and if, necessary.

The World has witnessed a number of challenges in recent years: a major financial crisis in Asia, slow world economic downturn, challenges in the insurance market (especially following the terrorist attacks on September 11) and a fall in the stock markets that led to wealth creation and has had serious effects on pension investments around the world. Globalisation, world-wide convergence and technological changes have been three major elements that influenced the development of the financial system in recent years. It seems that old regulatory structure and a classical model of regulatory capture has failed to realise the scope and scale of modern challenges and it is really a question of to what extent the existing regulatory framework can suffice in securing smooth and uninterrupted operations of a modern, national financial system.

Globalisation, understood as a world-wide process of market integration and alignment of markets, has been a major trend in the development of financial markets and also has been a major driving force that regulatory agencies faced all around the world. It has been greatly facilitated by technology, increased comparability of financial reporting standards and certainly greater mobility of people and capital. The classical regulatory division between banking and non-banking financial services has been either eliminated or marginalised. A number of competitors from non-financial sectors have moved in and offered various forms of financial services. For instance, many car companies in Europe will have separate sister companies offering car finance and consumer credit to potential customers. All major retailers in developing countries will have their own financial companies that will service credit card payments and the costs of accepting credit cards will be transferred within the same company (or family of companies). However, the rapid growth of alternative financial services providers raised an additional question as to what extent customers trust these providers, especially those that are new to the market and with no prior record to speak of.

Hand-in-hand with globalisation, one should consider financial convergence. These two phenomena are mutually dependent, although literature has failed to establish a clear (either theoretical or empirical) link between the two. The fall of Communism in East-Central Europe and South-East Asia, with the noticeable reform attempts undertaken by the Chinese government, have contributed to the significant physical widening of the market. The regulatory reforms have, in their own right, also led to the widening of the market. For the latter, the deregulation and technological advancement have enabled new participants to overtake traditional players in the financial marketplace and to become dominant players in exchange traded markets. However, the increase in participation of non-classical financial players may lead to unbalanced regulation, as these economic agents are not subjected to strict financial reg-

ulations and the risk may be (unwillingly) shifted to inadequately informed customers, as the set of instruments used in the markets is constantly becoming more complex and difficult to understand by non-professionals. The most notable example of these new players are hedge funds, especially those that are opting for complex trading policies appearing concurrently in a few markets for different financial instruments (not only FOREX operations).

Technological developments alone are pushing further the usual technological and physical barriers for trading. The quality of ICT technology offers companies to trade concurrently in a few different, often diverse markets, allowing them quite often, to circumvent the existing prudential regulations. In the past, the country of domicile was the major player in supervising financial institutions, while today it may be difficult to determine what the country is that should take the lead responsibility in the prudential supervision process. The country in which the headquarters' is located is not always the most appropriate country to undertake supervision, since the company may be intentionally formally registered in a country with lax financial supervision rules (often offshore havens). Under those circumstances, it is necessary to ensure that there is sufficient regulatory collaboration between interested countries and that an additional effort is made to ensure closer regulatory collaboration. It has been proven that even leading countries such as the US, may benefit from closer regulatory collaboration with other major countries, or supporting major international regulatory co-ordination attempts.

Nevertheless, despite all these efforts to ensure a higher level of comparability and consistency, the financial system is less consolidated than other industries, at least in global terms. Domestic banks still dominate their own home markets, although it may be changing in the former communist countries, where foreign ownership of banks is widespread. There are claims that in fact, in many European East-Central countries there are no domestic banks. In actual fact, the banks are domestic, but are predominantly foreign-owned (as is the case in Hungary). Across a number of countries, the financial sector is highly segmented and widely spread. In order to pursue sustainable growth it will be necessary to support a number of corporate restructurings leading to an increased number of mergers in banking and banking-related industries. Globalisation supported the development of competing regulation, as firms will look for a jurisdiction that offers them the best possible deal, but this does not mean the elimination of 'convergent regulation' where especially international organisations have been undertaking actions to remove artificial constraints on cross-border activities. Trends in de-mutualisation and privatisation of banks and building society-like financial institutions that consequently led to a wider share ownership have also been reported. These trends have also included the development of community banking initiatives and instruments, especially those that focus on micro-credit and support for underprivileged and marginalised social groups (Lukošiūtė, 2002). Community development banking (CDB) has been tested, not only in developing and

transitional countries (Šević, 1999c), but also in developed countries, such as the US. Recently, there have been attempts to introduce a CDB concept into the UK, to serve especially ethnic communities and those communities in falling urban areas (Šević, 1999c).

The channels of delivery of products have also changed, with the emergence of third party distributors, especially mortgage brokers and independent financial advisers. This has complemented the rapid growth of on-line and telephone banking, as well as on-line brokering. These innovations in the channels of delivery were complemented by alternative trading platforms and newly emerged financial markets (Šević, 2004). Non-banking financial institutions are to play a more prominent role in the financial system, as banking is to concentrate both physically and in the focus of activities, on more lucrative clients and segments of the market. Smaller and routine credits are usually serviced by non-banking financial institutions, of which many are associated with different retailers.

Undoubtedly, one of the issues to be seriously considered is risk and the manner in which risk is perceived and handled. Often, especially in emerging markets, there is very little, if any, difference between uncertainty and risk. In developed systems the distinction is known but often, especially in the case of large corporate failures, it is clear that managers make distinction only formally, but not in the process of strategic decision-making. Modern risk management requires the use of rather complex instruments for hedging risk and often markets fail to realise the far-reaching consequences of different risk techniques applied. The introduction of principle-based, rather than usual rules-based, regulation may be the answer, but there are limitations in handling those as well. As the superannuation industry is growing rapidly, one may wonder to what extent unhedged risk exposures may affect general belief in the financial sector in the case of systemic failure of superannuation funds, due to their misunderstanding of risk or mishandling of the same.

Certainly, closer regulatory observation is necessary to ensure that the stability of the system is ensured, but again without much interference in the daily operations that may hinder the creativity and the generation of continuous innovations in the financial services industry. Preventive regulatory activity may, in the future, spread and the regulatory agencies may act to reduce the opaqueness of the industry through enhanced disclosure and *education*. A possible 'regulatory innovation' may be, in fact, the introduction of 'market regulation' as in the case of New Zealand, where the industry itself drives the change in reporting and disclosure rules, ensuring that only the fittest are in business and that those that can threaten the good reputation are, in fact, excluded before they commit an act that may endanger the social prestige of the industry (profession).

The challenges for the stability and effectiveness of the national financial system (including Australia) are constantly emerging. The creation of a number

of enquiries on a periodical basis was the Australian government's and public's answer to those challenges. From the Royal Commission set up in 1936, to the Wallis Inquiry in 1997, a number of bodies looked at the structure, quality and performance of the Australian financial system, ensuring its international competitiveness and ensuring sustainable growth with enhanced stability. The momentum that triggered the institutionalisation of enquiries has been largely domestically initiated, but only after the international factor (or 'threat') had been recognised by leading political factors (at least with the two most recent – Campbell in 1981 and Wallis in 1997). But, do we always engage all the prominent stakeholders in public policy decision-making, despite fairly democratic surface rhetoric?

4. Modelling the Agenda Setting

As a rule in a democratic country, the changes in policy (or policy shifts) are decided in the public arena. This assumes the engagement of major political actors and, as a rule, processes are more or less feasible. At least theory focuses on processes that are in the public domain and consequently can be seen and the factors influencing them, observed effectively. However, scholars are fully aware that the preparatory phase is less visible, although often more important. In that phase, major players are setting the agenda and listing the issues which should be addressed in the public arena. In the agenda setting phase, the issues are screened, articulated, expanded and eventually launched into the public domain, that is put into the public decision-making mode (see: Cobb and Elder, 1972). However, the term "agenda building" was preceded by the term "agenda controlling" (see: Bachrach and Baratz, 1962), but the content is more or less identical.

The focus on the agenda building phase of the public policy decision-making process is important, as in that phase the decision-makers (public policy stakeholders) discriminate amongst the different issues, some of which appear in the public domain, whilst others do not. Some agendas can raise controversies amongst the actors in the political process and usually those that attract attention are those that are in the final instance addressed, either favourably or otherwise. Cobb, Ross and Ross (1976) clearly distinguished between public and formal agendas, whereby the public agenda comprises the issues that are socially perceived as important (there is some degree of social consensus present) and in which the government has a legitimate interest (which can be legislatively defined). In contrast, formal agendas are those recognised by the formal decision-makers (primarily the government) as important, and the government machinery has been set in motion to address those issues and enforce the measures to address these issues. Often these formal agendas can be found under synonyms such as institutional or government agenda. Formal agendas are usually more tangible and easier to define, as they are contained in government documents or materials. Public

agendas are somewhat intangible and often broader in scope (see Cobb, Ross and Ross, 1976) being seen as somewhat 'raw' and in need of some refining.

Quite often the issues on the formal agenda may not be in the public domain and were never a part of the public agenda. For an issue to be on the formal agenda, if there is no interest in it by major political players, the public must be informed of its existence and appropriately mobilised. After good public action an issue may be taken on the government's (formal) agenda, although it may be contrary to the interests of major stakeholders. Cobb, Ross and Ross (1976) developed three models of agenda building, referring to the process as 'career of an issue'. They recognised some four stages in the process – 1 – its initiation into the domain of the public and/or formal agendas; 2 – its specification to the targeted audience; 3 – its expansion from one agenda to another, and 4 – its entrance on to one or more agendas. They believed that the initiation stage is triggered by a social conflict, controversy or some perceived regulatory gap. The issue is singled out by a specific grievance or policy proposal by a group interested in the issue and followed through to the final stage (agenda entrance). Placing an issue onto the formal agenda, followed by a launch into the public agenda, usually means that facilitates the mobilisation of public support for an issue and the smoothing of the rigid position that formal decision-makers may have (either pro or contra the issue). On the other side, the decision-makers can also utilise the launch of an issue from their formal agenda into the public domain (arena) in order to gain public support and general public understanding of their actions (especially if there are strong interest groups dissatisfied with the proposal on the table). In either situation, the decision-makers are those that will decide upon the entrance of an issue onto the formal agenda (see: Cobb and Elder, 1972).

The formal decision-making process in an effective democracy entails the confrontation of different interests and interest groups which represent them. Cobb, Ross and Ross (1976) have identified three models which explain agenda building. They recognised the 'outside initiative model', 'mobilisation model' and 'inside access model' (Cobb, Ross and Ross, 1976, pp. 126-138). The first model (outside initiative model) is used to explain the situation in which an individual, group or organisation outside the formal government structures formulate an issue for reform that they want to bring into the public domain (publicise). Practice has shown that this may be done through a media campaign or other use of the media, the use of formal lobbying of politicians or other actions that may attract public attention (demonstrations, manifestations, public appeals, etc.). The outside initiative model assumes that the interested party has done everything necessary to be in the focus of public attention and through being in the public domain, 'forces' the government to be responsive to their proposal (and interests). In public policy literature this may often be classified as 'grass roots' initiatives that can be listed on the formal agenda if they receive enough public support. The ultimate goal is to have the issue placed on the formal agenda, but the ways that this may be

achieved differ greatly from country to country. However, one should realise that the 'elevation' of an issue from a public to a formal agenda does not in itself guarantee results.

The mobilisation model is used to describe the agenda building process in which institutions or leaders attempt to move an issue from a formal agenda to the public domain, in order to generate public support for their actions/aspirations. To a large extent, it may be perceived as a reverse process compared to the 'outside initiative model'. The issue is placed in the public domain by the decision of the formal decision-makers or people with direct access to them. This action is often forced by a major public scandal or other event that can undermine public credibility of the formal decision-makers or those closely connected to them (for instance the ruling party). The creation of commissions of inquiry or similar public bodies of the authority (often packed by professionals) is often, if not the predominant, method used under this model. The legitimacy, as a rule, is drawn from the significant amount of expertise that those engaged in process offer. In practice, this model is used when the implementation of any decision requires large or even unanimous public support. Under those circumstances, mobilisation is necessary and the public decision-makers are somewhat forced to enlist public support for their agendas. There is a clear attempt to expand the issue to new (interest) groups in order to gain the necessary support to achieve the desired (social) outcomes. The agenda entrance stage, under this model, is achieved when the policy issue is transferred from the formal (government) agenda to the public agenda.

Compared to the 'outside initiative model' the 'mobilisation model' is often more effective, as the formal decision-makers have more resources at their disposal than usual societal groups and therefore can achieve results easier. However, one should realise that the 'mobilisation model' can still fail, especially if there is a problem in communication between the formal decision-makers (the government) and the public and if strategy was inappropriate – not taking into account the realities of the societal situation or simply failing, for one reason or another, to engage lower level stakeholders in the process. The mobilisation model, if launched late, can simply be doomed to failure, as many stakeholders may opt to stay outside and not give the expected support. In those cases, the formal decision-makers may resort either to re-launching the issue with significantly more resources, or simply abandoning the reform agenda. In practice, we have seen both in a number of advanced democracies. Political short-sightedness and/or political arrogance can often be attributed to the failure of this kind of policy initiative.

The third model noted by Cobb, Ross and Ross (1976) – the inside access model – describes the policy situation in which a particular interest group seeks to exclude the public from the agenda building process. The initiators (those who initially control the issue agenda) try to place an issue onto the formal agenda and attempt to have it implemented with as little change as

possible, with no outside interference. The issue expansion is generally tightly controlled and if it does happen (often accidentally), it is confined to a small number of groups of influence, which often have similar (if not identical) policy agendas. Usually those groups are considered by issue initiators to be important for the implementation of the issue without whose support the issue could not be addressed. These interest groups often share an interest to confine the problem to their circles and seek a 'private' decision from and within the government, as they believe that they may be seriously defeated if the issues are brought into the public agenda. The major interest group in this model is usually an important insider and they initiate their agenda within the government itself. They are often a government department, semi-dependent government institution or even an independent government (often regulatory) agency. Initially, the issue is well formulated, but is communicated through the formal government channels to the leaders of other government departments and/or agencies as potential stakeholders (or rather, interested parties). One should realise that due to the complexity of the government decision-making process and the government formal organisation, no initiator can be guaranteed outright success. If success could be guaranteed even before the issue was raised, there would be no reason to develop the model.

Within this model (inside access model) the main aim of the issue initiator(s) is to gain a formal agenda status for an issue, with the full exclusion of outsiders (the public). However, one should not neglect the fact that the overall cost of this *haranguing process* within the government may be as high as the cost in two previously described and analysed models. The resources, which in the previous two models can be thrown into the public arena, will be spent on aligning interest groups within the government and/or associated structures (often the ruling party, especially in the models of Cabinet operation dominated by significant party factions – as with Japan). The model itself excluded 'outsiders', but it should be noted that the definition of an outsider may differ from one political arena to another. In a strict cabinet system, the major players' role can be reserved for cabinet ministers only (and departments headed by them), while in the government model with a wider number of players (presidential-like system or quasi-presidential systems), the number of players can be expanded. However, there is no rule on this, and in the analysis of this model, one should pay attention to the peculiarities of politico-administrative relations in the particular country (see, for instance Peters, 1987; 1988; Heady, 1996).

The models developed by Cobb, Ross and Ross (1976) are, as the authors themselves admitted, more of a conceptual than an empirical nature and they are by no means 'pure'. In practice, the models may intertwine and overlap, depending on the inclusion of societal (interest) groups and their changing interests and alliances. As we will see from our analysis, the agenda building in a modern democratic society requires a complex strategy and the involvement of different stakeholders. However, the public mobilisation agenda is

often practised by government when there is a need to enlist public support for reform attempts, especially when opposition is expected from inside the government, mainly due to traditionalism and general resistance of public bodies to any kind of externally (or even internally) initiated change. Change in regulatory capture and attraction of new authorities by the government, especially in countries with an Anglo-Saxon (or rather Anglo-American) tradition, is customarily received by the public with great scepticism. Any increase in government regulatory power is traditionally seen as a serious infringement on guaranteed civil rights and freedom. Therefore, the governments in Anglo-Saxon (Anglo-American[9]) countries will, as a rule, use major failures to bring issues to public attention, create enquiries and use parliaments as the most widely elected bodies to give legitimacy to their regulatory attraction or reform attempts. The last decade of the 20th century was marked by the significant growth in powers of the executive branch of government (Šević, 2005), but by the end of the 1990s, there were calls for more pro-active control exercised by the legislative as the most widely elected body, ultimately responsible for the overall well-being of the nation (see: MacNamara, 1999).

The engagement of parliament in overseeing government activities, especially in excessive situations, has been a traditional issue under the Westminster model of parliamentary democracy. The country of our focus in this paper, Australia, has 'inherited' the Westminster model from the UK (or rather from the British Empire), but has modified it to some extent (e.g. the composition of the chambers in the Australian Federal Parliament) after the model of the US Congress.[10] Royal Commissions or Commissions of Inquiry are often appointed to look closely at the burning issues and to give recommendations to the government.

Often, after a few years, another body (usually within the government) is commissioned to look at the outcomes of the inquiry and to see what recommendations have been accepted by the government and what the policy outcomes have been. This report, often produced by an authorised government department, will close an information loop and ensure that there is necessary feedback provided to a sponsor of the inquiry, as a rule – parliament. The format of the document is an interesting one, as often the government department just links recommendations with policy outcomes (very rarely policy outputs), but does not provide judgement of the outcome itself. Rather, the department provides only factual information and if the outcome

---

[9] See our article Šević (2003) for more on Anglo-Saxon (Anglo-American) traditional values and the reasons why we use these two terms interchangeably.

[10] The Australian Federal Parliament is bi-cameral, but the chambers are based on the British model. The lower house is elected on the representation model, where the number of representatives per state (and territory) is based on the total number of citizens (registered voters), whilst the upper house (Senate) is composed of Senators whose number is the same for all states (regardless of the size) i.e. 12 and territories (Australian Capital Territory and Northern Territory) with two senators elected.

is not correspondent with recommendations, the reason why government action failed to achieve the desired outcomes is provided (often in a very dry bureaucratic manner/language). However, this is also one of the traditions of the Westminster model, or rather the Whitehall model of civil service, where 'the civil service serve the government of the day'[11] in contrast to the *Franco-German model* of public administration where the civil service serves the (abstract concept of) state (see: Šević, 2001). Different inquires in the Anglo-American model of democracy[12] are to be seen as a major instrument for initiating the public mobilisation model as described by Cobb, Ross and Ross (1976). In this paper we will look at the application of enquiries into the state of health of the Australian financial system, with particular reference to the last enquiry popularly referred to as the "Wallis Inquiry" which was conducted in 1997.

5. The *Wallis Inquiry* into the Australian Financial System

The Wallis Inquiry was announced in June 1996 by the Rt. Hon. Peter Costello, MP and the Australian Federal Treasurer. He outlined the main mission of the Wallis Inquiry as follows:

> '*The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system wince the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness.*'

---

[11] *"Civil Servants are servants of the Crown. For all practical purposes the Crown in this context means and is represented by the Government of the day. There are special cases in which certain functions are conferred by law upon particular members or groups of members of public services; but in general, the executive powers of the Crown are exercised by and on the advice of Her Majesty's Ministers, who are in turn answerable to Parliament. The Civil Service as such has no constitutional personality or responsibility separate from the duly elected Government of the day. It is there to provide the Government of the day with advice on the formulation of the policies of the Government, to assist in carrying out the decisions of the Government, and to manage and deliver the services for which the Government is responsible. Some civil servants are also involved, as a proper part of their duties, in the processes of presentation of Government policies and decisions."* (HC 92-II, p. 7).

[12] We are fully aware that this term can be challenged, but we have used it to mark a particular democratic tradition of indirect democracy modelled in Anglo-Saxon countries after the Westminster model and a long-standing tradition of division of power and limited powers of sovereign as set out in the *Mange Carta Libertatum* in 1215. Interestingly, a facsimile of *Mange Carta* can be found in the Australian Federal Parliament, and is listed as one of the major acts defining the political traditions in Australia.

The Wallis Inquiry was to focus on two major issues: regulation and competition in the banking markets. All the major stakeholders generally agreed with the Treasurer that it was a good time to review the efficiency of the Australian financial system, following the review that was conducted by the Campbell Inquiry in the 1980s. To a large extent, the remit of the Wallis work was fairly similar to that of the Campbell team, although the societal attitudes were somewhat different. The Campbell Inquiry faced some serious distortions in the financial system resulting from the over-extensive regulations that were imposed on the Australian financial system, with a significant portion of state ownership over the national banking system. Although it is relatively less known, the labour governments in the 1950s heavily influenced the development of the financial system, as they had strong views that the banking industry (as potential, but not really a natural monopoly[13]) is better influenced through direct government ownership, than through close regulation. In fact, both methods were used concurrently, heavily crippling the Australian financial system and its efficiency and competitiveness. Interestingly, a dissenting voice of the Royal Commission in 1936 was Ben Chifley, later the Labour Treasurer and Prime Minister, who in his disagreement memorandum, claimed the need to strengthen regulation and to nationalise the banking industry. In fact, 1947 attempts to fully nationalise the Australian banking system can be traced to this document (see: Giblin, 1951; Crisp, 1961).

The Wallis Enquiry resulted in 115 recommendations, and those recommendations were, to a large extent, accepted by the government. Of those 115 recommendations,

- 25 were concerned with payments and electronic transfer;
- 21 were concerned with prudential regulation;
- 12 were concerned with the co-ordination and operation of regulatory bodies;
- 19 were related to the Corporations Law and financial disclosure requirements;
- 10 were concerned with exchange and markets;
- 9 dealt with consumer protection;
- 7 were concerned with competition policy;
- 7 were related to collective investments, and
- 5 dealt with the licensing regime for financial organisations.

The government refused to accept recommendation No. 83 which advocated the removal of the so-called 'six pillar policy' promulgated in May 1990. The central issue of 'six pillar policy' was to prevent the mergers between any of the four major banks or two major life insurance companies. Also, the Wallis report was not to deal with monetary policy, and interestingly, it did not advocate further (significant) deregulation, but was more concerned with

[13] See: Dowd, 1992

the rationalisation and reorganisation of the existing regulatory framework. The report focused on the rationalisation of major regulatory agencies. Post-Wallis regulatory structure consists of the Australian Prudential Regulatory Authority (APRA), the Corporations and Financial Services Commission (CFSC) and the Reserve Bank of Australia (RBA). APRA has the remit to regulate deposit taking institutions and insurance and superannuation organisations and processes, replacing the central bank and two other regulatory agencies (AFIC and ISC) which previously regulated banks, building societies and credit unions and the life, general insurance and superannuation industry, respectively. CFSC was to be in charge of the supervision of disclosure requirements and consumer protection, replacing different agencies overseeing the insurance brokerage and payment system. Finally, RBA was given the primary task of taking care of monetary policy, financial system stability and supervision of the overall payment system through the Payment System Board. The Bank lost its supervisory powers, but attracted the powers of the Australian Payments System Council – APSC – which was disbanded.

Many Anglo-Saxon scholars would see this as stripping the Bank of its statutory powers, as in the British tradition the bank was in charge of both monetary policy conduct and the supervision of deposit-taking institutions (primarily banks). However, on a more comparative level, there is no need to panic. It has been a world-wide trend to argue for independence of the central bank and its primary focus on the conduct of monetary policy (and ensuring financial system stability), whilst supervisory duties were entrusted to specialised agencies outside the Bank itself. The overall focus shifts on prudential supervision and regulation and under those rules, RBA can still show interest in the operations of banking institutions, although formally it is not in charge of the enforcement of rules. As the banking system is a major channel for the implementation of monetary policies, it is of the utmost importance to ensure that the banking system is sound and operating. This is why 'maintaining financial system stability' as a major task for the central bank can be and usually is, interpreted rather widely.

The Wallis Inquiry looked at the overall competitive position of the Australian financial system and Australian financial services industry. The focus on this issue was triggered by a clear dominance of the 'big four' national banks (The Commonwealth Bank, the National Australia Bank, the Australia-New Zealand Bank (ANZ), and Westpac). The Wallis report was preceded by a Prices Surveillance Authority probe into bank charges (see: Price Surveillance Authority, 1995). A careful reader of the Wallis report will see that the members of the Enquiry were fully aware of the public's concern as to what extent banks abuse their position of power vis-à-vis customers and customer groups (organised and spontaneous). Banks dominate the financial system in several ways. They still have the central position in non-cash payments, especially the use of cheques. In fact, until mid-1995, cheques could only be drawn on banks, and the four major banks, with the addition of the Colonial State

Banks, were solely in charge of the Bank Interchange and Transfer System (BITS) that they operated. The BITS was the largest of the three high-value electronic payment systems in the country. The major four banks also amalgamated a number of regional banks and in that way acquired a dominant position in different regions of the country. Banks, through their subsidiaries, were constantly present in non-banking financial services markets such as insurance, fund management and other financial advisory services.

Table 1. – ACCESS TO FINANCIAL SERVICES

Method	(June) 1997	1999	2000	2001	2002
Bank Branches	6,121	5,358	5,003	4,712	4,728
Non-bank Branches	1,391	1,358	1,208	1,428	1,236
Bank Agencies	6,992	6,528	5,043	N/A*	N/A*
Non-bank Agencies	1,760	1,417	887	N/A*	N/A*
GiroPost	2,627	2,724	2,814	2,814	2,962
ATMs	8,182	9,367	10,818	11,915	11,714
EFTPOS	164,199	265,391	320,372	362,848	402,084
TOTAL:	191,272	292,163	346,145	383,717	425,724

Source: RBA Bulletin and APCA Payment Statistics

* – Data not comparable due to the change in reporting methods.

In fact, on the eve of the Wallis report, banks controlled over 80 per cent of all assets attributed to financial intermediaries and nearly 60 per cent of assets of all financial institutions.[14] This is a high proportion of asset holding for a country which formally had a market-based financial system (see: Šević, 1996b; 1999). Finally, banks somehow avoided the major shake-up of financial institutions that occurred in the early 1990s. In fact, the Banking Act provisions on insurance of deposits initiated, to some extent, adverse selection phenomenon, as banking deposits were relatively safe, and it made banks uniquely safe amongst the Australian financial institutions. However, this is not only a major issue in Australian banking, but can be found in many other countries (see: Šević, 1996a; 1996b). It seems that banks have been the central problem in many previous enquiries, beginning with the Royal Commission on the Monetary and Banking System 1936 and the initial response that remained dominant, revolved around 'public competition and regula-

[14] See for more on the situation in the Australian financial services industry in the mid-1990s in Council of Financial Supervisors, 1996.

tion' (see: Lewis, 1997). However, it seems that Wallis was not 'impressed' by the post-W.W.II over-regulation of the Australian financial system, which has been significantly reduced following the Campbell Inquiry in the 1980s, but opted for promoting 'private competition and contestability', as outlined by a member of the Inquiry in the mid-1980s following the publication of the Campbell report (see: Harper, 1986).

Table 2. – FINANCIAL INSTITUTIONS' SHARE OF TOTAL INSTITUTION ASSETS (PER CENT) – POST-WALLIS

(September)	1997	1998	1999	2000	2001	2002
Banks (other than RBA)	44.4	43.8	43.6	43.1	43.9	46.9
Superannuation Funds	14.6	14.5	15.7	16.7	15.4	13.9
Life Insurance Offices	11.1	10.8	10.6	9.9	8.9	8.0
Other Managed Funds	7.1	7.9	8.5	8.7	8.4	8.3
General Insurance Offices	.7	4.9	4.5	4.2	4.2	3.8
Money Market Corporations	6.0	5.2	4.1	4.3	4.8	4.3
Finance Companies	3.0	3.4	2.9	2.5	2.4	2.3
Securitisation Vehicles	2.0	2.6	3.3	4.0	4.8	5.7
RBA	3.4	3.2	2.9	3.0	3.1	2.9
Credit Unions	1.4	1.4	1.4	1.3	1.3	1.3
Building Societies	0.9	0.9	0.9	0.7	0.6	0.6

Source: RBA Bulletin and supplied unpublished RBA data

Consequently, the Wallis report focused, to a large extent, on the issue of entry barriers, and one of the major recommendations was to allow foreign entities to acquire assets of the Australian financial institutions. Certainly, the Wallis Inquiry was aware of general capital movement trends and the impact that globalisation may have on the developments of the national financial services industry. One should be aware of the developments in Australia at the time when the Wallis report was produced. The interest in capital markets and trading in capital markets nationally had been growing rapidly, people's capitalism was on the increase and trading was largely decentralised, still allowing people to benefit from arbitrage from within their own country. The Wallis report opened doors for demutualisation, the spreading of the portfolio of services offered by different financial intermediaries, facilitating transition from building societies and credit unions into classical banks. Non-banking entities were allowed to enter the payment system and offer their services to customers without any intermediaries. So Telstra (the national, although privatised, telecommunication company), Diners and American Express took advantage of this opportunity and entered the market with a big bang (see: Lewis, 1997).

The outcomes of the Wallis Inquiry and the impact of its report can probably be grouped in a similar manner as the recommendations themselves. When it comes to the Regulatory framework issue, the Report clearly facilitated the

creation of a flexible regulatory structure, which is more responsive to the stakeholders and external forces and consequently the regulatory goals are somewhat clearer with the clear delineation of regulatory authorities within the explained simplified regulatory organisational structure. The Wallis report contributed to the increase in accountability of the agencies charged with meeting the regulatory goals, as all the regulatory agencies have been given operational autonomy and abilities to exchange information necessary for discharging their statutory duties. Further, it seems that the regulation of similar financial products was no more consistent, allowing greater comparability, which in turn promotes competition. One may also claim that the Wallis report was charged with supporting greater 'competitive neutrality' across the national financial system.

Table 3. – ANALYSIS OF THE PAYMENT SYSTEM

Method/form	1997	2000
EFTPOS	13.6%	14.7%
Credit cards	9.0%	16.3%
ATM withdrawals	13.6%	13.7%
Direct entry debits	4.3%	7.9%
Direct entry credits	19.4%	20.2%
Cheques	39.9%	27.2%

Source: RBA Bulletin

The expected outcome of the Wallis Report was to establish more contestable, efficient and fair financial markets, which should result in reduced costs to final customers. Contestability focus (as recommended by Harper, 1986) ensured gaining the best from the discipline enforced by the threat of entry or potential competition upon the 'old' banks within the Australian banking system (see the illustrations in the tables). The recommendations focusing on the regulation of conglomerates and international competitiveness resulted in positive policy outcomes. Regulation that followed the Wallis report (The Financial System Reform Act, 2001) provided more effective regulation, facilitating, at the same time, competition and efficiency within the industry. Also, this resulted in a positive impact on the international competitiveness of the Australian financial system. The Wallis Committee attempted to respond to the key issue, that is, how best to preserve the opportunities for future competition within and of the Australian financial system. The Wallis report was strongly against the concentration in banking, assuming that over-dominance of one of the four would certainly have a negative impact on both central and regional banking markets.

The Wallis report builds well on the stage set up by its most immediate predecessor (the Campbell Inquiry), but also by two Martin Committee reviews (conducted in 1984 and 1991 respectively) which had a more limited purpose to review regulatory processes as set out initially by the Campbell report. The

Wallis report was not to touch upon the conduct of monetary policy and the Committee itself respected fully its mandate, although one may claim that some of the recommendations may have remotely influenced the monetary policy outcomes. The Wallis Committee worked for ten months, reported within the required period (before the end of March 1997), had 452 submissions, met with 136 organisations and individuals and produced a 400-page discussion document, held five public meetings and finally prepared a 700-page report with 115 recommendations to the Government. As we have already mentioned, the government accepted all but one recommendation. The Wallis Inquiry was conducted in a very efficient manner and recommendations were those that deliberated future developments of the Australian financial system.

6. Conclusion

The Wallis Inquiry into the Australian financial system marked the development of the financial system in Australia in the late 1990s and the first years of the 21st century. It has been both a continuation of the deregulation movement set by the Campbell Inquiry and also attempts to foresee what is to be done to make the Australian financial system effective and efficient, both internally and internationally. The recommendations mainly hit the banks, as the major players in the financial system, but also touched upon all other (including non-deposit taking) financial institutions.

Historically, the financial system in Australia has been scrutinised by the Committees of Inquiry. In 1936, the Royal Commission into the Monetary and Banking System was set up to assess the current situation of the banking and monetary system and recommend necessary changes. The Commission has huge problems with private bankers, who strongly opposed public intervention and the introduction of 'proper' central banking. The implementation of recommendations was postponed for a while because of the break-out of W.W.II, but the years following the end of the war were marked by 'public competition and regulation' and attempts to nationalise the banking system. For some 40 years, public regulation has built up and prevented innovation and creativity within the sector. This was not very different to many other developed countries, as banking in the 1950s and 1960s was a nice profitable business, by default (see: Smith and Walter, 1997; Šević, 1999).

The Campbell Inquiry, which reported in 1981, in fact had to serve as a corrective factor in overcoming the consequence of long-applied regulatory policies initiated by the Royal Commission. In fact, continuous applications of direct controls for nearly four decades saw the market share of banks decline sharply (see: Lewis, 1997). There were those who believed that the banks had contributed to this, themselves and also the over-extensive application of administrative-like monetary instruments that prevented innovative behaviour.

By the late 1970s, the public view was that there is a need to introduce more market-based instruments and depart from administrative measures.

The deregulation initiated formally by the Campbell report, led to more market-based monetary policy, a trend that, in fact, the Royal Commission preferred, but due to the strong opposition of private bankers, failed to launch into the public domain. As with the US, the wave of deregulation influenced the changing structure of the financial system which contributed to the fragility of the system and inability of public institutions to take a full view of the system's functioning and development and their capacity to undertake necessary corrective actions. The Wallis Inquiry closed the loop, as it focused on the appropriateness of the existing regulatory framework and the quality of competition within the Australian financial system. The Wallis Inquiry did not attempt to give final judgement, but rather to trace the changes for the introduction of a flexible financial system that can cope effectively with sudden changes and changing an internationally competitive landscape. The focus moved from the banks onto the customers and effective financial systems were to provide the necessary support for a single customer (or fragile customer groups), as banks traditionally were seen as an overly-powerful contractual party. Due to Wallis, banks lost their close (and often cosy) relationship with the RBA, were exposed to international competition in their national market, including the possibility of being taken over by a foreign banking entity and finally the payment system was no longer monopolised by the major banks.

As for the model used in introducing the changes into the Australian financial system, it seems that the 'inside access model' was in fact predominant in agenda setting. While in the case of the Royal Commission, the banking sector was well organised and to a large extent took the bite out of policy recommendations, in the Campbell and Wallis Inquiries, the government had its own agenda, which was largely upheld by the respective committees and the banking sector failed to influence the process significantly. The initiation of the reform programme came directly from the Treasurer at the exact moment he announced the creation of the committee and setting out the remit of the Inquiry. The public submissions were heard, but they were not orchestrated by the interested parties to limit the reach of the Committee results and the recommendations. Those with profound and extensive knowledge of the Australian financial system and the Australian political realities certainly expected many of the recommendations and the overwhelming government acceptance of the recommendations is further proof that the Wallis committee supported the government agenda and did not offer any dissonant voices that were to create any government concern.

The Australian financial system early in the 21st century is competitive and ready to be well-integrated into the world financial currents. The foreign ownership of banks is allowed in Australia and a number of both foreign banking and non-banking entities entered the Australian financial system; Australian

banks also continued their international expansion, focusing primarily on the major international financial centres, not only regionally (Austral-Asia), but also globally. The Wallis report opened new possibilities that bankers were fairly quick to grasp. Time will be the best judge of the outcomes of this policy shift that the Wallis Report initiated in Australia.

BIBLIOGRAPHY:

Allen, F. and D. Gale (2000): *Comparing Financial Systems*, Cambridge, The MIT Press

Australian Financial System Inquiry (1981), *Australian Financial System: Final Report of the Committee of Inquiry into the Australian Financial System*, Canberra: The Australian Government Printing Service (known as the Campbell Report)

Bachrach, P. and M. S. Baratz (1962), Two Faces of Power, *American Political Science Review*, 65(4), pp.

Bernanke, B. (1983): Non-Monetary Effects of the Financial Crisis in the Propagation of the Great Depression, *American Economic Review*, **73**, pp. 257-276

Bundesministerium für Wirtschaft (1996), *Economic Assistance for Small and Medium-sized Enterprises in Western Germany*, Bonn: Federal Ministry of Economy

Carson, R. (1990): *Comparative Economic Systems*, New York: M. E. Sharpe

Chirinko, R. S. and J. A. Elston (1996): *Banking Relationship in Germany: Empirical Results and Policy Implications*, RWP No. 96-05, Kansas City: Federal Reserve Bank of Kansas City

Cobb, R. W. and C. D. Elder (1972), *Participation in American Politics: The Dynamics of Agenda Building*, Allyn & Bakon

Cobb, R. W., J. K. Ross and H. R. Ross (1976), Agenda Building as Comparative Political Process, *American Political Science Review*, **20**(1), pp.

Council of Financial Supervisors (1996), *Annual Report*, Sydney: Reserve Bank of Australia

Crisp, L. R. (1961), *Ben Chifley*, Melbourne: Longman

Dowd, K. (1993), Is Banking a Natural Monopoly?, *Kyklos*, **45**(3), pp. 379-392

Edwards, J. and K. Fischer (1993), *Banks, Finance, and Investment in Germany*, Cambridge: The Cambridge University Press

Federal Reserve Bank of Atlanta (1993), *Financial Derivatives*, Atlanta: FRB of Atlanta

Francke, H.-H. and M. Hudson (1984), *Banking and Finance in West Germany*, London: Croom Helm

Freeney, P. W. (1995), *Securitization: Redefining the Bank*, New York: St. Martin's Press

Harvard Business Review (1991), *Hothouse Management: Acquisitions, Takeovers and LBOs*, Cambridge: Harvard Business Review

HC 92 (1985-6), *Seventh Report from the Treasury and Civil Service Committee: Civil Servants and Ministers, Duties and Responsibilities*, Vol. I "Report", and Vol. II "Annexes, Minutes of Evidence and Appendices", London: HMSO

Heady F. (1996), Configuration of Civil Service Systems in: Bekke H. A. G. M., J. L. Perry and T. A. J. Toonen (Eds.), *Civil Service Systems in a Comparative Perspective*, Bloomington: University of Indiana Press: 207-226

Hoshi, T. (1995), Evolution of the Main Banking System in Japan, in M. Okabe, ed. *The Structure of Japanese Economy: Changes on the Domestic and International Front*, Basingstoke: Macmillan, pp. 287-322

Giblin, L. F. (1951), *The Growth of a Central Bank and the Development of the Commonwealth Bank of Australia, 1924-45*, Melbourne: The Melbourne University Press

Grosfeld, I. (1994): *Financial System in Transition: Is There A Case for A Bank Based System?*, CEPR Discussion Paper No. 1062, London: Centre for Economic Policy Research

Harper, I. R. (1986), An Application of Contestable Market Analysis to the Australian Banking Industry, *Economic Analysis and Policy*, 16(1), pp. 50-60

Journal of Economic Perspectives (1988), *Symposium on Takeovers*, **2**(1), Winter, pp. 3-82

Lewis, M. K. (1997), The Wallis Inquiry: Its Place in the Evolution of the Australian Financial System, *Accounting Forum*, 21(2), pp. 229-253

Lewis, M. K. And R. H. Wallace, eds. (1997), *The Australian Financial System: Evolution, Policy and Practice*, Melbourne: Addison-Wesley Longman

Lukošiūtė, V. (2002), *Commercial Micro-finance in Lithuania: Micro-enterprise Development, Self-reliance, and Social Justice*, unpublished thesis, Klaipeda: Lithuania Christian College

Marer, P. (1991), Models of Successful Market Economies, in P. Marer and S. Zecchini, eds. *The Transition to a Market Economy*, Vol. I, Paris: OECD, pp. 108-114

MacNamara (1999), Foreign Affairs on Central Bank

Peters B. G. (1987). Politicians and Bureaucrats in the Politics of Policy-Making in: J.-E. Lane, (Ed.), *Bureaucracy and Public Choice*, London, England, UK: SAGE Publications, pp. 256-282

Peters, B. G., (1988). *Comparing Public Bureaucracies: Problems of Theory and Methods*, Tuscaloosa, AL, USA: University of Alabama Press

Price Surveillance Authority (1995), *Inquiry into Fees and Charges Imposed on Retail Accounts by Banks and other Financial Institutions and by Retailers on EFTPOS Transactions*, Canberra: Price Surveillance Authority

Šević, Ž. (1996a), *Central banka Položaj, organizacija, funkcije* [The Central Bank: Position, Organisation, Functions], Belgrade: Čigoja štampa

Šević, Ž. (1996b), *Financial Reform in a Transitional Economy: Some Conceptual Issues*, Tokyo and Belgrade: Ryoichi Sasakawa Young Leaders Fellowship Fund and Yugoslav Association of Sasakawa Fellows

Šević, Ž. (1999a), *Banking Reform in South-East European Transitional Economies*, London and Sofia: The University of Greenwich Business School, Balkan Center for Public Policy and Related Studies and Humanities Research Centre

Šević, Ž. (1999b), *Bank Restructuring in Central and Eastern European Countries as a Part of Macroeconomic Changes towards Market Oriented Economies*, Belgrade: BCPPRS and Cigoja štampa

Šević, Ž. (1999c), Entrepreneurship and SMEs Development in Transitional Economies: Is There a Case for Community Development Banking, in: S. Goic, ed. *Enterprise in Transition*, Split: Faculty of Economics and World Bank, pp. 2234-2255

Šević, Ž. (2000), Problems of Institutional Design in Economic Development: Economic Structure and Financial System Concepts Revisited, *Naše gospodarstvo/Our Economy*, **46**(4), pp. 467-486;

Šević, Ž. (2001), Politico-administrative Relations in Yugoslavia, in: T. Verheijen, ed. *Politico-Administrative Relations: Who Rules?*, Bratislava: NISPAcee, pp. 295-323

Šević, Ž. (2002), *Banking Reform in South East Europe*, Cheltenham: Edward Elgar Publishing

Šević, Ž. (2003), Ethos, Culture and Reform Patterns: Some British-Yugoslav Comparisons, *Cross-Cultural Management: An International Journal*, **10**(2), pp. 53-74

Šević, Ž. (2004), A Puzzle of Emerging Markets: A Systemic '*Surprisingability*', *Managerial Finance*, forthcoming

Šević, Ž. (2005), Central Bank, in J. Backhaus, ed. *Elgar Companion to Law and Economics*, 2nd revised and expanded edition, Cheltenham: Edward Elgar Publishing, forthcoming

Šević, Ž. and A. Šević (1998), Monetary Policy in a Transitional Economy: Some Open Questions and the Experience, *Economic Systems*, **22**(3), September 1998, pp. 299-304

Sheng, A. (1996), *Bank Restructuring: The Lessons from the 1980s*, Washington, D.C.: The World Bank

Smith, R. C. and I. Walter (1997), *Global Banking*, Oxford: Oxford University Press

Stein, J. (1993), *The Banking System in Germany*, Cologne: Bank-Verlag

Study Group Report (1994), *Defining the Roles of Accountants, Bankers, and Regulators in the United States*, Washington, D.C.: The Group of Thirty

Udell, G. F. and P. Wachtel (1995): Financial System Design for Formerly Planned Economies: Defining the Issues, *Financial Markets, Institutions and Instruments*, **4**(2), pp. 1-60

Walker, R. G. and S. P. Robinson (1994), Competing Regulatory Agencies with Conflicting Agendas: Setting Accounting Standard for Cash Flow Reporting, *Abacus*, June

Zhang, P. G. (1995), *Barings Bankruptcy and Financial Derivatives*, Singapore: World Scientific Publishers

About the Authors

Indra Abeysekera lectured at The University of Sydney prior to taking up his appointment at Macquarie University in 2004. Prior to commencing his academic career he worked in 20 organisations spanning across industry sectors in the private and public sector, both overseas and in Australia, as an employee in early stage and as a consultant in accounting and business at the latter stage of his career. They include Coopers & Lybrand (now PriceWaterhouseCoopers), Hawker de Havilland (now Boeing), Ansett Worldwide, GEC Alsthom, Unilever Australia, and U.S.A.I.D. Indra has published across a range of academic disciplines on intellectual capital and knowledge management with refereed articles in business and accounting journals. These journals include *The British Accounting Review, Critical Perspectives on Accounting, Research in Accounting in Emerging Economies, Australian Journal of Psychology, Human Resource Costing and Accounting,* and *Journal of American Academy of Business*. His doctorate thesis examined intellectual capital reporting practices in Sri Lanka.

Prodromos Chatzoglou is an associate professor in the department of Production and Management Engineering at Democritus University of Thrace, Greece. He is also director of the postgraduate program in Finance and Financial Information Systems at Technological Educational Institution (TEI) of Kavala, Greece, which is offered in collaboration with the University of Greenwich. He holds a BA in Economics (University of Macedonia, Greece), an MSc in Managerial Sciences (UMIST, Manchester, UK), and a PhD in Information Engineering (UMIST, Manchester, UK). His research interests include Information Engineering, Software Project Management, Information System Economics, Electronic Business, Knowledge Management and Information System Development. He has published many articles in the fields, wrote a book for System Analysis and assisted the publication of British academic books into Greek language.

Eno L. Inanga is a Professor of Accounting and Business Finance, and former Head of Accounting and Finance, at Maastricht School of Management, The Netherlands. Before then, he had served as Dean of the Faculty of the Social Sciences and, later, Head of the Department of Economics at the University of Ibadan in Nigeria. He had also held a visiting appointment in the Department of Management Studies in the University of the West Indies in Jamaica, and served on the Board of Directors of an oil company and an insurance company in Nigeria. Professor Inanga studied Accountancy in the University of Nigeria, where he was a Federal Government Scholar, and Accounting and Finance at the London School of Economics and Political Science in the University of London, UK, where he was a Commonwealth Scholar. His current research interests include aspects of corporate financial reporting, accounting research and accounting practice, African capital markets and domestic resource mobilization, financial resource base and fiscal decentralisation.

Dimitrios Kousenidis is an Assistant Professor in Financial Management in the Department of Economics at the Aristotle's University of Thessalonica, Greece. Dr Kouse-

nidis holds degrees from the Aristotle's University of Thessalonica (Greece) and from the University of Glasgow (Scotland). His research interests are in asset pricing models, performance measurement systems and in the information content of earnings for stock returns Dr Kousenidis was an investment advisor and member of the Board of Directors in a Greek closed-end fund and has served as internal auditor and consultant in many companies of Northern Greece. He holds a visiting position at the Technological Educational Institution of Kavala (Greece) where he teaches management accounting in the postgraduate program in Finance and Financial Information Systems franchised by the University of Greenwich.

Mervyn K. Lewis is the Professor of Banking and Finance in the School of International Business at the University of South Australia. Previously he was Midland Bank Professor of Money and Banking at the University of Nottingham, and Course Director of the MBA in Financial Studies. He was also a Consultant to the Australian Financial System Inquiry, Visiting Scholar at the Bank of England, and has been visiting professor at the Universities of Cambridge, Melbourne, Vienna, Wuhan, Mauritius, and Goettingen. In 1986 he was elected a Fellow of the Academy of the Social Sciences in Australia. Professor Lewis has authored or co-authored fourteen books and over one hundred articles or chapters. The latest published volumes are *Monetary Economics* (Oxford University Press, 2000) and *Islamic Banking* (Edward Elgar, 2001). He is currently working on two new books and editing a series *New Horizons in Money and Finance*.

Christos I. Negakis is an Assistant Professor of Accounting in the Department of Economics at the Aristotle's University of Thessaloniki, Greece. Dr Negakis holds degrees from the Aristotle's University of Thessaloniki (Greece) and from the Ca Foscari Universita degli studi di Venezia (Italy). His research interests are in the information content of accounting numbers, auditing, failure prediction models and performance measurement systems. Dr Negakis has served as an internal auditor and consultant for many Greek companies. He holds a visiting position at the University of Macedonia (Greece) where he teaches auditing in their postgraduate programme.

Darja Peljhan is an Assistant at the Department of Management and Organization at the Faculty of Economics, University of Ljubljana. She holds a BA from Faculty of Economics, University of Ljubljana, where she also received her Master's degree. Now she is preparing her PhD thesis where she investigates the changes that are made in the management accounting information system when continuous improvement is adopted in a company. The study also examines the changes in internal performance that occur after the adoption of continuous improvement. Her research area comprises cost management, especially cost management concepts and their use in companies. She attended several international conferences, where she presented papers in her research area. One of the papers was rewarded Best Paper Award at the European Applied Business Research Conference in Rothenburg, Germany in 2002. She published several articles in Slovenian, European, and US journals.

Wm. Bruce Schneider is the Professor of Accounting, Emeritus at California State University, Los Angeles, California and MsM/Visiting Professor of Accounting at the Maastricht School of Management, the Netherlands. He holds degrees from Occidental College and the University of Southern California and a PhD from the Drucker Center, Claremont Graduate University. He is also a Certified Public Accountant.

Željko Šević is the Reader of Accounting, Finance and Public Policy in the University of Greenwich Business School, where he also serves as the Director of Research, Outreach and European Affairs. He has been educated in Serbia, the UK and Netherlands and has held a visiting academic position in Australia, Austria, Japan, Croatia, Poland

and Bulgaria. Prior to becoming a full-time academic Professor Šević served as the Deputy Minister and Head of the Youth Department in the Ministry of Youth and Sports of the Republic of Serbia (1991-1993) and gained experience, at the senior level, in NGOs (1989-1991) and in the private sector (1994). His current research interests are in the public sector reform in Japan and Vietnam (on-going projects), and accounting reform in the public sector with the particular emphasis on the use of management accounting in public sector restructuring and the design of effective financial/fiscal information systems.

Metka Tekavčič is a professor in the Department of Management and Organization at the Faculty of Economics, University of Ljubljana. From 1999 to 2001 she was the Head of the department. Since 2001 she has held the vice-dean position at the Faculty of Economics, University of Ljubljana. She holds a BA, Master's and PhD degree from Faculty of Economics, University of Ljubljana. Her research interests are in cost management and performance measurement. She attended many international conferences, where she presented papers in her research area. She published a number of articles in Slovenian, European, and US journals.

Detailed instruction for authors

The Journal solicits papers which are 8,000 to 10,000 words in length. Shorter papers between 5,000 and 8,000 words will also be considered for publication, especially if they are review articles or if they put forward new, insufficiently explored ideas and approaches (often deemed to be premature by other journals). Book reviews should exceed 2,000 words and reviewers are required to submit a copy of the book reviewed if they initiate a review of the publication.

All submissions must be in English. However, as this journal belongs to the UN family, it encourages the translation of works originally written in other languages into English. Nevertheless, submission to the journal implicates that the paper has not been published elsewhere (regardless of the language of publication) and that it is not submitted for publication in any other medium.

All papers submitted for publication should be sent electronically to the Editor at the following address: Z.Sevic@gre.ac.uk or ecpd@eunet.yu

Submission of a paper will be held to imply that it contains original unpublished work. The Editor does not accept responsibility for damage or loss of papers submitted. Upon acceptance of an article, author(s) will be asked to transfer copyright of the article to the publisher – the European Center for Peace and Development at the University for Peace established by the United Nations (ECPD). This transfer will ensure the widest possible dissemination of information.

Manuscripts should be double-spaced with wide margins. All pages should be numbered consecutively. Titles and subtitles should be kept as short as possible. References, tables and legends for figures should be inserted into the main text and also submitted as separate files with the final version of the paper. This final version should be sent in hard copy form and on a 3.5" diskette or a CR-Rom to the editor at the following address: Zeljko Sevic, The Business School, University of Greenwich, Old Royal Naval College, 30 Park Row, Greenwich, London SE10 9LS, England, UK or ECPD, Terazije 41, 11000 Belgrade.

The first page of the manuscript should contain the following information: the title; the name(s) and institutional affiliation(s) of the author(s) and an abstract of not more than 200 words. At the bottom of the cover page, please provide the full postal address, telephone number, fax number, and E-mail address of the corresponding author. Please also supply up to five key words with up to three Journal of Economic Literature codes.

In principle, any acknowledgements, and information on grants received should be given in a first footnote, which should not be included in the consecutive numbering of footnotes, and marked with a asterisk (*).

Footnotes should generally be avoided. The Journal's view is that if the material is worth including in the paper, it should be incorporated into the text. However, footnotes can be used for very long lists of references that would otherwise break up the text, or for material that is substantive but takes the reader too far afield to be easily integrated into

the text. Acknowledgments also belong in the footnotes (e.g., "We thank John Long for suggesting this new approach/test/interpretation.") A general guideline is no more than one footnote to every 4-5 pages of text, not including acknowledgments and long lists of references. Footnotes are numbered consecutively in Arabic superscripts. Footnotes must not, under any circumstances, include displayed formulae or tables.

Displayed formulae should be numbered consecutively throughout the manuscript as (1), (2), etc. against the right-hand margin of the page. Section headers are left-justified with Arabic numerals. Only the first word is capitalized. Headers are in boldface type, and subheads are in italics. A period follows the last numeral. As headers and subheads introduce text, it is preferable that they not be immediately followed by additional subheads. References in the text to other sections of the paper are capitalized (e.g., "as noted in Section 2.2").

The first line of each paragraph is indented. The use of the active voice greatly improves the readability of a paper (e.g., "the tests show" or "we show," not "it is shown"), but authors should avoid the use of 'I', since good academic writing should be depersonalised. Italics, quotation marks, and capital letters are considered to be distracting and should be kept to a minimum (although the words a priori, etc., i.e., e.g., et al., ex ante, and ex post are italicised). Special terms can be italicised but only at the first occurrence, and all foreign (non-English) words should be italicised. Abbreviations should be kept to a minimum, and the full text with an abbreviation in brackets should be given when the term is used for the fist time. Do not assume that all readers are familiar with the abbreviations/acronyms that are used in your paper. The use of appendices is discouraged but if they are used, please refer to them as Appendix A, Appendix B, etc.

The Journal endorses full Harvard referencing style. Potential authors are strongly encouraged to consider the latest edition of the Chicago Manual of Style, before submitting their paper. The list of references should appear at the end of the main text (after any appendices, but before tables and legends for figures). It should be double-spaced and listed in alphabetical order by author's name. Everything in the list of references should be cited in the text, with no discrepancies in the spelling of the authors' names or in the date of publication. In the reference list, there are no quotation marks, no underlines, and no italics. The authors' last names and first initials are used. Only the first word of an article title is capitalised. Book and journal titles take normal initial capitals. References should appear as follows:

For Monographs/Books:

Hunt, B. and D. Targett (1995), *The Japanese Advantage? The IT Battleground in Europe, Oxford*: Butterworth Heinemann in association with "Management Today".

For Contributions to Collective Works (book chapters – edited volumes/conference proceedings):

Barsoux, J.-L. and P. Lawrence (1991), Countries, Cultures and Constraints in R. Calori and P. Lawrence, eds. *The Business of Europe: Managing Change*, London: SAGE Publications, 198-217.

For Journals:

Kornai, J. (1993), The Evolution of Financial Discipline under the Post-Socialist System, *Kyklos*, **46**(3), 315-336.

For Unpublished material:

Bonin, J. P. and M. E. Schaffer (1995), *Banks, Firms, Bad Debts, and Bankruptcy in Hungary 1991-94*, CEP Discussion Paper No. 234, London: Centre for Economic Performance at LSE

For WWW material:

CATO Institute (1998), *Rita Gluzman, Petitioner v. United States of America, Respondent, Brief of Amicus Curiae the Cato Institute in Support of the Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit*, http://www.cato.org/pubs/legalbriefs/gluzman.pdf [*accessed* 15th March 2001]

Journal titles *should not* be abbreviated. Also, the location of the university or publisher must only be a city. Do not provide information on a county, state or a country.

Citations in the text and footnotes should include the surname of the author(s) followed by the year of publication in brackets, such as (Merton, 1986). If the author refers to a direct quotation, this should be given under quotation marks and page number should be provided, such as (Merton, 1986: 3). If there are more than three authors credited to a single publication, the reference is referred to as the first author's surname, followed by et al. typed in italic, whilst all the authors will be listed at the end of the paper in the list of references. For instance, (Merton, *et al.*, 1986). Note that where there are more than two authors, their names should be separated by commas and multiple parenthetical citations should be separated by semicolons.

Use commas in numbers with more than three digits (e.g., 1,234 vs. 1234). Per cents appear as 12.34 per cent (not 12.34%). In principle, avoid the use of symbols in the main text. Decimals are preceded by a zero, as in 0.1234 (not .1234). A number or percent at the beginning of a sentence is spelled out (e.g., "Forty-two of these firms are in the full sample…") but it is preferable to use a different construction (e.g., "The full sample includes 42 of these firms…"). Months and years are written without commas or apostrophes (e.g., 1980s, January 1990).

Any illustrations will be reproduced photographically from originals supplied by the author; the publisher will not redraw them. Please provide all illustrations in duplicate (two high-contrast copies). Care should be taken that lettering and symbols are of a comparable size. The illustrations should not be inserted in the text, and should be marked on the back with figure number, title of paper, and author's name.

Tables should be numbered consecutively in the text in Arabic numerals and inserted into the main text. However, they must also be printed on separate sheets and saved into separate files labelled appropriately in an understandable manner (table 1, table 2, etc.) when the final version of the accepted paper is submitted in electronic and hard copy to the Editor. The legends, axis labels, column and row labels and footnotes for all figures and tables should be clear enough so they are self-contained; that is, the content of the table or the figure must be understandable without reading the text of the article and authors should avoid describing the same material presented in the tables in the main text. Each table must have a title (at the top) followed by a descriptive legend. The source(s) of the table must be given below the table, following the word 'Source:' written in italic script (For example: '*Source*: John, 1992, p. 23'). Authors must check tables to be sure that the title, column headings, captions, etc. are clear and to the point. All graphs and diagrams should be referred to as figures (e.g., Fig. 1), and should be numbered consecutively in the text in Arabic numerals. Illustrations for papers submitted as electronic manuscripts should be in traditional form.

The legends and captions for tables or figures should be complete enough that the table or figure can stand on its own. Large tables and graphs must be presented in landscape format, and tables should be typed in 9 pt script, while the main text is typed in 12 pt script. In particular, the TITLE AND LEGEND of the table or figure must describe the content of the numbers or symbols in the body of the table or the content of the figure. For example, a table legend that says "Descriptive Statistics" is unsatisfactory.

Equations in the text are indented on a separate line with the number of the equation right-justified. All equations are numbered, even if they are never referred to in the text. In general, equations are punctuated as normal parts of a sentence if the sentence continues after the equation, as follows:

Revenue, R is calculated as

$$R = P^*V \qquad (1)$$

where

– P is the selling price, and
– V is the volume of sales in units.

Ensure that the letter "I" and digit "1", and also the letter "O" and digit "0" are used properly, and format your article (tabs, indents, etc.) consistently. Characters not available on your word processor (Greek letters, mathematical symbols, etc.) should not be left open but indicated by a unique code (e.g., alpha, @, etc., for the Greek letter "alpha"). Such codes should be used consistently throughout the entire text and a list of codes should accompany the electronic manuscript. Do not allow your word processor to introduce word breaks and do not use a justified layout. Please adhere strictly to the general instructions below on style, arrangement, and, in particular, the reference style of the Journal.

Any manuscript that does not conform to the set instructions will be returned to the author(s) for necessary amendments before being sent to the referees.

Once the accepted paper is ready for going to print, the page proofs will be sent to the corresponding author. Proofs should be corrected carefully; the responsibility for detecting errors lies with the author. Corrections should be restricted to instances in which the proof is at variance with the manuscript. Each author will receive 5 reprints of his/her paper and a copy of the journal issue in which the paper has appeared. All the reprints will be sent to the corresponding author and he/she will be responsible for distributing reprints and copies of the journal to other co-authors.

Potential authors are strongly encouraged to consider the Journal of Financial Economics' style guide as this promotes good academic writing. However, if there is an inconsistency between the above instructions and the JFE style-sheet, the authors should adhere to the above stipulated guidelines. JFE style-guide can be accessed via WWW at http://jfe.rochester.edu.