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# STHE WEALTH TRANSFER TAXES: SELECTED IMPEDIMENTA TO THEIR ABROGATION

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## ABSTRACT

*The Internal Revenue Code (IRC) of the United States tax system imposes a tax, not only on the income earned by taxpayers throughout their lifetimes, but also on the amount of properties they give to their loved ones during their lifetime and on the wealth they bequeath to their heirs at the time of death. Those latter taxes, known variously as the gift tax, the estate tax, the inheritance tax, or the wealth transfer taxes, even after some substantial exemptions or tax free allowances, have generated a lot of controversies and debate. Many feel that they constitute a form of unfair "double-taxation", insofar as the decedents had already paid income taxes on their earnings and had thus used only after-tax dollars in the acquisition of the properties transmitted to their heirs. One of the classic counter arguments is that, as an individual accumulates large amount of properties, and given the compounding power of money, the gift and estate taxes remain the ultimate tool for an equitable redistribution of the nation wealth, with a view of avoiding an undue concentration of wealth among a small group of families.*

*This paper does not attempt to resolve, or even take side in, this fundamental disagreement. Rather, its purpose is to show that, the present IRC contains several provisions, highly beneficial to and frequently used by the taxpayers, which amount to a temporary deferral of taxes due but, with an implicit promise to pay them at a later date and upon the occurrence of certain events and conditions. Through appropriate tax planning, such later date or the realization of those events can be postponed virtually indefinitely throughout the taxpayer's lifetime. Thus, the death taxes remain the ultimate "checkpoints" when the postponed taxes can be collected, thereby bringing closure to the earlier or long ago transactions. Therefore, the theme of this paper is that, if the estate and gift taxes are to be eliminated, a correct conceptual framework requires that either the favorable provisions be repealed or their effects be greatly modified to account for the elimination of the later reckoning.*

*After a presentation of the arguments for and against the death taxes, the paper analyzes several of the favorable but conditional tax provisions, especially: the (IRC) Section 1031 like-kind exchanges gains, the Section 1033 involuntary conversions and severance damages gains, the Section 1044 and 1202 gains on the sale of publicly traded stock and of the Small Business Administration (SSBICs) stock, the Section 351 and 357 gain postponements in the formation of a corporation, the Section 306 preferred stock bailouts, and some other ones. It clearly shows that the*

*death taxes are needed as a final enforcement to several of those code sections. The paper then examines some judicially created doctrines, such as the continuity of interest, the continuity of business enterprises, and the step transaction doctrines, that in effect constitute a sanction by the judiciary of the initial postponement of taxes but with a promise, an engagement, a "contract" to settle later with the Internal Revenue Service. The elimination of the death taxes would do great damage to those provisions and to the court doctrines developed over a long time to administer them.*



# THE EVOLUTION OF A KEY INTERNAL REVENUE CODE SECTION: THE HOME OFFICE DEDUCTION

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## ABSTRACT

*Under the Internal Revenue Code (IRC), taxpayers have traditionally been able to deduct all of the "ordinary and necessary" expenses of conducting a trade or business from the revenue generated by such business. For those not engaged in a regular "trade or business but who nevertheless derive some income from a certain activity, their expenses related to the production of that income are also deductible. Thus, many taxpayers have in the past been deducting the cost of maintaining an office at home where they conduct either a regular business or some income producing activities. Examples would cover lawyers, doctors, salesmen using an office at home to prepare legal briefs, consult with patients or perform other administrative tasks related to their income generating work. Given the technological advances making telecommuting more prevalent, and more advantageous for both employees (flexibility, reduced commuting costs,) and employers (cost savings of not having to provide office space), the use of home office has vastly increased in our economy, going from an estimated 1.5 million taxpayers in 1991 to a far larger segment of the work force.*

*Until the middle part of the seventies, it was fairly easy for taxpayers to receive these deductions. So long as they could substantiate, by their records and receipts, their expenses in generating the income or in conducting the trade or business, they were virtually assured of the deductions for such items as a portion of the mortgage or rent payments, of the utilities, of the cost of furnishing and generally maintaining that portion of their home used as the "home-office". In the event of an audit by the Internal Revenue Service, they usually prevailed as long as they could show that the expenses involved were "appropriate and helpful" and "reasonable" in the trade or business.*

## **The restrictions of Code Section 280A**

In search of additional revenues to reduce the large federal deficits, in 1976 Congress enacted IRC section 280A, thereby imposing much stricter rules for those deductions. The new requirements were:

1. Taxpayer had to use the home office "exclusively" and "regularly" for business purposes.
2. That home office had to be taxpayer's principal place of business.
3. It had to be a place of business used to consult with clients or patients.

The Internal Revenue Service (IRS) enforced the first requirement to the letter, meaning that the home office had to be a location separated by some wall, partition, curtain or other physical demarcation. The United States Tax Court disagreed, saying that it found no such requirement in the legislation. That Court even ruled that a large walk-in closet would qualify as a home office. The second part of the first requirement still had to be met, that is the space had to be used regularly, not intermittently, for the business or income producing activity.

The second requirement generated even more controversy. What was to be considered the taxpayer's principal place of business? To help in the interpretation, the courts employed a new concept, "the focal point test". In the case of an employee, the principal place of business, that is, the focal point of his activities was deemed to be the business premises of his employer. This became almost an insurmountable obstacle for most employees. In one case, an expert violinist was hired by the opera at a large metropolitan area. During the performing season, he spent about 26 hours per week rehearsing at the opera center. But since the employer did not provide him with any private office facilities, he set up a studio at home to perfect his skills. Despite his unchallenged testimony at the trial, that usually he would spend 30 hours per week rehearsing in the home studio, the Tax Court denied him the deduction, using the reasoning of "the focal point test". The Court stated that the focal point of his activities was the opera center, not his home, in spite of the fact that he spent slightly more time there than at the center. Similar results were reached in case after case, when employees, faculty members, lawyers or consultants tried to deduct their home office expenses.

### **Reversals and controversy**

Those taxpayers, feeling unfairly treated by the application of this "focal point test", appealed their cases. The Second Circuit Court of Appeals dealt the IRS a significant setback in reversing a previous Tax Court decision. The undisputed facts were that a professor, Mr. Weissman, of a large university was spending most of his working time, not lecturing, advising students or grading papers on campus but rather doing research and writing in two of the ten rooms of his large residence. While the university provided him with an office, he had to share it with other colleagues and it was "not a safe place to leave teaching, writing, or researching materials and equipment." He satisfied the other conditions, since he showed to the satisfaction of the court that those two rooms were used "regularly" and "exclusively" for his research and writing activities. It also helped that he was writing a book at that time. The Appeals Court found that the Tax Court had misapplied the "focal point test" in the case, saying that the professor was engaged in two complementary but separate types of activities, both of which were necessary for receiving tenure, promotion or advancement from the university. The first portion of his activities, his teaching, was conducted on the premises of his employer; the second one, a "dominant" portion, his research and writing, were conducted in his home office. "To the extent that Tax Court found [the] College to be the focal point of Professor Weissman's employment activities simply because he taught courses there, it erred as a matter of law by failing to consider all aspects of his activities.

A different Appeals Court, the seventh, also ruled against the IRS in a later case. Sally Miers, an employee of a corporation, set up a home office where she did some work in connection with her employment. When the IRS objected to her deductions for the expenses of maintaining her home

office, she went to the Tax Court. The latter, invoking the "focal point test", sided with the IRS. In reversing, the Seventh Circuit Court of Appeals stated: "We, like the Second Circuit, question the usefulness of the focal point test...As applied by the Tax Court, [it] places undue emphasis upon the location where goods or services are provided to customers and income is generated, not necessarily where work is predominantly performed. The focal point test is concededly easy to apply...Yet we do not believe this approach is fair to taxpayers or carries out in the most appropriate way the apparent intent of Congress...In applying these standards to the present case, we conclude that the Tax Court erred in denying taxpayers a deduction for a home office... We reverse the decision of the Tax Court...

### **More restrictive requirements and a possible trap.**

The IRS appeared defeated as many similar court rulings went against it. But in 1993, the United States Supreme Court reversed in favor of the IRS an Appeals Court decision which had affirmed a previous Tax Court ruling favoring a taxpayer. An anesthesiologist at three hospitals in the nation capital, Dr. Soliman, had set up an office at his residence to perform work related activities: update his patients' records, read medical journals, consult with patients by telephone. He had to do so, he testified at the trial, because none of the three hospitals provided him with a private office on their premises. In reversing the Appeals Court decision, the Supreme Court introduced a new element, that of "the comparative importance" of the activities. "The essence of the professional service provided by the doctor was treating patients (in the hospital operating rooms), not maintaining patients' records (done in his home). Thus, the home office became less important than the hospital rooms and the deduction is denied.

As the controversy continued among new victories for the IRS, Congress enacted new amendments on the subject to the Internal Revenue Code. In addition to the requirements of Section 280A, the Tax Reform Act of 1997 stated that the term "principal place of business" now must also satisfy the following ones:

1. The office is used by the taxpayer to conduct administrative or management activities of a trade or business.
2. There is no other fixed location of the trade or business where the taxpayer conducts these activities.

In effect, those new requirements have now made it all but impossible for an employee to deduct expenses for a home office when he is provided with office space by his employer.

### **The tax trap**

A tax trap can be defined as any unwanted or unforeseen tax consequences forcing the taxpayer to either pay more taxes or to forego deductions to which he believed he was entitled. Some of these traps may be judicial, some statutory and some simply the result of judge-made precedents. Examples would be the step transactions doctrine, the collapsible corporation rules, and the constructive ownership regulations. The deduction for a home office, even by a self-employed

person who is entitled to it, may become such a trap at a subsequent sale of the primary residence in which the home office was located. A taxpayer may exclude up to \$250,000 (\$500,000 if married and filing a joint return) of the gain from the sale of his principal residence if he had lived there at least two of the five years preceding the sale. But what effect would a previous deduction for a home office in a residence would have on the availability of Section 121? While some uncertainties lingered for some time, the IRS finally clarified its position. It ruled that only the depreciation deduction claimed on the home office portion of the principal residence after May 5, 1997 would have to be reported as taxable gain, while the balance of the gain would remain eligible for the exclusion of code section 121.

In summary, the home office deduction has effectively been taken away from most employees, especially those who are furnished an office on the business premises of their employers. Even if such office is not provided, the five conditions of both section 280A and of the Tax Reform Act of 1977 would have to be met for the deduction to be claimed. Such a deduction remains available for the self-employed, but under strict adherence to the IRC provisions. Finally, even a legitimate deduction can trigger a somewhat unfavorable tax treatment at a later sale of the primary residence where the "home office" is located.

### Footnotes

- 1 Internal Revenue Code (IRC) § 162.
- 2 Internal Revenue Code § 212.
- 3 Hoffman et al. Individual Income Taxes, 2006 ed. West Federal Taxation, Thompson, South-Western , p. 9-22
- 4 TC Memo 1981-140.
- 5 R. Chauls, TC Memo 1980-471; Bilenas, TC Memo 1983-661.
- 6 Weissman v. Comm. (2 Cir; 1983) 55 AFTR2d 85-539, 751 F2d 512, rev'd #85, 724 PH Memo TC.
- 7 Ibid.
- 8 Meirs v. Comm. (7 Cir; 1986), 57 AFTR2d 86-642, 782 F2d 75, rev'd 84, 607 PH Memo TC.
- 9 Soliman v. Comm. (1993), 71 AFTR2d 93-463, -US-Sct., rev'd (4 Cir; 1991), 67 AFTR2d 91-1112, 955 F2d 52, 94 TC 20 (No. 3).
- 10 Hoffman et al. Individual Income Taxes, 2006 ed. West Federal Taxation, Thompson, South-Western , p. 9-21
- 11 Sommerfeld, Ray, Federal Taxes and Management Decisions, Richard D. Irwin, Inc. Homewood, Ill. 121986. p. 286-302.
- 13 IRC section 121.

# **ETHICS EDUCATION IN U. S. ACCOUNTING PRACTICE – A STATUS REPORT**

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## **ABSTRACT**

*The primary purpose of this descriptive article is to examine the current state of ethics education and training of U. S. accounting practitioners. Accounting ethics requirements for U. S. accounting practitioners with the designations of Certified Public Accountant (CPA), Certified Internal Auditor (CIA), or Certified Management Accountant (CMA) were examined in four different ways. First, the ethics education requirements necessary to take each of the examinations were examined. Second, an examination was made of the required ethics content on the qualifying examinations for these designations. Next, the ethics requirements necessary for certification after successfully completing the examinations were determined. Finally, the Continuing Professional Education (CPE) (Continuing Professional Development (CPD)) requirements necessary to maintain the certifications were examined. The results indicate that there is little emphasis on ethics in the qualifications, testing, and continuing education of certified accountants in the United States.*

## **INTRODUCTION**

Accounting problems with U. S. companies Enron, WorldCom, Tyco, Xerox, HealthSouth, Merck, Adelphia Communications, and the dismantling of Arthur Andersen resulted in an increased discussion of accounting ethics in the United States and the enactment of the Sarbanes-Oxley Act of 2002. Recently, there has been an escalation in the level of debate with regards to "ethics" education in the accounting profession. With the well-publicized corporate scandals and legislative actions affecting the profession, both academic and practitioner publications have had many articles calling for increased ethical training for both accounting students and professionals. Several U. S. professional bodies, such as the American Institute of CPA's (AICPA), the American Accounting Association (AAA), and the National Association of State Boards of Accountancy (NASBA) have increased their emphasis on accounting ethics in practice and in education.

A dominant factor in determining the level, type, and composition of education received by U. S. accounting professionals is the educational requirements necessary to attain and maintain professional certifications. In this study, the authors examined the three major certifications popular among U. S. accountants -CPA, CMA, and CIA - to determine the amount and timing of ethics education and training for these accounting professionals. The empirical portion of this study is

composed of four parts. First, what is the ethics education required to qualify to take each of the three professional examinations? What is the ethics coverage testing on each of the examinations? What ethics training is required of examination candidates in order for them to become certified after successfully completing the examination? And finally, what ongoing continuing ethics education is required to maintain these certifications?

### Background

Guidance and discussion related to ethical values are not new to the U. S. accounting profession. The inclusion of morality in practice dates back to the inception of the AICPA (American Institute of Certified Public Accountants) Code of Professional Conduct in 1909 (see a comprehensive historical perspective in (Moriarity, 2000)). The Bedford Committee (American Accounting Association, 1986) recommended that ethics be a significant component of U. S. accounting education. In 1987, the National Commission on Fraudulent Financial Reporting (Treadway Commission) suggested that ethical values should be included in accounting curricula as part of the skills set needed by those entering the profession (Arthur Andersen & Co., 1987). The discussion began to significantly surface in the accounting academic community when Albrecht (1992) presented a model of ten universal values that define a starting point for research in the field of ethics for accounting educators and researchers.

Albrecht's research (1992) did not result in an increase in published ethics research in major accounting journals. Recently, Bean & Bernardi (2005) found that in the leading American Accounting Association journal, *The Accounting Review*, less than 2% of the published articles over the last 25 years were related to the subject of ethics. Consequently, despite vocal cries for additional research in the area, only 168 of 6,200 accounting faculty indicate that ethics is an area of interest to them (Bean & Bernardi, 2005).

The past public record exploring the issue of accounting ethics, and the need to increase coverage at all levels, shows some important trends. Regulatory bodies appear to be reluctant to increase ethics coverage requirements for accountants prior to, in the midst of, or after certification as practitioners. Well-respected accounting research journals provide little incentive for faculty to research in this area, and the number of faculty doing so is woefully low. Finally, while the practitioner community is replete with calls for greater ethics emphasis in the profession (see for instance the PriceWaterhouseCoopers (2003) report admonishing the profession for its lack of ethical education opportunities), few actual changes have been implemented.

## METHODOLOGY

The primary purpose of this study is to examine the present ethics coverage required of U. S. accountants that are professionally certified (CPA, CIA, CMA). The CPA designation is given by states to individuals who have successfully satisfied the requirements in the particular state in which they are certified. The CIA designation is given by the Institute of Internal Auditors and reflects competence in the principles and practices of internal auditing. The CMA credential is a professional designation for management accountants and financial managers and is awarded by the Institute of Management Accountants. All three certifications have educational requirements, examination requirements, and CPE requirements.

## **RESULTS**

### **Certification Examination Content Specifications**

#### **CPA Examination**

According to the AICPA website ([www.aicpa.org](http://www.aicpa.org)), the CPA examination is a four-section, two-day, 14-hour (840 minute) examination. Each of the four sections is tested separately. The AICPA provides very detailed examination content specifications for the CPA examination. The most recent version was updated October 19, 2005 and identifies the technical content to be tested on each of the four sections of the examination. Based upon the content specifications identified by the AICPA, the proportions of each of the four examinations that were comprised of required ethics questions were computed. Ethics is only tested in the three-hour Regulation section. The ethics content comprises 15%-20% of the total Regulation Section. Therefore, at most, 36 minutes (or 20% of 180 minutes) of the three-hour Regulation section is devoted to testing on accounting ethics. This 36 minutes comprises 4.3% of the total examination time on the uniform CPA examination.

#### **CIA Examination**

According to the Institute of Internal Auditors website ([www.theiia.org](http://www.theiia.org)), the CIA examination is a two-day examination comprised of four 3.5 hour parts (14 total hours or 840 total minutes), with each part consisting of 125 multiple-choice questions. Accounting ethics is covered modestly in two sections of Part I of the examination. The total test time for accounting ethics on the 14-hour CIA exam is computed to be between 3.9 and 11.8 minutes. The maximum coverage, therefore, would be 1.4% (11.8 of 840 total minutes) of the total examination time.

#### **CMA Examination**

The CMA examination is a two-day 13-hour examination comprised of four parts. ([www.imanet.org](http://www.imanet.org)). Accounting ethics is tested in Part 4 – Business Applications. The CMA Content Specification Outline states, "There will be at least one question that will be devoted to an ethical situation presented in a business-oriented context." Part 4 includes all the content topics from parts 1,2, and 3 as well as four additional special topics "Ethical considerations" is section 4. of Additional Part 4 Topics. Therefore, at the absolute maximum, accounting ethics would comprise one-fourth of the three-hour Part 4 or 45 minutes. Forty-five minutes out of a total examination time of 13 hours (780 minutes) would be 5.8% of the total examination time.

The maximum accounting ethics coverage on the three major professional examinations in accounting are: CPA – 4.3% of total examination time; CIA - 1.4% of total examination time; CMA – 5.8% of total examination time.

## **Educational Requirements Needed to Sit for Professional Accounting Examinations**

### **CPA Examination**

Since the CPA designation is awarded by individual U. S. states or other governmental entity, the requirements to qualify to take the examination vary for each entity. An examination of the education requirements by each of the fifty U. S. states revealed that only four states required the completion of an ethics course or the coverage of professional ethics as a prerequisite for sitting for the CPA examination. Those four states are Maryland, Nebraska, Ohio, and Texas.

### **CMA Examination**

The educational requirements to sit for the CMA examination are either:

- ◆ holding a bachelors degree, in any area, from an accredited college or university
- ◆ passing the U.S. CPA examination or hold a comparable professional qualification
- ◆ achieve a score in the 50th percentile or higher on either the GMAT ( the Graduate Management Admission Test is an entrance examination commonly used for admission to graduate business programs)or the GRE (the Graduate Records Examination is an entrance test commonly used for admission to graduate study in liberal arts programs)

There is no specific educational requirement in accounting ethics.

### **CIA Examination**

In order to be eligible to sit for the CIA examination, candidates must hold a bachelor's degree or its equivalent from an accredited college-level institution. There is no specific accounting ethics educational requirement.

## **Ethics Requirements after Successfully Completing Examination and Prior to Licensure**

After successfully completing the CPA examination, 24 U. S. states require applicants to complete an ethics course prior to certification. This requirement is shown in Table 2. Twenty-one states require that the AICPA Professional Ethics Course (Ramos, 2006) be taken while three state boards (California, Texas and Wisconsin) prepare their own ethics examination. The AICPA course was revised in 2006 and is available as a text or on a CD-Rom. In order to complete the course, candidates must take and pass an open-book, 50 multiple choice examination. A passing score is 90 or above (www.aicpa.org). After successfully completing the CIA or CMA examination, no additional ethics testing is required.



## CONCLUSIONS AND RECOMMENDATIONS

Minimal emphasis the U. S. accounting profession places on ethics knowledge and ethics study both before and after certification. The coverage of ethics on the three most common U. S. professional exams is minor ranging from 1.4% on the CIA examination to 4.3% on the CPA examination to 5.8% on the CMA examination. Each of the professional examinations is structured in such a way that a candidate can successfully pass the examinations with little or no knowledge of accounting ethics.

It is surprising that only four of the fifty U. S. states require CPA candidates to study ethics prior to sitting for the examination. Of the four states, only two require a traditional three-hour course. Approximately one-half of all states require CPA candidates to successfully complete an ethics course after passing the examination but prior to certification. The vast majority of these states require the professional ethics course prepared by the AICPA. This course, Professional Ethics: The AICPA's Comprehensive Course, focuses on the AICPA Code of Professional Conduct and the objectives of independence. Neither the CIA nor the CMA certifications require any ethics training prior to certification.

One of the major findings of this study is the relative lack of ethics training required by CPA's as part of their regular CPE requirements. The maximum training is four hours per year and thirteen states require no ethics CPE. It would appear that requiring additional ethics CPE would be a relatively simple step for most state boards of accountancy. For CIA's and CMA's, it would appear that increasing the ethics requirements would be even less difficult to mandate since the CPE requirements come from a single professional organization.

Over five years have passed since the enactment of the Sarbanes-Oxley Act of 2002. It is time for the U. S. accounting profession to take the lead in promoting additional ethics training for all current accounting professionals and all accounting professionals in training.

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# CRISIS AND VOLATILITY: CORRELATIONS BETWEEN ASSASSINATIONS, ATTEMPTS, AND MARKET REACTIONS

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## ABSTRACT

*Circumstances within the market are normally the most studied causes of changes in market volatility. However, as multi-national involvement continues to grow the global economy, foreign markets become more correlated over time. This paper will study the macroeconomic causes of these changes, rather than sole market activity. Moreover, it will include 16 prominent political world figures and the time periods in which an assassination or assassination attempt had taken place against their lives. The incapacitation of a political leader has, in the past, had significant social and economic consequences. By defining volatility as the standard deviation between periods of crisis and calm using key market indicators over time in the U.S., the E.U., Japan, and Israel, this study's intent is to find sufficient evidence that threats on the lives of political figures has an adverse effect on market stability on a global scale.*

November 22, 1963 John F. Kennedy	(Assassination) U.S. President
January 21, 1968 August 15, 1974 Park Chung-hee	(Assassination Attempts) President of South Korea
June 6, 1968 Robert F. Kennedy	(Assassination) U.S. Presidential Candidate
May 15, 1972 George C. Wallace	(Assassination Attempt) U.S. Presidential Candidate
December 1973 Luis Carrero Blanco	(Assassination) Spanish Prime Minister
September 5, 1975 September 22, 1975 Gerald Ford	(Assassination Attempt) U.S. President
March 30, 1981 Ronald Reagan	(Assassination Attempt) U.S. President
May 13, 1981 John Paul II	(Assassination Attempt) Pope
October 6, 1981 Anwar al-Sadat	(Assassination) Egyptian President

October 12, 1984 Margret Thatcher	(Assassination Attempt) British Prime Minister
November 4, 1995 Yitzhak Rabin	(Assassination) Israeli Prime Minister
July 14, 2002 Jacques Chirac	(Assassination Attempt) French President
September 5, 2002 Hamid Karzai	(Assassination Attempt) Afghani President
March 12, 2003 Zoran Dindic	(Assassination) Serbian Prime Minister
December 14, 2003 December 25, 2003 July 6, 2007 Pervez Musharraf	(Assassination Attempt) Pakistani President
December 27, 2007 Benazir Bhutto	(Assassination) Pakistani PM

# **A PROPOSED VARIATION OF THE CAPABILITY MATURITY MODEL FRAMEWORK AMONG FINANCIAL MANAGEMENT SETTINGS**

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## **ABSTRACT**

*This research investigates the perceived attributes of the Capability Maturity Model (CMM) process maturity framework within the context of financial management processes. An ANOVA analysis was conducted among financial management personnel to investigate hypothesis statements that reflected the basic tenets of the five-layer CMM framework. Each hypothesis statement reflected a financial management environment attribute with respect to each of the CMM framework maturity levels. The hypothesis statements queried the following maturity levels: initial (undefined and random), repeatable, defined, managed, and optimizing. Each outcome of the hypothesis accepted the null hypothesis. Based on the testing outcomes, indications of the various stages of the CMM framework are suggested as being present among the queried environments.*

## **INTRODUCTION**

Nightingale and Mize (2002) introduce a process maturity model with respect to lean enterprise transformation. Hardgrave and Armstrong (2005) discuss process maturity modeling with respect to software development. Crawford (2006) discusses process maturity with respect to project management. Gillies and Howard (2003) introduce process maturity with respect to organizational change management from the perspective of personnel. Sawyer (2004) considers process maturity with respect to human behavior. Rana and Ahmad (2005) discuss process maturity with respect to testing and quality considerations. Adams and Campbell (2005) discuss process maturity with respect to risk management. Each of these maturity models expresses the maturation of processes through time beginning with an ad hoc environment through an optimized environment.

Many of these models were derivatives of the original software Capability Maturity Model (CMM). According to Gillies and Howard (2003), the original CMM encompassed process maturation through the stages of initial (undefined and random), repeatable, defined, managed, and optimizing. This research considers the process maturity of financial environments with respect to these basic stages through quantitatively examining personnel perceptions of the basic assumption

of each maturity level to investigate whether the perceptions of respondents indicate that the primary characteristics of the CMM framework are perceived to exist among the queried environments.

### RESEARCH QUESTION

This research effort investigates the following research question: is there a perceived potential for the basic framework of the CMM to be manifested within the domain of financial processes? The hypothesis statements for this research are directly mapped to the five maturity stages of the CMM, and are given as follows:

*H01: Financial processes are ad-hoc or chaotic.*

*H11: Financial processes are not ad-hoc or chaotic.*

*H02: Financial processes are disciplined and repeatable.*

*H12: Financial processes are not disciplined and repeatable.*

*H03: Financial processes are standardized and consistent.*

*H13: Financial processes are not standardized and consistent.*

*H04: Financial processes are predictable.*

*H14: Financial processes are not predictable.*

*H05: Financial processes are evaluated continuously for improvement.*

*H15: Financial processes are not evaluated continuously for improvement.*

### METHODOLOGY

The methodology for this research included the use of a physical survey of among a variety of services within the city of Memphis, TN. A Likert scale was used to collect data for hypothesis testing. A 42% response rate was manifested, and the Chi-Squared test examined whether the received sample responses were truly indicative of the application areas demonstrated by those of the sample distribution versus those of the population. Data processing involved the use of an ANOVA analysis to examine the perceptions of financial management personnel with respect to the primary research question and hypothesis statements given within this document. Stratification involved separating the responses into either supervisory or non-supervisory personnel categories. Further, this study was intended to serve as a pilot study.

### LIMITATIONS AND BIAS

This research only considers processes that exist within financial environments. Therefore, it may not be applicable outside the immediate discipline and domain of interest. Regional sampling bias may influence this study because all members of the population and sample were drawn from the area of Memphis, Tennessee. This study was intended to serve as a pilot study, and its amount

of collected data was limited. A Chi-Squared test was performed to determine whether bias existed with respect to whether the received sample responses were truly indicative of the application areas demonstrated by those of the sample distribution versus those of the population. The outcome suggested the presence of bias. Because time did not allow this researcher to issue a second survey distribution, all of the data used during the data processing was generated from the received responses. Therefore, the outcomes associated with this low response rate may not be indicative of the responses that may be manifested among a larger response rate among a geographic distribution of greater scope. Further, non-response bias may also influence this study given the incomplete set of returned surveys. This study did not query specific processes. Instead, it approached general financial processes from a cumulative perspective.

## DISCUSSION

The stratification of the respondents divided the responses into either supervisory or non-supervisory categories. Hypothesis testing occurred through the use of ANOVA processing with respect to these groups (d.f. = 27;  $\alpha = 0.05$ ). The outcomes of the primary hypothesis tests were as follows:

Hypothesis Topic	F-Value	F-Critical	Significance
1. Undefined processes	1.16	4.22	None suggested
2. Disciplined/Repeatable process	1.51	4.22	None suggested
3. Standardized/Consistent process	0.01	4.22	None suggested
4. Predictable processes	0.24	4.22	None suggested
5. Optimized processes	0.31	4.22	None suggested

## CONCLUSIONS AND RECOMMENDATIONS

The testing outcome of the first hypothesis suggests that the personnel perceptions of processes within the respondents' financial management environments are undefined. The outcomes of the remaining hypothesis tests suggest that the personnel perceptions of processes within the respondents' financial management environments are disciplined and repeatable, standardized and consistent, predictable, and are evaluated for continuous improvement. Overall, these outcomes suggest the manifestation of a perceived conformance to the maturity framework levels derived from the CMM framework. Therefore, given such outcomes, the development of a potential financial maturity model, using the basic levels of ad hoc, disciplined and repeatable, standardized and consistent, predictable, and continuous improvement evaluation, may have a basis for development.

Although the testing outcomes suggest that personnel perceive the existence of basic attributes that are associated with the prescribed maturity levels, a formal financial maturity framework does not yet exist. The use of such a maturity framework within the financial management discipline may embellish a firm's capacity to effectively perform organizational

functions and improve the efficiency of financial operations. Such a financial management maturity model would conform to the concept of innovation advocated by Clackworthy (2006) with respect to value-based management.

Overall, value-based management concepts, within the context of financial management, provide firms with various tools and philosophical approaches that contribute to the maximizing of the wealth of shareholders while providing both qualitative and quantitative benefits for the organization. Such concepts of value-based management are applied among a variety of firms that range in size from proprietorships to Fortune 1000 organizations. However, regardless of the sizes, types, missions, and purposes of the firms, they all share one common factor: financial processes. Through approaching financial processes from a perspective of maturity based on the CMM framework, firms may gain a tool through which they may enhance their infrastructure to provide a greater level of optimization and efficiency with respect to the philosophies espoused by value-based management. Therefore, consideration should be given to the crafting of a financial maturity model through which financial processes may be enhanced to maintain process effectiveness, improve efficiency, and honor compliance requirements within the scope of value-based management initiatives.

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# **THE NEGATIVE EFFECT OF THE MARRIAGE PENALTY TAX ON AMERICAN SOCIETY**

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## **ABSTRACT**

*This study is an extension of prior research that quantifies the magnitude of the marriage penalty tax (MPT) and measures the distributional effects on the U.S. population in general. We use the Internal Revenue Service's Statistics of Income (SOI) data and the Census Bureau's year Current Population Survey (CPS) database. Estimates of the MPT are computed based on the effects of the most recent tax act to all taxpayers according to class of income. The study examines distribution of the MPT and projects effects of current tax law affecting MPT, the Jobs and Growth Tax Relief Reconciliation Act of 2003. Enactment of this tax law was partly motivated by President Bush's assessment that the tax code frequently taxes couples more after marriage and the MPT contradicts not only basic values but any reasonable sense of fairness. However, even after the passage of the act, results of this study indicate that while the marriage penalty tax is reduced, it continues to negatively impact American society. This, in turn, may have important implications for the social welfare of the nation.*



# **AN ANALYSIS OF THE PERFORMANCE IMPACT OF INFORMATION SYSTEMS DESIGN AND BUSINESS STRATEGY: THE CASE OF INFORMATION SCOPE AND ORGANIZATIONAL PROACTIVENESS**

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## **ABSTRACT**

*The use of information technology no longer conveys the competitive advantage to the users that they received when the technology was introduced. Due to the large scale adoption of information technologies, the focus needs to shift away from the technology to the application and use of the information developed through by the technology. This information needs to be evaluated in the context of the business strategy of the organization. This paper examines the use of information in terms of its scope and how it relates to the proactiveness of the business. There is a well developed literature on the theoretical relationship between the scope of the information gathered and the proactiveness of the firm but there is no empirical analysis to verify the theoretical constructs. A survey of chief executive officers indicates that the coalignment of information scope and organizational proactiveness has a significant and positive impact on firm performance.*

## **INTRODUCTION**

The use of information technology has become widespread because it is powerful, widespread, and available at low or modest cost. According to Carr (2003), IT has become so omnipresent, that by itself it no longer provides an identifiable competitive advantage in business. What is important, according to Dearstyne (2004), is the creative use of the information obtained from a system rather than the technology used to create, transmit, and present the information. One way to accomplish this is to align the information systems design with the strategy that an organization is pursuing.

Scope is an important characteristic of the information obtained from an information system and is an critical element which should be considered in the design of an information system (Chenhall and Morris, 1986). Scope describes the focus, quantification, and time horizon of the information. Narrow scope information focuses on internal economic data of a historical nature stated in monetary terms. Broad scope information encompasses economic and noneconomic data stated in monetary and nonmonetary units which can be used in predicting the consequences of future events (Gordon and Miller, 1976).

Proactiveness has been discussed as an important element in strategy research. It plays an important role in the typologies of Miles and Snow (1978) and Venkatra-

man (1989). According to Miles and Snow (1978), the Prospector attempts to find and exploit new opportunities before the competition. To accomplish this, the Prospector must be constantly conducting broad environmental scanning in order to quickly identify these opportunities before the competition recognizes them. This requires the Prospector to invest in systems which allow it to continuously monitor a wide range of environmental conditions, trends and events. At the other end of the strategic continuum, Miles and Snow (1978) identified the Defender which is concerned with protecting its limited, narrow domain. It attempts to accomplish through an internal focus which concentrates on maximizing the efficiency and productivity of the organization. The external environment is viewed as being composed of a few relatively important factors, each of which are relatively static, can be easily predicted, and are not expected to significantly influence the internal operations of the firm (Miles and Snow, 1978). The systems employed by the Defender reflect this emphasis on an internal focus rather than an external one. From an information systems standpoint, the Prospector follows a very proactive strategy and is best served by a broad scope system while the Defender follows a less proactive strategy and is best served by a narrow scope system.

Venkatraman (1989) views proactiveness as being characterized by participation in emerging industries, continually searching for new market opportunities, and experimenting with potential responses to changing trends. In addition, while he views the early entry into new markets to be considered proactive, he also considers the abandonment of operations as soon as they exhibit evidence of declining profitability to be proactive.

The basic premise of this research is that the scope of the information provided by the information system must be congruent with the level of proactiveness of the strategy being pursued. Broad scope information is needed to support a strategy based on a high level of proactivity. However, if a less proactive strategy is being followed, broad scope information is not required. In fact, broad scope information will be detrimental to effective decision-making as information overload will result. According to Tushman and Nadler (1978), information overload is a major contributor to dysfunctional decision-making in organizations.

## METHODOLOGY

Structural equation modeling was used to test the proposition that the coalignment (COAL) of information scope (SCOPE) and proactiveness (STPRO) has a significant impact on firm performance (PERF). A confirmatory modeling strategy (Hair et al, 2006) was followed employing a second order factor analysis. SCOPE, STPRO and PERF are first order factors and COAL is a second order factor with SCOPE and STPRO as its indicators. This results in the testing of two hypotheses, stated in the alternative:

- H1: SCOPE and STPRO are significantly related to COAL, and*
- H2: COAL has a positive and significant relationship with PERF.*

SCOPE was measured using the six-item scale developed by Chenhall and Morris (1986) to measure the scope characteristics of information provided by management accounting systems. As the management accounting system is an integral part of the overall information system of an organization, these characteristics were deemed applicable to the information obtained from the

overall system. STPRO was assessed through the five-item scale developed by Venkatraman (1989) measuring the proactiveness dimension of the Strategic Orientation of Business Enterprise (STROBE) construct. PERF was measured using an eight-item scale developed by Mahoney et al (1963) for assessing organizational performance in accomplishing eight managerial tasks: planning, investigating, coordination, evaluating, supervising, staffing, negotiating, and representing. Previous research has shown that managerial assessments of performance, as used here, are highly correlated with internally obtained objective indicators of performance (Dess and Robinson, 1984).

### **SAMPLING FRAME AND DATA COLLECTION**

Publicly-traded firms limiting their operations to one industry, as indicated in the Disclosure database, were chosen as the sampling frame for this study. Firms operating in only one industry were selected due to the inherent problems identified by Chandler (1962) and Rumelt (1974) in analyzing the organizational responses of firms operating in multiple market segments. This resulted in 1,948 firms being identified.

The research instrument was sent to the chief executive officers of the 1,948 firms. Follow-up letters were mailed six weeks later. Anonymity of the respondents could not be guaranteed as it was deemed desirable to have the ability to identify the responding firms so the responses could be matched with other firm information for use in subsequent research.

Responses were received from 210 firms, of which 149 were useable in this research. The responding firms represented eighty-nine different industries. This resulted in an effective response rate of 7.7 percent which was deemed acceptable considering the level of the individual to whom the research instrument was sent and the fact that anonymity could not be guaranteed.

### **DATA ANALYSIS AND DISCUSSION**

A factor analysis was performed on each of the three scales. The analysis showed that one item in the SCOPE scale and two items in the STPRO scale either loaded incorrectly, reflected cross-loadings (.40 or greater on more than one factor), or did not have a significant loading (.40 or greater) on any factor. These items were deleted.

Reliability of the modified scales was assessed through the calculation of Cronbach's alpha. All except the STPRO scale reflect a Cronbach's alpha above the threshold of .60 deemed acceptable by Nunnally (1967). This scale reflects a Cronbach's alpha value of .54, which is slightly below the acceptable value specified by Nunnally (1967). However, Novick and Lewis (1967) consider Cronbach's alpha to be a lower bound measure of reliability and provides a conservative estimate of a measure's true reliability. Therefore, all of the measurement scales were deemed to reflect adequate reliability.

Nonresponse error was evaluated through procedures suggested by Armstrong and Overton (1977) and Churchill (1991). The responses were segregated into quartiles based on the date of receipt, with late respondents being a proxy for nonrespondents. Data from early respondents (1st quartile) were compared to the data from late respondents (4th quartile). The analysis suggested that nonresponse error was not a major consideration.

The internal fit of the model was analyzed by examining the standardized loading estimates, standardized residuals, and the modification indices. The standardized loading estimates were all significant in that they exceeded the suggested critical value of 1.64 (Bagozzi and Yi, 1988). Examination of the standardized residuals and modification indices indicated that the model should be modified. Modification involved eliminating one of the items in the SCOPE scale and three of the items in the PERF scale.

The goodness of fit statistics for the modified model are shown in Table 1. An examination of the goodness of fit statistics indicates that all values surpass the critical values suggested by Bagozzi and Yi (1988).

Statistic	Value
$\chi^2$	46.19
P-value	.70
GFI	.95
AGFI	.92
TCD	.86
RMSR	.14

GFI - Goodness of Fit Index  
 AFGI – Adjusted Goodness of Fit Index  
 TCD – Total Coefficient of Determination  
 RMSR – Root Mean Square Residual

As indicated earlier, acceptance of the coalignment model requires the testing of two hypotheses which were previously stated. Table 2 shows the path estimates and associated t-values for the relationships hypothesized in H1 and H2.

Relationship	Parameter Estimate	t-value
SCOPE - COAL (H1)	.36	3.45
STPRO - COAL (H1)	.96	4.18
COAL - PERF (H2)	.55	4.91

The values reveal that significant positive relationships exist between SCOPE and COAL and between STPRO and COAL. Therefore, H1 is accepted. A positive and significant relationship is indicated to exist between the COAL and PERF. Therefore, H2 is accepted.

Based on the goodness of fit criteria and the acceptance of the two hypotheses, the coalignment model is accepted. These results support the proposition that the congruence of

information scope and the level of proactiveness in the firm's strategy have an impact on the organization's performance.

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# **METHODOLOGICAL ISSUES IN ANALYZING FINANCIAL STATEMENTS IN THE PRESENCE OF OPERATING LEASES**

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## **ABSTRACT**

*In 1976 the Financial Accounting Standards Board (FASB) issued its now infamous Statement of Financial Accounting Standard No. 13 "Accounting for Leases", which provided new guidance for the accounting of lease arrangements. A major component of this statement was the distinction made between "capital" leases and "operating" leases. A cottage industry arose that structured leases to meet the more favorable "operating" lease requirements. The success of these efforts was documented in a 2005 SEC study showing that 96 percent (\$1.25 trillion) of all future cash flow payments committed under leasing contracts was associated with operating leases. In present value terms this means that some \$1 trillion in lease obligations is currently unreported on the balance sheets of U.S. companies. The "success" (some would say abuse) of operating leases led the SEC to recommend that the FASB (in conjunction with the International Accounting Standards Board, or IASB) reconsider its accounting guidance for leases, a process that the FASB and IASB began undertaking in earnest in July 2006.*

*It has become obvious that irregularities within lease accounting have become a critical issue when evaluating corporate financial statements. Prior researchers have examined several aspects of the impact capitalizing operating leases would have on corporate financial statements. This paper examines how the proposed changes in lease accounting could affect financial analysis, particularly the calculation of key financial ratios used in credit analysis such as the Altman Z-score. Alternative methods for valuing operating leases are also examined.*

## **INTRODUCTION**

The accounting guidance for leases is found Statement of Financial Accounting Standard 13 (SFAS 13) Accounting for Leases. This statement provides a two-pronged approach. First, leases that transfer the benefits and responsibilities of ownership to the party using the asset are treated as "capital" leases; the present value of the required lease payments is reported as both a fixed asset and a financing liability with the value amortized over time. "Operating" leases, those that do not transfer ownership, nor cover more than 75 percent of the asset life, nor have present values greater than 90 percent of the value of the asset, are accounted for as rental contracts with no asset or liability recognition and only periodic rental expenses charged against revenues.

The accounting guidelines have produced a situation where similar transactions receive different accounting treatment depending on very artificial distinctions. Accordingly, companies have taken advantage of these distinctions and structure leases to achieve specific accounting

treatment. These companies have been aided by a large number of attorneys, accountants, and lenders to the point where lease structuring to meet accounting or tax goals has become an industry unto itself (SEC, 2005). In fact, the SEC determined that because of lease accounting rules, some \$1 trillion is currently being unreported on the balance sheets of U.S. companies.

Potential implications of capitalizing operating leases have been extensively examined in a variety of ways (Imhoff, Lipe & Wright, 1991, 1997; Beattie, Edwards, & Goodacre, 1998; Hodge & Ahmen, 2003; Bennett & Bradbury, 2003; Noland, 2006). However, none of these papers focuses on how credit analysis might be affected. Furthermore, none examine alternative methods used to value operating leases. This paper offers an examination of both of these topics.

## DATA AND METHODOLOGY

Data was gathered from Compustat with the primary sample comprised of all U.S. nonfinancial companies that reported lease obligations for each of the past five reporting periods. 595 companies were included in the primary sample. Variables examined included:

- ◆ Altman Z-score, defined as  $Z = 1.2X_1 + 1.4X_2 + 3.3X_3 + 0.6X_4 + 0.999X_5$ , where  $X_1$  is the ratio of net working capital to total assets,  $X_2$  the ratio of retained earnings to total assets,  $X_3$  the ratio of earnings before interest and taxes to total assets,  $X_4$  the ratio of market value of equity to book value of liabilities, and  $X_5$  the ratio of total sales to total assets.
- ◆ The current ratio, calculated as total current assets divided by total current liabilities.
- ◆ The quick ratio, calculated as the total of cash, marketable securities, and receivables divided by total current liabilities.
- ◆ The debt ratio, calculated as total liabilities divided by total assets.
- ◆ The interest coverage ratio, calculated as total earnings before interest and tax expense (EBIT) divided by total interest expense.
- ◆ An expanded interest coverage (fixed charge coverage) ratio, which includes the fixed charges associated with operating lease payments
- ◆ The EBITDA coverage ratio, calculated like the interest coverage ratio, but adding back the amount of depreciation and amortization expense to the numerator.
- ◆ ROIC (return on invested capital), defined as earnings before interest and taxes (EBIT) valued on an after-tax basis divided by the sum of total debt and total equity.

Capitalizing operating leases can have many effects on financial statements. It impacts both sides of the balance sheet by including the present value of future lease payments as newly recognized debt liabilities and fixed assets. It affects the income statement as operating expenses (lease payments) are reclassified into depreciation and financing components.

We examined the impact that capitalizing operating leases has on financial ratios used to evaluate credit standing. Each ratio was calculated using the original financial statement data and then again after making adjustments to account for operating leases. We specifically focused on

Altman Z-scores to see how it might be affected, particularly for companies with significant amounts of those types of leases reported in its financial statements.

## RESULTS

A summary look at the sample provides a glimpse of the magnitude of the issue. The average size (total assets) of the 595 companies was \$5.3 billion, with a median of \$1.1 billion. The average amount each company was undervalued (as measured by the present value of leases) was \$471 million, with a median of \$117 million. Total assets and liabilities were understated by an average of 10 percent. Likewise, the average interest expense for these companies was \$48 million (median \$7 million). Reclassifying the lease expenses into depreciation and interest expense components increased reported interest expenses by an average of \$35 million, with a median of \$9 million. Thus, reported interest expenses would on average more than double.

Such changes would have a dramatic impact on the calculation of financial ratios. For example, the mean current ratio based on reported figures was 2.26 (median 2.03). Adjusting the figures to account for the operating leases caused these figures to fall to 2.04 (1.77). The Altman Z-score suffers an even larger drop, from a mean of 5.05 (median 4.40) using as-reported data to 3.68 (3.37) with the adjusted figures. A summary of results is found below in Table 1.

Ratio	As Reported Mean	Adjusted Mean	As Reported Median	Adjusted Median
Current Ratio	2.25	1.94	2.03	1.77
Quick Ratio	1.48	1.30	1.22	1.07
Altman X1 (WC ÷ TA)	0.2580	0.1973	0.2644	0.1830
Altman X2 (RetEarn ÷ TA)	0.1787	0.1129	0.2800	0.2035
Altman X3 (EBIT ÷ TA)	0.0991	0.0710	0.0982	0.0719
Altman X4 (MVEq ÷ TL)	4.6111	3.1446	3.2230	2.2784
Altman X5 Sales ÷ TA)	1.3796	1.1620	1.2612	1.0790
(Altman Z-score	5.02	3.70	4.40	3.37
Interest coverage (EBIT ÷ Int)	35.58	7.66	8.09	4.04
Using Total Lease Payments		3.73		2.61
Using 1/3 of Lease Payments		6.39		4.12
EBITDA Coverage	49.36	11.38	12.41	6.67
Debt Ratio	89.56	154.70	80.32	123.20
Return on Invested Capital	8.81	6.29	8.74	6.23

Another key result is seen in the changes in Z-scores for individual companies. Scores above 3.0 represent companies unlikely to suffer financial distress, while those below 1.8 show those that are likely to suffer financial difficulties. 463 of the 595 companies had Z-scores above 3.0, but only 359 maintain that level after making the operating lease adjustments. Thus, nearly one-quarter (22.5%) of the companies fell below the "safe" threshold. Similarly, 549 companies had scores above 1.8, yet 44 of those fell below the all-important "danger" threshold of 1.8.

### ALTERNATIVE VALUATION MODELS

Besides valuing leases using the present value methodology, there are at least three other heuristic approaches discussed in the literature. These include multiplying the current year's lease expense by a factor of 8 (Imhoff, Lipe & Wright, 1993), multiplying next year's lease expense by a factor of 6 (Ely, 1995), or multiplying all lease obligations by two-thirds, with one-third of each year's payment deemed to be the lease financing costs (Gibson, 2007). The one-third, two-third approach is noteworthy given its simplicity and its legitimacy, as it is often used in securities filings with the SEC when companies report their "earnings to fixed charges" ratios.

To compare these alternative methods, we used a broader sample (all companies other than financial, non-US, and zero or negative equity). The sample of 4,390 companies was classified as either "non-lesers" (524), "minimal" lesers (2,632), "moderate" lesers (1,021) or "-+heavy" lesers (213). The designation was based on the total (present) value of lease payments as a percentage of the company's total assets with 0.01% to 5% defining "minimal" lesers, 5.01% to 50% "moderate" lesers, and above 50%, "heavy" lesers.

Table 2 shows the differences in means and medians of leases as a percentage of total assets using each of the four methods. It is evident that the one-third, two-thirds approach consistently understates the value of leases relative to the present value methodology, while the multiplier approaches consistently overstate the value of leases, and by a considerable margin

	Mean	Std Dev	Median
Minimal Lesers (n = 2632)			
PVOLpct	0.0258	0.0213	0.0213
PVOL13pct	0.0214	0.0194	0.0170
PVOLx8pct	0.0865	0.0765	0.0687
PVOLx6pct	0.0535	0.0473	0.0435
Moderate Lesers (n = 1021)			
PVOLpct	0.1581	0.0866	0.1314
PVOL13pct	0.1373	0.0846	0.1098
PVOLx8pct	0.3518	0.2740	0.2879

	Mean	Std Dev	Median
PVOLx6pct	0.2480	0.1597	0.2051
Heavy Leasers (n = 213)			
PVOLpct	0.8052	0.5343	0.6615
PVOL13pct	0.7342	0.5371	0.5998
PVOLx8pct	1.2258	0.8947	1.0089
PVOLx6pct	0.8319	0.4679	0.7313
Note: PVOLpct denotes the present value methodology at a 6% discount rate, PVOL13pct is the one-third, two-third approach, PVOLx8pct is the 8 times current lease expense approach, and PVOLx6pct is the 6 times next year lease expense approach.			

The valuation methods were also evaluated in terms of their correlations. Here we find that the one-third, two-thirds method clearly dominates the other two heuristic methods in terms of its ability to track the results of the more sophisticated present value approach. For example, for "minimal" leasers, the one-third, two-thirds approach has a correlation coefficient of 0.9314 with the present value approach, while the 8x and 6x methods only have correlations of 0.4452 and 0.7656, respectively. For "moderate" leasers, the difference is even more striking (0.9514 compared to 0.1380 and 0.4972), and the differences remain pronounced for "heavy" leasers (0.9775 compared to 0.4952 and 0.7739).

## CONCLUSIONS

In light of the current discussions about the proper accounting for "operating" leases, we have reviewed some of the potential impacts that capitalizing those leases would have on various financial ratios, particularly those used to assess credit risks. Given the crucial role that credit analysis plays in the credit functions of the economy, changes caused by the retooling of this accounting standard could have a dramatic impact on the credit process.

The issue of gauging the financial statement impact of situations where companies use operating leases is not a new one. It has been examined since FASB 13 was first issued thirty years ago. Earlier approaches have been lacking in terms of examining the impact on credit assessments. We have provided a new start to assessments of the effects operating leases have on various company's operations, and the financial reporting of those operations. This will likely continue to be a fruitful area of research, given the practical nature of the results, and the current economic situation in which credit-providers have come under such increased scrutiny.

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# USING FINANCIAL STATEMENT ANALYSIS TO EXPLAIN THE VARIATION IN FIRMS' EARNINGS-PRICE RATIOS

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## ABSTRACT

*The earnings-price (E/P) ratio represents a market-based ranking of a firm's value relative to its earnings. Entities of like size operating in the same industry and enjoying similar current earnings, however, may experience significantly different E/P ratios. This occurs because share price reflects the market's perceptions of the future earnings (and cash flow) potential of a company rather than its present earnings. Indeed, significant research exists indicating that the E/P ratio acts as a predictor of future earnings growth. Firms with high E/P shares often experience low earnings growth, while companies with low E/P stock have high earnings growth. The question that is largely ignored in the literature, though, is what factors are useful in explaining the variation among firms' E/P ratios? More specifically, other than current earnings, what variables influence the market's expectations concerning an entity's future earnings potential?*

*Ou and Penman (1989) demonstrate that several traditional financial statement variables can be used to predict whether a company will experience an increase or decrease in one-year-ahead earnings. In addition, Anderson and Brooks (2006) note that four primary factors influence E/P ratios (i.e., year, industry, size, and idiosyncratic effects). Idiosyncratic effects represent those factors unique to individual entities. Controlling for year, industry, and size, the current study develops ordinary least squares regression models to explain the variation in firms' E/P ratios using financial statement variables to capture the idiosyncratic effects. The final model contains a parsimonious set of independent variables that explains a large portion (i.e., 62%) of the variation in the E/P ratios among firms. The primary contribution of this study lies not in the identification of a particular set of variables but rather in the overall finding that traditional financial statement analysis can be used to remove much of the mystery surrounding how the market values a firm's stock relative to its earnings.*

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# INTERNATIONAL STOCK MARKET DIVERSIFICATION

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## ABSTRACT

*Investors have historically been advised to use simple risk adherent strategies in their portfolios such as diversifying across countries to take advantage of inverse relationships with stock market movements. Technology has changed the environment where there are very few obstacles to hinder investors to buy or sell assets anywhere in the world today. Most so-called "domestic" or "international" firms of the past are now "global" firms. There are also many other options for investors to use for risk aversion. This study investigates the relationships between ten international stock indexes. The results show that there is a strong, positive association between the indexes in most cases. The positive relationships suggest that international diversification as a traditional portfolio risk technique may no longer be valid.*

## INTRODUCTION

Investors have traditionally been advised to include simple risk adherent strategies when building individual portfolios. One such simple strategy often suggested is to diversify internationally. A person needs only to watch television or pick up any financial advertising material to see advisors suggesting asset percentages of various weights to be allocated between domestic and international security markets.

Intuitively, foreign investing helps to diversify a portfolio because foreign stocks tend to be influenced, at least in part, by those economic events and interest rates that are inherent to that area. Consequently, one would expect an inverse relation between foreign and U.S. stock prices. On the other hand, as technology changes, supply and demand factors for most assets, especially oil, has seemingly made all companies global. As the demand grows for oil uses for transportation or heating, supply constraints result in increased prices globally. We now live in a global economy where investors have ready international access to all markets. Therefore, we might no longer expect these same inverse relations across international stock indexes. The objective of this study is to investigate and analyze how ten international stock market indexes have behaved over the last fifteen years. This information is intended to provide insight towards not only possible higher returns for investors, but also portfolio risk aversion.

## LITERATURE REVIEW

A review of the literature indicates that there has been considerable research seeking significant relationships or interactions among various indicators of economic activity and stock returns in all types of markets: domestic, international and emerging. Economic indicators included, among others, industrial production (Flood and Marion, 2006), interest rates

(Hondroyiannis and Papapetrou, 2001), inflation (Moore, 1990), and currency rates (Amoateng and Jovad, 2004).

Many studies have examined different diversification issues across international markets. Chan, Gup, and Pan (1992) observed the existence of international market efficiency and found no evidence of co-integration among stock prices among the major Asian markets and the United States. They conclude that international diversification among these markets is effective. Madura and Soenen (1992) examined the benefits of international diversification over the 1984-1988 period and suggest that gains from international diversification existed, especially for Japanese investors.

Sarkar and Li (2002) studied returns among fifteen G7 and emerging market countries and conclude that investing in emerging market stocks offers substantial benefits. On the other hand, Kashefi (2006) studied how the introduction of the euro as a single currency across many countries has affected international diversification opportunities

## METHODOLOGY

Monthly values for the international indexes for the 15-year period, 1991-2005, were used in this investigation. All values selected were those on the last trading day per month. The international indexes selected included the United States Standard & Poor's 500 (S&P500), the Japan Nikkei 225 (NIKkei), the Hong Kong Hang Seng (HKHaSe), the Singapore Straits Times (SingST), the Germany DAX (GerDAX), the United Kingdom FTSE 100 (UKFTSE), the Canada TSX (CanTSX), the United States Dow Jones Industrial Average (DJIA) and the United States Dow Jones Utility Average (DJUA).

The 15-year data set allowed enough data to observe relationships among the variables over four recent periods: 15 years (1991-2005), 10 years (1996-2005), 5 years (2001-2005), and 1 year (2005). Correlation matrixes were computed using all index values over each time period in order to find significant relationships.

## RESULTS AND ANALYSIS

Table 1 shows the correlation matrix for the ten stock indexes for the entire 15 years of monthly data.

	S&P500	NIKkei	HKHaSe	SingST	GerDAX	FCAC40	UKFTSE	CanTSX	DJIA	DJUA
S&P500	1.0000									
NIKkei	-0.5695a	1.0000								
HKHaSe	0.8050a	-0.3654a	1.0000							
SingST	0.0520	0.2144a	0.5235a	1.0000						
GerDAX	0.9485a	-0.4096a	0.7716a	0.0458	1.0000					
FCAC40	0.9359a	-0.4561a	0.7418a	0.0485	0.9738a	1.0000				
UKFTSE	0.9549a	-0.4090a	0.7921a	0.0809	0.9656a	0.9139a	1.0000			
CanTSX	0.9239a	-0.6017a	0.8420a	0.1869b	0.8542a	0.8648a	0.8279a	1.0000		

	S&P500	NIKkei	HKHaSe	SingST	GerDAX	FCAC40	UKFTSE	CanTSX	DJIA	DJUA
DJIA	0.9779a	-0.6744a	0.7992a	0.0471	0.8902a	0.8841a	0.8990a	0.9385a	1.0000	
DJUA	0.8149a	-0.4408a	0.6385a	0.0662	0.8059a	0.8338a	0.7763a	0.8267a	0.7879a	1.0000

a Significant at the .01 level  
b Significant at the .05 level

Looking initially at the entire table, there is a distinct difference between the NIKkei and the other indexes. The NIKkei is the only index of those studied that reacts inversely with any of the other indexes and does so with all except the SingST. All the other indexes exhibit positive relationships. Most of the correlations are relatively high which suggests that the economies of those countries are closely linked.

Table 2 shows the correlation matrix for the ten indexes for the last ten years of monthly data. Again, in all cases except the NIKkei and the SingST, the indexes exhibit positive, significant correlations among themselves.

	S&P500	NIKkei	HKHaSe	SingST	GerDAX	FCAC40	UKFTSE	CanTSX	DJIA	DJUA
S&P500	1.0000									
NIKkei	-0.1512	1.0000								
HKHaSe	0.5288a	0.3446a	1.0000							
SingST	0.0351	0.4736a	0.6893a	1.0000						
GerDAX	0.8942a	0.0820	0.5203a	0.0015	1.0000					
FCAC40	0.9257a	-0.0932	0.5450a	0.0515	0.9568a	1.0000				
UKFTSE	0.8704a	0.2013b	0.4553a	-0.0004	0.9313a	0.8511a	1.0000			
CanTSX	0.7581a	-0.2887a	0.6483a	0.2641a	0.6236a	0.7202a	0.4853a	1.0000		
DJIA	0.9223a	-0.4301a	0.4598a	0.0078	0.7302a	0.8227a	0.6636a	0.8116a	1.0000	
DJUA	0.7630a	-0.1680	0.4911a	0.1527	0.7080a	0.7500a	0.6666a	0.7739a	0.7470a	1.0000

a Significant at the .01 level  
b Significant at the .05 level

Table 3 uses the last 5 years of data, 2001-2005, and very interestingly; all indexes exhibit strong positive correlations in all cases. In other words, the markets among the different countries moved either up or down in unison which is contrary with portfolio theory calling for diversification across countries.

	S&P500	NIKkei	HKHaSe	SingST	GerDAX	FCAC40	UKFTSE	CanTSX	DJIA	DJUA
S&P500	1.0000									
NIKkei	0.8603a	1.0000								
HKHaSe	0.8958a	0.8354a	1.0000							

SingST	0.5940a	0.5808a	0.7486a	1.0000						
GerDAX	0.8385a	0.7947a	0.6180a	0.2992b	1.0000					
FCAC40	0.8279a	0.7813a	0.6073a	0.2902b	0.9934a	1.0000				
UKFTSE	0.8712a	0.8202a	0.6782a	0.3756a	0.9829a	0.9846a	1.0000			
CanTSX	0.7996a	0.7713a	0.9112a	0.8175a	0.4499a	0.4370a	0.5410a	1.0000		
DJIA	0.9563a	0.8205a	0.8815a	0.6035a	0.7329a	0.7049a	0.7495a	0.8017a	1.0000	
DJUA	0.8896a	0.8585a	0.8448a	0.6145a	0.7966a	0.8028a	0.8665a	0.8007a	0.7888a	1.0000
a Significant at the .01 level										
b Significant at the .05 level										

The final correlation matrix was computed using only one year of data, 2005, and the results show that the indexes are positively correlated with each other. Table 4 shows that the pair-wise correlations are relatively high. For example, the GerDAX exhibits coefficients of over .98 when correlated with its fellow European counterparts, the FCAC40 and the UKFTSE.

	S&P500	NIKkei	HKHaSe	SingST	GerDAX	FCAC40	UKFTSE	CanTSX	DJIA	DJUA
S&P500	1.0000									
NIKkei	0.8115a	1.0000								
HKHaSe	0.8521a	0.6613b	1.0000							
SingST	0.8856a	0.7027b	0.8820a	1.0000						
GerDAX	0.9251a	0.9147a	0.8405a	0.9143a	1.0000					
FCAC40	0.9129a	0.8556a	0.8780a	0.9409a	0.9868a	1.0000				
UKFTSE	0.9174a	0.8824a	0.8912a	0.9170a	0.9876a	0.9904a	1.0000			
CanTSX	0.9164a	0.8677a	0.8178a	0.9056a	0.9648a	0.9471a	0.9547a	1.0000		
DJIA	0.7706a	0.5852b	0.4613	0.4366	0.5409	0.4947	0.5127	0.5366	1.0000	
DJUA	0.6868b	0.6366b	0.9025a	0.8573a	0.8224a	0.8829a	0.8696a	0.7826a	0.1439	1.0000
a Significant at the .01 level										
b Significant at the .05 level										

Although the table shows high coefficients, a high correlation between the markets is not a measure of identical returns, but only that the markets are prone to move in the same direction. On the other hand, an investor can still benefit from diversification as long as the portfolio has investments in different countries as well as different sectors.

## CONCLUSION

This study was very interesting. The results demonstrate that there is a strong relationship among the international indexes over the four time periods investigated. The relationships were positive and significant in almost all cases. In addition, the correlation between the indexes appears to increase as the time periods became more current.

The conclusion is contrary to what most investors expect because investors typically diversify portfolios across countries. The positive relationships found in this investigation demonstrate that traditional risk strategies diversifying across countries as a good thing may no longer be true. Times have changed. Technology innovations have provided us with an environment where there are very few obstacles to hinder investors to buy or sell any asset anywhere in the world. The diversification benefit associated with international investing historically appeared because the foreign economies were in various stages of growth or recession as well as the related currency impact on returns. Over the last decade as economies have become more interconnected, the benefits derived from investing in different economies are decreasing.

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# NINETEENTH CENTURY COST ACCOUNTING PRACTICES AND THEIR INFLUENCE ON CURRENT ACCOUNTING METHODOLOGY

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## ABSTRACT

*This paper reviews the significance of military cost accounting practices used during the U.S. Civil War. Many of our modern cost accounting practices were derived from those utilized by the U.S. Army from 1861 to 1865. Cost accounting practices were vitally important during this period in order to properly manage all expenses relating to "men and materials." Army accounting clerks and quartermasters were taught comprehensive accounting principles and practices at West Point. Prior to the Civil War period, the accounting systems used by American business firms differed little from the basic bookkeeping principles introduced by Pacioli in 1494. These military principles were incorporated into American businesses following the war.*

*The first portion of this paper relates to the development of cost accounting in the United States from the late 1700s to the Civil War era. In particular, major improvements in cost accounting theory introduced at the West Point Military Academy by Colonel Sylvanus Thayer are discussed. Thayer is often called the father of the Military Academy and the originator of a "new managerialism." This new managerialism involved an emphasis on discipline and ethical behavior as well as procedures and practices aimed at improving academic standards. Thayer provided the leadership for major improvements in the identification, classification, and management of costs. His disciplined education created a framework used by numerous military institutions around the country in an effort to properly record and classify all types of costs. Thayer's practices were incorporated into three major texts used in the training of all accounting clerks and quartermasters.*

*The second part of this paper reviews the three instructional texts that were required reading for any soldier who prepared accounting statements and reports. The Revised Regulations of the Army of the United States 1861, The Company Clerk, and The Quartermaster's Guide were major instructional guides for any soldier who was required to prepare periodic accounting reports or statements. These documents described the numerous reports that were required for a military company or regiment on a daily, weekly, monthly, or quarterly basis. The required reports involved the identification and summary of all costs related to the men and materials. Accounting for payroll alone presented a huge burden as soldiers were frequently promoted or were employed on "extra-duty" work details which provided additional earnings.*

*The third segment of this paper reviews actual Civil War accounting records. These documents emphasize the importance of a standard costing system that was used extensively by the army. For example, the army developed a standard cost system for all types of clothing used by the soldiers. Cost reports were prepared in order to determine if a soldier was over or under budget on his clothing allowance. Other reports discussed in this paper include budgets used by the army in its effort to control costs. Many of the cost accounting reports utilized today can be traced to the army's accounting system of the 1860s.*

*This paper should be of interest to conference attendees as they discover the importance of military training on the development of cost accounting in the United States. Many of the accounting principles used by the army during the Civil War continue to benefit American businesses today. West Point trained soldiers took their knowledge of cost classification and management with them as they accepted executive positions in business firms following the war. The authors feel that this paper will provide information of interest to any educator involved in teaching cost or managerial accounting.*



# **FORMAL ACADEMIC DISCIPLINARY ACTIONS AND ENTRY INTO THE PROFESSION OF ACCOUNTING**

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## **INTRODUCTION**

### **Accounting Profession's Concern for Ethical Behavior**

Due to recent events in the profession, ethical concerns have been highlighted and a commitment to ethics by the profession re-emphasized. Enron, Global Crossing, and other accounting-related scandals have caused the profession and society to consider the ethical failings which contributed to the scandals. Developments such as the Sarbanes-Oxley and the Public Companies Accounting Oversight Board have forced the accounting profession to re-examine its commitment to ethics and have perhaps shaken the profession from a degree of complacency.

For the accounting profession to continue to thrive, a commitment to ethics must be maintained and if possible strengthened. One means of strengthening its commitment to high ethical standards would be a careful screening of new applicants to the profession. By preventing entry to those who have had previous ethical lapses, the profession would be seen as ensuring its high ethical standards. It would seem prudent to deal with potential problems at the earliest possible stage.

### **Formal Disciplinary Hearings in Academe**

Many major universities have adopted formal codes of conduct which define academic dishonesty and have established formal procedures to hear and adjudicate alleged violations of the code. The exact nature of the code, the hearing procedures, and the nature of the punishments allowed vary widely but all colleges and universities have some stated policy about academic dishonesty.

Due to potential litigation concerns, most universities have adopted more formal procedures for punishments associated with academic dishonesty. Many colleges and universities are now centralizing the process to some degree so that records are available of students who have been judged to have committed academic dishonesty. Of course, these records are generally confidential, however, the student usually can permit the release of the information. A common procedure used by many colleges and universities with an honor code is the use of a designated grade for unsuccessful completion of a course due to academic dishonesty. For example, the newly adopted honor code system at Mississippi State University has the option of an 'XF' grade. The 'X' designates the failure as due to an academic dishonesty issue (US Federal News Service, February 28, 2007). Access to such information on incidents of academic dishonesty is generally available to a potential employer or other interested party if the student waives the confidentiality.

The purpose of this paper is to examine how the profession screens potential applicants for ethical deficiencies. In particular, I examine whether the application process would gather

information on formal disciplinary actions against the applicant during his or her academic career. This seems to be a good source of information about the moral character of the applicant.

If a state board learns that an applicant has been found guilty of academic dishonesty, a decision would need to be made as to the acceptability of the candidate. It could be argued that such an incident is predictive of future unethical activities. Some research has found such a link between previous unethical acts in an academic environment and a proclivity to commit unethical acts in the workplace (Nonis and Swift 2001). At a minimum, a state board would be responsible to at least consider the circumstances of the incident of academic dishonesty in order to determine if it would constitute a serious ethical lapse or not.

## METHODOLOGY

A major entry point to a career in public accounting is the CPA exam. This marks the first point in which the student aspiring to a career in public accounting interacts with the professional bodies who regulate the accounting profession. Once students have completed the necessary education requirements (or are nearing completion), they may become eligible to sit for the CPA exam, which is the qualifying exam for a certification in public accounting.

I obtained the initial application form from 53 of the 54 boards of accountancy currently accepting applications for the CPA Exam. Each application form is reviewed for questions or statements which would require the applicant to reveal disciplinary actions taken by academic institutions. These questions can either directly solicit the information or be phrased in such a way that they indirectly would require disclosure of the disciplinary actions. In addition, most applications had statements which emphasized the importance of full and honest disclosure on the application. Such statements may entice or intimidate an applicant into more careful and complete disclosure. Even if the board does not directly or indirectly solicit information about academic disciplinary actions, these statements may encourage an applicant to disclose such actions in the spirit of full disclosure.

## RESULTS AND DISCUSSION

### Direct Questions

Surprisingly, as seen in Table 1, only one state, Alabama, explicitly requests information about formal academic disciplinary hearings. A CPA exam applicant to the state of Alabama is required to respond yes or no to this question: "Have you ever been expelled or disciplined by a college or university?"

### Indirect Questions

Indirect questions are requests for information from the CPA exam applicant which is written broadly enough that an applicant would reasonably assume that disclosure of an academic disciplinary action could be required. These types of questions are classified into three categories and are discussed separately in the following sections.

Thirteen states ask questions about past disciplinary actions against the applicants. If these are phrased broadly enough to include, based on my opinion, formal actions by academic institutions, they are classified here. Questions which specifically refer to formal legal proceedings or formal actions taken by regulatory agencies are not included. The specificity of such questions could reasonably be assumed to exclude the hearings of an academic disciplinary board since such university boards are neither courts nor regulatory agencies.

Forty-four states ask the applicant if he or she has ever applied to another state and has been denied permission to sit for the exam. Such questions are designed, in part, to prevent an unacceptable applicant from one state from possibly skirting around requirements by applying in another state with more lax requirements. By requesting such information, a state can learn about the circumstances for the earlier denial. The denial could be based on a past incident of academic dishonesty which was detected in a previous application to another state. One possible reason for such jurisdiction shopping could be an attempt to conceal a formal disciplinary action. By asking this question, the state is forcing the applicant to reveal the situation.

Seventeen states require the applicant to provide information about their moral character. The information is requested in three different ways. The first two require the applicant to provide a self-assessment of their moral character. The third method requires unrelated third-parties to provide the assessment of good moral character.

### **Penalty Statements**

Penalty statements are statements which inform the applicant of the serious consequences of failing to completely and truthfully disclose requested information. Statements of these types may be useful to entice an applicant to disclose a formal academic disciplinary action in the spirit of full disclosure even if no question or request for information directly deals with the issue. I found that these types of statements came in two forms: statements about misleading applications and statements about perjury.

Forty-seven states have a statement which informs the applicant of his or her responsibility to provide full, complete, and/or non-misleading information (often with explicit or implicit threats of consequences for failure).

Thirty-five states make a statement that the information provided by the applicant is covered by state perjury laws. These perjury statements should clearly impress upon the applicant the importance of the application process and the serious consequences of a knowingly improper application form. Such statements should encourage the applicant toward fully disclosing, perhaps even over-disclosure, rather than under-disclosure. In such a situation, it is probably best for the state board to have more information than needed to make the decision on acceptability to sit for the exam rather than to have important information excluded.

### **SUMMARY AND SUGGESTIONS FOR FUTURE RESEARCH**

Because the accounting profession is expected by the public and by its own standards to maintain high ethical standards, it is important that the profession identify and deal with unethical members. One method for accomplishing this would be to carefully screen applicants as they

attempt to enter the profession. If there are ethical concerns in the applicant's past, it should be examined and considered as part of the determination for admission to the profession. In this study, I examine the current screening of initial applicants to the CPA exam for a particular type of ethical lapse. Since many colleges and universities have adopted formal disciplinary procedures, this seems to be a good source of potential information about the ethics of the applicant.

My survey of the initial application form for the CPA exam for each state shows that only one state directly requests this information while a few others request other related information in such a broad fashion that formal academic disciplinary actions would like be disclosed. Many other states have other questions which could possibly lead to the disclosure of such information.

This appears to be a weakness that the profession could easily correct. As society continues to demand high ethics from the accounting profession, the profession should be making every attempt to carefully admit only those persons with the proper ethical background. If there is a serious ethical lapse in an applicant's past, at a minimum, it should be carefully evaluated to determine if it indicates a moral flaw which could reveal itself again, this time in a professional setting. It is also possible that the ethical lapse could be serious enough by its very nature to preclude the applicant from the profession. Regardless of the ultimate outcome, such information could be easily collected and evaluated by the state boards as part of the application process.

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# **MERLOT: NEW FEATURES AND ADDED BENEFITS FOR ACCOUNTING AND FINANCE EDUCATORS**

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## **ABSTRACT**

*For more than a decade, the personal computer together with the Internet and learning management systems have enabled faculty to use technology to facilitate active learning in their accounting and finance classes. Anecdotal evidence from surveying principles of accounting students indicates 60% would like mini-lectures available as podcasts for downloading to iPods as a means for reviewing accounting concepts. Yet, faculty members know how time consuming it can be to locate high quality and relevant online teaching materials to enhance their courses much less create them. Having tutorials available to help students refresh or reinforce knowledge of accounting and finance concepts like time value of money could add value to many existing courses. The MERLOT (Multimedia Educational Resources for Learning and Online Teaching) resource at [www.merlot.org](http://www.merlot.org) offers a multi-faceted solution and membership is free. This paper introduces or reacquaints accounting and finance faculty to MERLOT by exploring new features and added benefits from the perspectives of an associate editor and external reviewer. (Presentation funding provided by Networks Financial Institute.)*

## **INTRODUCTION**

Having been raised in a multimedia learning environment characterized by Sesame Street and computer games; today's college students have different educational preferences. In general, they have more experience processing information rapidly with an increased capacity for nonlinear learning. They are comfortable using hypertexts and accessing multiple screen components concurrently when using multimedia applications. They prefer visual contexts that foster active learning environments and have less tolerance for passive lectures. They like the trial and error approach for problem solving and immediate rewards (Prensky, 2001).

Incorporating digital learning objects into accounting and finance courses can be an efficient and feasible way for faculty to play to the learning preferences of this technology savvy college student generation. Digital learning objects ARE modular, interactive multimedia technology based segments of reusable instruction designed to support learning (Clyde, 2004; Wiley, 2000). They can be small applications like video clips; live data feeds for a laptop news ticker, or animations and online calculators. Digital learning objects also can be complete web pages that combine text, images, and other applications to deliver instructional events.

For accounting and finance faculty learning new technologies can be an overwhelming and time consuming endeavor. The mere task of locating high quality and relevant teaching materials can be frustrating as well. MERLOT (Multimedia Educational Resources for Learning and Online Teaching) bridges this gap. To date, MERLOT is the largest, comprehensive, international,

Internet-based, interdisciplinary referatory of peer-reviewed, teaching and learning materials in existence today. Through the peer review process, MERLOT recognizes the scholarship of teaching by providing accounting and finance faculty with an opportunity to publish and share the teaching materials they have created or discovered. The purpose of this paper is to make new accounting and finance faculty aware of this valuable resource, and also reacquaint those faculty already familiar with MERLOT to new features and added benefits.

### **HISTORICAL MILESTONES**

During its early years, MERLOT was a collaborative effort of five parties: the State Higher Education Executives Organization (SHEEO), the California State University System, the University System of North Carolina, the University System of Georgia and the Oklahoma State Regents for Higher Education. A pilot program took place from October 1999 through June 2000. Four disciplines were created (biology, physics, business, and teacher education) with team members selected by each MERLOT partner. Standards, policies, procedures and processes were pilot tested to implement the peer review process..

In July of 2000, eight disciplines were added (chemistry, health sciences, history, information technology, mathematics, music, psychology, and world languages) and the partnership expanded to include 23 institutions and systems of higher education. Training sessions were held on the campuses of select university partners where team members assembled to learn about the MERLOT project, its, goals and processes, and the roles they were to play.

By fall of 2001 MERLOT was incorporated as an official not-for-profit entity. Engineering was added as the thirteenth discipline. Discipline Teams became Editorial Review Boards and the review group expanded to include external reviewers, individuals beyond those selected by MERLOT partners. The next major upgrade to MERLOT occurred during 2006. The layout and design of the home page changed dramatically to better exploit the use of frames. The total number of academic disciplines represented grew to 17. Browsing components were enhanced, new features were incorporated, and workflow processes were streamlined.

### **DISCIPLINE COMMUNITY SERVICES**

By joining MERLOT, members become part of a discipline community. Members can now link to their discipline community directly from the MERLOT home page. Every Discipline Community portal contains the following five content areas: Teaching, People, Learning Materials, Beyond MERLOT, and Showcase. Teaching contains tips and guidelines for teaching business with technology including online sessions. This section also provides links to modules on teaching special needs and a MERLOT portal on pedagogy. The People tab connects the business community members to its editorial board and peer reviewers. Information on how members can become involved as a peer reviewer, submitter, and author can be found as well as links to information about the Virtual Speakers Bureau and annual MELOT International Conference. Learning Materials lists each business major area, providing another way to link to the business collection. Beyond MERLOT provides links to professional associations, discussion forums, calls for papers,

conference announcements and business journals. Showcase contains an online resource, project, or an individual the editorial board wants to feature as exemplary.

### **LEARNING MATERIAL PROFILES**

Digital learning objects catalogued in MERLOT are called artifacts. For each item contributed to MERLOT, a material detail or learning profile is created. The Material Detail identifies the title of the module, its material type and technical format, a link to the item's uniform resource locator (URL), the dates it was added and modified, as well as author(s) and the person who submitted it to the MERLOT collection. Material types include simulations, animations, tutorials, drill and practice activities, quizzes and tests, lectures/presentations, case studies, reference materials, learning object repositories, online courses, and workshop/training materials. Technical formats range from html/text, portable document files (pdf) and blogs to PowerPoint presentations, podcasts, and Flash videos to name a few. A brief description follows as well as a listing of the browsing categories in which the module is classified. Additional information includes identifying the learning material's primary audience, accessible languages, copyright status, source code availability, section 508 compliance and Creative Commons licensure. From the material detail users can also access the peer review, member comments, and any assignments posted for the MERLOT artifact.

### **THE PEER REVIEW PROCESS**

Since MERLOT is an open community, anyone can contribute digital materials to the repository. As a result, having standardized evaluation processes is critical to maintain the scholarly credibility of the repository. The peer review model used by MERLOT is an assimilation of the peer review process used by journals, other academically published materials, and prepublication reviews (Cafola, 2006). New reviewers are required to complete a Macromedia Breeze enabled GRAPE (Getting Reviewers Accustomed to the Process of Evaluation) boot camp conducted via teleconference.

Evaluation standards used by MERLOT reviewers involve assessing an object's quality of content, potential effectiveness for teaching and learning, and ease of use with strengths and concerns noted. In addition, reviewers use a five star rating scale to indicate degrees of worth in each of the three areas. One star indicates materials are not worth using, whereas five stars indicate materials are excellent all around. Not only do MERLOT review standards help faculty assess the usability of existing modules, MERLOT criteria can also serve as guidelines for authors to consider as they develop new instructional materials. In fact, Manwell-Jackson (2004) developed and validated an assessment instrument for evaluating web based employee compliance training materials used by academic medical centers based on MERLOT's peer review evaluation instrument.

### **TASTING THE ACCOUNTING AND FINANCE COLLECTION**

The MERLOT collection currently contains links to over 19,000 items, of which 2,900 are related to 12 broad areas of business. Of this figure, 346 items are categorized for accounting and

241 are identified as relevant to finance. Each major area within business is further subdivided by topic. Accounting and finance each have ten subcategories. Learning materials that serve multiple disciplines are cross listed. For example, the same module on time value of money would be found by searching either the fields of accounting or finance. Learning objects are ranked by Overall Rating with the peer review having precedence over member comments written for the module. Materials can also be sorted by title, author, material type, date added, and date peer reviewed. Advanced Search features enable querying the collection using key words, date ranges, material type, audience, technical format, and source code availability.

Based on research by Nas (2003), the majority of accounting faculty have not embraced the use of instructional technology. A disconnect appears to exist between the instructional strategies used by faculty and the preferences of the current generation of college student.

MERLOT can bridge this gap by offering accounting and finance faculty one stop shopping for teaching and learning materials. Many digital learning objects can be tailored to a specific course through the creation of an assignment. Animations and simulations can be incorporated into class demonstrations. A sampling of some of the high quality materials referenced in the MERLOT repository include:

- ◆ Guide to Financial Statements by Arthur Downing from Baruch College is an interactive Flash tutorial that introduces students to the income statement, balance sheet, and statement of cash flows. The tutorial has interactive activities, quizzes, related links, and a study guide.
- ◆ Cash Flow Statement by Dr. David Annand from Athabasca University, Canada, is an Authorware tutorial designed for Canadian students. It teaches them how to create a statement of cash flows using the indirect method from balance sheet and income statement information.
- ◆ Double Entries, an online international newswire from AccountingEducation.com reports breaking news from the accounting profession around the world. Upon subscribing, the newswire arrives by e-mail weekly. Having students subscribe to this free newswire is a way to emphasize globalization. Instructors could use it as a basis for assigning short essays.
- ◆ Disk Lectures – Time Value of Money 1 by Dr. Peter Ekman from the Central European University School of Business was designed for a MBA level finance course. It consists of 16 audio enhanced PowerPoint learning modules covering a wide variety of time value of money concepts, including how to use a financial calculator.

## **PROFESSIONAL DEVELOPMENT AND OTHER MEMBER BENEFITS**

MERLOT resources can also help faculty learn how to use new technologies or apply new teaching methods. Through the Pedagogy Portal faculty can find materials relevant to problem-based learning, online teaching, cooperative learning, and case-based instruction. For example, information on how to incorporate blogs, Wikis, personal response systems, podcasts, screen casting, and lecture webcasting can be found. Other topics include ice breaker activities for the first day of class, ways to make teaching effective, and how to motivate students.

Two digital learning objects of particular interest are the award winning MERLOT Classics artifact Active Learning with PowerPoint by Paul Baepler and the Editors' Choice WebQuest Page by Dr. Bernie Dodge. Active Learning with PowerPoint is an online workshop comprised of five



Flash videos designed to help faculty convert PowerPoint lecture material into a dynamic teaching experience. A WebQuest is an inquiry based self-contained activity designed to support higher order thinking skills. Dr. Ronald Tidd from Central Washington University has applied Dodge's model to a variety of accounting courses he teaches.

Added benefits for MERLOT members include personal profiles, personalized collections, and the virtual speakers' bureau. The Personal Profile feature allows members to create an online curriculum vita. The Personal Collection is a compilation of MERLOT modules that members can access like the Favorites feature in Internet Explorer. Finally, individuals willing to share their expertise can become a member of MERLOT's Virtual Speakers' Bureau. Guest experts participate in a class through discussion forums, chat sessions, online conferencing, or face-to-face meetings.

### **CONCLUSION**

In summary, MERLOT can help accounting and finance faculty find the right online materials faster. Through the dedication of its members, MERLOT is becoming a comprehensive inventory of teaching and learning materials. MERLOT helps members share expertise and build relationships with peers who value the scholarship of teaching.

In 1975 retired New York Authur Young & Company partner, Frederick E. Horn predicted developments that would impact the academic preparation of the accountant for the next 25 years. Two of these developments involved: 1) new technology applied to instruction and the learning process and 2) the emphasis on education shifting from the educational institution to the individual (Horn, 1975). Clearly, Horn was a visionary. To quote the wisdom of Confucius, "I hear and I forget. I see and I remember. I do and I understand." As educators, we may be more successful if we enhance our students' abilities to learn by expanding our ability to teach flexibly and MERLOT can help. MERLOT separates the skin from the pulp with the most distinctive flavors precipitating to the top. To complement your accounting and finance classes why not offer your students a taste of MERLOT. Visit [www.merlot.org](http://www.merlot.org).

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# EXEMPT ENTITIES AND TAX SIMULATIONS ON THE UNIFORM CPA EXAMINATION

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## ABSTRACT

*Exempt Entities is a term of art encompassing many different types of non-profits per the Internal Revenue Code. Tax simulations are now a regular part of the Uniform CPA Examination requiring students to use a tax database to solve a particular problem. The Internal Revenue Code lists the types of exempt organizations, the various requirements for exempt organization status, the tax consequences of this status, the ramifications of unrelated business income, reporting requirements, and the various differences of public charities versus private foundations. A public charity, per the Internal Revenue Code, exists to benefit the public interest, e.g. the Salvation Army. Private foundations are not public charities. An example is the Tiger Woods Foundation. These private foundations usually have a single major source of funding in the form of gifts from one individual or family. Exempt entities must not participate in any political campaign or they could lose their exempt status. This situation could be the focus of a tax simulation question on the CPA examination.*

## INTRODUCTION

Exempt Entities is a term of art encompassing many different types of non-profits per the Internal Revenue Code. Tax simulations are now a regular part of the Uniform CPA Examination requiring students to use a tax data base to solve a particular tax problem. These exempt organizations, a similar term of art for non-profits, would rather not be subject to the Federal Income Tax. Given the many types of exempt entities it may be an area of the federal tax law that could be used as a source of tax simulation questions on the Uniform CPA Examination.

The Internal Revenue Code lists the types of exempt organizations, the various requirements for exempt organization status, the tax consequences of this status, the tax ramifications of unrelated business income, reporting requirements, and the various differences of public charities versus private foundations. These topics are generally covered in an Advanced Federal Income Tax course, but seldom included in most textbooks used for Governmental and Not-for-Profit courses. Some of the relevant issues from the Internal Revenue Code include the following: 1) serving the common good, 2) the for-profit prohibition, 3) net earnings of the organization, 4) benefits to the members of the organization, 5) political influence, 6) prohibited transactions, 7) qualifying for exempt status, 8) reporting requirements, 9) losing the exempt status, and 10) regaining the exempt status. This tax law information could be used as supplemental reading for a governmental and not-for-profit accounting course by filling a gap between the focus on financial reporting and implications of federal tax law.

## **SECTION 501 OF THE INTERNAL REVENUE CODE AND THE PUBLIC CHARITY**

Federal tax law per section 501 of the Internal Revenue Code (Code), prescribes an exemption from tax on various entities. These entities are sometimes described as "exempt organizations (EO)." Federal tax law provides that these EO comply with federal tax law to maintain tax-exempt status and to avoid any penalties. A partial list of these section 501(c)(3) entities include the following: a corporation, fund, or foundation that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purpose. Net earnings from these entities cannot be used for the benefit of any private shareholder or individual. As a result, a 501(c)(3) EO is sometimes described as a public charity. In other words, the EO is in existence under the Code to benefit the public interest. To benefit the public interest would not include paying an officer, director, or an employee of the EO unreasonable compensation. This situation could be grounds for the loss of tax-exempt status.

EO that benefit the public interest include churches and religious organizations. So under 501(c)(3) of the tax Code, these EO are eligible to receive tax-deductible contributions in the form of cash or property. However, it should be noted that these EO must not be spending a substantial part of their activity attempting to influence legislation; the EO must not intervene in political campaigns. As far as political campaigns are concerned, the EO must not participate in, or intervene in, any political campaign on behalf of, or in opposition to, any candidate for public office. Further, all EO under section 501(c)(3) are prohibited from engaging in activities that result in the inurement of the entities' income or assets to the unreasonable benefit to insiders of the EO. Insiders could include the ministers, board members, officers, and employees of the EO. Examples include the payment of dividends, the payment of unreasonable compensation, and the transferring of property for less than fair market value. Any one of these situations could lead to a loss of the tax-exempt status.

### **PRIVATE FOUNDATIONS**

Section 501(c)(3) of the Code also includes private foundations; these EO are not public charities. These private foundations usually have a single major source of funding, usually in the form of gifts from one individual or one family. Most of the EO have as their main activity the making of grants to other charitable organizations and to individuals, rather than the direct operation of charitable programs. Private foundations include private operating foundations, exempt operating foundations, and grant-making private foundations. According to the Internal Revenue Service (IRS), private operating foundations and exempt operating foundations are quite rare. The grant-making foundation usually makes grants to other EO. For example, a grant-making foundation makes a yearly payment to support a 501(c)(3) college or university. It should be noted that a private foundation is responsible for an excise tax on its net investment income. The Code contains provisions that impose two-tier excise taxes on private foundations, foundation managers, or others that engage in prohibited acts, such as contributions to political campaigns.

## **UNRELATED BUSINESS INCOME**

Under section 6104(d) of the Code, a section 501(c)(3) EO, with gross income from an unrelated trade or business of \$1,000 or more, must make its annual exempt organization business income tax return available for public inspection. The tax on unrelated business income is based on corporate rates. An EO subject to the tax on unrelated business income must file Form 990-T. The form must be filed if the exempt organization's gross income from unrelated business income is \$1,000 or more. An EO will also be required to make estimated tax payments if it expects its tax to be \$500 or more. If an EO fails to pay the correct estimated tax when it is due, it may be charged an underpayment penalty for the period of underpayment. Form 990-W is available as a worksheet and can be used to calculate the correct amount of estimated tax. Gross income from an unrelated business, less any allowable deductions incurred in that unrelated business, will result in unrelated business taxable income. This taxable income is subject to regular corporate tax rates which have a graduated tax structure and starts at fifteen percent and goes up to thirty-nine percent, but with, at most, an average of thirty-five percent when taxable income reaches \$18,333,334; these corporate tax rates are for the 2007 tax year.

## **RECENT DEVELOPMENTS IN THE NEWS**

As the U.S. is in an election cycle, it is timely to look at the Code as it relates to EO and the election process. As noted earlier, EO must not participate in any political campaign on behalf of, or in opposition to, any candidate for public office. As a result, the IRS has put two EO on notice that they will be under investigation. One is the United Church of Christ where Senator Barack Obama, Democratic presidential hopeful and a member of that church, gave a speech last year to the church's General Synod. According to the Los Angeles Times, the IRS opened a similar inquiry into the Rev. Wiley Drake, a prominent Southern Baptist preacher in Buena Park, California because he endorsed Mike Huckabee's Republican presidential nomination bid in a written statement on church letterhead and on a church-related Internet radio show.

## **REVENUE RULING 2007-41 (JUNE 18, 2007)**

According to Revenue Ruling 2007-41, EO, under section 501(a) of the Code and described in sections 501(c)(3) may not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of, or in opposition to, any candidate for public office. If the IRS perceives a possible violation of the federal tax law, a letter will be sent to the EO noting the focus of the IRS examination; it will be limited to determining whether the EO intervened or participated in a political campaign. The IRS will examine all relevant facts and circumstances, and if a violation is found, the IRS could impose an excise tax on the amount spent on the activity, e.g. publication of a newsletter supporting one particular candidate for political office. In a worst case scenario, the EO would lose its tax exemption.

### **A TAX SIMULATION EXAMPLE**

In summary, many possible issues could be used as a source of tax simulation questions on the Uniform CPA examination. For example, a tax simulation problem could involve the following factual pattern: Church A is a section 501(c)(3) entity, and it maintains a web site that gives information about its ministers and about the church itself as well as information about members of the congregation. R is member of the congregation and is running for public office. Before the election, the church asks its members to support R, a fellow parishioner, in the upcoming election. Has the church intervened in an political campaign on behalf of R? As a tax simulation question on the Uniform CPA Examination, a candidate taking this examination should be able to find the cogent information needed to answer the question.

# THE PERFORMANCE AND DETERMINANTS OF FIRMS THAT REPRICE OPTIONS DURING A BEAR MARKET

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## ABSTRACT

*I examine a sample of firms that perform stock option repricings during the bear market of 2001. Repricings are preceded by an average one-year return of -62.7% and are directly associated with poor industry performance. After controlling for industry, prior performance, size, and underwater options, I find that repricing firms have a greater need to realign incentives than non-repricing firms and their stock prices perform better after repricing. My results are consistent with firms repricing options to restore the incentive effects of stock options and to retain existing employees.*





# EARNINGS MANAGEMENT, ETHICS, AND THE CAPITAL MARKETS

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## ABSTRACT

*This research investigates the post market effects created by the various earnings management schemes perpetrated from 1995 through 2002. The study compares stock price movement trends of 30 companies with the movement of the three major stock price indices; the DOW, NASDAQ, and S & P 500. The comparison was made over a six year time frame, January 1, 2001 to January 1, 2007. The researchers use an emphasis point of April 1, 2002, which was the approximate date of the culmination of media announcements involving reported earnings management schemes of the culprit companies.*

*The study indicates that approximately 43% of the companies sampled were engaged in some kind of earnings management scheme during this period of time. The paper concludes with a summary of the ethical attempts currently underway to correct earnings management schemes by the players involved in the free market system.*

## INTRODUCTION

During the scandals and financial statement restatements of the 2001-2002 period one common demand on company chief executive officers and chief financial officers evolved. This was to beat earnings forecasts by generation of double-digit returns. Why did the push for rapidly increasing stock prices that were experienced from the mid-1990s to the beginning of the 21<sup>st</sup> century evolve? Some (Jennings, 2004) say pressures on top management to inflate revenue and earnings figures was so great that CEOs and CFOs began to manage the figures in their quest to meet unrealistic demands of stockholders and other potential investors.

This paper discusses the rise of the earnings management concept widely present during that time and its subsequent impact on stock price movement. The researchers then investigate situations that contributed to the earnings management schemes. Next, the writers compare stock price movement of 30 companies with the three major stock market indices in an attempt to uncover management earnings situations. Finally, there is a discussion of ethics training of the parties involved that is aimed at elimination of earnings management schemes as they apply to annual financial statements.

## **FIRST EARNINGS MANAGEMENT DETECTIONS**

Random isolated instances of corporate impropriety by CEOs, CFOs, and other top management officials surfaced during the last half of the 20<sup>th</sup> Century. The McKesson and Robbins Case in 1939 involved material overstatements of accounts receivable and inventories (Zeff, 2003). After that, all was fairly quiet until the middle 1960s when bankruptcies of Penn Central and Four Seasons Nursing Centers generated huge losses for investors. These were followed by the Equity Funding scandal in 1973 and W. T. Grant bankruptcy in 1975 (Largay, 1980). Corporate investors began to look suspiciously toward CEOs and external auditors, who had the power and abilities to manage financial statement information for their own good. However, these improprieties now seem mild when compared to the ones of Enron, WorldCom, Adelphia, Global Crossing, Tyco, and K-Mart.

## **EARNINGS MANAGEMENT FROM 1995-2002**

In February 2001, Sunbeam Corporation received extensive media publicity involving the financial restatement process as the corporation filed for bankruptcy (Government Accountability Office, 2002). Shortly thereafter former CEO, Al Dunlap was charged with securities fraud. Sunbeam's management was involved in earnings management during the years 1996-1998. Dunlap came to the company in 1996 with promises to turn the company around. Liberal reserves were set up in 1996 to inflate the loss that year. The reserves produced overstatements of 1997 and 1998 earnings thereby giving the impression that Dunlap had turned the company around.

Enron's problems first surfaced in the latter part of 2001. Global Crossing and WorldCom followed in early 2002 and not far behind was Adelphia, Tyco, and K-Mart among others. The market continued the growth trend of the late 1990s through early 2002, but finally gave way to the wave of corporate scandals around the first of April 2002. The market appeared to bottom out in September, made some recovery through the latter part of 2002, but then hit bottom again in early 2003.

The Enron collapse was perhaps the first major shock for the investing public. Questions about its operations and declining stock price began to surface in early October 2001. A conference call to address investor concerns was held on October 22 in which Ken Lay attempted to downplay investor alarm. Then on November 8, the merger discussions with Dynegy were aborted. Enron was well on its way to collapse and the corporate investing world was set on its heels. Even so, the market did not suffer too greatly over this isolated incident of corporate fraud. The DOW Index was at 10073 on January 2, 2002; the S & P 500 at 1149; and the NASDAQ at 1610.

A Government Accountability Office report was highly critical of corporate improprieties that had begun to surface in the late 1990s. The report noted that the number of publicly held companies that restated financial statements increased 147% from January 1997 through June 2002. The report listed four factors that caused companies to use questionable accounting practices, including (1) corporate pressure to meet quarterly earnings projections and thus maintain stock prices during and after the market expansion of the 1990s, (2) perverse executive compensation incentives, (3) outdated accounting and rule-based standards, and (4) complex corporate financing

arrangements. Based on the number of restatements as of June 30, 2002, the increase was expected to exceed 170 percent by the end of the year (Government Accountability Office, 2002).

### IMPACT ON THE MARKET

Literature (Jennings, 2004) attributes the rapid fall of the markets beginning in early 2002 to a misplaced focus on ethics as part of business school curricula at the time which seemed to encourage management students to smooth earnings in order to maximize shareholder wealth. The impact of financial statement shenanigans on the market is evident when one observes stock price movement of the three major indices from January 1, 2001 to January 1, 2007 illustrated by Figure 1. Figure 1 shows a fairly sharp decline in April 2001, then a slight recovery until the 9/11 attacks in September 2001. A rapid recovery occurred following 9/11. The prolonged drop in stock prices began in April 2002, and bottomed out in late 2002. It did not recover to the pre-April 2002 levels for approximately two years. The researchers believe that the two year recovery period was caused primarily by adverse media releases that involved the prevalence of earnings management schemes in financial statement annual reports.

Figure 1  
Stock Price Indices: Dow Jones, NASDAQ, and S & P 500



Source: <http://moneycentral.msn.com>

Most of the previously mentioned improprieties related to earnings management were not perpetrated by top management alone. Internal accountants, CFOs, and independent auditors played vital roles in the earnings management schemes. Additionally, Wall Street officials contributed to the problem by lobbying for the Private Securities Litigation Act of 1995. This act made it more difficult to sue executives, auditors, and financial analysts for securities fraud. CEOs could “pipe

up” their company prospects with the new breed of financial statements known as forward-looking financial statements without fear of legal action.

The media reported almost daily on unethical behavior of Wall Street officials. Four high-ranking officials of a major Wall Street firm were indicted along with Enron officials for insider trading and stock price management schemes.

Jennings (2004) notes two common threads in the collapse of corporations during this time frame; financial pictures painted of the companies were grossly distorted and the companies were deeply involved in double-digit growth. The pressure to increase the numbers as the economy took a downturn increased with each passing quarter.

### **OBJECTIVES OF THIS STUDY**

In this study the researchers hope to accomplish three objectives. First, they hope to impress upon the readers the seriousness of impact that earnings management has on the free market system. Secondly, by the use of research methodology provide an estimate of the percentage of companies that managed earnings during 2001-2007. Finally, the writers hope to determine what the major participants in the securities market have done to reestablish confidence of the investing public in financial reporting.

### **METHODOLOGY**

The methodology in this study is based on the strong-form of the efficient market hypothesis (EMH) theory. The proponents of the strong form of EMH believe that markets are totally efficient and investors will pursue the highest yielding investments regardless of the amount of publicly available information about the securities (Investopedia, 2008). In other words, share prices always incorporate and reflect all information about the value of the company. The researchers used the chart shown in Figure 1 which plots stock price indices (DOW, NASDAQ, and S & P 500) as the benchmark for comparison of selected companies for the period from January 1, 2001 to January 1, 2007.

Stock price movement of 30 publicly held companies were compared with the three major stock price indices for the period. Companies that showed stock price movements that were similar to or better than the indices immediately after April 2002 were considered not to have managed their earnings to produce higher stock prices for their companies. Companies that showed stock prices consistently below the market averages, especially after April 2002, were considered to have participated in some type of earnings management scheme prior to 2002.

### **RESULTS AND FINDINGS**

Summary results of the 30 companies sampled are presented in Table 1. Seventeen (17) of the companies surveyed showed no evidence of earnings management during the time frame included in this study. On the other hand, nine companies showed trends that indicate earnings management of some sort. Three companies reflected stock price movements that indicate earnings management prior to April 2002 followed by no earnings management present from 2004 until the

end of the date of this study. Finally, one company had stock price movement that indicates no earnings management immediately after April 2002 but some earnings management present after 2005.

Trend	Number	Number	Number	Number	Total
No-Definitely	17				17
Yes-Definitely		9			9
Yes-2002; No-2004			3		3
No-2002; Yes-2005				1	1
Total	17	9	3	1	30

## CONCLUSION

This study shows that approximately 43% of the companies sampled managed earnings during the time covered by this research. This number is excessive when one considers that it includes only companies that continue to be in existence today. Enron, WorldCom, and Adelphia are companies not included in the research because they are no longer active. Even so, everyone is aware of their schemes involving earnings management while they were in operations.

Literature indicates that the various players involved in revitalization of ethics requirements in their respective areas are currently engaged in the process of initiating new ethical guidelines for their professions. The AACSB has placed much emphasis on integration of ethics education into the curriculum of business schools during recent reaffirmation visits (Griffin, 2006).

The American Institute of Certified Public Accountants (AICPA), National Association of State Boards of Accountancy (NASBA), and the AACSB are beginning to make moves to require up to nine hours of ethics courses in business school programs. The Federal government passed the Sarbanes-Oxley Act in 2002 that, among other things, placed independent auditors under the control of a newly created government organization known as the Public Company Accounting Oversight Board (PCAOB). The PCAOB requires company board of directors to select independent auditing firms thereby ensuring a separation of the audit function from control by top company management.

The only thing that seems to be missing from the picture is a concerted effort on the part of Wall Street to correct ethical violations of the past. Ironically, this missing part could well be the key to reestablishment of confidence of the investing public of information generated by the accounting profession, that is the publication of and the audits of annual financial statements.

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## CASH FLOW FROM ACCOUNTANTS TO END USERS

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### ABSTRACT

*Today, there are few people in finance (or in any other vocation or field of study for that matter), who would dispute the importance of cash flow. Conceptually, assessing the company's cash flows is paramount to the firm's valuation and decision-making. A company's cash flow statement is one of the most revealing financial statements available to investors. The increasing importance and effectiveness of free cash flow is placed in particularly high relief when compared to other popular investment metrics—specifically, earnings and its derivatives. Financial Accounting Standards Board (FASB) Statement No. 95, Statement of Cash Flows requires most businesses to provide a cash flow statement for each period for which results of operations are provided and classifies cash inflows and outflows as relating to operating, investing, or financing activities. Generally accepted accounting principles (GAAP) are very focused on the measurement and reporting of accrual-based earnings. The vast majority of all accounting standards released deal in one way or another with accrual-accounting concepts. For our purposes, let's say that the world is divided into two types of individuals—the accountants and the investors. The accountants and the investors are at opposite ends of the financial valuation spectrum. The accountant has two objectives. The first is to fairly represent the state of the business at a point in time, which is done via the balance sheet. The second objective is to record the receipts and expenses to show profits or losses, which is done via the income statement. Conversely, the investor's objective is to use the accountant's data and the principles of finance to create a fair market value for a company. The investor does this by discounting future expected cash flows with an assumed appropriate discount rate. At the heart of the investor's assumption is the expected stream of cash flows to be derived from the net assets owned by the entity. In other words, the investor is focused on cash flows while the accountant is focused on earnings. Because of this, the accountant is vulnerable to the many pitfalls and distortions caused by the presence of misleading accrual items within GAAP-derived financial statements. Since the issuance of SFAS-95 in 1987, several limitations and defects of SFAS-95 have been identified that warrant its reassessment. This paper demonstrates that current FASB cash flow statement classification rules are simplistic and fashioned with internal contradictions. As a result, the net cash flow subtotals (operating, financing, and investing) reported for each category are often contaminated by the cash flow effects of perplexing transactions, including the classification of interest, dividend payments, collections, purchases and sales of investments, and income tax payments and the effects of those transactions and similar contamination often results in misleading subtotals. While endorsing the SFAS-95 objectives for the cash flow statement and its three-way classification of operating, investing, and financing activities, the paper proceeds to point out major limitations of SFAS-95 that arise from its inconsistent and ambiguous implementation of that tri-level separation and its omission of an important component the relevant element of free-cash-flow.*





# THE WAL-MART EFFECT ON THE SECURITIES MARKET

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## ABSTRACT

*In the history of retail sales, no corporation has had as profound an impact on consumer spending across the United States as has Wal-Mart. In 2006, Charles Fishman wrote the eye-opening book, 'The Wal-Mart Effect.' This book describes how Wal-Mart has changed the landscape in retail trade along with both good and bad effects brought about by its rise to the powerful position it now commands. Mr. Fishman's book stops short in analyzing the impact Wal-Mart has had in the securities market. This research tests whether or not there is a "Wal-Mart Effect" in the securities market. Research from the most recent four decades among firms in retail trade indicates that Wal-Mart does have a distinct advantage over its competitors when it comes to wealth generation and its link to security prices. This finding has practical implications on patterns of future investment among current and future security investors.*

*Recent Penman et al studies have shown ratios to have increasing importance in relation to security prices. This study has singled out one firm in retail trade, Wal-Mart, as being exceptional among all other firms with respect to the number of stock splits that it has had during its corporate life. Because of this, it was determined that perhaps, with respect to Wal-Mart, there might exist informational content relative to security prices, measured by other than unexpected earnings. Relying on past Penman studies, book value was used as a proxy for wealth. When book value was analyzed in regression form for Wal-Mart and other firms in the retail trade industry in a stratified sample by decade, this variable was found to be significant for Wal-Mart but not for the rest of the industry. These results have tremendous implications. For one, investors interested in firms that have a history of stock splits now may have another tool to assess when making stock purchase decisions. Also, in light of this and recent other studies relative to ratios and stock prices, researchers will want to explore this avenue for further application. And lastly, perhaps there is an unique Wal-Mart effect taking place due to its financial history, that may not be seen or replicated in other firms, only future research can substantiate or dismiss this.*



## **U.S. MERGERS AND ACQUISITIONS: A TEST OF MARKET EFFICIENCY**

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### **ABSTRACT**

*The purpose of this study is to test market efficiency with respect to merger and acquisition announcements using standard event study methodology. Specifically, this study analyzes the effects of U.S. company mergers and acquisition announcements on stock price's risk adjusted rate of return using twenty recent mergers, as of August 31st, 2007. The weak, semi-strong, and strong form efficient market hypotheses which test an investor's ability to earn a positive abnormal return on the basis of merger announcements are examined. Specifically, this work focuses on the semi-strong form test in an effort to test the efficiency of merger announcement public information. Evidence here supports semi-strong market efficiency along with a positive signal exhibited by the sample of acquiring firms during the event period. Evidence of lingering excess returns after the merger announcement was also observed.*



## ONLINE DELIVERY OF ACCOUNTING COURSES: STUDENT PERCEPTIONS

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### ABSTRACT

*The authors taught introductory undergraduate, upper-division undergraduate and graduate accounting courses online using Tegrity Campus 2.0 integrated with a learning management system (WebCT, Angel) to prerecord and publish all course lectures and provide all other course-related content to students in the three accounting courses. Students in the three courses could access the archived video presentations over the internet or burn the presentations to a CD or a flash memory drive thus allowing students to view the digital videos at any time and as many times as desired. All of the students in the graduate course agreed that the online delivery of the course was as effective or more effective than a traditional course that meets in a classroom and all of the graduate students indicated that in the future they would prefer to take more online courses, compared with traditional courses. Students in the undergraduate courses were slightly less enthusiastic about online delivery; overall, approximately 75% of such students indicated that the online delivery of the courses was as effective or more effective than a traditional course. Further, unlike the students in the graduate course, less than one-half of the combined students in the two undergraduate courses indicated that they would prefer to take an online course versus a traditional course in the future. The authors agree that online delivery appears to be an effective alternative to physically meeting students in a traditional classroom setting but also believe, in this case, that the fully online delivery was more appropriate for the graduate course compared with the two undergraduate courses. The authors discuss several issues related to teaching the three online courses that accounting instructors may want to consider before undertaking such a teaching approach.*



# THE NAIROBI STOCK EXCHANGE AND NEW EQUITY CAPITAL:1998 TO 2004

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## INTRODUCTION

*The objectives of any stock exchange include two interlinked concepts. Their primary market role is to facilitate the movement of capital from savers to investors. In process of the primary market activities they will often aggregate the resources of small individual savers into sufficiently large capital sums that they can be successfully invested by commercial companies. In their secondary market role, by facilitating transactions between willing buyers and sellers they establish fair market prices for existing shares (the efficient markets hypothesis). In turn, this secondary market role of share pricing enables (primary market) new share issues to be priced at, or close to, fair market prices, thus militating against disadvantaging the issuers or the buyers of those new shares. The two roles are, therefore, interdependent.*

*The nature of the stock markets of developed countries need no rehearsal here: suffice it to say that the stock exchanges of New York, London, Tokyo and so on have been material positive factors in the burgeoning economies of the USA, Europe and certain parts of Asia for many years past. Some parts of the developing world have also used stock exchanges as vehicles of development, with perhaps China and India being the most obvious recent examples. The Shanghai Stock Exchange (SSE) was founded on 26th November 1990 (Devonshire-Ellis, 2007). At the end of 2005, the SSE boasted 1069 listed securities and 834 listed companies, with a combined market capitalization of RMB 2,310 billion (SSE, 2005). In 2005, listed companies raised RMB 3 billion on the SSE through Initial Public Offerings (IPO) and share placements (SSE, 2005). There were a total of 131 new listings between 2003 and 2005 (SSE, 2005)*

*Stock exchanges in Africa appear to have missed out on many of the opportunities seized elsewhere. Although there is a long history of stock exchanges in African nations, some going as far back as colonial times, their growth rates have generally been slow, or even stagnant, and their role in capital mobilization appears, in many cases, to have been negligible.*

*Quoting data from the World Bank's Financial Structure database, Honahan and Beck list fifteen stock exchanges active in sub-Saharan Africa (i.e. ignoring the substantial and active stock exchanges in Mediterranean Africa, such as those in Morocco, Tunisia and Egypt). (table 1 about here)*

*The NSE was established in 1954: only South Africa (1887) and Zimbabwe (1896) are older. The remaining exchanges were all established in the last 25 years of the 20th century. Of those fifteen stock exchanges South Africa is clearly an outlier, while Kenya is typical of the other fourteen. These all share the following features: a limited number of stocks is listed, market capitalization is a small percentage of GDP, value traded is a small percentage of GDP, turnover is low, the concentration of firms is low and few bonds are listed. Parkinson (1984) examined the*

*NSE in the context of development in Kenya. He reported that the NSE failed to make enough issues to satisfy savers' demands. Earlier Yacout (1980) had noted the heavy oversubscription of new issues in Nigeria and concluded that; there too, available savings were greater than new stock market issues.*

*In this article we will focus on the Nairobi Stock Exchange (NSE). The method is to examine the capital structure of all the companies listed on the NSE. We will attempt to differentiate between those companies that needed capital for expansion and those that did not. In respect of expanding companies we will attempt to identify how they financed their expansion. We will focus on three main categories of sources of finance: primary market transactions (that is, new share issues); organic growth (through the ploughing back of profits); and lastly, borrowing. In this way we will make an informed judgment of the way the NSE has contributed to the raising of capital and the development of the economy.*

*We will also set the compare the sum of stock market activity against aggregate information for Kenya as a whole, to get a sense of the scale of its activity.*

### **PREVIOUS RESEARCH**

According to the Efficient Markets Hypothesis (EMH) all relevant information is immediately and accurately impounded in the market prices of shares. If the EMH holds true it is not possible to make an abnormal return by trading on the basis of available information. For a detailed discussion of the history and early development of the EMH see Fama (1970).

Empirically the EMH is tested in three forms: weak form; semi-strong form and strong form. A typical weak form test would be to check for any serial correlation between share prices on consecutive dates. The absence of serial correlation implies that the share prices are performing a random walk. It is generally agreed that stock prices are weak form efficient. A typical semi-strong form test would be to examine the behaviour of a share price immediately before, during and immediately after a known event such as an earnings announcement or a takeover agreement. As with weak form tests, there is extensive support for semi-strong form efficiency, particularly in respect of the stock markets of the developed world. The strong form of the EMH states that all information, public and private, is fully and immediately impounded in share prices. As it is not possible, by definition, to know all the private information, the strong form is not a testable hypothesis.

In this study we are not so much interested in technical efficiency, though that has been assessed by Dickinson and Muruga (1994) and Parkinson (1987) in respect of the NSE. As is observed in both those studies, even if the market deviates somewhat from technical efficiency, the thinness of market trading militates against investors being able to profitably trade on that knowledge. We are more interested in the question asked by Samuels and Yacout (1981). Their question, put in the context of Nigeria was: what contribution did the stock exchange make to the mobilization of capital and the development of the economy? One of the dimensions of any stock exchange is its relationship to the economy in which it operates. Useful comparative statistics are somewhat problematical here, but one useful source is the World Bank Data which shows the market capitalization of stock market securities by country, area and for the world as a whole.



"Definition: Market capitalization (also known as market value) is the share price times the number of shares outstanding. Listed domestic companies are the domestically incorporated companies listed on the country's stock exchanges at the end of the year. Listed companies do not include investment companies, mutual funds, or other collective investment vehicles." (World Bank, 2007).

Honahan and Beck (2007, p. 51) indicate that, for the eight most active stock exchanges in Africa other than Johannesburg (that is: Botswana, Côte d'Ivoire, Ghana, Mauritius, Mozambique, Namibia, Nigeria and Zimbabwe) the stock market capitalization as a percentage of GDP rose from about 13% in 1994 to about 23% in 2005.

The NSE is a country with one of the lowest ratios of stock market capitalization to GDP. In 2000 it was 10.1%, compared to 89.3% for the world as a whole: by 2005 it had increased to 34.1%, which, though a substantial increase over 2000, was still a small fraction of the 137% recorded for the world as a whole (World Bank, 2007). The logical conclusion is that while the role of stock markets generally is on a growth trajectory everywhere, including Africa, the NSE plays a comparatively minor role in the economy of Kenya.

By the end of 2004, the NSE had a total of 49 listed companies. These were classified into two market segments; The Main investments Market Segment (MIMS) and the Alternative Investment Market Segment (AIMS). The MIMS represents the main quotation market and has more stringent eligibility, listing and disclosure requirements (Wangacha, 2001). As at the end of 2004, this segment had 44 listed companies, which are further classified into four categories (agricultural, Commercial and services, Banking and Financial and Industrial and allied segments) (NSE, 2004). The AIMS has the same strict disclosure requirements as the MIMS but has a lower entry and continuance requirements with respect to minimum assets, share capital and shareholders. By the end of 2004, this segment had only five companies (NSE, 2004)

Overall statistics for the NSE are summarized in table 2. This shows, for the years 1998 to 2004, the book value of total assets for all companies listed on the NSE, broken down into debt and equity, and the equity broken down into shares and reserves. Reserves, in this context, are predominantly retained earnings, but also include other monies set aside out of earnings, whether legally distributable (such as a general reserve) or legally not distributable (such as a revaluation reserve).

## STUDY FINDINGS

Table 2 show the equity raised by companies in the agricultural segment and the changes in their total assets during the period 1998-2004.

Equity type	1998	2004	Change	Percentage
Share Capital	1077	1077	0	0%
Retained earnings	8936	6846	2090	(23.4%)
Debt	2309	4363	2054	88.9%
Total assets	12321	12286	35.6	(-3%)

According to the results companies in the agricultural sector did not obtain any equity capital during the period under review. Indeed these companies borrowed over Kshs. 2 billion outside the NSE to finance operating losses.

Table 3 show the equity raised by companies in the Commercial and services segment and the changes in their total assets during the period 1998-2004.

Equity	1998	2004	Change	Percentage
Share Capital	3,331	3,557	226	6.7%
Retained Earnings	7,467	12,599	5132	68.7%
Debt	13,608	31,110	17502	128.6%
Total Assets	24,406	47,266	22,860	93.7%

Companies in this segment registered significant growth during the period under review. The total assets increased by over Kshs. 22 billion (93.7%). However only Kshs 226 million was raised though the NSE. Most of the expansion was financed through debt. It is to be noted that out of the nine companies in this segment only two companies issued shares to the public during this period.

Equity	1998	2004	Change	Percentage
Share Capital	6,598	14867	8269	125.3%
Retained Earnings	26,595	28,488	1,893	7.1%
Debt	210,155	312,591	102,435	48.7%
Total Assets	243,349	355,947	112,598	46.3%

According to the results in Table four the total assets of banking sector increased by over Kshs. 112 billion during the period under review. Eight out of the 11 companies in this sector issued shares through the NSE raising a total of Kshs. 8.2 billion. However this amount is insignificant when compared to the Kshs. 102.4 billion that was raised through debt to finance expansion.

Equity	1998	2004	Change	Percentage
Share Capital	8,862	10,688	1,826	20.6%
Retained Earnings	50,154	57,139	6,985	13.9%
Debt	40,851	51,144	10,293	25.2%
Total Assets	99,868	118,972	19,104	19.2%

This is the largest segment in the NSE with a total of 20 listed companies. During the period under review ten of these companies issued share to the public through the NSE. A total of Kshs. 1.82 billion was raised. We however note that the total assets in this segment increased by over Kshs. 19.1 billion. Fifty-four percent of this expansion was finance through debt which increased by about Kshs 10.3 during this period.

Equity	1998	2004	Change
Share Capital	134	57,629	57,495
Retained Earnings	1,616	(50,071)	(49,909)
Debt	1,062	116,443	115,381
Total Assets	2813	124,001	121,188

The alternative segment had five listed companies. During the period under review, one company (Kenya Orchards Ltd) made an IPO which raised over Kshs. 57 billion. However most of the capital was used to finance operating losses that increased by over Kshs. 52 billion during the period. Overall the total assets in this sector increased by about Kshs. 121 billion. Much of this expansion was financed through borrowing, which increased by over Kshs.115 during the period under review.

Equity	1998	2004	Change	% of total assets
Share Capital	19,868	30,189	10,320	6.6%
Retained Earnings	93,150	105,074	11,923	7.7%
Debt	266,923	399,209	132,285	85.7%
Total Assets	379,942	534,472	154,529	100%

Table 7 summarizes the changes in equities and total assets of the companies listed in the MIMS. According to the results only 6.6% of the expansion in this market was finance through new equity capital. Eight-seven percent of the changes in total assets acquired during this period was finance through borrowing which increased by over Kshs.132 during the six year period. In total 22 of the 44 companies in this segment issued new shares during the period (appendix 1). However these issues only raised Kshs. 10.3 billion which is insignificant when compared to the total investment in assets of Kshs. 154.5 billion during the period.

## CONCLUSION

This study addressed the issue of whether the NSE has contributed to the raising of capital and hence the economic development in Kenya. Our findings indicate that although the company's listed in the NSE have registered an enormous growth during the period under review, much of this has been financed through borrowed capital and retained profits. We therefore conclude that the NSE has failed in its primary objective of helping investors to raise capital. Furthermore there is little evidence to suggest that the NSE has contributed to the economic development of Kenya. These findings confirm earlier finding by Kimura and Amoro (1999), who concluded that there was no significant correlation between economic growth and the growth of the NSE during the period 1985-1996. Future research may be directed towards the examination of why the NSE has failure to promote capital mobilization in Kenya. We suggest the use case study approach.

Country:	Number of listed firms	Market Cap. % of GDP	Value Traded % of GDP	Turnover	Zero Return Weeks % of Total	Concentration of firms	Number of listed corporate bonds
Botswana	25	27.2	0.6	2.1	-	0.21	17
Côte d'Ivoire	39	12.3	0.3	2.5	-	0.21	-
Ghana	30	23.7	0.8	3.2	70	0.12	3
Kenya	47	26.1	2.1	7.9	41	0.20	-
Malawi (2002)	8	9.2	1.3	14.1	-	-	0
Mauritius	41	36.0	1.6	4.4	48	0.12	1
Mozambique	1	30.0	0.0	0.0	-	--	
Namibia	13	6.9	0.3	4.7	57	0.39	4
Nigeria	207	16.7	2.3	13.9	67	0.08	
South Africa	403	170.5	76.5	44.9	13	0.06	
Swaziland	6	8.3	0.0	0.0	-	-2	
Tanzania	6	6.2	0.2	2.5	-	-	6
Uganda	5	1.4	0.0	0.2	-	-	-
Zambia	13	8.0	0.1	1.5	-	-	0
Zimbabwe	79	41.3	2.9	7.0	37	0.08	-

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# THE EFFECT OF OIL COMPANIES STOCK PRICES AFTER HURRICANE KATRINA

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## ABSTRACT

*The purpose of this study is to test market efficiency with respect to the effect of Hurricane Katrina on the risk adjusted stock price returns for a sample of oil companies using standard event study methodology from the finance literature. Specifically, this study analyzes the effects of Hurricane Katrina on the stock price returns of a sample of 15 oil firms with interest in the Gulf of Mexico. The study identifies August 30, 2005 as the event date. The weak, semi-strong, and strong form efficient market hypotheses which test an investor's ability to earn a positive or negative abnormal return on the basis of hurricane event are analyzed. Specifically, this work focuses on the semi-strong form test in an effort to test the market efficiency of major weather event information. How fast did oil company stock prices react to Hurricane Katrina? Appropriate statistical tests for significance were conducted. Results show the sample's stock prices dropping prior to Katrina reaching land. Evidence here supports semi-strong form efficiency as the market anticipated the devastation of Hurricane Katrina prior to the event date.*





## EXEMPT INCOME AND MARGINAL TAX RATES

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### ABSTRACT

*This study examines the relationship between exempt interest income and marginal tax rates using the Internal Revenue Service, Statistics of Income Division, Individual Model Files for 1992, 1995, and 2000. Consistent with the implicit tax framework, 60% to 73% of taxpayers who invest in exempt interest income have the highest marginal tax rate in each year. From 5% to 8% have a zero marginal tax rate in each year. Surprisingly, however, taxpayers with a zero marginal tax rate had the highest mean investment in exempt interest income in 1992 and 1995 and nearly the highest in 2000. Analysis of the zero marginal tax rate taxpayers who invested in exempt interest income revealed that approximately two thirds of these taxpayers had income profiles consistent with the hypothesis that their zero marginal tax rate status was due to unexpected losses. The remaining zero marginal tax rate taxpayers had income profile consistent with their tax status being due to tax or risk aversion. This study should be of interest to all of those who assume that taxpayers with a zero marginal tax rate have little or no exempt interest income.*



# **GLOBALIZATION OF FINANCIAL MARKETS AND REFLEXION TO TURKISH SMALL AND MEDIUM SCALE ENTERPRISES: BASEL II**

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## **ABSTRACT**

*Bank for International Settlements (BIS) is an international enterprise that had been formed by central banks of various countries in 1930. A working group called "Basel Committee" had been formed within BIS in 1974 in order to make studies about banking. The purpose of financing function is to get the funds in optimum conditions that firm needs and provide the usage of these funds effectively. As from the early 20th Century in USA and Europe, significant improvements had materialized in the field of financial management. In recent days, significant improvements had materialized in banking, risk management application and technique, in financial markets and control approach as they had in other fields as well. Credit institutions and the enterprises which demand credit will be affected directly from this application by the start of adhibition of Basel II criteria. In this study, the effects of Basel II application on Turkish Small and Medium Scale Enterprises will be examined.*

## **INTRODUCTION**

In global capital world, international capital investments increase quickly. In this process, all of the national economies want to take interest from financial resources which circle the globe. This demand gets within the charm area of economic systems which hadn't integrated to global markets or been in this process. The countries which are fascinated by global capital movements need to modify their financial systems in order to take interest from this resource.

At this point, the economies need to follow the global rules in order to expand in global markets. In this context, these countries need to make arrangements and act with the context of Basel II which can be respected as the global rules of financial markets.

In this study, we will examine the arrangements that economic systems need to make in financial markets and the possible effects of these arrangements to economic systems.

## **THE MEANING AND SCOPE OF FINANCING CONCEPT**

The purpose of financing function is to get the funds in optimum conditions that firm needs and provide the usage of these funds effectively.

As from the early 20th Century in USA and Europe, significant improvements had materialized in the field of financial management. In conjunction with industrialization, fund demand of developing enterprises had increased and meeting these demands had become a significant problem. In spite of excessive fund demand, the transfer of small savings into major enterprises wasn't easy. Financing had been understood as creation of currency and provision of funds by reason of excessive fund demand. In other words, financing concept is known only as providing funds until 50's. Growth of enterprises and improvements of incorporated businesses had added weight to provision of financing. In this context, it is considered that the basic duty of financial management is to provide adequate and low-cost funds for enterprises on time (Ceylan, 2003: 4).

### **BASEL COMMITTEE AND NEW CAPITAL ADEQUACY ARRANGEMENT**

Bank for International Settlements (BIS) is an international enterprise that had been formed by central banks of various countries in 1930. A working group called "Basel Committee" had been formed within BIS in 1974 in order to make studies about banking. The purpose of committee which is formed by 12 members including USA, Germany, Belgium, France, Holland, Sweden, Switzerland, England, Italy, Japan, Canada and Luxemburg is to monitor the possible crisis in banking and exchange markets and provide a common standard in banks' working. Basel Banking Control and Audit Committee within BIS have initially published Basel Capital Accord in 1988. According to Basel I, capital adequacy of banks must be at least %8. The rate of capital to risk assets had been considered in calculation of capital adequacy (Pinelli, 2005: 3).

In recent days, significant improvements had materialized in banking, risk management application and techniques and control approach. Committee had prepared a new draft arrangement in order to substitute 1988 dated arrangement and committee had announced this draft as Basel II principles in 2004. These principles have been accepted by all banking sectors and it is expected that the arrangements will be activated in many countries between 2007 and 2009 (Rodriguez, 2003: 120).

Over two hundreds opinions had been delivered by interested parties about new arrangement which has more risk sensitivity. In project, draft standards in 1999 had been accepted as risk weight of countries. As for the risk weights of countries, the criteria of the risk weight's applied to bank being a degree more than the country's and weighing according to the bank's rating from outer leveling institutions and also risk's period had been determined to be appropriate.

#### **1. Purposes and Essential Elements of New Arrangement**

Basel II principles had been formed with a view to restructure the banking sector. Risk management and valuation standards are being changed by Basel II principles. It is expected that enterprises which use credits will be affected by the reason of changing standards. The risks, grading notes, country advices of enterprises will be the main factors which determine credit cost by activation of Basel II principles. It will be important for enterprises to have a confidential financial reporting process and adequate operational management culture to corporate governance principles in this period.

Basel Committee expects that the revision which will be made in January 2001 dated new capital arrangement meet the control and audit goals below. According to this, new arrangement (Yayla and Kaya, 2005: 4);

- ◆ Measuring the pending risks separately and better for each enterprise,
- ◆ Saddling top management with a responsibility in banking sector,
- ◆ Presentation of enterprises' and banks' financial accounts to public in a secure way,
- ◆ Setting up the whole banking system and capital market on a sound basis and making them more competition oriented and more stable,
- ◆ Maintaining the encouragement of stability and security in financial system and so protecting the overall level of capital in capital frame system,
- ◆ Need to increase competitive equality,
- ◆ Need to form a more comprehensive approach intended for handling the risks,
- ◆ Need to focus on international banks, but basic principles must be same for the banks which are on the different complexity levels.

New arrangement has intended to form a structure which has more risk sensitivity and more elastic, risk sensitivity increase in calculation of capital and new arrangement also has aimed at incentive and compatibility increase in regulating obligations.

<b>Table 1: Comparison of New and Old Arrangements of Basel Committee</b>	
Old Arrangement	New Arrangement
Focused on mono type risk measurement.	Bring internal risk management methodologies, audits and market discipline oriented structure.
Mono type model is applied for all of the enterprises.	Provide more flexible application(capital encouragements can be applied for a better risk management)
Risk basis oriented Capital adequacy structure.	More sensitive to risk.
Reference: Banks Association of Turkey; New Capital Adequacy Arrangement of Basel, October 2002, s.3.	

Basel II principles had been put on three basis as minimum capital adequacy, control of capital adequacy and market discipline.(Ferguson,2003,397)

### **1.a. Minimum Capital Adequacy**

Minimum capital adequacy had been defined in the first part of arrangement. Definition of available capital and the condition of % 8 available capital adequacy ratio had remained same in the new arrangement. But sufficient modifications had been made on the denominator of ratio. Credit risk had been defined in details, no changes had occurred on market risk and for the first time, transaction risk had been added (BAT, 2002:5).

Two different approaches are suggested for credit risk; standardized approach and internal grading based-approaches.

Standardized approach is the same as the present application in 1988 dated arrangement but risk sensitivity is higher than it. Personal risk weights lean on the category (countries, banks or enterprises) which includes the debtor. But personal risk weights will be determined by the criteria of an international grading enterprise with the new arrangement.

Risk weights had been determined as per different categories in standardized approach;

1. Risk weights of countries (sovereign claims),
2. Two different options exist for risk weight of banks:
  - Whole banks in a country will be evaluated as one category lower than risk weight of country (Banks I).
  - Risk weights are leaned against grading notes that bank got from grading enterprises (Banks II)
3. Corporation risk weights
4. Risk weights of real-estate credits.

### **1.b. Audit of Capital Adequacy**

The purpose of control is to be sure about banks have internal methods that can determine required capital in response to valued risks in a correct way. Banks need to dispose of capital in the ratio of their risks and the supervisors are responsible about to adjust this. In case of the usage of internal methods, they could be in charge of control and intervention. Determined principles for control and audit process within new arrangement are:

1. Banks need to develop strategies that can protect their level of capital and a process that can associate their risk profile with their capital adequacy.
2. Control authority must examine, evaluate, monitor and intervene in these process and strategies.
3. Control authority must provide banks to have minimum capital adequacy.
4. Control authority must intervene in capital adequacy before it decreases under minimum rate.

In the control authority part of structure, banks are needed to be inspected by an authorized upper authority in terms of operation of activities and system. This control authority is Banking Regulation and Supervision Agency (BRSA). Risk management systems of banks are evaluated, and it is expected that each bank set an adequate risk control system in control process. In Turkey, BRSA which is establish related to control of banking system, 4389 numbered law which is made for banking risk management system, Risk Management and Audit Techniques Office can simplify to apply Basel II principles (Be inci and Kaya, 2005: 60).

### **1.c. Market Discipline**

Market discipline in new structure will be provided by lucid exhibition of banks. A lucid structure is needed in order to make market participants have more information about risk structure

and capital adequacy of banks. Together with required more particular circumstances for credit risk, techniques of decreasing credit risk and supervisory acceptance of active securitization, transparency standards are valid for all banks. It is expected that banks have to be confidential and lucid about giving information to market and concerned parties in market discipline part of system. (Ko ar, 2006: 3; Alp, 2005: 59).

## **2. Financial Markets and Basel II**

In recent years, when the economic depressions in the world are examined in detail, it is obvious that the main reason of them is deficiency of risk management model (Christoffersen and Errunza, 2000: 3-20). Basel Committee had focused on risk management on capital markets in their studies. Basel II principles are the continuance of Basel I principles. In Basel I, while capital adequacy was calculating, only credit risk had been added on calculation, market risks and operational risks hadn't been taken into consideration. As known, operational risks of enterprises which use credits from banks are important factors in return of credits. Evaluation of this risk and usage in calculation of capital adequacy is necessary for banking sector. In Basel II principles, this risk is considered in calculation of capital adequacy. The method relating to measurement of capital which is needed to be kept against risk assets had changed partially and new methods had been developed in the field of measurement of credit risk (Yüksel, 2005: 5).

Committee had studied on standard and internal grading oriented methods of credit risk measurement. In this context, the importance of usage of standard risk measurement approach had been repeated again and opinions and suggestions relating to these topics which are submitted by market participators and other concerned parties are considered. On the other hand, significant improvements are performed in the fields of securitization of assets and technical discussions relating to specialization credits and the schedule was rearranged according to this.

According to Basel II principles, not only credit risk but also market risks and operational risks should be considered in calculation of capital adequacy. Operational risk is the suffering assets of enterprises by reason of negativity that enterprises encounter in employees, systems applied and control processes (BIS, 2005a, 140).

While operational risks are being evaluated, political risks, economic risks, legal risks, market risks and financial risks must be considered (BIS, 2005b, 24-35; Wyk, Dahmer and Custy, 2004: 264). Market risks are the risks that can be revealed by viable developments in general economy or in the sector that the banks show activity. Credit risk is the nonpayment risk of the credit that is granted by the bank. In traditional, while it is easy to measure the credit and market risks, it is not easy to form the boundaries and measurement of operational risks (Rosenberg and Schuermann, 2005: 1-46).

### **POSSIBLE EFFECTS OF BASEL II PRINCIPLES TO ENTERPRISES AND NATIONAL ECONOMIES IN THE PROCESS OF TRANSITION**

Necessary preparations about applications of Basel II principles had been mainly completed by banking sector. Concerned changes will affect the financing costs, processes of financial reporting and accounting structures of enterprises and also these changes will force to be made

various changes in these areas. New capital arrangement aims at more effective risk management, more secure and more effective banking activities in conjunction with ascribing new costs to banks.

Table 2: Evaluation Associated with New Capital Arrangement of Basel Committee	
Expected Effects of New Arrangement	Costs That New Arrangement Will Cause
Capital requirement will decrease.	The cost and needing of information to public opinion will increase.
Risk management will be better.	A cost will be point at issue for the establishment of required systems and their operation.
Better relations will be developed with systematizer authority.	The cost of collecting the required data will progress.
The relation between market and credit enterprises will be better.	Required costs for operation of systems and laboring of employees will progress.
Reference: Price Waterhouse&Coopers, FS Regulatory Alert, No:1.	

### 1. Basel II In Terms of Credit Cost

Though it can vary from one enterprise to another, average cost of a small enterprise's grading is anticipated around 30.000 Euro (Uyar and Aygören, 2006: 59). And this can cause unexpected cost load for enterprises. These numbers has a probability of being high then it is expected. Because, according to a research; it is estimated that the cost of Basel II application will be higher than expected in terms of both enterprises and banks (Mearian, 2005: 48). The general effects of credits to enterprises and markets are listed below:

- The credit cost that enterprises will use will change depending on grading note with Basel II application (M s rl o lu, 2006: 30). When the grading notes keep decreasing, credit risk and the cost credit will increase and it will get hard to take credit for concerning enterprise (Yüksel, 2005: 37). Grading enterprises will decrease the grading notes of enterprises which have insufficient equity capital structure (Uyar and Aygören, 2006: 61). This means that, the credit costs of these enterprises will be higher. But the enterprises which have high grading notes will be able to provide financing at a low rate of interest (Banks Association of Turkey, 15.01.2006).
- Mortgages which are approved today will lose ground with Basel II principles. In this context, the enterprises which have high management quality, strong financing structure and ability to present required informations on time and adequate way will be able to use credit in better circumstances.
- Basel II principles will force enterprises to institutionalize. Therefore, Basel II principles can provide enterprises take interest from foreign capital movements by making it easier to find foreign partners for enterprises.



## **2. Effects of Basel II Criteria to Market Institutionalization and Accounting Systems of Enterprises**

The effects of Basel II principles to enterprises' accounting structure can exist in point of abolition the effects of tax laws in accounting applications and in point of implementation of corporate governance applications. Continuation of this process, it is expected that Basel II principles will affect the financial reporting processes of enterprises significantly. At this point, transparency of financial reporting process, independent audit, internal control system, internal audit and risk management will be more important for enterprises. It should be expected that Basel II principles will cause significant changes. In this context, the effects of Basel II principles to internal economic system and institutionalization, accounting and the other systems of enterprises are sorted below:

- Application takes on a shape predominantly within the terms of tax regulations in Turkey by reason of deficiency of basic standards which will be used in financial reporting process. Financial accounts which are focused on taxes however, receded to show the truths. Implementation of accounting standards into application is critically important for reliability and transparency of financial accounts that Basel II principles predict (Ko ar, 2006: 21).
- Corporate governance principles which are equality; equal treatment for allotters and beneficiaries in all activities, transparency; announcement of financial and qualitative informations concerning enterprise on time, accurate, definitive and consistent to public, accountability; necessity of rendering of accounts to shareholders by management, responsibility; compatibility of enterprise's all activities with regulations, main agreement and inter corporate arrangements and the control of this are accepted in Basel II principles (Yüksel, 2005, 37; Uyar and Aygören, 2006:63).
- Basel II criterions will contribute to transparency on preparation of enterprises' financial accounts. Basel II principles want grading enterprises to analyze the process of financial reporting and financial accounts. According to Basel II principles, cooperation which will be established between banks and enterprises in financial reporting process is basic condition for providing transparency (Uyar and Aygören,, 2006: 65). In this context, enterprises need to submit all of their financial informations to banks and concerned grading enterprises on time, adequate, transparent and a secure way.
- Independent audit applications will become widespread within enterprises.
- At the present day, internal control system and internal audit had became necessity. Internal audit which is imperative only for banks and stock brokers will become a property in request by Basel II principles. Thus, enterprises need to set to work directed to compose an internal audit system.
- By reason of mushroom growths in economy, enterprises need to discover new strategies in order to secure their competitive advantages. Risk management and risk-focused audit are at the head of these strategies (Kishal and Pehlivan, 2006: 76). In recent days, accounting and financial reporting scandals had added to weight to risk management department of enterprises (Beasley, Clune and Hermanson 2005: 522). However, the risks which each enterprise will be exposed can show varieties by reason of different properties of enterprises.

Thus, enterprises need to form a specific model. This risk model can be a static risk model or a dynamic risk model which came into prominence lately (Fehle and Tsyplakov, 2005: 3-47 ). Researchs about this subject showed that enterprises which has a adequate risk management system got through the negative circumstances (O'Donnell, 2005: 177-195). According to Basel II principles, grading notes of enterprises which has adequate risk managements system will be higher than the others.

## CONCLUSION

It is expected that applications of banking sector will undergo changes incoming years with Basel II principles. Basic change point is the criteria which banks looked out for while they were giving a credit. This process will affect economic systems and enterprises which provide financing from banking sector. According to evaluations which are made by Institute of International Finance upon the effects of new arrangement to global markets;

- Increase of debtor-credit quality will provide a formal credit culture.
- Improvements in trust which are related to international information resources will provide opportunities to enlargement and deepen of capital markets.
- It will give rise to increase of market discipline, transparency and competition.
- There will be fundamental transformations in customer relations and product pricing.

However, the effects of this arrangement on economic systems of developed countries will be a far cry from the effects on economic systems of developing countries. It can also produce different effects on international banks and the other banks. In this context, continuing discussions and evaluations are below;

- The most important effect of new arrangement: banks will need to review their capital position.
- On the other hand, banks will need to publish more comprehensive announcements to public opinion.
- Both systematizers and banks will need logistic and economic resources in order to apply and audit the new capital arrangement.
- It is expected that internal grading oriented approach will cause serious problems in terms of banks which doesn't show activities on the international stage.
- It is discussed that when the new capital arrangement evaluated in terms of developing countries, it will have a sufficient effects.
- Increase of capital requirements of banks is expected in the countries which will lose advantages of being a member of OECD as Turkey.
- It is the subject of criticism that many banks are not ready about human resource and data set in order to use internal grading oriented approaches in credit risk measurement in new arrangement.

- It is known that the number of grading enterprises which show activities and have adequate reliability are too low if it is assumed that the applications of banks' standard approach is presumptive.
- It is put forward that usage of governments' notes as a ceiling of grading can limit the credits on economic crisis.
- It is discussed that prescribed benefits for short term credit are relatively limited in standard approach.

In this context, the subjects that enterprises in developing economies will be affected from this process and the things due to do are listed below;

- Profitability of enterprise which has high notes will be affected in a positive direction. Because credit costs change according as grading notes that enterprises have. Mortgages such as real-estate mortgages in the process of loan contracted will lose ground. The enterprises which have a high management quality, strong financing structure and talent to present necessary informations on time and sufficiently will be able to use credits in better conditions. This means that enterprises need to focus on the activities which are aimed at raising their credit notes. So, enterprises need to strengthen their capitals, make their accounting systems transparent and locate corporate governance in their enterprises.
- Basel II principles will push family corporations to institutionalization. Because of this taking profits from movement of foreign capitals can be easier for enterprises. Thus, foreign capital inflow accelerates and economic growth can be affected in a positive direction. In this context, enterprises need to attach importance to institutionalization for their own benefits and national economy.
- Credits fewer than 1 million Euros included in retail portfolio so their risk level is low. If credits fewer than 1 million Euros separated in different banks it can gather some cost advantages. But in this point, transaction costs must be considered. Also appraisal methods that are used by banks can provide some advantages to enterprises. For this, enterprises must work with the banks that have methods for their advantages.
- Enterprises must give their financial and not financial informations to banks and related grading enterprises on time and in clear, transparent and accredited way. In a word, financial reporting process must run in transparency.
- Independent audit gives informations about reliability of financial accounts and financial reporting process. For reliability of financial accounts, enterprises should investigate by some independent sources. Also enterprises need to establish some internal and external audit systems.
- Enterprises with risk management system will have higher grading notes, so enterprises must establish a dynamic and self related risk models. Grading notes can give informations about opposite enterprise's risk degree, so grades can be used to determine operation policy. Especially in selling, buying and procurement policy it can give different options. Working with the higher grading enterprises can decrease the operation risk. With Basel II application enterprises seem to abandon the traditional ways. They must establish more professional, transparent, informative, reliable management structure and financial reporting process.

In immediate future; enterprises which have unregistered applications, stay behind the updates in the world, don't upgrade the financial structure, don't upgrade their institutional performance, has a weak internal control structure will not be able to survive. Becoming widespread of enterprises which aren't able to harmonize to this process will generally affect economic systems. This interaction will cause to appal the economic systems in some countries as well.

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# **SHORT TERM MARKET REACTION TO EARNINGS RESTATEMENTS: VALUE STOCKS VIS-À-VIS GLAMOUR STOCKS**

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## **ABSTRACT**

*The purpose of this paper is to examine short-term stock price responses to earnings restatements due to accounting irregularities of value firms vis a vis glamour firms. It was hypothesized that, Ceteris Paribus, prices of value stocks drop more than those of glamour stocks at the announcement of earnings restatements.*

*Empirical results of this study show that there are significantly negative CAR over (-1, +1) window and (-5, +5) window surrounding the announcement of earnings restatements, suggesting that market perceives earning restatements due to accounting irregularities, negatively. The short-term impact of earnings restatement announcements on stock prices seems to fade away by the day 2 after the announcement. However, the results do not show that CAR (-1, +1) vary with any value/glamour identifiers such as BM, CP, and GS, which do not support the hypothesis that value stocks have higher negative CAR than glamour stocks do with earnings restatements. This suggests that the market does not perceive earnings restatements of value firms any differently than those of glamour firms. These results are robust across different measurement of variables, testing methods, and markets (bull market and bear market).*





# THE RISKS OF INTANGIBLE ASSETS IN FINANCIAL STATEMENTS

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## ABSTRACT

*Intangible assets that take place in financial statements is an argument, which have been gone on for a long time, in an academical platform, market environment and business environment. Intangible assets can be growing items during the merging and acquisition, it can ,as well as, sometimes be created by firms oneself. They are open to speculation by different ways because of abstract items. In this paper, the potential problems and risks are argued when intangible assets take place in financial statements, and overturned about solution of this problem.*

## INTRODUCTION

They are the asset items which don't exist physically but identically used for years as tangible assets and suffer a depreciation, wear and tear. 1980's are the years which is seen as an increase in acquisitions and management takeover in EU and USA. Paying sum which is appreciated in excess of book value for purchased or taken over corporation causes hard discussions about its demonstration in financial statements. By the conditions in Turkey, the rigorously entrance of foreign capital, the privatization of various domestic corporation and even the selling of private sector companies over the book and market value are conspicuous in this point. By the bidding made in June 2007, Petkim Petrokimya A. . is being sold with a value which is four times of its market price is the most up-to-date example for this subject. In USA, Philip Morris Co. had bought Kraft Foods for 12.9 billion USD and it had announced that 11.6 billion USD is paid for intangible assets in 1988. When the difference between the book value and market price reaches impressive numbers, it has been conceived by the increase of intangible assets' values.

Higher payings for especially intangible assets in acquisitions and management takeover is recorded as "goodwill" and the redeeming of this goodwill for definite periods will cause downside potential in company profits and the results in poor financial ratios.

Large majority of corporation executives and academicians have decided that the parts associated with intangible assets shown within goodwill should exist as a different asset item in financial statements but also arguments about this subject have experienced and they still go on.

Although there have been arrangements in UK, USA and International Accounting Standards in order to enable the detachment of intangible assets from goodwill, the discussions about this topic has not come to an end. (Kaya, 2006:113)

In this paper, we will mention the discussions about taking the intangible assets into financial statements, we will focus on the logic of these discussions and in order to contribute these

discussions, we will discuss especially the risks of taking the intangible assets into financial statements.

### **RELATED TERMS**

Various terms are used in order to mention ocular and intangible affluences that are acquired by firms except tangible and financial assets. These are the concepts as intangible assets, intangibles, intellectual capital, intellectual asset. In our paper, "intangible assets" will be used as a term.

### **DISCUSSIONS**

Existing implementation allows intangible assets which is purchased from out of the company which take place in financial statements and it also enables to give place to intangible assets which are gained by the name of goodwill at the time of management take over in financial statements (Powell, 2003:797–798). But apart form this, accounting arrangements in process mainly don't allow intangible assets formed in corporation which take place in financial statements (Kaya, 2005:138 and 2006:114). The main point of the discussions is the detachment of intangible assets from goodwill and the disallowance of intangible assets formed in corporation take place into financial statements. The main reason proposed by the ones who want the adoption of every intangible assets of corporations in financial statements is that; the allegation of actual affluences of firms can't be seen by the outside quarters and the result of this increases borrowing cost and corporations are becoming easy target for management take over. In our global world, despite intangible assets as trademarks, the knowledge of employees, technological developments, marketing and distribution systems are the most important assets for the corporations which works and realize the inventions in a intense competition market, it is also denoted that these values hasn't displayed in the financial statements of corporations (Power, 2001:44).

It is not as that we can't treat to intangible assets differently from other assets, intangible assets aren't less assets than the others. In another perspective, it is clear that the rules of displaying intangible assets in financial statements must be the same as the other assets (Stolowy and Haller, 2001:8)

According to Wood (1995), the main reason of this issue is; due to accounting application in progress is focused on tangible items, cost accounting is arranged for the values of tangible assets.

Mathews and Higson (2000), highlight that the reason of disagreement about this topic is the difference expectations in financial reporting. Also Mathews and Higson denote that according to reformist perspective less information is preferred over further information and usable and concerned data is more important than high-quality data about reliability and objectivism.

Applications in some countries (Turkey is the best example of it), intangible assets can be mirrored to financial statements in case of purchasing them out of company. About the topic, government has a limited approach by the fiscalization of the difference between the cost and the selling price at the time of the sale of intangible assets. Hence, it is a necessity for corporations to mirror their intangible assets to balance sheet immediately.

Roslender (2004) underlines that displaying the intangible assets in financial statements has no sense for stock investors and he also highlights that the evaluation as per market price is

fundamental. He accents that displaying the intangible assets in financial statements is a artificial process.

Power has quoted a study which is developed by Mather and Presnell in 1991. The result of testing the specified hypotheses related to the reason of taking the intangible assets into financial statements, it is realized that a strong evidence and support which are related to transference of giving information to capital market hasn't been observed.

Another point of view is that taking intangible assets in financial statements is not adequate for the structure of process-oriented double-entry booking system. The value of intangible assets can increase or decrease without any process. Besides, the yields of intangible assets are more ambiguous than tangible assets and for that reason it is not adequate for accounting system focused on cost (Kaya, 2006:14).

So far, we touched on the discussions about taking intangible assets into financial statements. Now, mentioning the approaches about "measurement" which is the precondition of taking intangible assets into financial account will make the study more efficient.

### **MEASUREMENT OF INTANGIBLE ASSETS**

Commencing to make a study of measurement about the intangible assets that are acquired by Skandia AFS (Swedish Financial Company) and publishing the results of this study in annual reports in 1991 are the landmarks of intangible assets.

The studies of Skandia AFS have been made by Leif Edvinson and these studies have been carried on by Karl-Erik Sveiby (Kaya, 2006:14). Sveiby has denoted that the parts of corporations' market price which can't be explained by tangible assets must be explained by intangible assets and these intangible assets has been described as invisible balance sheet by Sveiby. A measurement system called "intangible asset monitor" has been developed by Sveiby and in this system intangible assets has been divided into three parts as internal structure, external structure and personal skills. According to strategic goals of corporate management, it has been denoted that these three intangible assets categories should choose the necessary indicators in order to measure the creation of value capability by four angles as growth, regeneration, efficiency and risk improvement (Sveiby, 1997:6). There are different measurement systems of intangible assets except the models developed by Edvinson and Sveiby. Among these models there are some differences about the definition, classification, measurement of intangible assets (Kaya, 2006:4 and 2006:116).

Sullivan (2000), has highlighted that intangible assets management has three source. The first one is the study which analyses the effect of intangible assets on Japanese Corporations made by Hiroyuki Itami from Japan. The second one is made by the economists who are searching for different perspectives and theories about corporations. And the third one is Karl-Erik Sveiby's study which examines the human factor dimension of intangible assets.

Sveiby (2001) has mentioned that the studies concerning the measurements of intangible assets had started in 1950's by "q model" developed by James Tobin. Sveiby has also explained that these methods are analyzed below four main heading. These are (Kaya, 2006:116);

- Direct Intellectual Capital Methods: These methods attain a financial value by allocating the intangible assets and describing each of them individually. When an intangible asset is described under separate cover, it can be evaluated by itself.

- Market Value Methods: These methods are predicated on the difference between corporations' market value and own capital in calculating the values of intangible assets.
- Asset Return : Corporate's pre-tax incomes for a specific period is divided average tangible assets and asset return which is calculated in this way is compared to industrial average.
- Scorecard Method: Various components of intangible assets are defined, various indicator and index are generated and the results of these actions are reported as chart or score card. The aim of these methods are to determine the intangible assets which provide an advantage for corporation correctly, the aim is not to obtain a financial value. This term is used by Robert S.Kaplan and David P.Norton for the first time.

According to Bontis (2002), these four criterion in terms of measurement of intangible assets should be provided;

- The information about intangible assets should be controllable and reliable. When this information is put in financial statements and footnotes, many people will use them. Because of this usage, the right information should be given.
- The cost of measurement should not be upwards of the benefit of measurement usage.
- It should help managers about strategically and tactical management. Differently from past-focused traditional accounting, the measurement of intangible assets should give forward-looking information and help corporate managers about policy making.
- It should generate the information needed by shareholders.

Not only corporations' but also areas, countries and nations' intangible assets are measured. In a broader sense, intangible assets are the assets which are on process, provide advantage relatively on itself and have an opportunity to provide benefits in future. In 2005, a study realized in 15 countries which are member of European Union has measured human resources, educational level of public, technology usage level, structural sources, patents owned by countries, software, databases, and relational sources in order to provide a competitive and attractive environment. 15 European Union Members' intangible assets are evaluated comparatively in this study and it is confirmed that Scandinavian countries has sticked out (Andriessen and Stam, 2005). Such like studies has been introduced in 2003 for 10 Arabian Countries by Nick Bontis and in 1999 for Israel by Edna Pasher and Yogesh Malhorta. Various methods have been developed for various purposes intended for the measurements of intangible assets but it is not possible to mention about the existence of a generally accepted method.

Besides, including subjective assumptions and evaluations reduces the reliability of these methods.

## **THE RISK OF TAKING INTANGIBLE ASSETS INTO FINANCIAL STATEMENTS**

In many studies, taking the intangible assets into the financial statements by appreciating is necessary in order to administrate the corporation better and these ideas are sloganized as "If you don't measure, you can't administrate" (Roslender, 2004). However, it is denoted that this method of approach can be misleading and inclinations to manipulate the values of intangible assets of

corporate managements are hyper (Sveiby, 2001). Sveiby demonstrates Shell's misleading announcements related to oil and gas reserves. At the end of 1990's, Shell has aimed to increase the oil and gas reserves and engaged to award a prize in case of increasing the reserves. After this progress, between the years 1998 and 2003 the continuous growth of Shell has been declared, but early in 2004 Shell Corporation Management has explained that corporation's reserves are exaggerated for 23% and it has continued for five years. Sveiby specifies that subjective evaluations are needed to estimate the reserves. Also, while applications can be applied even in physical sources, the situation of intangible assets can be worse than it is (Kaya, 2006).

The example of Nokia Corporation is very important about the risk of reflecting the intangible assets to financial statements by measuring their values (Sveiby, 2001). Position at the end of 1999, Nokia's total assets in financial statements are 11 billion USD, liabilities are 5.3 billion USD and the residual costs are 5.7 billion USD. As of 2000 Nokia's market value is 190 billion USD. The difference between market value and book value of corporation is 183 billion USD and this difference results from intangible assets. In case of the display of these intangible assets on the financial statements, it will be needed to additional 183 billion USD on corporation's assets. Approximately after 1 year market value of Nokia has decreased to 97 billion USD. In this situation, if the way has been given to intangible assets in financial statements previous year, the depreciation of intangible assets that are displayed would cause to lose money of corporation about 86 billion USD. In that case, the expectation of Nokia's crashing hasn't come true. Contrarily, Nokia has continued to strengthen its leadership on market. But taking intangible assets into financial statements so as to show corporations' financial positions better, especially in the case of exaggerated measurement and evaluation, it is inevitable that mislead the investors (Kaya, 2006).

Rolls-Royce Company is another interesting example about the risks of taking the intangible assets into the financial statements. In 1960's because of R&D expenditures Rolls-Royce Company couldn't make profit. In order to show a profit, in 1967 Rolls-Royce has showed R&D expenditures in the assets. Share of profit and payment of takes are paid from the profit which is raised after this process has caused to go into debt. Transference of more sources to R&D applications has caused a perception on advancers that corporation could not secure profits and Rolls-Royce has felt the financial issues seriously.

According to Andriess, it is impossible to supply the deficiency between book value and market value in consequence of taking the intangible assets into financial statements. While the book value displays the sum of non-qualifying cost values of corporation's assets, market value is the values which are perceived cash flows by investors that will be gained in future. Also Tollington has highlighted that the presentation of a financial account which is full of future economic use for investors is insignificant.

## **CONCLUSION**

Decreasing the limitations of taking intangible assets into financial statements causes intensive discussions. Taking intangible assets into financial statements is defended. The main reason of the defenders of this opinion is that not taking intangible assets into financial statements causes to ignore significant affluences of corporations. It is highlighted that in case of not displaying this state on financial statements cause inventors to be informed insufficient.

But since subjective factors came into play and there is a lack of generally accepted criteria at the measurement and evaluation of these intangible assets, this value can be manipulated easily. Subjective evaluation and measurement will cause giving ill information to investors that is a more significant problem than giving short information. By examining this context, at the time of making changes and arrangement about this subject in the accounting and finance systems, it will be useful to take matters explained here into consideration.

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