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TAX EXEMPT PROPERTY: ECONOMIC BENEFIT OR COST?

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ABSTRACT

Tax issues have been of concern to citizens for centuries. In the United States, from the "Boston Tea Party" through today, "fair" and "equitable" taxation has been a topic for debate as well as citizen action. Government officials in geographic areas with large amounts of government owned and other tax-exempt properties frequently face complaints of "inequitable" taxation. In many cases tax discussions are based too much on emotion and not enough on actual facts. This study will analyze the costs and benefits associated with state employee low-cost or no-cost housing located on tax exempt property in Walker County, Texas. The results indicate the economy of Walker Coounty, and the integrated major municipality, received a net benefit.

INTRODUCTION

Tax issues have been of concern to citizens for centuries. In the United States, from the "Boston Tea Party" through today, "fair" and "equitable" taxation has ben a topic for debate as well as citizen action. Government officials in geographic areas with large amounts of government owned and other tax-exempt properties frequently face complaints of "inequitable" taxation. In many cases tax discussions are based too much on emotion and not enough on actual facts. If this exempt property would be on the tax rolls, the tax base would be enhanced. But the loss of state jobs could have a greater negative impact on the local economy than the increase in the tax base.

Certain components of the state system lend themselves to cost-benefit evaluations. One such component is the low cost or no cost employee housing that is provided to some employees. This housing will be evaluated in three forms. One form is apartments; the second form is in four state owned mobile homes; and the third form is state owned single family dwellings in Walker County, Texas and the city of Huntsville.

That taxes are unduly high and that this is a result of the tax exempt property in Walker County, which could be alleviated through some state action, is a frequently stated assumption. Little or no factual knowledge is also frequently part of this assumption. An analysis of these properties might allow these citizens to estimate how much some aspects of state entities cost, as well as, indicate what benefits accrue from these state entities.

The only component of exempt property that this paper will address is the employee housing furnished by the Texas Department of Criminal Justice (TDCJ) for a portion of its staff. These individual calculations could then be assimilated to yield a single figure that should be indicative of a total overall cost or benefit to the Walker County area as a whole.

The taxable value of the units if privately owned and the market rent rate of the units were the essential components of the study. There were other issues that also required consideration: the utility costs of this housing and the maintenance and the management costs if privately owned. An estimate of possible sales tax receipts was made assuming the funds not spent on rent were otherwise spent locally.

TAXABLE VALUE

TDCJ employees' housing consists of a variety of types of units. They are typically in the form of duplexes or small apartments, mobile homes and single family dwellings. The taxable value of these units was established by dividing the housing into the categories of apartments, single family homes and mobile homes.

The taxable value of the apartments was established by estimating the average taxable value per unit of similar privately owned apartments. There were two groups of taxable units created: one group was inside and one group was outside the city limits. The comparable units used in this study ranged in age from some of the oldest units in town to some of the newest, as well as, from very desirable to less desirable. The goal was to select units with the closest match to TDCJ units.

The mobile homes that the state owned were valued by gathering the taxable value of all mobile homes . This total value was divided by the number of mobile homes on the tax roll to yield an average taxable value.

The single family dwellings required locating several single family dwellings in Huntsville. These comparable homes were selected based on age, style, condition, and location factors that were somewhat comparable to the subject properties. The taxable value of each of these homes was added together and divided by the number of units to yield an average taxable home value.

There was no consideration for the fact that most of these units are extremely close to prison units (subjective) nor for condition of the units. Some of the TDCJ units are very old and may need remodeling or replacing. This was offset in the selection process of the comparable units which have similar age and conditions as the subjects.

The taxable value of each category of housing was calculated by multiplying the average taxable value of each type of unit by the total number of those units. The property tax was calculated by multiplying the total taxable value by the tax rates of each jurisdiction where they were located. These tax amounts were added together to give a total net tax that could be due if each of these properties were privately owned. Walker County Appraisal District provided the taxable values for the properties.

MARKET RENT RATE

Each type of housing unit in the system in Walker County had a market rent rate established for that unit. The market rent rate is the rent that is indicated from an analysis all similar rental

property in the county or city as is appropriate. This analysis should reveal what the prison housing could rent for if it was privately owned and available for public rental.

Rent information on all similar properties in the community was used to establish the market rent rate. Then an average rent was established for each of the various types of units located within the prison system.

The calculation of the market rent was similar to the taxable value. However, no consideration was given to housing proximity to any prison as this would be subjective.

OTHER RELATED ISSUES

Other issues required consideration in this study. One such issue was related to utility costs. The City of Huntsville charges privately owned properties a flat fee per month per unit for water, plus a sliding rate above 3,000 gallons of water. TDCJ housing is billed on a single meter that includes the entire prison unit with an average monthly charge per unit is $31.06, which includes water, sewer, and garbage pickup. Electricity was not considered, as the employee is responsible for the electrical usage in the housing unit.

The second issue requiring consideration was the maintenance of the units. The only aspect of maintenance of these units that was analyzed was the labor component, as the materials purchased for repairs come from privately owned suppliers regardless of ownership. The labor currently used for maintenance is typically performed by inmates at TDCJ, supervised by TDCJ employees. If the housing units were privately owned the maintenance could be performed by private labor. The amount of labor required was calculated by finding the amount of labor used in the maintenance of the comparable rental units used to establish the market rent rates.

Addressed in conjunction with the issue of maintenance was management. These duties are currently undertaken by the personnel officer at each unit.

Sales tax was the final area of consideration. It was assumed that any money not paid in the form of rent would be used to make other purchases in the city of Huntsville. The sales tax that is collected on a transaction includes a portion for the City of Huntsville and Walker County.

ANALYSIS OF FINDINGS

Tax Value and Property Taxes

State Owned Apartment Tax Value: There were a total of 163 employee housing units in Walker County that were valued by comparison to local apartments as of February, 1996. These will then be broken down into eighty units outside the city limits of Huntsville and eighty three inside the city limits. Comparable apartments were typically more mature units that ranged from very desirable to less desirable.

The average taxable value of these units is $14,419 for those units outside the City of Huntsville and a value of $12,859 for those units inside the city limits of Huntsville.

State Owned Mobile Home Tax Value: There are four mobile homes that are state owned. The taxable value of these units was calculated by taking the total taxable value of the privately owned mobile homes in that same park and establishing their average value. The total taxable value as shown by the Walker County Appraisal District was $385,020 for 48 mobile homes. This yields an average taxable value of $8,021 per mobile home. The taxes for these units, if privately owned, was calculated to be $32,084 in total taxable value

State Owned Single Family House Tax Value: The four employee housing units were compared to similar single family dwellings in Huntsville. The average taxable value for these units was $103,256 for a total taxable value of $413,024.

Total Property Taxes: Totaling the property taxes for all jurisdictions of the three components of TDCJ housing in Walker County produces a result of $63,757. The calculation is the sum of the above three housing units tax value times the appropriate tax rates.

RENTAL VALUE

Market rental rates came from the apartment management companies. Additional information came from real estate specialists.

State Owned Apartments: Based on the market rent rates, TDCJ employees living in the apartments save an approximate $909,000 in rent per year. The calculations are based on employees paying an average $25 per month to live in employee housing.

State Owned Mobile Homes: The four mobile homes that are state owned were estimated to have rent values of $475 per month per unit. These values are based on each mobile home having three bedrooms and two bathrooms. The annual rent savings of $21,600 are calculated with estimated rent of $25 per month per unit.

State Owned Single Houses: The rent rates for the single family housing was estimated from discussions with local realtors and newspaper listings. The rent was estimated at $1,100 per unit per month. An annual rent savings of $61,500 was calculated.

Total Rent Saved: The total rent saved by all TDCJ employees living on or in state owned-housing was estimated to be $992,100 per year. This calculation was derived from the summation of the above three housing units.

Other Related Issues: The City of Huntsville typically collects $31.06 in water/sewer/garbage utility bills per occupied unit from privately owned multi-family residences. Each of the TDCJ units are on a single meter and do not pay this fee. If the properties were privately owned, this could provide approximately $58,517.04 in collections per year for the City of Huntsville. This figure may not be completely accurate since TDCJ pays at least some part of these fees through the utility billings

sent to those units located within the city limits of Huntsville. Due to insufficient data, an estimate could not be made of the fees paid by the units in question.

The local ratio of management and maintenance personnel per local apartment complex is approximately one person, in each position, for each one hundred units. This could result in approximately five employees to perform these duties in positions that pay approximately $1,000 per month. The cost in local employment is $60,000.

The local sales tax collected on many business transactions includes two local jurisdictions. The local components of the sales tax collections include 1.5% of the sales tax collected is on behalf of the City of Huntsville and .5% of the sales tax collected is on behalf of Walker County. If these percentages are applied to the total rent savings per year the results indicate an economic benefit to the City of Huntsville and Walker County. The total was $21,817.20 per year.

SUMMARY AND CONCLUSION

There are at least two diametrically opposing positions concerning state employee housing that have been expressed. There were those who expressed the opinion that TDCJ employees had received the benefit of living quarters in lieu of compensation. On the other hand, others were of the opinion that TDCJ employees living in such housing were getting a "free ride" at the local taxpayers expense. These debates were the basis to evaluate several scenarios, attempting to identify possible costs or benefits of TDCJ employee housing to the local economy.

The first scenario depicts the current situation (i.e. TDCJ employee housing being state owned and exempt from ad valorem taxes). An assumption was made that all money saved in rent was otherwise spent locally. This assumption could not be entirely correct; however, it could be assumed that a major portion of those funds would, most likely, be distributed throughout the local economy. This scenario results in a benefit to the local economy of approximately $654,310 per year, which was calculated using annual rent saved, spent locally, lost ad valorem tax revenue, lost maintenance and management positions, and lost City of Huntsville utility fees.

A second scenario portrays private ownership of TDCJ employee housing, but with an owner that lived outside of the areal. It was assumed that the net profit from such property would be removed from the local economy and spent elsewhere. In this case, the local economy could lose approximately $969,690 per year, which was calculated using the annual rent saved, spent elsewhere, ad valorem tax revenue per year, gained maintenance/management positions, and gained City of Huntsville utility fees.

The final scenario assumed local ownership of TDCJ employee housing. An underlying concern lies in the likelihood that many apartment complexes generate little profit after management costs, maintenance costs, taxes, insurance, and debt service are taken into consideration. Additionally, an owner without debt service, might be inclined to reinvest those profits, which may or may not take place in the local economy. Under these circumstances, the local economy could lose approximately $969,690 per year, the same impact of a non local owner. This loss could be reduced in that the "profit" could be reinvested in the local economy, rather than removed from it.

Of the three scenarios, it is believed the current system of TDCJ owned employee housing provides a benefit to the community. This system may not directly inject $654,310 into the local economy, but it does appear to have a beneficial effect. Additionally, that benefit might be spread

more evenly across the community than any of the scenarios depicted here might indicate. This consideration results from the realization that the TDCJ employees, numbering in excess of 200, would be more diverse in their spending activities than a single owner or group of owners.

The analysis used in this paper might allow the affected citizens to view a cost-benefit value of state owned property to determine an economic impact this property has on the local community. This procedure can possibly be generalized to provide the basis for applications to similar situations.

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EQUITY VALUES, REVERSE DILUTION, AND SUSTAINABLE GROWTH

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ABSTRACT

The current market for equities is at or near an all time high. A firm's high price-earnings ratio may be temporarily self-justifying. A highly valued firm that continues to sell shares may experience high growth of earnings per share, even if the new funds are invested at relatively modest returns. Continued growth is dependent on continued issuance of shares and investment in new projects rather than on reinvestment of current earnings. The process creates an incentive to keep investing regardless of the quality of such investments. Like a pyramid scheme, such a process must end poorly.

This article explains this process with simplified numerical examples illustrating the results of growth through sale of shares and growth through merger. In order to diagnose this unhealthy type of growth, actual inflated growth is compared to sustainable growth. The greater the ratio of actual to sustainable, the more the firm's continual growth is dependent on reverse dilution and greater the potential for disaster. Finally, as an illustration, the growth of America Online is analyzed.

INTRODUCTION

Despite concerns expressed by economists including the Federal Reserve chair, many investors are convinced that the old rules concerning valuation no longer apply. To support this position, they may point to high earnings per share growth as a partial rationale for the historically high valuations seen in the equity market. This paper will show that a firm with a reasonably high price-earnings ratio may generate high growth in earnings per share by selling shares or merging with lower valued firms. The mechanism is mathematically similar to a chain letter or pyramid scheme. The outcome is also similar to that of a pyramid scheme. Eventually investors who rely on such growth as justification for high stock values face the probability of loss of substantial capital. Not only will the stock typically be overvalued when purchased but, because of the incentive to continue the cycle, there is a strong tendency for such a firm to accept substandard investments. Since new investments may be high relative to total firm size, a mistake may be catastrophic. Luckily, it is relatively easy to detect such unsustainable growth by comparing it to a computed sustainable growth.

GROWTH THROUGH EARNINGS RETENTION

First we will examine a firm, which is not selling shares, and is growing solely by retaining earnings and maintaining a constant ratio of debt to equity. The values in Table 1 are generated from an assumed initial equity of $100 and the ratios listed under assumptions. Although this forecast is simplified, similar results could be generated by a more detailed forecast. Also note that price earnings ratio has no effect on this model because the firm is not selling shares.

TABLE 1
NO SALE OF SHARES

	Year 1	Year 2	Year 3	Year 4	Year 5
Assumptions:					
Debt to Equity	1.00	1.00	1.00	1.00	1.00
Net Income/Beginning Assets	0.0700	0.0700	0.0700	0.0700	0.0700
Retention Rate	0.40	0.40	0.40	0.40	0.40
Price Earnings	35	35	35	35	35
New Shares issued at Year End	0	0	0	0	0
Assets (Beginning)	200.00	211.20	223.03	235.52	248.71
Liabilities (Beginning)	100.00	105.60	111.51	117.76	124.35
Equity(Beginning)	100.00	105.60	111.51	117.76	124.35
Net Income	14.00	14.78	15.61	16.49	17.41
Dividend	8.40	8.87	9.37	9.89	10.45
Shares (Ending)	100.00	100.00	100.00	100.00	100.00
Earnings per Share	0.14	0.15	0.16	0.16	0.17
Price-Earnings	35.00	35.00	35.00	35.00	35.00
Stock Price	4.90	5.17	5.46	5.77	6.09
Assets (Ending)	211.20	223.03	235.52	248.71	262.63
Liabilities (Ending)	105.60	111.51	117.76	124.35	131.32
New Equity	0.00	0.00	0.00	0.00	0.00
Equity(Ending)	105.60	111.51	117.76	124.35	131.32
Ending Equity per Share	1.06	1.12	1.18	1.24	1.31
Earnings per Share Growth		0.056	0.056	0.056	0.056
Equity per Share Growth		0.056	0.056	0.056	0.056
% Retained Earnings to Equity	5.30%	5.30%	5.30%	5.30%	5.30%

Based on the above assumptions this sample company will grow at 5.6% per year and the stock price in Year 5 will be $6.09 if investors believe that the price earnings ratio should be 35.

Note that the dividend discount model implies that investors will only earn a return of 7% assuming a payout ratio of .6 and a level growth of 5.6%. Conventional analysis would conclude the firm is overvalued. If the firm does not issue shares and does actually grow at only 5.6%, the price earnings ratio will eventually fall to that of a mature firm.

Now, given that the price earnings ratio (for whatever reason) is 35, the firm may choose to issue shares and thereby increase growth temporarily. The firm may be popular because of investor enthusiasm for its industry such as technology and Internet stocks today. It isn't important why the market values this firm at this level, it is sufficient for our example that it does.

GROWTH THROUGH SALE OF SHARES AND EARNINGS RETENTION

Now consider the effect of selling shares. The example in Table 2 is identical to that in Table 1 except that the firm will sell 15 new shares in each of the first three years.

TABLE 2: SHARES SOLD YEARS 1, 2 AND 3

	Year 1	Year 2	Year 3	Year 4	Year 5
Assumptions:					
Debt to Equity	1.00	1.00	1.00	1.00	1.00
Net Income/Beginning Assets	0.0700	0.0700	0.0700	0.0700	0.0700
Retention Rate	0.40	0.40	0.40	0.40	0.40
Price Earnings	35	35	35	35	35
New Shares issued at Year End	15	15	15	0	0
Assets (Beginning)	200.00	358.20	607.20	984.50	1,039.63
Liabilities (Beginning)	100.00	179.10	303.60	492.25	519.81
Equity(Beginning)	100.00	179.10	303.60	492.25	519.81
Net Income	14.00	25.07	42.50	68.91	72.77
Dividend	8.40	15.04	25.50	41.35	43.66
Shares (Ending)	100.00	115.00	130.00	130.00	130.00
Earnings per Share	0.14	0.22	0.33	0.53	0.56
Price-Earnings	35.00	35.00	35.00	35.00	35.00
Stock Price	4.90	7.63	11.44	18.55	19.59
Assets (Ending)	358.20	607.20	984.50	1,039.63	1,097.85
Liabilities (Ending)	179.10	303.60	492.25	519.81	548.92
New Equity	73.50	114.47	171.65	0.00	0.00
Equity(Ending)	179.10	303.60	492.25	519.81	548.92
Ending Equity per Share	1.79	2.64	3.79	4.00	4.22
Earnings per Share Growth		0.557	0.500	0.621	0.056
Equity per Share Growth		0.474	0.434	0.056	0.056

TABLE 2: SHARES SOLD YEARS 1, 2 AND 3					
	Year 1	Year 2	Year 3	Year 4	Year 5
% Retained Earnings to Equity	3.13%	3.30%	3.45%	5.30%	5.30%

Note that the growth rate of earnings per share jumps from 5.6% seen in Table 1 to 55.7%, 50% and 62.1% for the years following the sale of shares. (It was assumed that new equity would be raised the last day of each year and would affect the following year's earnings.) Under these assumptions the stock price will be $18.55 instead of $6.09 at the end of year 5. These enormous differences are entirely due to the sale of shares. Because of the high stock price, assets, equity and earnings are increasing faster than shares. This is known as reverse dilution. However, high growth is dependent on continued sale of equity. In our example, growth in year 5 will return to 5.6% since no shares were sold the previous year. Further, it is unlikely that the price earnings ratio will remain high once the market realizes that this firm is growing at only a mature growth rate. If the price earnings at the end of year 5 were to fall to 15, for example, the stock price would fall to $8.40. Any investor who had purchased shares in year 3 (for $11.44) or thereafter would lose. Often the results are much worse than this. Because of an incentive to keep the process going, the firm may continue raising capital even as it exhausts its stock of acceptable investments. If the size of a bad new investment is large enough, the survival of the firm may be threatened.

SUSTAINABLE GROWTH RATE

The sustainable growth rate is the rate that a firm can grow through earnings retention and maintenance of a constant debt to equity ratio. It is often (incorrectly) estimated as G=RB, where R is Return on Equity and B is the Retention Rate. (In our example in Table 1, RB is 5.3%.) Actually, this definition would be correct if one typically calculated financial ratios based on balances at the beginning of each year. Since we typically calculate financial ratios based on the end of each year, sustainable growth should be estimated as RB divided by (1-RB). In our example .053 divided by (1-.053) equals .056 which is the sustainable growth rate in this case. Note that Table 2 shows that growth returns to 5.6% after the sale of equity ends. (See Ross, Westerfield, and Jordan). The mechanism at work here (reverse dilution) is similar to that of any pyramid scheme. The high growth continues only as long as the firm issues new shares. The firm must find ways to invest the proceeds. In our example, the firm's assets increase from $358 to 1098 over a four-year period! The longer the process continues the more likely it is that the firm will stumble into bad investments. Eventually the pyramid will end. The firm will stop selling shares and investing the proceeds or it will make bad investments.

GROWTH THROUGH MERGER

As the pressure to invest a rapidly increasing amount builds, a firm may decide to try to continue the process by merger. If a firm with a relatively high price earnings buys one with a lower price earnings then the market may be tricked into valuing the earnings of the acquired company at the higher price earnings ratio. This possibility has long been recognized. May wrote a classic article explaining such growth over 30 years ago. He prophetically claimed "Sometime during each generation the magic of the chain letter is rediscovered." Consider Table 3.

Note that Companies A and B both earn 10% on total assets. For some reason, Company A has a Price-Earnings of 30 and B has a price earnings of only 10. If pooling of interest accounting were allowed, the increase in value would be the difference in price earnings ratios (20) times the earnings of Company B ($10) or $200. Since the acquiring company is probably now required to use purchase accounting and write off the goodwill against earnings, the example shows an increase in value of $185. Note that the reported earnings per share of Company A increase from $0.20 to $0.25 as a result of this one transaction. The company may conclude many mergers during the year. It is not unknown for firms to consummate as many as one merger per week when in the heat of such a feeding frenzy! This is really just another form of reverse dilution and will eventually end the same way.

TABLE 3
GROWTH THROUGH MERGER

	Company A	Company B	Merged Companies, Assuming Purchase Accounting	
Tangible Assets	200.00	100.00	300.00	
Goodwill			20.00	
Total Assets	200.00	100.00	320.00	
Liabilities	100.00	50.00	150.00	
Equity	100.00	50.00	170.00	
Writeoff of Goodwill			0.50	40.00 Years
Net Income	20.00	10.00	29.50	
Shares	100.00	100.00	120.00	Assume 20 shares issued for B
Earnings per Share	0.20	0.10	0.25	PRICE PAID is $120 (20*$6)
Price Earnings	30.00	10.00	30.00	
Price per Share	6.00	1.00	7.38	
Market Value	600.00	100.00	885.00	
Increase in Value			185.00	

ANALYSIS OF AMERICA ONLINE

America Online (AOL) is a leading provider of online information services for personal computers. The growth of AOL over the period 1992 to 1998 is summarized in TABLE 4. Note that AOL achieved growth in book value per share of 54% per year and of earnings per share of 55% per year. However the sustainable growth calculation shows that AOL would have grown at 5.7% per year through retention of earnings alone! Almost 90% 0f AOL's growth originates from either sale of shares or through merger! This was possible because of the high price earnings ratio that prevailed over the period. Note that common shares increased from 350.77 to 878.56 million during this time.

TABLE 4
AMERICA ONLINE - ANALYSIS OF GROWTH

	1992	1993	1994	1995	1996	1997	1998	AR*	GA*
Book Value per Share	0.05	0.06	0.21	0.36	0.69	0.16	0.68	.54	
Earnings per Share	0.01	0.01	0.01	0.03	0.04	(0.09)	0.4	.55	
Dividends	0.00	0.00	0.00	0.00	0.00	0.00	0.00		
(Earnings - Dividends)/Book Value	0.20	0.17	0.05	0.08	0.06	(0.56)	0.21		
Sustainable Growth	0.25	0.20	0.05	0.09	0.06	(0.36)	0.26		.057
Price-Earnings Ratio	32.20	48.70	79.80	60.70	175.00	NMF	357.00	*	
Common Shares	350.77	377.09	463.71	600.88	741.01	801.51	878.56		

AR* Annual Growth Rate
GA* Geometric Average
* Prices for 1996 and 1997 were estimated from Bloomberg.com stock price chart.
Source: Value Line Investment Survey, March 5, 1999

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CHANGES IN OUTSIDE OWNERSHIP PRECEDING MANAGEMENT BUYOUT ANNOUNCEMENTS

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ABSTRACT

The market for corporate control experienced a striking increase in both the quantity and size of management-led leveraged buyouts throughout the decade of the eighties. Bradley Desai and Kim (1988) posit that bidders face an upward sloping supply curve for shares in a takeover, so the per share offer that a bidder must pay in a successful tender offer is positively related to the minimum number of shares required for control. Stulz, Walkling and Moon (1990) find that gains are lower for firms with larger bidder holdings, and Easterwood et al (1994) find that the incidence of competition relates negatively to managers' pre-buyout ownership share in the target firm. From these studies, it follows that the ownership structure of a firm can be an important factor inherent in any management buyout.

Common wisdom suggests that prior to making a buyout offer, bidders often increase their holdings of the stock of the firm that they intend to purchase. This study examines that question and empirically tests whether significant changes in outside ownership occur preceding the announcement of a leveraged buyout offer.

The sample consists of 179 firms that received management buyout offers between 1978 and 1988 and whose stock traded on either the New York Stock Exchange or the American Stock Exchange. The data consist of outside ownership immediately prior, one year prior, and two years prior to the buyout offer announcement. The ownership data reflect the percentage of outstanding shares controlled by the first, second, and third largest outside owners.

In addition to the full sample of 179 firms, the data was partitioned into three sub-samples corresponding to three different situations: 1) the managerial team is the sole bidder, and no outside competition comes forward; 2) managers bid first, and competition arises from outside bidders; and 3) outsiders bid first, and competition ensues from managers. The sub-samples contain 112, 54, and 13 cases, respectively. Because of the small sample size of the third partition, only the full sample and the first two partitions are examined. A paired t-test is utilized to examine whether significant changes in outside ownership occur preceding the buyout offer announcement.

Preliminary investigation of the full sample shows that in the second year preceding a buyout, empirical analysis fails to reject the hypothesis that on average there is no significant change in outside ownership. However, during the year immediately preceding the buyout, there is a statistically significant decline in outside ownership. This finding contradicts conventional conjecture that bidders position themselves prior to a buyout by increasing their ownership stake in the firm for which they are preparing to bid.

THE PERFORMANCE OF SOCIALLY RESPONSIBLE MUTUAL FUNDS BASED ON RANK PERSISTENCE AND THE DEGREE OF SCREENING

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ABSTRACT

Increasing attention is being given to mutual funds that integrate social philosophies with investment decisions. Currently, about 60 funds claim that some degree of social responsibility governs their management. Studies examining the performance of such funds find no significant difference from their conventional counterparts. This paper continues the analysis of these specialized funds by examining persistence, rank performance among peers, and the relationship between performance and degree of social responsibility. The results strengthen the conclusions from previous research that indicate socially responsible funds exhibit a similar performance to conventional funds or benchmarks. Furthermore, these funds consistently perform average, and the degree of social responsibility is not related to performance.

INTRODUCTION

Over the last decade, the popularity of mutual funds has increased substantially, but so too has the scrutiny of their performance. In general, a majority of this research shows that most funds underperform the market or a market benchmark (Grindblatt and Titman,1993, 1989; Malkiel, 1995). Such inferior performance challenges one of the basic justifications for the existence of mutual funds; that is, that the professional management of funds should provide investors with superior returns. Recent attention has been directed at examining the degree to which the performance of a fund is consistent from year-to-year. The findings for fund persistence are mixed. On one hand, ranked performance in one year appears to repeat the following year during certain subperiods. On the other hand, during other subperiods, little evidence of persistence is found. Malkiel (1995) shows that in the 1970s, funds ranked in the top-half of performers were twice as likely to be in the top-half again the following year. However, by the 1980s, the odds that a top-half fund would remain in the top half in successive years were even. Furthermore, Malkiel finds no evidence that investors managing their funds using a persistence strategy could earn abnormal returns. Using a longer period to test for persistence, Grindblatt and Titman (1992) find evidence that mutual funds do exhibit persistence and that this reflects the fund manager's ability to outperform the market.

A relatively new philosophy governing portfolio management has emerged whereby investors combine investment with ethical concerns. The number of these socially responsible (or conscience) investors is growing as evidenced by the number of socially responsible mutual funds (SRMF) that now exist. Conventional investors tend to be wealth-maximizers and select a mutual fund or investment instrument based on the associated risk/reward characteristics. Socially responsible investors, however, also integrate the social philosophy of the fund into their investment selection process. Investors can sort themselves into funds that match their degree or passion for social issues. For example, some investors may prefer funds that screen for only one factor (eg. nuclear power) while other investors may seek funds that include or exclude firms based on a dozen variables (eg. tobacco, alcohol, environment, etc.).

Kurtz and DiBartolomeo (1996) show that stocks classified at socially responsible do not outperform the market. Examining 17 mutual funds that classify themselves as socially responsible, Hamilton, Jo and Statman (1993) find that the market does not punish or reward investors in such funds. Today, however, there are more than 60 of these funds. In addition, most current literature considers basic criteria to judge performance (excess returns and variability) and do not consider the degree of screening. This paper provides a more detailed view of the performance of SRMFs through rank persistence analysis, risk-measurement criteria (i.e. Jensen's alpha, Sharpe Ratio and Treynor Ratio) and degree of screening. In addition, we limit our analysis to funds that express in their prospectus that they are socially responsible. Previous research has relied on outsider services (eg. Lipper, CDA/Weisenberger) to identify and classify the samples. Our reading of fund prospectuses indicates that several funds classified as socially responsible by an outside service actually make no explicit claims in their prospectus of a socially responsible investment philosophy governing their investment decisions. We confine our sample to only "pure" SRMFs and find that their returns are less than those of the overall market benchmarks appropriate for each fund. We also find evidence that the degree of social screening does not explain differences in return performance among SRMFs, and that they are consistently average in their relative market performance.

LITERATURE REVIEW

While there is a great deal of literature on the performance of mutual funds, very little research focuses on the group of funds that screen for socially responsible concerns. The lack of research is due to a combination of the relatively small number of funds (until recently) and the short length of time the funds have existed.

Mueller (1991) examines 10 funds over the 1984-88 period and finds that 9 of them had lower risk-adjusted returns than comparable ones in their investment category. In addition, he finds that the funds had greater variability than their conventional counterparts. Hamilton, Jo and Statman (1993), using data covering 1981 through 1990 for 17 funds, conclude that socially responsible funds perform no better or worse in terms of excess returns. Most recently, Goldreyer, Ahmed and Diltz (1999) show that social screening does not predictably affect returns. However, their results indicate that funds that use inclusive screening perform better than funds that use other screening methods.

Diltz (1995) adds to the literature by considering the specific screens, but does not use actual mutual funds. Instead, using 159 common stocks over the 1989 to 1991 period, he constructs 14

different portfolios based on 11 screens. He concludes that overall, socially responsible investors will neither underperform nor outperform the market (although some of the screens provide excess returns). Kurtz and DiBartolomeo (1996) consider the behavior of stocks listed in the Domini 400 Social Index (DSI) between 1986 and 1994. They find no significant difference between the DSI and the S&P 500 either in terms of returns or variability.

DESCRIPTION OF THE DATA AND METHODOLOGY

Unlike the previous papers which choose funds or stocks based on reports made by organizations that focus on socially responsible firms (i.e. the *Council of Economic Performance*), we look directly at the funds' prospectuses. To be included in this study, the fund must specifically state (1) that "doing good" is an integral part of its operation, and (2) what "doing good" involves (ie. social screens). We initially identify a group of 67 socially responsible mutual funds from *Yahoo* and the *Social Investment Forum*, and then verify their socially responsible objectives from their prospectus. To qualify as socially responsible for our sample, funds must include (exclude) firms that satisfy (violate) socially responsible criteria. For example, *SteinRoe Young Investor includes* only those firms that focus on education. New Alternatives *excludes* firms that are not environmentally friendly. Several *Pioneer* funds, on the other hand, are included in the samples of many of the cited articles, despite the absence of an explicit socially responsible investment philosophy in the prospectuses. Forty-five funds form our sample based on a review of their prospectuses. Table 1 presents these funds and their screening choices. There is a range of screening: while some only focus on one criterion, others screen for up to 17 issues.

RESULTS

Table 2 compares the raw returns of the SRMFs to their respective benchmarks. The results for the full sample of 45 funds, as well as four subsamples with consistent portfolio objectives are presented. For the full sample, SRMFs significantly underperform their benchmarks in each subperiod examined. A similar underperformance is observed on the domestic equity subsample. These initial results are disappointing as they imply that SRMF investors (fund managers) may be penalized with lower returns as they filter out firms that do not satisfy the socially responsible parameters. The results are mixed for the Balanced and Fixed Income samples. For the International SRMFs, no significant difference is observed between fund returns and the benchmark. Conclusions about the relative performance of the last three subgroups, however, must be made with caution as the sample sizes are small. The most convincing evidence is, thus, provided by the domestic equity funds. It appears that the underperformance of these funds persists over time, as significant negative coefficients are associated in each of the 1-year, 3-year, 5-year and 10-year periods.

The dismal performance of SRMFs summarized in Table 2 implies that returns may be forfeited for adopting an investment philosophy that integrates concerns for the environment, animal cruelty, and other social issues. Absent from Table 2, however, is the degree of risk inherent in these portfolios. It may be that the underperformance in these funds is a manifestation of lower risk than what is composed in the benchmarks. As such, these funds may generate a fair risk-adjusted return. All studies to date find that after adjusting for risk, SRMFs exhibit a similar performance

to conventional funds. What has not been considered, however, is the relationship that these risk-adjusted returns have with the degree of social responsibility adopted by SRMFs. Table 3 provides the regression results between 1-year, 3-year and 5-year excess return performance (as measured by Jensen's Alpha, Sharpe Ratio, Treynor Index) and the degree of social responsibility in each fund. Although it appears from previous research that the existence of a socially responsible investment philosophy does not matter (no premium and no penalty) as returns are not significantly different from conventional funds, perhaps the degree of social responsibility within a fund does matter. In none of the regressions, however, is a significant relationship exposed between degree of social responsibility and excess returns behavior. That is, SRMFs with only one social screen performed similar to SRMFs with 17 screens. So it appears that the existence of social responsibility and the degree of social responsibility within a fund are not related to returns performance.

Table 4 compares the relative rank of SRMFs to all funds (socially responsible or otherwise) in each fund class as determined by *CDA/Weisenberger*. The mean rank column shows the average percentile rank of SRMFs in their class. For example, the mean rank of 47.52% for all funds indicates that the average SRMF is in the top 48% of its class. Columns 2-5 show how SRMFs ranked against the top 25%, 33%, 40% and 50% of funds. For the full sample and the domestic equity funds, SRMFs exhibit a significant performance difference at the 25% and 33% rankings. This means that, on average, SRMFs did not rank in the top quarter or third of all funds. No significant difference is found at the 40% and 50% rankings. SRMFs on average, therefore, ranked in the top 40% or so of all funds, hardly a superior performance. The final section of Table 4 presents the distribution of decile ranks for SRMFs, where 1 represents the number of SRMFs in the top decile of their class. No clear clustering of SRMFs is observed. Rather, funds are distributed evenly across deciles, indicating that although some funds are superior and other funds lag, as a whole SRMFs are fairly average performers in terms of relative ranking.

CONCLUSIONS

Ellen S. Cramer, a portfolio manager of a SRMF with *SalomonSmithBarney* states on the webpage of her fund the following:

> *"We believe that there will prove to be a connection between companies that maintain a positive social awareness and their long-term success. For example, companies that are proactive environmentally can usually avoid costly litigation and expensive clean-up costs. In addition, companies that create diverse and professionally satisfying workplaces generally attract the most talented people who in turn help to increase both productivity and profitability. In other words, being socially responsible can oftentimes be very good for the bottom line."*

This noble ideal is where wealth-maximizing investors and socially responsible investors intersect. Our results indicate, however, that the wealth premium has yet to materialize in funds that deliberately include/exclude firms based on social behavior. Rather, SRMFs continue to consistently produce average returns. Furthermore, funds with a small degree of social commitment perform similar to those funds with strict and extensive social screens. At best, investors committed to social investing can take comfort that little or no penalty is incurred in restricting investments to those that satisfy a wide range of degrees of social responsibility.

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Note: All Tables and other supporting information are available from the authors upon request.

BALANCING THE STATE BUDGET IN ALASKA: PERSONAL INCOME TAX OR PERMANENT FUND?

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ABSTRACT

Alaska is facing a revenue shortfall for the current fiscal year estimated to be anywhere from 600 million to over one billion dollars. The majority of state funding comes from oil royalties based on the value of the oil extracted. Since the amount of oil being produced in the state is declining and the market value of oil dropped below ten dollars a barrel this year, oil royalties are expected to be drastically below original estimates. The Alaska state legislature has some reserve accounts which can be used to fund the shortfalls for several years and has been cutting appropriations. However, early in the next century a major alternate source of funding must be developed. Two main revenue sources are being considered: either reinstating a state income tax on individuals or utilizing part of the Alaska permanent fund's earnings to finance state government. This paper will examine the advantages and disadvantages of each option to the state and its citizens.

EURO: CAN IT REPLACE U.S. DOLLAR?

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ABSTRACT

January 1, 1999 a new uniform monetary policy from within the European Monetary Union, call the Euro was introduced to the world. The Treaty of Maastricht established the Euro under the European System of Central Banks (ESCB). The treaty encompassed three goals by which to implement this new monetary policy. The effects of the euro on the U.S. dollar and the Japanese yen will also be highlighted in the paper; as well as some of the advantages and disadvantages of the new European Union. The introduction of the euro and the European Union will have a large impact on the life and economic growth of the countries involved.

INTRODUCTION

"After a century scarred by war, tyranny, terrorism and economic chaos, Europe stands on the brink of a new era of unity and prosperity." (Mander, 1999) The European continent has come to a new political and economic harmony after laying down its vast empires and rivalries. This last year as Europe embraced capitalism; they also introduced a single currency called the euro. (Mander, 1999) The euro was named the new currency of Europe in December 1995, with plans of implementation on January 1, 1999. Until the year 2002 the euro will co-exist with other national currencies. (The Euro, 1998) The euro, believed to be an alternative currency to the U.S. dollar, has created a mountain of capital (Mander, Europe, 1999).

TREATY OF MAASTRICHT

January 1, 1999, a new uniform monetary policy formed the European Monetary Union (EMU), call the Euro was introduced to the world. The Treaty of Maastricht called for the establishment of a European Monetary Institute (EMI). This institute was established to coordinate the work preparing for a European Monetary Union (EMU) and the implementation of the new euro. "An important part of the EMI's mandate has been the development of an operational frame work for monetary policy for the European System of Central Banks (ESCB), which will consist of the European Central Bank (ECB), and the national central banks of the European Union's (EU's) member states." (Enoch, 1998, pg. 38)

Currently there are eleven members of the European Union. The members of the EU will participate in the transition to the euro as their national currency, as well as striving to obtain the economic objectives of the European Union. (Green, 1999) The euro will replace the ecu on a one-

to-one basis. The ECU is defined as a reflection of changes in a basket of currencies such as French francs and German marks, not a currency. (The Euro, 1998) The countries participating in the new chapter in Europe's history are France, Germany, Belgium, Holland, Luxembourg, Spain, Italy, Ireland, Portugal, Finland and Austria. (Helms, 1999) The eleven European Union nations adopting the euro have a total population of 290 million, and a gross domestic product of $6.5 billion. These eleven countries implementing the euro are also referred to as euroland or eurozone. (The Euro, 1999) Approximately one-fifth of the global economy will be represented by the euro. The United States dollar is represented only marginally above that rate at 18.6% of world trade (Helms, 1999). Britain, Denmark, Greece and Sweden are not currently participating in the EMU. Greece and Sweden failed to satisfy economic criteria for membership. There are several countries still bidding to become a member of the EU such as Poland, the Czech Republic and Turkey. (Mander, 1999)

ADVANTAGES OF THE EURO

There are several advantages to the EMU and the euro. The first, is exchange rate stability. Second is the elimination of the money exchange in the European Union. Third, the market becomes a transparent market. Fourth, the euro creates a simplification of record keeping. Fifth, the euro will become a reserve currency. Finally, there will be a lower interest rate (What, 1999).

First, with the introduction of the euro exchange rates will cease to exist along with the fluctuation between European country currencies. Before companies that imported and exported among the European countries had to cover exchange rate risks. The euro will eliminate these kinds of cost for international businesses. The savings in this area will have a positive impact on the international trading and produce counties highly conducive to economic growth and employment. Second, the need for money exchange within the European Union will no longer be essential. An experiment was conducted "with a trip though all the EU member states, changing money fifteen times into the local currency without spending anything; at the end of the day only half the original amount was left." (What, 1999, Pg. 1) Third, the ability to compare will arise among EU countries will one currency. There will no longer be the challenge of exchange rates in the market, creating a transparent market that benefits the consumer. Fourth, the euro will simplify the task of record keeping. Bookkeepers will no longer have to establish price lists for each currency, resulting in the savings of time and money. Fifth, in the role of the international trade accounting unit, it is conceivable that the euro will partially oust the dollar. Stability for the European economy will come, as the EU becomes less dependent on the dollar's rate and its uncertain fluctuations that emerge with its exchange rate. Finally, the euro may have a positive effect on the European Union's interest rate. The birth of the euro will bring a lower interest rate in the EMU countries than ever before. (What…, 1999)

Another positive aspect of the euro is to breakdown the barrier between existing countries with the goal of a common financial integration. This financial integration could result in the birth of the world's largest financial market. The euro provides many incentives to the idea of European harmonization. Some of the incentives include: a sense of security in the European market; reduction in the cost of spot transactions; a transparency in pricing across the union; harmony in the marketplace; elimination of long-term foreign exchange risk in contracts; currency differences would be eliminated; and intra-state investment barriers would be dropped. This harmonization will be felt in day to day business internationally.

DISADVANTAGES OF THE EURO

The creation of a unified country and market will result in some confusion. The countries are working together in harmony, in theory but not necessarily in practice, as they make the transition. (Mander, Europe, 1999)

A large disadvantage of the introduction of the euro is the large cost of implementation. "Laws will have to be changed, administrative and other systems will have to be modified, the old money will have to be taken out of circulation, automatic teller machines will have to be replaced, people will have to be trained and information will have to be provided about the changes entailed through the introduction of the euro." (What are the Drawbacks, 1999, Pg. 1) Retailers will have to implement a second pricing system and two cash tills for a period of time. All products and services will be prices in euros and the national currency. (Mander, Dawn, 1999)

After a survey of large companies, it was estimated that it would cost $100 billion to implement the euro. The estimated costs to the euro-zone companies will restrict cash flows and redirect money they would otherwise would have been spent on growth and development. (Mander, Europe, 1999) Consultants from KMPG state that it will cost on average $51 million per company.

Other associated costs are price adaptation, severe measures, national policy exchange for economic policy, and one country's deficit affecting another's. When a new currency is used, the public must adjust to a totally different pricing system. The benchmark of prices they are accustom to has all but disappeared. This new learning process could take years for some people and in the mean time create an environment of mass confusion. (Euro will cost… 1998)

Next, many countries will experience a drastic setback to their budgets in order to meet the entry criteria for the European Monetary Union. This setback may cause a negative impact on the economic stability of the countries. Inevitably this impact would affect the countries that have large public sectors and social security that is increasing growing out of control. An increase in the national debt and in long run higher interest rates would be brought about by postponement of the necessary cuts. The fourth drawback is the surrender of national policy instruments for economic policy. The euro will cause an elimination of national exchange rates and national rate policy. Before the euro, countries could devalue its national currency in relation to other EMU countries as a means of stimulation the economy. In times of economic downturn the support for the economy would come from the requirement of national budgets to be in order by the EMU. It is expected that as national boundaries blur, labor mobility in the EMU will gradually grow. The government deficit in the one country will lead to a higher interest rate in another country. If an exceptional budget deficit occurs in a state then the other member states will experience consequences. Union interest rates may rise which may cause a decline in confidence in the financial market. This is the reasoning behind the EMU requirements that the public sector have their finances to be in line. Once a country joins the EMU their budget must be maintained.

CONCLUSION

Europe stands on the brink of a new era of prosperity and unity, after a century scarred by war, tyranny, terrorism and economic chaos. The introduction of the euro and the formation of the European Union will have a large impact on the life and economic growth of the countries involved. There are different views on how and if the euro will work at all. A few good aspects of the new

single currency are the incentive for countries to reduce their budget deficits. Current European market will attract a lot of investors and will become significantly greater than the sum of the former European markets. The euro has been seen as formulating a mountain of capital and what many believe will become an optional reserve currency to the U.S. dollar. The two superpowers will bear an enormous responsibility for the new global monetary system. "While for much of the century Europeans, polarized in conflict, faced a frighteningly uncertain future, the end of the century sees most of the Continent working toward the common goal of economic cooperation and prosperity." (Mander, Europe, 1999)

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EXCESSIVE FUNDRAISING FEES MAY CAUSE RETROACTIVE REVOCATION OF TAX-EXEMPT STATUS: RECENT DEVELOPMENTS

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ABSTRACT

Section 501 (a) exempts organizations described in section 501(c)(3) from Federal income tax. One of the requirements for exemption is that no part of the organization's net earnings may inure to the benefit of a private shareholder or individual. In addition, Treasury Regulations state that in order to retain its tax-exempt status, an organization must engage primarily in activities that accomplish one or more of its exempt purposes. The purpose of this paper is to discuss several court cases that demonstrate how excessive fundraising fees had led to the retroactive revocation of an entity's tax exempt status.

INTRODUCTION

Section 501(a) exempts organizations described in section 501(c)(3) from Federal income tax. In order to qualify for an exemption under section 501(c)(3), an organization must satisfy four criteria:

It must be organized and operated exclusively for certain specified exempt purposes, including educational purposes.
No part of its net earnings may inure to the benefit of a private shareholder or individual.
No part of its activities may constitute intervention or participation in any political campaign on behalf of any candidate for public office.
No substantial parts of its activities may consist of political or lobbying activities.

These requirements are stated in the conjunctive. An organization's failure to satisfy any of the four requirements is fatal to its qualification under section 501(c)(3).

The purpose of this paper is to discuss the causes leading to the retroactive revocation of United Cancer Council, Inc.'s tax-exempt status by applying the decisions of several previous court cases involving the revocation or denial of tax-exempt status.

In a recent court case, United Cancer Council, Inc., v. Commissioner, 107 TC No 17 (1997), the Tax Court retroactively revoked the tax-exempt status of a tax-exempt organization because of the contract it had with a professional fundraiser. The court ruled:

> **The professional fundraiser was an "insider for purpose of the inurement provisions of sections 501 (c)(3)(2)(c), 170 (c)(2)(c)."**
> **There was an inurement of net earnings to professional fundraiser and tax-exempt organization fails to qualify as an exempt organization or as an eligible charitable donee.**
> **Retroactive revocation of tax-exempt status by the Internal Revenue Service was not an abuse of its discretion.**

FACTS OF THE CASE

United Cancer Council, Inc. (hereinafter sometimes-called UCC) was organized in 1963 as a Delaware not-for-profit corporation. UCC was a membership organization. Its members consisted of local cancer agencies throughout the country. The Internal Revenue Service (hereinafter referred to as the IRS) ruled in 1963 that UCC was exempt from federal income taxes under section 501 (c)(3) and donors may deduct contributions made to UCC.

UCC's foundry members had been previously local chapters of the American Cancer Society. These members broke off from American Cancer Society to emphasize cancer prevention, detection, and treatment rather than basic medical research for a cancer cure. In addition, members also separated from the American Cancer Society in order to participate in United Way fund raising campaigns, which were prohibited by the American Cancer Society at the time. Between 1963 and 1984, UCC acted as a support organization for its affiliate member agencies by providing access to educational cancer materials, publishing a quarterly newsletter, and holding an annual meeting each fall of its membership. Membership dues paid by affiliate member agencies supported UCC.

In 1983, some of its affiliate member agencies threatened to withdraw from UCC, which precipitated a budget crisis for UCC. In order to resolve the budget crisis, the board of directors of UCC entered into a "Full Service Direct Response Fundraising Agreement" (hereafter known as the contract) with a professional fundraiser, Watson and Hughey Company (hereinafter sometimes referred to as W&H). The term of the contract expired on May 30, 1989.

At the time UCC entered into the contract with W&H it did not have the financial resources to conduct any type of fund raising campaign, including a direct mail campaign, of its own. In fact, UCC was on the verge of being insolvent. Under the terms of the contract, W&H agreed to advance money to cover the initial costs of the mailings and also agreed to give an immediate advance or "draw" against the projected future earnings.

During 1984 through 1989, approximately 79.6 million fund raising letters were mailed and of the 79.6 million letters, 51.8 million were "prospect" letters and 27.8 million were " housefile" letters.

UCC received $2.25 million as a result of the fundraising activities occurring between 1984 through 1989. This amount represents approximately a quarter of the $8 million received as fees by W&H and its brokerage division, it also represents less than 10% of the total amount contributed as donations. (See Tables 1 and 2). In addition to the fundraising fees received from UCC, W&H also derived substantial income from its co-ownership rights in UCC's mailing list.

Table 1: Total Contributions Received

Year	*Total Contributions*
1984	$ 240,380
1985	5,087,453
1986	7,869,015
1987	10,740,045
1988	3,883,352
1989	943,142
Total	$ 28,763,387

Table 2: Total Expenses

Year	*Total Expenses*
1984	$ 241,251
1985	4,980,949
1986	7,255,744
1987	9,734,233
1988	3,229,425
1989	1,082,315
Total:	$ 26,523,917

OPERATIONAL TEST

The purpose of operational test per Income Tax Regulation 1.501 (c)(3)-1 (c)(1) is to insure that resources and activities are channeled to further exempt purposes of the organization. The Treasury Regulations state three requirements, which must be met to satisfy the requirements of the operational test.

The organization must be primarily engaged in activities, which accomplish one, or more specified exempt purpose.

No part of the organization's net earnings may inure to the benefit of any shareholder or individual.

The organization must not be an "action" organization i.e., one that devotes substantial part of its activities in lobbying efforts or intervene or participate, in any political campaign on behalf of or in opposition to any candidate in public office.

The Internal Revenue Service in United Cancer Council, Inc. contended that taxpayer; First, was not operated exclusively for exempt purposes because its activities served private commercial purpose. Second, it operated in large part for the benefit of "W&H". And third, its earnings inured to the benefit of private shareholders or individuals.

The IRS did not contend that United Cancer Council, Inc. is an "action" organization i.e., one which devotes a substantial part of its activities attempting to influence legislation, or participates or intervenes, directly or indirectly, in any political campaign.

OPERATED EXCLUSIVELY FOR EXEMPT PURPOSES

According to Treasury Regulations an organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. [Section 1.501(c)(3)-(1)(c)(1), Income Tax Regs.]

In Martin S. Ackerman Foundation v. Commissioner (hereafter referred to as the Foundation) the court ruled that the Foundation, a small private foundation with nonpublic sources of support, assisted individuals in making charitable contributions of artwork.

The Ackermans, Martin S. and Diane L., were president and controlling stockholder, respectively, of Sovereign American Arts Corporation (hereinafter sometimes referred to as Sovereign), which was a private art dealer. Sovereign sold artwork, at a profit to itself, to individuals who were advised by the Ackerman's they could assist them in making a charitable contribution of the artwork purchased through Sovereign to a charitable and/or educational institution.

The fact that the Ackerman's had a controlling interest in Sovereign, which was a for profit organization, and were trustees of the Foundation, through which many of Sovereign's clients used to donate artwork purchased from Sovereign, created a situation which served the private interests of the individual donors and the trustees-the Ackermans.

The court also found the services the Foundation provided in helping individuals make charitable contributions of artwork were both substantial in nature and in furtherance of a non-exempt purpose, thus violating the requirements of section 1.501 (c)(3)-1(c)(1), Income Tax Regs.

Note: The Tax Court did not address the IRS's alternate argument for revoking the exemption in that UCC was not operated exclusively for charitable purposes.

INURE OF EARNINGS TO THE BENEFIT OF PRIVATE SHAREHOLDER OR INDIVIDUAL

An organization shall be exempt from taxation under section 501 (c)(3) if no part of the organization net earnings inure to the benefit of any private shareholder or individual. The term "inurement" does not mean that payments can not be made to shareholders or individuals. Rather, payments made for other than for reasonable compensation for goods and services are prohibited. In Orange County Agricultural Society, Inc., the court ruled that the society was not operated exclusively for tax exempt purposes because it made interest-free loans to two corporations both of which were owned by persons having a controlling interest in the Society.

According to Regs. 1.501 (a)-1(c), a "private shareholder or individual" is broadly defined as any person having a personal and private interest in the tax-exempt organization. These "private shareholders or individuals" are sometimes referred to as "insiders". UCC maintained that inurement doctrine applies to insiders who receive impermissible benefit from the organization and not to third parties with whom the UCC contracted for services.

Many times the IRS's two requirements that an organization must "operate exclusively" for tax-exempt purposes and "no part of the net earnings" may "inure to the benefit of any private shareholder and individual" frequently overlap. Each requirement must be looked at separately and failure to satisfy either requirement results in revocation of the organization's tax-exempt status.

In order to answer the question of UCC's net earnings inuring to the benefit of W&H the Tax Court examined the fundraising activities provided by W&H, in particular the direct mail campaign. In reviewing the direct mail campaign the Tax Court looked at the contract entered into between UCC and the professional fundraiser. Under Section 18 of the contract, W&H would still retain co-ownership of the mailing lists with UCC, even after the term of the contract has expired. Although co-ownership of the mailing lists is fairly typical in charitable fundraising arrangements, the Tax Court found the provisions of this arrangement to be both restrictive for UCC and to the benefit of W&H. An example of this cited by the court was the reimbursement of W&H's out-of-pocket expenses by UCC when W&H exchanged UCC's mailing list for another organization's mailing list. This had the effect of providing additional compensation to W&H by UCC, for W&H incurred no expense in the "exchange" of mailing lists with other organizations.

The Tax Court found the $2.25 million received from the total amount of contributions received represents such a small amount when compared to the amount of compensation received by W&H and the expenses associated with the fundraising campaigns so as to be almost an incidental product of the fundraising campaign. The Tax Court stated the contract was not a reasonable compensation arrangement and that W&H's compensation under the contract with UCC exceeded reasonable compensation. Thus, the Tax Court found there was an inurement to an insider, in violation of the restrictions in sections 501(c)(3) and 170(c)(2)(C).

In Unitary Mission Church v. Commissioner, the court ruled an organization's payment of reasonable compensation to an insider for services performed for the organization would not constitute inurement of net earnings, but excessive payment of compensation would. This led to the court denying Unitary Mission Church's tax-exempt status as a religious organization under section 501(c)(3) and section 170(b)(1)(A)(i).

PRIVATE INTERESTS AND UNRELATED THIRD PARTIES

In American Campaign Academy v. Commissioner (hereafter referred to as Academy), the taxpayer's primary activity includes an operation of a school to train individuals to fill responsible positions in political campaigns. The court ruled that Academy's activities benefited private interests of the Republican Party and held that private interest include those of unrelated third parties. Academy maintained that prohibition against private benefit is limited to situations in which an organization's insiders are benefited. Academy further argued that since "Republican Party activities and candidates" are unrelated third parties and must be excluded from the class of private persons whose receipt of a substantial benefit would cause the organization to be operated other than exclusively for exempt purpose. Since Republican activities and candidates are not interested insiders, private benefit analysis of Income Tax Reg. Section 1.501(c)(3)-1(d)(1)(ii) does not apply in the instant case. The court disagreed with Academy and observed that the prohibition against private inurement of net earnings seems redundant, since the inurement of earnings to an interested person or insider would constitute like conferral of a benefit inconsistent with operating for an exempt purpose.

In Rev. Rul. 76-456, 1976-2 C.B.151 with the instant case. In Rev. Rul. 76-456, the organization on a nonpartisan basis, collected, collated, and disseminated information concerning general campaign practices through the press, radio, television, mail, and public speeches. In the Rev. Rul., the IRS ruled that In comparison to Rev. Rul. 76-456, Academy conducted its educational activities with the partisan objective of benefiting Republican candidates and entities. Therefore, when an organization permits its net earnings to inure to the benefit of a private shareholder or individual, it transgresses the private inurement prohibition and thus operates for a non-exempt private purpose.

In the United Cancer Council case the Tax Court agreed with the IRS that Watson & Hughey Company was an "insider" due to its ability to significantly control UCC's fundraising activities for the benefit of W&H. W&H did this through its control over the Escrow Account funds, substantial control over UCC's finances,[11] and its exclusive contract to provide for UCC's fundraising activities. W&H's control over UCC's fundraising campaign is further manifested by UCC's unsuccessful efforts to obtain a copy of its own housefile in July 1988, about 11 months before the contract ended. W&H refused to provide to UCC a copy of its housefile until the contract was over. In addition, UCC receipts totaled less than 10% of the amount donors contributed, with the remaining 90% going to W&H.

RETROACTIVE REVOCATION

UCC asked the Tax Court to reconsider the retroactive revocation of its tax-exempt status to the 1984 date of the contract with W&H, claiming an abuse of the IRS's discretion. The Supreme Court has held that the IRS has broad power under the Code to retroactively revoke exemptions and a retroactive revocation can only be reviewed for an abuse of discretion. The Tax Court ruled that:

> The retroactivity of the revocation to the start of the contract is not an abuse of discretion when tested by the usual standards.
> UCC does not maintain these standards have been modified as a result of section 601.01 (n)(6), Statement of Procedural Rules, or Rev. Proc. 90-27.
> The retroactive revocation of UCC's tax-exempt status would not be an abuse of discretion even if usual standards were so modified.

The Tax Court concluded that the revocation would be meaningless if it occurred after the contract between UCC and the professional fundraiser, W&H had expired. The retroactive revocation did not, however, affect the charitable deduction that donors to UCC had taken since 1984.

REVOCATION OVERTURNED

In United Cancer Council, Inc., v. Commissioner, CA-7 Feb. 10, 1999, the Seventh Circuit Court overturned the Tax Court decision concerning the retroactive revocation of UCC's tax-exempt status. The Seventh Circuit Court (hereinafter referred to as the Seventh Circuit) was not impressed by any of the IRS's arguments in favor of denying and revoking UCC's tax-exempt status.

The IRS argued that since UCC had no money at the inception of the contract and all of the expenses of the fundraising campaign were borne by the fundraiser, W&H, the fundraiser was similar to being a founder of the charity. The Seventh Circuit stated that this has nothing to do with the inurement clause of section 501(c)(3). The Seventh Circuit said that if this were the case it would, "deny exemption to any new or small charity that wanted to grow by soliciting donations, since it would have to get the cash to pay for the solicitations from an outside source, logically a fundraising organization."

When it came to the issue of control the IRS said, since Watson & Hughey Company was United Cancer Council's sole and only fundraiser, the charity was at the mercy of Watson & Hughey Company during the term of the contract. This, the IRS claimed, gave the fundraiser effective control of the charity because United Cancer Council, Inc. would not be able to hire another fundraising firm if Watson & Hughey Company stopped its fund raising efforts.

The Seventh Circuit reply to the IRS's argument that Watson & Hughey Company had control over United Cancer Council, Inc. through the terms of the contract entered into between the fundraiser and the charity was to make two points: First, the exclusivity of the contract between the fundraiser and UCC lent assurance to the fundraiser that if successful, UCC would not hire other fundraisers that would benefit from the work done by W&H, and not to control UCC as claimed by the IRS. Second, when granted an exclusive contract, the firm has a legal obligation to use its best efforts in order to promote the contract's objectives. If the fundraiser failed in this endeavor UCC would be free to terminate the contract.

The Seventh Circuit Court remanded the IRS's alternate argument not addressed by the Tax Court – that is, UCC was not operated exclusively for charitable purposes. While not prejudging

the issue, the Seventh Circuit noted the board of a charity, like the board of an ordinary business corporation, has a duty of care, and a violation of this duty involving the dissipation of the charity's assets may support a finding that the charity was conferring a private benefit. This could hold true even if the contracting party, in this case a fundraiser of the charity, did not control the charity. This issue must be considered on remand by the Tax Court.

CONCLUSION

In the case United Cancer Council, Inc., v. Commissioner, 107 T.C. No. 17 (1999), the Tax Court found that United Cancer Council, Inc. failed to comply with section 501(c)(3) of the Income Tax Regulations and therefore found cause to retroactively revoked United Cancer Council, Inc.'s tax-exempt status. This decision was later struck down by the Seventh Circuit Court. The Seventh Circuit Court did not view the IRS's argument that Watson & Hughey's contract with United Cancer Council, Inc. violated the inurement provision of section 501(c)(3), nor did it agree with the Tax Court's findings that the fundraiser was an insider and can be considered a founder of the charity.

Although United Cancer Council, Inc. claimed its experience with its fundraiser Watson & Hughey Company was a success, it failed to renew the contract with Watson & Hughey Company when it expired in May 1989. United Cancer Council, Inc. hired another fundraising organization, with dire results, and in the following year declared bankruptcy.

It remains to be seen if we have seen the last of this case, for it goes right to the center of tax practice in the exempt – the tax-exempt status of the organization itself.

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MEASUREMENT DIFFERENCES IN SUBSTANCE AND FORM: AN ATTITUDINAL SURVEY ON LOCALIZED VALUE -ADDED ACTIVITY

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ABSTRACT

This paper outlines the main analytical components of measurement ambiguity as applied to the localization of value-added activity by multinational enterprises. Empirical data was collected using a survey of executives of foreign firms currently doing business in the USA. It gathered demographic data, queried executives' opinions about measurement issues in the determination of current local content value, inquired about local content embodied in their primary product, and assessed attitudes toward the importance of local content. Evidence supported a three part paradigm to explain sources of variation and clearly rejected the proposition that all product cost categories are considered equally appropriate for inclusion in local content calculations. These findings provide a beginning for harmonization of accounting standards. One set of rules would lead to more efficiency and increased transparency in reporting of local content and the localization of value-added activity

INTRODUCTION

Today competitive rivalry crosses country borders and global industries continue to develop; consequently the world economy has often become the relevant corporate environment. National sovereignty gives international business distinctive characteristics; diverse factor endowments, multiple national political objectives and exchange rate variations are everyday facts of life. Individual firms have many incentives to source raw materials and intermediate goods from various countries. Lower production cost, control of critical supplies, market logistics, financial hedging, political and legal local content requirements influence strategic procurement and production decisions which affect the degree of local content in end products.

As nations seek industrial supremacy, requirements for specific local content percentages affect competitive issues in both domestic and international arenas. For example, in Belgium long-standing investment aid programs are linked to job creation. As a result foreign suppliers of telecommunications equipment have had a hard time gaining market access without production facilities within the country. The European Community directive to liberalize public procurement gives E.C. bids preference; foreign bids may be ignored entirely if more than half of their price represents the value of products manufactured outside the E.C.. Rules to protect community based raw materials industries may adversely affect the industrial user groups (Maclean & Eccles, 1999).

When a firm like Toyota or Siemens locates value chain activities around the world, what criteria should determine the "country of origin" for the end product? Issues of measurement abound in the area of determining the percentage of local content. Often the question of measurement is avoided, parallel but perhaps unequal measures are promoted by different players in the international business community. True comparisons are stymied in these situations. However, if agreed upon measures can emerge globalized- local economies really can be better understood. To this end variations in the measurement of local content value are analyzed here. The actual substantive localization of value-added activities, calculation method preferences, and method application from the normative perspective were investigated.

LITERATURE REVIEW

Because the proposed research questions are multidimensional in discipline, various streams of literature must be considered. Accordingly this review delves into several areas in order to provide coverage of the different paths local content research has taken. The primary advantage of a multinational enterprise (MNE) as opposed to a domestic or national corporation, lies in the flexibility to transfer resources across borders through a globally maximizing network. However, as MNEs seek to create competitive advantage through global integration of their value chain activities, localization pressures accumulate throughout their worldwide markets. In recent years a great amount of international business research has articulated the need for MNE strategic objectives and investment motives to accommodate the political policies that originate in various host countries. Indeed, an extensive body of literature on foreign direct investment (FDI) has discussed the relative importance of location-specific, firm specific and internalization factors. International strategic management writers have addressed the shareholder profit maximization versus stakeholder equity conflict on a micro level, firm by firm. While examining the virtues of global production rationalization, they have also recognized the need to be locally responsive in the presence of differing economic, social and political objectives among host nations.

Global resource allocation is driven by many external environmental factors both economic and political. Political platforms and social ideology have significant influence on the propensity of a government to impose and enforce the use of domestic inputs by public and private enterprise located within national boundaries. The US Government Accounting Office calls local content rules an important policy tool (GAO, 1987). The economic literature may be used as a guide to explain how local content legislation effects domestic welfare. Reasons include but are not limited to sector specific employment, expansion (final and intermediate goods), competitiveness and national firms, industrial policy and defense, increased/reduced consumer surplus, trade distortion externalities and balance of payments (BOP) issues. An analysis of the socio-economic conditions which support increasing local content requirements and the strategic management reasons for localizing value-added activities are addressed elsewhere (Taylor, 1997). The foci of this paper are measurement issues.

North American and European trade agreements encourage multinational firms to develop local procurement policies and a network of production facilities within the region. As differences among national local content regulations phase out. production shifts, such as closing the Volvo plant in Halifax, are likely to occur. International trade statistics indicate growth in intra-firm trade

(Tang, 1993). This means that an ever growing number of products embody parts, components and raw materials originating around the world. According to the Government Accounting Office (GAO) this trend toward the internationalization of production makes it difficult to assign origin unambiguously and complicates the administration of trade policy measures directed at the products of specific nations (GAO, 1987). They continue to question the "origin" of component parts made in the USA by foreign owned firms.

THE AMBIGUITY PROBLEM

The value of local content has tangible and intangible aspects that may be inter-temporal as well. The primary problem is the ambiguity created by multiple definitions resulting in a lack of a common understanding about what constitutes local content value (LCV). There is no transparent disclosure of the actual amount of value produced locally. Ambiguity arises from substance and measurement; both can contribute to LCV variation. Differences may arise from differences in the actual amount of components acquired or produced locally, the calculation method chosen, **or from the costs included (excluded) in calculation (Tang, 1990). Substance variance occurs when the local inputs or value-added differs among products. However, the use of alternate calculation methods or deviation in application can result in disparate LCV values with no change in substance. Accordingly, the tri-part research tested three hypotheses. First respondents were surveyed to determine opinions about three calculation methods drawn from the literature. Next, both the normative and substantive dimensions of product cost were researched. Executives' attitudes about which categories of product cost are appropriate for inclusion in the calculation of local content were solicited; then the frequency of US localization for particular types of cost were investigated. This provided a cross-check for their espoused attitudes versus strategic actions.**

METHOD CHOICE: DISCUSSION OF CALCULATION METHODS

In the USA the Securities Exchange Commission (SEC), the Internal Revenue Service (IRS) the Government Accounting Office, and the Generally Accepted Accounting Principles (GAAP) for Certified Public Accountants (CPA) all have their own rules. Country of origin, tax liability, trade policy political pressure and proper financial disclosure motivate the rules. Multiple rules lead to multiple definitions which often reflect objectives of different stakeholders; but, do not necessarily beget clear disclosure of how much value was added locally. Executives were queried about preferences among the three methods. The Substantial Transformation (ST) method is used in the European Community to define the country of origin. When initiating the Auto Pact to encourage the establishment of local auto plants, Canada chose. the Value-Added (VA) method. The Number of Parts (NP) method ignores value and defines local content as the ratio of US parts to the total number of parts. This method encounters problems with "roll-up" accounting and deciding which parts to count.

METHOD APPLICATION: INFLUENCE OF ACCOUNTING CHOICES ON LCV

Generally accepted accounting principles (GAAP) insist appropriate accounting methods be applied on a consistent basis to report the substance of a transaction rather than its form. Fixed manufacturing cost is absorbed into product cost on a reasonable allocation basis. But, choices among depreciation methods, amortization schedules and inventory valuations allow firms flexibility in the time and place of income (cost) recognition. NAFTA does not have clear guidelines for purchasing and product support cost allocation There have been arguments against allowing the mortgage interest on a factory in the USA if the lending bank is Japanese (US Senate Finance Committee Hearing, 1991). International Accounting Standards (IAS) allow even more accounting choices. Firms benefiting from import protection make income decreasing accounting choices during the investigation period (Jones, 1988).

Transfer prices are the value assigned to components which move between divisions of a firm; for an MNE they have significant influence on the reported local content of the final product. Any increase (decrease) in the transfer price changes the local content ratio without any change in the actual substance of the transaction. International accounting reporting and disclosure requirements may differ from US requirements. Conceptually transfer prices should reflect a fair exchange in a free market; transfer price should be set at the price that would be charged in a basic arms length market transaction. MNEs manipulate transfer prices to meet local content requirements or to hide profits. High transfer prices on capital equipment indirectly inflate local content via depreciation. Foreign exchange risk and tax minimization policies and import protection goals (Jones, 1988) impact transfer prices.

RESEARCH CONCLUSIONS

Variation due to method choice was investigated. HO 1: Method choice contributes to variation in local content value. The position that method choice can be a factor contributing to variation in the value of local content is supported. Results of the SPSS parametric test suggest that there are differences in the distributions of choices for the three methods. Results indicate chi-square = 44.1613, df = 2, significance .0000. However, the degree of agreement about the best method was higher than expected. A majority of the respondent (67%) chose the value added method.

Product cost was investigated using a survey data collected within the framework of Porter's value chain and generally accepted cost accounting principles. Accounting information systems that utilize this framework can more easily generate reports for calculation of local content under the various methods as required. Both normative and substantive sources of LCV variation were investigated. Opinions were gathered about fifteen specific costs. The data collected spans three general cost categories, namely, factory costs, procurement costs and distribution costs.

Normative differences represent a lack of agreement about which product costs should be included in the calculation of local content w hen using the value-added method. The normative hypothesis, HO 2: All product cost categories will be considered equally appropriate for inclusion in local content calculation is rejected. Cochran's Q value (198.8582 with 14 df) indicates that HO

2 can be rejected ($p<.00002$). In other words, there is evidence of that some costs categories are more acceptable as appropriate for inclusion in local content determination.
Now consider HO 3: All categories of product cost are equally localized. This investigates the actual expenditure differences among cost categories. Cochran's Q (120.0831 with 14 df , $p<.000$) shows that HO 3 can also be rejected. This means that there is evidence that some cost categories are localized more frequently than others.

The emergence of a preferred method shows promise of increased future reporting transparency. The fact that a majority (67%) of the executives chose the value-added method makes these findings even more useful. Michael Porter (1990) popularized the value-added approach to strategic management which in turn has influenced managerial accounting texts and practice. Target costing and activity based costing (ABC) are managerial accounting techniques based on the value-added concept that are applicable to service as well as manufacturing firms. s (Brausch, 1994).

As industrial production processes, R & D and component parts procurement and competition (Porter, 1990), continue toward globalization, the country of origin issue will probably continue to be an important issue in the years ahead. As firms continue not only product but also international diversification (Morck & Yeung 1991, Mitchell et al. 1992) competitive and cooperative global alliances will be pursued beyond national boundaries into regional common markets. This will increase the desire of individual governments to maximize domestic welfare (Root, 1994) by enticing and controlling the transnational corporations operating within their borders (Brewer, 1993; Rolfe,1993; Root, 1994).

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RECENT SINGLE AUDIT ACT AMENDMENTS REQUIRE MAJOR CHANGES FOR AUDITS OF GOVERNMENTS AND NON-PROFIT ORGANIZATIONS

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ABSTRACT

The Single Audit Act of 1984 consolidated the auditing and reporting requirements for all government agencies receiving federal financial assistance. OMB Circulars A-128 and A-133 implemented regulations and standards and standards for governmental and non-profit agencies. These requirements are in addition to requirements set forth by the AICPA's generally accepted auditing standards and generally accepted government auditing standards. Recently, a number of major changes have been enacted which significantly affect audits of entities that receive federal funds. This paper summarizes the changes required by the major revisions to OMB Circular A-133 and recent amendments to the Single Audit Act.

BACKGROUND AND HISTORY

The Single Audit Act of 1984 put into law the audit requirements for all federal funded governmental units. Prior to 1984, a problem existed in that some governments rarely received audits examining federal funds, while others were faced with multiple audits, each examining a separate grant award. The Single Audit Act remedied this problem by changing the audit focus for entities receiving federal assistance from compliance with individual federal grant requirements to a single coordinated audit of the entire entity. Thus, the purposes of the Single Audit Act were to:

Improve the financial management of state and local governments with respect tofederal financial assistance programs

Establish uniform requirements for audits of federal financial assistance provided to state and local governments
Promote the efficient and effective use of audit resources; and
Ensure that federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to the Single Audit Act .

ENTITIES SUBJECT TO A SINGLE AUDIT

The Single Audit Act originally required an audit of each state and local governmental unit that receives federal financial assistance equal to or in excess of $100,000. Those state and local governments that received between $25,000 and $100,000 could elect to have either a Single Audit or a program-specific audit, and those that received less than $25,000 in federal assistance were exempt from the requirements of the Single Audit Act and other federal audit requirements. In recent years these requirements have been modified and amended as discussed below.

REGULATION AND IMPLEMENTATION

Under the Single Audit Act, the Office of Management and Budget (OMB) is required to establish regulations to implement the Single Audit. The OMB was established within the Executive Office of the President in 1970 and assumed responsibilities previously held by the Bureau of the Budget. The OMB communicates its financial and administrative requirements in the form of OMB circulars, which provide guidance and establish standards of performance relating to accounting, budgeting, financial management, grants, and contracts for federal agencies. Two OMB circulars, Circular A-128 and Circular A-133, relate specifically to the implementation of the Single Audit. Circular A-128, *Audits of State and Local Governments* was issued in 1985 and established requirements for state and local government audits. Circular A-133, *Audits of Institutions of Higher Education and Other Non-Profit Institutions*, was issued in 1990 and established requirements for institutions of higher education and other not-for-profit organizations that receive financial assistance either directly or indirectly from the federal government. In 1996, the OMB revised Circular A-133 to apply to both audits of state and local governments and not-for-profit entities. The revised Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* rescinds Circular A-128 and is effective for audits of fiscal years ending on of after June 30, 1997.

COGNIZANT AGENCIES

The OMB is responsible for assigning cognizant agencies to oversee the implementation of the Single Audit for state and local governments. The Director of the OMB is responsible for assigning a cognizant agency to implement the Single Audit Act requirements for a particular state or local government. The responsibilities of cognizant agencies include the following:

Ensure that audits are conducted in accordance with the OMB Circulars and reports are filed in accordance with the Act.

Provide technical assistance to recipients of federal financial assistance and to their independent auditors

Obtain or make quality control reviews of selected audits conducted by nonfederal auditors and distribute results of these review as appropriate

Advise recipients of substandard audits, and to

Promptly inform other affected federal agencies and appropriate federal enforcement officials of any reported illegal acts of irregularities.

REVISED CIRCULAR A-133

The revised Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations,* implemented in 1997, consolidated Circulars A-128 and A-133 and contains several important changes from the original Single Audit Act of 1984. Perhaps the biggest change is that single audits are now only required for entities receiving more than $300,000 in federal financial assistance. The Director of the OMB is required to review this threshold every two years, and may adjust the amount as necessary, but never below the $300,000 limit currently set. Additionally, all entities that receive less than $300,000 are now exempt from the requirements to be audited, a considerably greater threshold than the $25,000 set under the original Single Audit Act. All entities, whether subject to the requirements of a Single Audit or not, must maintain appropriate records of their federal assistance and must permit access to those records when requested. Other modifications found in the revised Circular A-133 will be referenced throughout this paper as appropriate.

OVERALL REQUIREMENTS

Prior to 1984, audits of governmental entities were regulated by the requirements of the AICPA's generally accepted auditing standards (GAAS) and the more specific generally accepted government auditing standards (GAGAS) which are set by the U.S. Comptroller General in accordance with Congressional directives. The Single Audit requirements build on these standards and add additional elements specific to entities receiving federal financial assistance. The reporting requirements under the 1984 Single Audit Act are:

The financial statements of the entity present fairly its financial position and the results of its financial operations in accordance with generally accepted accounting principles; and the entity has complied with laws and regulations that may have a material effect upon the financial statements;

The entity has internal control systems to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations; and

The entity has complied with laws and regulation that may have a material effect upon each major federal assistance program.

MAJOR VS. NONMAJOR PROGRAMS

The Single Audit Act has different audit and reporting requirements for "major" and "non-major" programs. A major program was defined as those programs whose expenditures met certain levels of spending. This level of spending varied among entities, as it depended on the total financial assistance received by the organization. For governments having a total annual expenditure of federal financial assistance up to $1 million, a major program is considered to be one for expenditures exceed the larger of $300,000 or 3 percent of total program expenditures. For governments having a total annual expenditure of less than $1 million, there are separate guidelines. The revised Circular A-133 changes the method by which a program is determined to be "major." Under the new law, there is a step-by-step analysis that guides the auditor through the selection of major programs. This process now focuses on a risk assessment rather than solely on the amount of monetary assistance received by the program as was previously done. An auditor's judgment plays a critical role in this four-step process. The four steps are as follows:

Identify the larger federal programs

The first step is to identify the larger federal programs, designated as Type A programs. These are programs whose total expenditures represent a significant percentage of total federal expenditures, and range from $300,000 to $30 million depending on the amount of federal financial assistance the entity receives.

Identify the other programs

All other programs are designated Type B programs, but are sub-classified as being either low-risk Type A programs, high-risk Type B programs, or minimum audited programs.

Low-Risk Type A Programs

The auditor should classify a program as low-risk Type A if it meets the following criteria: it has been audited as a major program in at least one of the two most recent audit periods, and no audit findings for reportable conditions, material noncompliance or known questioned costs in the most recent audit period, and the auditor's feels it should be classified as this based on the auditor's consideration of the Circular's criteria for program risk. This criteria is based on current and prior client audit experience, oversight exercised by federal agencies and pass-through entities, the inherent risks of the federal program, and designations by federal managers for programs that are considered low-risk.

High-Risk Type B Programs

The auditor should assess these programs using the same criteria as for low-risk Type A programs, but should only do so for larger Type B programs. These are programs whose expenditures are greater than $100,000 (or .3%) of total federal expenditures when the total is equal to or less than $100 million, or $300,000 (or .03%) of total federal expenditures when the total is more than $100 million.

Minimum Audited Programs

Regardless of the amount of federal financial assistance expended on a program, the auditor should, at a minimum, audit several programs. These include all Type A programs, high-risk Type B programs, and any necessary additional programs that will enable the auditor to audit as major programs federal programs with expenditures that, in the aggregate, include at least 50% of total federal expenditures.

Thus, the definition of a major program under the revised Circular A-133 takes into account both federal award amount as well as the degree of perceived risk in the program.

THE YELLOW BOOK

Generally accepted government auditing standards (the Yellow Book) provide the guidelines for which general governmental audits should be performed. The Yellow Book auditing standards are consistent with the AICPA's ten generally accepted auditing standards, but contain several additions and modifications in areas such as materiality and significance, quality control, and legal and regulatory requirements. The Yellow Book recognizes that the margin of acceptable audit risk may be lower than the risk for a regular commercial audit engagement. Additionally, the Yellow Book requires that those engaging in audits of governmental entities have an appropriate system of internal quality control and also be a participant in an external quality control review. Further, the Yellow Book requires auditors to identify relevant laws and regulations and determine which of those laws and regulations could have a direct and material effect on the financial statements or the

results of a related financial statement audit. Additionally, the Yellow Book requires that an auditor assess, for each material requirement, the risk of material noncompliance and to design audit procedures that will provide the auditor reasonable assurance that both unintentional and intentional instances of material noncompliance are tested. Finally, the Yellow Book contains a standard that more specifically details the method by which the auditor should document audit work than AICPA regulations.

INTERNAL CONTROL REVIEW REQUIREMENTS

In addition to GAGAS reporting requirements, the Yellow Book imposes an additional standard relating to internal control. This standard maintains that the report on the financial statements should either describe the scope of the auditors' testing of compliance with laws and regulations and internal controls and present the results of those tests or refer to separate reports containing that information. Thus, the auditor is required to provide a description of the scope of internal control work performed and the results of test performed during the audit. Additionally, the auditor is required to report irregularities, illegal acts, and reportable conditions in internal controls, and the auditor must recognize that some instances will require reporting outside the governmental entity being audited.

CHANGES UNDER CIRCULAR A-133

For entities subject to a Single Audit, the revised Circular A-133 provides specific guidelines relating to internal control. The revised Circular A-133 defines internal control as a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable laws and regulations. The auditor must perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. The Circular also requires the auditor to test the internal controls relevant to each federal program over each major program until at least 50% of federal financial assistance are subject to tests. These tests are in addition to those previously required under the Yellow Book.

COMPLIANCE REVIEW REQUIREMENTS

As with other audit procedures, at a minimum a Single Audit engagement requires the auditor to follow generally accepted auditing standards and the Yellow Book in terms of compliance review. In addition to those regulations, the revised Circular A-133 specifies several compliance review requirements for the auditor. These include test of compliance necessary to provide sufficient evidence to support an opinion on compliance as well as obtaining reasonable assurance that the organization has complied with requirements that could have a direct and material effect on each major program. In addition, the auditor must follow-up on prior audit findings and report on the status of any corrective action. More specific requirements of these areas are detailed below.

Audit Procedures

The objectives of auditing procedures for federal financial assistance are to provide sufficient, competent evidential matter to reasonably assure the detection of noncompliance with specific requirements applicable to major federal financial assistance programs. Additionally, the audit procedures must enable the auditor to issue a report containing either an opinion on compliance or a statement that such an opinion cannot be expressed. In designing tests for compliance, the auditor should use information from his understanding of the internal control structure and testing controls over federal programs. There are no specific requirements for statistical sampling, but the auditor should ascertain that sample sizes are sufficient and representative for each major program. As with most other audit procedures, the nature, timing, and extent of compliance testing should be based on the auditor's judgment and the overall strength of the entity's internal control structure.

Major Program Compliance

As discussed above, under the Single Audit Act the auditor is required to distinguish between "major" and "non-major" programs. The auditor is required to test compliance for each of the major programs, and as such should obtain reasonable assurance that the entity is complying with program laws and regulations.

Follow-Up on Prior Year Findings

The revised Circular A-133 now requires the auditor to follow-up on prior year audit findings. The auditor should ensure that the governmental entity has adequately corrected any problems identified in the previous year. The auditor must complete this follow-up even if the findings from the prior year do not relate to any major programs in the current year.

As discussed, a Single Audit encompasses both the requirements for a GAAS audit and a Yellow Book audit. The requirements under the Single Audit and the revised Circular A-133 are the most specific, and apply to all governmental and nonprofit organizations that receive federal financial assistance. The general shift to the risk-based approach when determining whether or not programs are "major" or "non-major" have been implemented to provide that the auditor focus more on programs that need more audit coverage when auditing internal control and compliance requirements.

Required Audit Reports Under the Single Audit Act

Under the Single Audit Act, there are several specific requirements by which auditors must comply when reporting their audit findings. These include an exit conference, auditee reporting requirements, a report on the financial statements, internal control and compliance reports, a schedule of findings and questionable costs, and a report on any illegal acts.

Exit Conference

The purpose of the exit conference is to discuss the audit draft reports for the Single Audit with management of the governmental entity. Additionally, the exit conference provides an opportunity for the auditors to discuss any errors, irregularities, illegal acts, and other matters discovered during audit proceedings that need to be communicated to the entity's management or audit committee. The auditor should clearly document the exit conference and should use this documentation to finalize reports and resolve any open issues from the fieldwork.

Auditee Reporting Requirements

The governmental entity is required to assemble a reporting package that must include the financial statements and Schedule of Expenditures of Federal Awards, a summary schedule of prior audit findings, the auditor's report, and a corrective action plan. Under the original Single Audit Act of 1984, this reporting package had to be submitted within 30 days after receipt of the auditor's report or nine months after the end of the audit period, whichever was earlier. Under the revised Single Audit Act of 1996, however, the due date for submitting a reporting package is now the earlier of 30 days after receipt of the auditor's report or 9 months after the end of the audit period. In addition to this, the governmental entity should make copies of the reporting package available for public inspection.

Schedule of Prior Audit Findings

One of the mandatory reports that auditors must complete for entities subject to the Single Audit is a schedule of prior audit findings. This summary schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs. For items that have been corrected by the government entity, the summary schedule only needs to list the audit findings and state that proper corrective actions were taken. Additionally, the auditor should include a corrective action plan in this schedule to account for items discovered in audit proceedings that need to be corrected by the entity. The plan should give the names of the contact persons responsible for corrective action, the corrective action that must be completed, and the anticipated completion date.

Report on Financial Statements

The Single Audit Act requires an organization-wide financial statement audit in accordance with generally accepted auditing standards. This report will generally include the auditor's opinion on the basic financial statements as well as a paragraph referencing any additional financial schedules relevant to the entity's audit. In addition to these reporting requirements, the revised Circular A-133 requires that auditors attach a summary of the results of the audit to the package or materials they submit to the federal government.

Internal Control and Compliance Reports

One of the major requirements of Circular A-133 is that the auditor issue a report on internal control as it relates to the financial statements and major programs, as well as a report on the entity's compliance with laws, regulations, and the provisions of contracts or grant agreements. The report on internal control should describe the scope of testing of internal control and the results of those tests. The report on compliance should include an opinion as to whether the entity complied with laws, regulations, and provisions of contracts or grant agreements that could have a direct and material effect on each major program.

Schedule of Findings and Questioned Costs

In addition to the internal control and compliance reports, Circular A-133 provides that the auditor include a separate report showing findings and questioned costs. This report is primarily for the use of the entity's audit committee or cognizant agency, as they will determine the appropriate resolution of any issues in the report.

Illegal Acts

Detection of illegal acts should be an important component of the compliance testing during an audit engagement of a governmental unit. Auditors are required to report any irregularities or illegal acts that are significant and have a material effect on the financial statement. If the auditor discovers instances of illegal acts or irregularities that are not significant and do not have a material effect on the financial statements, the auditor may choose to report these instances in the management letter. As would be expected, all documentation concerning irregularities or illegal acts should be adequately documented in the auditor's workpapers.

CONCLUSION

In conclusion, the Single Audit Act of 1984 consolidated the auditing and reporting requirements for all government agencies receiving federal financial assistance. OMB Circulars A-

128 and A-133 implemented regulations and standards for governmental and non-profit agencies, and the revised Circular A-133 of 1996 further consolidated requirements providing legislation for any entity receiving federal financial assistance. In addition to fulfilling requirements set forth by AICPA's generally accepted auditing standards and generally accepted government auditing standards, there are additional requirements for entities subject to the Single Audit. These requirements include internal control review requirements, compliance review requirements, and required audit reports. The Single Audit Act has successfully streamlined the manner by which federally funded governmental and non-profit agencies are funded, continually improving the performance of these agencies.

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The Single Audit Act of 1984

TIPS FOR INVESTING

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ABSTRACT

In January 1997, the United States Treasury, for the first time, issued $7 billion of 10-year inflation-indexed bonds. Treasury inflation-protection securities (TIPS) provide investors with a tool to protect their portfolios against the devaluing effects of inflation by adjusting the principal amount (and thereby also adjusting the interest income) in order to keep pace with the current rate of inflation. As of February 1999, the Treasury had issued a total of $47 billion of TIPS notes and bonds. However, not much is known about the investment performance of TIPS. To date, only two empirical studies have examined TIPS (Lamm 1998; Lucas and Quek 1998), and both studies were based on data during only the first few months of TIPS trading. The proposed study seeks to contribute to the financial and taxation literatures by analyzing a longer time series of TIPS trading data. More specifically, we will examine the risk/return characteristics of TIPS, study their role in an investment portfolio, and assess their after-tax investment implications for individual investors. Moreover, we will also compare the impact of the different inflation rates and tax treatments on inflation-indexed bonds in foreign countries to the inflation and tax effects on TIPS in the United States.

BACKGROUND INFORMATION

In January 1997, the United States Treasury, for the first time, issued $7 billion of 10-year inflation-indexed bonds. Treasury inflation-protection securities (TIPS) provide investors with an additional tool to hedge (protect) their portfolios against the devaluing effects of inflation. Both the semi-annual interest payments and the principal amount on TIPS are adjusted daily to keep pace with the current rate of inflation (measured by the change in the Consumer Price Index over a six-month period). The strong investor reception to the initial issue prompted the Treasury to issue $16 billion more in April and July of 1997. As of February 1999, the Treasury had issued a total of $47 billion of TIPS notes and bonds.

Given the recency of these securities, not much is known about the risk/return characteristics of TIPS, their role in an investment portfolio, or their after-tax implications. With respect to taxes, bondholders are taxed annually on increases to the principal portion of the bond, even though the increase is not received in cash until the bond matures. Hence, unless these bonds are placed in tax-deferred retirement instruments (e.g., Individual Retirement Accounts), other assets in the investment portfolio may need to be liquidated each year in order to pay these taxes. This study will investigate the tax implications of TIPS.

To date, only two empirical studies have examined the portfolio investment or tax implications of TIPS (Lamm 1998; Lucas and Quek 1998). In both studies, the analyses were based on data during only the first few months of TIPS trading. Because of limited data on the investment performance of TIPS, Lamm (1998) conducted his study of TIPS using a rather simple technique

known as scenario analysis. We seek to make a contribution to the literature by using the more rigorous approach of time-series regression analysis over a longer time series of data. Our study will utilize at least 30 months of trading data to study the investment performance of TIPS.

OBJECTIVES

This proposed study seeks to investigate the following issues:

What are the investment implications for an individual investor's portfolio allocation with and without TIPS? One of the best ways to determine the effects of TIPS on individual investors is to analyze their risk/return properties in comparison to other investment classes, such as common stocks.

Is there a significant performance difference between TIPS and conventional Treasury bonds?

Do tax consequences reduce the ability of TIPS to avoid negative real (inflation-adjusted) returns such as occurred in the 1970s? Is there a particular inflation rate threshold at which investors should be indifferent to TIPS after taxes?

After taxes, are TIPS a more cost effective and more reliable hedge against inflation than traditional hedge investments like real estate, gold, and commodities (all three have high transaction costs and do not increase value in perfect correlation with inflation)?

What are the interactive effects of inflation and tax laws on the performance of inflation-indexed bonds in foreign countries and the United States? Outside the United States, inflation-indexed bonds are not such a novelty. Other countries that have issued similar bonds are Australia (since 1985), New Zealand (1977 to 1984, resumed in 1995), Sweden (since 1994), Canada (since 1991), and the United Kingdom (since 1981), all with varying degrees of success. With the exception of the United Kingdom, inflation-indexed bonds have accounted for only a small proportion of total government debt outstanding. This study will compare the impact of the different inflation rates and tax treatments on inflation-indexed bonds in foreign countries to the inflation and tax effects on TIPS in the United States.

METHODOLOGY

We will apply time-series statistical techniques to study the investment performance of TIPS. For example, time-series regression analysis of returns will be employed to examine the systematic risk of TIPS relative to the aggregate stock market (i.e., its stock market beta) and to the aggregate bond market (i.e., its bond beta). Relative performance analysis will be conducted examining average returns before and after taxes, standard deviations, coefficients of variation, and correlation coefficients for TIPS, common stocks, corporate bonds, conventional Treasury bonds, gold, and other asset classes. Portfolio analysis will be conducted in order to assess the role of TIPS in an

investor's investment portfolio. Vector autoregression techniques will be employed to investigate the dynamic relationship between TIPS and conventional Treasury bonds using data from the United States and other countries. These techniques will allow us to determine if TIPS and conventional Treasury bonds respond differently to economic shocks (e.g., inflation), and whether a temporal lead-lag relationship exists between them. This type of analysis is important because of its implications for investment decision-making. Many market observers track the *spread* between yields on conventional Treasury bonds and TIPS with the same maturities. Interest rates on TIPS are lower because investors receive a separate payment equal to the prevailing inflation rate. No such separate payment is made to investors of conventional Treasury bonds. Hence, the spread between the yields on TIPS and conventional Treasury bonds of the same maturities is viewed as an indicator of the inflation rate that investors anticipate over the life of the TIPS. For instance, the yield on the 3.375% January 2007 TIPS on February 16, 1999 was 3.81%, whereas the yield on the conventional Treasury bond of the same maturity date was 5.20%. The spread is 1.39%, which is quite close to the most recent report on the change in the Consumer Price Index. However, the predictive accuracy of the TIPS-conventional bond yield spread is not yet known because of the recency of TIPS.

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INTERNAL AUDIT STEPS FOR DETECTING ENVIRONMENTAL PROBLEMS

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ABSTRACT

Environmental risk management is important to company survival. Effective management and compliance with environmental regulations, requires everyone in the company to be involved, especially the internal auditor. The paper reviews potential internal audit steps and preview problems associated with managing environmental risk. Internal auditing steps suggested include the following: review of internal controls with risk and exposure assessment; monitor systems for change; review the minutes and general ledger; review management position concerning disclosure and severity of contamination; become aware of transportation and off site liabilities; review waste management contracts; assess sales contracts for evidence of limiting contractual obligations requiring sellers to pay only part of potentially assessed fees; and review insurance contracts. Our conclusions suggest that internal auditors should use the same internal auditing skills used for every aspect of the company=s business, begin with reviewing internal controls, risks and exposures, and monitoring systems for change, pay particular attention to the management=s attitude toward environmental ethics and environmental laws, and assess whether employees are adequately trained, and begin searching for suspicious transactions.

ACCOUNTANT'S LEGAL LIABILITY: AN ANALYSIS OF THE EFFECTS OF THE PRIVATE SECURITIES REFORM ACTS OF 1995 AND 1998

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ABSTRACT

Subsequent to two decades of increasingly active and organized political activism on the part of the accounting profession, the passage of the Private Securities Litigation Reform Acts of 1995 and 1998 (PLSRA) marked the first major federal legislative attempt to impact accountants' legal liability since the original issuance of the Securities Acts of 1933 and 1934. The 1995 Act has been the only piece of legislation to have withstood a Clinton veto and has made fundamental changes in the ways in which auditing firms may be sued in federal courts. The 1998 Act was passed to close loopholes in the 1995 act whereby actions against auditors were being taken to state courts, and the 1998 Act essentially limits security class action lawsuits involving nationally traded securities to federal courts. After nearly four years' experience with these acts, litigation against private firms has been sparse, but results to date indicate that, while strides have been gained in liability reform, further legislation may be necessary in order to more fully ptotect the profession from unwarranted litigation. This paper explores the legislative history of the acts and the details of the acts in terms of their effects on accountants' legal liability. Additionally, the paper examines litigation events occurring subsequent to passage of the Act.

ESTIMATING THE DEMAND FUNCTION FOR MILL CLOTH IN BANGLADESH

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ABSTRACT

This is the first study which computes both price and income elasticities of demand for mill cloth in Bangladesh. The study is part of a doctoral dissertation by the first author who collected the data for the study herself in Bangladesh. The study makes for interesting comparison with similar research that has been conducted in India and Pakistan.

INTRODUCTION

While several studies have estimated price and income elasticities for mill cloth in India, none has done so for Bangladesh. The crucial parameters of interest in a demand function are income and price elasticities. Both own price elasticities and cross-price elasticities are important. Among the latter, the elasticity of demand for mill cloth with respect to the price of food is of special interest. In a poor country like Bangladesh, with low income levels, the majority of the population spends a substantial amount–as much as 72% – of their income on food. In such a situation any change in food prices will have a significant effect on the demand for non-food items like clothing. With reference to Indian context, Sastry (1979) mentioned that " it is perhaps the most important cross price elasticity of demand for cloth in India."

For the empirical estimation of a demand function, the first important task is to choose a functional form. A variety of functional forms have been used to estimate demand functions. One form often used is the linear demand equation. A somewhat more convenient form is the multiplicative demand equation. Its loglinear representation is:

$$\text{Ln } Q = a_1 + b_1 \text{ Ln } P + b_2 \text{ Ln } I + u$$

where a=Ln A, Q is quantity demanded, P is price and I is income. A random-error term u is added to account for omitted variables, mis-specification of the equation, and errors in measuring variables. The convenient property of this functional form is that all the coefficients directly estimate price and income elasticities, and they are constant. In the light of this analytical framework, a time-series demand function for mill cloth in Bangladesh has been estimated for the period 1979-1982. Disposable income, price of mill cloth, and food prices (all in real terms in 1972-73 prices), have been considered as the explanatory variables for demand for mill cloth.

The following equation was estimated by the ordinary least square method

$$\text{Ln } D = a_o + a_1 \text{Ln } P_c + a_2 \text{Ln } P_f + a_3 \text{Ln } I$$

where
D = aggregate domestic demand for mill cloth in million yards
P_c = retail price of cotton mill cloth in 1972-73 prices
P_f = index number of food prices in 1972-73 prices and
I = real disposable income in 1972-73 prices

To capture the effects of substitution of other goods on the demand for mill cloth we have considered the food-price variable in the demand function. The handloom sector is decentralized, scattered in rural areas throughout the country. Consequently, there appear to be hundreds of different varieties of cloth produced by handloom weavers in different areas of the country, whereas in the nationalized mills only a few varieties of standardized cloth price data due to non-standardization has been mentioned by the Bureau of Statistics as the main reason for ignoring that sector. That explains why the researchers in India, which is regarded as much richer in terms of the availability of data, had to do without the handloom sector while estimating the demand function for mill cloth in India. When the inadequacy of the data is fully recognized, there appears to be no other alternative. It is not, however, hard to imagine the effects of handloom prices on demand for mill cloth. It is very likely that the cross-price elasticity of handloom cloth would have a positive effect. As mentioned before, only 20% of mill cloth will be directly affected by the handloom prices. In any case some upward bias would be expected in our estimation of own-price elasticity.

DESCRIPTION OF DATA AND REGRESSION RESULTS

We now turn to a brief discussion of the data used. Domestic demand for mill cloth is estimated as follows:

$$D = Q - s$$

where
D = domestic demand for mill cloth;
Q = production of mill cloth; and
s = change in stocks of mill cloth.

Bangladesh does not export any mill cloth. Cloth imports are basically limited to synthetics, which are of different quality than mill cloth, which is typically made of cotton. That is why we do not have any export or import component in the estimation of demand for mill cloth.

The data on production and change in stock of cloth for the period 1972-1982 are taken from the *Annual Reports of the Textile Corporation*. These data are in physical units and relate to the fiscal year, which runs from July to June. Personal disposable income at constant (1972-1973) prices is estimated as:

Personal disposable income = NNP + M

where NNP = net national product at (1972-73 prices) which is equal to gross national product minus depreciation (GNP - DP);

M = (B + T) - (A + E + F + G) deflated by the CPI ;
B = national-debt-interest payments;
T = transfer payments;
A = domestic product accruing to public authorities
E = savings in the private sector;
F = savings in the government sector;
G = corporate direct taxes, other direct taxes, land revenues, and other miscellaneous receipts.

A summary of the regression result is presented below:

Table 1
Statistical Results of Demand Function (Aggregate)

Estimates of price and income elasticities of demand for mill cloth (Bangladesh: 1972-1982).

Eq.	Dependent variable	Constant	Own price elasticity	Income elasticity	Food price elasticity	R^2
1	Mill Cloth	4.51	-.92	1.17	-1.59	.50
	t-statistics:	(1.36)	(-1.77)	(2.24)	(-2.28)	

We have obtained the theoretically expected signs on the price and income elasticities for the estimated equation. The most striking result is the strong impact of food prices on the demand for mill cloth. All the coefficients are statically significant at a 0.95 test level, except for own price elasticity, which is significant at 0.90 level. The total explanation, as revealed by the r-squared value, is 50%. The elasticity of demand for mill cloth with respect to its own price is -0.92, whereas cross elasticity with respect to food price is -1.59. In absolute terms, the magnitude of food-price elasticity appears to be quite high, compared to its own price elasticity. These results imply that for every 10% increase in the price of mill cloth the demand for mill cloth goes down by 9.2%. Similarly, a 10% increase in food price will bring about a 16% decline in the demand for mill cloth, which shows that the adverse effect of increases in food prices is much stronger. Obviously the impact of an increase in food price will be different for different income groups. Most likely, the poorer sector of the population will be hit harder, as they spend as much as three fourths of their income on food. When food prices rise, given their already low level of income, they have to spend an even larger proportion of their income on food, so much less of their income is available for the purchase of non-food items like clothing. In such situations cloth purchases could be postponed for a while, as cloth after all is not as essential as food. Therefore, the higher elasticity of food price is not unreasonable.

The inclusion of a time trend in the equation was not useful. In fact, the t variable when used as an additional independent variable appears to reduce the coefficients of both price and income to

insignificance. In other words, the time trend could not capture any change in taste. As we are dealing with a very short period of time (only ten years) it is unlikely that there has been any remarkable change in people's taste.

Conceptually, the formulation of the demand function in per-capita terms is more satisfactory, as it takes into account the effect of population. Our attempt to estimate a demand function for mill cloth in per-capita terms in the above format did not yield statistically significant coefficients for either income or price. The R-squared value also went down to 0.31. However, the signs of the coefficients remained the same.

We decided to use a range of income elasticity from 1.00 to 1.25 as an extraneous estimate. The range was fixed on the basis of our knowledge of the findings obtained from our own cross-sectional study, where we estimated the income elasticities. Besides, we got the similar results from the aggregate demand function. With these considerations in mind, the following equation was estimated by the method of ordinary least squares:

$$(\text{Log } D - N \log Y_d) = b_0 + b_1 \log P_c + b_2 \log P_f$$

where
- D = per capita demand for mill cloth in yards;
- N = income elasticity of demand;.
- Y_d = Per capita disposable income;
- P_c = price of mill cloth; and
- P_f = price of food.

The results are presented in Table 2. An inspection of these results shows that all the coefficients, as well as the R-Squared are increasing with the increase in a priori income elasticity as we go from equation 1 to equation 4. Although we have experimented with a range of 1.00 to 1.25 of income elasticities, we will concentrate our analysis on equation 3, which uses 1.20 as the income elasticity, for that is what has been revealed as the income elasticity by the cross-sectional analysis and also by the estimate of aggregate demand function. We must not, however, forget that these results cannot be compared with the results of Table 1, because the methods of estimation for the two equations are different. Results of the second equation are conditional on the extraneous income elasticity, whereas in the first equation both the price and income elasticities are simultaneously estimated.

All the coefficients have the expected signs and are statistically significant at a 0.95% test level. The total explanation revealed by R-squared value is 0.76. Own-price elasticity is -0.89 and cross-price elasticity with respect to food is -1.61, whereas in the aggregate demand function they were -0.92 and -1.59 respectively. In other words, their elasticities did not change considerably with the new estimation procedure.

There could be significant difference in the pattern of consumption of cloth between rural and urban people. In fact, there is copious evidence to suggest that this is so in Bangladesh. Such difference may arise due to difference of taste. In order to capture such differences an income distribution variable was considered. The proportion to total income of income originating in the agricultural sector (representing the rural population) and the proportion to total income of income originating in the non-agricultural sector (representing urban population) were considered. But inclusion of either variable made the estimation worse. No conclusion could be reached as to the

preference of mill cloth over handloom cloth by rural people and urban people. This might be because of measurement error in the variable; it is not necessarily true that urban people have income only form the non-agricultural sector or vive versa. Second, the consumption of the poor, who constitute the bulk of the population, may have been adversely affected by widening income inequalities over the period. Without any proper income distribution variable it is not possible to reach any firm conclusion about this hypothesis.

Table 2
Statistical Results of Demand Function (in per capita term)

Estimates of price elasticities of demand for mill cloth with a priori information on income elasticity.

Eq.	Dependent variable	Constant	log (Pc)	log (Pf)	log (y)	R^2
1	Log D	4.87 (1.68	-.78 (-2.88)	-1.44 (-3.02)	1.00	.70
2	Log D	4.91 (1.69)	-.84 (-3.03)	-1.52 (3.18)	1.10	.75
3	Log D	4.96 (1.69)	-.89 (-3.24)	-1.61 (-3.32)	1.20	.76
4	Log D	4.98 (1.69)	-.92 (-3.32)	-1.64 (-3.39)	1.25	.77

Notes:
D = Per capita demand for mill cloth
N = A priori income elasticity of demand. The range used is for 1.00 to 1.25
P_c = Price series of mill cloth in real terms.
P_f = Price series of food in real terms.
Figures in parentheses are t values.

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CHIPS ON DIPS: TESTING AN EQUITY TIMING & SELECTION STRATEGY

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ABSTRACT

This paper tests a simple and popular trading rule - the purchase of high quality stocks at 52 week price lows - commonly known as buying chips on dips, by utilizing forty stocks randomly chosen from the S&P 100 for the period 1989 - 1998 and comparing the results of theoretical trades to equivalent investment in the S&P 500 Index. Overall, the results strongly support the strategy. Returns on the model portfolio of individual stocks are significantly higher than returns on the model index portfolio, with an insignificant volatility difference when compared through linear regression. Further, transaction costs for such a system are found to be minimal, since the system utilizes a buy and hold strategy that seeks strong selection and timing.

INTRODUCTION

Academic studies concerning the prediction of stock prices have changed noticeably in recent years. While early practical proofs often supported a random walk theory for stock returns, more recent work argues that stock returns are partially foreseeable. Credible work substantiating such predictability theories has been published by Fama & French (1987 & 1988), Lo & MacKinley (1988), as well as Poterba & Summers (1988).

Such evidence could have significant consequences for market timing strategies. However, there is considerable debate as to whether or not the accuracy and magnitude of returns from suggested market timing strategies are sufficiently rewarding when additional trading costs are deducted from returns. Fuller & Kling (1994), while conceding a degree of predictive ability to market timing strategies, argue that such abilities are negated by higher costs in practice. Brock, Lakonishok & LeBaron (1992) studied common technical trading rules that give simple buy and sell signals, with favorable results, however they did not make any adjustments for higher trading costs.

This paper documents evidence that a simple market timing and selection methodology commonly promoted by stock brokers and financial advisors could in fact be profitably traded, allowing for transaction costs, without incurring added risk. It investigates a common stock buying theory that claims equity value is best found when blue chip stocks trade at long term lows. The

theory is formalized in a context that evaluates how a system built on this tactic would have performed in real trading over an extended period. A simple regression model comparing returns from a model portfolio, built over time, with returns from a broad market index portfolio, built with identically sized investments and timing, is used to evaluate risk.

The purpose of this paper is to outline a formal trading model that permits simple technical trading that yields above market rates of return, allowing for transaction costs, at risk levels no more than commensurate to those returns.

LITERATURE REVIEW

Published efforts to find ways to improve on returns in stock investments have followed several strategies. One has been to attempt the forecast of future returns in order to seek out supposed market inefficiencies, generally through the use of dividend/price ratios (Fama & French, 1988). Others have used pure technical indicators, usually focused on average pricing and aberrations from those averages (Poterba & Summers, 1988; and Brock, Lakonishok & LeBaron, 1992), while some have used regression models (Fuller & Kling, 1994). All of the cited literature, regardless of methodology used, came to some similar conclusions. One, that stock prices were predictable, at least to some degree. And two, that because of transaction costs and the limits of predictability, it was probably not possible to use such predictions to trade profitably.

It was noted in reading of the methodologies used, that several similarities may have contributed to the shortcomings in results. Each of the works studied relied upon decision estimates of future prices and/or dividends as opposed starting with present prices seeking future value. Each involved trading both into and out of the market as opposed to buy and hold. And each was based on trading indices as opposed to individual stocks.

DATA

Historical data provided by Commodity Systems, Inc. on the S&P 500 Index and the individual S&P 100 (OEX) stocks were used. Open, low, and close prices were captured for a ten year period from 1989 to 1998 inclusive. Prices of both the individual stocks and the index were back adjusted to reflect splits and reinvestment of dividends. Of the 100 stocks represented in the OEX, forty were chosen as a test sample by rank of a random number assignment.

METHODOLOGY

The model tested is based on a common equity investment theory that better returns are obtained by buying blue chip stocks on price dips. The conventional rationale supporting this theory is that blue chip companies, while they may occasionally suffer setbacks, also have the resources to withstand rough times and to correct any firm specific problems, and that they normally do grow over the long term. The argument further promotes the value of a stock that has seen a recent drop in price, in that the stock may be thought of as "on sale," that the buyer is dollar cost averaging at lower than average prices, and in any event, the buyer is assured of not buying the top of the market. On

average, this would make sense, that a price dip is a below average price, and thus would have a greater probability of seeing a higher future price.

One of the most common variants of this theory uses a new 52 week price low as the standard to indicate a buy, and it was that variant that was tested. In notational form, the price low test can be written as a simple if-then statement:

If $L_t < \min L_t^{-52}$, then buy O_{t+1}

where:

L	=	the low in price for the week;
t	=	the current week;
L_t^{-52}	=	the lows in price for each of the 52 weeks prior to the current week;
O_{t+1}	=	the opening price for the week following the current week.

If the price test was met, that is, the low for the current week was less than the minimum low of the prior 52 weeks, then a set dollar purchase of that stock was made at the open of the following week, with fractional shares assumed for simplicity. For each stock purchase made, a purchase of a broad market index, the S&P 500, was made for an equal dollar amount. Holdings were accumulated in two separate model portfolios, one made up of the individual stocks and the other consisting of shares of the index.

No trades were made for the first 53 weeks. At the end of the 53rd week, the lows for the week on each of the stocks was tested against their respective lows for each of the previous 52 weeks. Thus the earliest possible buy signal was at the start of the 54th week, generating 468 weeks of subsequent rolling, cumulative testing for the model using some 62,000 individual price data points.

For the regression testing to determine the relative volatility of the portfolios, the excess yields for each week were compared. Excess yield was defined as the difference between the respective raw yields of the portfolios and the risk free yield on the 90 day Treasury bill for that week, with an allowance made for any additional investments made at the start of that week.

In notational form, the measure of excess yield in a portfolio can be written as:

$$\% \text{ change } V = ((V_t / (V_{t-1} + I_t)) - 1) * 100 - T_t$$

where:

% change V_t	=	the percentage change in value of the portfolio during the current week;
V	=	the value of the portfolio;
t	=	the current week;
I_t	=	the Investment made at the open of the current week
T_t	=	the risk free yield on the 90 day Treasury bill for the current week; and the constants simply convert the results into ordinary expressions of percentage.

RESULTS AND DISCUSSION

Three things were sought in the test that were not all simultaneously available within the models of the reviewed literature: higher returns, minimal transaction costs so as not to negate any higher returns obtained, and no more than commensurate risk.

On the matter of returns, the model stock portfolio has an ending value more than 26% greater than that of the model index portfolio. Certainly the fundamental result sought, higher returns, has been met.

Table 1 presents an interesting piece of data regarding yields. It shows the mean, median, minimum, and maximum weekly excess yields. As can be seen, the mean excess weekly yield for the test portfolio was .27% from 1990 through 1998, while the S&P 500 portfolio average excess weekly yield was just .20%. And while the minimum excess weekly yield on the stock portfolio was considerably lower than that of the S&P, -6.59% vs. -5.22% respectively, the maximum was also markedly less, 7.04% vs. 7.24%. This might well be explained by the nature of the model itself, that being the purchase of equities making new lows, thus giving lower minimum yields by focusing on the most downtrodden stocks in a down market, and still finding some few stocks making new lows in an up market, yet having better overall value in the long run. The median weekly yields of .26% for the index portfolio and .45% for the model portfolio offer further support for skewing of the distribution of returns.

Table 1
Weekly Yields in Excess of Risk Free 90 Day T-Bill

	S&P Portfolio	Stock Portfolio
Mean	0.20	0.27
Median	0.26	0.45
Minimum	-5.22	-6.59
Maximum	7.24	7.04

Regarding transaction costs, with electronic brokerages now offering sub-$10 commissions for stock trades, and free data commonly available, total transaction costs for the model would be less than 2% of the difference in returns for the two portfolios. Beyond simply being less expensive to make transactions now as opposed to a decade ago, this model does not trade nearly as often as do the methods cited in the literature. There are simply fewer transactions for which costs must be born. Even if purchases under the model were made in increments one-tenth the size shown, transaction costs would be well below any threshold of concern.

What is most surprising, perhaps, is the strength of the statistical results for the regression. The coefficient estimate of the X variable, the beta of the model portfolio, is very close to 1, with a very small standard error and high t-statistic (Table 2). And as indicated by the coefficient of

determination, R^2, approximately 70% of the variation in the dependent variable, stock portfolio yield, is explained by variation in the independent variable, market yield. The balance of the variation, approximately 30%, must be a function of the stocks chosen and the timing of the buys. This correlates quite well with the approximately 26% higher return in the stock portfolio. The low standard deviation of returns obtained from the trading rule suggests that the higher yield performance is attained without additional risk.

Table 2: Regression Analysis of Returns: Stock vs. S&P 500 Portfolio

Multiple R	0.8382608	R Square	0.7026812	Adjusted R Sq	0.7020432
Standard Error	1.121954			Observations	468

ANOVA

	df	SS	MS	F	Significance F
Regression	1	1386.34723	1386.3472	1101.3412	8.027E-125
Residual	466	586.591889	1.2587809		
Total	467	1972.93912			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	0.0804134	0.05255826	1.5299862	0.1266987	-0.0228671	0.183694
X Variable 1	0.9734328	0.02933223	33.186461	8.03E-125	0.91579294	1.0310726

SUMMARY AND CONCLUSION

Past conclusions on the practical application of technical analysis to obtain higher excess equity returns may have been premature. If a system which attempts to identify and capitalize on good present prices is substituted for systems which try to predict good future prices, higher returns are obtained. If a system of minimal numbers of transactions is substituted for one with frequent transactions, transaction costs drop. And if a system consistently seeks out lower cost opportunities than the average market, then volatility can be minimized.

This paper formalizes the theory that superior stock yields can be obtained by buying new lows in blue chip stocks. The model described produces a technical trading rule that selects both the timing and choice of stock purchases. For the 1989 - 1998 sample period, the rule performed well compared to the S&P 500 Index, yielding significantly higher returns than chance would allow for, with very little difference in volatility, while minimizing transaction costs through lessened trading activity.

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INNOVATIVE TAX POLICY PROJECTS UTILIZING A GLOBAL PERSPECTIVE

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ABSTRACT

This paper relates to the use of group research projects in taxation courses, which emphasize Internet research on a global scale. It is important for students to realize that they must develop a "global mindset". Recruiters often recommend that students take courses of an international business nature. This project attempts to encourage students to evaluate tax systems employed around the world.

The assignment begins with the instructor discussing Adam Smith's Canons of Taxation. Concepts such as equality, fairness, and economy are discussed as requirements of a good tax structure. The end result of the student's research is to develop an "ideal tax system". Students create proposals related to the reporting of income, claiming of deductions and credits, and a suggested tax rate schedule including both rates and dollar brackets.

A project of this type can be utilized in either an introductory or more advanced tax course. It works especially well with a tax policy course. The author has used this assignment for the past three years with excellent success. Comments from students have been very favorable with the majority feeling that it is a worthwhile project. Student groups present their findings in class using a PowerPoint slideshow and Word lecture outlines. This project aids students by improving their oral and written communication skills, research techniques, and teamwork abilities.

INTRODUCTION

Many university courses taught today have developed an "international flavor". Recruiters often suggest that students consider an International Business minor or at least take several courses that reflect this concept. With this in mind, the author attempted to develop a project for his taxation classes, which emphasized a comparison of foreign tax systems with the current U.S. structure. The strategy was to use the Internet as a research tool in order to accumulate information related to a number of tax systems and have the students evaluate the fairness of each of these various systems. In an effort to improve teamwork skills, the project was developed using a group presentation approach.

The author refers to this assignment as his "Adam Smith" research project. It has been used successfully during the past three years in a number of taxation classes. The emphasis of this project involves a review of the tax policy currently used in the United States compared with foreign countries in hopes of determining what features appear to be most beneficial to the stakeholders

involved. In other words, what tax system principles, characteristics, and requirements would be most advantageous for both the government and the majority of the country's citizens? Students often have very strong beliefs on this subject that they freely share which creates excellent classroom discussions.

The project begins with the introduction by the instructor of Adam Smith's "Canons of Taxation". A review of this famous set of criteria for good tax policy serves as the foundation for the assignment. In his book "*The Wealth of Nations*", Smith presented four basic characteristics of a good taxation system. His canons of equality, convenience, certainty, and economy provide the students with a benchmark for an "ideal" taxation system.

Smith believed that taxpayers should contribute to the system in proportion to the revenue that they enjoy. This led the United States to adopt as one of its major tax principles the concept of "ability to pay". Smith also felt that both the amount and time of payment of tax should be specific and easily determined by the citizens of the country. In addition, he felt that the tax should be levied at the time when it was most convenient for the taxpayer to pay it. Finally, Smith believed that the government should take as little as possible from the taxpayers over what was brought into the treasury. In other words, the tax should be economical to assess and collect. These four canons provide valuable principles for the development and operation of any tax system and are used by students during their evaluation of alternative tax structures.

The author also reviews with the students several statements by Wilbur Mills, long time chairman of the House Ways and Means Committee, which reflect Smith's beliefs. Mills felt that tax reform should seek for greater reliance on the principle that equal incomes should bear equal tax liabilities (equality). He also felt that the tax system should interfere as little as possible with the operation of the free market mechanism in directing resources into their most productive uses. In addition, Mills believed that our tax system should have greater ease of compliance and administration in order to provide economy. The use of the Smith/Mills philosophy provides an excellent conceptual introduction to students prior to the assignment of this group research project. It provides them with some important historical literature concerning the principles of a good tax system.

THE PROJECT REQUIREMENTS

With Smith's principles in mind, a group project was developed by the author that attempted to encourage student teams of two or three members to construct a tax system that was as close to an "ideal" system as possible. The instructor first suggests that students review the United States tax system and then select two or three foreign countries for examination. The intent is to get students thinking about an "ideal system" which provides maximum benefits to both the government and its citizens at a reasonable cost.

Student groups are encouraged to seek information from a variety of sources. For example, library on-line services such as LEXIS-NEXIS Academic Universe and Internet research in general both provide students with resources that can be used for this project. The LEXIS-NEXIS Academic Universe, for example, contains a database of over 1.4 billion documents from over 18,300 sources. Also, the Big 5 accounting firm's home pages provide many links to foreign sites providing information on tax policy. These homepages offer the user a large database of relevant information related to currently employed taxation systems from around the world.

Especially good international research materials can be found on the Ernst & Young site in the form of the EY Passport. This research database is available both on the Internet site and also in the form of a CD. The CD is free upon educator request from any E&Y office. The EY Passport contains a wealth of tax and business information from over 130 countries. The firm updates this information on a quarterly basis. A visit to "www.eyi.com" provides the student with a good starting point for gathering tax policy from various countries. After registering on the site, students will gain access to special reports and protected areas of the Internet site. In particular, the tax library becomes available for the student's use.

The project requires students to research the current tax structure of two foreign countries and compare them with the United States. Students normally prepare a type of SWOT (strengths, weaknesses, opportunities, and threats) analysis in order to summarize aspects of each country's tax policy that either supported or violated Smith's Canons of Taxation. The student teams would then summarize the positive features of each country's system and propose a tax system that they felt was conceptually and operationally near perfect.

The project requires a thirty-minute presentation by the student teams using a PowerPoint slideshow. Presenting groups also distribute a one-page lecture outline (summary) for use by each member of the class. Classmates use the outline to take notes and prepare questions that they ask following the presentation. Each team also prepares an 8 to 10 page paper summarizing the major concepts discussed in their presentation. Through this process, the students improve their research abilities as well as oral and written communication skills. Teamwork attitudes and analytical abilities are also developed. Students feel that this is a "real world" type of project that can provide them with improved skills useful when they become employed.

To further aid students in their research, the author prepared a homepage that contained links to numerous research sites. In particular, an effort was made to include URL's on the website that related to all functional area of business. Therefore, accounting and taxation, finance, marketing, management, and human resource links were all provided to aid students in any type of business research. One purpose of the homepage was to benefit students in other business courses that required a research project. The homepage was also used to provide updated course materials to students in each of the author's courses.

CONCLUSION

Based upon feedback from students during the last three years, the author believes that the majority of participants have found significant value in this project. Students feel, in most cases, that the typical tax system found today in most countries contains many regulations that violate the four Canons of Taxation proposed by Adam Smith. This project requires students to work as a team and brainstorm the very difficult process of developing a system of taxation that provides equality, convenience, certainty, and economy for both the government and its citizens. Projects of this nature benefit the student through the improvement of oral, written, research, and teamwork skills. The appendix of this paper includes a few sites used in the past by students in the process of researching tax systems around the world.

It is the author's hope that this paper will provide taxation instructors with constructive ideas that can be utilized in their classes. A project of this type provides many benefits for both the instructor and the students. It has proven especially beneficial in providing active class discussions

since most students will eagerly voice their opinion on what they feel is good tax policy. Projects such as these aid students by encouraging a truly global perspective in the research that they conduct.

APPENDIX – GENERAL RESEARCH SITES

Internal Revenue Bulletin -http://www.fedworld.gov/ftp/irs-irbs/irs-irbs.htm This site allows the user to download the weekly IRB using the Adobe Acrobat Reader. The site is updated daily.

PriceWaterhouseCoopers Tax News Network - http://www.taxnews.com/tnn_public This location contains legislative updates, business tax updates, and a global tax update. It also contains a "tax sites" area with many links to global research databases.

Tax Foundation - http://www.taxfoundation.org/index.html This site contains a huge amount of historic information that includes the typical family tax burden, burden by income class, and state tax statistics.

Taxweb - http://www.taxweb.com This page contains an excellent combination of federal, state, and local tax developments. It has links to many federal sites and a wealth of locations providing news on the latest tax developments.

Dick Armey's Flat Tax - http://www.flattax.house.gov This location discusses the flat tax proposal by House Majority Leader Dick Armey. Students often support a plan such as this 17% proposal.

Tax Sites (D. Schmidt) - http://www.taxsites.com This is a huge collection of links to virtually any tax related area. Students can research current regulations related to all types of state taxes, as well as federal income, estate, gift, and excise taxes.

APPENDIX - COUNTRY SPECIFIC SITES

Australia – http://www.ato.gov.au/ The official Australian Tax Office site.
Canada – http://www.rc.gc.ca/ The official Revenue Canada site.
France – http://www.finances.gouv.fr/ (Available only in French)
Great Britain – http://www.inlandrevenue.gov.uk/ The official UK site for taxation information.
Hong Kong – http://www.info.gov.hk/info/tax.htm (Basic information with link to govt. page)
Ireland – http://www.icai.ie/cats The Chartered Accountants Taxation Summary page.
New Zealand – http://www.treasury.govt.nz/ (Tax documents using Adobe downloads)
Poland – http://www.polandonline.com/tax.html (Information on various taxes)
Sweden – http://www.rsv.se/english/ National Tax Board (Info. In English)
Switzerland – http://www.swisstax.com (Site provided by Howard Hull)

ACCOUNTING FOR DERIVATIVES UNDER SFAS NO. 133

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ABSTRACT

This paper first discusses the economic use of derivatives and then describes the common types of derivative instruments. Following this background, the provision of SFAS No. 133 are discussed. This release requires all companies to recognize derivative financial instruments as assets and liabilities, and to measure them at fair value. The specific accounting for derivatives depends on whether the instrument is designated as a hedge or not. The statement further requires the firm to identify the hedge as a fair value or cash flow hedge and to measure hedge effectiveness.

If a hedge is not considered to be highly effective, the special accounting treatment provided by SFAS No. 133 is disallowed. Additionally, for an effective hedge, the portion of the hedge that is ineffective is recognized immediately in income. In the final section of the paper, the provisions of SFAS No. 133 dealing with fair value and cash flow hedges, and ineffective and effective hedges, are illustrated in a numerical example.

CASH BALANCE PENSION PLANS: WHAT ARE THEY AND WHY ARE THEY BECOMING SO POPULAR AMONG U.S. COMPANIES?

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ABSTRACT

There is a new type of pension plan on the horizon. While many companies are eliminating their traditional defined benefit pension plans, others are converting to this new type, the cash balance plan. Since 1985, when the cash balance plan was first introduced, more than 500 U.S. Corporations employing over ten million people have converted their traditional defined benefit plans to cash balance plans. BankAmerica Corporation was among the first employers to convert to cash balance plans. Since then, many other large and medium sized employers, including RJR Nabisco, IBM, and AT&T have made, or are considering, conversions from their traditional pension plans to cash balance plans.

Companies realize they are no longer able to hold good workers with the promise of future benefits from a pension plan. Therefore, the most important strategic reason to offer pension plans is to attract young mobile workers. It appears the cash balance plans with constant disclosure of their value will be much more effective than the more invisible traditional pension plans in attracting most workers in the new millennium. However, older workers' pension benefits have been greatly reduced when their companies convert to a cash balance pension plan.

This research explores the advantages and disadvantages of cash balance pension plans as compared to defined benefit plans and 401(k) pension plans. The employee's viewpoint of cash balance plans is presented with explanations of who will benefit and who will be hurt by a company's conversion to this plan. An explanation of why so many U.S. companies are converting to cash balance pension plans is also presented.

PENSION ACCOUNTING IN HONG KONG: WHAT DO INVESTORS AND EMPLOYERS NEED TO KNOW?

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ABSTRACT

The general purpose of this project is to investigate the accounting practices for pension costs in Hong Kong. Part of the objective is descriptive. The study will provide statistics about the number of defined benefit, defined contribution plans and general information about the type of related pension reporting.

Information about the accounting practices for pension costs was gathered from 1996 annual reports. Fifty-four companies were selected in a systematic random selection. These firms represent approximately 8.2% of the companies traded on the Hong Kong Stock Exchange in 1996.

The accounting practices for pensions vary at this time in Hong Kong. It may be helpful for investors and employers to understand some of the issues surrounding pension accounting. In some cases, these issues may, also, become important for company managers. The main conclusions follow:

1. *Most selected firms (50%) have a defined contribution plan.*
2. *18.5% of firms have a defined benefit plan.*
3. *31.5% did not indicate that the firm had an employee retirement plan.*
4. *Most companies base their pension costs on the actual dollar contributions paid during the year.*

THE USE OF INTERACTIVE COMPRESSED VIDEO MEDIA TO TEACH INTERMEDIATE ACCOUNTING I

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ABSTRACT

This study investigates the use of a distance learning method called interactive compressed two-way video delivery to teach intermediate accounting students. ICTV has been advocated as especially beneficial to higher learning institutions that cover remote service areas and those that wish to offer courses internationally. The primary purpose of this study is to determine whether or not students' performances and attitudes towards accounting differ between intermediate accounting students taught traditionally and intermediate accounting students taught using interactive compressed two-way video delivery.

The results from this study indicate that students' performances and attitudes do not differ when they take a two-way video class rather than a traditional class. However, performance results do indicate an interesting interaction between the classes and the amount of hours students work. Students in the two-way video class that worked more than twenty hours per week on their jobs performed better than students in the traditional classes that worked more than twenty hours per week on their jobs.

HOW TO INCREASE THE COMPARATIVE VALUE OF CASH FLOW STATEMENTS

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ABSTRACT

Financial Accounting Standards Board (FASB) Statement 95 has specific provisions for standardization of presentation that make financial analysis of the statement of cash flows possible. The statement is required to be classified in to operating, investing, and financing activities, which provides the opportunity for comparative analysis with other companies. The statement of cash flows is generally considered to have enhanced comparability because of its standardized format. However, there are some transactions for which classification is unclear and for which noncomparable practices are used. Their impact on the statement could be important. These cash flows controversy include: 1. substance versus form reporting format, 2. direct versus indirect method, 3. interest cost and long-term debts in the cash flows statement, and 4. noncash transaction. The purposes of this paper are to analyze the issues involved with SFAS No. 95 and examine related disclosures required by SFAS No. 95. Make suggestions for improved reporting pertaining to the way that the required disclosures are made.

EVOLUTION OF STANDARD AUDIT REPORTS

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ABSTRACT

The primary objective of an external audit of financial statements is to present a competent, unbiased opinion as to whether &c statement present in all material respects the financial position, results of operations and cash flows in accordance with generally accepted accounting principles. An audit report is the formal communication in which an auditor states that the audit was performed in accordance with generally accepted auditing standards and expresses (or disclaims) an opinion on the financial statements. The content and format of the audit report has been changed many times since the early 1900s with the overall objective being clarification of the auditor's responsibility when associated with financial statements. This paper describes the specific content changes which occurred in the historical development of the, standard audit report in the United States. This paper presents the, significant relevant historical events which influenced the development of the, audit report to provide perspective on the, evolution of this important communication on process. Sources used in developing this paper included minutes of meetings of various accounting and financial organizations' formal committees, formal and informal reports of relevant organizations, original Statements on Auditing Procedures and Statements on Auditing Standards, and an extensive literature review.

Prior to 1917, audit report content varied extensively since, there were no consistent, uniform sources of guidance for issuing reports. The accounting profession was identifying its purposes and refining its organization structure during the first two decades of the 1900s, and audits of corporate financial statements were continuing to evolve as economic activity rapidly expanded. Audit reports from 1917 to about 1934 were influenced extensively by actions of the Federal Reserve and the new Securities and Exchange Commission, as well as by the increasingly consolidated accounting profession. Dramatic events during these years included the effects of a wartime economy followed by an extensive, economic depression, rapidly-expanding governmental regulatory influences, and increasing expansion of the U. S. economy, all of which precipitated changes in auditors" report responsibilities.*

In general, after the 1930s, changes in audit reports were, principally initiated within the accounting profession with only tangential external influences. The creation of the Committee on Auditing Procedures in 1939 and its successor (Auditing Standards Board) provided the source of the format changes and continuous refinements in audit reports. Principal changes In the content of the audit report in recent decades have resulted from extensive expansion of pronouncements for amounting. Principles which indirectly influence the audit process, continuous concerns related to litigation, and processes for change within the auditing profession such as establishing research

activities, creating formal internal committees and boards to initiate change, and establishing special independent commissions to examines the effectiveness of audit reporting processes. Certain content of the audit report was implemented and then sometimes subsequently revoked or substantially modified. The history of change relative to the audit report indicates that as the profession advances, the audit report will continue to evolve as a reflection of that advancement.

LEASE FINANCIAL STATEMENT ACCOUNTING PRACTICES: TYPES AND NUMBERS FOR HONG KONG

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ABSTRACT

The purpose of this research study was to investigate existing lease disclosure practices for financial statements in Hong Kong. Part of the purpose of this project is descriptive. The study classified, summarised and analysed the lease accounting practices for a sample of Hong Kong companies.

Annual reports for a year ending during 1996 were examined to gather information about the accounting practices for leases for financial reporting in Hong Kong. The fifty companies were selected in a systematic random selection process. The fifty companies selected represent approximately nine percent of all the companies traded on the Hong Kong Stock Exchange for 1996.

Some of the major conclusions from this study include the following:

1. Most Hong Kong companies are involved in lease transactions as either lessees and lessors or both.
2. The dollars committed to lease transactions are significant.
3. The profit and loss effect is, also, significant.

SEARCHING FOR THE FAVORITE-LONGSHOT BIAS DOWN UNDER: AN EXAMINATION OF THE NEW ZEALAND PARI-MUTUEL BETTING MARKET

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ABSTRACT

This paper tests for the presence of the favorite-longshot bias in a new setting. This bias - the tendency for bettors to underbet favorites and overbet longshots - has been found in most studies of pari-mutuel and bookmaking betting markets in the United States, the United Kingdom, and Australia. However, beginning with the study of Busche and Hall (I 988) there is growing evidence that in at least some pari-mutuel betting markets there is no favorite-longshot bias. This paper examines the previously unexplored New Zealand pari-mutuel betting market on horse races for evidence of this bias. Utilizing a large sample of recent New Zealand thoroughbred horse races, we find that while early, off-track bettors price this bias into odds' late (on- and off-track) bettors eliminate much of the bias by the close of betting. That is, our results reinforce the view that not all pari-mutuel betting markets are characterized by a favorite-longshot bias at the close of betting. We also find evidence that late bettors in this market are smart bettors.

INTRODUCTION

Fifty years ago psychologist Richard Griffith (I 949) examined American racetrack betting on winners for evidence on the ability of market participants to detect differences in the probabilities of uncertain outcomes and found a remarkable "near congruence" between subjective win probabilities calculated from win pool shares for different odds groupings and observed win frequencies. However, Griffith also found that win pool shares were lower than win frequencies for favorites and higher than win frequencies for longshots. Over the next forty years, this favorite longshot bias was consistently identified in studies of pari-mutuel betting markets in the United States, the United Kingdom, and Australia, and in British and Australian bookmaking markets. The weight of this evidence led Thaler and Ziemba (1988; 163) to claim the favorite-longshot bias as "the most robust anomalous empirical regularity" found in these betting markets.

The standard explanation for the favorite-longshot bias in pari-mutuel betting markets employs a representative-agent model of racetrack betting. Weitzman (I 965) and Ali (I 977) use the observed relation

between probability and return to estimate the shape of the agent's utility function and find these agents have a (local) preference for risk. Given this preference for risk, Quandt (I 986) shows a necessary condition for equilibrium in a betting market is that expected returns to favorites exceed those of longshots (that is, there exists a favorite-longshot bias).

Recently both the ubiquity of the favorite-longshot bias and the assumption of the standard explanation that all bettors are alike have been challenged. In their study of the Hong Kong racetrack betting market, Busche and Hall (1988) find that favorites, rather than being underbet, are, if anything, overbet. Likewise, there is no pattern of overbetting of longshots. A subsequent examination by Busche (1994) of pari-mutuel betting at Japanese racetracks shows no favorite-longshot bias in a second Asian market. Additionally, Swidler and Shaw (1995) examine a small Texas track and find no evidence of the bias. There is also evidence that all bettors are not alike. Some bettors, especially those betting late and those betting on-track, appear to be better informed than early bettors and off-track bettors (for example, see Figlewski (1979), Asch, Malkiel, and Quandt(1982),Crafts(1985), and Schnytzer and Shilony(1995)). And there is evidence from the British bookmaking market (Shin (1993) and Vaughan Williams and Paton (1997)) that insider trading explains at least some of the favorite-longshot bias.

This study examines a previously unexplored betting market, the New Zealand pari-mutuel betting market on thoroughbred horse races. The examination is motivated by the above discussion. We employ the two standard methods of testing for the existence of the favorite-longshot bias on a large sample of recent New Zealand horse races. We conduct a regression-based test of the relationship between returns and odds. Finally, we examine changes in odds between the opening of on-track betting and the close of betting for evidence of differentially informed traders.

We find strong evidence of a favorite-longshot bias in the odds at the opening of on-track betting, but much less evidence of the bias in the odds at the close of betting. It appears that early, off-track bettors - presumably mostly recreational bettors - price the bias into odds. However, late bettors appear to eliminate much of this bias - especially the underbetting of favorites - by the close of betting. We find evidence in odds movements that late bettors tend to be informed bettors.

The paper is organized as follows. The next section provides background information on the New Zealand racetrack betting market and on the data set used in the study. The following section examines opening and closing odds for evidence of the favorite-longshot bias using the standard tests. Section III uses a regression-based test to explore the relationship between returns and odds. Section IV examines odds movements after the opening of on-track betting for evidence of informed traders. Section V concludes.

THE NEW ZEALAND PARI-MUTUEL BETTING MARKET

It is often said that New Zealand is dominated by "rugby, racing, and beer." Certainly, there is no shortage of racing. In addition to harness and greyhound racing, there is usually at least one thoroughbred race meeting in New Zealand every day. There are 58 racetracks in this small country holding thoroughbred race meetings. These range from small country tracks holding a single annual race meeting to the most popular racetrack, Ellerslie, with its twenty-five meetings per year. Combining this frequency of race meetings with the typical ten races per meeting produces over 3,200 annual thoroughbred horse races for bettors to wager on.

Since 1951 all legal betting in New Zealand has been conducted by the Totalisator Agency Board (TAB)[1]. Currently, this regulated monopoly organizes pari-mutuel betting on thoroughbred horses, trotters, and greyhounds and fixed-odds betting on game outcomes of sports like rugby and cricket. The TAB operates both on-track betting windows and an extensive off-track network of betting agencies, sub-agencies (in retail shops and pubs), and telephone betting centers (catering to approximately 100,000 accounts). Over the last several years annual dollar betting volume for thoroughbred horse racing has averaged just over $\$_{nz}$ 45 0 million off-track and around $\$_{nz}$ 60 million on-track. Given the annual number of races noted above, this is an average volume of about $\$_{NZ}$160,000 per race.

While some exotic bets (quinellas, doubles, "Pick 6," and the like) are popular with New Zealand bettors, the standard bet is on a horse to win the race. For most weekday race meetings, the TAB opens off-course betting for all races on the card about one hour prior to start of the first race. Betting on weekend races (mostly held on Saturdays) opens on Friday after the close of that day's racing events. On-track betting begins roughly 30 minutes before the start of each race. Off- and on-track pools are combined in calculating payoffs. Payoffs for a $1 win bet are quoted in terms of win prices with these win prices being rounded down ("breakage") to the nearest 5 cents. The TAB "take" on win and place[2] pools averages 16.9 percent over our sample period. Combining breakage and track take, we estimate an average track takeout of 17.4 percent.

The data set used in this study comes directly from the TAB[3]. It covers all thoroughbred races ("gallops") run in New Zealand between August 1, 1994 and October 31, 1997. For each horse in every race, we have information on its odds at the opening of betting at the track (the "opening" win price, or WPO) and the closing of betting (the "closing" win price, or WPC), the horse's placing, "margin" (distance behind the winner), and whether or not the horse suffered a mishap in the race. After eliminating 31 races with dead-heat winners, there are 10,332 races and 117,775 horses in this data set.

TESTING FOR A FAVORITE-LONGSHOT BIAS

There are two obvious strategies for testing anomalies in financial markets: either examine old data using new test procedures, or examine new data using existing procedures (see Farna (I 998) for a much more eloquent development of this point). In this section we adopt the second strategy. There are two common procedures testing for the existence of the favorite-longshot bias. The first compares subjective and objective win probabilities. If subjective win probabilities (calculated from track odds) reflect actual win frequencies, there should be no difference between these probabilities. If a favorite-longshot bias exists, low odds horses (that is, horses bettors consider to have high likelihoods of winning) tend to have subjective probabilities below these horses' actual winning frequencies. These probabilities are reversed for high odds horses. The second method examines returns to horses in various odds groupings. If market odds reflect the true probability of events, then unit bets on horses in each odds grouping should earn a return equal to the negative of the track takeout. If a favorite-longshot bias exists, low odds horses tend to have returns exceeding the negative of takeout (possibly even exceeding zero) and, as odds lengthen, returns increasingly fall below (losses exceed) the takeout.

We apply both tests to our New Zealand data set. Table I shows subjective win probabilities and actual win frequencies for horses grouped by order of favoritism. There is a pronounced favorite-longshot bias at the opening of on-track betting. For the top four favorite ranks subjective win probabilities are significantly smaller than actual winning frequencies (at the I percent significance level for the first two favorite ranks, at the 5 percent level for third-ranked horses, and at the 10 percent level for fourth-ranked horses). Conversely, subjective win probabilities are significantly larger than actual winning frequencies for all but one grouping (the sixteenth) between the sixth- and the seventeenth-ranked horses (with all but two of these differences significant at the 1 percent level). The bias is less apparent at the close of betting. The underbetting of favorites largely disappears - there is no significant difference between subjective and objective win probabilities for the top three-ranked favorite groups. The overbetting of longshots is reduced, although not eliminated. Instead of virtually every favorite ranking at and below the sixth-favorite rank being overbet at the opening of on-track betting, at the close only the tenth-, eleventh-, and thirteenth-favorite groups have subjective probabilities significantly higher than objective probabilities.

These results are not the product of the aggregation method used to group horses. In results not reported here for space reasons, we show other aggregation methods - by even-sized odds categories and by even numbers of horses in each odds category - produce the same picture of a pronounced favorite-longshot bias at the opening of on-track betting and a reduction of this bias, especially the underbetting of favorites, by the close of betting.

Table 2 shows, at various odds groupings, both actual rates of returns for unit bets at the close of betting (that is, at WPC) and the hypothetical returns that horses would have earned if betting had ended at the opening of on-track betting (that is, at WPO). These returns should be compared to the negative of track takeout at each odds category which varies from -0. 1850 for low odds horses to -0.1690 for horses in the highest odds categories'. A pattern emerges from the comparison of hypothetical opening returns to takeout: low-odds horses (most noticeably those with WPO $\leq$ 5) tend to have opening returns higher than the negative of takeout and high-odds horses tend to have opening returns below this benchmark (especially horses in odds groupings at and above WPO>25).. There is a different pattern of returns at the actual close of betting. For most odds groupings up to (20<WPO<25) returns to unit bets are clustered around the negative of takeout. In contrast, higher-odds groupings continue to have returns below this level, with losses for extreme longshots (those with WPO>50) being even greater than the hypothetical losses to betting these horses at the opening of on-track betting.

ARE LATE BETTORS SMART BETTORS?

There is a widely held view that informed bettors in a pari-mutuel betting market are more likely to wait until late in the betting period before making their bets. In such a market all returns are determined by the final odds. Early in the betting period when the size of the betting pools are relatively small odds are much more volatile - by waiting informed traders can obtain a better estimate of the variance of expected returns. There is also a strategic reason for waiting. By so doing, the informed trader can reduce 'bandwagon' effects'.

Considerable support for this view that late bettors tend to be smart bettors comes from studies of pari-mutuel markets in the United States and bookmaking betting markets in the United

Kingdom. For example, in their study of races at Atlantic City in 1978, Asch, Malkiel, and Quandt (I 982) find that over the betting period winning horses are 'bet down' (their odds fall) while the odds of losing horses move in the opposite direction. They also calculate marginal odds based on bets made in the last eight minutes of betting and show an even larger fall in the odds of winners. Crafts (I 985) shows a similar result for the British bookmaking market. Crafts examines changes in odds between the opening odds (the forecast price or FP) and the odds offered by on-track bookmakers at the end of the betting period (the starting price or SP). Horses whose odds fell from FP to SP had higher returns at SP than those horses whose odds lengthened over the same period. Moreover, bets made at FP would have yielded large positive returns for horses more heavily backed between FP and SP while horses drifting out of the money would have had large losses.

There is also evidence that on-track bettors tend to be better informed than off-track bettors. Figiewski (1 979) separates off-track and on-track betting pools in his study of betting at New York tracks and shows that handicapper information adds significant improvement to the predictions based on off-track odds, but produces no improvement on predictions based solely on on-track odds. Support for this view is provided by Schnytzer and Shilony (I 995). These authors examine the Australian racetrack betting market where there is both off-track and on-track parimutuel betting (betting from both pools is amalgamated to determine payoffs) and an on-track bookmaking market. Schnytzer and Shilony show that betting in the off-track pool is very different from the on-track pool (for example, the rank correlation coefficient between off- and on-track odds is only 0.40). On-track bettors appear to be better informed, earning a (pre-takeout) return of 9.7 percent compared to a loss of 3 percent for off-track bettors.

In this section we examine odds changes from the opening of on-track betting to the close of betting for evidence that, in the New Zealand pari-mutuel betting market, late (on- and off-track) bettors are more informed than early, exclusively off-track bettors. Tables 4 and 5 present the results of this examination. To take into account the difference between a given change in win prices for a horse already at a low opening win price relative to a horse at a much higher win price, these tables show proportional changes in odds. Table 4 shows win percentages and returns for horses in two broad categories - those more heavily backed (((WPC-WPO)/WPO)<O) and those less heavily backed (((WPC-WPO)/WPO)>O). If payouts were based on opening win prices, horses more heavily backed by late bettors would have earned, on average, returns above the negative of takeout and those less heavily backed would have earned, on average, returns lower than the negative of takeout. Further, opening returns increase markedly as one moves across more heavily backed subdivisions and decrease as one moves across subdivisions of less heavily backed horses. Odds changes over the period of on-track betting largely eliminate differences in closing returns between horses more and less heavily backed.

Table 5 shows odds movements between the opening of on-track betting and the close using the ranking of favorites established by off-track bettors. Late bettors identify and back horses more likely to win: across all favorite ranks, horses more heavily backed in late betting have higher percentage of winners than do those horses less heavily backed. As a result, horses more heavily backed would have earned consistently higher, and sometimes even positive, opening returns than those earned by horses less heavily backed. A different pattern of returns is apparent at the close of betting. For most favorite ranks, and importantly, for all five top-ranked groupings, actual returns for more heavily backed horses are both lower than the negative of takeout and lower than the returns

for less heavily backed horses. Late bettors (some of whom may be 'bandwagon' bettors) backing favorites more likely to win appear to more than eliminate the general underbetting of favorites apparent at the opening of on-track betting.

CONCLUSIONS

This study examines a previously unexplored betting market, the New Zealand pari-mutuel betting market on thoroughbred horse races, for evidence of a favorite-longshot bias. Using a large sample of over 10,000 races and nearly 118,000 horses we find strong evidence of a favorite longshot bias in the odds at the opening of on-track betting, but much less evidence of the bias in the odds at the close of betting. While the bias remains in closing odds for longshots, there is little or no underbetting of low odds horse/favorites. These results reinforce the evidence of Busche and Hall (1988) and others that not all pari-mutuel betting markets are characterized by a favorite-longshot bias at the close of betting.

Additionally, we find evidence that New Zealand racetrack bettors are not all alike. While early bettors may be largely noise traders, there is evidence that late bettors tend to be informed bettors. They identify and bet on horses that, at opening odds, offer positive expected returns. Their betting thus serves to eliminate the mis-pricing of these horses created by the early, off-track bettors. That is, as at Northern Hemisphere tracks, there is strong evidence here of differentially informed traders.

TABLES AND REFERENCES ARE AVAILABLE FROM THE AUTHORS

THE NO-ARBITRAGE CONDITION AND FINANCIAL MARKETS WITH ENDOGENOUS MARKET STRUCTURE

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ABSTRACT

The standard no-arbitrage condition is defined in perfectly competitive financial markets. In a perfectly competitive market the existence of an arbitrage opportunity translates into an infinite arbitrage profit. This violates the perfectly competitive financial market assumption of small, or atomistic, market participants. Therefore, this paper examines the role of the no-arbitrage condition in financial markets with endogenous (malleable) market structure. In such markets, the small, or atomistic, investor in the process of, and before, making infinite arbitrage profit becomes large enough to affect market prices. The no-arbitrage condition is useful in ascertaining the patterns of prices that are consistent with equilibrium in such markets.

A significant literature now exists that examines the role of the no-arbitrage (NA) condition in financial markets. The standard no-arbitrage (NA) condition is defined in perfectly competitive financial markets. In a perfectly competitive financial market the existence of an arbitrage opportunity translates into an infinite arbitrage profit. This violates the perfectly competitive financial market assumption of small, or atomistic, market participants. Therefore, this paper examines the role of the no-arbitrage (NA) condition in financial markets with endogenous (malleable) market structure. In such markets, the small, or atomistic, investor in the process of, and before, making infinite arbitrage profit becomes large enough to affect market prices. The primary objective of this paper is to examine the constraint the no-arbitrage (NA) condition imposes on the pattern of prices that are consistent with the existence of equilibrium prices.

The reviews the standard definition of the no-arbitrage (NA) condition and provides mathematical and verbal presentations of the concept. It notes that the context of such a definition is the perfectly competitive financial markets. The paper proceeds to examine the implications of the no-arbitrage (NA) condition in malleable financial markets.

The paper concludes with a Theorem which demonstrates that the implications of the NA condition for malleable financial markets would be same as those explored for the NA condition in the competitive financial markets.

CASH DIVIDEND RESUMPTIONS AND LONG-TERM EQUITY PERFORMANCE

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ABSTRACT

Firms that announce the resumption of cash dividends from 1962 through 1992 are observed to earn significantly positive excess buy-and-hold returns both during the period of announcement and throughout the 36 month post-announcement period. The sample of all dividend resuming fn-ms is shown to earn three year post-announcement buy-and-hold excess returns of 2 1. 1 0%, and 15.20%, measured against the market and size adjusted benchmarks, respectively. It thus appears that dividend resuming firms are sending a signal to the market that the market does not fully comprehend or interpret because evidence suggests that the market underreacts to the announcement. Evidence also suggests that the revaluation of equity or correction of mispricing continues over a post-announcement horizon of up to three years.

An alternative analysis, performing Fama-French three factor regressions on a calendar time portfolio, also reveals statistically significant positive excess performance for the sample of dividend resuming firms. Fama-French 3-factor regressions, adjusting for the market, size, and book to market factors, are performed on a calendar time portfolio of dividend resuming firms. For the full sample containing all calendar months, the Fama-French regression intercept term translates into an excess return of 11.23% when compounded over 36 months.

In the decade of the 1990s, several studies have appeared in the financial literature revealing long-term excess performance following certain corporate events. This study lends further support to those recent studies that reveal the existence of long-horizon equity (post-announcement) anomalies. Further support is also found for the Michaely, Womack, and Thaler (1995) study of dividend initiations and omissions because in this study, we observe that significant long-horizon excess returns occur after another category of corporate dividend announcements; resumptions in this study.

THE VARIABILITY OF THE DIFFERENT LEVELS OF INCOME REPORTING

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ABSTRACT

The issuance of SFAS 130: "Reporting Comprehensive Income has given rise to a third level of income reporting which complements the operating income and net income in the traditional income statement. The pronouncement does not change any existing generally accepted accounting principles on measurement and recognition. Yet, contenders of SFAS 130 are concerned that reporting comprehensive income will create a more volatile earning measure.

This study investigates the volatility of the three levels of income reporting: operating income, net income, and comprehensive income. This study examines the components of each level of income reporting and tracing the history of the development of the components of other comprehensive income. Empirical results from testing data collected from the Standard and Poor's Compustat database of corporate reports from 1986 to 1995 reveal that comprehensive income is more volatile than net income and operating income. Operating income has the least volatility. Results from the cross sectional analysis suggest that not all industries have the same impact of income volatility. Implications of the empirical results are discussed in this study.

HOW TO INTEGRATE ACTIVITY-BASED COSTING SYSTEMS WITH FIRMS CHARACTERISTICS TO ENHANCE DECISION MAKING

Suduan Chen, Chang Gung University

ABSTRACT

Advanced manufacturing technologies are changing the basis of competition in the market place. In response to advanced manufacturing technologies and a more competitive marketplace, changes are beginning to occur in cost management systems. Following the cost management system's conceptual design, activity based costing systems have been proposed as one of the alternatives to improve many of the shortcomings of traditional cost accounting, assuming that manufacturing activities consume resources and that products demand the manufacturing activities. Several accounting researchers have hypothesized that certain firm characteristics are important to the selection of activity-based costing as a cost management system. However, other than theoretical work, there has been very little empirical research on this topic. Therefore, the purpose of this study is to examine how differences in firm characteristics affect firms satisfaction with activity-based costing.

FACTORS THAT OBSTRUCT INTERNATIONAL ACCOUNTING HARMONIZATION

Suduan Chen, Chang Gung University

ABSTRACT

The expansion of international capital markets and the availability of instantaneous global communications have placed on accounting the onus to provide useful and comparable information across international borders. There is a general consensus that a world-wide standardization of accounting principles could benefit users of financial information which originates in different geographical locations. Although the general trend in the literature supports harmonization, some significant arguments have been advanced against that process. The main argument is that socioeconomic and cultural differences between countries that cause the objectives of those countries' accounting systems actually or potentially to be different, will always exist. The question remaining is whether a need for international accounting standards really exists, and if the answer is yes, then what are the environmental factors that affect accounting harmonization? This paper attempts to show a relationship between international accounting clusters and their respective environments, and identified those factors that affect accounting practice. These factors are helpful to officials making decisions about international transactions and to policy-making organizations considering international harmonizations of accounting standard.

ELI LILLY'S VENTURE INTO THE PHARMACY BENEFIT MANAGEMENT BUSINESS: WHAT WENT WRONG?

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ABSTRACT

The pressure, levied by managed care organizations, to contain costs induced pharmaceutical firms into purchasing pharmacy benefit managers (PBM) in order to protect their products and prices. Eli Lilly acquired PCS, the largest PBM, in 1994. Four years after buying PCS for $4.l billion, Eli Lilly sold the division to Rite Aid for $1.5 billion. The high hopes for the pharmacy benefit manager and its affects on Lilly's market share and profit were dashed. This article through a multi-period event study and financial statement analysis examines the merger in detail. Specifically, questions concerning why the merger was undertaken, returns to stockholders, and why the merger failed are discussed.

INTRODUCTION

On July 11, 1994, Eli Lilly announced its acquisition of PCS, a pharmaceutical benefit manager (PBM), for $4 billion. It was the third vertical merger in the pharmaceutical industry within a year. The growth of managed care organizations and worries about the Clinton health care initiative prompted firms to look for ways to meet the challenges of cost containment.
Merck was the first firm to purchase a PBM, Medco, in 1993. Smith Kline Beecham purchased Diversified in early 1994. Not wanting to be left without a PBM, Lilly followed suit by buying the last remaining large benefit manager in mid-1994.

The market immediately worried about the acquisition. Eli Lilly's stock price fell 13% on the announcement day and another 3.3% the following day. Of concern was the price paid for the firm, 130 times PCS' annual profits. Merck's purchase of Medco was at 26 times earnings, whereas SmithKline Beecham paid 58 times earnings. Lilly countered that it paid less per covered life and controlled life than the other two mergers. Covered lives are the number of lives to which a PBM provides pharmacy benefit services. A more important figure is controlled lives, or patients to which a PBM can restrict drug choice to a formulary. By restricting drug choice, a PBM can substitute drugs for which it has a cost advantage thus increasing profit. Lilly's figures implied it paid $78 per covered life and $133 per controlled life. Merck paid $174 per covered life and $388 per controllable life. SmithKline paid $164 per covered life and $209 per controlled life. Outside analysts viewed Lilly's figure of 30 million controlled lives as too high. Using a more conservative figure of 10 million controlled lives, Lilly paid $400 per life, more than Merck or SmithKline (Neish, 1994).

Of secondary concern for the stock market was that PCS, while the largest of the PBMS, did not have mature links with its business partners. Medco came with a substantial distribution system,

while Diversified had strong links with United Healthcare. PCS needed to find and establish links within the managed care industry. Lilly announced after the acquisition that it would begin to look for partners, especially a large health management organization, to help cover the purchase price (Wall Street Journal, 1994).

THE ROLE OF PHARMACY BENEFIT MANAGERS

Pharmacy benefit managers are the insurance component of the pharmaceutical industry. PBMs manage drug claims for health care plans. The health care debate triggered by the Clinton plan pressured pharmaceutical firms to reduce costs. While pharmaceuticals are a smaller proportion of total health care costs than components such as hospitalization and physician charges, pharmaceutical price inflation has exceeded the CPI for almost the entire decade. PBMs provide a way to keep costs down by restricting drug choices to a list of covered drugs or by giving higher benefits to drugs on a favored list. The list of drugs covered by the insurance plan is called a formulary. Manufacturers believed that if they owned the PBM, they could give their drugs preference in the formularies.

The long-term benefits of a controlled formulary were unknown at the time of the mergers. Once every person was covered by a plan, gains between PBMs would come from stealing customers away from each other or from consistently gaining decreased wholesale prices for the drugs from manufacturers. For the pharmaceutical manufacturers, only drugs without generic equivalents would benefit. Once the drug was off patent and faced with lower price, generic competition, the drug would no longer be cost efficient for the PBM and would be off the formulary.

Managed care organizations are interested in the entire illness notiust drug prices because they cover the entire medical treatment. A more desirable business plan to sell them is a method of treating illness the results in the lowest cost for the overall treatment, not just one particular aspect of the treatment process (Mandelker, 1995). Drugs are an important component of the process because they are typically cheaper than an emergency room visit and long-term complications from non-compliance with a treatment by patients. The future of the pharmaceutical benefit industry is in disease management, where a company sells an outcome instead of parts of a treatment. This implies that the drug component could be a more expensive part if the overall treatment cost less and was successful. A main part of disease management is establishing treatment protocols for physicians and emphasizing changes in personal habits to avoid non-compliance with the protocols for patients. Many of the drugs used today are for chronic conditions, conditions that can not be cured but are not necessarily life threatening. The conditions can become life threatening if the patient does not actively contribute to his or her care, such as by not taking the medication, by not exercising, or by not eating healthier. While paying for prescription drugs and increased monitoring is expensive, it could prevent some hospitalizations, the most costly medical intervention.

Lilly is a leader in insulin. Together with PCS, it instituted a program for diabetics. It also formulated a program in peptic ulcers to go with its drug Axid. The programs include newsletters to patients reminding them to take medication, lifestyle changes the patients can undertake to ease the condition, and information to doctors on up-to-date treatments.

The long-run role of pharmacy benefit managers in the treatment process is unstable. Instead of paying PBMs to buy and distribute drugs, national HMOs may decide to do their own purchases or form purchase networks, thus appropriating some profit from the PBMS. In addition, large hospitals and HMOs are the sources of data for utilization and outcomes that PBMs use in determining cost-

effective treatments. The HMOs may rather do their own analysis instead of contracting it to outside players (Schwartz, 1994). Capitation is also another trend in managed care. HMOs pay a per capita annual fee for pharmaceutical benefits. Capitation squeezes margins on PBMs as they compete for contracts with the large HMOs by increasing benefits and lowering premiums.

INITIAL EXPERIENCE

While the Federal Trade Commission (FTC) allowed the mergers of Merck-Medco and SmithKline Beecham-Diversified to proceed without any interference, it became involved in the Lilly merger. The FTC was concerned about the potential monopoly control Lilly might have if it excluded other firms' drugs from its formulary. Also, Lilly might gain access to financial data and, more importantly, bid prices from other firms who would try to have their drugs listed on the PCS formulary. The FTC erected a firewall between Lilly and PCS products. Lilly could not restrict access to PCS' formulary to any drug, effectively eliminating any potential cost advantages or any gains of market share that Lilly expected at the time of the merger. Lilly also could not access any PCS data on firm with which it conducted business. PCS would be run as a completely separate company with no advantages to Lilly.

To pay for the acquisition, Lilly undertook a substantial amount of debt. It issued $3.8 billion in commercial paper and through 1995 converted $1.3 billion into long-term debt. In comparison, Merck issued $2 billion in debt in its acquisition. The increased debt hindered Lilly's financial performance. Its long-term debt to sales ratio tripled to 37%, three times Merck's ratio. Interest payments for Lilly increased dramatically from $63.7 million in 1993 to $102.4 million in 1994 and $271.7 million in 1995. The debt decreased the times interest earned ratio by more than 50% to less than 10 times. Lilly's earnings growth had been lackluster prior to the merger. It wasn't until 1996 that Lilly's earnings per share surpassed the 1992 value.

Moody's and Standard & Poor's bond rating services questioned the additional debt and the corresponding default risk. Lilly's bond carried a triple A rating from both services before its merger with PCS. After the merger, S&P downgraded the bonds to an AA rating where it remains today. Moody's downgraded Lilly twice in 1994. The first downgrade was from Aaa to an Aa 1 rating. After the merger was completed, the rating was downgraded again to an Aa 3 rating, where it remains today.

While Lilly had high hopes for the merger and impending synergies, the market was unclear if the gains could be realized and sufficient enough to offset the debt. Clearly, the intervention by the FTC and the resulting restrictions on Lilly hindered any potential gains. Randall Tobias, CEO of Lilly, stated that the FTC involvement decreased the synergies and made it difficult to operate PCS. He wished the firm had never acquired PCS (Koberstein, 1998). Later that year, Lilly sold PCS to Rite Aid for $2.6 billion less than it had paid for the firm.

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AN EXPERIMENTAL TEST OF THE EFFECT OF PERFORMANCE STANDARDS IN A CONTINUOUS IMPROVEMENT ENVIRONMENT

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ABSTRACT

Many studies in accounting, management, and psychology have shown that, in general, work standards or goals positively impact work performance. However, Deming (1983) and Conway (1992), two noted Total Quality Management (TQM) experts, maintain that such standards are detrimental to work performance in TQM and continuous improvement (CI) environments. This study examined three questions on the effects of work standards on performance in a continuous improvement environment. First, do standards act as anchors and constrain performance as work processes and tasks are revised and new standards are set? Second, will participation in the Cl process mitigate that anchoring? Third, will the level of standards on the initial task influence participation in the Cl process by affecting the number of suggested improvements?

These research questions were tested with 212 college students in a computer laboratory using a 3 by 2 design. The manipulations include the standard levels on the initial task (easy, difficult, or do your best) and participation in the Cl process (participation versus no participation). Subjects' performance was measured as they worked at a simple inventory control task and at the revised task.

The results indicate that, contrary to acting as an anchor and constraining performance, personal goals and assigned goals for an initial task impacted revised task performance. Self-efficacy and personal goals on an initial task carried over to the revised task.

GASB'S YEAR 2000 ISSUES DISCLOSURE REQUIREMENT: IMPLEMENTATION RESULTS FOR VIRGINIA LOCAL GOVERNMENTS

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ABSTRACT

*The Governmental Accounting Standards Board (GASB) Technical Bulletin No. 98-1, Disclosures about Year 2000 Issues, requires governments to disclose certain information about steps taken to become year 2000 compliant. The requirements of the Technical Bulletin are effective for financial statements on which the auditor's report is dated after October 31, 1998. The AICPA felt that sufficient audit evidence may not exist to support the required disclosure. In such cases, the auditor should issue a qualified opinion (scope limitation) with respect to the required disclosures. The position of the AICPA creates an unusual situation in financial reporting. If an entity follows GAAP reporting requirements and provides the year 2000 disclosures, the auditor may qualify his or her opinion. If the entity fails to provide the required disclosures, it should receive either **a** qualified or adverse auditor's opinion. This study examines the June 30, 1998 financial statements and auditor's reports for counties and cities in Virginia. The results indicate inconsistent implementation by govennnents and different responses by the auditors to the disclosures. This variability led the AICPA to issue Technical Bulletin No. 99- 1, which provides additional guidance on reporting Year 2000 disclosures for periods ending after December 31,1999.*

BACKGROUND

On October 22, 1998 the Governmental Accounting Standards Board (GASB) issued GASB Technical Bulletin No. 98-1, *Disclosures about Year 2000 Issues.* This Technical Bulletin requires governments to disclose certain information related to the amount of resources committed to make critical computer systems and other electronic equipment year 2000-compliant. It also requires a general description about the stages of work in process or completed at the end of the reporting period to address these issues and the additional stages of work necessary to make the government's critical systems year 2000-compliant.

The requirements of the Technical Bulletin are effective for financial statements on which the auditor's report is dated after October 31, 1998, with earlier application encouraged. It also requires that the above disclosure be part of the notes to the financial statements.

The American Institute of Certified Public Accountants (AICPA) raised concerns about the reporting requirements of the Technical Bulletin because they felt the disclosures were neither assertable by management nor verifiable by auditors. In an article in the November 1998 *CP,4 Letter,*

the AICPA was advising auditors to be cautious about being associated with the disclosures required under the Technical Bulletin.

The AICPA felt that sufficient audit evidence may not exist to support the required disclosure. In such cases, the auditor should issue a qualified opinion (scope limitation) with respect to the required disclosures. If the government failed to report the required disclosures and the auditor determines that the financial statements are materially affected by the omission, the auditor should issue either a qualified or adverse opinion because of the departure from generally accepted accounting principles (GAAP).

The position of the AICPA creates an unusual situation in financial reporting. If an entity follows GAAP reporting requirements and provides the year 2000 disclosures, the auditor may qualify his or her opinion. If the entity fails to provide the required disclosures, it should receive either a qualified or adverse auditor's opinion.

The timing of the above requirements and guidance may have affected the implementation by local governments and their auditors. GASB did not issue a draft Technical Bulletin on year 2000 disclosures until July 24, 1998. The final Technical Bulletin was issued on October 22, 1998. The AICPA advice to general members appeared in the November 1998 *CPA Letter*. However, the disclosures were required for financial statements on which the auditor's report is dated after October 31, 1998.

DESCRIPTION OF STUDY

The purpose of this study is to examine the initial implementation of GASB Technical Bulletin No. 98-1 by local governments. This study examined the June 30, 1998 financial statements of counties and cities in Virginia. The Auditor of Public Accounts, a state agency, has oversight responsibility over the financial reporting of local governments. Because of this oversight, financial reporting is fairly consistent among these governments. All local governments have a June 30th year-end and are audited by independent public accounting turns.

This study examined the notes to the financial statements and auditor's report contained in the June 30', 1998 Comprehensive Annual Financial Reports (CAFRs). The study reports findings for 94 of the 95 counties and 39 of the 40 separate independent cities in Virginia. The two missing governments did not have 1998 CAFRs on file with the Auditor of Public Accounts.

YEAR 2000 DISCLOSURES

The Technical Bulletin requires year 2000 disclosures if the auditor's report is dated after October 31,1998 and encourages such disclosures for all other governments. Table 1 reports the number of cities and counties that included a year 2000 issues note in their CAFR. The table reflects that, overall, about one fourth of local governments' CAFRs (30.8% of the cities and 22.3% of the counties) included such a note. It should be noted that in four cases the note disclosure was labeled "unaudited."

Compliance with the Technical Bulletin where the auditor's report was dated after October 31,1998 was then tested. Table 2 reports the percent of localities that had a note regarding the year 2000 issue when the auditor's report was dated after October 31,1998. The table reflects that two thirds of such governments provided a note. Inversely, the table reflects that one third of the local

governments did not comply with the requirements of the Technical Bulletin. The table also reports results based on population size as follows: large (>100,000 inhabitants), medium (between 50,000 and 100,000 inhabitants), small (<50,000 inhabitants). The table reveals total compliance for large entities, three fourths compliance by medium-size ones, and almost two thirds compliance by small governments. It should be noted that only one of the twelve large governments has the audit report dated after October 31, 1998. The results suggest that larger governments were more likely to comply with the Technical Bulletin than small ones.

Early adoption of the Technical Bulletin was also tested. This is the case where the auditor's report is dated prior to November I , 1998 and a year 2000 issues note is included in the CAFR. Table 3 reports that fewer than one in ten of governments that fall into this category made the voluntary disclosures. The highest percentage (26.7%) was for medium size governments.

IMPACT ON THE AUDITOR'S REPORT

The impact of the year 2000 disclosures on the auditor's report was also examined. As discussed earlier, the AICPA has made two recommendations regarding disclosures of this information. If the financial statements contain a Year 2000 note, the auditor may not be able to obtain sufficient audit evidence with respect to the disclosures, and thus should probably issue a qualified opinion due to a scope limitation. On the other hand, if Year 2000 disclosures have been omitted, in violation of the Technical Bulletin, then the auditor should issue a qualified or adverse opinion (depending on materiality) due to a departure from GAAP.

To test whether auditors followed these AICPA recommendations, the type of auditor report issued when the reporting entity did make the required Year 2000 disclosures was examined. Table 4 reveals that, when the disclosure was made, half of auditor reports were qualified for large governments, while only one out of seven of medium-size and one fourth of small government reports were qualified.

The auditor's report was also examined for the twelve governments that did not make the Year 2000 disclosures when the auditor's report was dated after October 31, 1998. In every case, the auditor gave an unqualified opinion, even though the financial statements audited clearly do not comply with the Technical Bulletin. The majority of reporting entities not making the required disclosures fit into the "small" category, as previously defined.

CONTENT OF DISCLOSURES

As previously reported in table 1, a total of thirty-three governments included a Year 2000 note in their CAFR. The information contained in the notes was examined to detemiine if the disclosure contained the information required by the Technical Bulletin. Governments were required to disclose information about any significant amounts committed to make computer systems and other electronic equipment year 2000 compliant. In addition, governments should disclose the stages of work completed to make computer systems and other electronic equipment critical to conducting operations year 2000-compliant. Table 5 reports the number and percentage of governments reporting such information.

Table 5 reports that only a third of the thirty-three governments provided information about the resources committed to make critical computer systems and equipment year 2000 compliant. The

amount of resources committed by these governments ranged from no financial commitment to over $2 million. It appears that the amount reported may not be fully attributed to the cost of Year 2000 activities. Many of the reported amounts included the cost of purchasing replacement hardware and software that, while probably implemented at an accelerated pace, would have very likely been replaced at some future point.

The Technical Bulletin requires governments to include in its disclosure a description of the stages of work in process or completed for both computer systems and electronic equipment. Table 5 reports that 54.5% of the notes addressed both computer systems and other electronic equipment while 45.5% of the notes only addressed computer systems. In addition, nine governments limited their discussion of computer systems to just accounting software. Of those nine, five failed to describe any activities and simply stated that their accounting software was already compliant, based primarily on assurances from their software vendor.

For the twenty-eight governments that did describe the "stages of work", there was a great deal of variance in the type and focus of the information provided. The Technical Bulletin indicated that the following four categories should be used to describe the stages of work: Awareness Stage, Assessment Stage, Remediation Stage, and Validation/Testing Stage. These stages can be viewed as distinct phases, but in reality, the phases overlap significantly in any organization. For example, comprehensive assessment may be continuing while remediation and/or testing occurs for those systems that had previously been identified as non-compliant. Fourteen of the twenty-eight governments indicated that they were in different stages of activities for different computer systems. Table 6 provides a summary of the stages of work mentioned in the note disclosure. The table reflects that most governments are still in the assessment and remediation stages.

CONCLUSION

Based on the analysis of audited financial statements for Virginia governments for the year ended June 30,1998, it appears that the implementation of the Technical Bulletin varied among the governments and their auditors. A significant number of governments and auditors appear to have not been aware of the reporting requirements. This may be due to the timing of the Technical Bulletin's issuance. As it relates to auditors following the guidance provided by the AICPA, again the findings varied. This could be a combination of the auditor not being aware of the guidance or not agreeing with the need to follow such guidance.

The actual content of the disclosure also varied among governments. Most governments did not report amounts committed and several governments only reported information regarding computer systems. It appears that additional guidance may be needed to increase consistency regarding this disclosure. Consistency will increase the usefulness of this reporting requirement.

CHANGES TO TECHNICAL BULLETIN NO. 98-1

On March 29, 1999, GASB issued Technical Bulletin No. 99-1, *Disclosures about Year 2000 Issues -- an amendment of Technical Bulletin 98-1.* This Technical Bulletin contains two major revisions to the disclosure requirements regarding year 2000 issues. The first is that the required disclosure may either be presented in the notes to the financial statements or as part of required supplementary information following note disclosures. In previous accounting standards, GASB has

used required supplementary information as a means of communicating information outside the basic financial statements.

The second revision to Technical Bulletin No. 98-1 represents a change in wording aimed at clarifying the intent of the disclosure. Technical Bulletin No. 98-1 contained language about resources committed or stages of work completed to make computer systems and other electronic equipment year 2000-compliant. The revision replaces the "year 2000-compliant" language with "to address the year 2000 issue for computer systems and other electronic equipment". The revision goes on to state that the disclosure should indicate that completion of the work is not a guarantee that the systems and equipment will be year 2000 compliant.

The AICPA has responded to Technical Bulletin No. 99-1 by posting updated guidance on its Web page. The guidance indicates that if the disclosure is contained as required supplementary information outside the basic financial statements, such disclosure does not affect the auditor's opinion on the basic financial statements. The guidance also provides circumstances where the auditor may or should expand the audit report to address the required supplementary information disclosures. However, the auditor's opinion does not need to be modified.

Technical Bulletin No. 99-1 removes the unusual situation in financial reporting where an entity that follows GAAP reporting requirements could receive a qualified auditor's opinion. The provisions of Technical Bulletin No. 99-1 are effective immediately with retroactive application allowed. Both Technical Bulletin provisions terminate for reporting periods ending after December 31, 1999.

TABLE 1
YEAR 2000 DISCLOSURES MADE IN 6/30/98 CAFRs ?

	CITIES	COUNTIES	TOTAL
YES	12/39 (30.8%)	21/94 (22.3%)	33/133 (24.8%)
NO	27/39 (69.2%)	73/94 (77.7%)	100/133 (75.2%)

TABLE 2
YEAR 2000 DISCLOSURES MADE WHEN AUDIT REPORT WAS DATED AFTER 10/31/98?
(based on population size of government)

	>100,000	50,000-100,000	<50,000	TOTAL
YES	1/1 (100%)	3/4 (75%)	20/31 (64.5%)	24/36 (66.7%)
NO	0/1 (0%)	1/4 (25%)	11/31 (35.5%)	12/36 (33.3%)

TABLE 3
YEAR 2000 DISCLOSURES MADE WHEN AUDITOR REPORT DATED PRIOR TO 11/01/98?
(based on population size of governments)

	>100,000	50,000-100,000	<50,000	TOTAL
YES	1/12 (8.3%)	4/15 (26.7%)	4/70 (5.7%)	9/97 (9.3%)
NO	11/12 (91.7%)	11115 (73.3%)	66/70 (92.8%)	88/97 (90.7%)

TABLE 4
TYPE OF AUDIT OPINION GIVEN WHEN GOVERNMENT MADE YEAR 2000 DISCLOSURES
(based on population size of government)

	>100,000	50,000-100,000	<50,000	TOTAL
QUALIFIED	1/2 (50%)	1/7 (14.3%)	6/24 (25.0%)	8/33 (24.2%)
UNQUALIFIED	1/2 (50%)	6/7 (85.7%)	18/24 (75.0%)	25/33 (75.8%)

TABLE 5
CONTENT OF YEAR 2000 DISCLOSURES
(based on population size of government)

INFORMATION	>100,000	50,000-100,000	<50,000	TOTAL
Funds Committed	1/2 (50%)	4/7 (57.1%)	6/24 (25%)	11/33 (33.3%)
Computer and Electronic Equipment	2/2 (100%)	3/7 (42.9%)	13/24 (54.2%)	18/33 (54.5%)
Computers Only	0/2 (0%)	4/7 (57.1%)	11/24 (45.8%)	15/33 (45.5%)

TABLE 6
STAGES OF WORK REPORTED IN NOTE DISCLOSURES

	Awareness	Assessment	Remediation	Validation/Testing
Computer Systems	1/28 (3.6%)	17/28 (60.7%)	18/28 (64.3%)	9/28 (32.1%)
Electronic Equipment	1/18 (5.5%)	14/18 (77.8%)	6/18 (33.3%)	1/18 (5.5%)

A DISCUSSION OF THE "IRS RESTRUCTURING AND REFORM ACT OF 1998"

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ABSTRACT

The IRS Restructuring and Reform Act of 1998 covered many topics other than the restructuring of the IRS. It contains provisions that effect individuals, corporations, retirement plans and estates and gift taxation. It contains provisions that are technical corrections of previous legislation and some provisions that were meant to raise revenue. This paper discusses the restructuring of the IRS and how this will effect taxpaying citizens. It also mentions some of the more important provisions that effect taxpayer rights and audits of individuals.

INTRODUCTION

In the fall of 1997, the Senate Finance Committee conducted hearings on abuses by the IRS. These hearings went on for several months and brought out many ways in which the IRS employees were abusing the power of the law. Many people were brought in to testify before the committee and parts of the hearings were televised. Many of the witnesses brought up things that had happened to them at the hands of the IRS that were simply atrocious. Some of them had lost all of their property and were bankrupt because of the IRS. These people had not done anything, in some cases, to warrant such abuse but the IRS through errors that were made by employees had treated them as if they were criminals. These hearings caused Congress to pass The IRS Restructuring and Reform Act of 1998. The act was enacted on July 22, 1998. It contains many provisions that effect individuals, corporations, retirement plans, estate and gift taxes, technical corrections of previous legislation, and some provisions that were meant to raise revenue. This paper discusses some of those provisions.

IRS REORGANIZATION

The ACT calls for the reorganization of the Internal Revenue Service from geographic divisions to operating units that serve certain groups of taxpayers who have similar needs. IRS Commissioner Rossotti called for this type of change in January 1998. Congress did not provide any guidelines on how the restructuring was to be implemented. It is assumed that the current employees of the IRS will implement the changes but what will happen to the current 33 district offices and 10 service centers was not discussed. Will this change help taxpayers or make matters worse? The answer to this question will be resolved as time goes by.

TERMS FOR IRS COMMISSIONERS

The ACT calls for the Commissioner of the IRS to serve a term of five years which will allow for some continuity, more stability and hopefully, will allow the implementation of the changes in the structure of the IRS to be made in the best manner possible. The Commissioner, in the past, has been appointed by the President and confirmed by the Senate and on the average has served only three years. With all the changes that are required by the ACT, the five-year term should be better for the IRS and the public.

IRS MISSION STATEMENT

The IRS mission statement that was in effect before the ACT was passed focused on tax collection rather that service to the public. It seems that the IRS was more interested in making sure that the taxpaying public paid everything that they owed rather than providing assistance in the filing of tax returns. The new mission statement is supposed to emphasize service rather than tax collection. The old mission statement contained provisions that the service was suppose to provide service to taxpayers but everyone can see that the service was secondary. Is the new mission really going to be different from the old one? Can the IRS change its habits? Again, the answers to these questions will be determined as time passes. We will have to wait and see how the service reacts to the changes. If you think about what the IRS has to do, audit taxpayers, collect the additional taxes due and administer the tax laws, it would seem to the authors that it is going to be difficult for it to emphasize service to taxpayers.

IRS OVERSIGHT BOARD

The ACT contains a provision for the establishment of an IRS Oversight Board. This is supposed to help to rebuild the public's confidence in the IRS which, over the years, has deteriorated. The board will have nine members that will each serve a five-year term. It will be composed of six people from the private sector, the Secretary of the Treasury, a representative of IRS employees and the Commissioner of the IRS. The board will have the authority to control the actions of the IRS and will give more responsibility to the National Taxpayer Advocate. The ACT provides for the current Taxpayer Advocate to become the National Taxpayer Advocate. The idea is for each state to have a local taxpayer advocate who is suppose to look after the rights of taxpayers. The service is suppose to advertise and promote the office of the taxpayer advocate and the advocate is suppose to be independent from the IRS office. The advocate is to be given additional authority to issue taxpayer assistance orders. As the name implies, the advocate is suppose to help the taxpayer and if the law works as planned, the advocate will be very beneficial to taxpayers. There has been a taxpayer advocate for many years and the IRS has still abused taxpayers. Will this provision make a difference? In the authors opinion, it will be helpful if it is advertised and more people know about it.

IRS EMPLOYEE ACCOUNTABILITY

In the past, employees of the IRS have been evaluated on how many audits they performed, how much money they assessed and on how much money they collected. This act provides that the

employee evaluation will not be based on the amount of money collected or quotas. Also, the ACT stresses employee accountability. Misconduct by an employee is to be used against the employee in an evaluation of performance. If an employee falsifies documents, commits perjury, harasses or retaliates against a taxpayer or another employee of the IRS, or threatens to audit a taxpayer for personal gain or benefit, the IRS is suppose to terminate that employee. These provisions should make it easier for the tax paying public in its dealings with the IRS. Also, it will make it better for the IRS employees. They will not have to worry about the time that it takes them to conduct an audit. They can do a better job of auditing a taxpayer, which should help in assessing the correct amount of tax that a person owes.

EXPANDED TAXPAYER RIGHTS

The ACT contains many provisions that are supposed to help taxpayers when the IRS is auditing them. The law limits the number of financial status audits that the IRS can perform. In the past, the IRS could perform a financial status audit if the return that was being audited contained items that would seem to be improper when compared to the lifestyle of the taxpayer. If the gross income on the return and the amount of deductions claimed were inconsistent, the auditor could perform a financial status audit. The IRS routinely did this type of audit. In the interview of a taxpayer, an IRS auditor would routinely ask financial status questions about the lifestyle of the person. These questions could provide information that would cause the auditor to perform a financial status audit. These types of audits are much more thorough than the normal audit that was usually done. The auditor looked at all the assets that a taxpayer had. All bank accounts were examined. All sale transactions were examined. The AICPA had been trying for years to get congress to limit this type of audit. It thought that this type of audit allowed the IRS to presume that a fraudulent situation existed without due process. This was done without the taxpayer having legal representation. The Act provides that financial status audits cannot be performed unless the IRS auditor has already seen indications of unreported income.

BURDEN OF PROOF

Under past law, the burden of proof in tax cases was usually on the taxpayer and not on the IRS. The IRS could assess additional tax based on information that it had obtained and it was up to the taxpayer to prove that the information was incorrect. Under the new law, if certain conditions are met, the burden of proof shifts to the IRS. If the taxpayer has complied with substantiation and record-keeping requirements of the Internal Revenue Code and has cooperated with the reasonable requests for information, documents, interviews, and meetings with the IRS then the burden of proof falls on the IRS rather than the taxpayer. Certain corporations, trusts, and partnerships are not eligible to use this provision. Many people feel that this provision will cause the IRS to perform audits that are much more intrusive into the taxpayer's affairs even though it was meant to be helpful to the taxpayer. If the IRS knows that it is going to have the burden of proof shifted to it, it will perform a more thorough audit so that it has all the information that it will need in case that it has to go to court.

TAXPAYER, PREPARER PRIVILEGE

In the past, only attorneys have had attorney-client privilege. The talks between the attorney and the client were considered to be confidential. The information that was discussed between them could not be used against the taxpayer. Under the new law, this privilege is extended to anyone that is authorized to practice before the IRS. Only tax advice information, however, is privileged. What is tax information? The law does not define exactly what this information is. Everyone who prepares tax returns is not covered by this provision. Only those who are authorized to practice before the IRS are covered. Will this provision be helpful to the taxpayer? It should be but we will have to wait and see how the provision is interpreted before we can say for sure.

CONCLUSIONS

The IRS Restructuring and Reform Act of 1998 is a very important piece of legislation and it will be many years before its effects can be determined. The restructuring has started and will continue until all of the provisions are implemented. CPA's and others who are able to represent taxpayers before the IRS should be wary of some of the provisions. Some of the provisions will be helpful to taxpayers but some of them could be harmful to the taxpayers. Only time will tell how this act will be looked upon.

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