Volume 9, Numbers 1 and 2 ISSN 1544-0036

JOURNAL OF LEGAL, ETHICAL AND REGULATORY ISSUES

An official Journal of the
Allied Academies, Inc.

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Academy Information
is published on the Allied Academies web page
www.alliedacademies.org

The *Journal of Legal, Ethical and Regulatory Issues* is published by the Allied Academies, Inc., a non-profit association of scholars, whose purpose is to support and encourage research and the sharing and exchange of ideas and insights throughout the world.

Whitney Press, Inc.

Printed by Whitney Press, Inc.
PO Box 1064, Cullowhee, NC 28723
www.whitneypress.com

The *Journal of Legal, Ethical and Regulatory Issues* is published by the Allied Academies, Inc., PO Box 2689, 145 Travis Road, Cullowhee, NC 28723, USA (828) 293-9151, FAX (828) 293-9407. Those interested in subscribing to the *Journal*, advertising in the *Journal*, submitting manuscripts to the *Journal*, or otherwise communicating with the *Journal*, should contact the Executive Director at info@alliedacademies.org.

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LETTER FROM THE EDITORS

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REVERSE AGE DISCRIMINATION: A NEW TWIST TO AN AGE-OLD PROBLEM

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ABSTRACT

In General Dynamics Land Systems v. Cline the Supreme Court held that it was not illegal under the ADEA to preference older workers over younger workers with respect to some benefit plans, even though both sets of employees were protected under the Age Discrimination in Employment Act. This paper will examine that case, as well as the decisions of the lower courts with respect to this issue of reverse discrimination under the ADEA. It will also examine whether or not other theories of liability recognized under Title VII, such as workplace harassment and disparate impact discrimination, translate into liability for employers under the ADEA.

INTRODUCTION

General Dynamics Land Systems v. Cline involved a group of workers between the ages of 40 and 49, who claimed to be the victims of reverse age discrimination because their employer provides more generous benefits to fellow workers who are 50 and older (Brostoff, 2003). This lawsuit, brought by Dennis Cline and nearly 200 other workers, was filed because a renegotiated labor contract between General Dynamics and the UAW stipulates that full health-care retirements benefits are provided only to retirees with 30 years seniority and who were at least 50 years of age at the time of the new contract (Austin, 2004). Younger employees at the company argued that the contract violates the Age Discrimination in Employment Act of 1967, which prohibits workplace discrimination against workers 40 and over. In essence, the plaintiffs alleged that they were the victims of reverse discrimination, a term used to refer to discrimination in favor of members of a class that civil rights legislation was designed to protect. Such cases previously had been brought by Title VII plaintiffs, who were Caucasian, or alternatively male, alleging that they had been discriminated against in favor of racial minorities, or women, respectively (Minkin, 2003).

A federal district court in Toledo, Ohio, dismissed the claim, but a divided three-judge panel of the Sixth U.S. Circuit Court of Appeals ruled in July of 2002, that the workers did in fact have a legitimate case. The majority opinion held that if Congress wanted to limit the ADEA to protect only those workers who are relatively older, it clearly had the power and acuity to do so, but it did not (Hofmann, 2003). General Dynamics appealed, and on April 21, 2003, the high court agreed to review the case.

This paper first will examine the ADEA, and its place in federal civil rights legislation. It will compare the application of other judicially developed theories of liability under Title VII, such as the law of harassment being a form of discrimination, as well as the theory of disparate impact discrimination, and their acceptance under interpretations of the ADEA. It then will discuss and analyze the decisions of the lower courts in the General Dynamics case, which involved allegations of reverse discrimination, also a recognized theory of liability under Title VII, and its application to the ADEA. Finally, it will examine the decision ultimately rendered by the United States Supreme Court, its policy ramifications, and potential impact on other areas of law that attempt to bridge theories of liability between Title VII and the ADEA.

THE AGE DISCRIMINATION IN EMPLOYMENT ACT OF 1967: AN OVERVIEW

The Civil Rights Act of 1964 was enacted "to achieve equality of employment opportunities and remove barriers which operated in the past to favor an identifiable group of white employers over other employees." (Griggs v. Duke Power Company, 1971, p. 431). Specifically, Title VII provides that "[I]t shall be an unlawful employment practice for an employer-- (1) to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin . . ." (42 U.S.C. § 2000e-2(a)(1)(2003)). Age was not included among the forbidden criteria under Title VII. Subsequently, the Secretary of Labor investigated the issue of age discrimination, and concluded that it was common for employees to be discriminated against in the workplace because of their age, and inaccurate stereotypes about the abilities of older workers (Recent Case, 2003). The preamble to the ADEA explains that the law was enacted to protect older workers from arbitrary discrimination arising out of invalid stereotypes about the presumed impact of aging on workplace performance (Kilberg, 2003). The stated purpose of the ADEA is "to promote employment of older persons based on their ability rather than age; to prohibit arbitrary age discrimination in employment; and to help employers and workers find ways of meeting problems arising from the impact of age on employment" (29 U.S.C § 621(b)(2003)).

The ADEA prohibits discrimination against individuals over the age of forty because of their age, and also prohibits covered entities from depriving individuals of employment opportunities or taking any other adverse action against such individuals because of their age. Specifically, the ADEA makes it unlawful for a covered employer "(1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age; (2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or (3) to reduce the wage rate of any employee in order to comply with this chapter" (29 U.S.C. § 623 (a)(1)-(3) (2003)).

HARASSMENT AS A FORM OF DISCRIMINATION UNDER THE ADEA

The ADEA shares the goal of Title VII with respect to the removal of artificial, arbitrary, and unnecessary barriers to employment when those barriers operate invidiously to discriminate on the basis of criteria, which are irrelevant to job performance. As a consequence, courts tend to follow developments in other areas of civil rights law in interpreting the ADEA as well. For example, harassment can be a form of discrimination under Title VII (Abrams, 1998). The first case to articulate such a proposition involved national origin and racial harassment (Rogers v. EEOC, 1971). However, sexual harassment cases primarily have been responsible for developing and explaining how harassment results in a form of disparate treatment discrimination. The Supreme Court has held that actionable harassment must be sufficiently severe and pervasive so as to alter the conditions of employment and to create an abusive environment judged from the totality of the circumstances from the perspective of a reasonable person in the plaintiff's position (Meritor Savings Bank v. Vinson, 1986). Those circumstances include the frequency and severity of the discriminatory conduct, whether it is physically threatening or humiliating, or mere offensive, and whether it unreasonably interferes with an employee's work performance (Harris v. Forklift Systems, Inc., 1993). While illegal harassment need not be psychologically injurious before the situation is actionable, the conduct must be unwelcome and sufficiently hostile so as to filter out ordinary tribulations in the work place to insure that Title VII does not become a general civility code (Oncale v. Sundowner Offshore Services, Inc., 1998)

Many courts also recognize the viability of such hostile working environment claims under the ADEA (Vigil, 1996). The Sixth Circuit was the first federal appeals court to recognized such claims of discrimination based upon age, holding that "in light of the ADEA's employment of the "terms, conditions, or privileges of employment" language, we have no doubt that a hostile working environment may be stated." (Crawford v. Medina General Hospital, 1996, p. 834). Similarly, the Ninth Circuit concluded that violations of Title VII and the ADEA may be shown by proof of a hostile environment (Sischo-Nownejad v. Merced Community College Dist., 1991). Other circuit courts have hinted that such claims are cognizable under the ADEA. The Second Circuit asserted that the analysis for hostile environment is the same under Title VII and ADEA (Brennan v. Metro. Opera Ass'n, 1999). Likewise, the Seventh Circuit recognized that, while hostile environment claims were viable under the ADEA, they are rare (Young v. Will County Dept Public Aid, 1989). Courts that do recognize the viability of such claims tend to follow precedent established under Title VII as to what proof the plaintiff must establish in a prima facie case for an actionable hostile working environment based upon age, as well as the basis for imputing liability to an employer (Burns v. AAF-McQuay, Inc., 1999). For example, in Crawford v. Medina General Hospital (1996) the plaintiff alleged that several inappropriate remarks had been made by her supervisor and co-workers, including statements to the effect that women over fifty-five should not be working, and that old people should be seen and not heard. The appeals court determined that, aside from those remarks, there was little evidence to suggest that hostility in the workplace was the product of age-based bias, characterizing Crawford's complaints as mere offensive utterances, as opposed to physically threatening or humiliating conduct. Nevertheless, assuming sufficient evidence, there seems no reason why hostile environment claims based upon age should not be accepted as a form of illegal disparate treatment under the ADEA, as just as they are recognized under Title VII (Gembala, 1999).

DISPARATE IMPACT DISCRIMINATION AND THE ADEA

While many lower federal courts apply the law of workplace harassment under Title VII to the ADEA, courts seem more reluctant to apply Title VII's theory of disparate impact discrimination to the ADEA. The theory of disparate impact provides that facially neutral employment criteria may violate Title VII if they have a disparate impact upon members of a protected class and cannot be justified by a business necessity (Griggs v. Duke Power Company, 1971). The Supreme Court initially interpreted Title VII so as to prohibit such practices in order to prevent pretextual discrimination in the absence of direct evidence of discriminatory motive (Rutherglen, 1987). Subsequently, the Civil Rights Act of 1991 amended Title VII so as to expressly recognize such liability (Greenhouse, 2002).

Prior to *Griggs*, plaintiffs had to establish that they intentionally were treated less favorably because of their race, color, religion, sex, or national origin either by direct or circumstantial evidence. In the absence of direct proof of discriminatory motive, plaintiffs must establish that they suffered an unfavorable or adverse employment decision, and that the employer did not treat race, color, religion, sex, or national origin neutrally in making the decision (McDonnell Douglas Corp. v. Green, 1973). The burden then shifts to the defendant to establish a legitimate, nondiscriminatory reason for the adverse employment action, that is, that legitimate factors motivated it. If the employer succeeds, then the individual must show that the employer could have used other practices that do not have a discriminatory effect, and can still serve employer's legitimate interest in order to maintain their claim, or offer evidence that the justification is a mere pretext for discrimination (Texas Dep't of Cmty. Affairs v. Burdine, 1981). In contrast, proof of discriminatory intent is not required under disparate impact theory.

Although the Supreme Court never has ruled expressly whether or not Title VII's disparate impact theory translates into the ADEA, dicta in a 1993 case suggests that it does not apply (Sloan, 1995). In Hazen v. Biggins, (1993) plaintiff was terminated a few weeks before his pension benefits would have vested. The First Circuit found the company liable under the ADEA, reasoning that a jury could have found that the company decided to fire Biggins before he could receive his pension rights and that age was inextricably intertwined, since his pension rights would not have been so close to vesting if it were not for his age. The Supreme Court vacated the judgment, however, clarifying that disparate treatment does not automatically occur when the employee's motivation is a component other than age, even if the component is correlated. The majority further opined that "[W]hen the employer's decision is wholly motivated by factors other than age, the problem of inaccurate and stigmatizing stereotypes disappears. This is true even if the motivating factor is correlated with age…" (Hazen v. Biggins, 1993, p. 611).

Since *Hazen*, the lower courts have split as to the application of disparate impact theory to the ADEA. The First Circuit refused to apply disparate impact theory under the ADEA, in part, because the Secretary of Labor's report differentiated between arbitrary age discrimination and other procedures that have disproportionate effects on older workers. (Mullin v. Raytheon, 1999). The court also reasoned that the text of the statute was limited to prohibiting only intentional discrimination concerning age, and concluded that the purpose of the ADEA was to address disparate treatment only (Archer, 2000). That Congress failed to add disparate impact to the ADEA at the time when it was simultaneously amending Title VII to specifically include the term provided other evidence of an intent to exclude the theory's application to the ADEA (Johnson, 2000). Similarly, the Seventh Circuit relied on *Hazen* to conclude "that decisions based on criteria which merely tend to affect workers over the age of forty more adversely than workers under forty are not prohibited" (EEOC v. Francis W. Parker School, 1994, p. 1077). Also, in concluding that ADEA claims cannot be based on a disparate impact theory of discrimination, the Tenth Circuit compared the wording of the ADEA to that of the Equal Pay Act, both of which appeared to offer an exemption if the differentiation is based on any reasonable factor other than age or sex respectively (Ellis v. United Airlines, Inc., 1996). Although not deciding the issue, the Courts of Appeals for both the Sixth and Third Circuits have recognized that *Hazen* casts considerable doubt concerning the application of disparate impact theory to age claims (Lyon v. Ohio Educ. Assoc.,1995; Dibiase v. SmithKline Beecham, 1995).

In contrast, the Eighth Circuit endorses the viability of disparate impact theory, recognizing the parallelism between Title VII and the ADEA (Smith v. City of Des Moines, 1996). Similarly, the Ninth Circuit, which addressed the issue before *Hazen*, relied on the comparable language, structure, and purpose of both statutes to validate the carry over. (EEOC v. Borden, 1984). The Second Circuit also recognized the applicability of disparate impact theory to the ADEA before the Supreme Court's decision in *Hazen* (Geller v. Markham, 1980). While the Supreme Court denied certiorari in the Second Circuit case, Justice Rehnquist, who dissented from that denial, asserted that "the decision of the Court of Appeals is inconsistent with the express provisions of the ADEA and is not supported by any prior decision of this Court…This Court has never held that proof of discriminatory impact can establish a violation of the ADEA, and it certainly has never sanctioned a finding of a violation where the statistical evidence revealed that a policy, neutral on its face, has such a significant impact on all candidates concerned, not simply the protected age group" (Markham v. Geller, 1981, p. 948).

The Supreme Court recently had an opportunity to resolve the conflicting views among the circuit courts. However, the Court dismissed the case after hearing oral arguments, determining that certiorari had been improvidently granted (Adams v. Florida Power Corp., 2002). In that case the district court concluded as a matter of law that disparate impact theory was unavailable under the ADEA; however, because of the controversy among the circuits, the district court certified the question to the Court of Appeals for the Eleventh Circuit. The Eleventh Circuit first examined the statutory language of the ADEA, and determined that, while the language of the ADEA is similar to Title VII, it was distinguishable enough to question extending the disparate impact theory to ADEA cases because the ADEA that provides that an employer may "take any action otherwise prohibited…where the differentiation is based on reasonable factors other than age" (Adams v. Florida Power Corp., 2001, p. 1323). The court also examined the similarity in statutory language of the Equal Pay Act and the ADEA, and concluded that, since disparate impact theory is not available under the Equal Pay Act, it is not available under the ADEA. The court also cited the differences in the legislative history of the acts to support its determination that disparate impact claims are not available under the ADEA.

Whether or not the Eleventh Circuit was correct in its conclusion remains the subject of debate. Some commentators argue that disparate impact theory should apply with equal force under both Title VII and the ADEA (Ziegler, 1984; Saunders, 1996; Alexander, 1999). Recognition of the theory is necessary to fully eliminate age discrimination, which is the purpose of the ADEA (Clemmons & Bales, 2000). At a minimum, courts should recognize the theory under the section of the ADEA, which applies to federal sector employers, for consistency (Fentonmiller, 1998). In contrast, others argue that the current statute does not provide for such claims, and that it is the role of Congress, not the courts, to recognize the applicability of the theory to age discrimination claims (Pontz, 1995; Barrentine, 1996-97). As a practical matter, since jury trials are mandated under the ADEA, lay persons may not be able to comprehend and accurately resolve the complex issues of statistical analysis and validity that characterize disparate impact litigation (Herbert & Shelton, 1996).

REVERSE DISCRIMINATION AND THE ADEA

The Civil Rights Act of 1964 was designed to eliminate rampant discrimination against racial minorities and the resulting disadvantages suffered as a result of such practices. Sex, as an illegal criteria for employment decisions, was later included in an attempt to defeat the legislation in Congress. (Price Waterhouse v. Hopkins, 1989). Specifically Title VII makes it illegal for employers "to fail or refuse to hire or to discharge any individual, or otherwise to discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's race, color, religion, sex, or national origin; or (2) to limit, segregate, or classify his employees or applicants for employment in any way which would adversely affect his status as an employee, because of such individual's race, color, religion, sex, or national origin." (42 U.S.C. § 2000e-2(a)(1)(2003)). That phrase, "because of" has been interpreted by courts as prohibiting all discriminatory practices based upon the forbidden criteria, and as not being limited to discriminatory practices aimed only at those persons for whom the legislation was enacted to protect. As a result, the Supreme Court has held that Title VII protects whites from being discriminated against in favor of racial minorities (McDonald v. Santa Fe Trail Transp. Co., 1976). Similarly, men are protected from discrimination based upon sex, even by members of their same sex. (Oncale v. Sundowner Offshore Services, Inc., 1998).

Does that same phrase, which makes it unlawful to discriminate "because of" age under the ADEA, protect younger workers from reverse discrimination in favor of older workers within the same protected class? In other words, is age (within the protected class) an illegal consideration, as are sex and race under Title VII? The Supreme Court has held that a covered employee can still establish a violation of the ADEA, even though an employee over forty years, who is in the same protected class, replaced the older worker (O'Connor v. Consolidated Coin Caterers Corp., 1996). However, in that case an older worker was discriminated in favor of a younger worker, which seems to be of the same genre of practices made illegal by Congress in passing the legislation, notwithstanding that both parties were over forty years of age. On the other hand, reverse discrimination, by definition, reverses that result within the protected class. It would seem that recognizing such potential for liability for age-based preferences could result in substantial litigation, since an employer could be liable for treating a forty year-old employee more favorably than a fifty year-old employee, who could also sue for being treated less favorably than the same forty year-old employee (Zaremba, 2003).

Prior to the Sixth Circuit's decision, which recognized the viability of reverse discrimination under the ADEA, other circuit courts of appeals had rejected the analogy to Title VII cases. The Seventh Circuit held that the ADEA did not provide a cause of action for reverse discrimination because of the lack of proof that the legislation was intended to protect younger workers from discriminated against "because of" their age. The appeals court also seemed to fear an onslaught of suits based upon retirement plans that set minimum age thresholds, simply because of the broad term employed by Congress. (Hamilton v. Caterpillar, Inc., 1992). The Second Circuit also observed that, because the ADEA allows minimum age considerations for retirement plans, younger workers could be excluded without violating the ADEA (Dittman v. General Motors Corp., 1997)). Likewise, the First Circuit in dicta suggested that the ADEA did not forbid employers from treating older workers more generously than younger workers (Schuler v. Polaroid Corp., 1988). The Ninth Circuit, as well, noted that the ADEA does not ban such preferential treatment (Stone v. Travelers Corp., 1995). Further, the Secretary of Labor's Report, which prompted passage of the ADEA, focused on eliminating arbitrary discrimination based upon inaccurate stereotypes, not upon eliminating non-arbitrary preferential classifications (Recent Case, 2003). The economic and social ramifications of prohibiting employers from favoring older workers in the allocation of benefits could frustrate the intent and purpose of the law (Minkin, 2003).

On the other hand, some commentators argue that recognizing reverse discrimination claims furthers the goals of the ADEA by fighting all discrimination in the workplace and protecting all workers of the same class, and also assert that relative age is irrelevant (Cullen, 2003; Buchakjian, 2003). Others argue for allowing reverse discrimination claims in part, but support an exception for some healthcare or retirement benefit programs, where such exceptions are reasonable and not arbitrary (Rogers, 2003; Topputo, 2003). Prior to the Supreme Court's grant of certiorari in the General Dynamics case, the Equal Employment Opportunity Commission (EEOC) interpreted the ADEA as prohibiting discrimination based upon age among members in the protected class (29 C.F.R. § 1625.2(a) (1988)). Although the Supreme Court has yet to resolve the split among the circuit courts with respect to the application of disparate impact theory to the ADEA, nor has it addressed whether Title VII precedent with respect to harassment as being a form of discrimination applies equally to the ADEA, it was against this backdrop of controversy that the Court agreed to hear the appeal from the decision of the Sixth Circuit in General Dynamics.

CLINE V. GENERAL DYNAMICS LAND SYSTEMS, INC.

In 1997, Michigan-based General Dynamics Land Systems changed its retiree health benefits policy to one that provides full retiree health benefits to workers who were at least fifty years of age on July 1, 1997. This change was made as a result of a modification in the union contract. The previous labor contract between General Dynamics and the UAW stipulated that the company provided full retiree health benefits to workers, who accumulate thirty years of seniority. But under the new agreement, the company only had to provide such benefits to workers who had thirty years of seniority and who were fifty or older as of the effective date of the agreement (Brostoff, 2003). Immediately thereafter, workers between forty and forty-nine years of age sued, claiming that their employer violated the ADEA. At the time, Dennis Cline was forty-seven years old, and had accumulated twenty-eight years of service. This modification of the labor agreement effectively ended his health retirement benefit (Richey, 2003).

In essence, these relatively younger employees claimed that they were promised benefits when they began working that were later taken away, and that they are denied benefits to which relatively older workers are entitled. As pointed out previously, the ADEA makes it illegal to discriminate because of age against any worker forty or older. But the wording of the statute leaves open to dispute exactly what kind of discrimination lawmakers sought to bar. Does it protect older workers, or does it also cover workers older than forty but younger than others receiving favored treatment because of their older age? General Dynamics contended that the ADEA protects workers from being discriminated against because they are too old, not because they are too young. In opposition, General Dynamics employees agued that the language of the ADEA clearly provides that persons age forty and older may not be discriminated against because of their age (Richey, 2003).

The district court characterized the sole issue before it as being whether or not an employer may legally provide a benefit to workers over the age of fifty, while denying that same benefit to workers below the age of fifty. To that query the court answered in the affirmative. The court determined that the purpose of Congress in enacting the ADEA was to address the problems faced by older workers, not workers who suffer discrimination because they are too young. As a result, the court granted the defendant's motion to dismiss for failure to state a cause of action (Cline v. General Dynamics Land Systems, Inc., 2000).

On appeal, the Sixth Circuit reversed, concluding instead that the ADEA provides a cause of action for employees within the protected class who claim that their employer discriminated against them on the basis of age because of the employer's more favorable treatment of older employees within the same protected class (Cline v. General Dynamics Land Systems, Inc., 2002). The appeals court determined that the language of the statute "clearly and unambiguously forbids employers from defining the terms and benefits of 'any individual's' employment based solely on his or her age." (Cline v. General Dynamics Land Systems, Inc., 2002, p. 469) The court asserted that the term individual was not limited in meaning to older workers. Further, the court opined that "[t]o hold as the ADEA requires us to hold, that employment age discrimination against *any* worker at least 40 years of age is prohibited, does nothing to defeat the congressional intent to protect 'older workers' and 'older persons'" (Cline v. General Dynamics Land Systems, Inc., 2002, p.470). The Court distanced itself from the characterization of the case as one of reverse discrimination, insisting that the expression had no ascertainable meaning in law, since an action either is, or is not discriminatory. Finally, the court deferred to the EEOC's interpretation of the statute, being persuaded that it was a true rendering of the language. The dissenting judge argued that whether or not the case was characterized as reverse discrimination, the ADEA was passed to alleviate problems faced by older workers, not younger workers. As an aside, the dissent asserted that, as a matter of common sense, the ADEA was not intended to interfere with collective bargaining agreements.

The Supreme Court reversed the decision of the Sixth Circuit by a 6-3 vote. Justice Souter, writing for the majority, stated that the ADEA forbids discriminatory preference for the young over the old, and characterized the issue before the Court as "whether it also prohibits favoring the old over the young. We hold that it does not." (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *8). The Court evaluated the circumstances surrounding the passage of the ADEA, including then-common policies of age ceilings on hiring. It also discussed hearings on the Act in Congress that examined unjustified assumptions about the effect of age on the ability to work and negative attitudes about employers concerning older workers, including economic concerns about higher pension and benefit costs. In sum, the Court concluded that the "prefatory provisions and their legislative history make a case that we think is beyond reasonable doubt, that the ADEA was concerned to protect a relatively old worker from discrimination that works to the advantage of the relatively young," asserting that the "enemy of 40 is 30, not 50" (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *18-*21).

The court rejected the notion that the statute's plain meaning dictated a different result. Justice Souter concluded that the term "age" employed by the ADEA was not comparable to the terms "race" or "sex" as employed by Title VII because the latter two terms are general ones, which require modifiers to indicate a relatively narrow application, like "black" or "female." In contrast, "the prohibition of age discrimination is readily read more narrowly than analogous provisions dealing with race and sex. That narrower reading is the more natural one in the textual setting, and it make perfect sense because of Congress's demonstrated concern with distinctions that hurt older people." (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *32) The court also dismissed a single remark of one of the sponsoring Senators, which suggested that the law prohibited age from being a factor in an employer's decision either way, as being against the greater weight of evidence favoring a different interpretation. Finally, the Court justified its departure from the EEOC's reading of the statute, because the agency, when it adopted its interpretation, gave no reasons for its view, aside from noting that the provision was carried forward from an earlier regulation, which also provided no explanation. Justice Souter further iterated that an agency was only entitled to deference in its statutory interpretation in situations in which "the devices of judicial construction have been tried and found to yield no clear sense of congressional intent. Here, regular interpretive method leaves no serious question, not even about purely textual ambiguity in the ADEA." (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *36).

Writing for the three dissenting justices, Justice Thomas characterized the appeal as what should have been "an easy case," in sum, because the plain language of the statute "mandates a particular outcome: that the respondents are able to sue for discrimination against them in favor of older workers. The agency charged with enforcing the statute has adopted a regulation and issued an opinion…both of which adopt this natural interpretation of the provision. And the only portion of legislative history relevant to the question before us is consistent with this outcome" (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *39). Justice Thomas characterized the plain reading of the statute, one supported by the EEOC and seemingly a sponsoring Senator, as unambiguously prohibiting all discrimination based upon age within the protected class. In particular he justified this result by comparing the ADEA to reverse discrimination suits brought under Title VII, and a clear absence of Congressional concern, at the time the Civil Rights Act was passed, about any problems involving discrimination against whites, or any evidence that white workers were suffering at the expense of racial minorities. Commensurately, male on male sexual harassment was never cited as a social problem to be remedied by Title VII. Nevertheless, Supreme Court precedent permits the recognition of both types of discrimination suits under Title VII "because of" race or sex. The dissent, therefore concluded, that "the ADEA prohibits discrimination because of an individual's age, whether the individual is too old or too young…" (General Dynamics Land Systems, Inc., v. Cline, 2004, p. *59).

POLICY AND LEGAL IMPLICATIONS

The Supreme Court in General Dynamics Land Systems, Inc. v. Cline interpreted the text and legislative history of the ADEA as allowing an employer to set minimum age requirements for some employee benefits, and to treat older members of a protected class more favorably with respect to the provision of certain benefits. In other words, employers to a certain extent may take into account age with the respect to the provision of benefits without violating federal law. From a legal perspective, it is thus clear that reverse discrimination claims are not cognizable under the ADEA, as they are under Title VII of the Civil Rights Act of 1964. Will this conclusion affect other areas of the law in which lower courts have assumed that the statutes should be interpreted in tandem?

The creation of a hostile working environment, which discriminates against *individuals* with respect to compensation, terms, conditions, or privileges of employment, *because of* their race, color, religion, sex, or national origin violates Title VII. Should the ADEA be interpreted to reach the same conclusion now that the Court has clarified the use of such terms as "individual" and "because of" by Congress under the ADEA? There seems to be nothing in the opinion to suggest that cases of harassment based upon age would not be actionable as a form of disparate treatment, providing that the offensive conduct was directed at someone in the protected class on account of their age. The abusive working environment in harassment cases often echoes the inaccurate stereotypes of older workers, the effect of which the ADEA was designed to curb, for example, badgering an older female worker with demeaning comments about going through menopause and questioning her mental capacity (EEOC v. Massey Yardley Chrysler Plymouth, 1997). Further, it seems likely that an older worker could state a cause of actions under the ADEA for discrimination based upon age through the creation of a hostile working environment, even if the harassing conduct stemmed from workers within the same protected class. However, it now seems less likely that a younger member of a protected class could state a cause of action for harassment if the harassers were older workers creating an intolerable working environment because of the worker's relative youth, notwithstanding that the employee is in the same protected class, and the harassment was "because of" age.

Would the incorporation of Title VII's disparate impact theory into the ADEA, be more or less likely given the Court's most recent decision? The Court did cite it decision in *Hazen* in General Dynamics Land Systems, Inc. v. Cline for the proposition that the action taken in *Hazen*, that is, firing an employee because his pension was about to vest, was analytically distinct from age discrimination, even though the termination would never occur without advanced years. As in *Hazen*, the Court reiterated that discrimination on the basis of one's pension status was insufficiently related to the underlying concerns of the ADEA, such as pervasive stereotypes of faltering older workers and related stigmas that attach to the elder workforce, in addition to arbitrarily imposed age-ceilings, a common hiring practice at the time the ADEA was passed. In reviewing the statements of purpose and findings cited by Congress in the Act, the Court cited, among other impediments suffered by older workers, the costs of otherwise desirable practices that may work to the disadvantage of older workers, presumably because of their age. Therefore, one could argue that some employment practices, while neutral on their face, could violate the ADEA if their impact disproportionately affects older workers *and* the practice perpetuates the evils the remedial legislation was designed to prevent. For example, a practice of hiring only recent graduates (whatever their age), or hiring exclusively at entry level positions, adversely impacts older, experienced workers with greater longevity in the workforce, and arguably represents an invidious bias against age that is inextricably intertwined with preconceived notions of the desirability of youth and freshness, and not just economic factors. Recognizing such parallelism with Title VII in certain disparate impact cases is particularly attractive since the ADEA codified the business necessity defense, providing "[i]t shall not be unlawful for an employer, employment agency or labor organization (1) to take any action otherwise prohibited under subsection (a),…of this section where age is a bona fide occupational qualification reasonably necessary to the normal operation of the particular business, or where the differentiation is based on reasonable factors other than age." (29 U.S.C § 623(f)(2003)).

With respect to the human resource policy ramifications, the Supreme Court's decision seems favorable. In contrast, the impact of upholding the Sixth Circuit's decision could have resulted in significant negative implications for retirement benefit programs and early retirement plans, a possibility that sparked several public interest groups to voice concerns after that decision. The National Education Association asserted that, rather than stemming from age-based animus or stereotypes, such differential allocation of benefits, in the areas of pensions, health care, severance pay, and the like, reflects an attempt to target scarce resources to those employees who need them most (Richey, 2003). Prior to the ruling by the Sixth Circuit, employers had assumed that the ADEA permitted more generous benefits for older workers, based on a variety of factors, including the Older Workers Benefit Protection Act (Hofmann, 2003). Further, the National Association of Manufacturers contended that each personnel action could ripen into a discrimination claim, and that the reverse discrimination claim at the heart of the General Dynamics case would allow job applicants who are substantially younger than the person selected to establish a prima facie case of age discrimination (Brostoff, 2003). The United States Chamber of Commerce added that the ruling by the Sixth Circuit produced significant uncertainty in an area of great importance to employers (Greenberger, 2003). If employers had to extend retirement health benefits to everyone aged forty or older, it is reasonably predictable that they may decide to extend such benefits to no one (McTague, 2003). Finally, a decision by the Supreme Court, which upheld the Sixth Circuit's position, could have infused rigidity into employment decisions, and removed the freedom of employers to accommodate any special needs of older workers, particularly because the ADEA applies to all the incidents of the employment relationship.

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CULTURAL AND GENDER DIFFERENCES IN THE ETHICAL BELIEFS OF ACCOUNTANTS

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ABSTRACT

This study examines differences in the ethical responses of accountants in an international environment. The link between culture and the gender of the subjects are the variables of interest. Accountants (n=326) from eight countries, representative of Hofstede's (1991) high and low individualism dimension values, were chosen for the study. The respondents were requested to give their agreement level associated with five questionable behaviors associated with the work environment. Each item incorporated an individualism cultural element for the accountants to consider when responding to the survey.

*The results of the analysis by culture and gender indicated mixed results. The cultural variable was significant ($\alpha \leq .05$) on three of the five items; gender, on two; and the culture*gender interaction term, on two. The results partially support the expected cultural link, and the results of the gender variable analysis lend limited support to the expected gender differences. Whenever a difference is indicated, the females supplied the more ethical responses.*

INTRODUCTION

The continuing reports in the news media of corporate wrongdoing illustrate the need for a greater understanding of ethics in the workplace, particularly with regard to those responsible for financial activities and reporting. Additionally, the ever-growing trend toward business globalization brings a multiplicity of cultural differences within international companies. Although certain ethical values, such as honesty, tend to be somewhat constant across cultures, others, such as private property rights, are culture specific. Likewise, some cultures judge actions that subordinate the good of the group to the welfare of the individual to be highly unethical while others do so to a lesser degree or not at all. To address issues of professional ethics, it is necessary to consider how ethics and group culture are interdependent.

This research examines whether there is a cultural element present in the ethical beliefs of accountants. Culture for this research will adhere to Hofstede's definition, which stresses the "collective programming of the mind" (1987, 1) or "software of the mind" (1991, 4) in reference to the shared beliefs and values of individuals that compose a society. Hofstede believes this mental programming or communal conditioning that individuals share with other societal members affects the way they interpret their environmental experiences (1983, 76).

As defined by Hofstede, Individualism (IDV) is a measure of the relative importance societal members place upon their own beliefs and welfare. In societies exhibiting high individualism (high IDV), societal members focus to a great degree on themselves or a small peer group when making decisions and taking action. On the other hand, members of collectivistic societies (low IDV) place a higher degree of emphasis on the good of the society or the organization as a whole, even at the sacrifice of the good of the individual. In accounting, the IDV index is linked to evidence that the importance of an independent attitude and individual initiative varies from culture to culture.

LITERATURE REVIEW

Over the last two decades, mixed results from ethics research have been reported in the international literature. In a survey of business and governmental personnel from the US and Hong Kong, Dolecheck and Dolecheck (1987) reported a cultural link (i.e., using the individualism dimension) in their results. The US respondents indicated that laws are considered minimal requirements, while the Hong Kong respondents indicated the belief that ethics is directly linked to following the law. In surveying US and Hong Kong managers, Ralston et al. (1994) reported some cultural differences in the responses. The individualistic, Western belief was that generally ethical behavior applies to everyone, “while in the East, ‘face’ and ethical behavior depend on the situation” (997).

Karnes et al. (1989) used cases to survey practicing public accountants in the US and Taiwan concerning unethical business behaviors. The individualistic US accountants focused on legal factors, while the collectivistic Taiwanese accountants were concerned with the in-group affected and with balancing of benefits and harms from the behaviors. Dubinsky et al. (1991) investigated whether industrial sales personnel from the US, Japan, and South Korea reponded differently to 12 ethically-based scenarios. The results indicated numerous significant cultural differences in the responses.

Ralston et al. (1993) studied managerial style of US, Hong Kong, and China subjects. Four typically Western and four typically Eastern measures were used. As predicted, there were significant cultural differences on seven of the eight measures between the US and Chinese managers.

The influence of culture on organizational decisions was examined by Kelley et al. (1987) using managers from financial institutions. The respondents were from Japan, China, Mexico, and three ethnic-American counterparts (i.e., Japanese-Americans, Chinese-Americans, and Mexican-Americans), and Anglo-American managers. The results indicated a recurring cultural element in the responses, which was particularly evident in the Chinese data. Ethredge and Erdener (1999) surveyed employees newly entering the work force. There were greater similarities with the responses of the Chinese and South Korean subjects, relative to the US and Mexican subjects. The Asian subjects' responses were linked to assessing the actions according to whether they produced the greatest possible good for all affected by the decision (i.e., a more collectivistic view).

Becker and Frische (1987) examined attitudes among marketing managers from France, Germany, and the US regarding codes of ethics and the general philosophy of business ethics. The survey results indicated idealistic responses by the French managers, pessimistic responses by the German managers, and realistic responses by the US managers. In somewhat similar research, Schultz et al. (1993) surveyed managers from France, Norway, and the US concerning (1) the likelihood of reporting, (2) the responsibility to report, (3) the seriousness of the act, and (4) the personal cost to report unethical behavior. There was general support for the expected cultural differences in the results. Results generally support the proposal of Hofstede that national culture dominates organizational culture in value judgment decisions.

Alderson and Kakabadse (1994) surveyed senior managers from the US, the United Kingdom (UK), and Ireland. Ethical attitudes of the managers were examined from four perspectives: (1) ethical issue implementation, (2) management/peer influence, (3) ethical issues in business, and (4) responsibilities toward key stakeholders. The survey results indicated significant differences by country on ethical issues in business and the implementation of those issues.

Codes of conduct have also become a research topic of interest. Langlois and Schlegelmilch (1990) surveyed CEOs and reported significant differences in their analysis of the usage and content of corporate codes of ethics for large corporations from the US, UK, France, and Germany. The German codes stress "shared responsibility of management and employees"; French and UK codes "promote a sense of belonging"; and the US codes "stress fairness and equity" (532-533).

Cohen et al. (1992) examined the influences that might affect the acceptance and effectiveness of international codes of professional conduct. The authors express concern about the general applicability of the International Code of Ethics issued by the International Federation of Accountants (IFAC). The concern relates to the elements of ethnocentricity related to the major contribution by more developed countries and a lack of sensitivity to cultural influences within less developed countries.

Several studies over approximately the last decade have focused on accountants and the cultural link to work-environment beliefs and decision making. In a study of US, British, and Australian accountants, Pratt et al. (1993) reported evidence of a self-selection process when large US firms recruit local accountants in Britain and Australia. These results are an example of a cultural influence in the international accounting job market environment. Using accountants from the US and Japan, Ueno and Wu (1993) examined budget control practices. The results of the differences in the practices and procedures were linked to the individualism cultural dimension differences between the two countries. Surveying accountants from two cultural designations, Smith and Deis (2000) examined attitudes toward the Comparability Project of the International

Accounting Standards Committee. The results indicated support for the expected cultural differences.

Using Rest's (1979) Defining Issues Test (DIT), Tsui (1996) examined ethical reasoning levels of auditors from the US and Hong Kong. The results generally supported the expectation that a highly individualistic culture, such as the US, would supply the higher DIT score and exhibit greater independence in an audit-conflict situation. The DIT was also used by Tsui and Windsor (2001) to examine ethical reasoning of auditors from two diverse cultures. The collectivistic culture was represented by Hong Kong and Mainland China, and the individualistic culture was represented by Australia. The results indicated the predicted cultural differences. Patel et al. (2002) also reported differences in the examination of an auditor-client conflict scenario. Using accountants from Chinese Malaysia, India, and Australia, the analysis results indicated that the Australian accountants were less likely to revolve and less accepting of resolving auditor-client conflicts by acquiescing to clients' wishes. These results are indicative of the individualistic cultural beliefs.

In a survey of Latin-American accountants, Paláu (2001) reported an overall collectivistic focus in the responses of the accountants. The results of this survey were different from a similar survey used with more individualistic US respondents. In contrast to these studies, Abratt et al. (1992) surveyed managers from South Africa and Australia concerning ethical situations. In spite of the diverse political and cultural differences between the countries, very similar response results were reported. In a study examining audit decision making by accounting professionals from the US and Japan, Yamamura et al. (1996) reported results that did not generally support expectations based on Hofstede's cultural dimensions. The results were explained more by environmental factors (e.g., potential for litigation) than by cultural factors.

There is a considerable amount of reported results and diverse methodologies to support the link between ethical beliefs and culture. The individualism cultural dimension, which is used in the current study, has been the most popular cultural dimension used in the reviewed literature. Nevertheless, much remains to be learned about the relationship between professional ethics and cultural dimensions.

Some reported results support the hypothesis that gender differences exist in ethical beliefs and behavior. Gilligan (1982) used the term, "ethic of care," to differentiate between male and female belief systems. Females tend to value interpersonal relationships and have an *interconnected* outlook, while males tend to have a *separate* outlook. White (1992) believes that Gilligan's work gives an appropriate explanation for these exhibited differences. Similar results were reported by Chusmir et al. (1989). In a survey of industrial managers, the females ranked higher on interdependent values (i.e., self-respect, forgiveness, helpfulness), and males ranked higher on more independent values (i.e., ambitious, courageous, logical). When Barnett and Karson (1989) surveyed insurance firm employees, the results supported that females were more sensitive to nurturing-type scenarios. The females were concerned that information might be used at someone else's expense.

In a survey of ethics using present and future managers, Schminke (1997) focused on the gender of the actor in the scenario. The study reported no significant differences in the basic ethical orientation of the respondents. However, overall the respondents were more agreeable to a decision made by a male actor than a female actor. Somewhat similar evidence of negative attitudes by males toward female executives was reported by Dubno (1985) and Everett (1997). In a study using ethical scenarios to survey US accountants, Smith and Rogers (2000) report very limited differences based on the gender of the respondents. However, there was more agreement when the respondents were assessing the ethical actions of a female actor over the ethical actions of a male actor in the scenario.

Objectives of the Study

For accounting, ethics is an issue with potentially far-reaching consequences that can have an effect on the profession as a whole. The recent problems created with Enron, World Com, and others testify to the seriousness of the dilemma. However, ethics is not only a domestic issue; it is also a global one. A more practical understanding of the subtle differences occurring across societies in dealing with ethical decisions is important to the continued viability of the accounting profession and the profession's products worldwide.

This research extends the examination of ethical responses into a cross-cultural context. The study targets differences in the responses to the dilemmas based on culture (i.e., level of cultural individualism) and gender of the accountants surveyed.

Research Hypotheses

Individualism (based on Hofstede's high IDV or low IDV designation) is the cultural element of interest for the examination. In a collectivistic culture (i.e., low IDV), the societal members are expected to put the best interests of the "group" (considered from the standpoint of a familial group or an organization-identified group) before those of the individual. If an ethical dilemma has an effect on the group, the group effect is expected to have a greater influence in the decision than any consequence to any individuals. That can mean subordinating what is in the best interest of the individual for what is believed to be the greater good of the group or organization. This willing participation or acceptance of actions linked to what is best for the organization can be described as "communitarian motives" (Cohen et al., 1993, 5). A choice of what is best for the organization would be considered appropriate and expected in a collectivistic society.

The survey items were designed to include an element, within the ethical dilemma, linked to "what is best or expected by your organization." Because of the expectation associated with the individualistic (IDV) cultural dimension, the following research hypothesis is proposed:

H_1: Accountants from the low IDV culture will agree more with the ethical dilemmas.

The literature review indicates mixed results associated with the gender variable in studies of ethics. Whenever gender differences are indicated, however, the female respondents have overwhelmingly supplied the more ethically sensitive responses. Based on these previous results from gender-difference studies, the following hypothesis is proposed:

H_2: Female accountants will agree more with the ethical dilemmas than male accountants.

METHODOLOGY

Eight countries were selected for examination: Chile, Germany, Hong Kong, Mexico, Netherlands, New Zealand, US, and Venezuela. Discrimination on the IDV dimension was the most important factor in the selection of the target countries. It was important that the countries that were selected represented either Hofstede's high IDV or low IDV values and contributed to a global representation for the data analysis. Table 1 shows the countries by high or low IDV designation and the cultural scores indicated by the Hofstede research (1980).

Table 1 - IDV Scores for 8 Surveyed Countries
(Hofstede, 1980, 158)

High IDV Culture	IDV	Low IDV Culture	IDV
US	91	Mexico	30
Netherlands	80	Hong Kong	25
New Zealand	79	Venezuela	23
Germany	67	Chile	23

The data were collected in two ways. Some of the surveys were personally distributed to the participating offices by the researchers. Other offices of international accounting firms in the eight countries were sent packets of survey instruments for distribution in their offices. The cover letter for the survey guaranteed individual and firm anonymity. After completion, the sealed survey responses were returned intact, by mail, to the researchers. Two versions of the survey were used to address any response-order bias. T-test analysis indicated no significant difference by the two versions (i.e., n= 182 and 144) of the survey. Of the 1,600 surveys, 326 were returned for an overall 20.4% response rate.

The survey has three parts. The first part is the Hofstede *Values Survey Module* (see Hofstede, 1980, 283-286 for the complete survey) used to test the stability of the individualism cultural dimension over time. The second part of the survey contains five work-environment statements that were evaluated by the accountants. The survey statements were adapted from surveys used in earlier ethics research (Dolecheck & Dolecheck, 1987; Froelich & Kottke, 1991; Hunt et al., 1989; Preble & Riechel, 1988). A 5-point Likert scale was used for the survey responses, where 1 = strongly agree and 5 = strongly disagree (i.e., indicating the coding for analysis for the two different versions).

Demographic information is requested in the third part of the survey. Table 2 provides the demographic data for the accountant respondents, as well as response rates by the IDV designation, gender, age, work area, and certification. The composite respondent is a male working in the audit area, aged 25-34 years old, and a certified/chartered accounting professional.

Table 2 - Respondent Demographics

Demographic	Number	Percent
Culture Response:		
High IDV	193/800	24.1
Low IDV	133/800	16.6
Gender:		
Male	194	59.7
Female	131	40.3
Age:		
< 25 years	55	16.8
25-34 years	204	62.6
35-49 years	52	16.0
> 50 years	15	4.6
Work Area:		
Audit	235	72.3
Tax	47	14.5
MAS	17	5.2
Other	26	8.0
Certification:		
CPA/CA	122	37.5
Other	108	33.1
None	96	29.4

ANALYSIS AND RESULTS

The SAS general linear model (GLM) procedure was used to examine the five survey items for response differences. The statements in the survey were designed to require the accountants to incorporate their individualism cultural beliefs when addressing the ethical issue of each statement. A professional work group or organizational group dynamic was an element of the situations described in the survey statements. Table 3 gives the five ethical items used in the survey to capture the individual cultural influence.

Table 3 - Ethical Survey Items

Item No.	Survey Item
1	I find that sometimes I must compromise my personal principles to conform to my organization's expectations.
2	An employee should overlook someone else's questionable actions if it is in the best interest of the company.
3	Sometimes, it is acceptable for an employee to lie to a customer/client to protect the company.
4	Any employer-paid days available (such as sick days) should be viewed as vacation days that an employee deserves.
5	It is acceptable to compromise personal principles to conform to your organization's expectations.

The independent variables for the analysis were Culture (i.e., either high IDV or low IDV), Gender, and a Culture*Gender interaction term. The accountants' mean response of the agreement/disagreement with the ethical dilemmas surveyed was the dependent variable. A significant ($\alpha \leq .05$) cultural effect was indicated on three of the five survey items. On all significant cultural items, the individualistic culture (high IDV) supplied the more ethically sensitive responses. There were significant gender differences in the responses on two of the five survey items, and the interaction term was significant on two. Table 4 give the results of the analysis.

Item No. 2, "an employee should overlook someone else's questionable actions if it is in the best interest of the company," refers to the subordination of one's personal principles for what is considered best for the organization. The expectation that the low IDV culture would agree more with the statement was confirmed by the analysis. There were significant differences ($\alpha \leq .006$) in the responses with the low IDV culture agreeing with the statement more ($\bar{x} = 3.31$) than did the high IDV culture ($\bar{x} = 3.61$). There was also a significant ($\alpha \leq .003$) gender main effect, with female accountants ($\bar{x} = 3.68$) supplying the more ethical responses than the male accountants ($\bar{x} = 3.35$).

Item No. 4, "any employer-paid days available (such as sick days) should be viewed as vacation days that an employee deserves," was expected to illicit greater agreement from the more individualistic culture. However, the results were unexpected because the low IDV culture agrees with the statement more. Collectivistic values and beliefs consider individual employees to be a component of the "organizational family." If employees are a part of the family unit, in which they are taken care of, then communally earned, employer-paid days can be considered deserved and, hence, not considered to be unethical. Such a view would provide a higher level of response agreement (i.e., low IDV, $\bar{x}$ = 3.36; high IDV, $\bar{x}$ = 3.72).

Table 4 - GLM Main Effect Results/Duncan's Comparisons
($\alpha \leq .05$)

Item No.	Model		Significant Variables			Duncan's Results
	f- and	p-value		f- and	p-value	
1	2.63	.050	Cult*Gen	4.99	.026	See Table 5
2	5.88	.001	Culture	7.53	.006	High IDV more ethical
			Gender	8.69	.003	Female more ethical
3	nonsignificant					
4	2.96	.033	Culture	7.45	.007	High IDV more ethical
5	5.34	.001	Culture	5.02	.026	High IDV more ethical
			Gender	4.53	.034	Female more ethical
			Cult*Gen	6.47	.011	See Table 5

Item No. 5, "it is acceptable to compromise personal principles to conform to your organization's expectations" puts emphasis on a general belief that is collectivistic in nature. As predicted, the responses of the accountants from the low IDV culture ($\bar{x}$ = 3.39) agreed with the statement significantly more ($p \leq .026$) than did the responses of the accountants from the high IDV culture ($\bar{x}$ = 3.65). There was also a significant ($p \leq .034$) gender main effect on Item 5, with female accountants ($\bar{x}$ = 3.69) supplying the more ethical response than the male accountants ($\bar{x}$ = 3.45).

Two of the survey items (1 and 5) indicated significance on the Culture*Gender interaction term. Table 5 gives the Duncan's pair-wise comparisons of these two survey items. These items were the survey items referencing "putting organizational expectations before personal principles." On Item 1, females from the high IDV group ($\bar{x}$ = 3.37) indicated significantly greater disagreement than did high IDV males ($\bar{x}$ = 2.93) and low IDV females ($\bar{x}$ = 2.92). Somewhat similar results were found in the responses for Item 5. Females from the high IDV group ($\bar{x}$ = 3.94) indicated significantly greater disagreement with the action than all of the other groups. On Items 1 and 5, high IDV females express the greatest disagreement with the actions and low IDV females indicate the least disagreement (i.e., greater agreement). On both items, a significant difference was found between high IDV females and low IDV females. Significant differences were also found between high IDV males and high IDVfemales on both items. The results indicate that the response significance is driven by both the gender and the culture variables.

CONCLUSIONS

The results of this study lend a degree of support to the premise that accountants in societies exhibiting high individualism place more emphasis on personal principles, even in situations where their decisions may be contrary to the values of the firm. In contrast, accountants in low individualistic societies were more likely to indicate they would adhere to the values of the firm when those values are in conflict the accountants' personal ethical beliefs. On three of the five items used in this study, respondents from high individualistic societies were more likely to indicate that they would not subordinate their personal ethics for the values of the organization. Respondents from high individualistic societies were more likely to indicate they did not believe an employee should overlook someone else's questionable actions if it is in the best interest of the company. Also, the high IDV group was more likely to indicate disagreement with compromising one's personal principles to conform to the organization's expectations. The results in these two items are consistent with the idea that individuals in an individualistic society feel a greater degree of independence from the organization. Respondents from low IDV societies, on the other hand, indicated they were more likely to follow a course of action expected by the firm in cases where their personal values were inconsistent with those of the organization. Employees of low IDV cultures are more likely to feel a greater obligation to conform to the expectations of the organization. This would suggest a lesser degree of independence between the employee and employer in low IDV cultures.

Table 5 - Duncan's Comparisons for Significant Culture*Gender Interaction Terms
($\alpha \leq .05$)

Item No.	Culture/Gender	n	$\bar{x}$*	Ethical Sensitivity Results**	
1	High IDV/Female	78	3.37	A	
	Low IDV/Male	79	3.08	A	B
	High IDV/Male	114	2.93		B
	Low IDV/Female	52	2.92		B
5	High IDV/Female	79	3.94	A	
	High IDV/Male	113	3.45		B
	Low IDV/Male	80	3.44		B
	Low IDV/Female	52	3.33		B

* The higher the mean, the greater the disagreement with the questionable survey items.
**Those groups with the same letter are not significantly different; those with different letters are.

The results on the item related to vacation days, though significant, was not in the hypothesized direction. An explanation for this unexpected finding may relate to the familial view of the organization. The employee may feel that being an integral member of the organization entitles him or her to take days off from work. Such an attitude would be consistent with a low IDV society.

Significance on two items with regard to the gender variable lends additional support to prior studies showing greater ethical sensitivity by females. In both high and low IDV cultures, females were less likely to agree that one should overlook questionable actions of an individual if it would be in the best interest of the company. Females also indicated less support for subordinating one's personal principles to conform to the expectations of the organization. Thus, greater ethical sensitivity by females was found in both high and low IDV cultures.

The results of this study suggest the need for additional research to determine which types of ethical issues are likely to cause inconsistency between the expectations of the firm and the personal values of the individual. Congruence between the values of the firm and those of the individual becomes a greater challenge for multinational firms operating in many different cultures. The professional standards that guide the accounting profession are viewed through the cultural lenses of the society in which each office operates. Therefore, the application of the standards depends on their interpretation within the local culture. The effective operations of multinational accounting firms depends on understanding the cultural differences that may result in inconsistent outcomes among the various offices making up the firm.

ENDNOTE

Partial financial support for this project was provided by a Stephen F. Austin State University research grant.

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THE WORKER ADJUSTMENT AND RETRAINING NOTIFICATION ACT: POLICY AND PRACTICE ISSUES FOR EMPLOYERS

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ABSTRACT

The Worker Adjustment and Retraining Notification Act (WARN) provides that, with certain exceptions, employers of 100 or more workers must give at least 60 days advance notice of a plant closing or mass layoff to affected workers and to the appropriate local government officials. The purpose of the act is to provide protection to workers, their families, and communities, to facilitate workers and their families some transition to adjust to the prospective loss of employment, to seek and obtain alternative jobs, and if necessary, to enter skill training and or retraining that will allow these workers to successfully compete in the job market. While the act has received renewed attention in recent years, the act has also been described as "a Quagmire of Confusion" and a 2003 GAO study identified numerous concerns expressed by both employees and employers as to how the law is supposed to work. The purpose of this paper is to identify potential legal issues and problems that employers may encounter with respect to WARN Act compliance and what organizations can do to minimize their exposure and liability associated with the WARN Act.

INTRODUCTION

The Worker Adjustment and Retraining Notification Act (WARN) Act Pub. L. 100-379, 102 Stat. 890, was enacted on August 4, 1988(29 U.S.C. 2101 et seq.). The WARN Act provides that, with certain exceptions, employers of 100 or more workers must give at least 60 days advance notice of a plant closing or mass layoff to affected workers or their representatives, to the State dislocated worker unit (see 29 U.S.C. 1661(b)(2)), and to the appropriate local government(29 U.S.C. 2902 and 2903). The term "mass layoff" means a reduction in force that:

> *Does not result from a plant closing; and results in an employment loss at the single site of employment during any 30-day period for; at least 50-499 employees if they represent at least 33% of the total active workforce, excluding any part-employees;*

> *or 500 or more employees (excluding any part-time employees).in this case, the 33% rule does not apply)* (Employment and Training Administration, 2003, p. 28)

The term "plant closing" is:

> *the permanent or temporary shutdown of a single site of employment, or one or more facilities or operating units within a single site of employment, if the shutdown results in an employment loss at the single site of employment during any 30-day period for 50 or more employees, excluding part-time employees. All of the employment losses do not have to occur within the unit that is shut down. For example, if the 45 person accounting department in a firm is eliminated and, as a result of the accounting department's closing, five positions in the clerical support staff are eliminated, a covered plant closing has occurred* (Employment and Training Administration, 2003, p. 28).

Section 8(a) of the Act requires that the Secretary of Labor "prescribe such regulations as may be necessary to carry out this Act. Such regulations shall, at a minimum, include interpretative regulations describing the method by which employers may provide for appropriate service of notice as required by this Act" (29 U.S.C. 2107(a)). The purpose of the act is to provide protection to workers, their families, and communities by requiring employers to provide 60 calendar days in advance of plant closings and mass layoff notice to facilitate workers and their families some transition to adjust to the prospective loss of employment, to seek and obtain alternative jobs and if necessary, to enter skill training and or retraining that will allow these workers to successfully compete in the job market. In addition, the act is intended to provide state dislocation units notice so that dislocated worker assistance can be promptly provided.

The act is enforced entirely through the federal courts. Employees, their representatives, or units of local government can bring civil actions in federal district courts against employers, and employers who violate the act may be liable for back pay and benefits to each aggrieved employee. The penalty is calculated for each working day that notice was not provided, up to a maximum of 60 days. Employer liability may be reduced by any wages the employer pays over the notice period and by any voluntary and unconditional payment not required by a legal obligation. Employers who fail to provide notice required to a unit of local government may be subject to a civil penalty not to exceed $500 for each day of violation. If the employer provides the appropriate payments to eligible employees within three weeks after the closing, the penalty may be avoided. The court may at its discretion, allow the prevailing party a reasonable attorney’s fee as part of the costs in any suit (Employment and Training Administration, 2003). The U.S. Department of Labor (DOL) is also responsible for providing assistance in understanding the regulations and providing educational materials to facilitate employers’ and employees’ understanding of the act. Employers cannot be required by the WARN Act to refrain from closing a plant, relocating operations, or implementing layoffs. An employer can only be required to give a 60-day advance notice or provide back pay and benefits to the affected employees for each day that the employer failed to give notice, up to the required 60 days. The law at section 5(b) specifically states, "a Federal court shall not have authority to enjoin a plant closing or mass lay-off" (Pub. L. 100-379, 102 Stat. 890). There is no injunctive relief available under the Act.

The purpose of this paper is to identify potential legal issues that firms may encounter with respect to WARN Act compliance, examine recent court decisions dealing with compliance, and to provide policy and practice suggestions on what organizations can do to minimize their exposure and liability associated with the WARN Act.

BACKGROUND

The enactment of the WARN Act was a result of sustained public pressure dating back to the early 1970s, and was fueled in large part by the increased use by American companies of downsizing (Klapholz, 2000). Numerous studies of the 1970s and 1980s time period identified "profound effects on communities, individuals, and states" associated with the use of downsizing.

> *In addition to sometimes lengthy unemployment and reduced income, displaced workers often experienced a multitude of physical and emotional problems. These negative effects on public health, and the financial burdens imposed on states as a result of increasing unemployment levels, were exacerbated because very few employers disclosed their decision to significantly reduce or cease operations in advance, thus leaving workers and communities without an opportunity to adjust and plan for the impending dislocation* (Klapholz, 2000, p. 2).

Initial legislation asking firms to notify employees that planned to relocate operations outside of the United States first appeared in the Trade Act of 1974. Title II, Section 283 of P.L 93-618 of the Act "asked firms that planned to move operations outside the United States to provide at least 60 days' advance notice to employees likely to be adversely affected by their actions as well as to the Secretaries of labor and Commerce" (Levine, 2004, 2). The WARN Act (P.L. 100-379) became law in 1988 without President Regan's signature and became effective in 1989. The law "generated fairly little interest" over the next decade, due in large part to the sustained economic expansion that occurred over the period (Levine, 2004, 2).

Renewed interest in the issues associated with mass layoffs resurfaced in 1998 when firms announced their intention to displace 677,795 employees (Levine, 2005). The 240,000 plus increase in the number of announced employee layoffs reported in 1997 was attributed to economic conditions in Asian countries and downturns in U.S. based oil producers and related service companies. The number of layoff announcements was relatively constant in 1999 in spite of continued overall expansion of the economy (Levine, 2005). The steep increase in 2001 was largely a result of the 2000 recession and the September 2001 terrorist attacks (see Table 1).

Table 1
Staff Cuts Announced by U.S. Companies 1989-2004

Year	Number of employees	Year	Number of employees
1989	111,285	1997	434,350
1990	316,047	1998	677,795
1991	555,292	1999	675,132
1992	500,000	2000	613,960
1993	615,186	2001	1,956,876
1994	516,069	2002	1,466,823
1995	439,882	2003	1,236,426
1996	477,147	2004	1,039,735

Source: Levine, 2005 & News reports based on *The Challenger Employment Report.*

With respect to the WARN Act, the statutes primary focus is directed at helping workers who will suffer what the U.S. Department of Labor calls extended mass layoffs. An extended mass layoff is defined as one lasting longer than 30 days and involving at least 50 workers (Levine, 2005). The leading reason identified for extended mass layoffs is seasonal work (end of winter or summer recreational activities for example) and internal company reorganization (bankruptcy, business ownership change, financial difficulty, and reorganization) (Levine, 2005). Offshore and domestic movement of work, currently one of the more popular topics associated with job loss in the popular press, "has been found to account for a small share of layoffs that last more than 30 days and involve at least 50 workers" (Levine, 2005, p. 10). Short and long term layoff activity for 1996 through 2004 is in Table 2.

Table 2
Short – and Long- Term Layoff Activity 1996-2004

	Mass Layoffs		Extended mass layoffs		
Year	Events	Initial UI claimants	Events	Initial UI claimants	Separated Workers
1996	14,111	1,437,628	4,760	805,810	948,122
1997	14,960	1,542,543	4,671	879,831	947,843
1998	15,904	1,771,069	4,859	1,056,462	991,245
1999	14,909	1,572,399	4,556	796,917	901,451
2000	15,738	1,835,592	4,591	846,267	915,962
2001	21,467	2,514,862	7,375	1,457,512	1,524,832
2002	20,277	2,245,051	6,337	1,218,143	1,272,331
2003	18,963	1,888,926	6,181	1,200,811	1,216,886
2004	15,980	1,607,158	4,879	816,259	956,327

Source: U.S. Bureau of Labor Statistics data on mass layoffs covering employees in All industries on extended mass layoffs covering employees in the private nonfarm sector (i.e., excludes agriculture and government), (Levine, 2005, p. 10). **Note**: Data for 2004 are preliminary.

STATE LAWS

In the 16 years since its enactment, many employers and human resource professionals have become aware of the federal version of the WARN Act. However, many may not be aware of the different version enacted by states. De Meuse and Dobrovolsky identified 17 jurisdictions (16 states and the Virgin Islands) in 2004 that had either enacted their own version of the WARN Act or had other relevant provision pertaining to mass layoffs and plant closings (De Meuse and Dobrovolsky, 2004). Since then Illinois has also enacted its own WARN Act (Girard, 2005). The first difference with most of the state statutes and the federal statute involves coverage (see Table 3). The federal WARN Act applies to employers with 100 or more full-time employees. Those states, and the Virgin Island, with their own WARN Act apply their statute to as few as 10 employees. The Virgin Island's act extends coverage to employers with 10 employees with five states dropping coverage down to employers with 50 or more employees. Michigan requires employers to provide notice to employees when 25 or more employees in a business establishment considering a closing or relocation of operations and the New Jersey code requires employers to provide notice of mass separations of 25 or more employees to the state unemployment agency and provide employees Form BC-10 instructions for claiming New Jersey unemployment benefits. Some states also require continuation of group health care coverage and others require severance pay.

Table 3
State WARN Legislation

State WARN Acts	Effective Date	Notification	Employer Coverage	Additional Health Coverage and Retraining Allowances	Additional Notification Requirements
California	2003	60 days	75	Any benefits to which the employee is entitled including the cost of any medical expenses incurred by the employee that are covered under an employee benefit plan	The Employment Development Department
Hawaii	1987	60 days	50	Employees are eligible for four weeks dislocated worker allowance	The State Labor Director
Illinois	2005	60 days	75	No additional coverage beyond WARN	Chief elected officials for the county and municipality in which facility is located & individual employees who are represented by a union
Maine	1971	60 days	100	Employees are eligible for severance pay at the rate of one week's pay for each year of employment	The Director of Bureau of Labor Standards in writing not less than 60 days prior to relocation
Maryland	1986	90 days	50	Health care coverage or the option of continuing the current health plan at the employee's own expense, retraining allowances, a severance pay package tied to the employee's wage level or length of employment, job assistance	No additional coverage beyond WARN
Massachusetts	1984	Every employer who is closing a facility must promptly report to the commissioner in such form & manner as the commissioner prescribes.	50	Employees are eligible to receive reemployment assistance benefits and health insurance benefits.	The director of the Department of Labor and Workforce Development
Minnesota	1989	"Early Warning System" states that notice shall be given as early as possible, in addition to any notice required under the WARN Act	100	No additional coverage beyond WARN	No additional coverage beyond WARN

Table 3
State WARN Legislation

Tennessee	1988	60 days	50	No additional coverage beyond WARN	The Commissioner of Labor and Workforce Development
Virgin Islands	1986	90 days	10	Employees are eligible for severance pay the rate of one week's pay for each year of employment	The Commissioner of Labor and Workforce Development
Wisconsin	1975	60 days	50	No additional coverage beyond WARN	The Department of Workforce Development & the highest official of municipality

Other State Statutes & Codes	
Connecticut (Conn Gen Stat)	Effective since 1995, companies with at least 100 employees that close down or relocate out of state generally follow the WARN Act rules. In addition, the state regulation requires companies to continue group health coverage for 120 days
Kansas (Kan Stat)	Effective since 1989, Notice to Secretary of Human Services regarding the cessation of operations.
Michigan (Mich Comp Law)	Effective since 1986 employers must provide a notice to the Michigan Department of Labor and employees when there are 25 or more employees in a business establishment considering a closing or relocation of operations.
New Jersey (NJ Admin Code)	Since 1997, employers must provide notice of mass separation of 25 or more employees to the state unemployment agency and deliver to employees Form BC-10 instructions for claiming New Jersey unemployment benefits.
New York (NY Lab Law)	Labor Law added in 1989 that requires employers to provide certain notification to terminated employees regarding cancellation of their employer benefits.
North Dakota (ND Adm. Code)	Effective since 1989, employers must file a notice with the Public Employment Service Office nearest the worker's place of employment, and provide a list of the names and Social Security Account numbers of the workers affected.
Pennsylvania (Phil Code)	Effective since 1982, Philadelphia ordinance requires employers with 150 employees to give 60 days written notice of closure or relocation.
South Carolina (SC Code)	Effective since 1994, if an employer requires advance notice of employees who quit, employer must give employees at least the same amount of time (with a minimum of two weeks before a plant closing).

Source: De Meuse and Dobrovolsky, (2004), and Michels, (2005).

CRITICISM

Like most federal regulations, the WARN Act has been criticized. Initially, opponents argued that advance notice would be costly for employers and that

> *such a requirement reduces the flexibility of management to make decisions impairs the free mobility of capital, encourages the best workers to seek opportunities elsewhere, results in increased turnover and lower productivity and employee morale, depresses stock prices, and reduces the probability that clients and customers will continue relationships with the organization* (Wagar, 1992, p. 589).

However, proponents of the act were not so critical. Managers in large corporations argued that WARN act regulations would have only a marginal effect since advance layoff notice was already provided to employees and other stakeholders. Empirical data support the marginal effect in large firms. Alexander and Spivey (1997) conclude that the act "did not affect the market value of large firms" (p. 918) and observed a negative effect on small firms perhaps due to smaller firms not being monitored by external stakeholders. The "absence of monitoring for smaller, less well-known firms may create agency problems between managers and employees, necessitating regulations such as WARN to protect employees" (Alexander & Spivey, 1997, p. 918).

LEGAL ISSUES FOR EMPLOYERS

"Warning! WARN Act a Quagmire of Confusion" (Crews, 2004).

Since its passage, the WARN Act has presented employers and employees with numerous problems and has been described as a "quagmire of confusion." Problems associated with the act for employers include how it is supposed to work, who to warn, and when to warn (Crews, 2004). An additional problem exists for employers with multi-state operations. State legislation, as detailed earlier in this paper, while similar in basic form and intent often includes additional and sometimes more stringent provisions than the federal statute.

In 2003, the General Accounting Office conducted a detailed review of the WARN Act. After interviewing interested parties and reviewing relevant court cases, the GAO concluded:

> *that certain definitions and requirements of WARN are difficult to apply when employers and employees assess the applicability of WARN to their circumstances. In particular, employers, employee representatives, and others reported it problematic to apply the statute's provisions when calculating the layoff threshold (i.e., whether the requisite number of employees have been laid off within prescribed*

time frames) that triggers WARN requirements. In addition, the courts have applied the statute's provisions in varying ways, resulting in decisions that do not always clarify employer responsibilities and employee rights under the law (GAO, 2003).

The GAO study found support for the assertion that the act has created confusion and difficulty in implementation for employers. The GAO noted that employers provided more notices than there were WARN events in 2001. There were 5,349 notices but only 1,974 plant closure and mass layoffs that appeared to meet the WARN criteria for advance notice (GAO, 2003, p. 11).

Under the WARN Act, a number of factors determine whether employers are required to provide notice. When calculating the timeframe to determine when notice is required, WARN looks at the employment losses that occur over a 30-day period. For example, if an employer closes a plant which employs 50 workers lays off 40 workers immediately, and then lays off the remaining 10 workers 25 days later, then it is a covered plant closing.

WARN also looks at the employment losses that occur over a 90-day period. An employer is required to give advance notice if it has a series of small terminations or layoffs, none of which individually would be covered under WARN but which add up to the number requiring notice. An employer is not required to give notice if it can show that the individual events occurred as a result of separate and distinct actions or causes and are not an attempt to evade WARN.

The Preamble to the WARN Act regulations gives an example of 90-day aggregation. It suggests that an employer should look both ahead and behind 90 days to determine whether separate but related events would trigger coverage. Below is a specific example of a situation in which 90-day aggregation might apply under WARN.

DAY 1 - Company has 180 employees DAY 2 - Company terminates 30 employees (150 is now the number for WARN computations) DAY 31 - Company terminates 29 employees (now 121 remaining employees) DAY 60 - Company terminates 6 employees (115 remaining employees) DAY 90 - Company terminates 5 employees (110 remain)

Assuming no notice was given, the company is liable to all 70 employees who were terminated because the mass layoff threshold has been reached through separate actions that did not occur for separate and distinct causes within this 90-day period. All employees terminated within the 90 days have suffered a mass layoff and are entitled to 60 days' notice before the date of termination. For this purpose, the date on which the company size is measured is Day 1. The aggregation periods are rolling and the second layoff starts a second 90-day period where the applicable workforce is 121 workers (Employment and Training Administration, 2003).

In the 2003 GAO study, cases related to layoff thresholds were the most commonly litigated issues (see Table 4). The calculation of the layoff threshold was the most significant problem for both employers and employees when attempting to determine if the requisite number of employees had been laid off within the prescribed time frames.

The statute also provides three exceptions to the full 60-day notice requirement. However, notice must be provided as soon as is practical even when these exceptions apply, and the employer must provide a statement of the reason for reducing the notice requirement in addition to fulfilling other notice information requirements. The exceptions are as follows:

> *Faltering company: When, before a plant closing, a company is actively seeking capital or business and reasonably in good faith believes that advance notice would preclude its ability to obtain such capital or business, and this new capital or business would allow the employer to avoid or postpone a shutdown for a reasonable period; Unforeseeable business circumstances: When the closing or mass layoff is caused by business circumstances that were not reasonably foreseeable at the time that 60-day notice would have been required (i.e., a business circumstance that is caused by some sudden, dramatic, and unexpected action or conditions outside the employer's control, like the unexpected cancellation of a major order); or Natural disaster: When a plant closing or mass layoff is the direct result of a disaster such as a flood, earthquake, drought, storm, tidal wave, or similar effects of nature. In this case, notice may be given after the event* (Employment and Training Administration, 2003, p.8).

The second largest number of court cases identified in the GAO study focused on the exceptions under the act, with the "unforeseen business circumstances" exception receiving the most attention.

Table 4
WARN-Related Court Cases by Litigation Subject 1998-2002

Issues	Court Decisions
Single site	6
Sale of company	6
Affected employees	6
Employers acting in good faith to comply	8
Back pay	10
Employer definition	10
Unforeseen business circumstances	11
Layoff threshold	18

Source: GAO Analysis, Guild Law Center, Lexis, and West Law (GAO 2003, p. 15).

RECENT COURT CASES

In February, 2005, the Seventh Circuit Court of Appeals decided Roquet v. Arthur Andersen L.L.P (Roquet v. Arthur Andersen, 2005). While the judge who wrote the decision described the case as "not your typical WARN Act fare as it involves hot-button topics like Enron, document shredding, and indictment," the primary focus of the case did concern the unforeseen business exception to the act's notification requirements (Roquet v. Arthur Andersen, 2005).

In 2002, Arthur Anderson employed over 27,000 employees in 80 locations throughout the United States. One of Andersen's major clients was the Enron Corporation. Andersen not only audited Enron's publicly filed financial statements but also provided internal counseling. The collapse of Enron, due in part to gross misstatements of its earnings, led to a Securities and Exchange Commission (SEC) subpoena requesting Enron related documents in November, 2001. It was during the investigation that the SEC discovered that Andersen employees had destroyed thousands of relevant documents in the six weeks leading up to its receipt of the subpoena (Roquet v. Andersen, 2005). While employees expressed concern about the possibility of clients defecting and possible layoffs, Andersen "worked hard to try to resolve its Enron related ills with the SEC and the U.S. Department of Justice (DOJ) (Roquet v. Andersen, 2005).

Through late February of 2002, "Andersen had not suffered a significant loss of business nor was it giving any thought to a mass layoff." On February 22, 2005, Andersen's lawyers met with lawyers from the DOJ, and on the next day, briefed Andersen's management team. A participating manager e-mailed the following update to employees:

> *At our meeting on Saturday, February 23, 2005, the current status of the investigation into document destruction was presented by the outside lawyers from Davis Polk. They are moving forward as quickly as possible to bring this matter to a conclusion as it relates to the firm with the Department of Justice. Our desired time table is to be in a position at the end of February to have the desired conclusion and an agreement in principle with the DOJ, so that we can finalize our disciplinary actions and prepare an internal announcement followed closely by a public announcement of the resolution of this investigation* (Roquet v. Arthur Andersen, 2005).

During the first two weeks in March, 2002, a flurry of activity sealed Andersen's fate. On March 1, the DOJ informed Andersen it was going to seek an indictment of the company. While Andersen attempted to convince the DOJ to focus its prosecution on culpable individual employees, the DOJ refused and instead unsealed indictments against the company on March 14, 2002. The announcement of the indictment "triggered massive client defection. From March 15 to the 31st, Andersen lost $300 million in business." On April 8, 2002, management gave notices of termination to 560 employees, including Nancy Roquet and Coretta Robinson, the named plaintiffs in the subsequent class action lawsuit (Roquet v. Andersen, 2005).

In reaching its decision, the court cited DOL guidance and numerous other case precedents. While the DOL encourages a case-by-case examination of the facts in lieu of per se rules, unforeseen business circumstances may be reasonably unforeseeable if it was caused by some sudden, dramatic, and unexpected action, or by conditions outside the employer's control (20 C.F.R. 639.9 (b)(1)). When determining whether a mass layoff was caused by unforeseeable business circumstances, courts evaluate whether a similarly situated employer exercising reasonable judgment could have foreseen the circumstances that caused the layoff (20 C.F.R. 639.9 (b)(2)). The district court had concluded that the need for the mass layoff by Andersen was the public announcement of the indictment on March 14 and that the "economic hemorrhaging really did not begin until word of the indictment got out" (Roquet v. Anderson, 2005). While the plaintiffs attempted to convince the court that Anderson should have reasonably foreseen the indictment, the court noted that in the past, "the government typically went after culpable individuals, not companies as a whole" and that while it was a possibility it was not probable and thus not reasonably foreseeable (Roquet v. Anderson, 2005).

The Seventh Circuit cited a Sixth Circuit case that noted that the WARN Act was not intended to deter companies from fighting to stay afloat:

> *WARN was not intended to force financially fragile, yet economically viable, employers to provide WARN notice and close its doors when there is a possibility that the business may fail at some undetermined time in the future. Such reading of the Act would force many employers to lay off their employees prematurely, harming precisely those individuals WARN attempts to protect. A company that is struggling to survive financially may be able to continue on for years and it was not Congress's intent to force such a company to close its doors to comply with WARN's notice requirement* (Watson v. Michigan Industrial Holdings, Inc. 2002).

Michigan Industrial Holdings Inc. (MIHI) was forced to close its plant on January 19, 1996. Earlier on the same day of the closing, Watson, its principal customer, refused to make a weekly payment that was necessary to keep the facility operational. The company was already in poor financial health with serious cash flow problems. MIHI had been operating on a month-to-month basis with the customer and had reason to believe that it would be producing parts for the customer through the end of 1996. At the time of the facility's closing, Watson was required to pay within seven days of invoice because of MIHI's dire financial straits. MIHI was informed by the customer for the first time on January 19, 1996 that the weekly payment would not be made, and MIHI was forced to cease production and close the facility later that day (Watson v. Michigan Holdings Inc., 2002).

In a 2004 decision by the Ninth Circuit Court of Appeals, the court was confronted with threshold issues and the good faith, faltering company, and unforeseeable circumstances exception. Darby Lumber, Inc. (DLI) in September of 1998 employed 88 employees and operated a lumber mill that manufactured, marketed, and sold finished lumber. In January, 1996, DLI has acquired 100 percent of shares of Bob Russell Construction (BRC) which operated as a construction company, building log roads, and hauling timber for DLI. In September, 1998, BRC employed 18 employees. On September 24, 1998, the general manager of DLI placed a written statement in the paychecks of all DLI employees, advising them of the financial difficulties of the company, and informing them of a "major layoff" (Childress v. Darby Lumber, Inc., 2004). On September 25, 1998, DLI shut down the mill and laid off all of the employees. While limited operations continued for several months, eventually all of the BRC employees were laid off. The District Court granted summary judgment for the plaintiffs and ordered the defendants to pay sixty work days of wages/benefits lost to the employees ($60,345.46) in damages to the plaintiffs and $123,033.44 in attorney's fees to the plaintiffs (Childress v. Darby Lumber, Inc., 2001).

The Court of Appeals in affirming the District Court's grant of summary judgment for the plaintiffs and the award of damages and attorney fees, agreed with the District Court's decision that BRC and DLI satisfied the single employer status requirements under the Act. Under the WARN act, subsidiaries which are wholly or partially owned by a parent company are treated as separate employers or as a part of the parent company depending of the degree of their independence from the parent. Factors that are considered include:

> *common ownership, common directors and or officers, de facto exercise of control, unity of personnel policies emanating from a common source, and the dependency of operations* (Childress v. Darby Lumber, Inc. 2004).

Thus the combined operations had 106 employees and met the requirements of the act.

The Court of Appeals also noted that DLI provided evidence that they had little or no knowledge of the WARN Act. The court noted that "mere ignorance of the WARN Act is not enough to establish the good faith exception" and "does not show that they had an honest intention to follow it" (Childress v. Darby Lumber, Inc., 2004).

In appealing the District Court’s denial of the unforeseeable circumstances exception, DLI pointed to a decision by U.S. Bank on September 7, 1998 refusing to rewrite DLI's credit as the sudden and unforeseeable event that caused by shutdown of the mill. The court cited DLI's response to a discovery request on the matter where DLI stated that:

> *The closure of the plant and layoffs in September 1998 was occasioned by losses to the company which could not be sustained any longer. These losses were a function of the depressed lumber market, increased cost of raw materials, operational*

difficulty in the startup of a new planer, and factors affected by the price of raw material and finished goods beyond the control of Darby Lumber, Inc. In turn, raw materials and finished goods markets and prices were affected by the general economic down- turn in Pacific Rim countries, influences by NAFTA, and significantly influenced by environmental pressure to halt sales of forest service timber (Childress v. Darby Lumber, Inc., 2004).

The appeals court concluded that the statement by DLI makes it clear that the plant closure was not caused solely by the decision by U.S. Bank but by a variety of factors over time, thus the closure was foreseeable. The district court had also noted that while U.S. Bank had decided not to rewrite DLI's loans on September 7, 1998, DLI did not actually lose its line of credit with the bank until November 1998 (Childress v. Darby Lumber, 2001).

A recent twist to the liability for notification requirement involved the responsibility of investors to provide notice when the company declares bankruptcy. In Vogt v. Greenmarine Holding, LLC Outboard Marine Corporation (OMC), employees brought suit against a group of investment companies that owned or controlled a majority of OMC. OMC declared bankruptcy and shut down all of its facilities with no notice to the 6500 employees shortly before Christmas in 2000 (Vogt v. Greenmarine Holding, LLC, 2004). The decision by the District Court "may signal a future threat of liability in the Second Circuit and elsewhere to companies who act as major investors to other business entities that allegedly commit WARN Act violations (Konkel, 2004).

POLICY AND PRACTICE SUGGESTIONS

In our dynamic economy, many companies are streamlining their operations to maintain a competitive position in the market- place. Although such actions can help your company become more efficient, this may result in the elimination of existing jobs and facilities (Employment and Training Administration, 2003, p. 1).

Covered employers are required to have an understanding of their obligations under the WARN Act. To that end, covered employers must have an understanding of what can trigger the notice requirements under the act including mass layoffs and plant closings.

Additional circumstances that can trigger WARN include a temporary layoff of less than six months that is later extended for more than six months. If the extension occurs for reasons that were not reasonably foreseeable at the time the layoff was originally announced, notice need only be given when the need for the extension becomes known. Any other case is treated as if notice was required for the original layoff. A reduction of the hours of work for 50 or more workers by 50 percent or more for each month in any 6-month period may also trigger WARN. Thus, a plant closing or mass layoff need not be permanent to trigger WARN (Employment and Training Administration, 2003, p. 5).

The determination of the employee threshold requirement for triggering WARN notice was found to be one of the more confusing aspects under the act and generated the largest amount of litigation (GAO, 2003). Employers must work closely with qualified legal counsel to determine whether their reduction in force falls within the parameters. As the Ninth Circuit Court of Appeals noted the Childress v. Darby Lumber case, ignorance of the law does establish a good faith exception (Childress v. Darby Lumber, Inc., 2004).

Covered employers must also have a clear understanding of the notice requirements under the act. Notice to individual employees must be written in clear and specific language that employees can easily comprehend and must contain the following:

> *A statement as to whether the planned action is expected to be permanent or temporary and if the entire plant is to be closed, a statement to that effect; The expected date when the plant closing or mass layoff will commence and the expected date when the individual employee will be separated; An indication as to whether or not bumping rights exist; and The name and telephone number of a company official to contact for further information* (Employment and Training Administration, 2003, p. 9).

Employers are also required to give advance notice to the State Rapid Response Dislocated Worker Unit as well as to the chief elected official of the local government. When employees are represented by a labor union, employers must also provide notice to the bargaining agent/chief elected officer of each affected union or local union official (Employment and Training Administration, 2003, pp. 9-10). An employer does not need to provide notice to strikers or to workers who are part of the bargaining unit(s) and are involved in the labor negotiations that led to a lockout when the strike or lockout is equivalent to a plant closing or mass layoff. The WARN Act does not affect employers' or employees' rights and responsibilities under the National Labor Relations Act. Additionally, an employer does not need to give notice when permanently replacing a person who is an "economic striker" (Employment and Training Administration, 2003, p. 16).

Employers should also be aware that selling a plant does not completely relieve the notice requirements if a plant closing or mass layoff occurs. The seller must give notice for a covered plant closing or mass layoff before the sale becomes effective, and the buyer must give notice after the sale becomes effective (Employment and Training Administration, 2003, p. 12).

In terms of reducing exposure to litigation, employers may be wise to develop voluntary separation programs including severance pay. Two obvious reasons support the use of these options to reduce exposure to litigation. First, voluntary separations are generally less traumatic for all involved. Second, outplacement counseling and severance pay tend to make employees less vindictive and may generate fewer claims. "It's no great secret that employees who become quickly reemployed tend to lose interest in pursuing claims against their former employer"(Bowser and Holt, 2004). Bowser and Holt also recommend the use of waiver and release agreements that relieve the employer from any liability or claims arising out of the employee's employment or termination (Bowser and Holt, 2004).

Whether the decision to reduce the workforce is driven by economic or competitive considerations, management needs to develop selection criteria to determine who will actually lose their jobs. Typical criteria employed include seniority, performance, ability, and the elimination of the position or function. Whatever criteria is employed, management must communicate clearly to those affected the reason for the reduction in force, the criteria used, and the process for deciding who will lose their job (Bowser and Holt, 2004). All those involved in the decision making should be provided with proper training on the criteria and the process. Organizations wishing to reduce their exposure to litigation for human resource decisions must accept that the training of decision makers is not an option but rather a mandatory requirement.

Once a notification strategy is formulated, employers should implement the plan while paying proper attention to the logistics of the process. It is recommended that the following questions be addressed in the termination process:

> *What will the message be? Who will deliver the message? Where will the message be delivered? How will post termination inquiries be handled?*

In addition, security procedures include handling workplace violence incidents, eliminating access to facilities, and deactivating passwords to e-mail and other information systems. "Unfortunately, in today's world security is an issue that can't be overlooked" (Bowser and Holt, 2004).

While the federal WARN Act requirements are complex, employers with multi-state operations must also be cognizant of state WARN Acts and other applicable state laws and regulations. If organizations do not stay abreast of WARN Act requirements, penalties in terms of damages, attorney fees, and damage to employees left behind can be severe. Knowing WARN Act requirements, obtaining qualified legal counsel, proper planning, and training of key decision makers are critical for successful compliance.

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THE EFFECTS OF LEGAL ENVIRONMENT ON VOLUNTARY EARNINGS FORECASTS IN THE U.S. VERSUS CANADA

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ABSTRACT

Past research documents managers' reluctance to issue voluntary earnings forecasts in part due to legal considerations. Since Canadian laws create a less litigious environment than those of the U.S., this study finds that when the two environments are compared, Canadian managers issue voluntary earnings forecasts more frequently across the board. In addition, the Canadian forecasts tend to be more precise than those of their American counterparts.

INTRODUCTION

Prior research in the study of voluntary earnings disclosures finds that managers release information that is unbiased relative to subsequently revealed earnings and that tends to contain more bad news than good news [Baginski et al.(1994), and Frankel (1995)]. Such releases are also found to contain information content [Patell (1976), Waymire (1984), and Pownell and Waymire (1989)]. Although forecast release is costly, credible disclosure will occur if sufficient incentives exist. These incentives include bringing investor/manager expectations in line [Ajinkya and Gift (1984)], removing the need for expensive sources of additional information [Diamond (1985)], reducing the cost of capital to the firm [Diamond and Verrechia (1987)], and reducing potential lawsuits [Lees (1981)].

More recently, studies show that managers are more likely to issue voluntary forecasts in a less litigious environment [Frost (2001)], [Johnson et al, (2002], while another [Baginski et al. (2002)] indicates that there are legal environment differences between the U.S. and Canada in issuing earnings forecasts when smaller size firms are evaluated. My research extends the aforementioned studies by evaluating U.S. and Canadian firms of all sizes and over a more extended period. The research question becomes: Do Canadian firms issue voluntary earnings forecasts with greater regularity than U.S. firms and which forecasts exhibit greater accuracy?

Clarkson and Simunic (1994) note that unlike the U.S., courts in Canada generally require unsuccessful plaintiffs to pay the costs of a successful defendant. Also, because plaintiffs have no absolute right to a jury trial in Canada, judges hear technical cases and are less likely to award large settlements. In addition, Canadian provinces do not permit trial lawyers to work on a contingency basis. Also, it is much more difficult to bring a class action suit in Canada. All of these differences in the legal systems create a natural environment in which voluntary earnings releases may be perceived differently.

HYPOTHESIS DEVELOPMENT

Three hypotheses are tested. First, King et al (1990) finds that forward-looking information disclosure in the U.S. increases the firm's exposure to legal liability. It is, in part, for this reason that many U.S. firms have exhibited a reluctance to issue voluntary forecasts on a consistent and on-going basis. The first hypothesis, stated in the alternative form is:

H1: Canadian firms, faced with a less-litigious legal environment, engage in more voluntary earnings forecasts relative to U.S. firms.

The second hypothesis, also stated in the alternative form, relates to previous studies that indicate U.S. firms are less likely to issue voluntary forecasts during good news periods for fear of litigation:

H2: Canadian firms, faced with a less-litigious legal environment, engage in voluntary forecast releases that are less-related to earnings than U.S. firms.

The third hypothesis, stated in the alternative form, centers around the notion that as voluntary forecast are made with greater frequency, they also tend to exhibit greater accuracy over the long term:

H3: Canadian firms engage in more precise forecasting of earnings information.

RESEARCH DESIGN

The sample consists of all quarterly and annual estimates made during the period 1983-2003 meeting the following criteria: 1) The voluntary earnings forecast was recorded by the Dow Jones News Retrieval Service (DJNRS). The Canadian exchanges list the Dow Jones as a preferred means of disclosure. 2) Earnings data was obtained from Compustat. The overall sample consists of firms which made at least one management earnings forecast during the period 1983-2003. All American exchanges (NYSE, NASDAQ, OTC, ASE) and all Canadian exchanges (Toronto, Vancouver, Montreal, Regional, Nonlisted Canadian) were included in the sample Table 1 provides the summary of the sample used in the study.

Table 1
Study Sample Summary

	U.S.	Canadian	Total
Firm-years available on Compustat	227,170	24,364	251,534
Firm-quarters available on Compustat	579,127	87,271	666,398
Total firm-years/quarters sample	806,297	111,635	917,932
Forecasts identified by DJNRS	8,940	2,960	11,900
Loss due to Compustat requirement	(881)	(342)	(1,223)
Final forecast sample	8,059	2,618	10,677

TEST OF HYPOTHESIS 1

Table 1 reports that 251,534 firm-years and 666,398 firm-quarters are available on Compustat for the sample total of potential voluntary forecast periods from 1983-2003. A total of 8,059 U.S. forecasts are made by 842 firms (9.58 per firm over 21 years) while 2,618 Canadian forecasts are made by 250 Canadian firms (10.48 per firm over 21 years).

Forecast Frequency and Good Versus Bad News Forecasts

To test H1 and H2, a logistic regression model is used similar to the one employed in Baginski et al (2002). It employs a combined sample of Canadian and U.S. firms across all potential forecasting periods (n = 917,932):

$$FORECAST_{it} = a_0 + a_1\, \Delta ESIGN_{it} + a_2\, CANADA_{it} + a_3\, CANADA_{it} \times \Delta ESIGN_{it} \qquad (1)$$

Where:

$FORECAST_{it}$ = 1 if the firm issued a voluntary earnings forecast during the period and 0 otherwise.

$DESIGN_{it}$ = the sign of the earnings change[1], 1 if ≥ 0 (good news), and 0 if < 0 (bad news).

$CANADA_{it}$ = 1 if the potential forecasting period relates to a Canadian firm, 0 otherwise.

Figure 1 maps the coefficients in Equation (1) to H1 and H2. Column (1) lists the coefficient sums in earnings increase periods (i.e., good news, $\Delta ESIGN_{it}$=1) for Canadian firms in row 1 and for U.S firms in row 2. Column (2) provides analogous coefficients for earnings decrease periods (i.e., bad news, $\Delta ESIGN_{it}$ =0). The last row indicates the difference *between countries* in the propensity to issue forecasts in periods of good news ($a_2 + a_3$), and bad news (a_2). Hypothesis 1 predicts that Canadian firms issue more forecasts, thus, both sets of coefficients are expected to be positive ($a_2 + a_3 > 0$, $a_2 > 0$).

Column (3) in Figure 1 provides coefficients associated with differences between good and bad news periods (i.e., "sign-related" forecast behavior) in Canada (row 1) and the U.S. (row 2). The last row in the column shows that the coefficient a_3 measures the difference *between countries* in sign-related forecasting behavior. If legal-liability-created asymmetric forecast disclosure incentives in the U.S. lead to more forecasts in bad news periods, then the expectation is that $a_1 < 0$. Hypothesis 2 predicts $a_3 > 0$, indicating that Canadian managers are less likely to skew forecast disclosures toward bad news periods.

Figure 1
Mapping Equation (1) into Hypothesis Tests

	Good News Period $\Delta ESIGN_{it}$=1	Bad News Period $\Delta ESIGN_{it}$=0	Difference Across Sign
Canadian (CANADA = 1)	$a_0 + a_1 + a_2 + a_3$	$a_0 + a_2$	$a_1 + a_3$
U.S. (CANADA = 0)	$a_0 + a_1$	a_0	a_1
Difference Between countries (row 1 – row 2)	(H1 test during good news periods): $a_2 + a_3 > 0$	(H1 test during bad news periods): $a_2 > 0$	Difference between countries in sign-related behavior (H2): $a_3 > 0$

FORECAST PRECISION

King et al (1990) argue that U.S. managers are concerned about potential litigation if a forecast turns out to be inaccurate. Accordingly, researchers have argued that, when faced with perceived higher expected litigation costs, U.S. managers will issue less precise forecasts (i.e., range, minimum, maximum or general impression forecasts instead of point forecasts). Empirical evidence shows that this is consistent among U.S. firms [Skinner (1994), Baginski and Hassell (1997), Bamber and Cheon (1998)].

The Canadian legal system exacts lower legal penalties for inaccuracy than does the U.S. system. Canadian managers are therefore likely to issue more precise management forecasts (H3) and to make forecast precision choices that are less likely to depend on whether the firm is performing poorly during the period (H2). To test these hypotheses, the following ordered logistic regression model is used for a pooled sample of all forecasts issued by U.S. and Canadian firms (n = 10,677).

$$PRECISE_i = b_0 + b_1\ \Delta ESIGN_i + b_2\ CANADA_i + b_3\ CANADA_i \times \Delta ESIGN_i \qquad (2)$$

Management forecast precision is measured using an ordinal coding scheme that assigns the highest value to the most precise forecasts. PRECISE equals 3,2,1, and 0 for point, closed interval, open interval, and general impression forecasts, respectively. Hypothesis 3 predicts that Canadian firms will issue more precise forecasts because the legal penalties for inaccuracy are smaller. For earnings decreases, this suggests that $b_2 > 0$, and for earnings increases, it suggests that $b_2 + b_3 > 0$. If fear of legal liability leads U.S. firms to issue less precise forecasts when the firm is performing poorly, then $b_1 > 0$. Hypothesis 2 predicts that Canadian forecast precision is less skewed toward poor performance than is U.S. forecast precision ($b_3 < 0$).

RESULTS

Forecast Frequency and Good Versus Bad News Forecasts

Table 2 describes variable distributions for the sample of 917,932 potential forecasting periods and 10,677 voluntary earnings forecasts. This table shows that forecast frequency is only .9995% for U.S. firms and 2.3452% for Canadian firms. Table 2 also indicates that Canadian firms release voluntary management earnings forecasts 58% of the time when the earnings information is good news compared with 38% of the time for their U.S. counterparts. With respect to precision of the forecast, Table 2 shows that Canadian firms are more likely to issue point forecasts (most precise) 54% of the time versus 23% for U.S. firms.

Table 2
Variable Distributions for 1983-2003, Sample of 917,932, Potential Forecasting Periods (n= 111,635, Canadian and n= 806,297 U.S.); and 1983-2003 Sample of 10,677, Management Earnings Forecasts (n= 2,618 Canadian and n= 8,059 U.S.)

	Good News Periods	Bad News Periods	Total
	($\Delta ESIGN_{it}$ =1)	($\Delta ESIGN_{it}$ =0)	
Potential Forecasting Periods:			
U.S Firms	330,582 (41%)	475,715 (59%)	806,297
Canadian Firms	63,632 (57%)	48,003 (43%)	111,635
Total	394,214	523,718	917,932
Management Earnings Forecasts:			
U.S. Firms	3, 021 (38%)	5,038 (63%)	8,059
Canadian Firms	1,514 (58%)	1,104 (42%)	2,618
Total	4,535	6,142	10,677
Forecast Frequency Rates in Potential Forecast Periods:			
U.S. Firms	.9139%	1.0591%	.9995%
Canadian Firms	2.3793%	2.2999%	2.3452%
Management Forecast Type:			
	U.S. Firms	Canadian Firms	Total
Point	1,854 (23%)	1,426 (54%)	3,280 (31%)
Range	2,176 (27%)	445 (17%)	2,621 (25%)
Minimum	2,015 (25%)	524 (20%)	2,539 (24%)
Maximum	1,113 (14%)	131 (5%)	1,244 (12%)
General Impression	901 (11%)	92 (4%)	993 (8%)
Total	8,059 (100%)	2,618 (100%)	10,677 (100%)

Table 3 presents the Equation (1) logistic regression tests of H1 and H2. Coefficient a_2 is significantly positive (p = 0.002), so Canadian firms are more likely to issue voluntary earnings forecasts during bad news periods relative to U.S. firms. The sum of coefficients $a_2 + a_3$ is also significant (p = .001), indicating that Canadian firms are also more likely to issue voluntary earnings forecasts during good news periods. These results support H1's prediction that lower legal liability in Canada leads to more forecast disclosures during both good *and* bad news periods. These results are also consistent with findings in Table 2.

With respect to H2, the results are also consistent with expectations. U.S. firm behavior is as expected, coefficient a_1 is significantly negative (p = 0.007). This indicates more forecast disclosure in bad news periods relative to good news periods. Coefficient a_3, which measures the difference between U.S. and Canadian sign-related behavior, is significantly positive (p = 0.001) indicating that Canadian forecasts occur more often in good news periods. These results are also consistent with findings in Table 2.

Table 3

Management Earnings Forecast Frequency in the U.S. and Canada

$FORECAST_{it} = a_0 + a_1\, \Delta ESIGN_{it} + a_2\, CANADA_{it} + a_3\, CANADA_{it} \times \Delta ESIGN_{it}$

Independent Variable (Coefficient)	Expected Sign	Coefficient Estimate (p-value)
Intercept (a_0)	None predicted	-6.210 (0.001)
ΔESIGN (a_1)	negative	-0.129 (0.007)
CANADA (a_2)	positive (H1 for bad news)	0.491 (0.002)
CANADA x ΔESIGN (a_3)	positive (H2)	0.639 (0.001)
Coefficients $a_2 + a_3$	positive (H1 for good news)	0.882 (0.001)

Forecast Precision

Table 4 presents results of Equation (2). As H3 predicts, the b_2 coefficient is significantly positive (p = 0.001), indicating that Canadian firms issue more precise forecasts in bad news periods than do U.S. firms. Also the sum of coefficients $b_2 + b_3$ are significantly positive (p = 0.001), indicating that Canadian firms issue more precise forecasts in good news periods than do U.S. firms. Coefficient b_1 is significantly positive (p = 0.033) indicating that U.S. firms issue less precise forecast when earnings are declining. In summary, results reported in Table 4 support H3, indicating that Canadian firms issue more precise voluntary earnings forecasts than do U.S. firms.

Table 4 $PRECISE_i = b_0 + b_1\ \Delta ESIGN_i + b_2\ CANADA_i + b_3\ CANADA_i \times \Delta ESIGN_i$		
Independent Variable (Coefficient)	Expected Sign	Coefficient Estimate (p-value)
ΔESIGN (b_1)	positive	0.293 (0.033)
CANADA (b_2)	positive (H3 for bad news)	1.209 (0.001)
CANADA x ΔESIGN (b_3)	negative (H2)	-0.207 (0.291)
Coefficients $b_2 + b_3$	positive (H3 for good news)	0.821 (0.001)

SUMMARY

This paper uses the largest sample of voluntary earnings forecasts to date, covering a 21 year period, to show that characteristics of forecast disclosures vary when comparing two countries with differing legal systems. Canadian managers, faced with a less litigious environment than U.S. managers disclose more earnings forecasts (in both good news and bad news periods) and are more precise in their forecasts. An implication is that substantial differences in legal systems across countries might provide a key for stockholders, with respect to disclosure issues, which in turn may affect investment decisions of investors who are exposed to varying protections under different legal systems.

ENDNOTES

1 The change in earnings is defined as $(EPS_{it} - EPS_{it-k})/PRICE_{it-k}$, where EPS_{it} equals earnings per share for firm i in period t, EPS_{it-k} = earnings per share for firm i in period t-1 for annual and t-4 for quarterly period; and $PRICE_{it-k}$ equals security price for firm i at the end of period t-1 for annual and t-4 for quarterly periods…all obtained from Comnpustat.

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END OF VOLUME 9, NUMBER 1

BEGINNING OF VOLUME 9, NUMBER 2

SOFTWARE ERRORS: RECOVERY RIGHTS AGAINST VENDORS

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ABSTRACT

Businesses that experience problems with physical products they have purchased find that the legal system provides adequate redress for their grievances. Large verdicts or out of court settlements are not unusual for product liability in business-to-business transactions. Software vendors routinely immunize themselves from such product liability by including exculpatory language in the agreements to which users must agree as they install the software. This paper examines the rights of companies to collect damages from software vendors when their products introduce errors or fail to perform transaction processing tasks correctly. The paper also outlines future trends in this area.

ERRORS IN BUSINESS SOFTWARE

Software vendors regularly ship software that has defects that are known to the vendor and that the vendor does not disclose to the purchaser (Kaner and Pels, 1998). Some of these defects are quite serious. For example, in the case of *Mortenson v. Timberline* (2000), Mortenson used Timberline's Precision Bid Analysis Software to prepare a bid for construction of a medical center. The software contained errors that caused Mortenson to bid the job approximately $2 million lower than it should have bid. Bills (2002) reports a software glitch at the Bank of America that processed automated clearing house payments incorrectly, resulting in unauthorized charges to thousands of customer accounts.

Although individual examples of software errors are interesting to read, the true danger of the current situation is made clear by studies of the extent to which accounting software is plagued by errors and by estimates of the dollar impact of these errors. *Financial Executive's News* (2002) presented a feature report on a series of common errors in mid-level accounting software packages. Goodwin (2002) reports the results of a study of 45 financial software applications. The study found that more than half of the applications contained errors that could have been fixed easily if they had been detected during the design of the software. Estimates of the annual cost to U.S. businesses of software errors is approximately $60 billion (Jusko, 2002; Trembly, 2002).

The way that software errors enter the software production process and the final software product is also enlightening. If software errors were the inevitable outcome of a complex process, which some researchers have argued in the past (Foster, 2003; Nakashima and Oyama, 1999; Roush, 2003), then there might not be much that legal reform could do about the problem. Although it is true that some software error situations are probably beyond the control of software vendors (for example, the rapid development cycles of annual revisions of tax preparation software might make them the exception to the rule (Johnston, 2001)), most business software developers do not work on tight deadlines and rapidly changing tax rules.

Kaner and Pels (1998) report that some software publishers track the number of errors that are discovered in their software after it has been released, calling these bugs their "surprises." They only include errors in this category that had not been detected in the software development process by programmers, quality assurance technicians, or by their own customer support staff. A common experience among these companies is to have fewer than five "surprise" bugs surface after the software is released. Many of them report only one or two such "surprise" errors.

This means that the large number of bugs identified in the industry press is not a true reflection of some innate condition in software development. In fact, it suggests that most software vendors know about the vast majority of the bugs that exist in the software they release. They just are not telling their customers about the errors.

LIMITS OF TOLERANCE

An increasing number of writers are reporting that business managers and IT staff members are coming to believe that tolerating software errors is no longer necessary (Foster, 2003; Hunter and Boscher, 2003). They argue that improving software design tools and software design methods offer hope for higher quality software. As companies realize the cost of error-laden software, they are demanding that internal software developers use these design tools and methods to improve the quality of the software developed in-house (Hayes, 2003). The number of companies that have reached the limits of their tolerance is growing. Since there is ample evidence that the tools now exist to produce software that is less error-laden than that being currently produced, a logical place to turn for recourse is the legal system.

LEGAL RECOURSE FOR SOFTWARE ERRORS

Legal recourse is based on damages; therefore, the logical place to begin is to identify the types of damages that might provide the basis for lawsuits or threats of lawsuits. The U.S. legal system provides for several types of damages that depend on the specific type of harm suffered by the software user. Compensatory damages, also called direct damages, provide the most common basis for lawsuits. These damages flow directly from the contract. For example, if defective software caused physical damage to the purchaser's computer, the costs of repairing the damage would be compensatory, or direct, damages.

A second type of damages is consequential damages, also known as special damages. Consequential damages are those that result from the unique circumstances of a particular injured party. Compensatory damages are rarely awarded. The remedy for compensatory damages was first outlined in *Hadley v. Baxendale*, a seminal case from 1854. The Hadleys operated a flour mill. The mill's crank shaft broke, causing the mill to grind to a halt. The Hadleys employed Baxendale to take the damaged part to a foundry to be repaired. Baxendale promised delivery of a repaired part in one day, but was delayed and did not return for five days. As a result of Baxendale's delay, the mill was shut for five days beyond the promised delivery date of the part. The Hadleys sued for their lost profits. The court denied the Hadleys any recovery, holding that a party may only recover consequential damages if the breaching party should have foreseen them. Baxendale could have reasonably assumed that the Hadleys had an extra crank shaft, therefore it would be unfair to presume that Baxendale realized the delay would halt the mill. Unfortunately for purchasers of error-laden software, courts have held that producers of such software who disclaim liability for defects or nonconformance are liable for neither compensatory nor consequential damages.

SHRINK WRAP, CLICK WRAP, AND WEB WRAP LICENSES

Click wrap terms are those embedded in the software itself. Shrink wrap terms are on the packaging of the software. Finally, Web wrap terms are available on a Web page after the product is purchased online. The issue with all three of these licenses is that purchasers cannot review the terms until they purchase the software and unwrap it, or until they place an order and pay for the software.

The controversy over click wrap and shrink wrap licenses can best be illustrated by two cases. In a case involving the sale of a Gateway computer over the phone, the computer arrived with the terms of the contract in the box. The consumer used the computer, did not like it, and petitioned the court for permission to join a class action lawsuit. The terms of the contract, however, required arbitration. The court held that by keeping the computer for more than thirty days, the consumer had agreed to arbitration, therefore waiving his right to become part of a class action lawsuit.

In *ProCD Incorporated v. Zeidenberg*, Zeidenberg purchased software made by ProCD. The software contained a shrink wrap license. The license was also embedded in the software. Ziedenberg purchased the software for personal use (Ziedenberg could have purchased the software for commercial use, but the license was much more expensive). Zeidenberg claimed that to be binding, the terms of the license needed to be on the outside of the box. The court disagreed, citing other examples in which purchasers learned of terms after purchase (for example, airline or movie tickets). The court also cited the Uniform Commercial Code (UCC) section 2-204, which states that "A contract for the sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract." The court explained that Zeidenberg had the option of returning the software if it disagreed with the contract terms.

Courts across the country have disagreed on exactly how to interpret click wrap, shrink wrap, and Web wrap licenses. Courts have used, in general, three theories in deciding such cases. Some courts have held that the offer is made when the purchase offer is communicated and that the offer is accepted when the shipment is sent. This theory is consistent with the UCC's informal approach to contracts. Other courts hold that the license terms are proposals for additions to the contract terms. Under the UCC, such terms do not become part of the contract because they significantly alter the rights of the parties (that is, they limit the liability of the seller). Yet other courts have devised a new theory of contract layering. Contract layering permits contract terms to be accumulated in stages until the contract is completely formed. Because the UCC governs contracts for software that is contained in "goods," such as diskettes or CDs, some legal researchers believe that the UCC's liberal rules may support the contract layering theory.

The theory of contract layering was most famously applied in the case (mentioned earlier) of *M.A. Mortenson Company v. Timberline Software Corporation*. Mortenson was a construction contractor who purchased software to prepare bids on projects. Mortenson prepared a bid, the software malfunctioned, and the result was that Mortenson underbid a project by $1.95 million. Mortenson sued Timberline Software for damages. Timberline argued that consequential damages were excluded under the terms of the software license. The issue, therefore, was whether a limit on consequential damages that had been enclosed in the software's shrink wrap license was enforceable against the purchaser of the licensed software.

Mortenson argued that because the purchase order fulfilled the basic requirements of a contract under the UCC, it was a "fully integrated contract." In such a contract, terms set outside the contract (in this case, the purchase order constituted the contract) were not to be considered by the court. Since the limitation of remedies clause was in the shrink-wrap license instead of on the purchase order, Mortensen asked the court to consider damages. Timberline countered that because key contract terms were missing from the purchase order, the purchase order could not be considered an integrated contract. The court held that even if a purchase order standing alone could be considered a contract under the UCC, in this case it could not.

Mortenson's second argument was that the delivery of the license terms (in the shrink wrap) was merely a request to add additional or different terms that was never agreed to by the parties. Under UCC 2-207, an offeree who accepts may include in the acceptance terms that are additional to or different from those in the offer. The additional or different terms become part of the contract unless the offeree states that the acceptance is conditioned on the offeror's assent to the new terms. In such a case, there is a counteroffer, which may be accepted or rejected. Moreover, additional terms (that is, terms that bring up new issues not contained in the original offer) are considered proposals to add to the contract. These proposals become part of the contract unless: (1) the original offer insisted on its own terms; (2) the additional terms materially alter the original offer; or (3) the offeror receives the additional terms and promptly objects to them.

Under UCC 2-207, when it comes to different (that is, contradictory) terms (i.e. terms in the acceptance that contradict terms in the offer), the majority of courts hold that the different terms cancel each other out. The court may then apply the appropriate UCC "gap-filler" terms. Gap-filler terms are provisions of the UCC that supply the missing terms (for example, the manufacturer offers a thirty day warranty and the buyer's acceptance states the warranty must be for 180 days; under the UCC, both warranties are cancelled and replaced by a standard UCC warranty). The court in *Mortenson* rejected this second argument as well, instead holding that the terms of the shrink wrap license were part of the contract and that Mortenson's use of the software constituted assent to the agreement, including the license terms (thus using the layered contract theory).

The dissent opined that this decision abandoned traditional principles governing contract offers and acceptances. According to the dissent, the use of traditional contract principles would have yielded a different analysis (and outcome). Mortenson issued a purchase order that identified the parties, the product, the quantity, the price, and other terms. Timberline's representative accepted the offer by signing the purchase order and promising to ship the software. As the offeror, Mortenson controlled the terms of the transaction, to which Timberline unequivocally agreed. Under this reasoning, the parties created a binding contract before Mortenson could have discovered Timberline's license agreement. The subsequent delivery of the license agreement constituted a proposal to modify the contract. Because Mortenson never expressly agreed to the terms of the license agreement after the contract was made, the dissent would have held for Mortenson.

The patent unfairness of the layered contract theory is clear to many observers in *Mortenson.* A party purchases software and uses it for that software's intended purpose. The software malfunctions and costs the user $1.95 million. Because of a shrink wrap license inside the box of the software, the user has no recovery!

ATTEMPT AT REFORM

As a way of dealing with this and other controversial issues, it was proposed that there be a new article added to the UCC, the Uniform Commercial Information Transaction Act (UCITA). Because of the controversial nature of UCITA, it was ultimately drafted as a separate law. UCITA's purpose was to propose new laws to cover contracts to create, transfer, modify, or license computer information. Not covered under UCITA were transactions in goods, software embedded in goods (with a few exceptions), movies, and sound recordings.

To date, only two states have adopted UCITA (Maryland and Virginia). Controversy over the proposed new law came from many sources. The American Bar Association felt the statute was to complex for even a lawyer to understand. Libraries argued that UCITA, by allowing states to follow different rules regarding software, would whittle away at federal copyright law. The main problems with UCITA are as follows: (1) it allows software publishers to change the terms of the contract after a purchase; (2) it allows restrictions that prohibit users from criticizing or publically commenting on software they purchased; (3) it allows software to contain "backdoor" entrances, potentially making software vulnerable to infiltration by unauthorized hackers; and (4) it allows software publishers to sell their software "as is" and to disclaim liability for product shortcomings. Supporters of UCITA (including Microsoft, LexisNexis, and the Business Software Alliance) argued that UCITA was needed because the UCC did not anticipate contracts for software, which are generally license agreements. Moreover, they feel that the UCC does not adequately address e-commerce issues (ABA, 2004).

During the debates over Article 2B of UCITA, several individuals and organizations proposed that software vendors be strongly encouraged to reveal known defects to customers. The proposed mechanism to accomplish this was to (non-waivably) hold vendors / publishers accountable for defects that they knew about and did not disclose at time of sale, but to free software vendors / publishers from liability for consequential damages arising out of defects that were either unknown to the vendor / publisher at time of sale or were known and disclosed in the product documentation. Such proposals came from Todd Paglia (representing Ralph Nader), the Association for Computing Machinery, the Institute for Electrical and Electronic Engineers, and the Independent Computer Consultants Association. One proposal was that in mass-market products, accountability for consequential damages be limited to reimbursement for provable out of pocket expenses, to a maximum of $500 per claim. The goal was to create an incentive for disclosure, not to subject vendors to unlimited liability. These proposals were repeatedly ignored or rejected (ABA, 2004)

PROPOSALS FOR REFORM

There are steps that could be taken to allow purchasers of software a remedy for defective or nonconforming software, while prohibiting unlimited liability against software manufacturers. Giving incentives to manufacturers to reveal known defects is the first step. Limiting the time for consumers to bring a complaint for defective software (i.e. a short statute of limitations) is another possibility. Moreover, potential liability could be assessed based upon the nature of the error. For example, if the software program when used properly does not perform the major function for which it is intended, the damages permitted would be much higher than for minor defects or malfunctions.

CONCLUSION

The limited liability of vendors for direct and consequential damages is a problem that is causing growing concern among business users of software. For accounting software in particular, the problem of consequential damages is becoming a significant element of companies' exposure to unforseen liabilities. Specific legislation that addresses direct and consequential damages for software products is a possible solution.

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EXPLORING THE LEGAL FRAMEWORK FOR BUSINESS AND ETHICAL PRACTICES IN GHANA

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ABSTRACT

Paper reports the findings of a study conducted in 2004 as part of a project leading to the development of business codes for Ghana. The analysis of the legal and regulatory framework specifically dealt with the extent to which the legal and regulatory environment meets international best practices and standards of business conduct and the extent to which self-regulatory mechanisms and voluntary codes/guidelines established by enterprises and trade/business associations are accommodated under the framework. Key findings include weaknesses of the business registration regime, which continues to keep a lot of informal businesses out of formal registration. Further, the legal and regulatory regime for the registration and governance of businesses has failed to catch up with international best practices. In view of the inadequate framework for governance of businesses under the Companies Code, listing on the Ghana Stock Exchange further increases the chances of a company strengthening its governance structures by virtue of the rules of the Ghana Stock Exchange and the Securities and Exchanges Commission. Where corporate governance codes exist, enforcement mechanisms are not very well laid out. Disciplinary actions, when taken, are not publicized. Accordingly, the public is often unaware of its rights in instances of violations. While Government has an important role to play in the area of providing the legal framework for enhancing best practice standards in business registration, governance and even closure, it would still seem like the ultimate responsibility for good business behaviour still lies with Ghanaian businesses.

INTRODUCTION

Against the background of globalization, increased competition among developing countries for FDI flows, and increased levels of poverty in Sub-Saharan Africa, there is emerging increased awareness among African leaders of the need to promote the private sector as catalysts to sustainable growth and poverty reduction. Within the context of The New Partnership for African Development (NEPAD), African leaders have pledged their commitment to ensuring democracy, political, economic and corporate governance to promote investment and economic growth as the engine for poverty reduction within their nations.

In January 2001, Ghana's President John Agyekum Kufuor declared that his government would usher in "a golden age of business" in Ghana. This was to serve as a signal of the government's desire to work towards private sector development and thereby promote economic growth. This commitment was accentuated by the Ghana Poverty Reduction Strategy (GPRS) which outlines Government's broad policies to support growth and poverty reduction. The main thrust of the GPRS is the empowerment of all Ghanaians to participate in wealth creation and to partake in the wealth created through sound economic management for accelerated growth, increased production and promotion of sustainable livelihoods, good governance and increased capacity of the public sector, promoting the active involvement of the private sector as the main engine of growth and partner in nation building, and provide special programmes in support of the vulnerable and excluded. While government is making every effort to promote private sector development, government, development partners, private sector and civil society must each play their role in ensure that businesses are registered, operated, and closed (if need be) in accordance with laws and practices that promote sustainable economic development. Good business practices are key to and SME in Ghana becoming a player in the new globalized economy.

In furtherance of its commitment to private sector development, the government introduced a number of significant measures including the creation of a Ministry for Private Sector Development (MPSD) in 2001 to champion pro-private sector policies within government in close dialogue with the private sector, the establishment of the World-Bank funded Ghana Investors Advisory Council to advise the President on mechanisms for enhancing the investment environment in Ghana, the launch of the National Medium-Term Private Sector Development Strategy and the National Trade Policy which among other things seeks to remove legal, regulatory, and institutional bottlenecks which affect the growth of the private sector, and the establishment of a commercial court to improve commercial dispute resolution.

In spite of these laudable efforts, the environment for doing business in Ghana continues to present administrative bottlenecks that work against new investments and constrain growth of existing businesses (World Bank FIAS, 2003) . The legal, regulatory, and administrative framework for the registration, conduct, and closure of businesses of businesses require far more attention than so far received. Sustainable development requires government to provide a clear framework of rules and procedures governing access to public services and the conduct of businesses in a way that protects the interests of all stakeholders. Administrative and legal reforms to promote private sector development must therefore aim among other things, at providing a stronger framework for ensuring that businesses are organized, governed, and operated in accordance with international best practice rules that promote growth. Poor administration of laws relating to the issuance of licenses and permits, unequal access to public services and resources, delays in the delivery of public services, poor auditing and tax administration, all impede efforts at achieving good corporate governance. Research has established that the level of administrative delays in a country is negatively correlated with the strength of governance (Morisset & Lumenga Neso, 2002).

Unleashing sustainable economic growth through private sector development cannot depend solely on government's efforts. Government regulation by itself, does not guarantee effective and sound business ethics and corporate governance. The private sector has a large role to play in this effort and so do stakeholders such as investors, employees, business associations, professional bodies, and civil society. Research shows that voluntary codes of business ethics and corporate governance formulated by private sector bodies have greater chances of success than mandatory governance rules put in place by government. Business responsibility is increasingly considered not to include profitability alone but to incorporate issues compatible with societal objectives and legitimate social concerns. Research shows that 73% of global institutional investors are willing to pay a premium for the shares of a well-run company over one considered poorly governed but with a comparable financial record. In emerging markets where corporate governance is perceived to be poor, investors are prepared to pay a premium as high as 30% compared to 12-14% for North America, where corporate governance is perceived not to be so poor Mckinsey & Company; 2002). Consequences of poor corporate governance include loss of lifetime savings by individuals, weakening of investor confidence in the capital market, collapse of companies, and lack of long-term productivity and growth of the entire economy.

The challenge in many developing countries is to get businesses to recognize the ever growing importance of good corporate governance and ethical business practices as the essence of survival, growth, and sustainability. In many developing economies, owner-managed small and medium enterprises (SMEs) make up the majority of businesses. Ghana's SMEs (with a profile similar to many other African countries) were estimated as employing in excess of 15% of the country's labour force in 1994. The employment growth of 5% within the SME sub-sector at that time was determined to be higher than what was being experienced in both the micro and large scale enterprises segments. In 1998, the outputs of SMEs collectively accounted for about 6% of Gross Domestic Product (GDP) . Records available at the Ministry of Trade and Industry (MoTI) indicate that approximately 90% of registered businesses in Ghana are considered to be SMEs. Earlier research has shown that Ghana's private sector continues to be dominated by unincorporated sole proprietorships that fall outside company regulation (Institute of Directors Ghana, 2000). Businesses regulated as companies are usually small in size, owner-managed, and hardly feel accountable to any stakeholder group beyond their shareholders, if at all. In some cases, ownership is concentrated in the hands of majority shareholders leaving minority shareholders feeling marginalized. Measures leading to dilution of control are usually resisted due to the private benefits associated with corporate control. Most small companies tend to look for loan capital instead of equity as a result. Businesses are unable to grow without sacrificing high levels of corporate control. Creditors perceive high agency costs associated with lending to such businesses (Mensah, Aboagye, Addo & Buatsi, 2003).

In spite of several efforts by government and development partners over the years, not much appears to have been achieved in transforming the country's SME sub-sector into that energetic, productive machinery required for powering the economy onto a growth path of rapid and sustained development.

THE RESEARCH GAP

Research on ethical, legal and regulatory frameworks has focused largely on western and developed economies. In the mid-1970s the USA was the first major country in the world to experience an extensive movement among large business enterprises in the utilization of codes of ethics in their operations. Berenbeim (1988, p. 92), who conducted a study on company codes of ethics in the USA, Canada, Europe, Japan, Australia and elsewhere, found codes to be "less prevalent outside the United States and Canada". There is an extensive body of research on codes of ethics, mainly in the USA, examining their content, the way they are formed and their advantages and disadvantages. Previous research related to the US have included work by scholars like Cressey and Moore, 1983; Mathews, 1987; Benson, 1989; McDonald and Zepp, 1989; Dean, 1992; Lefebvre and Singh, 1992; and Wood, 2000. Other scholars who have conducted research in industrialized economies in respect of codes of ethics include, Adams et al., 2001; Fraedrich, 1992; Gellerman, 1989; Harrington, 1991; Laczniak and Murphy, 1991; Sims, 1991; Somers, 2001; Stoner, 1989, Raiborn and Payne 1990 and Stead et al. 1990

Schlegelmilch and Houston (1989, p. 10) also observed that there was at the time of their 1989 research report, there seemed to be "a dearth of U.K. literature on business ethics in general and corporate codes of ethics in particular". In 1988, Langlois and Schlegelmilch (1990) also surveyed 600 European firms in equal numbers from France, Germany and the UK. Very little attention has been paid to Ghana which is generally perceived within the international community as representing one of the best African hope models for economic and political progress. This study therefore proposes to contribute to the literature by focusing on the evaluation of Ghana's preparedness to attract local and foreign investors as well as develop SMEs in Ghana, by investigating the adequacy of Ghana's legal framework for the conduct of business and ethical practices in Ghana. It is also useful to mention that there are certain African countries like Nigeria which are notorious for shady business and corrupt business because of the perceived absence of appropriate legal frameworks for the conduct of business and ethical practices. Ghanaian policy makers would therefore benefit from this study to the extent that it may end up pinpointing certain weaknesses in our legal frameworks and therefore recommend some ways in which the legal framework could be made stronger.

Research on the African business codes situation have been few and far between and this Ghanaian study is going to attempt to fill part of that yawning gap in the academic literature because in an increasingly globalized world best practice is beginning to apply to every company in the global village.

OBJECTIVES OF THE STUDY

The objectives of this study are therefore to ascertain the extent to which:

1. The legal and regulatory framework for business conforms to international best practices and standards of business conduct as regards business practices and codes;
2. The extent to which self-regulatory mechanisms by enterprises and trade/business associations are accommodated under the framework; and
3. The extent to which any shortcomings identified by this study can be rectified and by what processes.

METHODOLOGY

This study was carried out in the second and third quarters of 2004. This study employed an ethnographic qualitative research approach. Key tools utilized included participant observations, focus group discussions, limited interviews and exhaustive reviews of acts, laws and relevant statutes related to business and ethical practices in Ghana. This study was carried out based primarily on various laws and regulations in force, international treaties, and other literature relating to the registration and operations of businesses particularly investor relations, labour and industrial relations (including issues of child labour, work place discrimination, health and safety of employees, HIV/AIDS at the workplace and gender), consumer protection, tax obligations and administration, environmental protection, corporate social responsibility, unfair competition, and bribery and corruption. Limited interviews of owners, directors, and top management of SMEs and large businesses, trade and business associations, and relevant government agencies were also carried out in relation to these issues. The researchers also spent a few days at company sites just observing how they conducted their day to day businesses.

DISCUSSION OF FINDINGS

This section of the paper discusses the findings results of the study carried out on the adequacy of the legal, regulatory, and institutional arrangements for doing business in Ghana, in line with international best practice. There is also a discussion of the extent to which business operators and other stakeholders had put in place measures to promote good business ethics and corporate governance.

The current legal and regulatory regime for the registration, operation and closure of businesses in Ghana has a number of inherent weaknesses, when measured against international best practice standards.

A. One major weakness of the registration and licensing regime for businesses is the multiple registration requirements and procedures, the lack of capacity of the different Registrars to enforce these requirements, and the largely centralized system of business registration. These weaknesses impose different levels of administrative burdens on businesses that opt for formal registration. These weaknesses also continue to act as a disincentive to informal sector businesses to move to formal registration.

B. The legal framework for registration of companies in Ghana has not kept up with international best practice. The Companies Code, 1963 (Act 179), based largely on the English Companies Act of 1948was generally heralded as being ahead of its time when it was promulgated in 1963, it has seen no major changes since then. Current attempts at revising the Code have mainly involved editorial changes. The Code is therefore in dire need of a comprehensive revision based on key pro-private sector development policies. Of particular importance is the need to formulate a policy on the promotion and formalisation of small-businesses, and the reduction of the cost of compliance to small businesses. Company law reform in Ghana must also be in line with current thinking on good corporate governance practices and facilitate capital formation. For instance, contrary to best practice in corporate governance, there is no requirement under the Companies Code for the appointment of independent directors. Also the Code does not preclude the appointment of the same person to the two offices of Chief Executive Officer and Chairman of the Board. There is also no requirement for the establishment of an audit committee of the Board.

C. The weaknesses of the governance framework of the Companies Code are somewhat dealt with by the Ghana Stock Exchange (GSE) Listing Regulations. The Companies Code makes room for additional regulation of companies subject to special regulation . Companies seeking a listing on the GSE must show written evidence regarding the operation and effectiveness of an audit sub-committee of its board of directors. The Listing Regulations provide that the audit sub-committee shall as far as possible be composed of the company's non-executive directors. The Securities and Exchange Commission's Regulations (LI 1428) also require public companies to maintain audit committees of their Boards. The Securities & Exchange Commission's voluntary Code of Best Practices on Corporate Governance, which is based on principles adopted by the Organisation of Economic Cooperation and Development (OECD) and the Commonwealth Association for Corporate Governance (CAGG), also recommends a number of best practices in corporate governance. While these provisions are not binding, the SEC encourages compliance by the Ghana Stock Exchange, licensed securities market operators, and issuers of publicly traded securities, and requires a statement in the Annual Reports of the affected companies showing the extent of compliance with these Guidelines. Perceived high costs of listing on the stock exchange and the cost of surrendering control to the public makes public flotation unattractive for most SMEs.

D. Companies regulated under special industry regulation such as banks, insurance companies, mining companies, also tend to have stricter obligations to govern and operate their businesses in the interest of all key stakeholders, including investors, clients, agents, employees, and the State. As a result, various stakeholders have advocated for the promotion of more listings on the Ghana Stock Exchange through increased tax incentives.

E. The legal regime affecting the governance of state-owned enterprises (SOEs)is not harmonized as some SOEs continue to be regulated by specific statutes by which they were established and are therefore outside the scope of the Companies Code, while others operate under the Companies Code. It is worthy of note, however, that a concerted effort has been made to bring corporate governance, management and practice in the public sector in line with international best practice standards. Under the 1992 Constitution specific provisions seek to entrench principles of good corporate governance in the public sector. Chapter 24 provides a code of conduct for public officers with specific anti-conflict provisions.

F. The legal framework for the protection of shareholders and creditors has not seen any major reforms. For instance, there is no regime for the reorganization of insolvent companies under court supervision, as an alternative to liquidation. The current procedures for the protection of creditors' rights are largely dependent on the High Court. No designated bankruptcy courts currently exist. Relief for creditors therefore is not timely, if at all.

G. Weak tax administration systems currently in place, allow many businesses to evade their tax obligations with impunity, thereby increasing the tax burden on complying businesses. Recent improved cooperation and coordination between the Internal Revenue Service (IRS) and the Companies Registry has led to an improvement of the ability of the tax agencies to keep track of registered businesses for tax collection and monitoring purposes. A lot however still remains to be done, particularly in the area of compelling informal sector businesses to register and meet their tax obligations.

H. The Labour Act of 2003 largely meets international best practice standards in creating a balance between the rights of employers on the one hand and employees on the other in terms of health and safety, discrimination, child labour, and fairness issues. The absence of specific provisions on HIV/AIDS issues under the Labour Act is however inconsistent with the International Labour Organisation (ILO)'s "Code of Practice on HIV/AIDS and the World of Work".

I. No clearly articulated consumer-protection policy currently exists in Ghana. General laws, which offer protection for consumers establish basic standards for the production, labelling and sale of food, drugs and other consumer goods, are intended to ensure the protection and safety of consumers. These laws however, do not provide specific mechanisms through which consumers may formally seek redress for such violations of their rights. Furthermore, these laws have fallen out of line with the United Nations Guidelines for Consumer Protection which provide a framework for governments to devise and strengthen policies and legislation to protect their customers.

J. The Protection Against Unfair Competition Act, 2000 (Act 589) which seeks to protect against unfair competition and other incidental matters is generally seen as inadequate and as a result, a more comprehensive Competition and Fair Trade Practices bill is being proposed to among other things establish a special court and a complaints office to deal with competition issues.

K. The current environmental protection regime does not provide specific mechanisms through which communities may formally seek redress for such violations of their rights.

L. While government policy has favoured social corporate responsibility, by the introduction of tax incentives for corporate sponsorship of charities, sports development and promotion, educational scholarships, and rural and urban community development projects, approved by Government from the 2001 tax year, data on the extent to which companies take advantage of these tax incentives is, however, not readily available. Indications are however that in the major extraction sites, mining companies account for a significant share of social infrastructure and provision of social services .

M. In spite of various laws against bribery and corruption, evidence abounds to the effect that supply-side and demand-side corruption is prevalent in Ghana, with businesses spending being an appreciable percentage of their income on rent-seeking behaviour.

N. Very few businesses have Codes of Business Ethics and strong corporate governance structure. Those that have Codes in place tend to be subsidiaries of multinational companies.

O. Many stakeholders find the traditional concepts and governance structures addressed by the OECD and Commonwealth Association on Corporate Governance and which were used for the survey inappropriate in the developing context. They tended to argue requiring SMEs and informal businesses to adopt formal structures such as well-functioning boards of directors, audit committees, codes of ethics, accounting and audit functions was itself burdensome and unnecessarily complex.

P. Stakeholder groups such as the Consumer Association of Ghana (CAG), and the Shareholders Association of Ghana are weak and are hardly able to survive.

CONCLUSION AND RECOMMENDATIONS

The findings of the study show that formal registration of businesses promotes the adoption by businesses of formal structures and enhances the chances of operating in a responsible manner. Weaknesses of the business registration regime, however, continue to keep a lot of informal businesses out of formal registration. Further, the legal and regulatory regime for the registration and governance of businesses has failed to catch up with international best practices. Even the minimum and often outdated standards prescribed under the Code, have hardly been enforced by the Registrar of Companies, because of a lack of adequate resources. Inadequate resourcing of other State agencies involved in monitoring business behaviour and white-collar crime impacts negatively on their ability to keep up with technological advancements in monitoring and surveillance, and that of cross-border issues. Weaknesses in the judicial and penal systems affect effective enforcement of the rights of stakeholders.

If formal registration of more businesses is to be achieved, the legal and institutional framework for registration must be simplified and streamlined. Consideration should also be given to the possibility of decentralisation of the business registration process. While listing on the Ghana Stock Exchange further increases the chances of a company strengthening its governance structures by virtue of the rules of the Ghana Stock Exchange and the SEC, perceived high costs associated with listing prevents more SMEs from seeking access to the capital markets. As a result, various stakeholders have advocated for the promotion of more listings on the Ghana Stock Exchange through increased tax incentives.

Creditors must provide capital within the framework of prudential lending and accounting norms, backed by sound recovery laws and efficient processes. An Insolvency law which offers more protection for businesses and their creditors in accordance with the U.S. "Chapter 11" model will go a long way to promote sustainability and growth of SMEs. Shareholders, especially institutional investors must be more active in promoting good corporate governance and good business ethics.

Government, businesses, and development partners must consider supporting programmes to strengthen shareholder, consumer, and community-based, groups to enable them to advocate for better business practices.

While substantial reforms are required in the policy, legal, and regulatory framework for business in Ghana, care must be taken to ensure that such reforms are carried out using a bottom-up approach. These reforms must be within the context of well-developed policies formulated through dialogue between regulators, private sector, civil society, research organizations.

At the firm level, businesses must show more commitment to engaging in better business practices. More orientation and training must be provided by the Institute of Directors for directors to increase their understanding of their duties under the law. Boards should adopt policies that promote good business practices. The development of new codes of business practices for the private sector, is critical for supplementing the policy and regulatory reforms required to promote better business practices. The principles of the United Nations-initiated Global Compact provide a good guide to establishing best practice in corporate and business conduct.

Care must however be taken to ensure that international business practice legal reforms and codes of conduct are not adopted wholesale. There is a need to customize these standards especially being mindful of the fact that the great majority of local companies are micro, small or medium, and also being mindful of the large informal sector. This is consistent with the consensus from the African Consultative Meeting on Corporate Governance held in Kenya in 2000, and the Pan-African Consultative Forum on Corporate Governance (2001) in South Africa.

In an increasingly competitive global economy, local businesses, in pursuit of their primary business objectives of profitability and growth, may well find that adherence to socially-responsible corporate governance practices is as important as business strategy implementation in determining bottom-line growth.

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GUIDEPOSTS CONCERNING THE DEVELOPMENT AND IMPLEMENTATION OF QUALITY CHILDCARE/DAYCARE FOR INNER-CITY FAMILIES

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ABSTRACT

The issue of childcare quality is one facing many American families today. The role of government in solving this problem is the subject of heated debate. How can government aid those families in need while balancing the incentives of labor force participation and in-home parental childcare? The solutions are many and varied, but they leave little to be desired. An increase in funding for government programs improves quality but also encourages increased labor participation of those who might otherwise remain at home to care for their children. If government does not aid deficient pre-school programs, those who have no choice but to work are left with low-quality programs which could possibly harm the future school performance of their children and have a negative impact on future generations.

INTRODUCTION

There is no doubt that childcare in this country is less than ideal. Finding quality daycare, especially for low-income parents and children, is a major dilemma in the United States (Jaeger, 2000). Mocan (1995) states that the average daycare is below a level considered "good" by professional educators. Furthermore, there is a link between quality childcare and education in child development (Mocan, 1995). However, this connection leaves out the home situation of the child. According to a study of 100 daycare centers in the spring of 1993, the quality of daycare is tied into child development, and it would cost $0.13 per hour per child to improve the average daycare from mediocre to "good" (Mocan, 1995).

Jaeger (2000) states there is little political or social support for the changes necessary to improve the quality of daycare. This leads to the questions: do low-wage workers have to settle for low-quality childcare? Are working families to expect their children will not develop as fully as their wealthier counterparts? When is government intervention appropriate and necessary? Can the market correct this potentially devastating flaw in our education system? In addition, is it appropriate to subsidize daycare and not subsidize in-home care by a parent? This is a small part of the overall debate about the suitability of daycare versus in-home care by a parent.

STATISTICS

Since 1970, the labor force participation rate of married women with young children has doubled (Michalopoulos, Robins & Garfinkel, 1992). According to Department of Labor statistics, three-fifths of married women with children under the age of six and one-half of married women with children under the age of one are participating in the labor market (Anonymous, 2000). According to a 1992 Department of Commerce study, women in poverty spend 21 percent of their income on childcare (Mocan, 1995). "According to the National Center for Education Statistics, in 1995 there were approximately 21 million infants, toddlers, and pre-school children under the age of six in the United States; more than 12.9 million of them (61.43 percent) were in childcare" (Anonymous, 1997). This is not to say these children are in full time daycare, but rather that they spend some amount of time in daycare.

PROPOSED SOLUTIONS

Some of the proposed solutions include establishing and enforcing stricter daycare center regulations, offering higher salaries for workers, increasing subsidies to families and daycare centers, and instituting tax credits for families with children. Each of these proposals will be considered in this paper, along with continued discussion of the debate between daycare versus in-home care.

TRAINING REQUIREMENTS FOR CAREGIVERS

Training and continuing education are required of daycare workers in most states, but, according to Jaeger (2000), the convenience and timing of training sessions is a problem for workers. To promote a high quality system for childcare provider development, Jaeger (2000) suggests an increase in the visibility and accessibility of professional resources to providers for training purposes.

THE COLLABORATIVE

The Philadelphia Childhood Collaborative is a three-year experiment investigating the benefits of increasing professional resources to providers where they live or work (Jaeger, 2000). To achieve this, the organization used neighborhood resource rooms, training, and traveling teachers to supply childcare providers with the education they needed to fulfill the state-required minimum of six hours of annual continuing education. Approximately 2500 providers in the Philadelphia area used the services, and more than half used the services more than once. Of those surveyed, 60 percent said they benefited from the service. However, over the eight-month evaluation period, the quality of care was unchanged (Jaeger, 2000).

Although this solution helps solve the problem of convenience and time constraints on the providers, it does not solve the problem of lack of quality. Those seeking training to improve their skills will usually be concerned about the quality of care they are providing. It is those providers who do not seek training, but do only what is required of them, who are of the most concern when considering quality of care. The government can do little to regulate emotions, and few programs can change a person's outlook on life. It is only the parents and the owners of the daycare facilities who can prevent the uncaring provider from taking care of children.

CHILD-TO-STAFF RATIOS

Child-to-staff ratios signify the number of children allowed with a minimum of one teacher or caregiver. A lower ratio equates to more attention to each child and essentially better quality. Research shows regulations lowering the child-to-staff ratio increase quality but also costs (Chipty, 1995). An alternative to the traditional center provider is an in-home provider. This alternative, according to Chipty (1995), usually provides higher quality and lower cost when compared to a traditional daycare center. Of course, not everyone has access to this type of care. Accessibility depends on the supply of in-home providers in a given area.

LICENSING AND SAFETY REGULATIONS

All out-of-home childcare centers must be licensed by a state regulatory agency; usually the state and local health departments regulate these centers. In-home centers are regulated only if they house a certain number of children.

Childcare facilities must maintain a minimum level of safety in order to operate. Each state has its own guidelines governing the level of safety which must be maintained. The National Child Resource Center states that children should be protected from physical harm, including intentional and unintentional injury, guarded against serious infectious diseases, and nurtured in an affectionate environment (Chang & Sterne, 2000).

FEDERAL REGULATIONS

According to the *National Research Council's* report "Who Cares For America's Children? Childcare Policy for the 1990s," Chang and Sterne (2000) call for "uniform national childcare standards" which can be adopted by all states. Presently, there are no federal guidelines regulating childcare centers. Jaeger (2000) states that "regulations by themselves do not guarantee quality." Chipty (1995) asserts that enforcement efforts are weak when it comes to regulation violations. Chipty (1995) continues by stating regulations have a negative effect on equilibrium prices, quantity, and quality. However, regulations are a necessary evil when it comes to the safety of children. We cannot risk our children to prove the "invisible hand" theory.

SUBSIDIES--THE CLINTON PROPOSAL

On January 7, 1998, President Clinton proposed the allocation of approximately $20 billion over the next five years to childcare outside of the family home. This would include $7.5 billion over five years to double the number of children receiving childcare subsidies to more than two million by the year 2003. The initiative also increased tax credits for childcare for three million families and provides tax credits to businesses which offered childcare services to their employees. To improve early learning, the initiative included $3 billion over five years to establish an Early Learning Fund which would help local communities improve the quality and safety of childcare for children ages zero to five (Anonymous, 2000, Clinton's proposal).

The main mechanism for this proposal is to increase funding for childcare block grants to states. This would increase the amount of childcare available to the poor. While this is a noble goal, is it the intent of the government to provide quality childcare or daycare? In a larger sense, is the government subsidizing, to some extent, out-of-wedlock births and single mothers? According to Willis (1987), when state resources compete with the financial role of a father, teenage childbirth increases. Is the government doing this by artificially lowering the cost of daycare when it should be creating tax policies to guide the population toward in-home care by a parent in a two-parent environment?

THE OMNIBUS BUDGET RECONCILIATION ACT AND OTHER FEDERAL EDUCATION PROGRAMS

The Omnibus Budget Reconciliation Act of 1990 included a childcare and development bloc grant to states. This bloc grant included $750 million in 1991 increasing to $925 million in 1993, 75 percent of which went directly to subsidize expenditures on childcare for low-income families (Berger, 1992).

Each year, the federal government provides about $4.6 billion for pre-school education and $4.4 billion in bloc grants, such as the Childcare Development Fund. The pre-school education programs for low-income children include Head Start, Even Start, and Title I. The Department of Health and Human Services oversees Head Start and The Department of Education oversees Even Start. Both of these programs focus upon preparing children for primary school. Title I funds, which are traditionally used to support economically disadvantaged elementary and secondary students, often subsidize pre-school programs as well. State governments provide $2 billion annually to support pre-school programs (Shaul, 2000). The associate director for Education, Workforce, and Income Security Issues testified before a Senate committee that the effectiveness of Head Start, Even Start, and Title I programs is unknown because of lack of information (Shaul, 2000).

SUBSIDIES TO PROVIDERS

Berger and Black (1992) studied the effects of Louisville's 4C (Community Coordinated ChildCare) and Kentucky's Title XX Purchase of Care. Both of these programs provide subsidies to daycare facilities (up to $50 per week per child) depending on the income levels of individual families. The parent must work a minimum of 20 hours per week. Berger and Black (1992) found that in both cases, single mothers were more likely to enter the labor force and be more satisfied with childcare when they received these subsidies. Most households cannot pay the true cost of childcare, resulting in low pay for childcare workers (Jaeger, 2000). The low incomes of caregivers and providers causes high turnover in their employment (Chang & Sterne, 2000). There is little to no research available concerning the effects of subsidies on childcare workers as they relate to quality of care, but basic economic theory states that as incomes rise in a profession, there will be an increase in the supply of workers in that profession. With an increase in the supply of willing workers, daycare centers can pick and choose from a larger pool of potential employees and as a result, increase their chances of hiring quality workers.

EFFECTS OF SUBSIDIES

According to Berger and Black (1992), subsidies appear to increase parental satisfaction concerning childcare. Michalopoulos, Robins, and Garfinkel (1992) state that subsidies only help those who use the money to purchase slightly higher quality market care over free care. If more money is made available for subsidized daycare, thus lowering the cost of daycare, then the incentive is to utilize daycare as the childcare of choice. This would have the unintended consequence of creating an anti-home care bias. Indeed, there is already a bias present as the first $5000 of childcare is tax deductible, while the stay-at-home parent not only loses the income, but receives no tax incentive. In contrast, according to Blau (1988), subsidies for childcare do not encourage labor force participation. Blau (1988) notes that in a tight labor market, employer subsidized childcare may entice mothers into the labor force.

TAX INCENTIVES AND TAX DEDUCTIONS

At the moment, there is no government-subsidized incentive for full-time in-home care by a parent. There is a $500 per child tax deduction per year. This small amount is not enough of an incentive to abandon work and become a full-time caregiver. If the decision is made for one parent to become the full-time caregiver, then the income the caregiver relinquishes is another burden the family must shoulder. If we assume both parents contribute equally, and one income must be sacrificed to provide in-home childcare, then we can see the overwhelming incentive to choose outside childcare.

According to Steuerle (1990), the most important tax credits available to low-income families are the EITC (earned income tax credit), the child-tax credit, and the childcare credit. The EITC is offered as cash instead of services. How does this affect incentive? The reaction is mixed. It does offer parents the choice to stay at home or seek in-home care, but it lessens the incentive to work (Steuerle, 1990). Steuerle (1990) considers these credits to be like a NET (negative earnings tax). These differ from a negative income tax in that they are not based on income and there is no phase-in of benefits. Credits phase out moderate-income levels and avoid high combined tax rates with implicit tax rates (Steurle, 1990). According to Michalopoulos, Robins, and Garfinkel (1992), a refundable childcare tax credit would distribute childcare benefits equally by increasing the shares of the subsidy to low-income families, but despite the increased funding to childcare, quality does not follow the same trend.

PROBLEMS WITH TAX INCENTIVES

The decision about how children will be cared for is a highly personal as well as political problem. If one decides to forego a second income in favor of parental childcare, one must accept a diminished standard of living. This decision would be viewed in light of the assumption that this is the better model. There are, however, a number of problems with this. If both parents are educated and motivated individuals who desire to work and can earn substantial incomes, then one parent will have to make the emotionally charged decision on which equally fulfilling career to abandon. In this scenario, the implicit assumption is that the single working spouse can meet all the material needs of the family.

What about the households which are unable to maintain a suitable standard of living from a single working spouse? These families may not have the luxury of one parent providing in-home care. Families that have incomes less than $14,400, paid for childcare, and had children under the age of five spent 25 percent of their income on childcare (Mocan, 1995). This clearly leaves the family under the federal poverty level. This, in turn, could lead to a decision to no longer work and turn to government subsidies for familiar support. If people choose to abandon self-reliance, this violates the intent of the proposal, which is to aid families so they can work.

Looking at the different incentives the government is considering, one finds they are not large enough to make a meaningful difference in the decision to put a child in daycare or keep the child at home with one parent. Any tax credit large enough to be meaningful is impossible because of fiscal considerations. The federal government cannot afford to give a $10,000 or greater subsidy to each family wanting to have in-home care for their children by a parent. Even the higher proposal of a $900 per child tax credit is not enough to incite one parent to stay at home to care for a child or children.

CONCLUSION

The availability of alternative forms of childcare affect cost (Chipty, 1995). Where there are many forms of alternative care, the consumer can choose the best and most cost-effective means of childcare. The decision of a woman to work does not automatically mean she is in the market for childcare. Sometimes, friends or family members provide care at little or no cost (Blau, 1988). Not everyone has access to all of the alternatives.

In every culture the family is the primary agent responsible for the care and nurturing of a child. Family background is an important indicator of the success or failure of a child (Willis, 1987). It is difficult to understand why a parent would not do everything possible to ensure that the best interests of the child are protected. These are value judgments, which are impossible to legislate. But people operate from incentives. They will continue behavior for which they are rewarded and refrain from behavior for which they are punished. According to Steuerle (1990), increasing funds to programs like Head Start have better results in improving quality than increases in childcare allowances. The ideal situation is for one parent to stay at home with the children until they are ready to start primary school. Although the government cannot subsidize low-income families for wages lost by staying at home, they can encourage parents to stay at home by expanding tax credits to parental care and not penalizing marriage with the tax code.

Is it possible to legislate this outcome? Probably not. How then are we, as a society, able to deal with this issue and produce an acceptable outcome? Members of society must individually, as parents, take responsibility for the raising of their children. If we are able to find a daycare which will lovingly teach our children the way we would, then we make an individual choice to place them there. The more likely decision is the family unit must make sacrifices. The additional income of one parent may be a casualty of the overriding need to raise our children in a way that we, not the government, deem correct.

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INFORMATION TECHNOLOGY PROFESSIONALS MEET SARBANES-OXLEY

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ABSTRACT

The Sarbanes-Oxley Act of 2002 (SOA) is a law that will affect the lives of top level company officers along with finance and accounting professionals. Top level officers are responsible for the veracity of financial reporting under the SOA. Finance and accounting professionals have traditionally been the corporation's experts regarding financial and operational controls. However, in today's world, information technology (IT) professionals play a key role in designing and maintaining the systems that enforce those controls. This paper examines the challenges that IT professionals will face as they find themselves face-to-face with the provisions of the SOA, a law that could put executives in jail and cause middle managers to lose their jobs.

INTRODUCTION

The Sarbanes-Oxley Act of 2002 (SOA) was passed in the United States (U.S. Code, 2002) in response to a series of significant failures in corporate governance, including Enron (Schwartz, 2001) and the related failure of accounting firm Arthur Andersen (Eichenwald, 2002), HealthSouth (Day, 2003), Tyco (Sorkin, 2002), and WorldCom (Moules & Larsen, 2003). Even Europeans, many of whom were convinced that this rash of management frauds were a result of American's hyper-capitalism mania and could never happen in the refined atmosphere of the continent, found that they were not immune when Parmalat's $15 billion in understated debt and huge overstatements of sales and earnings were exposed.

The SOA imposes a number of reporting and compliance requirements on companies, their managers, and their directors. It also imposes a number of requirements on the systems of internal control used in companies. In this paper, we examine how IT professionals will need to be involved with SOA compliance activities in companies that are subject to the law.

IT REPORTING LEVELS IN THE ORGANIZATION

In many organizations, IT professionals report to a Chief Information Officer (CIO) who reports, in turn, to a Vice President of Finance or Administration. This traditional reporting path places the top IT officer of many companies below the senior decision making level. Companies that do this see IT as a service function and not as a source of competitive advantage (Laudon & Laudon, 2004; Oz, 2004). The senior finance or administration officer often has an accounting background. In many cases, this means that the person to whom the CIO reports knows little about IT issues. An increasing number of companies, including Novell and FedEx, have taken a different tack. These companies have placed responsibility for IT investments and IT strategy in the hands of their boards of directors (Hoffman, 2004). These companies have realized that there is significant legal risk involved if IT projects are not managed properly because inadequate controls can result from IT project failures (Hardesty, 2004). An understanding of internal control demands an understanding of the underlying accounting and administrative systems of the company (Hall, 2004). As every business of any size has computerized its accounting and administrative systems, the people who know these systems well and who understand their design are increasingly members of the ranks of IT professionals. IT professionals, both inside the company and in consulting firms outside the company, can provide valuable services to the company as it attempts to comply with the internal control standards set by the SOA.

DOCUMENTATION OF CONTROLS

The Sarbanes-Oxley compliance deadlines that most large companies will face in 2004 and 2005 for the first time include a major challenge. Section 404 of the SOA requires that companies subject to the law document their internal controls, including internal IT controls. However the SOA is unclear about which controls need to be documented and how the documentation should be accomplished.

The control documentation must include a risk assessment process and must result in the documentation of controls. Company internal IT auditors have been doing this type of work, documenting and testing general and application controls over software, for years (Gelinas & Sutton, 2002; Hall, 2004). Audit firms have begun to explore ways to monitor their clients' IT risk assessment procedures and assess the information systems audit work that is done by clients' internal IT audit staff. Hoffman (2004a) notes that the Public Company Accounting Oversight Board (PCAOB) has not told companies to use any specific method or approach when documenting IT controls. A number of options exist (such as COBIT, COSO or ISO 17799), which makes it difficult for the audit firms to provide advice to their clients about which controls need to be documented (Hoffman, 2004b).

SAS 70 REPORTS

Suppliers of IT services, such as software vendors, system integrators, and system design and implementation consultants, provide their customers with annual reports, called SAS 70 reports (so named after the Statement on Auditing Standards Number 70, which established internal control guidelines many years ago). These SAS 70 reports describe the accounting and operational controls that exist in the systems they sell or have designed and installed. Not all vendors and consultants produce these reports and many SAS 70 reports do not include enough detail to satisfy SOA requirements. In some cases, the SAS 70 reports are sent too late to be included in the annual audit work and financial statement preparation. Some companies who have outsourced their software development work to offshore contractors are now finding that their contractor has no IT testing or revision controls. To the extent that these contractors create financial or key information systems for companies, they could put the outsourcing company at risk with respect to SOA compliance (Hoffman, 2004a).

SPECIFIC IT RISKS UNDER SOA

Although SOA is, at its base, legislation designed to control financial activities, the main way it accomplishes this goal is to require companies to produce better financial reports. Oversight of internal controls has long been seen as a good way to do this (Romney & Steinbart, 2002; Winters, 1994). SOA's focus on internal controls does appear, however, to go beyond the policy reviews, procedures and external financial audits that companies have relied on in the past. The SOA gives the Securities and Exchange Commission (SEC) the responsibility for defining exact compliance regulations for internal control sufficiency, but it is virtually certain that IT controls will be included in the list (Kubilus, 2003). To date, IT professionals have been standing by as CEOs, CFOs, lawyers and company auditors identify and deal with SOA compliance issues. CIOs will soon need to enter the fray and bring IT controls into the picture.

One classic risk area is in the failure to adequately segregate duties. In IT, separation of program development, testing, and implementation can be critical. Many IT organizations are unaware of the importance of segregation of duties as a control concept. Developing a process for identifying segregation of duties controls and evaluating them is something that IT professionals can do as well as internal audit staff. Many times, companies have systems that were constructed internally without adequate controls. When these systems are used for financial information processing, they become potential sources of SOA violations. Even companies that purchase packaged applications can be vulnerable. When the purchased software is modified, built-in controls can be neutralized or eliminated in the customization process. Very few organizations have procedures in place that provide for an automatic review of controls in modified systems.

The costs of failed IT projects are legendary (Wallace & Keil, 2004). A leading cause of IT project failure is poor project management. Thus, project management methods and systems become key elements in a good system of internal control. IT professionals must develop processes that monitor the selection and implementation of systems that affect the financial processing or reporting of the company. If they fail to do so, they subject the company to SOA sanctions.

IT also can be deeply involved in records management (Kubilus, 2003). Whether it is maintaining copies of current e-mail messages and instant messaging files, or retention of backup information regarding old transactions that might have been fraudulent. The IT professional is often in a position to enforce controls that have a bearing on SOA-related concerns. Lanza (2004) notes that two of the most important elements of any SOA compliance program is the proper use of data analysis tools and data mining software. Data analysis functions include the use of query tools that allow users to ask questions of the enterprise-wide information system (Gelinas, 2002). In large organizations such as those subject to SOA, this system will, in most cases, have been designed and implemented by the company's IT staff. It will definitely be maintained by IT staff. The people who know the most about the enterprise-wide information system will always be IT professionals. Many companies have undertaken major knowledge management initiatives in recent years (Angus, 2003; Awad and Ghaziri, 2003). These initiatives have, in most cases, been designed and implemented by IT professionals. As SOA requirements become part of the fabric of large companies, they will be included as part of these companies' knowledge management systems (Lanza, 2004).

AN IT ACTION PLAN

IT industry analysts such as Johnson (2003) recommend a series of steps that IT professionals should include in an SOA compliance action plan. First, they recommend that IT professionals do some research. IT professionals are not accountants and they are not auditors. They do not know about basic control concepts such as segregation of duties. They seldom understand the significant differences between financial systems and other company IT systems.

The second step is to do some benchmarking. Find out what other IT professionals are doing to comply with SOA. In many companies, CIOs are sitting on the sidelines while the accountants and lawyers scramble to meet the challenges of the SOA (Hoffman, 2004b). IT is an integral part of the control landscape in any company. The CIO and senior IT managers must be proactive in pushing the importance of IT processes and the risks inherent in ignoring IT controls.

Step three is to become familiar with software vendor and consultant offerings. Some software vendors are offering upgrades that include documented controls. Some of these products are even keyed to specific SOA elements. Vendors of software reporting tools, supply chain management tools, and document management systems are also working to offer systems that can help with internal control documentation.

Step four is analyze ongoing IT projects for control weaknesses and failure risks. If the software project has any financial implications, the risk of failure of the system implementation effort can be a control weakness in itself, under SOA.

CONCLUSION

IT professionals have been left out of the scramble to comply with SOA provisions. As the deadlines for compliance approach, more and more companies will find that they need to turn to their IT professionals to document controls, and to develop processes that will allow them to identify and evaluate controls. Proactive CIOs and senior IT managers can help their companies by taking the initiative and moving forward with an action plan that will help them be ready when the other members of the management team wake up and realize the important resource they have in the IT function.

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THE STARS OF MORNINGSTAR: WHY THEY MAY NOT SHINE VERY BRIGHT

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ABSTRACT

Morningstar star ratings are a well known third party provider of information on mutual funds used by fund companies, advisors and investors. The star ratings oversimplify a complex choice by seizing on an individual's limited ability to process information (Simon, 1957) and a need to reduce complexity (Kahneman, 2000). Rating methodologies may contain ambiguities that discount the value of the ratings, and at a minimum argue for the use of more than one method to select investments. Regulators would benefit from understanding the problems that have been identified with Morningstar. More importantly, regulators should understand how investors make choices and how Morningstar may influence those choices. The powerful image created by Morningstar star ratings may contribute to a degradation in the quality of investor choice. Morningstar simplifies the investors search for information and reduces complicated quantitative performance data to simple images and symbols. The fund companies use Morningstar's rating system extensively in their advertising and this further reinforces the simplification of a complex choice.

INTRODUCTION

Extensive rules have evolved to protect buyers from the unscrupulous, and product disclosures are a mainstay of those rules. Kirsh (2002) asks a simple question: "does disclosure appear to work?" More specifically, does disclosure help consumers understand enough about the product to make reasonably informed choices? Equity products are inherently more complex and risky than many types of products, and the sources of information investors use to make investment decisions are of critical importance.

Regulations that stipulate what, when and how investment firms can communicate with the public are voluminous, and oversight is shared among several federal agencies, self-regulatory organizations (SRO) and the fifty states. The number and types of investment alternatives have exploded and the number of mutual funds exceeds 12,000. Comparative rating agencies have evolved to simplify the decisions making process for the consumer and these rating services describe themselves as the "trusted source" whose mission is to "help investors make better decisions." Of these agencies Morningstar is the best well known and acts as a pseudo consumer advocate when they tout their "independent expert view." Does Morningstar help consumers understand enough about the product to make reasonably informed choices, or do they oversimplify a complex choice by limiting the information upon which consumers will base their investment choices?

It is important to recognize that the capacity of disclosure to actually achieve transparency, foster product knowledge and facilitate comparison-shopping has typically been assumed as a matter of common sense (Kirsch, 2002). The National Association of Securities Dealers (NASD) the primary SRO dedicated to overseeing mutual fund companies have queried their membership as to whether they should continue to prohibit the use of bond mutual fund risk ratings by their members. They where specifically concerned that "some ratings represent their opinions by a word, symbol or number that attempts to be a single, all encompassing measure of a fund risk." Morningstar star ratings are arguably the most well known third party provider of information on mutual funds used by fund companies, advisors and investors. The star ratings oversimplify a complex and profound choice by capitalizing on an individual's limited ability to process information (Simon, 1957) and a need to reduce complexity (Kahneman, 2000).

The simplicity of the star ratings obviates product disclosures and act as buying heuristic. The stars become the primary proxy for choice, and while Morningstar indicates that the ratings are historical tools and do not predict the future the powerful image they create overshadows their warning. Vinod and Morey (2002) indicate that while the cautionary advice offered by Morningstar is sound, many people still use the ratings as a predictor of future investment performance. Jacoby, Chestnut and Fisher (1978) in a behavioral process approach to information acquisition found that people acquired a mean proportion of 2% of the available information and that information search concentrated on 6 of the 35 available information dimensions. Studies also demonstrate that consumers acquire less information when brand names are present (Jacoby, Chestnut & Fisher 1977; Van Raajj 1977). Morningstar is arguably better known as a brand than many of the fund companies themselves.

Hutchinson and Alba (1991) report that consumer learning of even simple relationships may frequently fail. Consumer learning is of critical importance because consumers must learn what attributes are important and other variables that differentiate products from one another. The more information attributes a product possess the more likely choice complexity and beliefs are formed based on irrelevant information. Hutchinson and Alba (1991) assert that from a public policy perspective consumers are considerably at risk. A distinction must be made between the availability and the processability of information (Kuusela and Spence, 1998). Processability refers to the ease with which information can be assimilated and used, and is therefore affected by how it is presented. The powerful image created by Morningstar ratings may contribute to a degradation of the quality of investor choice.

Morningstar simplifies the investors search for information and reduces complicated quantitative performance data to simple images and symbols. The fund companies use Morningstar's rating system extensively in their advertising and this reinforces the simplification of a complex choice. The star system allows consumer to frame investment questions more readily, weigh their choices systematically and anchor their performance expectations consistently. Although, research demonstrates that the same information presented in different formats can result in different decisions (Bettman, 1986). Complicate arise when fund companies compete for investor funds through advertising that skews the framing of choice, redistributes weights assigned to choice, and undermines performance anchors.

Numerous barriers to achieving the goal of fairness and transparency with disclosure exist. These barriers include framing bias, anchoring bias, cognitive bias relating to personal selling, availability bias and the representative bias. Morningstar enables these biases to function more extensively and effectively, becoming a heuristic, or bias in and of itself. It is critical to fully explore the impact of Morningstar on investor choice because the number of households that own equities has swelled from twenty to sixty percent in the past ten years. Even individuals who have a greater knowledge of risk and investment did not use their skill to align their personal investment strategies with their risk preferences (Dulebohn, 2001). If people with experience fail to capitalize on their knowledge those with limited knowledge are at greater risk of failing to align their investment choices with their risk preferences.

The literature on Morningstar is reviewed and those problems that have been identified with their methodology are highlighted to underscore the importance of looking at multiple measures prior to choice. Then issues that have been identified with mutual fund advertising are explained and how they degrade choice is discussed. Each bias that acts as a barrier to achieving fairness and transparency is explained and how each combines with Morningstar is explored. It has been demonstrated that people respond to precisely equivalent messages depending upon whether they are posed (framed) as risks or gains. Kirsch (2002) describes anchoring as a mental shortcut people use to make estimates under conditions of uncertainty. Cognitive bias relating to personal selling reveals that most consumers tend to rely heavily on producer representations and recommendations (Hall, 2000). The availability bias causes people to ignore statistical data in favor of evidence that is vivid or easily available to them (Hanson and Kysar, 1999). The representative bias describes the tendency of people to judge the likelihood of some event in relation to its similarity to some other event. The literature on Morningstar and behavioral decision theory is bridged to demonstrate that star rating can act as a heuristic and degrade the quality of investor choice.

NOISE

The ability of investors to process information is limited (Simon, 1957). Investment decisions are inherently complex and involve the evaluation of risk and return. Complicating the investment decision is the dazzling array of choices, and the complexity of the quantitative methods used to evaluate those choices. The scope of choice and the complexity of risk/return measures overwhelm investors who, in response generally seek to simplify choice and reduce measurement methods to a level of analysis they understand. The fact that investors can only process so much information at a given time means that they need a set of criteria to weigh alternatives that are easy to understand, use, and provide adequate results.

The most abundant type of information about investment alternatives and choice is what Black (1993) referred to as noise. Noise is any information that people perceive to be true, but is largely opinions and uninformed advice. Although there is usually some objective truth in noise, finding it is like finding fresh water in the middle of the Atlantic Ocean. Black (1993) observes that, "in the way we observe the world, noise is what makes our observation imperfect. It keeps us from knowing the expected returns on a stock or portfolio. It keeps us from knowing, what if anything, we can do to make it better" (p. 3). Since noise is a feature of the information landscape that cannot be ignored, it is important to regulators and investors in the complicated and dynamic financial markets.

The way information is collected, processed and analyzed by individual investors will determine their beliefs about investment alternatives, and ultimately their investment choices. Black and Varian (1993 & 1985) indicate that "differences in belief must derive ultimately from differences in information." Noise influences the selection process for investors or shapes perceptions about the different types of investments. Noise affects investors and advisors by contributing to the way they frame choice, weigh the importance of the choices in the choice set and influence the factors that anchor their expectations. As Black has observed "there is so much noise in the world, people adopt rules of thumb. They share their rules of thumb with each other, and very few people have enough experience with interpreting noisy evidence to see that the rules are too simple. (p. 11)" Rules of thumb, alternatively referred to as heuristics, are inherently affected by or consist of noise.

NOISE AND MORNINGSTAR'S CONTRIBUTIONS

In the paper, *When Fund Picks are Short on Stars* (5/7/03), Emily Hall, an analyst with Morningstar remarked, "the star rating is a historical tool. It indicates how a fund has done in the past, but it is not a predictor of the future." Sound advice offered within the body of a larger explanation of how a fund with only three stars could be a recommended fund by the Morningstar analyst. Investors base their judgment on the stars, and fail to differentiate the extensive criteria available to assist with the selection of funds. Schwartz (1998) observed that most people make decisions using rough and ready comparisons and this behavior persists even when the benefits of additional information are painfully obvious. Investors refer to the past for an indication of the future. The stars may not be a predictor of the future, but it is naïve to believe that they are not used to predict the future. Potential investors only care about prior performance to the extent that the fund will continue to have substantially the same or better performance in the future.

If investors rely on ratings to predict future performance – to what extent do Morningstar ratings predict mutual fund performance? Blake and Morey (2000) studied the predictive value of Morningstar as compared against alternate predictors: a naïve predictor of in-sample historical average monthly returns, one and four index in sample alphas, and in-sample Sharpe ratios. Blake and Morey (2000) found that Morningstar ratings are predictive of low performing funds. Funds with one and two stars generally perform much worse than other funds in their group. They report that there is only weak statistical evidence to suggest that five star funds out perform three and four star funds. These findings were robust over different samples, ages, loads and styles. Blake and Morey (2000) recommend that other approaches to developing predictors may be more useful, and that investors should not confuse highly rated funds with highly performing funds.

The star ratings are a quantitative measure based on a funds risk adjusted returns relative to its peers. What constitutes risk adjusted returns and peers are important distinctions advisors and investors should understand when using the star ratings either retrospectively, or prospectively.

Morningstar groups funds into four broad categories: Domestic Equity, International Equity, Municipal Bond and Taxable Bond. Rankings are ultimately based on three, five and ten year historical averages weighted for the life of the fund, but a large number of funds are new and consequently cannot produce data that would make for a more meaningful comparison. Vinod and Morey (2002) have found that Morningstar creates uncertainty because they fail to discriminate fund age in the development of fund rankings. They have found that investors should be less confident about the risk between similarly rated funds with different ages. New funds have significantly more estimation risk than more seasoned funds (Vinod & Morey, 2002).

The methods used to calculate the star system are applied to a pool of funds that have broad differences. Fund to fund, one of the main differences is fund age, with the majority of funds having been created in the past ten years. Vinod and Morey (2002) demonstrated that age differences are important. Morey (2002) has found that the average overall star rating for an older fund are consistently higher, and may be significantly higher than newer funds. This anomaly is a result of the methodology Morningstar uses to calculate the ratings. This finding indicates that investors can be less confident about their investment choices. The studies indicate that new funds make ratings that are artificially inflated because of estimation risk, and older funds may have persistently high ratings because of the method Morningstar uses to calculate ratings. Morey (2002) indicates that fund flows are higher for funds with higher ratings and this demonstrates that ratings matter. Morey (2002) and Vinod and Morey (2002) aptly illustrate that the ratings contribute to the noise and complicate choice.

FRAMING OF CHOICE

People make decisions all the time, both knowingly and unknowingly. The framing of choice refers to the nature of the question a person poses to himself or herself. For example, there is a vast difference between telling a woman she looks like the first day of spring versus telling her she looks like the last day of a long hard winter. Same day, but each will generate an entirely different response. Deciding is predicated on choice – making a selection from among several alternatives. The risk associated with making a particular decision depends on the level of uncertainty associated with the several outcomes that can be selected. The risk is built into the question that the individual frames to evaluate a particular option from the choice set. The individual will evaluate the choice within the context of the knowledge they possess, are able to acquire prior to deciding, or they infer from past experience. The quality of the outcome will be determined by the quality of the questions the individual asks himself or herself during the process of deciding. Research indicates that our selections [choices] often help determine our preferences, and many choices are made with great difficulty, or without strong conviction, but the act of selecting shapes preferences dynamically (Schwartz, 1998).

Investment decisions are decidedly complex and can have far reaching implications for the individual investor. Investment decisions are complex because they involve long time horizons, uncertainty about economic and political events, uncertainty about the stability of individual earnings potential and a myriad of other factors that increase the complexity of choice. Since individuals are only able to process a finite amount of information they rely on heuristics to simplify the process of deciding (Kahneman & Tversky, 2000). The use of heuristics results in many good decisions, and avoids the chaos that decision making would promote in their absence. The use of heuristics also results in many poor choices – particularly when the individual lacks previous experience that would enhance the quality of heuristics used.

Individuals frame questions to themselves based on heuristics that have been helpful in guiding choice in the past. The framing of choice is modified as an individual acquires additional information; regrettably the majority of information is noise (Kahneman & Tversky, 2000). The same option can be framed in several different ways and the final question results from a process of formulation. Formulations help individuals determine the utility [usefulness] and value of each option within a choice set. Each option in the choice set is evaluated along two dimensions: experience value and decision value. Experience value refers to the degree of pleasure or pain, joy or sadness associated with the actual experience of an outcome. Decision value refers to the contribution the anticipated outcome will have on the overall attractiveness or aversiveness of an option (Kahneman & Tversky, 2000). Decisions that rate high on joy and attractiveness are more likely to be selected, and those that are sad and aversive will be avoided.

Economists and decision theorists speculate that individuals make optimal choices. However, to make an optimal choice, one would need to be able to evaluate all possible options within a given set of choices. Since the making of investment decisions is an ongoing and dynamic process, it is unrealistic to expect an individual with only a limited ability to process information to evaluate all available options (Kahneman, 2000; Kahneman & Tversky, 2000; and Thaler, 1993). The individual will most likely simplify the process of deciding with heuristics, on which he or she will frame the questions about decisions they have to make. The quality of these questions will determine the quality of the financial outcomes they realize. The old adage is true, "if you want a better answer, ask a better question."

WEIGHTS AND CHOICE

The evaluation of options involves an analysis of the probability of each outcome in a choice set. Decision weights are inferred from choices between potential outcomes, but decision weights are not probabilities. Decision weights measure the impact of events on the desirability of outcomes, not the probability of an outcome (Kahneman & Tversky, 2000). They reflect what we want to come true not what is most likely to come true. Decision weights have broad implications for choice, because they will bias choice toward what we want, not what we will most likely get.

To illustrate, football players decide who will receive the ball based on the toss of a fair coin. The chances of heads or tails are equal, or the probability of outcome is the same whether the athlete chooses heads or tails. If outcomes are equal then choice is irrelevant, except choice is very relevant to the athlete. The athlete believes that the choice matters and carefully selects heads or tails. No matter the outcome of the toss the player has a fifty percent chance of winning the toss. The player selects based on what they believe, not on what is probable. Each toss they win will serve to reinforce their belief that selecting heads over tails, or vice versa matters.

The quality of choice is tempered by what the individual wants, or believes because this drives their desire. Noise also affects the value assigned by the individual to a given choice, because noise helps determine what we believe. For example, Bob is talking to his neighbor Mary, who explains that she recently made a handsome return on an investment in the XYZ Mutual Fund family. Bob, who has been thinking about investing, invests in the XYZ Mutual Fund family as well. The problem is that Mary invested in the small cap fund that participated in three "hot" IPOs while Bob invests his money in the international fund heavily invested in Asia. Bob's investment will not result in the same return as Mary, which means he will not be happy with his investment return because current health concerns are dampening markets. Bob invested based on what he believed would happen, which was based on noise. Decision weights are a function of desire, not probability.

ANCHORS AND CHOICE

Anchoring involves the process whereby an individual has to develop a judgment or an attitude by producing a number. The result will be strongly biased toward any value, even if it is arbitrary, that the respondent is induced to consider as a candidate answer (Kahneman, Ritov & Schkade, 2000). Anchoring presents particular problems for individual investors because they may anchor their choices with irrelevant numbers. Anchors can develop from any source, but most sources are imbued with noise. Noise leads to incorrect or inflated expectations that are difficult to reconcile with reality.

To illustrate the problems associated with anchoring, assume Bob is talking to Barbara, who explains that she just invested in the ABC Bond Fund and it has returned more than ten percent per year for the past five years. Bob knows that bonds are safe and would like to make an investment, but is disappointed to learn that ABC can only be purchased through a broker. Since he buys only no-load funds, he sets out in search of a bond fund that will provide similar returns. Bob is disappointed by his search, however, because he can only find funds that have returned seven percent. Bob neglected to determine the type of bond fund Barbara's invested in, which was a junk bond fund, nonetheless, Bob anchored his expectations with Barbara's investment performance.

The performance of the bull market is still fresh in the minds of many investors who are hoping that the days of double-digit returns will come back. It is not certain if those types of returns will ever return, but basing expectation on double-digit returns can lead to negative consequences. Investor beliefs are usually mired in the past, but those beliefs form the anchor, or basis by which investors will make decisions.

SYMBOLS IN ADVERTISING

The star system employed by Morningstar to rate mutual funds capitalizes on a powerful and well-known symbol system. Star ratings are used extensively to rate restaurants and hotels, and these ratings inform the public about what they can, and should expect from these businesses. Everyone knows the difference between a "five star dinner" and a "one star dinner," and the difference between a five-star and a one-star hotel. Morningstar ratings are signs [symbols] that have two components: signifiers and signifieds. Signifiers are sensory representations used by advertisers to convey meaning, and the star is representative of quality. Signifieds are what the signifier stands for or implies and advertisers use them to imply meaning. The star is representative of quality and five stars represent the finest quality (Domzal & Jerome, 1992). Advertisers use symbols and images to encourage the audience to suspend its sense of reality so that connections between problems and solutions can be highlighted.

The value and effectiveness of a specific symbol requires a subjective evaluation. McDougall, de Bruijn and Curry (2000) explored the effects of icon (symbols) characteristics on user performance. They assert that icons are better at communicating ideas than words because they can transcend language barriers and present meaning in a condensed form. Most novice investors do not understand the language of finance and have difficulty interpreting financial statements, earnings reports and other financial data. The requirement that fund companies issue "plain English" documents illustrates the difficulty investors have navigating the range and complexity of choice. Several attributes have been identified that make some icons better than others at conveying meaning and transcending language barriers.

Icons have been evaluated for effectiveness and three characteristics that make icons effective have been identified: concreteness and complexity, distinctiveness and task demands. Concreteness and complexity refers to the extent the icon depicts things with which people are already familiar: people, places, or things. Star ratings are well established in our society and are not complex. Distinctiveness enables the icon to visually separate itself from other material presented simultaneously. The stars are distinct and enable the investor to focus in on that aspect of an advertisement that is critical and determinative of choice. The stars give consumers the ability to compare funds easily, and in that respect are excellent for the task demands they were created to solve.

Symbol selection is a careful process because different symbols convey different meaning to diverse groups of individuals. Goodsell (1977) has categorized symbols as authority symbols and services symbols. Authority symbols are used to convey to the consumer the professional legitimacy of the provider. They reduce the perceived risk and increase the perception of the expertise of the provider. On the other hand, service symbols are designed to attract the consumer to the organization. Typically these ads depict the consumer and services provider interacting and are symbolic of the type of service that the consumer should expect. The use of star symbols enables the mutual fund companies to take advantage of both authority and service symbols. "Five star" ratings imply an unparalleled experience and only the finest organizations are capable of achieving "five star" status.

Mutual fund companies are different from companies that sell tangibles. There is a difference between advertising services from other products. A consumer can touch and smell a new car, but it is very difficult to wrap your arms around a mutual fund. The products are abstract and advertisers rely on concrete cues and symbols as testimony to what the service company can provide (Cobb-Walgren & Mohr, 1998). It is estimated that seventy-five percent of the information that people take in through their senses is visual (Hanson, 1987). Companies that offer intangibles are challenged to make their products tangible.

Investments are complex intangibles and the methods of evaluating risk and return are inaccessible to many investors. Investors who lack financial expertise are more subject to the effects of noise in the marketplace. The star rating system enables investors to easily compare funds within a context they readily understand. As symbols, the stars are concrete and simple, very distinctive and provide an easy basis for investors to understand one fund from another. The stars also convey legitimacy (authority) and understanding (service). More importantly, the stars facilitate choice and enable consumers to reduce the volume of information they have to process to make satisfactory choices.

The star system has several distinct advantages, but the star system does not help the consumer understand the real complexity that underlies their choices. The star system does not address diversification or the level of risk. Additionally, the ratings may encourage investors to compare any fund to any fund based on the stars, and not on the basis of asset class. This behavior can lead to extremely poor choices. Morey and Vinod (2001) indicate that even though Morningstar cautions against using their ratings to predict future performance the reality is that many people do use the system to predict future performance. They also indicate that in many ads the only performance information offered is the stars.

MUTUAL FUND ADVERTISING

NASD Conduct Rule 2210 – 3 specifies that all advertisements that include rankings must disclose that past performance is no guarantee of future performance, and if the ranking is a symbol the ad must also disclose the meaning of the symbol. Symbols are powerful tools used by fund companies to attract funds, and the star ranking system is an effective symbol that allows the investor to suspend judgment in favor of heuristics. Jordan and Kass (2002) evaluated the role of judgmental heuristics in private investors' evaluations of risk and return and how mutual fund advertising contributes to poor choice. They claim "investment decisions are characterized by high exogenous uncertainty, as future product performance must be estimated from a set of noisy and vague variables" (p. 130). Investor purchase decisions are grounded in two criteria: perceived investment risk and expected return. Jordan and Kass found that investor perceptions of risk are driven based on emotions, not on abstract financial analysis. Investors forego formal statistical analysis in favor of judgmental heuristics. They find that the extent to which advertising evokes the use of judgmental heuristics, advertising will be effective at influencing investor risk-return perceptions. The star ratings promote the use of heuristics.

Further confounding the difficulty in making investment decisions are what Hersh Shefrin calls obfuscation games. Mutual fund companies attempt to make investors' decisions opaque through their advertising. Shefrin identifies seven games that fund companies play: incubator fund game, hiding the losers, opaque fees, benchmarking, masking the risk and coming out with all guns blazing. In the incubator game a fund company starts a number of closed funds and incubates them. Over a period of time some incubator funds will have success and the fund will be opened to the public. It is a game because people will consider the success skill, not luck. Investors were not aware that many incubator funds are started and fail, some magnificently.

In the hide the losers game a fund company will take a poorly performing fund and merge them into another fund. Opaque fees refer to the manner that fees are presented: performance is stated in dollar terms and fees are expressed as percentages. The fees appear small on a relative basis, but if they were presented in dollar terms they would evoke a different meaning and would be judged more critically according to Shefrin. The benchmark game takes advantage of the fact that investor do not understand diversification very well. Shefrin states that investors "misinterpret variety for diversification, and pick many different kinds of funds as a result. (p. 172)" Fund companies offer many styles and this takes advantage of investor behavior patterns by confusing variety for diversification.

The scope of permissible investing activity is detailed in the prospectus, but an adequate understanding of the range of choices available to fund managers is beyond the grasp of most investors. Managers are able to vary the risk over the course of the year, which increases the exposure to risk beyond investor expectations. The real risk that investors are exposed to is masked by their limited understanding of complex financial maneuvers. The final game is the come out with all guns blazing and it is usually done with managers of new funds. The fund company puts on the media blitz to try and portray the fund as “hot” when in fact it may just be hot potato. Shefrin observes that bias leaves most investors vulnerable to the games played by mutual fund companies.

The point of advertising from the perspective of the fund company is raising more assets, and the companies are going to use those methods permitted by law and prevailing ethics to achieve that end. Advertisers are well aware that consumers favor emotion to reason and Morningstar ratings assist fund companies in raising assets. Funds with high ratings experience greater funds flow (Barber& Odean, 2002). The extent to which the ratings depict the real level of risk is of critical importance to investors. Mutual fund advertising adds to the noise and confounds choice.

DISCUSSION

Sharpe (1998) finds that the key information an investor needs to evaluate a mutual fund are: an assessment of how the fund will be affected by future movement in asset classes, likely return above some benchmark with similar risk exposure, and the risk vis-à-vis the benchmark. These recommendations apply to each asset class within a well-balanced portfolio, and investors would generally find the task of finding and maintaining this type of data onerous. The value of an advisor is helping the client cut through the noise, and frame choice within bounds that are consistent with their tolerance for risk and long term objective, properly weight each asset class against sound benchmarks, and anchor their expectations in objective and achievable rates of return.

People have a limited ability to process information and rely on heuristics to simplify choice. Morningstar facilitates, and may even contribute to investors oversimplifying investment choices because they make selections based on stars, not the criteria established by Sharpe. We believe what we want to believe and seek out information that confirms our choices. Even thought fund companies are required to disclosure that “past performance does not indicate future results” investors look to the past for an indication of the future. Morningstar reports what happened, not what will happen, and as Blake and Morey (2000) admonish, investors should not confuse highly rated funds with highly performing funds.

Bernstein (1998) has remarked that our ability to predict the future, to gain some mastery of risk is what drives modern market economies. Too add to Bernstein, we have mastered methods of quantifying risk, but we have not mastered risk. What comes will may, and most investors are unfamiliar with the complex methods that modern finance has available to estimate the risk of a particular investment. We have the stars, but investors should be reminded that the stars may appear bright they are millions of miles away. A five star fund may be a beacon, a bright oasis amidst the uncertainty, but like the stars in the sky their predictive ability may be millions of miles away.

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ETHICS IN ADVERTISING: SEX SELLS, BUT SHOULD IT?

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ABSTRACT

The purpose of this paper is to discuss whether or not it is ethical to use sexual appeals in advertising. The study also examines (1) if sex actually sells and if so, when and where is it being used in advertising, (2) the use of men and women in ads of a sexual nature, and (3) the role that ethics plays in the use of sexual appeals in advertising. It is important because it not only focuses on the use of sexual appeals in advertising, but also how ethical it is to do so.

The study found that sexual appeals are used often in advertising. Sex does catch people's attention in advertisements, but usually without much brand recognition. Women have been the primary focus in sexual advertising in the past and present, but men are starting to be used more often as the sex object in advertisements. Ethics plays a definite role. There is no clear view of what is ethical and what is unethical when it comes to advertising, but with careful consideration and planning, it is possible for advertisers to find a common ground and use sexual appeals without offending people in the process.

INTRODUCTION

As stated by Richmond and Hartman (1982), "Every media consumer is alert to 'sex in advertising.' Its pervasive use and misuse are constantly before us, and typically elicit strong criticism" (p.53). As one can see, the use of sex in advertising has been happening for several decades and the reason for it? – It works. Advertisements that are sexy in nature tend to be remembered more often than advertisements that are not. The question to ask, though, is how ethical is it to use sexual appeals in advertisements? This research paper will discuss whether or not sex sells, when and where sexual appeals are used in advertising, who is the primary focus in the ads, and the ethical dilemma of using sexual appeals in advertising.

The purpose of this study is to discuss whether or not it is ethical to use sexual appeals in advertising? The study also examines (1) if sex actually sells and if so, when and where is it being used in advertising, (2) the use of men and women in ads of a sexual nature, and (3) the role that ethics play in the use of sexual appeals in advertising.

This study is important to its readers because it not only focuses on the use of sexual appeals in advertising but it also looks at how ethical it is to do so. Advertising draws people in and coaxes them into buying things based on how the ads make them feel. It is not always fair to assume that everyone knows what the advertisers are doing.

DOES SEX SELL?

"Does sex sell?" Actually, sex does not sell, but sexiness does (Cebrzynski, 2000, p. 14). Using sex appeals in advertising is a good way to target certain market segments but not all. What is identified as sexual appeals in advertising? Where and when should sex be used in advertising? Does the use of sexual appeals lead to an advantage for brand remembrance? These questions will be the next topics of discussion for this paper.

The use of sexual appeals in advertising has been happening for decades. Sex is everywhere. There are several different distinctions as to what is being categorized as sex appeal. A study conducted by Ramirez and Reichert (2000) revealed four characteristics of sexy ads: (1) physical features of models, (2) behavior/movement, (3) intimacy between models, and (4) contextual features such as camera effects (p.267).

Ramirez and Reichert (2000) sought to find what people consider sexy in advertising. The most common referent was physical features (66%), followed by a model's movements and verbal and nonverbal communication (39%), contextual features (26%), and proxemics (15%) (p.269). They made an important note that what people referred to as sexy differed gender to gender. The study showed that females responded more to context than males did at 35% to 20%. It also showed that 28% of the females responded to proxemics or references to physical distance or relative interaction between models compared to 6% of the males (p.269).

WHEN AND WHERE SHOULD SEX BE USED IN ADVERTISING?

This section will discuss the usefulness of sexual appeals in advertising, but not from the ethical stand point. Sexual appeals only work in some advertisements. Many studies have been conducted regarding this subject.

Jones, Stanaland, and Gelb (1998) conducted an experiment to see how men and women responded to beefcake and cheesecake ads. A beefcake ad is an ad that has a sexy male model as the center of the ad. A cheesecake ad is an ad that has a sexy female model as the center of the ad. The study found that women had higher recognition scores for the ad showing a nonsexy male model than for the beefcake ad, and men had higher recall scores for the ad showing a nonsexy female than for the cheesecake ad. The study also found that women had lower recognition scores than men for the beefcake ad, and women viewing the cheesecake ad had higher recognition scores than women viewing the beefcake ad. Also, men had lower recall than women for the cheesecake ad. They concluded their study with the statement, "The nonsexy ads seemed to do the most good with the least harm" (p.36).

It is important to evaluate the audience who will be viewing the ads before invoking a sexual appeal into the ad. A recent study conducted by Whipple and McManamon (2002) found that there is not an industry-wide conspiracy that advertisers use men as voiceovers in ads. Rather, individual advertisers and agencies make decisions about specific products and ad executions. For instance, a spokesperson and an announcer's sex can affect advertising evaluations for a gender-specific product but not for non- gender imaged products (p.87).

"Advertising research reveals that sexual appeals are attention getting, arousing, affect inducing, and memorable" (Reichert, Heckler, and Jackson, 2001, p. 14). But, although studies have demonstrated that sexual appeals attract attention to the ad, they do so typically without a corresponding advantage for brand information processing. Although using sexual appeals in brand advertisements has not proven to be as effective as needed, using them in social marketing may be beneficial. "From a social marketing perspective, sexual appeals may be beneficial for the simple reason that they are attention-getting and potentially motivating desirable message characteristics in a saturated media environment" (Reichert, Heckler, and Jackson, 2001, p. 18).

The use of overt sexual appeals in print advertising has increased considerably in contemporary advertising practice. According to an article by Henthorne and LaTour (1994), today it is common for a reader of any age to pick up a general-interest consumer magazine and find an advertisement featuring provocatively posed and attired models for many consumer products (p.82). During the past decade, the use of sexual appeals in print advertisement has become commonplace. Among the most memorable companies, which base their advertisement on sexual appeals, is Calvin Klein. Their ads usually feature a nude couple in a somewhat provocative position. Also, many of the print advertisements for Calvin Klein jeans are just as suggestive and memorable (p.82). Ads of this type are designed to elicit what the originators hope is a vicarious experience of sensuality (Henthorne and LaTour, 1994, p. 82).

In the 2000's, the use of sexual appeal in advertising continues to be a very controversial topic. A 1994 study done by Henthorne and LaTour revealed that an ad which contains a strong overt sexual appeal results in a significantly less favorable attitude toward the ad, attitude toward the brand, and purchase intention than an ad that contains little or no sexual appeal (p.90). For example, a very controversial AXE subway ad in Mexico has an arrow pointing up the shiny miniskirt of a woman driving a convertible sports car. Another ad shows a man with his arm around a woman with the arrow pointing down the front of her low-cut shirt. Next to the arrows is the statement: "To get what you want" (Ordonez, 2003, p.48). In this case, strong overt sexual appeal is being used in order to place brand remembrance on AXE. As a result, the brand also has been labeled as a company which is involved in strong overt sexual advertising (Ordonez, 2003, p.48).

Although the use of highly sexual print ads is viewed more negatively, the attitude of women is significantly more negative than that of their male counterpart. As the morals and ethics of society change over time, what is considered appropriate and acceptable by society must also change. Therefore it is necessary to re-evaluate the assumptions on which strategic decisions are based when it comes to print advertising. Advertisers need to look at potential social issues and consequences at stake when considering an advertisement based on sexual appeal.

Ethical issues involving sexual appeal in commercials are more controversial than those involving print advertising due to the high number of viewers that see commercials. Sexual appeals in commercials have many types and consist of a variety of elements. They often involve visual elements such as attractive models, and they may portray varying degrees of nudity and suggestiveness. Although commercials often use visual elements for sexuality, appeals may also include verbal elements and music. A study conducted by Severn, Belch, and Belch (1990) found that the use of sexual advertising appeals detracts from the receivers' processing of message content. The use of sexual appeals in the study seemed to detract from the processing and retention of message arguments. However, it did appear that the recipients would focus their attention more on the execution elements of ads using this type of appeal (p.21). With the use of sexual appeals in commercials being both controversial and productive in remembering a product, there is a fine line that advertisers should follow to keep the controversy to a minimum. According to Gould (1994), advertisers can attempt to accommodate the seemingly conflicting concerns of the public by following four guidelines: (1) targeting commercials as carefully as possible to avoid unnecessary conflict and to minimize the viewing of sexual appeals by people who might be disconcerted by them, (2) heightening their own awareness of the impact of their sexual appeals on the public at large as well as on their target market, (3) testing the effects of their commercials, not only on their target, but also on other members of the public who might see their commercials, and (4) considering the effects of their commercials in prompting individuals, whether in their target or not, to take actions that have negative consequences (p.78). Regardless of the guidelines, it is difficult for both managerial and governmental policy makers to know how to approach this sensitive ethical dilemma because of the variety of ethical and moral standards of today's public. In any market, advertising and promotions are partly an educated guessing game. You are bound to have unexpected hits and disappointing flops. At home or abroad, the old saying almost always proves true: "It pays to advertise" (Zhan, 1999, p.83).

ARE WOMEN THE PRIMARY FOCUS?

For years, many have believed that women are the primary focus of sex appeals used in advertising. This is not necessarily correct. Women seem to be the target most recognized in sexual appeals, but men have been targeted more recently.

Women have often been the targets of sexual advertising because it seems to work in many cases. Sex is a powerful and easy method of getting male attention and making a product desirable. In advertising, it is easy to get a man's attention by using women's bodies and associating getting the women if he buys the product (Taflinger, 1996, p.8). The most well known target of women as sexual appeals has been in beer commercials and advertisements. Usually the ads go something like this: a beautiful woman is sitting at a bar and a man comes up and she does not notice him at all. Then he orders a certain kind of beer and all of the sudden, he is desirable to this woman. They then get caught up in the moment and ultimately the man gets this woman (because of the beer).

Another example of the man getting the hot woman because of a particular product that supposedly makes the man more desirable to the women is the AXE commercial. AXE is a body spray for men. In the commercial, the men who use AXE get beautiful women. In fact, AXE is so effective that if in any way you come in contact with this body spray, you will be instantly wanted. The commercial features an old man getting a young, hot woman because of the "AXE Effect" (2004).

Women are used over and over again in advertising as sex appeals. But, some do not realize that these advertisements are often targeted at women as well. Victoria's Secret is a good example of this. They want women to think that if they buy Victoria's Secret products, they could be like the beautiful, sexy models on their commercials. Obviously these bra and panties are not going to look this good on just anyone. But, at first glance, a woman might think, "Wow, she looks awesome; I should get that outfit so I can look that good too."

Women are not the only focus in sexual appeal advertising. Men play a large role as well. According to Taflinger (1996), "It is rare for advertising to use sex as an appeal for women. Women are often less interested in the sex act itself for its own sake. They are interested in sex for what it can mean in the future. They may enjoy it as much as men, but for them it has far greater significance. Advertising cannot take advantage of a woman's instinctive sexual desire because advertising's job is not to build for the future–it is to sell a product now" (p.6). Here, Taflinger tries to explain that women are not interested in sexual appeals on television. They are interested in sex for their future. Although this seems to be correct in some instances, it is questionable when thinking about all of the ads that target men as the sex selling object.

Some recent ads that target men as sex objects and sexual appeals are Abercrombie & Fitch and Calvin Klein. Abercrombie & Fitch is notorious for using men as sexual objects in their advertising. Many times, it is a large group of men standing around half naked if not completely nude. Although this company is a clothing company, they mainly advertise using naked pictures of their models. This does not make much sense except to assume they are trying to sell sex.

Sex does sell for Abercrombie. But is it to women? Many questions have been asked about the nature of Abercrombie's advertisements. Some speculation has brought up the question: who are they trying to target with these advertisements?

Men are used over and over again in advertising, although it is generally targeted at the younger market. It is targeted at not only women but men also. This generation of women is becoming more open to sexual advertisements and is more apt to be enticed by them. According to a study conducted by Morrison and Sherman (1972), when looking at nudity and sexual arousal together, the majority of the women who rated ads high in nudity also reported being sexually aroused by the ads. This is contrary to traditional views that women are not as sexually aroused by nudity as men are (p.19).

THE ROLE OF ETHICS

Abercrombie, Express, Sony, Calvin Klein: all big companies with big brands who promote to the public in a big way; therefore, they rely heavily on agency expertise to help them do so. Likewise, in the ethical paradigm that is marketing through sex to the public, who should be accountable for the way in which the campaign is conducted?

Clearly, agencies shoulder the majority of the responsibility for the campaigns they deliver. Ensuring compliance with regulatory guidelines often falls to the agency and although the client does hold the ultimate responsibility, they will often follow the agency's lead. As a result, a true partnership needs to be developed in order to ensure a sustainable relationship based on trust and transparency. This is necessary to get the success that is sought after (Gould, 1994, p.76).

How can agencies and their clients establish this desired state of partnership? By seeing what the goal is–sexual appealing, successful campaigns that send sales through the roof and still makes sure negative publicity stays away from the brand.

A helpful path that leads agencies along the route to creating effective and responsible advertising entails five key elements: the brief, time pressures, competition, measures of success, and commercial pressures. The brief is important because a good brief lays the foundation for a good campaign. Second, sufficient time creates the conditions necessary to create a great idea. Third, do what is right for the brand and the target audience regardless of the competition. Fourth, evaluate your measures of success qualitatively as well as quantitatively. Last, respect the relevant codes of practice and do not let commercial pressure affect your campaign. Thoroughly implementing these key elements will help agencies and companies launch a successful campaign. The measure of a great agency is its ability to help the promoter navigate that path and counter balance the pressures it brings (Gould, 1994). Working in partnership with the promoter, the agency can embrace the responsibilities it holds and have fun, while keeping the public safe, warm, and fully protected.

While ethics and the role which it plays in advertising continue to generate a great deal of attention, the role of the educator has become an important factor for advertising. Social changes in the U.S. have further complicated the situation and raised the need for attention to ethical advertising. The use of sex and sexual appeal in advertising is at an all time high (Ramirez and Reichert, 2000, p.267). With this being said, professional educators play a big role in keeping this trend ethical and sexy at the same time. Educators need to firmly imply the positives of ethical advertising and behavior compared to possible downfalls of unethical advertising. Simply put, the philosophy has been that all advertisers must fish in the same pond and when the waters are muddied by unethical advertising, everyone catches less fish. This is a very true philosophical statement that educators can preach to their students. The result has been to exhort ethical behavior because it is good business. A further reason for educators to preach ethical standards has been the clear understanding that such activity can often be used to head off governmental regulation which the industry always feels would be impossibly restrictive (Fraedrich and Ferrell, 1992). As one may know, the foundations and fundamentals of students are what they will rely on when in the workplace; therefore, good fundamentals and practices are a key component for ensuring ethical behaviors during stressful situations.

In short, the role in the development of advertising ethics lies in a proper emphasis of advertising as an institution to assist the students in proper and ethical behavior in the advertising industry. Advertising will continue to have a weak public image until the field of practice is built on a more professional base. With educators encouraging thoughtful attention to problematic aspects of advertising, students will be better mindful of ethical questions and situations. As a result, the students will attain their goal of a "Professional Advertising Education."

To understand more fully the positive and negative effects and ethical dilemmas arising from the use of sexual appeals in advertising, one must consider the fundamental concepts contained in normative ethical theories of moral philosophy (Gould, 1994, p.78). Normative ethical theories can either be classified as teleological or deontological.

Teleological philosophies are defined as philosophies concerned with the moral worth of an individual behavior (Fraedrich & Ferrell, 1992). Teleological philosophies maintain that the individual should examine and determine the probable consequences of alternative actions and behaviors in a specific situation (Henthome & LaTour, 1994, p.82).

Deontological philosophies focus on specific actions or behaviors of the individual without regard to the consequences of the actions. Thus, deontology opposes the principal tenet of teleology (Fraedrich & Ferrell, 1992). Deontology supports the theory that the rightness or wrongness of actions should be judged by the actions themselves instead of the outcomes. It is not realistic to believe that individuals make ethical decisions strictly on the basis of either teleology or deontology. Individuals do not use clearly defined concepts of ethical philosophies in making specific ethical evaluations but a mixing of theses philosophies are used.

With this being known, the expectations of a print ad displaying strong sexual appeal should yield a significantly less favorable attitude toward the ad, the brand, and purchase intention than an ad containing only mild sexual appeal. This expectation is supported by a study conducted by Henthorne and LaTour (1994). It was clear in the study that undesirable reactions and consequences might result from the use of strong overt sexual appeals (p.88). Although risky, sexual appeal is often a creative way to capture the consumer's attention. The point at which sexual appeal may be viewed as unethical and counter productive is what advertisers are concerned with. Sex objectification is very much in the "eyes of the beholder" and, therefore, leaves the object of effective advertising very challenging. As a result, there is no simple solution when it comes to the use of sexual appeal in advertising. The best advice is for advertisers to recognize the ethical complexity of sexual appeal in advertising and incorporate that understanding in their strategic thought. Henthorne and LaTour, (1994) state "As the ethical considerations of society change over time, what is considered appropriate and acceptable in advertising must also change" (p.88). So, it is imperative to continually re-evaluate what society would consider acceptable and consider the full level of consequences of their actions before considering what they perceive as ethically acceptable.

SUMMARY AND CONCLUSION

The study discussed whether it is ethical to use sexual appeals in advertising. The study also examines (1) if sex actually sells, when and where it is being used in advertising, (2) the use of men and women in ads of a sexual nature, and (3) the role that ethics plays in the use of sexual appeals in advertising. This study is important because it not only focuses on the use of sexual appeals in advertising, but it also looks at how ethical it is to do so. Advertisers try to appeal to people's emotions and coerce them into buying things they really do not need.

The following conclusions were drawn from this research:

Q. Sex sells sometimes. After evaluating the characteristics used in ads as sexy, the main characteristic identified was physical features. Sex appeal does not always lead to brand remembrance, but rather using sexual appeals in social marketing, like condom ads, will prove to be a better fit and will work better to send a message. Sex is used everywhere in advertising including print ads, commercials, and on the Internet. Sexual advertisements are mainly targeted at younger groups that have a different, more open view of sex.

R. Answering the question: Are women the primary focus in sexual appeals? – Yes, they are. With the growing open mindedness to sex that the younger females in America are experiencing, men have been targeted more and more. Abercrombie and Fitch uses male models as sex objects in almost every ad. They are even known for targeting the homosexual market. The use of men in advertising is growing and will be highly used in the future.

The role that ethics plays in using sexual appeals in advertising is that there is a fine line between what people think is acceptable and what they think is unacceptable. The main thing to consider is what is the product or service that is being sold and who is the targeted consumer. For example, it would be unethical to put sexual appealing commercials on Nickelodeon.

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