



Proceedings of the 2008 Annual Meeting

Mid-Atlantic Region

American Accounting Association

April 24-26, 2008

Hyatt Regency Penn's Landing Hotel

Philadelphia, PA

Hosted by: The Steering Committee of the Mid-Atlantic Region

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1. Introduction

Earnings have a very important role in management-controlled firms. It can be used to predict future cash flows so that investors can put a value on the firm (the informativeness role of accounting). This role is especially important when firms raise funds in seasoned equity offerings (SEO), because the history of earnings up to the SEO event provides a clue on the firm's type: poor or strong. Firms with poor performance use the inflow of funds to survive through the injection of new capital. Strong performers also finance the expansion of operations and growth. At the same time, SEO firms takes place after a long process that involves underwriters, analysts, auditors, and organization changes. This gives insiders the opportunity to present earnings and earnings trend that appeal to investors; that is, firms can manage earnings. Indeed, the earnings management literature has established that firms tend to inflate earnings before SEO (Teoh, Welch, and Wong (1998)), which allows them to boost the price.

If the market could separate strong from poor performers, the earnings signal would have been credible and the market would not discount the earnings signal. Unfortunately, the earnings management strategy of both good and poor performers is the same. Strong performers have incentives to inflate earnings to boost the market price. Borrowing reported earnings from future periods is unlikely to hurt their reported earnings as the future actual performance is expected to be sufficient. Poor performers have incentives to manage earnings upwards too in order to pool with strong performers and hide poor performance. Given that investors cannot distinguish between these types, the market price can discount the earnings of a strong performer too much and the earnings of a poor performer too little. This, in turn, provides insiders with opportunity to engage in profitable insider trading. At the same time, the insider trading is a signal that allows the market to improve the assessment of the firm since earnings management obscures the truth. In this study, we examine earnings management and insider trading for firms that conduct SEOs. We pose the following research questions:

- Does earnings management around SEOs still exist?
- How does the market react to the pattern of earnings management and insider trading around SEOs.

The first question is motivated by the fact that earlier works employed the Jones model to calculate abnormal, managed accruals. This model has been under criticism (Dechow, Sloan, and Sweeney (1995), Dechow and Skinner (2000); Kothari, Leone, and Wasley (2005); and others) for being misspecified because, for example, the relationship between accruals and performance is not linear. In this study, we therefore use the Kothari, Leone, and Wasley's methodology. We are also motivated by the fact that prior research established that firms manage earnings upwards, reporting thus inflated results ((Teoh, Welch, and Wong (1998); Rangan (1998); Shivakumar (2000); Marquardt and

Wiedman (2004); and Kim and Park, 2005)).¹ Prior studies concluded that earnings management is pernicious because of the association between earnings management before SEOs and the post issue underperformance (Teoh et al (1998), and Rangan (1998)). If the market has become more suave and attempts to undo earnings management, it may well be the case that firms no longer have incentives to engage in this practice.

The motivation for the second question follows from the insider trading literature that established that insider trading is a signal of superior insiders' private knowledge (e.g. Seyhun (1986, 2000)). Earnings management may reduce the quality of earnings as a value-relevant signal. The insiders' trading can thus have incremental informational value. The market is unlikely to observe the earnings management attempt or may fail to interpret it correctly (for example, the market cannot distinguish between strong performers signaling value and weak performers trying to hide the bitter truth). So, even if the market's discount of the earnings management may be correct on average, it may be too low for some firms and too high for others (Kim and Park (2005)). The party that knows whether the discount reflects firm's earnings management is the insiders, who can then trade on the discount. In this case, these insiders have incentives to purchase shares at a deflated price.

If earnings management is pernicious and the market is naive, insiders will attempt to sell shares at an inflated price to make monetary gains. If earnings management is neutral, insiders trade for liquidity reasons and to escape allegations by the SEC for insider trading by adopting a trading program. That is, the pattern of insider trading is random. If earnings management signals strong performance, insiders will purchase shares. Importantly, observe that the market's response to earnings management alone does not allow us to distinguish between the types and settle the literature's mixed results. The market's response to earnings management and insider trading does (when insiders respond to earnings management).

We study a sample of 2,783 firms that conducted SEO in the 1987-2005 period, which are neither regulated industries nor financial institutions. Our findings are as follows: We first replicate the test of Teoh et al. using a current version of earnings management model. The new tests reveal that median net income peaks at the SEO year and then declines. When we replicate the Teoh et al. methodology, we find a different pattern for net income and cash flows. Still discretionary current accruals are higher before the SEO year than afterwards.

An examination of insider trading shows that most firms with insider trading fall into one of two categories: their insiders either sell or purchase shares in each year, before, during, and after the SEO. Firms whose insiders belong to the "high sell" group manipulate earnings upward (downward) in the year of (before) the SEO and the year after. This pattern is consistent with firms manipulating earnings to increase the SEO issuance price. In contrast, firms whose insiders purchase in the year before the SEO, deflate income in each year (-1,0,1). The latter finding is surprising because firms that deflate earnings are likely to have a lower issuance's proceedings.

¹ For international evidence on earnings management at SEO, consult Yoon and Miller (2002), who find evidence on earnings management by 249 Korean seasoned equity offering (SEO) firms during the period 1995-1997.

This study has several contributions; it contributes to the literature on earnings management around SEO literature in that we identify firms that manage earnings downwards before the SEO in order to hoard reported earnings for future periods. The study shows insider trading is a valuable signal that distinguishes between firms that boost earnings too much and others. It establishes the scope of phenomenon of weak firms mimicking strong firms does not exist when insider trading volume is high. Furthermore, this study contributes to the literature that examines insider trading with other signals.

This study proceeds as follows; Section 2 presents hypotheses developments. Section 3 presents sample selection and procedures, section 4 presents the methodology, section 5 presents results, section 6 conclusions and future studies.

2. Hypotheses Development

2.1. Earnings management and SEOs

Since earnings provide a signal to investors that affect the issuance price (see e.g., (Kim and Park (2005))), firms have incentives to inflate earnings in order to increase the price. This dynamics implies that firms have incentives to hoard reported earnings before the event, present high earnings in the event year and then report low earnings after the SEO event as a result of reversal of accruals or report high earnings if, for example they are concerned with costly litigation.

The publication of scholarly studies might affect the behavior of firms and the market thereafter. For example, after the publicizing of Jaffe's (1974) study on insider trading, the abnormal returns from trading on this phenomenon were reduced significantly. Furthermore, the economic environment in late 1990 and at the start of this century may not be conducive to earnings management.

The nineties were a period with a boom in SEOs. That time was also characterized by bullish market and investors' optimism. In euphoric markets, investors do not pay much attention to earnings Coffee (2003). Another difference is that following the burst of the bubble in 2000, regulation FD in 2000, that changed the information available publicly, the accounting scandals of Enron in 2001 and WorldCom in 2002, and the Sarbanes-Oxley Act of 2003 (SOX), there is a change in information asymmetry between firms and the market and a change in the attitude towards earnings management. (Cohen, Dey, and Lys (2005a)), for example found that earnings management increased in the 20th century and declined after the enactment of the SOX. Given that the volume of SEO has not declined in the 21st century, it may well be the case that earnings management around SEO has been mitigated. Hence, we first examine whether earnings management still takes place. This leads to our first hypothesis.

H1: Firms that raise capital in SEO manage earnings upwards before the SEO event

A related hypothesis concerns the pattern of reported earnings of SEO firms before and after the event year. A higher offer price benefits the issuer in that it results in more cash proceeds; (Kim and Park (2005)). Kim and Park also find that firms that make opportunistic accounting decisions (earnings manipulation) also issue shares at inflated

prices. They refer to this phenomenon as the issuers' greed hypothesis. However, such firms cannot continue to manipulate earnings upwards forever, because in the long run, earnings do not exceed cash flows. They will have to reverse this trend. Specifically such firms are likely to reverse their upward earnings manipulation after the SEO year. This results in earnings peaking in the SEO year and then declining.

In the Introduction, we discussed that some firms are strong performers who raise capital to finance growth. Such firms are likely to show a trend of increasing earnings, and even if they manage earnings, they are likely to prefer to exhibit smooth growing trend of accounting performance. The dynamics of timing of reporting performance lends the following hypothesis.

H2: Reported earnings peaks at the SEO year.

2.2. The market's response

The interest in earnings management in SEOs has been motivated by an attempt to explain the underperformance of SEOs firms. Loughran and Ritter (1995) examined companies that issued stock during the 1970-1990 periods. They found that investors obtained only 7% return from SEOs. If investors had instead of investing in these issuers, invested the same amount in a non-issuing firm which was equal in size they would have earned returns of 15% per year. Loughran and Ritter showed that firms involved in SEOs exhibit high financial performance in the year before the offering as compared to the year of the offering. We expect to find an association between managed earnings and market's response. If earnings management is pernicious in that it obscures the true performance of the firm, the market cannot distinguish between a dollar of true performance and a dollar of managed earnings. In general since the market is semi-strong Fama (1980), we expect that earnings provide (noisy) information to the market regarding performance and regarding how much to discount the report. In the year of the SEO and the following year, firms may be subject to scrutiny by their investors so there is pressure to perform well in both year 0 and year 1. If earnings management is neutral, the market forms precise expectations on the degree of managed earnings. In this case, firms manage earnings because of a 'signal jamming dynamic' where firms that fail to manage earnings are penalized by the market and are then underpriced (Kim and Park (2005)).² Rangan (1998) provides evidence that support this hypothesis.

Finally, if firms manage earnings to signal strong performance, stronger signal will elicit stronger reaction from the market. We summarize this discussion with the following hypothesis.

H3: The cumulative abnormal returns around SEOs are positively affected by earnings management.

2.3 Earnings management and Insider Trading

The SEO provides a unique setting to examine the behavior of insiders because as discussed in the Introduction, insiders have superior information over investors. The SEO setting provides them with an opportunity to engage in profitable trading because they

² Example: suppose that the market expects firms to inflate earnings by 20%. A firm that earns 120 then has no reason not to report 144. Because if for example, it reported the truth, the market will evaluate it as if its true earnings are 100.

alone know what the firm will truly do with the proceeds of the offering and they alone know if the firm managed earnings. The average investor may react neutrally to offerings when managers' incentives are tied to shareholders. They would however react negatively to SEOs when there is insufficient managerial stakes to deter the misuse of SEO proceeds, (Kim and Purnanandam (2006)).

Prior research has found insiders to be contrarian. For instance, insiders are more likely to sell (purchase) shares following periods of price appreciation (declines) in anticipation of subsequent price reversals; Seyhun (1992). Also insiders have been said to be contrarian because they have been found to sell when performance is strong while other investors buy and buy when performance is poor while other investors sell, Jenter (2005), Sawicki (2005), Lakonishok and Lee, (2001), and others. Given that insiders have the correct expectations on firm's value, this strategy earns them abnormal returns, (Seyhun (1982) and others)³ Contrarian behavior leads to insiders exploiting mispricing, (Rozeff and Zaman (1998)). Piotroski and Roulstone (2005) also show that insider trades are linked to future outcomes of earnings and returns. Again this implies that insider's trade on superior knowledge and mispricing. Insider trades therefore create an incentive to inflate or depress reported earnings. This discussion lends my next hypothesis.

H4: Insider trading before the SEO year is consistent with contrarian trading behavior; insiders of firms that manipulate income downwards in the years before the SEO will sell shares while insiders of firms who manipulate income upwards in the year before the SEO will buy shares.

Market performance is influenced by many factors. Not only does earnings management affect stock prices or returns as discussed in the prior section but also insider trading activities may influence market performance. Earnings management and insider trading are more prevalent when stock prices are high due to high past returns; (Kadan, Ohad and Yang (2006)). Also insiders sell their stockholdings at inflated prices as a motive for earnings manipulation, (Agrawal, Anup and Cooper (2007)). Managers also tend to inflate earnings before selling stock. During the market bubble's last years, stocks of firms which insiders sold the most, rose higher than stocks which insiders sold the least; (Huddart, Louis (2006)). (Beneish and Vargus (2002)) conclude that managers trading activities can be used ex-ante to determine earnings management and accrual quality. They find that insiders' sales are significantly higher than insiders' buy when the accruals in the year ahead are income increasing. Park and Park (2004) predict and find that managers manipulate discretionary accruals to increase earnings in current period before selling in next period. It is also known that insiders have superior information. For instance, according to (Chemmanur, and Jiao (2007)) firm insiders are able to partially assess potential SEO demand for their equity from the pre-offer market price. Given that

³ In this study, we focus on the reaction of insiders to earnings management around SEO event. There is evidence that some insiders react to the SEO event itself. Gerard and Nanda (1993) show that there is manipulative informed trading around SEOs. For instance, institutional investors sell shares of the offering before the SEO even though they have favorable information about the SEO firms. They do this to conceal the positive information they possess. These trading strategies are however profitable only if these investors can recoup their losses by obtaining share allocations at reduced prices.

the market is aware of the superior information of insiders⁴, we also study the following hypothesis.

H5: Cumulative abnormal returns are associated with insider trading around SEOs

3. Sample selection and procedures

The initial sample contains 10,787 firms issuing seasoned equity offerings between 1985 to 2005, from the Thomson SDC Platinum new issues database. The cut-off of 1985 coincides with calculating accruals from the statement of cash flows. We deleted all SEOs made up of financial institutions (SIC codes 6000-6999), regulated industries (SIC codes 4000-4999) and firms which do not have sufficient data on Compustat, resulting in a sample of 2,783 firms. For each SEO, we identified all non-issuing firms sharing the same three-digit SIC code as the issuing firm in the year prior to the SEO.⁵ Tables 1 and 2 show the sample selection criteria and the distribution of SEOs by the year of issue, respectively.

Table 1: Sample Selection

Sample	Number of firms
Total SEO firms	10,787
SEO firms less financial institutions and regulated industries *	10,752
SEO firms on Compustat	2,783

* financial institutions (SIC 6000-6999); regulated industries (SIC 4000-4999)

From the initial sample of firms issuing seasoned equity offerings from 1985 to 2005, We delete firstly SEOs made up of financial institutions (SIC codes 6000-6999). Secondly, regulated industries (SIC codes 4000-4999) and thirdly firms which do not have sufficient data on Compustat, resulting in a sample of 2783 firms.

Table 2 presents the distribution of sample firms across years. The minimum number is 10 firms and the maximum is 250 in 2003. As this table illustrates, the 1990s are characterized by three-digit SEOs firms: the minimum is 138 in 1991, and the highest volumes occur in 1993 (202), 1996 (247), and 1997 (218).

Table 2

Time Distribution

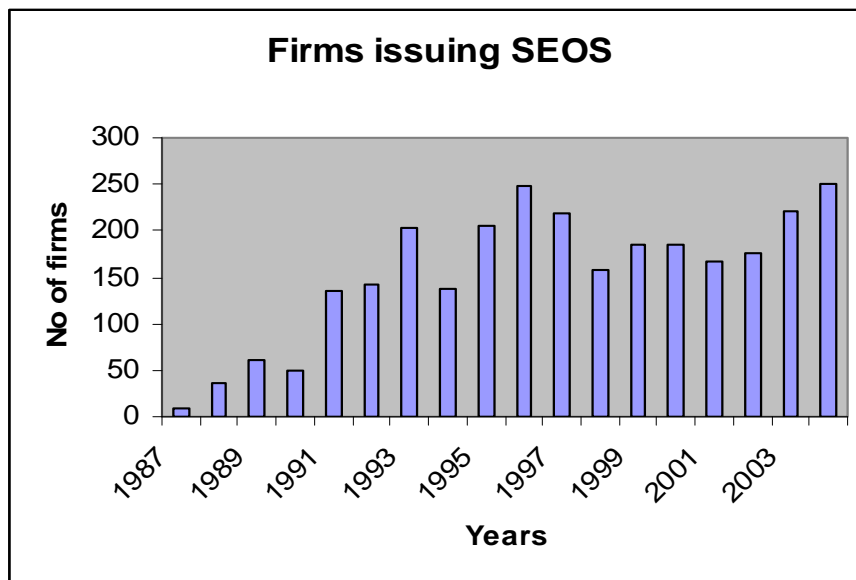
⁴ In this study, we focus on the earnings management aspect of the information asymmetry between the SEO firm and the market. The finance literature brought to the fore that even without earnings management, the market may be suspicious of the firm. Insiders have superior information than outside investors about the firm value. Insiders therefore choose to issue equity when their firms are overvalued; this is known as the lemon problem; Myers and Majluf (1984), Baker and Wurgler (2000).

⁵ While many prior studies match on 2 digit SIC codes (e.g. Teoh et. al, 1998), this methodology results in SEO firms being matched with firms in widely varying industries. Using 4 digit SIC codes provides a closer match, but shrinks the sample size considerably. We therefore employ 3 digit SIC codes as a compromise between increased accuracy and sample size.

Year	Frequency	Percent	cum freq	Cum %
1987	10	0.36	10	0.36
1988	36	1.29	46	1.65
1989	60	2.16	106	3.81
1990	49	1.76	155	5.57
1991	136	4.89	291	10.46
1992	141	5.07	432	15.52
1993	202	7.26	634	22.78
1994	138	4.96	772	27.74
1995	206	7.4	978	35.14
1996	247	8.88	1225	44.02
1997	218	7.83	1443	51.85
1998	157	5.64	1600	57.49
1999	186	6.68	1786	64.18
2000	184	6.61	1970	70.79
2001	167	6.00	2137	76.79
2002	176	6.32	2313	83.11
2003	220	7.91	2533	91.02
2004	250	8.98	2783	100

To examine whether there is a pattern of SEOs over time, we present Figure 1. Figure 1 shows the frequency distribution of the firms issuing SEOs. Figure 1 clearly shows that there are cycles between 1987-1993, 1994-1999 and 2000-2005.

Figure 1



We next present statistics of the main variables. Table 3 shows the total asset, book and market value of the firms offering SEOs. Mean (median) total assets, market

value, book value and sales of firms engaging in SEOs were \$2,408.42 (313.74), 20.79 (5.19), 665.77 (163.63) and 1496.20 (223.57) million respectively.

Table 3: Characteristics of seasoned equity Offering

Size of SEO	Mean	Median	Std. Dev
Total Assets (millions)	2408.422	313.738	11450
Market Value (millions)	20.794	5.198	90.670
Book Value (millions)	665.775	163.633	1861
Sales (millions)	1496.20	223.569	6832

4. Methodology

4.1 Earnings management

We measure the extent of earnings management using the cross-sectional variant of Jones (1990) methodology developed in Teoh, Welch, and Wong, (1998) and Kothari, Leone, and Wasley (2005). These approaches separate accruals into two components; normal, or non-discretionary, accruals that results as a natural consequence of business structure and operations common to the industry (i.e. credit policy, business conditions, etc...) and abnormal, or discretionary, accruals that arise from earnings management. Managers seem to have more discretion on the discretionary current portion of accruals. We identify abnormal accruals (my proxy for earnings management) using a two-step process.

Following Hribar and Collins (2002) we define Total Accruals as Net Income minus Cash flow from operations (Compustat item # 172 - 308).

$$\text{Total Accruals} = \text{Net Income (\#172)} - \text{Cash flow from operations (\#308)} \quad (1a)$$

We define CA, or Current Accruals as:

$$\text{Current Accruals} = \text{Total Accruals} + \text{Depreciation expense (\#196)} + \text{loss/gain on Sale of Property Plant and Equipment (\#213)}. \quad (1b)$$

We decompose current accruals into its discretionary and non-discretionary components in a two-stage procedure as follows. In the first stage we regress accruals on a model that links normal accruals to change in cash (Sales change less change in accounts receivables) and to lagged return on assets (proposed by Kothari et al. to account for the non-linear relationship between accruals and performance). To alleviate

heteroscedasticity, we scale all variables by lagged total assets (Compustat item #6) A_{t-1} , thereby yielding the following no-intercept regression:

$$\frac{CA_t}{A_{t-1}} = \hat{\beta}_0 \frac{1}{A_{t-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it} - \Delta AR}{A_{t-1}} + \hat{\beta}_2 \frac{ROA_{t-1}}{A_{t-1}} + \varepsilon_t \quad (2)$$

For each SEO firm, we estimate the regression in equation (2) using all non-SEO firms in the same 3-digit SIC code as the SEO firm in the year prior to the announcement of the SEO. In the second stage of the estimation, we use the coefficients from the regression in equation (2) to calculate discretionary current accruals (DCA) as follows:

$$\frac{DCA_{it}}{A_{i,t-1}} = \frac{CA_{it}}{A_{i,t-1}} - \left[\hat{\beta}_0 \frac{1}{A_{t-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it} - \Delta AR}{A_{t-1}} + \hat{\beta}_2 \frac{ROA_{t-1}}{A_{t-1}} \right] \quad (3)$$

In equation (3), discretionary current accruals deflated by lagged total assets (henceforth referred to as DCA) is defined as the difference between total current accruals and “non-discretionary” or “normal” accruals (the bracketed term on the right hand side of the equation). It represents the “abnormal” or managed component of current accruals and is used as our proxy for earnings management.

We follow a similar procedure in calculating discretionary (i.e. abnormal) long-term accruals. We first define Total Accruals (TA) as net income before extraordinary items and discontinued operations less cash flow from operating activities (i.e. Compustat items #123 - #308). We then estimate the following regression for total accruals (the additional regressor, *PPE* is defined as property, plant, and equipment).

$$\frac{TA_{it}}{A_{i,t-1}} = \hat{\beta}_0 \frac{1}{A_{t-1}} + \hat{\beta}_1 \frac{\Delta Sales_{it} - \Delta AR}{A_{t-1}} + \hat{\beta}_2 \frac{PPE_t}{A_{t-1}} + \hat{\beta}_3 \frac{ROA_{t-1}}{A_{t-1}} + \varepsilon_t \quad (4)$$

As in the estimation of discretionary current accruals, we then use the coefficients from regression (4) to calculate Discretionary Total Accruals as

$$\frac{DTA_t}{A_{t-1}} = \frac{TA_t}{A_{t-1}} - \left[\hat{\beta}_0 \frac{1}{A_{t-1}} + \hat{\beta}_1 \frac{\Delta Sales_t - \Delta AR}{A_{t-1}} + \hat{\beta}_2 \frac{PPE_t}{A_{t-1}} + \hat{\beta}_3 \frac{ROA_{t-1}}{A_{t-1}} \right] \quad (5)$$

Finally, we define Discretionary Long-term Accruals (henceforth DLA) as the difference between discretionary Total Accruals and Discretionary Current Accruals:

$$\frac{DLA_t}{A_{t-1}} = \frac{DTA_t}{A_{t-1}} - \frac{DCA_t}{A_{t-1}} \quad (6)$$

4.2 Post-SEO performance

We measure post-SEO performance using three Net Income-based metrics. In the first instance (henceforth NI1), we calculate annual Net Income scaled by lagged total assets. However, this measure may be biased by unobserved industry-specific differences. Hence, we also calculate industry-adjusted Net Income (henceforth NI2) as

the difference between the SEO firms's annual asset-scaled Net Income and the industry-median asset-scaled Net Income. While this measure captures industry effects, it does not control for time-varying patterns such as mean reversion in Net Incomes. Therefore, we also calculate performance-matched Net Income (henceforth NI3) as the difference between the SEO firms's asset-scaled Net Income and the asset-scaled Net Income of the firm with the closest asset-scaled Net Income in the year prior to the SEO. We match issuers by non-issuers in the same SIC code by the criterion of total assets. We look for the firms which have the closest absolute total assets within that year. We then use the same three methods to calculate cash flow. To take care of outliers, we winsorize at the 2.5 percentile.

We measure the financial performance of firms conducting SEOs by abnormal returns. We follow the market model where Return, is defined as follows.

$$R_{jt} = \alpha_j + \beta_j R_{mt} + \varepsilon_{jt} \quad (7)$$

R_{jt} is defined as the return of the common stock for the jth firm on day t. R_{mt} is the return of the market index on day t. ε_{jt} is random variable that is not correlated with R_{mt} and also has expected value of 0. It is not autocorelated and homoskedastic. β_j measures the sensitivity of the return to the market index.

Abnormal return is defined as

$$AR_{jt} = R_{jt} - (\hat{\alpha}_j + \hat{\beta}_j R_{mt}) \quad (8)$$

Where $\hat{\alpha}_j$ and $\hat{\beta}_j$ are ordinary least square estimates of α_j and β_j . Over a period of trading days beginning with T_1 and ending with T_2 , the cumulative average abnormal return is

$$CAR_{T_1 T_2} = 1/N \sum_{j=1}^N \sum_{t=T_1}^{T_2} AR_{jt} \quad (9)$$

To determine if there is an association between abnormal returns and insider trading and discretionary accruals we run the following regression model.

$$CAR = \alpha_0 + \alpha_1 IPR + \alpha_2 DTA + \varepsilon \quad (10)$$

Where CAR is the cumulative abnormal return, IPR is the insider purchase ratio and DTA is discretionary accruals.

4.3 Insider trading

Shareholdings of Insiders

We obtain data from the Thompson Financial (TFN insider Filing Data), which contains information on all publicly traded U.S. companies. We use their insider trading definition and define corporate insiders broadly to include those that have “access to non-public, material, insider information.” These insiders are required to file SEC forms 3, 4 and 5 when they trade in their company stocks. To analyze the pattern of insider trading of issuers of seasoned equity offerings, we adopt the insider purchase ratio used by Piotroski and Roulstone, (2005) and Sawicki, (2005) that measures insider trading behavior. We calculate the insider purchase ratio (IPR) as follows;

$$IPR_t = \frac{BUY_t}{BUY_t + SELL_t} \quad (11)$$

Where BUY_t and $SELL_t$ are (respectively) the number of shares purchased (sold) in open market transactions by registered insiders of a firm during a given fiscal year relative to the year in which the SEO occurs. We divide the sample into quintiles based on the level of IPR_t , and examine the relative levels of abnormal accruals across groups.

5. RESULTS

5.1. Performance Around SEOs

Since net income is made up of accruals and cash flow from operations; we try to determine which component of net income is responsible for its overall performance. Accruals can be classified into current adjustments involving short-term assets and liabilities such as advancing revenue recognition (credit sales) and delaying expense recognition. Long term accruals are adjustments such as depreciation, and loss/gain on disposal of assets. The proxy for earnings management is discretionary total accruals, which is made up of the discretionary current and discretionary long term component. However managers seem to have greater discretion over current than long term accruals (Guenther (1994)). So following Teoh et al (1998), we try to analyze the relationship between that component of discretionary total accruals; discretionary current accruals that influences net income the most, and also cash flow from operations.

Table 4 presents the patterns of NI1, NI2, and NI3 for the seven year window around the SEO year. As in prior studies, we find that median Net Income (NI1) (“raw” or unadjusted Net Income) increases prior to the SEO and decreases thereafter. However mean NI1 does not follow this pattern. It increases from 0.073 in year -2, to 0.088 in year 0 and then increases slightly in year 1 and increases up to 0.166 in year 3. Median NI2 also shows fluctuations, but peaks at 0.009 in year -1 declines slightly in year 0, increases from year 0 to year 2 and declines in year 3. Mean NI2 increases from year -2 to 0.126 in year 0, declines in year1 and increases to 0.184 in year 3. Mean NI3 increases to year 0 and increases thereafter. Median NI3 declines from year -3 to year 0 and then improves to 0 in year 3. The zeros may be explained by the assumptions behind the matching procedure. The basic assumption of the matching procedure is that the matched firm is identical to the SEO firm.

TABLE 4: Net income performance

Year	-3	-2	-1	0	1	2	3
NI1: raw or unadjusted net income							
Median	0.016a	0.017a	0.022a	0.027a	0.026a	0.019a	0.019a
Mean	0.133a	0.073a	0.074a	0.088a	0.090a	0.114a	0.166a
N	2037	2384	2782	2779	2488	2270	2054
NI 2: industry-adjusted Net Income							
Median	0.007a	0.003a	0.009a	0.006a	0.008a	0.008a	0.006a
Mean	0.215a	0.117a	0.125a	0.126a	0.122a	0.166a	0.184a
N	2037	2384	2782	2779	2488	2270	2054
NI 3: performance matched Net Income							
Median	0a	0	-0.003	-0.006	-.001a	0.001a	0
Mean	-3.877	4.565	-0.061	0.385	0.432	0.227c	1.556
N	2037	2384	2782	2779	2488	2270	2054

a represents statistical significance level 1% for t-tests for means and wilcoxin p-value for median.

b represents statistical significance level 5% for t-tests for means and wilcoxin p-value for median.

c represents statistical significance level 10% for t-tests for means and wilcoxin p-value for median.

Similar to prior studies we try to find out what causes net income to behave in such pattern. We therefore analyze its components, which are cash flow from operations and accruals. Table 5 shows the performance of cash flow from operations. We find that median CF1 increases from year -3 to year -1 and declines to 0.050 in year 0 and begins to increase again to 0.067. Mean CF1 and CF2 decreases from year -3 and declines to 0.261, 0.233 in year 0 and increases from year 1 to year 3. Mean CF3 also behaves in similar patterns, however median CF3 is erratic.

Table 5: Cash Flow from operations

Year	-3	-2	-1	0	1	2	3
CF1: raw or unadjusted cash flow							
Median	0.045a	0.046a	0.051a	0.050a	0.054a	0.061a	0.067a
Mean	0.476a	0.393a	0.353a	0.261a	0.332a	0.396a	0.472a
N	2037	2384	2782	2779	2488	2270	2054
CF2: industry-adjusted cash flow							
Median	0.017a	0.011a	0.015a	0.00495a	-0.563a	0.0167a	0.01a
Mean	0.475a	0.378a	0.316a	0.233a	0.291a	0.352a	0.413a
N	2037	2384	2782	2779	2488	2270	2054
CF3: performance-matched cash flow							
Median	0.002a	0.001a	-0.001a	-0.004b	0.001a	0.005a	0.0003a

Mean	0.591a	0.336a	0.258a	0.155a	0.291a	0.396a	0.497a
N	2037	2384	2782	2779	2488	2270	2054

a represents statistical significance level 1% for t-tests for means and wilcoxin p-value for median.

b represents statistical significance level 5% for t-tests for means and wilcoxin p-value for median.

c represents statistical significance level 10% for t-tests for means and wilcoxin p-value for median.

To determine which of the four components of accruals is primarily responsible for the profile of net income. We segregate accruals into discretionary total accrual (which is the proxy for earnings management, panel A, and nondiscretionary total accrual, panel b). Following Teoh (1998), we further segregate discretionary and nondiscretionary total accruals into their current and long term portions to determine which portion is responsible for the net income performance.

Table 6 segregates accruals into its components. Median discretionary accruals increases from year -3 to year -1 then declines from year 0 to year 1 and begins to increase again. Mean DCA fluctuates, however, apart from the year before the SEO, it is generally higher in the prior SEO years than the years after the SEO. The pattern of DCA follows net income and the results support Teoh et al who find earnings management around SEOs. Mean and median discretionary long term accruals are generally negative; however they are smaller in the years before the SEO than after the SEO years. This pattern does not follow net income. Of the two components of DTA, DCA seems to follow a similar path as net income.

Median non discretionary current accruals remain the same in the years before and after the SEO and increases slightly at the year 0. Mean non discretionary current accruals, and mean non discretionary long term accruals yield erratic results and do not follow the same pattern of net income.

Table 6: Accruals							
Year	-3	-2	-1	0	1	2	3
Panel A : Discretionary Total Accruals							
DCA : Discretionary Current Accruals							
Median	0.025a	0.029a	0.094	0.025a	0.013a	0.015a	0.014a
Mean	0.399a	0.400a	0.021a	0.071	0.135a	0.117a	0.136a
N	1579	1811	2029	2193	2039	1853	1664
DLA: Discretionary Long Term Accruals							
Median	-0.034a	-0.033a	-0.029a	-0.023a	-0.067a	-0.015a	-0.019a
Mean	-0.450a	-0.212	-0.243a	-0.153a	-0.099a	-0.108a	-0.164a
N	1579	1811	2029	2193	2039	1853	1664
Panel B : Non- Discretionary Accruals							

		NDCA: Non- Discretionary Current Accruals					
Median	0.001a	0.001a	0.001a	0.002a	0.001	0.001a	0.001a
Mean	0.050c	-0.307	0.072	0.114b	0.025c	0.074	0.001
N	1579	1811	2029	2193	2039	1853	1664
		NDLA :Non- Discretionary Long Term Accruals					
Median	-0.007a	-0.008a	-0.010a	-0.006b	-0.047a	-0.005a	-0.004a
Mean	-0.222a	-0.354c	-0.209a	-0.111c	-0.102a	-0.537	-0.065b
N	1579	1811	2029	2193	2039	1853	1664

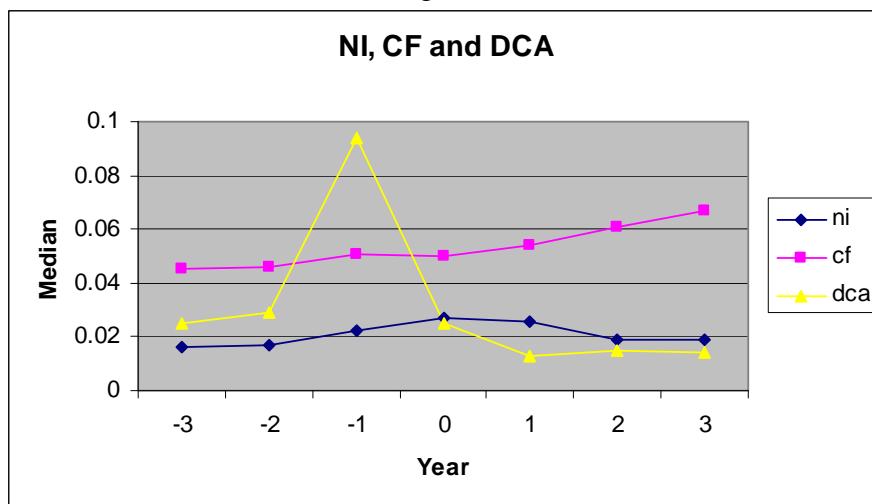
a represents statistical significance level 1% for t-tests for means and wilcosin p-value for median.

b represents statistical significance level 5% for t-tests for means and wilcosin p-value for median.

c represents statistical significance level 10% for t-tests for means and wilcosin p-value for median.

Figure 2 shows the median net income, cash flow from operations and discretionary current accruals of SEO firms. Observe that discretionary current accruals follow different pattern than cash flows from operations and net income. This graph shows that from year -3 to year 3, net income peaks at year 0 and then begins declining at year 1. DCA is higher in the three years before the SEO than in the three years after the SEO. Also cash flow from operations is lower in the three years before the SEO than the three years after. This pattern confirms the findings of prior studies of earnings management in the three years before the SEO. This pattern also provides support for H1. The behavior of net income around year -1 to year 1 also provides support for H2.

Figure 2



5.2 Insider trading

Table 7 Quintile 1 and 2 presents results for SEO firms which have high IPR ratios which represents the majority sales group; quintiles 4 and 5 represent firms with low IPR ratios which is majority purchases, while quintile 3 is neutral. Most firms showed negative discretionary accruals which is income decreasing earnings. The firms in the majority sales group exhibit income decreasing accruals in the years before and after the SEO while they exhibit positive or income increasing accruals in the year of the SEO. Even though this seems counter-intuitive it confirms the contrarian approach. This result also provides evidence for H4. The firms in the buy group however decrease income in the year of the SEO.

For the high purchase group in Table 7, we find evidence of firms manipulating earnings downwards in the year before the SEO but upward in the year of the SEO and the year after the SEO for quintile 4. However, even though firms in quintile 5 exhibit income decreasing earnings management throughout, the decrease is greater in the year before the SEO than the year of the SEO. This provides evidence that insiders manipulate earnings downwards before purchases. The results in the high sales group which show discretionary accruals to be highest in the year of the SEO and that of the downward earnings manipulation before purchases confirms earnings management around SEOs.

Table 7: Insider purchases and sales

Quintiles	Variable	N	Mean	Std. Dev.
1	DTA_{t-1}	64	-0.156	1.104
	DTA_t	75	0.081	0.872
	DTA_{t+1}	67	-0.099	0.487
2	DTA_{t-1}	75	-0.003	0.720
	DTA_t	75	-0.609	4.305
	DTA_{t+1}	60	0.023	0.306
3	DTA_{t-1}	70	-0.407	1.381
	DTA_t	77	-0.040	0.674
	DTA_{t+1}	62	-0.160	0.665
4	DTA_{t-1}	77	-0.087	0.525
	DTA_t	71	0.227	3.435
	DTA_{t+1}	58	0.316	3.162
5	DTA_{t-1}	74	-0.095	1.315
	DTA_t	76	-0.004	1.087
	DTA_{t+1}	66	-0.0150	0.437

DTA_{t-1} Discretionary total accruals in the year before the SEO

DTA_t Discretionary total accruals in the year of the SEO

DTA_{t+1} Discretionary total accruals in the year after the SEO

Quintile 1 and 2 represents the majority sales group

Quintiles 4 and 5 represents majority purchases

Quintile 3 is neutral

Table 8a shows results of a regression analysis of CAR for three days (dependent variable) on independent variables of insider purchase ratio (a year prior to the SEO) and discretionary accruals for the year of the SEO. The results suggest that there is an association between returns and IPR which was significant. No association was however found between returns and the discretionary accruals for the year of the SEO. H3 was not supported. H5 was however supported.

Table 8a: Regression for Full Sample in the year of SEO

$$CAR_3 = \alpha_0 + \alpha_1 IPR_{t-1} + \alpha_2 DTA_t + \varepsilon$$

Regression analysis of cumulative abnormal returns for three days (dependent variable) on independent variables of insider purchase ratio (a year prior to the SEO event) and discretionary accruals for the year of the SEO for the full sample in the year of the SEO.

Dependent variable CAR				
Independent Variable	α	Standard error	t-value	p value
Intercept	0.0004	0.093	0	0.996
IPR	-0.513	0.237	-2.17	0.031
DTA _t	0.054	0.144	0.37	0.71
N=328 R ² =0.0142 Adj R ² =0.0082				

DTA_t is Discretionary total accruals in the year of the SEO

IPR is the Insider Purchase Ratio

CAR₃ = Cumulative abnormal return for three days

6. Conclusion and Future Studies

Findings provide evidence to show that earnings management around SEOs is still evident in the 21st century. This is evident from the results of net income peaking in the year of the SEO. Discretionary current accruals were higher in the prior SEO years than post SEO years. Cash flow from operations were however higher in the years after the SEO than the years before.

Findings partially confirm prior studies which even though were not conducting SEOs also found insiders to be contrarian. The results shows signs of the contrarian approach because firms manipulate earnings downward in the year before the SEO and manipulate it upwards in the year of the SEO when they sell their shares and then they have to reverse the trend in the year of the SEO. The results also show that insiders manipulate income downwards before purchases.

Study shows that there is an association between the insider purchase ratio and

cumulative abnormal returns for the full sample in the year of the SEO, implying that insider trading influences the markets financial performance. There was no evidence of discretionary accruals influencing the market in the year of the SEO.

In conclusion this study's findings contribute to the literature in several ways. It shows insider trading is a valuable signal that distinguishes between firms that boost earnings too much and others. It establishes that the scope of phenomenon of weak firms mimicking strong firms does not exist when insider trading volume is high. Finally the study augments to the literature by examining how abnormal returns are influenced by earnings management and insider trading.

Future studies will distinguish between sub-periods within which earnings management occurs in the 21st century and before. This is because after the Sarbanes-Oxley Act of 2003 (SOX), there has been a change in information asymmetry between firms and the market and a change in the attitude towards earnings management. Since prior studies found that earnings management increased in the 20th century and declined after the enactment of the SOX, we will try examine if similar findings will be seen for SEOs.

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The Changing Public Reports by Management and the Auditors of Publicly Held Corporations a Comparative Study of a Manufacturing Industry and a Service Industry, Charles J Pineno,

ABSTRACT

As a result of the Enron debacle based in a wave of revelation of accounting irregularities and securities fraud interlinked to Adelphia, Tyco and WorldCom, Congress passed the Sarbanes-Oxley Act (SOX) in June 2002. This was the most significant securities law change since passage of the original Federal Securities Law in 1933 and 1934. This paper provides background information on sections 302 and 404 of the Act. Based on that information, the Internal Controls Report of Management and the Independent Auditor's Report of General Motors Corporation and Ford Motor Company from the years 2002 through 2006 are summarized, analyzed, and compared with the reports of the hotel industry including Hilton Hotels Corporation, Marriott International, Inc., and Choice Hotels International, Inc. Various differences are noted and implications are considered.

INTRODUCTION

In response to numerous accounting scandals that rocked corporate America at the turn of the 21st century, the US Government passed the Sarbanes-Oxley Act of 2002 (SOX). Scandals affecting corporations such as Tyco International, Enron, WorldCom, HealthSouth, and Adelphia resulted not only in the loss of millions of dollars in wealth and thousands of jobs but also in the decline of the public trust in financial accounting and reporting.

BACKGROUND

Accordingly, SOX established standards for all public company boards, management, and public accounting firms in the United States and thereby gave publicly traded companies a much greater understanding of internal controls and the need for such controls. These standards require corporations to evaluate and disclose the effectiveness of their internal controls as they relate to financial reporting as well as the Independent Auditor's Report attesting to such disclosure. In addition, SOX requires that any material weaknesses in a corporation's financial reporting be disclosed in the annual and quarterly filings, and that the CEOs and CFOs verify financial reports. This paper focuses on the internal control reporting format and content as well as the Independent Auditor's Report.

This complex and wide-ranging statute deserves section-by-section analysis. The provisions include accounting reforms, the SEC, financial reporting, corporate governance, Wall Street practices, securities fraud, officer conduct, document destruction, whistleblowers, attorneys, and internal ramifications. The focus in this paper is on financial reporting. After addressing auditor's shortcomings, Congress turned directly to the corporations themselves and set forth a broad range of rules addressing corporate disclosure, responsibility of officers and directors, and corporate governance reforms.

Sections 302 and 404 of the Act are considered applicable for corporate reporting.

The problem, solution, implication and consequence for those two sections are clearly stated by Robert Prentice in his Student Guide Booklet on the Act. His presentation includes:

SECTION 302

The Problem. Corporate management has primary responsibility for the presentation of financial statements and the creation of processes and systems of control to ensure that accurate information finds its way into those statements. That theoretical responsibility notwithstanding, in the white hot competition and excitement of the dot.com bubble, many corporate executives seemed to believe that it was their job not to produce accurate financial statements for the auditors to certify, but to bully the auditors into certifying as aggressive a set of financial statements as possible. Accuracy was not an important consideration if the auditor's certification could be obtained to "CY" the company's "A". In litigation, CEOs occasionally disclaimed any responsibility at all for financial statements, even though they had signed them.

The Solution. Section 302 requires each public company's CEO and CFO to certify that they have reviewed the quarterly and annual reports their companies file with the SEC, that based on their knowledge the reports do not contain any materially untrue statements or half-truths, and that based on their knowledge the financial information is fairly presented.

They must also certify that they are responsible for establishing and maintaining their company's internal financial controls, that they have designed such controls to ensure that relevant material information is made known to them, that they recently evaluated the effectiveness of the internal controls, and that they have presented in the report their conclusions about the controls' effectiveness.

They must additionally certify that they have reported to the auditors and the audit committee regarding all significant deficiencies and material weaknesses in the controls and any fraud, whether or not material, that involves management or other employees playing a significant role in the internal controls. Finally, the CEO and CFO must indicate whether or not there have been any significant post-evaluation changes in the controls that could significantly affect them.

Implications and Consequences. Many pre-SOX financial statements were signed by CEOs who meant to signify nothing more than "these financial statements may not be accurate, but they're not so bad that I couldn't talk my auditor into signing off on them." Since SOX, CEOs and CFOs risk considerable personal responsibilities if they do not believe that the filings they sign are accurate and have not put into place reliable internal financial controls so that they can reasonably have some faith in their own beliefs. SOX also refers to these internal financial controls in Section 404.

It is likely no coincidence that when this provision and Section 906 (which sets forth

criminal penalties for false certification of financial statements) first applied to large public companies in August of 2002, HealthSouth's CFO resigned rather than certify the accuracy of HealthSouth's financial statements. His resignation tipped over the first domino, starting the process that within six months or so led to the uncovering of one of America's largest financial frauds. By August 2003, the SEC had nailed its first CEO and CFO for certifying reports without good faith.

SECTION 404

The Problem. In Section 404, Congress again addressed the problem of the accuracy and reliability of public companies' financial statements. Section 302 requires CEOs and CFOs to certify that to their knowledge the reports their companies file with the SEC are accurate. But how are they to know that the information upon which they predicate their beliefs is reliable?

Perhaps more to the point, company executives, notably Jeff Skilling, former CEO of Enron, testified before Congress that they just had no idea that their companies' financial statements were off by *billions* of dollars. Congress sought to deprive these executives of plausible deniability.

The Solution. Complementing Section 302, Section 404 requires each annual report to contain an "internal control report" stating the responsibility of management for establishing and maintaining an adequate internal control structure so that accurate financial statements could be produced and contained an assessment, as of the end of the most recent fiscal year, of the effectiveness of the internal control structure and procedures. Section 404 also requires auditors to audit the internal control assessment of the company as well as the financial statements.

Implications and Consequences. Section 404 is the most controversial of the provisions of Sarbanes-Oxley. During the Watergate era when the scandals that led to passage of the Foreign Corrupt Practices Act (FCPA) erupted, many top executives of leading companies testified before Congress that they had no idea how low-level underlings had laid their hands on millions of dollars of company assets to pay bribes to foreign government officials in order to land contracts for the companies. The FCPA required public companies to institute effective internal controls to stop the bribes and to make executives accountable. Section 404 goes further, but has similar goals.

Section 404 focuses on internal financial controls, so that information used to produce financial statements is reliable. "Best practices" may include:

- A disclosure committee to review procedures and processes
- A disclosure coordinator, to be the one person anyone in the organization can go to with a question and who tries to keep everyone on the same page
- A time line and responsibility chart
- Subcertifications, where lower level employees certify the accuracy of the information they send up the line

effectiveness opinions and deficiency reporting under the Act and AS 2 provide enough information to satisfy all stakeholders that corporations have sound internal control, compliance, and governance frameworks and that such reliability of financial reporting is improving (McCuaig, 2006).

This paper considers changes in the reporting over the years that tends to lead to better information and general reliability. For both industries as well as possible global organizations accounting implications are based on an SEC idea of a single set of rules.

INTERNAL CONTROLS REPORT

The General Motors Corporation 2002 internal controls report had five paragraphs consisting of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Unqualified certification
4. Independent audit in accordance with auditing standards
5. Audit committee responsibilities

In 2003, the paragraphs continued with the addition of the Code of Ethics under SOX Section 406. The change was expected with the Act of 2002. In 2004, management filed two separate reports. The first report consolidated the information in the official paragraphs from 2002, added SOX Section 302 and specific language on reporting and disclosure. A separate report addressed reforming and disclosure controls. Year 2005 seemed to follow the year 2004 reporting format. In 2006, significant information was stated concerning material weaknesses. Management concluded that their internal control over financial reporting was not effective as of December 31, 2006. The separate internal control report focused on disclosure and remediation of material weaknesses. Table 1 summarizes the paragraph comparisons year by year.

Ford Motor Company's 2002 internal controls report had four paragraphs consisting of:

1. Responsibility for integrity and objectivity
2. Internal controls
3. Independent audit in accordance with auditing standards
4. Audit committee responsibilities

In 2003, the paragraphs were the same ignoring any reference to SOX Act or any sections of the Act. In 2004, the paragraphs took on a different wording and the consolidation of paragraphs such as the 2002 paragraphs on (1) responsibility and (2) internal controls. Also, information related to the Treadway Commission was added as well as a separate paragraph on the New York Stock Exchange required disclosure, but there was no mention made of the SOX Act.

In 2005, the report seemed to follow the 2004 report paragraph by paragraph. Again, no mention was made of the SOX Act. In 2006, Ford decided to break paragraph three of the 2004 report concerning internal controls and the auditors into two paragraphs. None of the Ford reports mention the SOX Act. Table 1 summarizes the paragraph comparisons year by year.

Comparisons between GM and Ford seemed to convey in 2002 more specifics by GM with such information as the Securities Exchange Act of 1934, and the SOX Act of 2002. Also, GM had five officers sign the report whereas Ford had only two. In the later years, GM gave more specifics such as with Sections 302 and 406 of the SOX Act.

The hotel industry companies' internal control reports have from none to three paragraphs for years 2002 and 2003 consisting of:

1. Integrity, objectivity, and a highly developed system.
2. Conformity with accounting principles generally accepted in the United States.
3. Audit Committee.

In 2004, Hilton Hotels Corporation added management's report on internal control over financial reporting consisting of:

1. Accordance with United States generally accepted accounting principles.
2. Framework based on the Treadway Commission's Report (COSO).
3. Independent registered public accounting firm's attestation report.
4. No changes that have a material affect.

In 2004, Marriott International, Inc. added four paragraphs consisting of:

1. Reporting supported by written policies and procedures.
2. May not prevent or detect misstatements.
3. Criteria based on the Treadway Commission's Report (COSO).
4. Independent registered public accounting firm's report appears in the annual report.

Marriott eliminated the audit committee paragraph and language relative to a highly developed system.

In 2004, Choice Hotels International, Inc. added management's report on internal control over financial reporting consisting of:

1. Accordance with generally accepted accounting principles.
2. Inherent limitations and risk.
3. Criteria based on the Treadway Commission's Report (COSO).
4. Auditing firm's report which appears herein.

For 2005 and 2006 the companies mention supervision by the Chief Executive Officer and Chief Financial Officer and any excluded assets. In particular, Marriott and Choice Hotels had very consistent language for both years. The summary of the analysis is reported in Table 3.

Table 1: Responsibilities for the Consolidated Financial Statements and Other Financial Information

General Motors Corporation					
Paragraph	2002 (base)	2003	2004	2005	2006

1	√	√	√	√	-
2	√	√	-	-	-
3	√	√	-	-	-
4	√	√	2	2	6
5	√	√	3	3	-
6	-	Added: Code of Ethics SOX: Sec. 406	√	√	-
7	-	-	Added: Corp. responsibility for fin. reports SOX: Sec. 302	√	-
8	-	-	Paragraph 7 cont.	√	-
	-	-	Added: Internal Controls Over Financial Reporting and Disclosure Controls	√	Material Weaknesses Stated
Ford Motor Company					
1	√	√	-	-	-
2	√	√	-	-	-
3	√	√	-	-	-
4	√	√	-	-	-
I			2, 3	√	√
II				√	√
III			3	√	√
					Added: 1 paragraph
IV			Added: Corp. responsibility for fin. reports SOX: Sec. 302	√	√

INDEPENDENT AUDITOR’S REPORT

The independent auditor’s report generally follows the format of the following paragraphs:

1. Introductory
2. Scope
3. Opinion

Historically, audit reports referred simply to Generally Accepted Auditing Standards and

Generally Accepted Accounting Principles. GM's independent audit report by Deloitte & Touché LLP for 2002 added a disclosure paragraph after the opinion paragraph.

In 2004, GM's annual report contains a separate report on internal controls by Deloitte & Touché LLP. Also, their standard report addresses the standards of the Public Company Accounting Oversight Board, but does not mention the SOX Act. The auditors do relate to certain FASB Standards in their annual reporting.

Ford's independent audit report by PricewaterhouseCoopers LLP combines the introduction, scope and opinion paragraphs as a single paragraph. Their second paragraph discusses notes to the financial statements. That format is followed in years 2003 and 2004. In 2004, the auditors added a section to their report dealing with internal controls that continued for years 2005 and 2006. In 2005, the auditors added a paragraph that seemed redundant concerning their purpose of forming an opinion based on applying auditing procedures. In 2006, that new paragraph introduced in 2005 was continued. The auditors did refer to FASB Standards in their annual reporting each year.

Deloitte & Touché LLP style of separate reports for auditing and internal controls seemed more detailed and inclusive. Both auditors mention the Public Company Accounting Oversight Board. This requires the auditors to plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material aspects. Both auditors, through their reporting, state specific standards and their application to the client's financial information. The summary of the analysis is reported in Table 2.

The hotel industry companies' independent auditor's reports generally follow the format of the following paragraphs:

1. Introductory
2. Scope
3. Opinion

However, Hilton's auditors added additional paragraphs to address the reports of the prior auditors who have ceased operations. The financial statements have been revised to include necessary adjustments and to indicate no opinion or any form of assurance on 2001 or 2000 financial statements taken as a whole. In addition, in 2004-6, Hilton's auditors added a paragraph on criteria established by the Treadway Commission. For the same time period, Marriott's auditors added language relative to the Public Company Accounting Oversight Board. For the same time period, Marriott's auditors had added a paragraph on criteria established by the Treasury Commission but makes no mention of the Public Company Accounting Oversight Board for the year 2005. For the same time period, Choice Hotels' auditors had a combined report that included internal control over financial reporting. Hilton and Marriott had separate reports by their auditors relative to internal control over financial reporting. The summary of the analysis is reported in Table 4.

COMPARISON OF INDUSTRIES

Management's report on internal control over financial reporting by the hotel companies

was more detailed and specific. For example, in the 2006 Hilton Annual Report stated, as permitted by the Securities and Exchange Commission, management’s evaluation excludes the lodging assets acquired from Hilton Group PLC on February 23, 2006; such businesses represent approximately 51% of their total assets as of December 31, 2006 and 38% of their total revenue for the year ended December 31, 2006. However, none of the hotels reported any specific mention of SOX or specific sections of SOX, whereas, General Motors and Ford mentioned Section 302 of SOX.

The independent auditors’ reports are similar as to their opinion of the financial statements by both industries. Within the hotels’ reporting, the independent auditors added a separate report on internal control over financial reporting. Essentially, Choice Hotels had an extensive report that included a separate section on internal control over financial reporting. Hilton and Choice Hotels had interesting reports with the transition from Arthur Anderson LLP to Ernest & Young LLP and PricewaterhouseCoopers LLP, respectively as the independent registered public accounting firms.

Differences exist among U.S. companies within an industry, as well as between different industries, as demonstrated in this paper. Each industry has common language, issues, and reporting. Both industries reported an explanatory trend in addressing internal control in detail. The primary focus is on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In addition, the standards of the Public Company Accounting Oversight Board (United States) are referred to.

Table 2: Independent Auditors Report

General Motors Corporation					
Paragraph	2002 (base)	2003	2004	2005	2006
1	√	√	√	√	√
2	√	√	√	√	√
3	√	√	√	√	√
4	1. SFAS # 142 <i>Goodwill and other Intangible Assets</i>	1. FASB # 46 <i>Consolidation of Variable Interest Entities</i> 2. SFAS # 123 <i>Accounting for Stock-Based Compensation</i> 3. FASB # 142	1. FASB # 46 2. SFAS # 123	1. FASB Interpretation # 47 <i>Accounting for Conditional Asset Retirement Obligations</i> 2. FASB # 46(R) 3. AFAS # 123	1. SFAS # 158 2. FASB Interpretation # 47
5	-	-	Internal Control Integrated Framework -	√	-
Ford Motor Company					

1	√	√	√	√	√
2	1. SFAS # 142 <i>Goodwill and other Intangible Assets</i> 2. SFAS # 144 <i>Acc. for the Impairment or Disposal of Long-Lived Assets</i> 3. SFAS # 133 <i>Acc. for Derivative Instruments and Hedging Activities</i>	1. SFAS # 148 <i>Accounting for Stock-Based Compens. – Transition and Disclosure</i> 2. FASB # 46 <i>Consolidation of Variable Interest Entities</i> 3. SFAS # 142 4. SFAS # 144	1. SFAS # 142 2. SFAS # 148 3. FASB # 46	Paragraph 3 1. FASB # 46 2. FASB # 47 <i>Acc. for Conditional Asset Retirement Obligations, as interpretation of FASB Statement No. 143</i>	√
	-	-	Added: Internal Control over Fin. reporting	√ (added 1 more paragraph)	√

Table 3: Management’s Report of Hotels

Hilton Hotels Corporation					
Paragraph	2002 (base)	2003 (Form 10-K)	2004 (Form 10-K)	2005 (Form 10-K)	2006 (Form 10-K)
In 2004 added <i>Managements’ Report on Internal Control Over Financial Reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√ <i>with changes</i>
3	-	-	√	√	√
4	-	-	√	√	√
Marriott International, Inc.					
Paragraph	2002 (base)	2003	2004	2005	2006
1	√	√	√	√	√
2	√	√	√	√	√

3	√	√	√	√	√
In 2004 added <i>Managements' Report on Internal Control Over Financial Reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√
3	-	-	√	√	√
4	-	-	√	√	√
5	-	-	√	√	√
6	-	-	√	√	√
Choice Hotels International					
Paragraph	2002 (base)	2003	2004	2005	2006
In 2004 added <i>Managements' Report on Internal Control Over Financial Reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√
3	-	-	√	√	√
4	-	-	√	√	√

Table 4: Independent Auditor's Report of Hotels

Hilton Hotels Corporation					
Paragraph	2002 (base)	2003 (Form 10-K)	2004 (Form 10-K)	2005 (Form 10-K)	2006 (Form 10-K)
1	√	√	√	√	√
2	√	√	√	√	√
3	√	√	√	√	√
4	√	√	-	-	-
5	√	√	-	-	-
6	√	√	-	-	-
	-	√	-	-	-
7	√	√	-	-	-
	-	-	-	-	√

			Added <i>new</i> paragraph about <i>Internal</i> Control – <i>Integrated</i> Framework	√	√
In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√
3	-	-	√	√	√
4	-	-	√	√	√
	-	-	-	-	√ Added New paragraph
5	-	-	√	√	√
6	-	-	√	√	√
Marriott International, Inc.					
Paragraph	2002 (base)	2003	2004	2005	2006
1	√	√	√	√	√
2	√	√	√	√	√
3	√	√	√	√	√
4	√	√	-	-	√
			Added <i>new</i> paragraph about <i>Internal</i> Control – <i>Integrated</i> Framework	√	√
In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√
3	-	-	√	√	√
4	-	-	√	√	√
5	-	-	√	√	√
6	-	-	√	√	√
Choice Hotels International					

Paragraph	2002 (base)	2003	2004	2005	2006
			Added <i>new</i> <i>paragraph</i>	√	√
1	√	√	√	√	√
2	√	√	-	-	-
3	-	√	√	-	-
In 2004 added: <i>Report of Independent Registered Public Accounting Firm on Internal control over financial reporting</i>					
1	-	-	√	√	√
2	-	-	√	√	√
3	-	-	√	√	√

CONCLUSIONS

The Sarbanes-Oxley Act is a landmark piece of Federal Regulation that continues to be debated even by the president and vice-president of the United States. It created a new Federal Agency (the PCAOB) that has forced corporations at home and abroad to revamp their governance practices. The Act changed the accounting industry, protected whistleblowers, created many new crimes (especially for document destruction), and increased punishment for violation of many existing ones. However, the immediate purpose of restoring confidence in the securities markets has been accomplished (Prentice, p.60).

The contribution of the independent auditor is to provide credibility to information by publicly submitting their report in the form of an opinion as to the fairness of the financial statements. Independent auditors have no material personal or financial interest in the business, therefore, their reports can be expected to be impartial and free from bias.

The changing format and information, as illustrated by the specific reports in the annual reports, has been prompted by the Sarbanes-Oxley Act. Corporations strive for full disclosure but the presentations, including the details, will vary based on management's focus and priorities as well as their business practices.

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Towards a Positive Theory of Dysfunctional Behaviors in the Accounting Community,
Mohamed Elbannan, Cairo University, Egypt

ABSTRACT

A multi-level theoretical framework, grounded in organizational and managerial cognition theories, is proposed to explain dysfunctional behaviors in the accounting community at the standard-setting, organizational, and the individual practitioner levels. The theory argues that current dysfunctional behaviors in accounting are a product of four vicious circles acting within each of the three levels. At the standard-setting level, lobbying and politicization of the standard-setting process produces compromised standards that cause public discontent. Owing to the entrenchment of regulations in the accounting community, standard-setters interpret public discontent with some of its standards as calls for heavier regulations. At the accounting organization level, the complexity of regulations and heightening threat of litigation creates a formalized environment that stifles organizational learning, increasing the level of formalization within these organizations. At the practitioner level, the increasing organizational formalization and the threat of litigation encourages the practitioner to conform to ineffective rules. Conformity creates a sense of helplessness in the face of public discontent, and the pressure to appear consistent in their application of these rules. The ensuing deterioration in individual professionalism is channeled back to the standard-setting process through memberships on standard-setting bodies and other organizations, and contributes to the dysfunctions at the standard-setting level.

Keywords: Accounting; Cognition; Dysfunctions; Lobbying; Standard-setting.

INTRODUCTION

Accounting professionals are entrusted with the burden of communicating reliable financial information that will be the basis for decision making. The economic utility of accounting statements and audits to capital markets has been well-researched in academic and professional literatures. However, the accounting profession has not kept pace with environmental changes facing preparers and users of accounting information. Auditors are parties to an increasing number of costly lawsuits that accusations of severe audit failures. Increasing divergence of accounting information from firm market valuation made it no longer the basis for decision making. The recent accounting scandals (e.g., Enron and WorldCom) have prompted public discontent and demands for regulatory intervention.

This paper proposes a multi-level theory of dysfunctional behaviors within the accounting community grounded in streams of research from organizational and managerial cognition theories. The theory suggests that accounting dysfunctions are a function of processes taking place at the levels of the (1) FASB, (2) accounting organization, and (3) practitioner. I argue that the accounting community is suffering from four vicious circles (Masuch, 1985) leading to a downward spiral of deteriorating performance and slow response to increasingly demanding user groups (see Figure 1).

Dysfunctional behaviors start at the accounting standard-setting process being subject to tremendous pressures from parties lobbying for self-interest. Lobbying and the ensuing politicization of the process leads to the standard-setting process producing complex, ineffective standards that mostly reflect the interests of large preparers of financial statements (corporations). Public discontent with these standards is interpreted by accounting standard-setters as public calls for more stringent rules and increased formalization. Inevitably, when revised standards are issued using the same dysfunctional standard-setting process, the process starts all over, and the first vicious circle is created.

The second circle takes place at the accounting organization's level and involves increasing formalization due to the firm growth, increased formalization at the standard-setting level, and the ensuing environmental uncertainty felt by client/preparer organizations subject to the new rules. The new rules set within these organizations are meant to reduce their uncertainties and to gain legitimacy and support of society. Increasing formalization within an organization increases the complexity of work flow within these organizations. Given that organizational learning, adaptability, and flexibility are adversely affected by the increased complexity, managers of these organizations tend to increase their control over operations through more rigid and centralized controls. The more stringent standards and the more rigid organizational environment reduce the degree of professionalism of individual practitioners. The end result is that increasing formalization within an organization to cope with the increased FASB rules leads to more formalization within these organizations, and a second vicious circle is created.

The third circle involves the individual practitioner's exposure to a highly formalized environment, strict conformity to ineffective authoritative rules, sense of helplessness in the face of public discontent with accounting-related scandals, and the personal need to engage in behaviors consistent with their adopted "watchdog" image. This circle negatively affects the practitioners' on-the-job reflection, making them feel stagnant, passive, and detached from public needs, resulting in damage to practitioners' professionalism. The end result is a downward spiral of deterioration in practitioners' professionalism and increased formalization at the organizational level that further reinforces the antecedents of deteriorating professionalism.

The fourth circle takes place at the aggregate accounting community level, linking the standard-setting and the individual components of the model, and it tends to reinforce dysfunctions at both levels (see Figure 1). These negative characteristics of individuals that lead to deterioration in their level of professionalism, find their way back to the standard-setting process, because they become institutionalized in the practitioner's professional character, and reinforce the Board's culture of politicization and factionalism that will result in compromised standards. In reciprocity, stagnation in thought at the FASB passes over to practitioners, and the circle is created.

This paper contributes to extant literatures on organizational dysfunctions, standard-setting, and cognition by offering a multi-level contingent theory of dysfunctions in the accounting community through comprehensive assessments of standard-setting, organizational and cognitive processes driving these dysfunctions. Prior research (e.g., Donnelly, 2003; Radtke and Tervo, 2004) examined organizational and personal drivers of audit dysfunctions, but excluded accounting dysfunctions. Also, the studies studied dysfunctions at a single (personal or organizational) level of analysis, but did not study them in an integrated theory that examines multiple levels of analysis. While some articles have attempted to draw upon the literature from the organization theory field to explain

standard-setter behavior (Fogarty, 1992; Fogarty et al., 1992), the behavior of practitioners was not adequately researched. In addition, the processes acting on the practitioner's cognition is an area of promising future research.

The theory includes specific propositions that summarize the theoretical arguments advanced in this article and that are designed to be tested in future empirical research. At the end of the paper I provide some general guidelines on how such empirical research might be conducted, in order to encourage researchers to empirically investigate the proposed relations. Also, this paper is intended to provide insights for accounting policy makers concerning conditions under which an increase in the intensity of accounting dysfunctions might be experienced, and consequently how the incidence of such negative phenomena may be controlled in the future.

While the paper studies what seem to be accounting standard-setting and professional issues that are US-specific, the propositions and recommendations are generalizable to other countries which currently (or in the future will) have a capitalist, equity-financed economy. The US is a leading economic power, one in which it may be argued that economic phenomena originate and subsequently replicate in other developed countries and later in developing countries. I see phenomenon taking place in the US not to be specific to the US, but rather a sign of things to come in other countries. After all, the US has some of the most efficient capital markets and developed regulations in the World. Regulators, accounting standard-setters, investors, and other interested parties from less developed countries should therefore be understandably interested, in my view, in regulatory and professional accounting developments in the US.

The paper is organized as follows. The following section reviews the literatures relevant for this study. The next section presents the theoretical framework and propositions. Suggestions for empirical testing of the propositions are also discussed. Finally, I conclude by suggesting improvements for the utility of the accounting function to society.

LITERATURE REVIEW

Since the Middle Ages, when accounting was first practiced as a tool for self-discipline, record-keeping, and projecting a favourable image of one's self in Europe, until today, the main concern of the accounting practitioner has been the same: the generation of financial information that will enable sound decision-making, which took different forms over the ages (Carruthers and Espeland, 1991). Accounting values have been institutionalized fairly rapidly into social values because modern businesses and investors could not undertake business rationally without it. Its sophisticated techniques may have helped create Capitalist societies as we know them today, because they have institutionalizing the values of accuracy, discipline, and fairness in business people since the early medieval times. Rationalization of economic activities has been the primary function of accounting since then (Weber, 1956).

While accounting practitioners are expected to consistently maintain and project an independent, professional attitude, the profession in general is heavily regulated and deviation in the application of these regulations may bring legal and career ramifications for practitioners. The legal system can be used to impose civil liability on those who fails to exercise their responsibilities in a professional

manner (Latham and Linville, 1998). This strong rule-orientation of the profession became institutionalized in the individual and collective minds of consecutive generations of practitioners. In this section, I review the literature on dysfunctions within the accounting community, the dynamics of the accounting standard-setting process from the perspectives of accounting choice and organizational theory, and finally cognitive processes affecting the decision making process of the individual practitioner.

Dysfunctions at the standard-setting level

Studies point to negative aspects of accounting practices reducing the reliability of accounting information. Experts criticize current financial reporting model for its emphasis on periodic reporting and cost-based financial statements, is more suitable to describing the financial performance of the 1950s industrial-era organizations rather than the technology-oriented and information-dependent organizations of the twenty-first century (Elliott and Jacobson, 1991). Modern organizations operate differently in terms of capital structure, asset base, strategic focus, competitive advantage, and market and geographic domain. All these organizational features and strategies favour more timely reports that emphasize market valuation and both financial and non-financial resources (Francis and Schipper, 1999).

Current financial statements either fail to reflect important business phenomena such as “information-age” assets (Elliott, 1995) and impact of competition and deregulation, or require debatable treatments, such as the case of intangible assets (Lev and Zarowin, 1999), all of which have led to a decrease in the value relevance of earnings (Collins et al., 1997). To satisfy their needs for reliable information, investors are increasingly turning to other sources of information (e.g. stock analysis reports), which might come at an additional economic cost. Voices within the accounting profession advocate the creation of new financial accounting models that will serve the newly emerging needs of investors. In a highly litigious U.S. society, these factors exert unprecedented pressures on the accounting professionals.

Dynamics of the standard-setting process

Established in 1973, FASB is the U.S. privately funded rule-making body authorized by the SEC to “both identify and resolve issues concerning the usefulness of various types of financial information in particular circumstances”. The SEC, in turn, has its founding clause in the 1933 and 1934 legislation, where it was given authority to establish accounting principles for its registrants, corporations that must comply with the SEC reporting requirements in order to enlist on stock markets. FASB was delegated authority for accounting standard-setting with respect to those corporations. The FASB was not delegated enforcement authority, which remains in the hands of the SEC.

Miller et al. (1998) states that,

FASB seeks the participation of members of the economic community in the procedures of setting standards. Through their participation, the FASB is more capable of (1) identifying unresolved financial accounting questions, (2) ranking those questions in importance, (3)

identifying the alternative answers, and (4) evaluating the answers to find the most suitable one for the present circumstances. Furthermore, by involving the community in extensive and thorough due process procedures, the Board can develop a more broadly based consensus in support of its conclusions than it could if it operated in vacuum.

FASB has seven members who, before serving on the Board, must sever their relationship with their previous employers. Their independence is enhanced by a large annual salary. Prior to the enactment of the Sarbanes-Oxley (SOX) Act in 2002, FASB obtained funding through its parent organization, the Financial Accounting Foundation (FAF). FAF is administered by sixteen trustees with two primary tasks: to raise funds for the operation of the organization and to appoint members of the FASB, but not to interfere in any way with FASB's standard-setting process. But their power over the decision of FASB member appointment provides the trustees with opportunity for indirectly influencing the process over the long run.

Eleven of the sixteen trustees are elected to their positions by electors who represent the eight sponsoring organizations; the remaining five are called "at large trustees" (represent the public) and are elected by the eleven trustees. The eight sponsoring organizations represent investment bankers, business executives, government groups, CPAs, and accounting academics. It was pointed that, as of 1997, business corporations and auditors occupied almost 44% of seats on the FAF. As of 1996, 54 percent of the funds contributed to FASB came from public accountants and 41 percent from preparers. Sources of revenues generated by FASB include 32 percent from donations and 68 percent from the sale of publications (Miller et al., 1998).

According to the 2000 FAF annual report, these figures changed only slightly. Preparers and auditors still generated 89 percent altogether; the sources of revenues generated by FASB included approximately 26 percent from donations and 74 percent from the sale of publications. Thus, while FASB's dependence on financial support from corporations and auditors is reducing over time, Donations comprise over one-quarter of total funds available for FASB. The picture did not change much in 2001 and 2002, prior to the enactment of SOX Act of 2002. Net operating revenues for FASB in 2002 and 2001 were \$17.2 and \$19.9 million respectively, which included publication sales of \$13.3 and \$14.8 million. Direct costs of sales of \$1.4 and \$1.6 million and salaries of \$9.3 million for both years resulted in net operating surpluses of \$6.5 and \$9 million respectively. FAF's unallocated costs amounted to \$12.2 million in 2002 and \$11.6 million in 2001. If these unallocated FAF costs were allocated to FASB, it would have reported a deficit in these two years. The purpose of the above discussion is to show the dependence of FASB on preparers and the potential influence of these preparers over the FASB structure and decisions.

In addition to the direct financial support that business corporations provide to FASB, the latter is also dependent on corporations for its legitimacy. Although FASB possesses standard-setting authority, its authority extends only as long as the most influential of its stakeholders are reasonable satisfied. The continued existence of FASB hinges on how it handles the authority delegated to it by SEC. FASB predecessors were dissolved mainly because the SEC never did formally endorse them as a source of authority while they existed. The point here is that the degree to which FASB and its constituents work harmoniously towards the goal of stable and effective accounting standards will affect how the SEC perceives FASB as an effective rule-making instrument.

An effective standard-setting process is essential for the production of high quality accounting standards, which in turn is required for the smooth functioning of efficient capital markets. Researchers contend that high quality standards are a function of an efficient standard-setting process and standard content (Pasewark et al., 2002; Rogero, 1998). Essentially, a high quality standard affects the decision making process of users and can only be produced through a well-balanced process. However, studies indicate that preparers lobby the FASB extensively for their interests significantly more than any other constituent group (Tandy & Wilburn, 1992). There is consensus in the accounting literature that the FASB accounting standard-setting process is highly politicized (Wolk et al., 1984; Chasteen et al., 1993; Miller et al., 1998), and concerns have been voiced over the negative effects corporate lobbying has on the fair representation of the interests of the different constituents to the process. I briefly review next the literature on FASB politicization and corporate lobbying in order to understand how preparers influence the standard-setting process.

Lobbying and politicization of the process

Accounting has been described as a political standard-setting process that involves inputs from several interested parties. Chasteen et al. (1993) argues that,

During the course of the due process procedure, the SEC, other agencies, and business groups (among others) may try to influence Board action. For example, during its deliberations on accounting for investments in debt securities, the FASB received substantial pressure from the SEC in favour of market value accounting, and pressure opposing market value accounting from banks, the Federal Reserve Board staff, and others. On numerous occasions efforts have been made to sway Board decisions to protect specific self-interests, even to the point of arguing that a standard under consideration would “lead to the economic ruin of a particular industry or group of companies.” Assertions of this sort regarding economic consequences were made during the course of deliberations on accounting for oil and gas reserves, accounting for troubled debt restructuring, accounting for leases, accounting for research and development expenditures, accounting for pensions and postretirement benefits, accounting for investments in debt securities, and accounting for employee stock options.... Within the FASB itself, it often is necessary for individual Board members to make concessions on some aspects of a standard in order to achieve other points that they consider more important... In summary standard-setting by the FASB is a political process as well as a technical process. Choices must be made among alternatives, and the alternatives selected are unlikely to satisfy everyone who will be affected by them. Pressure is exerted on those who set standards, and compromises often are necessary in order to make a proposed financial accounting or reporting practice generally acceptable.

FASB was structured so that input from the various constituent bases would be clearly received in the standard-setting process. For example, broad representation by preparers of financial statements and auditors on the board of trustees of the FAF and on the FASB is ensured, and the standard-setting process is prolonged so that issues are meticulously discussed. Researchers argue that organizational structure is shaped so as to adapt to societal expectations that are based on cultural norms, standards set by professional bodies, and requirements of resource providers. By complying, or by appearing to comply, through adopting a structure that is just a façade disconnected from how

work is organized, FASB obtains approval, legitimacy, and continuing support from powerful organizations and from society, while its internal process is not equally effective (DiMaggio and Powell, 1983, 1991). As Meyer (1980) puts it,

In general, FASB is faced with diverse criticisms, which may appear at some time contradictory. Some claim that FASB has issued too many pronouncements since its inception, other claim too little was published. Some maintain that the Board is too conceptual in its approach to issues, while others claim that it is too oblivious to time-honoured accounting theory. Some assert the Board has been too drastic in effecting change, and others believe it has been too timid in imposing its views. Some feel the FASB's pronouncements are too broad, and others are critical because its Statements are too specific. Several limitations inherent in the FASB structure and in its decision making process seem to have these adverse effects. In additions, questions are raised whether the Board does in fact engage in a research-oriented approach to resolving accounting issues, whether it is sufficiently sensitive to the nuances of enterprises other than large, publicly-held corporations, and whether the Board is mindful of particular industries' apparent need for special accounting rules. Moreover, concern has been expressed about the absence of an appeal mechanism.... The impression one might well receive is that of a series of seemingly disparate pronouncements which in fact reflect the one common theme-of more stringent rules and more detailed disclosures.

Lobbying: Accounting choice and organizational theory explanations

Studies investigating lobbying activities in the context of accounting institutions are a part of the literature on accounting choice concerned with management choice of accounting methods to accomplish certain objectives (see, for example, Holthausen & Leftwich, 1983; Kelly, 1983; Zmijewski & Hagerman, 1981). Lobbying can be defined as actions taken by interested parties to influence the outcome of deliberations of a rule-making body or the entire standard-setting process (Sutton, 1984). Lobbying studies indicate that firms lobby in order to minimize or alleviate expected negative consequences of a proposed standard on the contractual obligations of a firm with various parties, such as, management, creditors, and other stakeholders. Various studies explained corporate lobbying behaviors from an accounting choice and organization theory perspectives. Accounting choice studies suggest that the FASB standard-setting process is highly political (Watts and Zimmerman, 1978); a number of FASB constituents may lobby extensively to resist proposed FASB standard due to their expected adverse effects on contractual agreements (Ettredge, et al., 2002; Kelly, 1982, 1983; King and O'Keefe, 1986); and due to the power of the SEC and Congress over FASB, corporate action is likely to have a strong effect on the outcome of the FASB standard-setting process. Additionally, Elbannan and McKinley (2006) proposed a contingent theory that is arguably more comprehensive in explaining corporate response by mapping standard, corporate, and industry attributes that motivate firm resistance to FASB standards.

Dysfunctions at the accounting organization level

Organization theory literature

I use arguments from organization theory literature to explain organizational behavior to environmental uncertainty. Actions and reactions taken by FASB as well as accounting organizations are grounded in this literature, particularly the resource dependence and neo-institutional theory. Apart from accounting choice explanations of corporate behaviors, researchers have invoked organization theory to explain corporate reactions to proposed FASB standards. One view that has been widely discussed has been the resource dependence perspective, which contends that organizations require resources to survive and these resources force them to depend on their environment. Resource acquisition may thus be problematic and uncertain because control over resources provides others with power over the organization. Survival of the organization can be partially attributed to its ability to cope with environmental contingencies, negotiating exchanges to ensure the continuation of needed resources, and buffering themselves from undesired control by other organizations in their environment (Pfeffer and Salancik, 1978). The competing interests of FASB constituents, and the effects of a proposed standard on wealth redistribution among these constituents, have contributed to the politicization of the FASB due process and suggest the existence of power and conflict (Booth & Cocks, 1990). Many studies focus on whether the FASB is dominated by the major auditing firms and their corporate clients (Hussein & Ketz, 1991; Puro, 1985).

Another view that has been widely discussed has been the neo-institutional theory perspective (DiMaggio & Powell, 1983; Meyer & Rowan, 1977), which argues that institutional practices can be used to explain corporate behavior. By complying, or by appearing to comply, through adopting a structure that is just a façade disconnected from how work is organized, the organization obtains approval, legitimacy, and continuing support from powerful organizations and from society (Donaldson, 1995). Institutionalized rules function as myths which organizations and individuals incorporate to gain legitimacy, resources, stability, and enhanced survival potential (Meyer and Rowan, 1977). Arguments from the neo-institutional and resource dependence perspectives will be used to explain behaviors of FASB and accounting organizations.

Formalization

The effect of organizational structure and processes on professionalism and the workflow within organizations has been extensively studied. An important element of this research focuses on the study of formalization within an organization, defined as the control of job activities by administrative rules and procedures (Organ and Greene, 1981). Studies argue that it increases organizational efficiency and reduces role ambiguity (Kahn et al., 1964; Podsakoff et al., 1986). Others believe that it has serious negative organizational consequences that retard professional involvement within an organization. An increase in the degree of formalization is said to indirectly increase workplace alienation perceived by professionals through exacerbating role conflict (Kahn et al. 1964), and blurring organizational identification (Organ and Greene 1981).

Alienation is proposed by Lodahl and Kejner (1967) to reflect the opposite of the concept of job-involvement, in which a professional flourishes. It has been characterized as being a state created by a lack of workplace autonomy in which the individual perceives the job as being external to his or her nature (Dubin, 1956). Formalization results in alienation through reducing workplace autonomy, stimulating normlessness and isolation by downplaying professional standards, and leading to self-estrangement (Organ and Greene 1981). Further, Vlaar (2007) argues that formalization has additional negative effects. Formalization is argued to hinder creativity and innovation, inhibit flexibility that is needed for coping with complex, ambiguous and unstable task environments (Mintzberg 1994; Nooteboom 1999; Volberda 1998), stifle mutual accommodations (Ireland et al. 2002), and limit opportunities for adaptation (Nooteboom 1999). In addition, formalization was found to have negative effects at the individual level; it involves the risk of reducing performance and aspirations to minimum standards (Gouldner 1954; Katz and Kahn 1966), and to limit the scope for initiatives beyond those specified in agreements (Hendry 2002).

Dysfunctions at the individual practitioner level

Practicing accountants and auditors are professionals who are subject to a variety of managerial cognitive processes that affect their ability to process information and make decisions. In this section I review major studies that discuss the individual and organizational effects of these processes.

Audit failure and auditor independence

Audit failure is a basic concern for the investment community (Elliott and Jacobson, 1991; Magee and Tseng, 1990; Mednick, 1991; Palmrose, 1987, 1988, 1991, and 1994; St. Pierre and Anderson, 1984; and Siliciano, 1988 and 1997). Obtaining a “clean” audit opinion creates an enormous economic value to firms because it reduces investor’s information risk, lends credibility to financial reports, and attributes legitimacy to the firm. Inaccurate financial information is an important driver of information risk (Arens and Loebbecke, 1991; Wallace, 1987). By providing users with reliable audited financial statements, auditors help reduce investment risk and client’s cost of capital (Elliott, 1994). Additionally, reliable information is essential for ensuring efficient resource allocation and free movement of capital (Latham and Linville, 1998).

Auditors, however, have been criticized for increasing incidence of activities perceived contrary to independence, such as provision of non-attestation services to clients currently under audit, non-detection of fraudulent financial reporting, reluctance to issue ominous going-concern reports, and low-balling, among others. These activities, which diminish investor confidence in the accounting profession, are direct results of poor management of audit engagements, unsound audit practices, or unrealistic assumptions about the client and individual auditors (Palmrose, 1997). Raghunandan and Rama (1995) report that results of several studies showing that more than half of the companies declaring bankruptcies did not receive a going-concern modified report in the period prior to bankruptcy. In 1981, AICPA started a new requirement (SAS No. 59) for auditors to evaluate whether there is “substantial doubt” about client’s ability to survive for a reasonable period of time in every audit, creating a direct responsibility on the part of auditors to examine a client’s survival

potential in the course of an audit. It is issued when there are some indications of material uncertainties with respect to a client's future. Palmrose (1997) points that most of audit litigation involves either financially distressed clients or fraud instances. Between 30% and 40% of lawsuits were filed on clients about to be or already in bankruptcy. Some 46% of bankrupt public firms with lawsuits against auditors showed evidence of client fraud.

Managerial cognition literature

Individual cognition processes can be called on to explain how institutionalization takes place because institutions come from the cognition of individuals. Weick and his associates (1979; 1993; Weick and Roberts, 1993) use concepts such as schemata, cognition, and causal textures to conclude that an organization can be viewed as a body of thought and "can be characterized by the contents of the schemata members invoke routinely and through which they size up situations" (Weick, 1979). They believe that an organization can be described as "a body of schemata that direct the exploration of objects" (Weick, 1979), because actors with bounded rationality are presumed to be interested more in confirming their schemata than in actively trying to disprove them in order to reduce their uncertainties. Thus, schemata have a controlling effect on what people perceive and can be used to analyze what goes on in organizations and how conclusions are reached. In other words, Individuals continually re-enact behaviors, as taken-for-granted routines, which then becomes objectified into institutions over long time. Schemata and managerial cognition are influential elements that can explain how institutions that are outside the individual, gain social consensus at the individual (micro-) level, and become a coercive force on any individual actor.

Helplessness and consistency

Seiligman (1975) argues that helplessness, as a psychological phenomenon "produced by uncontrollability" (or perceived uncontrollability), "undermines response initiation" because "uncontrollable events undermine the motivation to initiate voluntary responses that control other events". He adds, "When an organism learns that it is helpless in one situation, much of its adaptive behavioral repertoire may be undermined". Further, he believes that a direct consequence of experiencing uncontrollability is reduced learning and a distorted perception of control. Helplessness is a powerful psychological element. Kets De Vries and Miller (1986) contend that, if it prevails as a personality trait, helplessness can lead to an avoidant culture, in which organizations start ignoring needs of society. They believe that the psychological traits of key members of the organization can determine to a large extent the culture of their organizations. When it comes to helplessness, depressive-style managers often help create an organizational culture that can be characterized as "avoidant".

The executives believe in routine work and they reduce their contributions to the minimum that is required of them. In general, depressive firms are inactive, extremely conservative, passive, and perform only routine tasks. Further, these authors argue these avoidant organizations are typically well established and serve a mature market, where little changes in the way of technology and competitive patterns over the years. In these organizations, formal authority is centralized, and control is exercised through formalized programs and policies. These organizations are "content

with the status quo” and “do little to discover the key threats and weaknesses in markets. It is difficult to say whether stagnation causes inattention to information gathering or vice versa”.

Further, Cialdini (1984) suggests that human beings tend to act in ways that will appear consistent to others; otherwise, we may be perceived as moody and indecisive. As suggested, in the face of increasing public discontent and threat of litigation, practitioners find sanctuary in strict conformity to rules. They then project an outward appearance of belief in those rules to fend off negative perceptions of others. However, consistency in applying rules, which are increasingly losing the confidence of the public, gradually drifts accountants away from any active role in the public debate for accounting change. Additionally, consistency helps in the creation of uniformity and groupthink among practitioners.

Professionalism and reflection-in-action

In his book “The Reflective Practitioner”, Schon (1983) suggests that the professions are facing increasing loss of public confidence. He acknowledges the distinguished rights and freedoms professionals enjoy because of the extraordinary knowledge they possess in matters of concern to human beings, but argues that professionally designed solutions to public problems have brought, and continue to bring, unanticipated adverse consequences recently. A series of national crises have had the effect of deteriorating the public confidence in professionals in general. Accountants have faced a similar blame during the Savings & Loans ordeal of the late eighties.

Schon (1983) raises the question of adequacy of professional knowledge to the needs of society, stating, “... professional knowledge is mismatched to the changing characteristics of the situations of practice – the complexity, uncertainty, instability, uniqueness, and value conflicts which are increasingly perceived as central to the world of professional practice”. More than ever, professionals are required to show more adaptability and flexibility regarding the changing body of knowledge and changing public’s expectations, both of which are caused by technological changes. Professionals should adopt a continuous learning approach in the context of their daily work. However, as mentioned earlier, increasing workplace formalization reduces autonomy, job involvement, and professionalism, leading to alienation and self-estrangement (Organ and Greene 1981).

However, Schon’s (1983) central thesis is that the most distinguishing characteristic of professionals is reflection-in-action, which is defined as the continuous on-the-job learning and the ability to exercise expert judgment to determine what is functional and what is not. A professional is distinguished from a layperson through not only his or her invaluable technical knowledge in a particular field, but also through the continuous evolution of learning as events unfold. An iterative process of trial and error is constantly underway, in the context of a broad ownership of problems until they are solved. Combining the arguments of Seiligman (1975) and Schon (1983) together, a key point of central importance to the paper is that helplessness *inhibits*, or at least reduces, reflection-in-action.

THEORETICAL FRAMEWORK

In this section I develop a theoretical framework and propositions to explain dysfunctional behaviors in the accounting community. In the theory I seek to identify the processes that will result in the incidence of dysfunctional behaviors, exploring independent drivers at the level of the FASB, accounting organizations, and the individual practitioner. Specifically, the framework provides some answers to the following questions: What caused the FASB standard-setting process to produce standards characterized by being ineffective, too complex, and at best an imbalanced compromise? What are the likely effects of FASB producing standards criticized by its constituents on the cognitive processes of individual practitioners and their decision making skills? What are the likely effects of the pressure for conformity to standards increasingly perceived by many as ineffective, the threat of litigation, and the sense of helplessness on the cognitive processes of individual practitioners and their decision making skills? What are the likely effects of increased FASB regulations on the cognitive processes of individual practitioners and on the standard-setting process itself? Each of the three levels involves a variety of legal, economic, and structural dynamics that are captured through arguments grounded in the neo-institutional, resource dependence, and managerial cognition theories reviewed above.

Dysfunctions at the standard-setting level: Lobbying

Many studies suggest that the quality of accounting standards is dependent on the effectiveness of the standard-setting process. Lobbying, politicization, and formalization are attributes of the accounting standard-setting process that greatly dilute the quality of proposed standards and result in further dysfunctions down the value chain of the profession. Intensity of these attributes depends in part on the degree of interdependence between FASB and its constituents. While FASB depends on its constituencies for financial support, legitimacy, and survival, its standards may create uncertainties for users of these standards regarding their survival and success.

Because of the interdependence marking the relationship between FASB and preparers and the uncertainties posed by the standard to FASB constituents, these constituents attempt to monitor and influence the behavior of the other party. These attempts range from providing inputs to the FASB due process, building up public support against a proposed standard, lobbying with more powerful bodies (exerting two-step leverage (Garguilo, 1993) over FASB through the SEC and the Congress), influencing the appointment of FASB members and FAF trustees, creating structures that coordinate action against FASB (e.g. Financial Executives Institute), seeking laws that will limit FASB discretion, and resorting to the judicial branch (courts) to stop a particular standard (Miller et al., 1998). Influencing FASB mechanisms for selecting accounting issues to regulate and the outcome of the standard-setting process are of particular interest to this paper.

Lobbying is conducted by any interested party with the intention of influencing the FASB decision-making mechanism. Supported by Congress members and the SEC, the power of preparers through lobbying activities sometimes proves a formidable challenge to FASB as evidenced by the final form of the standard assimilating preparers concerns more than other constituents (Miller et al., 1998). Business corporations were argued to lobby with the SEC and the Congress to exert pressure

of FASB to change its position on certain proposed standards (Miller et al., 1998). Possible intervention by the SEC or Congress overruling the natural outcome of the standard-setting process is another threatening situation.

The effect of lobbying on FASB is twofold. First, it makes FASB less flexible to public demands, and second, it makes the standard-setting process a highly political one. Individuals, groups, and organizations generally tend to lose flexibility in threatening situations (Staw et al., 1981). Threat-rigidity effects can be maladaptive, particularly at periods of major environmental changes (Staw et al., 1981). Lobbying qualifies as a threatening situation to members of FASB standard-setting process because parties engaging in lobbying tend to magnify the potential negative effects of a particular course of action they perceive adverse to their interests.

Acting under this pressure and threatening arguments by some groups, FASB members are bound to be rigid on the standard-setting process and may at times feel overloaded due to the magnified reactions to their preferred alternative. Balancing constituent interests at the macroeconomic level requires enormous flexibility in terms of input solicitation, information processing, and selection of the most appropriate course of action. Inflexibility of FASB members helps in the generation of standards that are ineffective, delayed, and complex (Elbannan and McKinley, 2006). Not only do these members lose flexibility xcvat times when it is most needed, but also they may lose touch with reality and this is where the public discontent of irresponsiveness accurately describes FASB behavior. Researchers suggest that the quality of standards is a function of the attributes of the standard-setting process and standard content (Pasewark et al., 2002; Rogero, 1998). The stronger the lobbying efforts directed at the process, the more the content of the produced standards will reflect the interests of the more powerful constituents.

Proposition 1: Other things held constant, the higher the intensity of lobbying within the standard-setting process, the less balanced the produced standard will be perceived by the constituents.

Given the lobbying activities influencing the standard-setting process, the due process becomes highly political. Politicization has been defined as “a preoccupation with the distribution of power and resources within the organization rather than their generation”, and theoretically, it may lead to “decisions that are based on distributional rather than technical criteria” (Nelson, 1997, 40). Distribution will manipulate symbols to avoid associating rewards with production (Nelson, 1997). As each FASB constituency strives to get its own demands highest on the list of priorities, the Board finds it difficult to satisfy all demands. Compromising will take place that will eventually lead to deviations from the pronounced mission of the FASB. Deviation will typically be in the direction of the most important stakeholder in terms of issues researched and regulated and the outcome of due diligence deliberations. The stronger the lobbying efforts by the competing constituent groups, the more likely the accounting projects on the agenda will be prioritized according to the relative powers of the groups. Groups whose political power is not well represented within the due process will find the accounting issues of interest to them further down the FASB agenda, and will interpret this as lack of responsiveness on the part of FASB.

Proposition 2: Other things held constant, the higher the intensity of lobbying within the standard-setting process, the less responsive the process will be perceived by the constituents.

If FASB constituents perceive the standard-setting process as slow in its response and the produced standard to be more in favour of the more powerful groups (Elbannan and McKinley, 2006; Meyer, 1980), public discontent with the process will increase and calls for change will be made. In its efforts to appear responsive to these calls, FASB issues new standards or revises highly criticized ones, such as the case with SFASs 123 and 131, but still uses the same politicized process that is subject to intense lobbying (Fogarty et al., 1994), generates still imbalanced pronouncements, and the circle repeats itself.

Organizational theorists believe that an organization needs other elements in its environment to provide it with resources necessary for survival. Survival is a function of the organization's ability to cope with environmental contingencies, negotiating exchanges to ensure the continuation of needed resources, and buffering itself from undesired control by other organizations (Pfeffer and Salancik, 1978). By complying, or by appearing to comply, through taking actions or adopting a structure that is just a façade disconnected from how work is organized, the organization obtains approval, legitimacy, and continuing support from powerful organizations and from society (DiMaggio & Powell, 1983; Meyer & Rowan, 1977). These two perspectives explain FASB's reaction in favour of the most powerful groups and later its revision of previous pronouncements to yield to public criticisms (Elbannan and McKinley, 2006).

However, these additional regulations are produced through the same ineffective standard-setting process. Masuch (1985) argues that managerial attempts to initiate change by increasing formalization, not only fails to realize managerial goals, but also invites apathy, alienation, and other dysfunctional participant responses. Not realizing the underlying cause of failure, the organization reacts to the consequent unsatisfactory results by increasing the pressure on the system, because it does not know the source of the unsatisfactory results. The more the controls, the more institutionalized apathy becomes, and the more the system gets "blocked" into a "suboptimal state of affairs". In its efforts to be responsive to calls for change, FASB issues new standards or revises highly criticized ones, using the same politicized process that is subject to intense lobbying, and generating similar results, and the circle repeats itself.

Proposition 3: Other things held constant, the less balanced the produced standard is perceived by constituents, the higher the public discontent.

Proposition 4: Other things held constant, the less responsive the process is perceived by constituents, the higher the public discontent.

Proposition 5: Other things held constant, the higher the public discontent, and the higher the degree of formalization within the standard-setting process.

Dysfunctions at the accounting organization level: Rise in formalization and threat of litigation

Organizations tend to comply, or appear to comply, with demands and expectations from powerful actors in their environment to obtain approval, legitimacy, and continuing support from these powerful organizations and from society. Compliance takes place through adopting a structure that is just a façade disconnected from how work is organized (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Tolbert & Zucker, 1996).

Large accounting firms are described as professional bureaucracies characterized by a high level of centralization, formalization, and application of professional norms (Montagna, 1968). These firms have grown enormously to keep up with the growth of their multinational clients. Since the 1950s, the number and complexity of operations of multinationals have increased substantially calling for large accounting firms to maintain presence or alliances with local accounting firms in many countries around the World. This growth had serious ramifications for organizational structure and dynamics.

Growth is a necessary condition for formalization to become fully developed. It increases the number of member interactions and thus creates a need for coordination and control efforts (Foss and Foss, 2005; Madhok, 2002; Walsh et al., 1987). Also, growth may lead to formalization simply in response to environmental pressure for organizational legitimacy (Meyer and Brown, 1977; Meyer and Rowan, 1977). As Meyer and Rowan (1977: 340) noted, 'organizations are driven to incorporate the practices and procedures defined by prevailing rationalized concepts of organizational work'. With increasing size comes the need to satisfy a wider and more sophisticated public (e.g. investors, banks, government agencies) (Walsh and Dewar, 1987). Besides growth, perceived environmental uncertainty may also cause an increase in the level of organizational formalization. Complex organizations should be administered to cope with uncertainty and to advance rationality including common goals, controlled workflows, interdependencies management, coordination structures, organizational design, informed assessments, employee-employer interest's convergence, and control over the organization (Thompson, 1967).

Increasing formalization at the FASB level is argued to increase formalization at the accounting organization level, because of the additional cost of training, application, and record-keeping required to comply with new FASB pronouncements. . More operating rules and policies are set within organizations to ensure the proper implementation of the new, complex regulations. Increasing formalization at the FASB level thus results in increasing formalization at the organizational level. These additional pronouncements increase the level of uncertainty perceived by accounting firms and accounting departments within business firms subject to FASB standards (Thompson, 1967) The increasing formalization within these accounting organizations is likely to trigger apathy, stagnation, groupthink, and deteriorating professionalism (Masuch, 1985). These negative phenomena reduce the effectiveness of accounting organizations and audit failures.

Effects of formalization on organizational learning and rigidity

Accounting is a mature profession where standard-setting dynamics revolve around centralized- and rule-dominated institutions. The increasing formalization on individuals affects the managerial style to become primarily avoidant, stagnant, passive, routine-oriented, and detached from reality (Kets De Vries and Miller, 1986). Additionally, the effects may extend to include the organizational structure and modes of operation. Lacking initiative, the structure of accounting organizations may be bureaucratic, rigid, formalized, and centralized and the general culture within these organizations is characterized with conservatism, uniformity and conventionality (Kets De Vries and Miller, 1986).

Groups subject to external threats, or placed in a competitive situation, are expected to demonstrate cohesiveness and bonding (Staw et al., 1981), which gradually invites uniformity among group members. A threat to group interests would increase the pressure towards seeking consensus, which entails restricting the flow of information and ignoring deviant solutions and positions. Perhaps more than other professionals, accountants and auditors may exhibit a high degree of cohesiveness because of their exposure to threat of litigation. At the group or organizational level, cohesiveness may lead to sameness and uniformity, which hampers organizational learning, adaptability, and flexibility. Further, Vlaar (2007) argues that formalization hinders creativity and innovation, inhibit flexibility that is needed for coping with complex, ambiguous and unstable task environments (Mintzberg 1994; Nooteboom 1999; Volberda 1998), stifle mutual accommodations (Ireland et al. 2002), and limit opportunities for adaptation (Nooteboom 1999)

Proposition 6: Other things held constant, the higher the degree of formalization within accounting organizations, the higher the degree of rigidity within these organizations.

Proposition 7: Other things held constant, the higher the degree of formalization within accounting organizations, the lower the organizational learning within these organizations.

Increasing formalization within an organization increases the complexity of work flow within these organizations. Given that organizational learning, adaptability, and flexibility are adversely affected by the increased complexity, managers of these organizations tend to increase their control over operations through more rigid and centralized controls. The resulting increase in organizational rigidity and decline in organizational learning is likely to decrease organizational effectiveness. Effectiveness positively correlates with formalization at the early stage of an organization's life, but negatively correlated with formalization in more mature organizations, and may even contribute to its decline (Walsh et al., 1987).

Proposition 8: Other things held constant, the lower the level of organizational learning, the higher the threat of litigation.

A second vicious circle is created whereby increasing standard-setting formalization and organizational growth contribute to an increase in organizational formalization, which in turn damages organizational learning and adaptability. The immediate effect is deterioration in

organizational effectiveness, which increases the threat of litigation that may contribute towards more organizational formalization to fend off this increasing threat.

Dysfunctions at the individual practitioner level: Decline in professionalism

This section is central to the proposed accounting dysfunctions model. It tracks dysfunctions to the practitioner's cognitive processes where a cultural conflict is argued to exist between the pronounced function of accountants and their actual practices. In this paper, the term "practitioners" refers to accountants and auditors equally because the adverse impact of dysfunctional standard-setting affects these two groups, as well as their organizations and clients, equally. Both groups are negatively affected by the increased formalization and deterioration in professionalism owing to their exposure to an institutional and organizational environment that depresses learning and reflection. Similar to Lewis's (1965) "Culture of Poverty", I argue that accounting practitioners are strictly adhering to a "Culture of Conformity" to authoritative rules and strict procedures. This culture can be characterized by a strong adherence to authoritative rules, conservatism and risk-aversion, preference of conventionality over creativity, and strong affiliation to regulatory bodies, qualities believed to be rewarding means of avoiding public discontent.

Formalization and threat of litigation promote practitioner conformity

A brief examination of the number, size, and complexity of FASB (and its predecessors) pronouncements, IRS Regulations, AICPA codes of conduct, and the multitude of accountants' handbooks reveals how highly written authoritative rules are regarded in the accounting community. In addition, formalization involves the risk of reducing performance and aspirations to minimum standards (Gouldner 1954; Katz and Kahn 1966), and to limit the scope for initiatives beyond those specified in agreements (Hendry 2002). The increased formalization in the practitioner's environment, coupled with the ever-present threat of litigation, create a special regard within the practitioner's thinking for conformity to prevailing rules and regulations. The negative effects of the increasing formalization within accounting organizations force the individual practitioner to favourably perceive conformity to rules. Strict adherence to rules can prove to be a lifesaver to accountants and *the* plan of defence in litigation situations (Merton, 1957; Rothschild-Whitt, 1979).

Proposition 9: Other things held constant, the higher the degree of formalization within accounting organizations and the higher the threat of litigation, the higher the perceived pressure by the practitioner for conformity.

Conformity brings helplessness

The impact of formalization on professionalism is likely to take place through direct and indirect means. Directly, formalization hinders professional involvement (Organ and Greene, 1981), taking away the feeling of control and the desire and ability from the practitioner to stay current and to act in an inquisitive manner. This is where society meets face-to-face with stagnation and other

accounting dysfunctions. Indirectly, the increasing formalization in the practitioner's environment eventually results in deterioration in practitioner professionalism through the processes of conformity, helplessness, and consistency. The perceived need for conformity to rules, as a means of shielding one's self from perceived environmental uncertainty (Thompson, 1967) results in the practitioner becoming intensely preoccupied with rules that are increasingly disconnected from experience and from the changing environment of the organization (Walsh et al., 1987).

The pressure to conform to ineffective rules, accompanied with having little control in changing these rules, creates a sense of helplessness (Seiligman, 1975) on the part of the practitioner with respect to the task environment and confidence in accounting institutions. To be perceived as consistent (Cialdini, 1984), the practitioner, however, continues to project an appearance of belief in the effectiveness and utility of the rules, reinforcing the appearance of conformity to rules. The sense of helplessness, coupled with the threat of litigation and personal need for projecting consistent behavior, has negative effects on practitioners, especially learning and reflection on the job. Eventually, those individuals who appreciate independence, uniqueness, and creativity may start acting in ways that will satisfy their needs for personal achievements.

Proposition 10: Other things held constant, the higher the perceived pressure by the practitioner for conformity, the higher the sense of helplessness.

Conformity and helplessness bring pressure for consistency

Once an accountant is convinced that conformity is a "safe way to operate", the individual projects a behavior that is consistent with this "culture of conformity" to persuade the world about the "correctness" of a specific action. Cialdini (1984) expressed the strength that the pressure of consistency has on human beings. According to him, we tend to act in ways that will look consistent to others; otherwise, we may be perceived as moody and indecisive. Consistent behavior, based on conformance to authoritative rules, drifts accountants away from the current needs of investors and the general public, leading to what may be called an "ivory tower" effect. Consistency reinforces conformity and a vicious circle is shaped.

Further, a conflict is created because there are two cultures in conflict involved: the culture of conformity, which actually exists in the accounting community with all its dysfunctional elements, and the symbolic "watchdog" façade conveyed to the world, where accountants promote themselves as the economy's watchdogs whose ultimate goal is allowing informed financial decisions by financial decision makers. This conflict has several negative effects on the accounting institution, organizations, and accountants. Some of the prominent effects include stagnation in the development of accounting theory and practice techniques, sameness and groupthink among accountants, a wider expectation gap between investors' needs and accountants' perception of their role, increasing dissatisfaction by the general public with accounting manifested in lawsuits and criticisms and diminishing role of accounting in the business world.

The threat of litigation also impacts professionalism negatively. Staw et al. (1981) believes that, in threatening situations, individuals may suffer from psychological stress and anxiety. These feelings

“often result in poor task performance and a tendency to persevere in well-learned courses of action” (Staw et al., 1981). More importantly, they believe, “threats resulting from radical environmental change may bring on a maladaptive reaction” (Staw et al., 1981). Practitioners facing litigation or the loss of a client feel the same threat. The practitioner stands to lose due to exposure to litigation, which breeds stagnation within these practitioners, and reduces their reflection in action (Schon, 1983). On the long run, the ability of the accounting field to attract high quality human resources may deteriorate.

Helplessness reduces reflection-in-action

The most critical impact of helplessness comes in the form of taking away the feeling of control in accountants and, with it, the desire and ability to keep current and act in a professional, inquisitive manner. Reflection action is seriously hindered. This is where society meets face-to-face with stagnation and other accounting dysfunctions. Schon (1983) provides important insight as to the expectations of society from professionals and the reasons that explain any lack of confidence in professional abilities. Schon’s characterization of the source and the impact of the problem leading to a crisis of confidence in professional knowledge can be generalized to the case of accounting professionals. Schon’s rationale for the increasing failure of professionals places the blame for dysfunctions in the society on the professionals who do not provide enough contributions to society to match their gains.

The failure of professionals and the general decline of confidence in professionals, in Schon’s point of view, is due to the following factors: (1) the fast pace of change in society that was not matched by large strides in gaining new knowledge on the part of professionals, (2) professionals serving themselves at the expense of their clients and ignore their obligations to the public, and (3) failure of professionals to discipline themselves effectively. These same factors can be applied to the subject of this paper to explain the dysfunctions in accounting and the decreasing public confidence in its role. Once lagging, reflection-in-action would have severe implications on the way the importance of accounting is perceived, the future development of the accounting field, and the way accountants perceive their contributions to society.

Proposition 11: Other things held constant, the higher the sense of helplessness, the lower the degree of practitioner professionalism.

Dysfunctions at the accounting profession: A closed loop

This paper suggests there may be four vicious circles responsible for the dysfunctions in the accounting field. The first circle takes place at the accounting standard-setting level, where the dysfunctional process produces ineffective standards that are met with public discontent. To treat this discontent, FASB issues more standards using the same dysfunctional process, exacerbating the problem. The third circle is what may be called “the culture of conformity”, a psychological phenomenon occurring at the practitioner level and is predominantly a result of interaction between the individual processes of conformity, consistency, and helplessness.

At the accounting organization level, the complexity of regulations creates a formalized environment that stifles organizational learning, adaptability, and flexibility, leading to more formalization within these organizations. The organizational level of analysis is seen in this paper as a “pass-through” medium, one through which the effects of formalization is passed from the institutional level downwards to the individual level, and deteriorating professionalism is passed from the individual level upwards to the institutional level contributing to its dysfunctions. Accounting organizations have contributed to the dysfunctions in the profession through siding by preparers in lobbying efforts. The third circles were introduced in this paper within their proper domains.

The fourth circle takes place at the aggregate accounting community level, linking the standard-setting and the individual components of the model, and it tends to reinforce dysfunctions at both levels (see Figure 1). The negative characteristics of individuals that lead to deterioration in their level of professionalism, find their way back to the standard-setting process, because they become institutionalized in the practitioner’s professional character, and reinforce the Board’s culture of politicization and factionalism that will result in compromised standards. Young (1996) investigated a FASB project on financial instruments, noting the presence of institutional thinking that excluded many skeptical interpretations of financial instruments while focusing the regulators on the traditional accounting concerns of disclosure, recognition, and measurement.

Compromised standards do not meet the needs of FASB constituents who place criticisms collectively on the accounting standard-setting process as well as on the profession (Meyer, 1980). The individual practitioner experiences this criticism firsthand as an implementer of the standards and auditor of the firm compliance to these standards, and, consequently, suffers from helplessness due to increasing perception of increased threat of litigation. The need for conformity and consistency at the individual level, coupled with the increasing formalization at the FASB and organizational levels, reduce the practitioner’s potential for learning, and ultimately professionalism.

A high degree of professionalism means that decision making is conducted at acceptable levels of efficiency, effectiveness, and competence. Formalization and professionalism serve to provide structure to job activities and the work environment (Organ and Greene, 1981). Formalization and professionalism are believed to be antithetical: low professionalism invites more formalization, while more formalization hinders organizational commitment (Michaels et al., 1988), the individual initiative to learn and act, and professionalism (Organ and Greene, 1981). Again, this actual culture in conflict with the symbolic one is channelled back to FASB through practitioners’ membership on the Board. All of these factors can help explain why accounting dysfunctions exist in the first place because they are applicable to the way FASB runs the profession. Additionally, the accumulation of vicious circles may explain organizational stagnation, which is more likely to happen in slowly, incrementally changing organizations like FASB.

Proposition 12: Other things held constant, the lower the degree of practitioner professionalism at the individual level, the higher the degree of formalization at the standard-setting level.

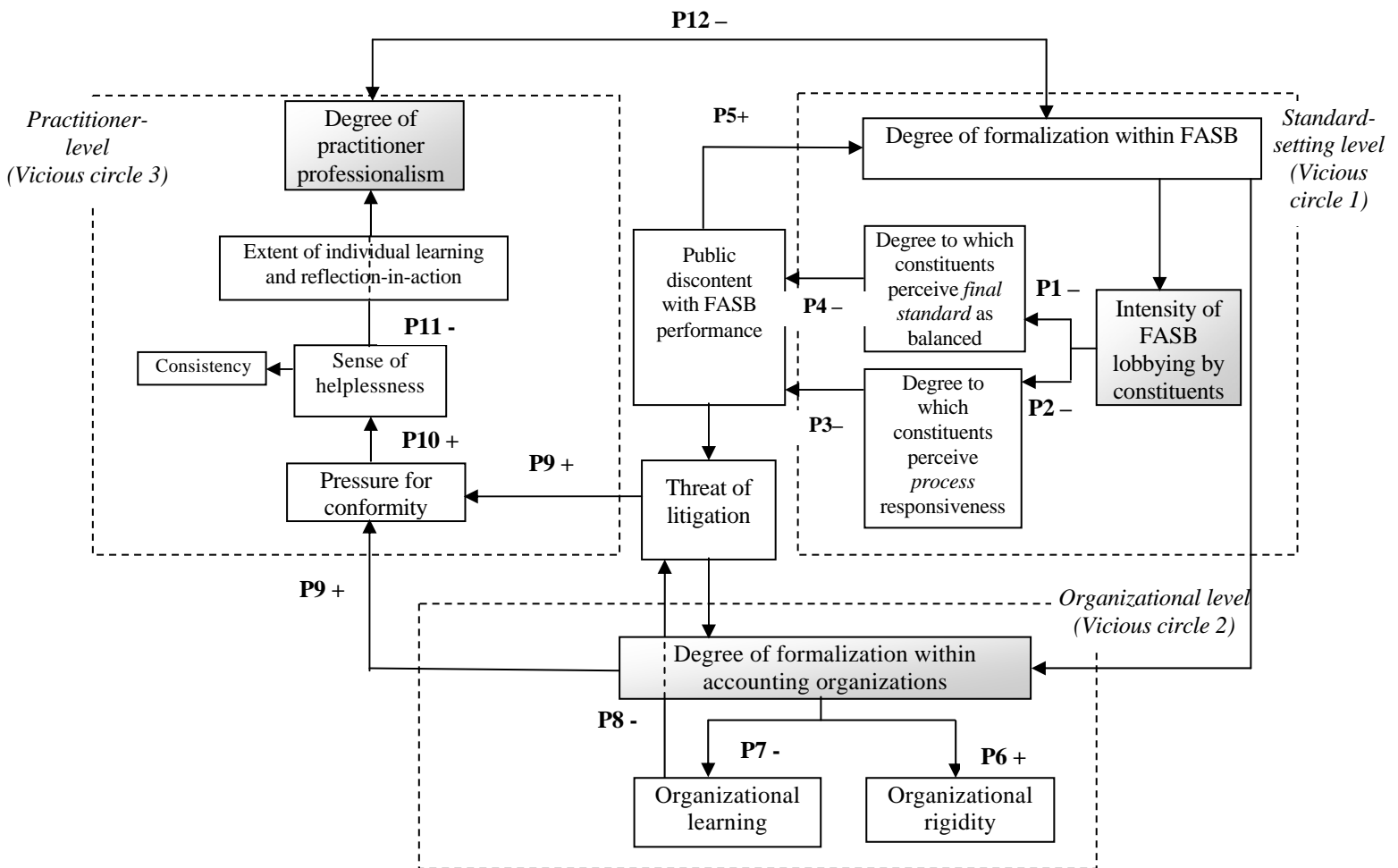
Figure 1 – The proposed theoretical framework of accounting dysfunctions

Vicious circle 1 (Dysfunctions at the standard-setting level): Propositions 1-5 Due to lobbying, politicization, and formalization, FASB continually issues complex ineffective standards that compromise public needs. Public asks for more useful information, which is interpreted by FASB as need for more rules, which invite more lobbying.

Vicious circle 2 (Dysfunctions at the accounting organization level): Propositions 6-8 The complexity of FASB rules creates a formalized environment within the accounting organization that stifles organizational learning, adaptability, and rigidity, leading to more formalization within these organizations.

Vicious circle 3 (Dysfunctions at the practitioner level): Propositions 9-11 Conformity to ineffective rules creates a perception of helplessness in the face of public discontent, and the pressure to appear consistent in their application of these rules. Consistency and helplessness reinforce conformity, forming the “culture of conformity”.

Vicious circle 4 (Link between the standard-setting and individual levels): Proposition 12 The fourth circle involves linking processes taking place at the standard-setting and practitioner levels of analysis. Individual dysfunctions find their way to the due process through the appointment of experienced accounting practitioners to Board membership. Practitioners, who are current members of the team partly in charge of setting accounting pronouncements, may have problems differentiating functional from dysfunctional practices, because of their long exposure to a stagnant practitioner culture. With their appointment, dysfunctions characterizing the practitioner behaviour negatively affect the responsiveness and technical effectiveness of the standard-setting process. In reciprocity, stagnation in thought at the FASB passes over to practitioners, and a fourth vicious circle is created.



EMPIRICAL TESTING OF THE PROPOSITIONS

To test the propositions, measures of the standard-setting, organization, and personal drivers of accounting dysfunctions could be generated either from secondary data (e.g., intensity of lobbying) or from assessments of experts (e.g., the degree of formalization). These measures could be entered into regression equations as predictors of the dependent variable in each proposition. In order to test Proposition 1, researchers could acquire data covering several different FASB standards and evidence of lobbying efforts against the proposed draft of the standards. One approach to collecting this data might be to create a survey instrument that measures the degree to which different FASB constituent such as institutional and individual investors, creditors, labor unions, etc., find those standards that were met with fierce lobbying to be balanced. Corporate lobbying has been typically in the literature using comment letters sent in response to FASB's request for input on exposure drafts (see Ettredge et al., 2002; Kelly, 1985; King & O'Keefe, 1986; Tandy & Wilburn, 1996).

Proposition 2 would also be tested using a survey instrument that measures the degree to which the different constituents perceive the FASB standard-setting agenda of emerging projects to be researched and regulated to be responsive to their needs. The instrument can list and describe the agenda projects currently being considered by the Emerging Issues Task Force, and then a sample of main constituent group could be asked to rate the standard in terms of the underlying issue's perceived priority to the constituent. Respondents could be drawn from the FASB constituents, who would be asked to reply to the questions on Likert scales whose values would range from "strongly disagree" to "strongly agree" for a consecutive series of FASB standards. This would permit the computation of quantitative scores representing the average perceived fairness of the produced standard and the perceived degree of responsiveness associated with an emerging standard.

Propositions 3 and 4 could be measured using the same measures for the independent variables as those used in Propositions 1 and 2, respectively. The level of public discontent should represent the parties with direct interest in FASB announcement, including special interest groups. Discontent could be measured using a continuous variable whose scores would be obtained from a questionnaire directed at investors, financial analysts, and financial statement preparers.

Proposition 5 could be tested using an association between public discontent and formalization. The degree of formalization could be measured using the information processing requirement scores, which can be determined objectively using an experiment where a group of practitioners with minimum years of experience would be asked to process cases involving accounting issues regulated by the standards. The time needed to complete the exercise and questions asking the respondents to evaluate the complexity of each standard can provide indication of the marginal formalization added by each respective standard. Control variables could be employed to hold constant factors that might confound the effect of the independent variable in each proposition.

To test Propositions 6 and 7, a set of standards that have been judged complex (high formalization) using the above technique can be used as the basis for measuring the effects of these standards, upon implementation, over the level of organizational learning and rigidity within organizations implementing the standards. A survey questionnaire can be used to estimate the levels of organizational learning, adaptability and flexibility for a sample of accounting firms. The literatures

on organization attributes of interest in each of the two propositions (e.g., degree of bureaucracy, rigidity, and centralization of workflow and organizational learning, adaptability and flexibility) contain several measures for the proxies of these attributes. To test Proposition 8, the perceived threat of litigation can be assessed by means of archival data concerning the outstanding number of lawsuits that accounting firms are subject to.

Propositions 9-11 test the effects of cognitive processes of conformity and helplessness on practitioner learning, reflection-in-action, and professionalism. To test Proposition 9, formalization can be tested as described in Proposition 5. Testing Propositions 9-11 involves the use of a survey instrument to be given to practitioner respondents from accounting firms after implementation of complex standards. The instrument would measure the pressure for conformity using a set of questions that measure the perceived pressure for compliance to institutional and organizational rules. Helplessness may also be measured using a set of questions that tests the degree of perceived control over the immediate environment.

Reflection-in-action, individual learning, and degree of professionalism can also be tested using similar sets of questions or experimentation. Control variables could be employed to hold constant factors that might confound the effect of the independent variable in each proposition. The degree of support for a proposition would be assessed by the significance of the regression coefficient for the relationship between the specified driver and the dependent variable. For example, if the regression coefficient expressing the relationship between formalization and conformity was positive and significant, support would be provided for Proposition 8. Similarly, if the regression coefficient representing the relationship between conformity and helplessness was positive and significant, there would be support for Proposition 10.

DISCUSSION AND CONCLUSIONS

This paper develops a theoretical framework that explains dysfunctional behaviors in the accounting community. Causes of dysfunctional behaviors are identified at three levels of analysis: the standard-setting, accounting organizations, and the individual practitioner. The theoretical framework is focused in a set of twelve propositions explaining the drivers of accounting dysfunctions at the standard-setting, organizational and individual practitioner's levels of analysis. The theoretical framework is not intended to be an exhaustive theory of all causes of accounting dysfunctions, but rather an expression of an interrelated set of behavioral drivers, which together form four downward spirals of performance. The arguments are grounded in organizational theory and managerial cognition streams of research to provide the theoretical underpinnings for the propositions. No other paper to my knowledge has attempted to propose a model of a similar scope. The paper ties causes of dysfunctions at different levels of analysis. For example, individual dysfunctions are modelled as a function of institutional, organizational, and cognitive factors.

Masuch (1985) defines vicious circles as "action loops with counterproductive results", where the same dysfunctional activities continue to occur in a reciprocal fashion. This paper suggests that accounting dysfunctional behaviors that caused deterioration in the public confidence in the accounting profession are a product of four vicious circles acting at and in between the practitioner, organizational, and standard-setting levels. At the standard-setting level, lobbying and politicization

of the standard-setting process produces compromised standards that cause public discontent. Owing to the entrenchment of regulations in the accounting community, FASB interprets public discontent with some of its standards as calls for heavier regulations. At the accounting organization level, the complexity of regulations creates a formalized environment that stifles organizational learning, adaptability, and rigidity, leading to more formalization within these organizations.

At the practitioner level, conformity to ineffective rules creates a perception of helplessness in the face of public discontent, and the pressure to appear consistent in their application of these rules. The ensuing deterioration in individual professionalism is channelled back to the standard-setting process through memberships on FASB and other organizations, and contributes to the dysfunctions at the standard-setting level. Society will be adversely affected through the increasing cost of getting information, the increasing cost of capital to firms, and the investors' reliance on possibly less quality information. The accounting field will gradually fail to attract qualified, creative members because of the unattractiveness of the profession. Existing members will be mostly "neutralized" because of the effect of groupthink, which will lead to more problems and less evolution in the field.

Implications for practice

Technical solutions to problems facing practitioners are constantly being offered in the literature. Accounting studies reviewed in this paper contain several of such solutions (Lev and Zarowin, 1999; Francis and Schipper, 1999). The solution may lie in "shaking" the traditional culture of accounting profession and professionals, possibly by adopting modern management philosophies, such as outsourcing, value chain analysis, total quality management, and business process reengineering, to traditional accounting institutions and role. The current business trend of outsourcing non-value added activities to external information systems (IS) companies, such as Xceed and IBM may be applied to the entire accounting function. Firms would transfer the entire accounting function to these IS companies, who would be in charge of creating accounting information to investors for a fee. Accounting firms might merge with IS companies for the best interest of the clients, to become "syndicators" of financial information.

The direct effect on is broadening the scope of functions that accountants are in charge of to include tasks down the "value chain" towards the final user. Accounting professionals would be in charge of providing all information relevant to investment decision making. Such information products would include company historical, future-oriented, and share performance information in addition to in addition to industry, market, and country outlooks. Being able to provide information supplementing but not conforming to GAAP, alternative values for hard-to-measure intangible assets, such as managerial talent and information, and non-financial performance measures would find their way into the information products.

Under this proposal, accounting firms would turn into large investor information-services organizations that integrate functions traditionally provided separately by accounting, auditing, brokerage, and financial analysis firms. By turning into syndicators of financial information, accounting firms would have to compete for investor dollars by preparing financial statements for firms based on GAAP and complementing them with future-oriented, valuation-related, and stock performance information used by investors for decision making. The overall value provided to users

would be maximized, because only a portion of information produced would consist of traditional GAAP financial statements, while a majority would consist of non-traditional information.

The audit function under this proposal would lose its significance over time, and the “attestation” function would be replaced by free market mechanisms, which will force these syndicators to obtain and maintain public confidence in the syndicator reports. This proposition would overcome many of the accounting dysfunctions, such as the irrelevancy of accounting information, because the syndicator would provide various sets of information products offered to the public, who will be free to choose the product they think is most relevant. Gradually, the public “consumers” of information will start demanding new items of information and products, and according to market forces, the syndicator that will provide the information product most effective in investment decision making will prevail. Over time, only those syndicators who respond to public needs of information (in a timely fashion) and at the least cost possible will survive. Since syndicators are expected to specialize in information production, economies of scale will step in to reduce the cost of providing information, and the result will be less transaction cost that will be felt throughout the whole economy.

FASB and forced organizational change

Cialdini (1984) proposes that forced change may be the only remedy in near hopeless situations. Unable to commence favourable change internally, FASB has been the target of SOX efforts for aimed at providing the standard-setting body with the mechanisms it needs to discharge its responsibilities in creating high quality standards and protecting investors in the most efficient manner. The SEC will continue to require FASB standards to be followed in preparing registrant financial statements. SOX requires FASB to be structured like a private entity with a board of trustees. Serving in the public interest, the majority of the trustees should not, concurrent with their service on such board and during the two-year period preceding such service, be associated persons of any registered public accounting firm. These organizational changes will have wide-ranging ramifications on the quality of FASB standards. They will lessen FASB’s dependence on its environment, particularly private prepares, for funding, legitimacy, and survival. Also, FASB members and practitioners will be less subject to threat of litigation now the standard-setting process is less politicized, albeit still subject to extensive lobbying.

FASB funding has also been a subject for change, with the obvious aim of reducing dependence on private funds. In addition to prohibiting contributions, SOX act requires FASB obtain funding from sources specified in section 109 of the Act. FASB will be financially supported by an accounting support fee collected from all publicly traded companies according to their size, and by sales of publications without compromising the perceived independence of the standards-setting body. Importantly, in response to public discontent of lack of FASB responsiveness to public information needs, SOX requires FASB to promptly consider changes to accounting principles necessary to reflect changing business processes. Additionally, since FASB will be organized into a quasi-governmental agency, its pronouncements will have the power of law. It remains to be seen whether FASB will become a government organization subject to the political influence of Congress as standards setting moves from the private sector.

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Fundamental Accounting Truths

Accounting is the medium of financial communication in business, consisting of the following truths:

1. Accounting is a technical language, using the terms of debit and credit as synonymous for the layperson terms of increase and decrease.
2. Accounting is a system expressing the activities of the three elements of assets, liabilities, and equity to create two informational segments: financial status at critical dates and a detailed classification and measure of unequal changes in assets and liabilities that have impact on equity.
3. Accounting reports financial information for accounting periods, officially the fiscal year and interim periods. The reporting by public corporations consists of comparative balance sheets as at the end of the most recent two years, and statements of (a) income, and optionally, of comprehensive income, (b) stockholders' equity, and (c) cash flows, for the three most recent years.
4. Accounting makes use of accounting standards, comprised of concepts, principles, and guidelines, often termed generally accepted accounting principles (GAAP), set by the Financial Accounting Standards Board (FASB).

The Intrinsic Nature of Accounting

Accounting transforms data in the form of financial events and period-end valuations into items and item changes, and simultaneously underlying units, through the use of accounts assembled by account classes for each of the three elements.

Accounting is best explained as a recording and reporting process based on deductive reasoning, defined in the Merriam-Webster Collegiate dictionary in a past edition as a "proceeding from the general to the particular, or from the universal to the individual, or, specifically, from given premises to their necessary conclusions." (A more recent definition of the dictionary emphasizes "given premises to their necessary conclusions.") In short, the accounting model is the result of aggregation and disaggregation (particularization), a perspective in the broad that embraces and controls value measurements in detail. This approach makes the vast diversity and scope of accounting logical, meaningful, and understandable.

The Meanings of Debits and Credits

Debits and credits are the content of entries which express in accounts the opposing effects of the elements, appearing in the accounting equation, as follows:

1. Debits denote increases in assets as resources, and decreases in liabilities and equity as sources.
2. Credits denote increases in liabilities and equity, and decreases in assets.

In a real sense, debits and credits are the increases and decreases outlined above. The debits and credits could be reversed, with the same financial effects. Each term expresses two types of directions, but are scientific in their converse treatments.

The Need for Clear Language

Accounting mystifies students by the use of vague, imprecise terms. Examples are the terms balance sheet, trial balance, and work sheet. Particularly damaging are the terms current and nominal. The first term is used to mean (a) the accounting period in progress, still not closed, and (b) the succeeding year, in classifying items as short-term and long-term on the balance sheet. The second term refers to the accounts for revenues, expenses, gains, and losses, often cited in accounting literature as existing in name only; a preferable, accurate term is operational, since the account categories named are descriptive of the positive and negative effects of operations on equity as a real item and element.

Structures of Accounts

Accounts, as previously stated, describe balance sheet items that have financial (economic) life, and income statement items that measure changes in equity as a result of operations.

The structures of the two types of accounts differ in great degree. The accounts for the items of life are dissected into components to fulfill the varied informational needs of management, commercial law, finance, income taxation, and, in the case of public corporations, the capital markets. The changes in equity are merely descriptive, without life, and, therefore, are simpler because of their being adjectival.

The structures of the accounts for balance sheet items differ as between simple items and complex items. Simple items are of short life and have a single characteristic at origin and not more than one characteristic during its holding period, before termination through collection, payment, sale, disposal, exchange, or expiration of life. Examples of single-account items are Cash in Bank; Interest and Dividends Receivables and Payables; Inventories of Supplies, and Unexpired Insurance, i.e., Prepaid Insurance. An item is short-term (current) if its life expires within one year; an exception is an operating cycle item expiring after one year but within the operating cycle.

Complex items are of long-term life, i.e., extending beyond the current period, defined above, and having one or more characteristics that require separate, individual treatment.

Accounts of long-term life may have one or more characteristics of increase or decrease, or both. Accounts with one characteristic are exemplified by (a) tangible assets, and (b) intangible assets having value to third parties, and long-term deferred charges to expense having value to the enterprise as a going concern. Items in the three classes, with the exception of land and goodwill, have two accounts: a primary account designating the asset and reflecting acquisition cost, and offsetting contra accounts titled Accumulated Depreciation and Accumulated Amortization, measuring cumulative allocations to expense accounts for each accounting period.

Complex items also include assets stated at market value, exemplified by marketable equity securities, expressed in three accounts: a primary account reflecting cost used in determining gain or loss on sale, and additive and contra accounts used to adjust the cost to higher or lower market values. Marketable debt securities and bond investments and payables, issued at face amount, at a premium, or at a discount, also entail three accounts: a primary account reflecting the face amount collectible or

payable at maturity, an additive account for the premium, and a contra account for the discount. The premium and discount accounts adjust the bond cash interest to the bond yield interest earned as revenue or incurred as expense.

FASB Accounting Standards

The goal of accounting is to report item changes and balances dispassionately and without bias, for use by management and external parties as stakeholders. The goal is expressed in three of seven FASB principles: (1) Objectivity and Reliability of Data, (2) Full Disclosure, and (3) Uniformity, Comparability, and Consistency in Financial Reporting.

The philosophical, qualitative content of accounting is seen in the following concepts and tempering guidelines issued by the FASB:

1. The concepts of (1) Entity; (2) Going Concern; (3) Monetary; (4) Periodicity; (5) Accrual Basis; and (f) Two-fold Effect. Regarding the last two concepts, the accrual basis system employed is a subset of the concept of Periodicity, and the two-fold effect, often a three-fold effect, is an undeniable characteristic of financial events.
2. The principles of (1) Objectivity and Reliability of Data; (2) Full Disclosure; (3) Revenue and Gain Realization; (4) Expense Incurrence; (5) Matching of Expense with Revenue; (6) Loss Realization and Sustainment; and (7) Consistency, Comparability, and Uniformity in Reporting.
3. The guidelines (conventions and constraints) of (1) Relevance of Data; (2) Substance Versus Form; (3) Probability Versus Improbability of Materialization; (4) Conservatism; (5) Materiality, and (6) Cost-benefit Relationship of Data.

The three principles relating to faithful representation, listed earlier, coexist with four principles, of an operative type, since they are functional in making entries and preparing financial statements. The four FASB principles that govern and regulate the accounting are the following: (4) Gain and Revenue Realization; (5) Loss Realization or Sustainment; (6) Expense Incurrence; and (7) Matching of Expense with Revenue.

All four principles emphasize the reporting of comprehensive net income, and should be expanded to encompass the reporting of financial position, based on logic and thoroughness. As to logic, both the measure of income performance and financial status are intertwined and equally important, and therefore deserve equal recognition.

Regarding logic, the elements of assets and liabilities are the reality, and, therefore, are creative of equity as the third reality. Accordingly, the thought process in recording is to focus on the effects of asset and liability on expense and revenue, and on gain or loss; also, gains and losses should be attributed separately, first, as to transactional events; second, as to unilateral occurrences or happenings; and, third, as to valuations.

Regarding thoroughness, the principles bearing on the four classes of net income determinants are qualitative, and therefore should be augmented to achieve (a) a realistic, summary

presentation to stakeholders, and (b) a coverage of the numerous equal changes in assets and liabilities and the unequal nonoperational changes that affect equity.

Proposed Additional Accounting Concepts

The preceding commentary on accounting standards indicates a necessity to enhance the FASB standards. The writer proposes two concepts and nine principles to make possible an explanation and a validation of every entry required to record practically all business events.

The two concepts are (1) Intent and Expectation, and (2) Chronological Sequence of Representation. The first concept has two applications. Intent has reference to management's planned policies, decisions, and actions serving to create assets and liabilities, and, simultaneously, revenues and expenses on the one hand, and gains and losses on the other. Expectation focuses on the future to the extent that it is predictive, such as data explicitly set forth in cash, operating, and capital budgets.

The second concept of Chronological Representation concerns the time sequence of origin of assets and liabilities in relation to revenues and expenses, and gains and losses. The revenues and expenses, in great degree, originate simultaneously with assets and liabilities, and, also, as derivatives of (a) assets precedent to their conversions into expense, and (b) liabilities precedent to their conversion into revenue. An inverse sequence of recording requires period-end adjustments to produce accurate financial entries, which prove cumbersome in preparing regular interim-period financial statements essential to efficient management, and require reversal entries to avoid duplication in collections and payments recorded on due dates in the ensuing accounting period.

Proposed Additional Accounting Principles

The nine additional accounting principles consist of one principle of classification and eight principles relating to valuation.

The Principle of Classification as it applies to the balance sheet requires a uniform presentation of assets, liabilities, and equity components. The FASB, in fact, should propose the classifications, in order to facilitate the comparison of enterprise information in the same and different industries. The balance sheet account classes, already standardized in degree, consisting of current and long-term categories of assets referred to as current assets, long-term investments, long-term tangible assets, long-term intangible assets, and long-term intangible deferred charges to expense. The same current and long-term categories are used for liabilities, namely, current liabilities and long-term liabilities. Regarding equity, accounts titled Investments, Withdrawals, and Income Summary for the period are closed out into an overall Equity account for unincorporated business entities. Corporations use structured account components that differ as between corporations classified as Subchapter C and Subchapter S under the Internal Revenue Code.

Public corporations are Subchapter C entities that utilize several accounts: Capital Stock to measure legal capital, Additional Paid-in Capital to reflect amounts in excess of legal capital, Retained Earnings to express accumulated net income less dividends, and Accumulated Other Comprehensive to express accumulated other comprehensive items, and Treasury Stock.

The Principle of Classification also embraces the statement of income and the optional statement of comprehensive income. Transparency is ensured if the classes of operational information are those employed in the multiple-step form of income statement. The single-step form is insufficiently classified and too sparse, and therefore should be rejected as a portrayal of income performance.

The multiple-step income statement is itself unduly convoluted as a result of an intricate dissection of realized and valuation gains and losses. A more effective, less-fragmented model should (a) develop a core income that separates realized nonoperating-cycle gains and losses from valuation

gains and losses, and (2) eliminate the other comprehensive income classification entirely, by including other comprehensive gain and loss items a part of the classification of extraordinary items displayed immediately following the reporting of gains and losses from discontinued operations.

Valuation gains and losses from uncollectible trade receivables and inventories stated at market value are properly classified as expenses, since they are risks of loss that are voluntarily invited and unavoidable in the quest for greater profits. Also, they are persistent and predictive as to occurrence, unlike the volatile valuation gains and losses that characterize extraordinary items. Extraordinary items should also include the losses from relatively permanent impairments in value of nonoperating cycle assets that, of course, are not reflected automatically at cash realizable and market values under prevailing principles and rules of valuation.

The eight principles relating to valuation are formal standards applicable to account groups, as follows:

1. Cash Realizable Value, applicable to asset claims, trade and nontrade, with due consideration to the time value of money; also, Cash Discharge Value, applicable to similar, converse, liability claims.
2. Market Value, applicable to marketable equity securities and to inventories of commodities carried at market value, and commercial and industrial products carried at the lower of cost or market value.
3. Equity Value Versus Cost Value, referred to as accounting methods. The equity value method reflects amounts based on percentages of ownership interests in sole proprietorships; partnerships; limited liability companies treated as partnerships; S corporations; and C corporations, whose voting stock outstanding is owned 20% or more by the investor enterprise. The cost method applies solely to C corporations owned less than 20%. The equity value method reflects the purchase cost of the investment, which is adjusted for the percentage shares of net income, net loss, and distributions from the investee company. The cost method reflects the cost of the investment, does not recognize the net income or net loss of the investee company, and treats the distributions from the investee company as revenue.
4. Face Amount or Amortized Cost, regarding issues at face amount, or at face amount plus a premium or minus a discount applicable to marketable debt securities and bonds owned, and, similarly, but conversely to bonds payable issued.
5. Original Cost, applicable to land and goodwill.
6. Original Cost and Limited Life, allocable as depreciation expense for long-term tangible assets, and as amortization for long-term intangible assets and long-term deferred charges to expense.
7. Undiscounted Value of Future Income Tax Benefits, recorded as Deferred Tax Charges, in recognition of temporary differences as between accounting and income tax treatments, and Undiscounted Value of Future Income Tax Payables, also as a result of temporary differences.
8. Relatively Permanent Impairment in Value of Assets, relating to items that are

not automatically reflected at cash realizable value and market value under normal rules of valuation.

The treatment of long-term deferred charges to expense has been controversial. The account class differs from long-term intangible assets in that the latter class possesses value recognized by all stakeholders, whereas the former class has value solely to the enterprise as a going concern. Some writers term the deferred charges as accounting assets, implying that the items have no value, and therefore should be reflected as expense at the time of expenditure. This reasoning is illogical since the costs are incurred to effect higher expense savings or other benefits in the future. Such is the case also with regard to restructuring charges, required by an FASB pronouncement to be treated as expense in the period of expenditure. The writer's opinion is that restructuring costs are valid assets, a belief that conforms to the concept of Periodicity, the principle of Matching Expense with Revenue and Expense Savings, and the guidelines of Probability Versus Improbability of Materialization of Contingencies, Conservatism, and Materiality.

The Group-Account, Item-Characteristic (GAIC) Methodology of Accounting

The writer has developed a novel, innovative system of learning financial accounting that differs from traditional methods presented to date. He terms the system the Group-Account, Item-Characteristic Methodology of Learning Financial Accounting. The system embraces both balance sheet items and the equity changes that establish comprehensive net income (net income plus other comprehensive net income).

Application of GAIC methodology to Balance Sheet Items

Regarding balance sheet items, the methodology assembles financial status items according to their similar nature and component characteristics expressed in accounts of varying structure for presentation in the financial statements as end products. Almost all balance sheet items can be classified by groups consisting of two or more similar members. Thus, short-term and long-term claims are identical in their classification as current assets and long-term investments, and, similarly, but, conversely, in their opposing appearances as current and long-term liabilities. As a second example, marketable equity securities are identical as to nature and treatment, whether they are classified as (1) cash equivalents or available for sale, or (2) as current assets or long-term

investments. Investments in marketable debt securities are also treated identically, whether classified as current assets, long-term investments, or both, if collectible in installments. Marketable debt securities issued, similarly, are classified as current liabilities or long-term liabilities, or both, based on whether they are due on a single-maturity date or a series of maturity dates. As another example, the equity method, as opposed to the cost method, is used to value the major types of business units, other than a stock ownership of less than 20% in corporations reporting under Subchapter C of the Internal Revenue Code. As a final example, depreciable long-term tangible assets, amortizable long-term intangible assets, and amortizable current and deferred charges to expense are similar in nature and treatment, reflected at cost at origin, and, except for land and goodwill, are allocated as expense over their estimated lives.

Each balance sheet group consists of a leader, knowledge-bearing account and similar follower, represented member accounts. A full knowledge of the nature, activities, and accounting treatments of the knowledge-bearing account automatically encompasses the represented members of the group. A single account represents simple items, and multiple accounts, complex items. The characteristics of increase and decrease apply to (1) the item as a whole, expressed in a single account; and (2), for an item possessing component characteristics, expressed in primary, additive, and contra accounts.

Applications of GAIC Methodology to Operational Changes

Regarding changes in equity from operations, the operational accounts employed are, in nature, descriptive of net income and other comprehensive income. The grouping of such accounts is based on (a) the manner of their origin, and (b) the reporting of their changes, before or after tax effect.

As to the first facet, the changes, classified as revenues, expenses, gains, and losses, originate in the following ways:

1. At inception of a transaction, assignable in total to the present period, classified as asset-revenue increases and liability-expense increases.
2. By accumulation, with reference to transactional changes expressed by the time-periods of the week, the month, and longer periods, accruing through the end of the accounting period and one or more future accounting periods.

3. By conversion of assets into expenses, and liabilities into revenues, during the accounting period, and at the end and beyond the present accounting period.
4. At inception or closure of nontransactional happenings, such as acts of nature, litigation, thefts, and embezzlements.
5. At inception, regarding transactional gains and losses, and usually at period-end, regarding valuation gains and losses.

As to the second facet, equity changes determinative of operating (core) income are recorded pretax, whereas gains and losses from discontinued operations and extraordinary items affecting net income are reported net of income tax effect. The latter reporting also applies to other comprehensive income and loss items.

Concluding Comment

The GAIC methodology of learning financial accounting is organized, segmented, and scientific. Vast, diverse details of business activities are condensed into comprehensible item- groups and characteristics, easily grasped and thoroughly learned. The writer has prepared a comprehensive chart of accounts that is representative of enterprises of all sizes, and by grouping similar accounts, the fundamentals of financial accounting are mastered, on the average, in one-third to two-fifths of conventional learning time. The time saved may then be applied to the analysis of the financial reports of public and private corporations, and to a resolving of accounting issues and scenarios representative of the business world.

Quality of internal control over financial reporting, corporate governance, and credit ratings,

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ABSTRACT

This paper examines the association between firm credit rating and quality of internal control over financial reporting, and whether corporate governance is plays a role in the association. Using a sample of firms disclosing internal control weaknesses during November 2003-July 2005, I find that internal control quality is negatively related to firm credit ratings and that firms disclosing internal control weaknesses are more likely to have lower credit ratings, speculative grade rating, smaller size, lower profitability, lower cash flows from operating activities, net losses in the current and prior fiscal year, higher income variability, and higher leverage than firms with no such disclosures. Additionally, I find that internal control weaknesses decrease the likelihood of a firm receiving an investment-grade debt rating, resulting in higher cost of debt financing, lower income, and lower overall attractiveness in capital markets. Finally, results suggest that the corporate governance strength, as proxied by Gompers (2003) G_SCORE, is positively related to internal control quality.

Keywords: *Internal control; Sarbanes-Oxley Act; Credit ratings; Corporate governance*

Data used in this paper are available from public sources.

QUALITY OF INTERNAL CONTROL OVER FINANCIAL REPORTING, CORPORATE GOVERNANCE AND CREDIT RATINGS

I. INTRODUCTION

This paper examines the association between firm credit rating and quality of internal control over financial reporting, and whether corporate governance plays a role in the association. Emerging new regulations have stressed the importance of strong internal control devices, particularly those aimed at bolstering quality of financial reporting and reducing information risk for investors and creditors. Weak firm internal controls impact investor and creditor interests negatively. Credit ratings, which represent an assessment by an independent external body of a firm's ability to meet future liabilities (Standard & Poor's 2002), are a function of firm perceived risk, which has been argued to be influenced by internal control adequacy (Ashbaugh-Skaife et al. 2007; Doyle et al. 2007).

In 2002, the Sarbanes-Oxley (SOX) Act was enacted into law in the U.S. to reclaim the decline in investor confidence following a series of high-profile accounting and audit corporate failures. Mechanisms set by the law include placing responsibility on management and external auditors to assess and report on the strength of firm internal controls. In particular, Sections 302 and 404 of SOX require firm management to certify their quarterly and annual financial statements and to assess and disclose significant internal control deficiencies to the audit committee of the board and to their external auditors, and material internal control weaknesses (hereafter ICWs) in their SEC filings. Research is still growing with respect to the costs and benefits of SOX regulations. However, filers have expressed concerns about the incremental cost of SOX compliance and reporting versus the benefits to stakeholders.

The existence of a material ICW indicates substantial failures in firm internal controls that may inflict negative consequences, such as a rise in its cost of capital. It signals to firm stakeholders the inability of firm management to maintain efficient and effective operations and produce reliable financial reports. Investors and creditors are advised to raise their required rate of return for firms disclosing ICWs under Section 404 (Wilfert 2005). Further, credit rating agencies indicate that internal control quality will be an important criterion in the evaluation of firm credit worthiness (Moody's Investor Service 2004; Fitch Ratings 2005). Accordingly, this study contributes to this ongoing debate by examining whether ICWs are associated with higher credit ratings.

On the other hand, the effectiveness of internal controls improves the capacity of financial reporting to fulfill its information and valuation roles (Brown 1998). The former SEC Deputy Chief Accountant asserted “we believe that the increased attention to internal controls on the part of management will reduce the potential for errors in the financial statements, including those due to fraud”, while former SEC Commissioner, Cynthia Glassman, in a public speech observed that “this disclosure can be an important tool for investors in evaluating the reliability of a company’s financial reporting”. Consequently, the intent behind internal control disclosures is to enable investors to draw conclusions about the adequacy of the system of internal control over financial reporting, thus allowing investors to assess the reliability of financial statements.

However, past research has failed to find conclusive evidence on a relationship between cost of capital and internal control quality. Ogneva et al. (2005) examine the association between ICWs and cost of equity capital and conclude that internal control weakness identified under Section 404 (or Section 302) not being directly associated, on average, with higher implied cost of equity. Nevertheless, studies examining the effects of corporate governance mechanisms on

equity prices found opposite results. Gompers et al. (2003) find that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions. No research was conducted however on the effects of ICWs on firm credit ratings.

Bond rating agencies play a vital informational and valuation role in the capital market by assessing and publishing their opinions of firms' creditworthiness in the form of bond ratings. Not only do ratings influence bond pricing but also resource allocation in an economy by directing investment dollars towards investment grade debt securities and away from speculative grade debt securities. As a result, bond ratings are closely related to cost of debt and significantly affect firms' financing decisions (Standard and Poor's 2001). Bond ratings by certain designated rating agencies are also explicitly referenced by regulators in numerous federal and state laws and regulations (Beaver et al. 2005; Covitz and Harrison 2003).

The importance of bond ratings has led to extensive research on the determination of bond ratings. Among the economic determinants examined, reported accounting numbers are perhaps among the most important. Using accounting information to determine bond ratings has long been a primary application of financial statement analysis (see for example, Foster 1986, Ch. 14). In this paper, I contribute to the extant literature by focusing solely on the effect of the quality of internal control over financial reporting on credit ratings. No other study, to my knowledge, attempts to link credit ratings to firm internal controls. Few studies however, have recently studied credit ratings as a function of corporate governance and income smoothing.

Using logistic regression, I examine the association between internal control quality and firm credit rating. The sample consists of 171 firms that disclosed ICWs in their SEC filings over the period November 2003 till July 2005. I find supporting evidence that, as hypothesized, internal

control quality is negatively related to firm credit ratings after controlling for firm characteristics that prior literature has shown to be related to credit ratings. Additionally, I find that firms disclosing ICWs are more likely to have lower credit ratings, smaller size, lower profitability, lower cash flows from operating activities, net losses in the current and prior fiscal year, higher income variability, and higher leverage than firms with no such disclosures.

I also examine the impact of internal control quality on a firm's probability of receiving an investment grade and the characteristics of firms receiving investment versus speculative rating grade. Results suggest that internal control quality decrease the likelihood of a firm receiving an investment-grade debt rating, resulting in significant implications for assessing debt financing costs. Firms with speculative grade debt rating are disadvantaged with higher cost of debt financing (higher financial leverage), lower income, and lower overall attractiveness in capital markets. Additionally, the average speculative grade firm has a higher proportion of ICWs, is smaller in size, lower in profitability, lower in operating cash flows, lower in stability of income, and higher in leverage compared to the average investment grade firm.

Furthermore, I also test whether the association between internal control quality and credit ratings is affected by the inclusion of corporate governance in the model. Results provide no evidence of a reduction in the explanatory power of the original association. I also find positive association between governance and ratings, lending support to the argument that strong corporate governance reduce the agency conflict between management and stakeholders. The results may also suggest that, for firms with no history of internal control deficiencies, rating agencies do not place governance on the top of firm evaluation criteria and give the degree of firm leverage a lower priority if the assessed firm has a good governance structure.

This study contributes to the intense debate regarding costs and benefits of the SOX provisions requiring internal control disclosures. It examines whether there is empirical evidence regarding one important perceived benefit of effective internal controls: lower credit ratings. This study results should be useful to regulators, auditors and corporations who are interested in evaluating the benefits of increased disclosures related to internal controls and especially internal control provisions in SOX. It is the first study to study the association between internal control quality and credit rating and also whether corporate governance strength affects internal control quality. The rest of the paper proceeds as follows. In Section II, the relevant literature is reviewed and in Section III the theoretical framework is developed, culminating in the study hypothesis. In Section IV, the sample, research design and summary statistics are described. Models and empirical results are reported in Section V. Section VI discusses additional analysis related to corporate governance. Section VII concludes the study with summary and directions for future research.

II. LITERATURE REVIEW

Many firms argue about the justification for the seemingly excessive costs of compliance to the provisions requiring additional disclosure in general, and internal control issues in specific, as is the case with SOX¹. Regulators and auditors, however, see that the perceived benefits outweigh such costs. Most arguments regarding the perceived benefits of these regulations directly or indirectly involve the cost of capital effects of improved internal controls arising from investor confidence in financial reporting quality. Firms with higher quality controls are believed to enjoy lower cost of capital, lower threshold for accepting investment projects, higher profitability, improved competitiveness, and easier access to capital.

As noted by Ogneva et al. (2005), regulators and practitioners alike argue that the implications for following SOX requirements are fruitful to companies because they are expected to produce “improvements that help to restore and reinforce investor confidence in our markets, and lower the cost of capital to issuers” (Donaldson 2005), and would result in “improvements in the reliability of periodic financial reports” and “lower cost of capital” (Ernst and Young 2005).

Internal controls as a component of firm risk

Internal control over financial reporting has long been recognized as an important feature of a company (see Kinney et al. 1990; Kinney 2000, 2001). Internal control is defined by the SEC as “a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the reliability of financial reporting” (SEC 2004), and “includes those policies and procedures that: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company’s assets that could have a material effect on the financial statements” (PCAOB 2004).

In the U.S., the enactment of the SOX² in 2002 came as a response to highly publicized financial statement frauds and restatements at former corporate giants. SOX’s increased reporting and compliance requirements, particularly those of Section 404, have raised some concern, however.

Although it is Section 302 that directs company management to identify and report control deficiencies in various filings with the SEC, it is Section 404 that requires firms to assess internal controls over financial reporting and take subsequent reporting of the control deficiencies seriously. Firms argue that assessing and reporting on internal controls imposes onerous costs in time and money, which in turn, results in adverse macroeconomic effects, such as loss of competitiveness.

The question of whether the ICW disclosure is value relevant or merely an addition to a company's compliance burdens is relevant to several parties. This study provides evidence on the importance of such disclosures not only to users of financial statements but also to firms preparing the statements. Without assurance of the well-functioning of internal control mechanisms in a firm, there can be no confidence in the accuracy of financial reports generated through a firm's accounting system, and more importantly, firm cost of debt will be higher, putting a firm at a disadvantage compared to similar firms with higher effective controls.

Discovered ICWs are divided into three categories according to level of deficiency: deficiency, significant deficiency, and material deficiency. SEC Final Rules require management to disclose all significant and material deficiencies to the company's auditors and board, but only material deficiencies to the SEC in its periodic filings. As noted by Ogneva et al. (2005), SEC regulations Final Rules of 2002 and 2003³ and AS 2⁴ states that the existence of a material weakness prohibits the listed firm from concluding it has effective internal controls⁵. Examples of material weaknesses are provided in the Appendix.

Research into the determinants and consequences of internal control deficiencies has gathered momentum over the past few years. Internal control was found to be weaker in young firms with small size, poor financial performance, more complex operations, rapid growth, current

restructuring activities (Doyle et al. 2007), lower audit committee quality (Krishnan 2005), incidence of earnings restatement Kinney and McDaniel (1989), recent changes in organization structure, more accounting risk exposure, and fewer resources to invest in internal control (Ashbaugh-Skaife et al. 2007). On the other hand, Ogneva et al. (2005) examine the association between ICWs and cost of equity capital and conclude that internal control weakness identified under Section 404 (or Section 302) not being directly associated, on average, with higher implied cost of equity. Specifically, they find that IC weakness firms have modestly higher cost of equity but this difference vanishes after controlling for economic characteristics associated with ICWs.

Financial advisers warn investors and creditors to raise their required rate of return for firms disclosing ICWs (Wilfert 2005), while credit rating agencies (Moody's Investor Service 2004; Fitch Ratings 2005) indicate that internal control quality will be an important criterion in the evaluation of firm creditworthiness; and public accounting firms such as Deloitte and Touche (2005) and KPMG (2005) suggest that compliance with Section 404 would improve the reliability of financial information and hence reduce a disclosing firm's cost of capital and increase the confidence in the bond markets (Ogneva et al., 2006).

In summary, the reporting community has complained that the costs of complying with Section 404 are not commensurate with benefits. Regulators and auditors, on the other hand, believe that the benefits of improved internal controls outweigh the costs of compliance through lowering cost of capital. Prominent users, such as credit rating agencies, have indicated that serious internal control problems will be a definite factor associated with costs of equity or debt capital. Given these divergent viewpoints, it is important to examine whether ICWs disclosed under Section 404 are indeed associated with higher costs of capital.

Importance of credit ratings

Bonds provide a critical mechanism for companies to raise funds to finance new and continuing activities and projects. Corporations raise substantially more capital in the bond market each year than they do in the equity market. The assigned rating is very important due to the implications it carries for the bond issue and the subsequent yield. The yield spread between major categories of bonds can be large, potentially resulting in a difference of millions of dollars in interest payments over the life of a bond issue. Additionally, there are also many regulatory requirements in the U.S.A. and abroad that are specified in terms of a firm's assigned bond rating. A long list of agencies allow investments to be made only in "Investment Grade" debt instruments (e.g. Aaa, Aa, A, and Baa). The fact that regulatory agencies define requirements partially based on independent ratings indicates the importance and degree to which the rating process is influential in the market system.

There is also substantial empirical evidence in the finance and accounting literature that establishes the importance and information content of bond ratings and changes in bond ratings. There is evidence on the effect of bond ratings on bond yields and consequently the firm's cost of debt capital. Ziebart and Reiter (1992) demonstrate that bond ratings directly affect bond yields. Other research demonstrates the effect bond ratings and bond rating changes have on firm equity prices. Ederington et al. (1987) find that bond ratings provide additional information to the market above and beyond a set of accounting variables. Evidence has indicated the downgrades in bond ratings are associated with negative abnormal stock returns (Holthausen and Leftwich 1986).

Furthermore, securities prices react to firms being placed on Standard & Poor's Credit Watch List, as well as actual upgrades and downgrades in the ratings (Hand et al. 1993). Studies have

also examined the market reaction to changes in bond ratings according to the cause of change. Goh and Ederington (1993) further examine stock price reactions to bond rating downgrades, and find that rating downgrades due to an increase in leverage of the firm results in no stock price reaction while downgrades due to deterioration in the firm's financial prospects results in a negative stock price reaction. Further research finds that firms receiving rating upgrades outperform firms receiving downgrades by 10 to 14 percent in common stock performance in the year following the bond rating change (Dichev and Piotroski 2001). Furthermore, they report that current ratings changes predict not only changes in future rating, but also changes in the firm's future profitability. Moreover, Ederington and Goh (1998) find that analyst's alteration of earlier earnings forecasts following ratings downgrades appear to be prompted by the downgrades. Evidence from these studies show clearly that both the stock and bond markets react in a manner that indicates bond ratings convey important information regarding the value of the firm and its prospects of being able to repay its debt obligations as scheduled.

Researchers suggest a relation between information risk and risk premium required by investors (Easley and O'Hara 2004; Leuz and Verrecchia 2004). Ogneva et al. (2005) suggest that poor internal controls lead to lower quality financial statements which increase cost of debt by increasing information risk. However, these studies focus on the relation between financial reporting quality and cost of equity capital. None of these studies investigated the effect of internal control quality on credit ratings. In addition, other studies find a relation between attributes of accounting information and cost of capital. Specifically, cost of capital is found to be related to commonly used measures of accounting quality (Francis et al. 2004a, 2004b), and increases in cost of capital to follow earnings restatement announcements (Hribar and Jenkins 2004). The effect of information risk on credit ratings is expected to be analogous to the effect on

the cost of equity capital, since both are a function of information risk. Therefore, lower credit ratings may be expected for firms with lower internal control quality.

Besides the relation between internal controls and information risk, weak internal controls over financial reporting may be indicative of generally poor management controls, which could increase business risk. Therefore, weak internal controls over financial reporting could be indirectly associated with higher business risk, which may affect debt rating and, consequently, yield (Ziebart and Reiter 1992).

III. HYPOTHESIS DEVELOPMENT

Ogneva et al. (2005) examine the association between ICWs and cost of equity capital, and conclude that ICWs identified under Section 404 (or Section 302) are not directly associated, on average, with higher implied cost of equity. Specifically, they find that ICW firms have modestly higher cost of equity but the difference disappears after controlling for economic characteristics associated with ICWs. Overall, their results are consistent with internal control weaknesses disclosed under Section 404 not being associated, on average, with higher implied cost of equity.

Ashbaugh-Skaife et al. (2006) argue that firm credit ratings, which evaluate the likelihood that a firm's future cash flows will be sufficient to cover debt service costs and principal payments, are determined by rating agencies' assessments of the probability distribution of future cash flows to bondholders, which in turn, depends on the future cash flows to the firm. Further, credit ratings decline as a result of a decline in the firm's expected future cash flow or an increase in the fluctuation in these cash flows increases.

Agency conflicts can increase the probability of default and reduce the value of stakeholders' claims (Jensen and Meckling 1976). The problem of moral hazard (e.g., excessive compensation)

caused by information asymmetry between managers and stockholders may reduce the expected future cash flows of the firm, and increase its default risk to bondholders, resulting in lower credit ratings (Ashbaugh-Skaife et al. 2006). Additionally, stockholder actions resulting in wealth transfer (e.g., in the form of dividends) from bondholders to themselves can affect the mean and the variance of the firm's future cash flows adversely, resulting in an increase in the firm's default risk to bondholders and a decrease in bond credit ratings (Ashbaugh-Skaife et al. 2006).

Accounting information is extensively used in the fundamental analysis that rating agencies perform in evaluating firm creditworthiness. Such information is used in developing and benchmarking profitability and leverage ratios necessary for assigning a rating to a bond issue (Standard & Poor's 2002). A difference of a single rating category (e.g. B vs. B-) can often mean a 100 basis point yield differential (Ashbaugh-Skaife et al., 2006). Information about internal control quality provide direct insight regarding the underlying reliability of the firm's audited financial statements, and is therefore extremely important to the rating agencies who depend upon these statements to assess firm default risk.

Although substantial research has been completed in the bond rating area, no previously published research has examined the effects of management's assessment of internal control adequacy on bonds. This study contributes to the literature concerning effects of ICWs on bond markets. The consequences of ICWs on financial statement users have been well documented in previous literature (Doyle et al. 2007; Gupta and Nayar 2007). If financial statement users perceive the ICWs to directly negatively impact firm performance or financial statement reliability, then they are likely to impose a cost of capital premium for information risk associated with their inability to rely on the financial statements (Bryan and Lilian 2005). A cost

of capital premium suggests a negative association between the material weakness assessment and bond ratings, given the inverse relationship established between bond ratings and bond yields (Ziebart and Reiter 1992).

Utilizing these measures I investigate the general assertion that a material deficiency in internal controls as determined by management and attested to by an external, independent auditor, is associated with lower credit rating. The following hypothesis (stated in the alternate form) suggests a negative association between firm credit rating and quality of internal control over financial reporting.

H1: Firm credit rating is negatively associated with internal control quality

IV. SAMPLE AND DESCRIPTIVE STATISTICS

Sample selection

The population under study consists of U.S. firms disclosing control weaknesses in their SEC filings. I use firm disclosures of ICWs as a proxy for internal control quality. ICW disclosures have only been widely disclosed in SEC filings, including Form 10-K, 10-Q, 8-K, S-3, and S-4, and in proxy statements, since August of 2002. Examples of such disclosures are provided in the Appendix. Data for this study was obtained from three sources: *Compliance Week*, *Compustat*, and Gompers' (2003) G_SCORE databases. Essentially, the final sample for the credit rating analysis is determined by the intersection of firms for which required data are available on the data sources noted.

Since November 2003, *Compliance Week* (a weekly newsletter that tracks Sarbanes-Oxley related compliance issues) has been collecting and publishing monthly reports on firms that

disclose internal control deficiencies. These publicly-accessible reports are list companies disclosing material weaknesses or deficiencies in internal controls by month during the period of November 2003-July 2005. There were 922 internal control disclosures over the named period. In the event there was more than one disclosure for the same firm, I do not include the firm multiple times in the sample, descriptive statistics, or statistical tests. There were 92 such duplicate disclosures⁶.

I then obtain financial data from the annual *Compustat* database and eliminate 70 firms that are not listed in *Compustat*. Further, 589 firms were deleted from the sample because they have no credit rating in *Compustat* (i.e., no entry in *Compustat* data item 280) during the sample period, resulting in a final sample of 171 internal control weakness firms. The sample selection procedure is detailed in Table 1. Essentially, the sample period in this study is significantly longer than that of other concurrent work as I examine 21 months of data, including both Section 302 and 404 disclosures. For example, Ashbaugh-Skaife et al. (2007) limit their analysis to Section 302 disclosures in the year prior to the effective date of Section 404.

(INSERT TABLE 1 ABOUT HERE)

Control sample

For the control firms, I use the sample of firms in *Compliance Week* that did not disclose any ICWs over the study period November 2003- July 2004. To avoid difference in power biases due to differences in size between sample and control firms, I elect to include only 171 control firms to match the 171 firms in the treatment sample. The selection of control firms was conducted on a firm-by-firm basis, as explained in the following procedure below, to ensure the maximum

convergence between sample and control firms and to eliminate biased parameters and probability estimates (Palepu 1986).

To match each sample firm (*Compliance Week* firms with internal control weaknesses) with a control firm (*Compliance Week* firms with no ICWs in the same year -or the year before- as the sample firm), I first select the control firm from the same year and industry. Asset-scaled net income of the control firm must be at least 80 percent of that of the sample firm. I begin with the four-digit SIC code; if no match is available, I search among three-digit SIC codes, then two-digits, and finally one-digit. I also require control firms to share the same executive compensation packages and the incidence of stock equity offerings in the event year as is the case with sample firms.

An overriding requirement for the selection of an individual control firm is that the control firm data (including credit rating) must be available on *Compustat* or the *SEC EDGAR* database to be included in the sample. If the precision matched control firm data is not available on all of these databases, the next best control firm is selected. Characteristics of control firms are shown in comparison to the ICW sample in tables 3, 4, 5, and 6. This procedure ensures that the control and treatment samples are homogeneous, that is, they come from the same population (*Compliance Week* database), are similar in characteristics (through pair matching), and are not affected by biases caused by differences in size. It should be emphasized, however, that in all study analyses, both samples were kept independent.

Characteristics of the final sample

In this subsection, I introduce and analyze the distribution of the ICW sample by month of disclosure in *Compliance Week*, type of weakness, industry, auditor size, and audit opinion

received to help assess how representative is the sample of the original population (US firms with S&P credit rating that disclose ICWs).

Distribution of ICWs by month of disclosure, type, and industry

The sample firms cover 21 continuous months, extending from November 2003 to July 2005. Due to the firms' availability in *Compustat* selection criterion, firms in the sample represent approximately from 6.9 percent to 57.1 percent of *Compliance Week* firms by month, as shown in Table 2. The distribution of observations over time suggests that firms tend to improve their reporting

(INSERT TABLE 2 ABOUT HERE)

Distribution of ICWs by type

Careful reading into the explanations cited by firms for their ICWs shows that most of these weaknesses are related to accounting issues (75.4 percent), such as inadequate accounting policies and inappropriate treatment of lease contracts. Of all accounting-based weakness disclosures, 34.5 percent were related to accounting policies and procedures, 10.5 percent were related to accounting for leases, and over 6 percent were related to inventory. Table 3 shows the breakdown of ICWs during the study period November 2003-July 2005.

For instance, CSK Auto Corp. noted that "controls over the estimation and accounting for vendor allowances did not operate effectively," and Ceridian disclosed "Inadequate financial statement preparation and review procedures." Solagen stated that it had a weakness in accounting systems and control procedures, noting that certain control procedures "were inadequate to insure that certain indirect costs associated with the production process were properly classified in the

Company's financial statements." Among the several problems cited by \$28 billion auto parts maker Delphi Corp., for example, were "ineffective or inadequate accounting policies to ensure the proper and consistent application of GAAP throughout the organization." Pacific Capital Bancorp noted that it "did not maintain effective controls over approval of general ledger journal entries." Problems with lease accounting and inventory tracking were also common.

Also, 6.4 percent of the disclosures cited tax issues. Hayes Lemmerz, for example, cited "ineffective reconciliation procedures associated with income tax accounting matters," and Kroger disclosed that it "did not maintain effective controls over the determination of deferred income tax balances related to a business combination." Apart from technical accounting issues, inexperienced or understaffed accounting departments were cited in about 9.5 percent of the disclosures. Cray, for example, cited "insufficiently trained accounting personnel and management," while Crown Media Holdings cited a material weakness related to a lack of sufficient expertise.

Overall, figures suggest that accounting related issues are a predominant cause of ICWs. This could be due to insufficient investment on the part of the firms in creating a flexible, sustainable accounting infrastructure that meets the needs of growing companies. As will be shown in Table 4, manufacturing firms make up a large percentage of sample firms, suggesting that poor cost accounting and financial reporting systems could be to blame. The results point towards an opportunity for information service providers who could offer their services in weak areas to firms with ICWs on an outsourcing basis.

(INSERT TABLE 3 ABOUT HERE)

Distribution of ICWs by industry

Table 4 shows the distribution of ICWs by industry. Results show that manufacturing industries have the highest representation among sample (41.5 percent) and control firms (49.7 percent). Further examination of the ICW weaknesses in the sample firms suggests that almost 64 percent of these weaknesses are related to inventory, revenue recognition, and other accounting policies. Transportation, communication and utilities industries make up 16.4 percent of sample firms (11.7 percent of control firms), while service industries comprise 15.2 percent of all sample firms (6.4 percent of control firms). Finance, Insurance, and Real Estate firms comprise 13.5 percent of sample firms. Overall, these four categories of industries make up 86.6 percent of all sample firms, while they make up 89.4 percent of the control firms.

(INSERT TABLE 4 ABOUT HERE)

Distribution of sample firms by auditor and audit opinion

Of the 171 ICWs, material weaknesses represent 105 (61.5 percent), significant deficiencies represent 10 (5.8 percent), and 56 (32.7 percent) were immaterial control deficiencies. Similarly, these 171 firms disclosed a total of 91 remediation actions, of which 83 were indicated as already taken or implemented by the reporting firms. Of the 171 companies, 144 (84.2 percent) were audited by Big-4 CPA firms: 50 by PricewaterhouseCoopers, 37 by KPMG, 31 by Ernst & Young, and 26 by Deloitte & Touche. Of the remaining 27 companies, 2 were audited by Grant Thornton and 3 by other smaller CPA firms. Panel A in Table 5 shows the breakdown of sample, control and *Compustat* firms by auditor.

Importantly, 24 listed firms had received a standard unqualified audit opinion from their external auditors in the fiscal period immediately preceding the disclosure of the internal control

weakness (21 control firms), while 141 listed firms had also received a unqualified audit opinion (136 control firms): for 126 listed firms their external auditors added some language emphasizing a matter regarding their financial statements, and for 8 listed firms the auditors expressed a substantial doubt about company ' s ability to continue as a going concern, and for 7 listed firms the auditors indicated that Generally Accepted Accounting Principles were not consistently followed by the company. Of the results that merit attention of regulators is that all 105 firms with material weaknesses received either Unqualified or Unqualified with additional language opinions. The original intent of SOX is to improve the reliability of financial statements for the benefit of capital market participants; regulators might use the results of this study in evaluating the effectiveness of SOX in meeting its own goals. Panel B in Table 5 shows the breakdown of sample, control and *Compustat* firms by audit opinion.

(INSERT TABLE 5 ABOUT HERE)

On the other hand, almost 55 percent of *Compustat* firms were audited by a Big-4 auditor, 35.5 percent received a standard Unqualified opinion, and 41.1 percent received an Unqualified opinion with additional language. Only 5 firms received either a Qualified or an Adverse Opinion. Therefore, on average, a larger proportion of sample firms are audited by Big-4 firms and have received a standard Unqualified or Unqualified with additional language opinions than *Compustat* firms. Again, this suggests that the average ICW firm possesses better accounting and financial resources (to afford a Big-4 firm) than the average *Compustat* firm. Future research might be interested in examining whether auditor size and audit switches affect the probability of disclosing ICWs.

Variable definitions

The dependent variable (CRDT_RTNG) representing firm credit rating is proxied by the long-term issuer credit rating compiled by Standard & Poor's and reported on the *Compustat* database (data item 280). The ratings range from AAA (highest rating) to D (lowest rating—debt in payment default). These ratings reflect S&P's assessment of the creditworthiness of the obligor with respect to its senior debt obligations.

Additionally, as stated above, credit ratings convey ordinal risk assessments. Because of the difficulty in quantifying the marginal effects of changes in the ICW variable on credit ratings with multiple categories, I follow Ashbaugh-Skaife et al. (2006) in using an alternative classification scheme for credit ratings that partitions credit ratings into two categories—investment grade or speculative grade, measured by the dependent variable INVST/SPEC. Many bond portfolio managers are restricted from owning speculative-grade bonds (Grinblatt and Titman 2002), and as such, firms incur significant costs if they receive a speculative bond rating. Furthermore, using a dichotomous credit rating classification allows a more ready assessment of the economic impact of internal control quality on firms' expected credit ratings.

(INSERT TABLE 6 ABOUT HERE)

Firm-specific explanatory variables are included in the analysis based on a survey of prior research on the determinants of corporate bond ratings (e.g., Horrigan 1966; Kaplan and Urwitz 1979; Boardman and McEnally 1981; Lamy and Thompson 1988; Ziebart and Reiter 1992). The ensuing analysis includes seven independent variables⁷, suggested by prior literature as determinants of credit ratings. Firm size (SIZE) is an important determinant of financial strength with larger total assets being consistent with higher bond ratings. Firm financial performance as indicated by its profitability is measured by the continuous variable ROA, and is an indicator of

firm default risk. An indicator variable (INDUSTRY) is used to control for lower default risk for firms operating in regulated industries. INDUSTRY is set equal to one if a firm is a financial institution or utility firm, (zero for firms not in these two industries).

The degree of leverage (LEVER) represents an important risk factor for bond holders with higher long term debt being consistent with lower bond ratings. Lower ROA and higher LEVER values reflect greater default risk. I use LOSS, a categorical variable set equal to one if the firm reports negative earnings in the current and prior fiscal year, as another control for default risk given that the likelihood of default is greater for firms that are unprofitable. A measure of cash flow (OPCASH) is beneficial to gauge the cash flow production capability of the firm. Higher positive cash flow is consistent with higher bond ratings. Finally, the degree of variability of the firm's income stream (CVNI) provides a measure of income stability with greater variability likely to result in a lower bond rating.

These control variables are added to the study models in various combinations to determine their importance in the bond rating process. The primary analysis involves an examination of the significance of the coefficient of the added variable. Finding a significant coefficient is consistent with the theory indicating that variable is an important factor in the bond rating decision process.

$$\text{CRDT_RTNG}_j = \beta_0 + \beta_1 \text{ICW}_j + \beta_2 \text{SIZE}_j + \beta_3 \text{ROA}_j + \beta_4 \text{INDUSTRY}_j + \beta_5 \text{LOSS}_j + \beta_6 \text{OPCASH}_j + \beta_7 \text{CVNI}_j + \beta_8 \text{LEVER}_j + e_j \quad (\text{model A})$$

β_1 represents the coefficient estimate for the independent variable ICW testing the hypothesized relationship, while β_2 through β_{10} represent the coefficient estimates for the control variables suggested by prior literature as determinants of credit ratings. Congruent with previous bond rating research, the variables SIZE, OPCASH, LEVERAGE, and CVNI are all five year averages

in order to prevent one year fluctuations from inaccurately portraying the long-term economics of the firm that are important to bond holders. Additionally, I also estimate the logistic regression model using $INVST/SPEC_j$, which is a two-category rating classification scheme—investment grade and speculative grade (model B).

$$INVST/SPEC_j = \beta_0 + \beta_1 ICW_j + \beta_2 SIZE_j + \beta_3 ROA_j + \beta_4 INDUSTRY_j + \beta_5 LOSS_j + \beta_6 OPCASH_j + \beta_7 CVNI_j + \beta_8 LEVER_j + e_j \quad (\text{model B})$$

Table 7 provides description and sources of data for model variables. In tables 8 and 9, the summary statistics and Pearson correlations for model variables are provided.

(INSERT TABLE 7 ABOUT HERE)

Descriptive statistics

Tables 6 and 8 present summary descriptive statistics for the dependent variable (CRDT_RTNG in model A and $INVST/SPEC$ in model B) and other model variables for the sample and control groups. The model A credit rating variable, CRDT_RTNG has a mean (median) score of 2.91 (4.00) for the sample group, 4.43 (3.00) for the control group, and 3.567 (4.00) for *Compustat* firms. The model B credit rating variable, $INVST/SPEC$ has a mean (median) score of 0.27 (0.00) for the sample group, 0.88 (1.00) for the control group, and 0.54 (1.00) for *Compustat* firms.

As for the firm characteristics variables, the mean (median) for the $SIZE^8$ variable is 3.43 (3.33) for the sample group compared to 4.11 (4.10) for the control group, and 2.20 (2.30) for *Compustat* firms. Firm profitability as measured by firm ROA was found to have a mean (median) of -0.01 (0.01) compared to 0.05 (0.05) for the control group, and -1.91 (0.01) for *Compustat* firms. Although mean ROA for the sample group is lower than that of the control

group, the range for the sample is spread more widely than for the control group. Also related to ROA is the coefficient of variation of firm EBIT (CVNI), which measures the variability of earnings, with a mean (median) of 2.33 ((0.33) compared to 0.21 (0.26) for the control group, and 0.88 (0.20) for *Compustat* firms. Additionally, sample firms carry a mean (median) operating cash flows (OPCASH) of 0.06 (0.06) compared to 0.10 (0.10) for the control group, and -0.46 (0.05) for *Compustat* firms. Moreover, the average sample firm has a mean (median) leverage (LEVER) of 0.33 (0.34) compared to 0.24 (0.23) for the control group, and 0.42 (0.17) for the *Compustat* firm. Data for the dichotomous variables LOSS and INDUSTRY indicate the average sample firm is more likely to have suffered from a net loss in the current and prior year and that the average firm in the financial services and utilities industries is less expected to suffer from ICWs than the control firms.

Overall, these results suggest that in comparison to the average control firm, the average sample firm disclosing ICWs is characterized by smaller size, lower profitability, higher variability of income, incidence of losses in the current and prior fiscal year, lower probability of being in the financial services or utilities industries, lower cash flows from operations, and higher dependence on debt in their capital structure. These results are in line with findings from the few studies conducted so far on ICWs. For instance, Doyle et al. (2007) find that ICW firms tend to be smaller, younger, financially weaker, more complex, growing rapidly, or undergoing restructuring.

On the other hand, the credit rating (computed based on the assigned score in Table 6) of the average sample firm is lower than that of the average *Compustat* firm (3.57). Other things held constant, this might indicate that credit rating agencies discount ratings of an ICW firm compared to listed firms, which include ICW and non-ICW firms. Further, in contrast to the

average firm in the control group, which outperforms the average *Compustat* firm on most variables, the average ICW firm is outperformed by the average *Compustat* firm on *all* variables.

Table 9 presents the Pearson correlations between credit ratings and the various model variables. Nine of the 10 model variables are significantly (at 0.01 or better) correlated with the credit rating variables (models A and B). The only variable that is not significantly correlated with the dependent variable in the models is the capital asset intensity ratio. The independent variable of interest (ICW) is significantly negatively correlated with the ratings variable in each of the two models, providing preliminary support for the hypothesized relationship. ICW is negatively related to all model variables, except LOSS, CVNI, and LEVER, as expected. According to these associations, firms disclosing ICWs are more likely to have lower credit ratings, smaller size, lower profitability, lower cash flows from operating activities, net losses in the current and prior fiscal year, higher income variability, and higher leverage than firms with no such disclosures. Correlations among the various model variables generally fall below 0.50, except in few cases. The highest correlations were between ROA and each of LOSS, and OPCASH, and this is expected since firm income is a common term in the calculation of each of these variables.

(INSERT TABLE 8 ABOUT HERE)

(INSERT TABLE 9 ABOUT HERE)

V. MODELS AND RESULTS

Modeling of bond ratings has a long history beginning with the seminal work done in the area by Fisher (1959) and extended by various studies (e.g. Horrigan 1966; Pogue and Soldofsky 1969; West 1970; Pinches and Mingo 1973, 1975). Kaplan and Urwitz (1979) continued this stream of research by comprehensively examining alternative prediction models and techniques. They

conclude that statistical techniques that exploit the ordinal nature of bond ratings such as probit or logistic regression are theoretically superior and econometrically more sound than methods that are not designed to accommodate ordinal dependant variables. Subsequent studies have attempted to outperform the Kaplan/Urwitz model, but none have proven to be clearly superior with most correctly predicting approximately 65 percent of the ratings (e.g. Belkaoui 1980; Ederington 1985; Iskander and Emery 1994). The Kaplan/Urwitz model continues to remain robust in the literature and has been utilized directly or with minor variations in recent research as the primary reference for modeling bond ratings (e.g. Francis et al. 2003; Graham et al. 2001; Ziebart and Reiter 1992; Shi 2003).

Consequently, the Kaplan/Urwitz model is chosen as the foundation model for testing both models in this study due to its robustness and econometrically sound approach. For purposes of this analysis, the multiple S&P credit ratings are collapsed into seven categories (model A). I also follow Ashbaugh-Skaife et al. (2006) in creating a second model using a two-category rating classification scheme—investment grade and speculative grade (model B) to facilitate the discussion of the economic significance of the results. Both measurements for credit ratings are provided in the schedule shown in Table 6. Below, I present the results of empirical tests conducted on the two models (A and B) suggesting that a firm credit rating is a function of ICWs and other firm characteristics (control variables). The models are tested through estimating an ordered logit model because credit ratings in each model consist of discrete levels.

Ordered logit results: Seven-level credit rating (Model A)

In model A, I test the predicted relation between ICWs and credit ratings, measured as a 7-level variable, while model B tests the relation between ICWs and credit ratings, measured as a

dichotomous variable (investment versus speculative grade. Table 6 shows variable measurement. Results of testing model A are shown in Table 9 under three titles: A1, A2, and A3. Model A1 is the full model that incorporates both ICW and the firm characteristics control variables, A2 includes only firm characteristics (control) variables, and A3 includes only ICWs with no control variables.

A likelihood-ratio test was conducted on the three models to determine their significance. In a likelihood-ratio test, the ratio of the maximum of the likelihood function under the null hypothesis and the maximum with that constraint relaxed is taken, manipulated and compared to the chi squared value corresponding to a desired statistical significance, to create a reasonable decision based on that comparison. Lower values of the likelihood ratio mean that the observed result was less likely to occur under the null hypothesis.

Model A1 is highly significant with a likelihood ratio χ^2 of 327.70 and a generalized R^2 of 0.64. Upon omission of the main independent variable ICW, the explanatory power of the model drops, but not substantially. Model A2, is also highly significant with a likelihood ratio χ^2 of 281.57 and a generalized R^2 of 0.55. The highly significant likelihood ratio χ^2 and the highly significant Wald χ^2 indicate that ICW adds significant explanatory power over and above the firm characteristics control variables. The coefficients on the control variables have the expected sign and are significant at the 0.01 level or better, except for CVNI, which is only marginally significant. Consistent with prior research (Horrigan 1966; Kaplan and Urwitz 1979), I find that credit ratings are positively related to SIZE, ROA, INDUSTRY, SIZE, and OPCASH, and negatively related to LEV, CVNI, and LEVER. The main independent variable, ICW, is highly significant and is negatively related to credit ratings, as predicted. As shown in model A3, which

contains ICW as a single independent variable, the model is highly significant with a likelihood ratio χ^2 of 147.21 and a generalized R^2 of 0.36.

In addition to factors proposed by prior literature as influencing credit ratings, the results in this paper suggest that lower credit ratings are associated with weaknesses in internal controls. The negative coefficient indicates that not only the existence of ICWs reduces a company's cost of debt, but also the logical consequence that more ICWs per firms would deteriorate its credit rating even further. That is, the disclosure of ICWs by firms in compliance with SOX is taken by rating agencies as a potential vulnerability that increases firm risk, and hence reduces its appeal for creditors.

Table 9 shows how firms with control weaknesses are more likely to also suffer from lower profitability and operating cash flows, less stable earnings, and high leverage. An ICW would not be expected to create all of these conditions; however, it might be a consequence of the same phenomenon that led to these conditions. So, the existence of such weaknesses can be taken as a signal of poor future performance and inability to create a satisfactory stream of cash flows for creditors and investors alike. As shown in Table 10, the model suggested in this paper explains 64 percent of the variation in firm credit rating scores assigned by rating agencies, and ICW by itself explains 36 percent of these scores. To improve their credit ratings, firms with ICWs have to work on remediating these weaknesses by finding their root causes. Some of these causes might be insufficient investment in the firm's accounting infrastructure and unexpected growth levels. In summary, I find that the internal control quality explains a significant proportion of the cross-sectional variation in credit ratings.

(INSERT TABLE 10 ABOUT HERE)

Ordered logit results: Investment versus speculative grade analysis (Model B)

Table 11 presents summary statistics for model B variables broken down by credit grade (investment or speculative). Speculative grade firms have a mean ICW of 0.87 compared to 0.24 for investment grade firms, a mean ROA of -0.02 compared to 0.05, a mean OPCASH of 0.06 compared to 0.10, a mean CVNI of 2.59 compared to 0.31, and a mean LEVER of 0.37 compared to 0.22. Additionally, the average speculative grade firm is less likely to be in a regulated industry (financial or utility), and more likely to have had a net loss in the current or prior period.

Additionally, the correlations in Table 9 show that the variable used to represent investment versus speculative grade (INVST/SPEC is coded one if the firm's credit rating is BBB or better, and zero otherwise) is negatively correlated with ICW (proxy for internal control quality), LOSS, CVNI, and LEVER, and positively correlated with SIZE, ROA, INDUSTRY, and OPCASH. The correlations and the summary statistics suggest that the average speculative grade firm has the following characteristics compared to the average investment grade firm: a higher proportion of ICWs, smaller size, lower profitability, lower operating cash flows, lower stability of income, and higher leverage.

Table 12 displays the results of estimating the logistic regression using INVST/SPEC as the dependent variable. The results are similar to the results of the CRDT-RTNG analysis reported in Table 10 in that I find that ICW and all control variables are significant determinants of INVST/SPEC, and all with the expected signs. This result suggests that internal control quality decrease the likelihood of a firm receiving an investment-grade debt rating, resulting in significant implications for assessing debt financing costs. Firms with investment grade debt rating enjoy lower cost of debt financing and have an optimal capital structure that is less

dependent on debt. In contrast, firms with speculative grade debt rating are disadvantaged with higher cost of debt financing (higher financial leverage), lower income, and lower overall attractiveness in capital markets.

(INSERT TABLE 11 ABOUT HERE)

(INSERT TABLE 12 ABOUT HERE)

VI. ADDITIONAL ANALYSIS

In this section, I follow the practice of Ashbaugh-Skaife et al. (2006) in examining the possible problem of endogeneity. If the disclosure of internal control weaknesses is endogenously determined such that there is a factor (or set of factors) that results in ICW disclosure and also affect credit rating agencies' assessment of firms' creditworthiness, then the preceding analysis suffers from a potential correlated omitted variable problem. This misspecification causes the parameter estimates to be inconsistent, which leads to misinterpretation of results. The lack of theory on the conditions triggering the ICW disclosure complicates the analysis of endogeneity. Ashbaugh-Skaife et al. (2007) suggest a relation between internal control quality and corporate governance, which might be the omitted correlated factor of concern. To test whether there is support to the argument that governance is related to ICWs, I test whether a) internal control quality is a function of corporate governance, and then I test whether b) credit ratings is a function of both corporate governance strength and internal control quality in the same model.

Internal control quality as a function of corporate governance strength

Internal controls are in place to ensure reliable financial reporting and custody over assets, among other purposes. Effective corporate governance mechanisms, such as an independent board and a capable audit committee, are designed to ensure that stockholders interests are at the center of management's attention. The more effective are these mechanisms, the higher the quality of internal controls over financial reporting, and thus the lower the perceived risk of the firm to its creditors. Prior literature examined the relation only narrowly.

Gompers et al. (2003) construct an index based on 24 governance provisions, referred to as the G_SCORE, to measure the power-sharing relationship between investors and management. The 24 provisions are classified into five categories of management power: (1) tactics for delaying hostile bids; (2) voting rights; (3) director/officer protection; (4) other takeover defenses; and (5) state takeover laws. Each firm's G_SCORE is the sum of points, where one point is awarded for the presence of each governance provision. Thus, a higher G_SCORE indicates lower shareholder rights and greater management power. Ashbaugh-Skaife et al. (2006) explain that governance mechanisms that provide independent monitoring of management benefit all stakeholders by encouraging effective managerial decision making that increases firm value and guarding against opportunistic management behavior that decreases firm value. Firms with lower shareholder rights are expected to suffer from poor monitoring and management disciplining techniques, which would consequently result in weak internal control structure.

More in line with the theme of this paper, Doyle et al. (2007) examines the relation between corporate governance and firm's internal control quality hypothesizing that a well-governed firm would exhibit fewer material weaknesses, all else equal. However, they find no significant relation. However, Krishnan (2005) finds that firms with more effective audit committees report

fewer internal control problems when reporting an auditor change. Therefore, I hypothesize that internal control quality (proxied by ICW) is negatively related to corporate governance strength (proxied by firm G_SCORE). This relation is tested empirically as model X.

In addition to the hypothesized relation with G_SCORE, ICW is also suggested to be a function of firm characteristics of, specifically, size, profitability, and incidence of losses in prior literature (Doyle et al. 2007). I therefore use these variables as controls in model X. Prior research hypothesizes that firm size may be a determinant of internal control quality (e.g., Kinney and McDaniel 1989; DeFond and Jiambalvo 1991), though the evidence is mixed (DeFond and Jiambalvo 1991; Krishnan 2005). Doyle et al. (2007) contend that large size may be responsible for 1) the presence of adequate financial reporting processes and procedures as well as an adequate number of well-segregated employees, 2) economies of scale for companies when developing and implementing internal control systems, and 3) the availability of greater resources to spend on internal auditors or consulting fees. Thus, I expect to find fewer control weaknesses in larger firms. As in the main analysis, firm size is measured as the natural log of 5-year average total assets (shown in Table 7).

Another determinant of internal control quality is expected to be a firm's financial health. Poorly performing firms simply may not be able to adequately invest time and/or money in proper controls. Good internal control requires both financial resources and management time, and this may not be a priority for firms that are concerned about simply staying in business. Consistent with this hypothesis, past research finds that financial reporting errors are negatively associated with performance (DeFond and Jiambalvo 1991) and that the existence of a loss is positively associated with reporting an internal control problem in audit-change firms (Krishnan 2005). I expect to find fewer internal control weaknesses in firms

with stronger financial health. I examine two financial resource measures, ROA (Net income before extraordinary items divided by total assets) and LOSS (whether or not the firm had a net loss during the current and the prior year) (shown in Table 7).

A logit analysis is conducted with ICW (proxy for internal control quality) as the dependent variable and G_SCORE (proxy for corporate governance strength) as the main independent variable, along with SIZE (proxy for firm size), ROA, and LOSS (proxies for firm performance). Summary statistics and correlations for the model variables are shown in Tables 13 and 14, respectively. The mean G_SCORE for the sample (ICW) firm is higher than that of the control firm, indicating lower shareholder rights in firms suffering from poor internal control quality compared to control firms which are matched on size and performance but have not ICWs. Empirical results of the logit analysis are listed in Table 14. Results show that G_SCORE is significantly negatively related to ICW, suggesting that quality of internal control is partially determined by the quality of corporate governance in a firm. This result comes after controlling for SIZE, ROA, and LOSS, all of which were significant, except for LOSS, and had the predicted signs. These findings lead to accepting the hypothesis that a well-governed firm would be more likely to have effective internal controls in addition to continuously implementing internal control monitoring mechanisms.

(INSERT TABLE 13 ABOUT HERE)

(INSERT TABLE 14 ABOUT HERE)

Inclusion of corporate governance into the model as a potentially contaminating variable

Results in Table 15 suggesting a relation between internal control quality and corporate governance strength support the conjecture that corporate governance might be the omitted correlated factor of concern and force the reexamination of model A results presented in Table 10.

Prior research provides evidence of a relation between corporate governance and credit ratings, albeit with inconclusive results. Gompers et al. (2003) find that firms with lower G_SCORE have higher firm values, higher profits, higher sales growth, lower capital expenditures, and lower corporate acquisitions. These factors should lower firms' credit risk leading to higher credit ratings. That is, firms with stronger shareholder rights are expected to have higher credit ratings because of lower risk characteristics. Consequently, a negative relation is expected between G_SCORE and credit ratings because firms with stronger shareholder rights (lower G_SCORE) are likely to provide better monitoring and control over management leading to more effective and efficient managerial decision making, which in turn leads to better overall firm credit worthiness and higher credit ratings (Ashbaugh-Skaife et al. 2006).

Alternatively, some studies hypothesize and find a positive relation between G_SCORE and credit ratings, because limits on shareholders' ability to meet and act places more power in the hands of management versus shareholders and can make it difficult to remove entrenched management. Some believe that corporate governance mechanisms play a role in mitigating

agency conflicts between management and all stakeholders, including debt holders (Ashbaugh-Skaife et al. 2006). Consistent with this “management disciplining” hypothesis, governance mechanisms tilted in favor of management can lower overall firm value, resulting in losses to both shareholders and bondholders.

If corporate governance strength influences both internal control quality, as shown in Table 15, and credit ratings, then corporate governance (G_SCORE) should be explicitly included in the original model A to examine whether ICW will lose significance in that case and suggest that corporate governance is the omitted correlated variable of interest (instead of internal control quality). In the following section, I test two models, both of which contain CRDT_RTNG as the dependent variable. The first model (model Y), tests CRDT_RTNG as a function of corporate governance and firm characteristics, and excludes internal control quality (ICW) from the model, to determine the explanatory power of the model without ICW, the variable of interest in this paper. The second model (model Z), tests CRDT_RTNG as a function of ICW, corporate governance, and firm characteristics. By explicitly including both of ICW and G_SCORE in the model, the significance of ICW will be either supported or weakened. Due to the mixed results of prior literature, I make no hypothesis as to the expected direction of the relation between corporate governance strength and credit ratings.

(INSERT TABLE 16 ABOUT HERE)

Table 16 shows that when examining the relation between G_SCORE and credit ratings after controlling for firm characteristics. In addition to examining the relation between the two variables over the whole sample, I also examine the relation after breaking down the data into a sample group (ICW firms) and the control group (Non-ICW firms) in order to examine the strength of the relation for each category of firms. Three different logistics regression analyses were conducted with respect to the CRDT_RTNG relation to G_SCORE (Model Y): first for the whole data of 342 firms, second for the ICW sample firms only and finally for control firms only.

All three versions of model Y are significant, albeit at different degree of explanatory power as evidenced by the adjusted R^2 . The results show an interesting conclusion: the relation between G_SCORE and CRDT_RTNG is more pronounced in the sample group (firms with internal control deficiencies). G_SCORE is positive for both groups, but is only significantly related to CRDT_RTNG for the sample firms and not for the control group. In general, the positive relation lends further support to the “management disciplining” hypothesis discussed in Ashbaugh-Skaife et al. (2006) and others. Interestingly, the relation between G_SCORE and CRDT_RTNG is not significant for firms with no control weakness disclosures. This may be due to rating agencies not placing governance on the top of the firm evaluation criteria if the firm exhibited no history of internal control deficiencies.

Further, many of the variables representing firm characteristics (ROA, CVNI, and LEVER) lose significance entirely after including G_SCORE in the model. In particular, the loss of significance for LEVER in the sample group is interesting since it is a primary driver for credit rating scores. This may be due to rating firms giving leverage a lower priority when assessing the creditworthiness of firms if the assessed firm has a good governance structure, which increases

the rating agency's confidence in the firm's future cash flow generation ability. Additionally, the loss of significance for the set of variables representing firm risk (LOSS, OPCASH, and CVNI) indicates the lack of concern on the part of rating agencies for these measures when the firm being evaluated for credit worthiness has no internal control problems.

More importantly, the results of testing Model Z in Table 16 shows that the model is highly significant with an adjusted R^2 of 0.63, which is higher than model Y. The ICW coefficient remains negative and highly significant, even after the inclusion of G_SCORE in the model. G_SCORE loses significance marginally when ICW is included in the model. Although G_SCORE is suggested to be a determinant of ICW, the latter seems to have a separate influence on credit ratings than that explained by corporate governance. The effectiveness of internal controls in a firm is dependent on several factors, some of which were suggested in Ashbaugh-Skaife et al. (2007) and this paper adds corporate governance as another determinant. However, credit ratings are dependent on firm risk in the first place, corporate governance (Ashbaugh-Skaife et al. 2006) may explain some of the variability in ratings but it does not explain the translation of governance strength into meaningful, enforceable policies and controls. These existence and enforceability of internal controls are a function of multiple predictors.

In view of the results of models X, Y, and Z, the following conclusion might be obtained. Although corporate governance strength appears to have a positive and significant relation to firm credit ratings for the sample group, internal control quality remains negative and significantly related to credit ratings. Therefore, this additional analysis part of the paper supports the results of the primary models A and B.

VII. CONCLUSION

Using a sample of firms that disclosed ICWs, this study investigates whether firms with poor internal control quality, evidenced by disclosure of weaknesses, are penalized by rating agencies with a lower overall firm credit rating relative to firms with strong internal control quality. Using logistic regression, I present evidence that internal control quality is negatively related to firm credit ratings after controlling for firm characteristics that prior literature has shown to be related to credit ratings. Additionally, I find that firms disclosing ICWs are more likely to have lower credit ratings, smaller size, lower profitability, lower cash flows from operating activities, net losses in the current and prior fiscal year, higher income variability, and higher leverage than firms with no such disclosures.

The second analysis conducted in this paper examines the impact of internal control quality on a firm's probability of receiving an investment grade status and the characteristics of firms receiving investment versus speculative rating grade. Results suggest that internal control quality decrease the likelihood of a firm receiving an investment-grade debt rating, resulting in significant implications for assessing debt financing costs. Firms with speculative grade debt rating are disadvantaged with higher cost of debt financing (higher financial leverage), lower income, and lower overall attractiveness in capital markets. Additionally, the average speculative grade firm has a higher proportion of ICWs, is smaller in size, lower in profitability, lower in operating cash flows, lower in stability of income, and higher in leverage compared to the average investment grade firm.

Furthermore, additional analysis indicates that the relation between internal control quality and credit ratings is not affected by the inclusion of corporate governance in the model, and that the positive relation between governance and ratings lends further support to the "management

disciplining” hypothesis (Ashbaugh-Skaife et al. 2006). The results may also suggest that, for firms with no history of internal control deficiencies, rating agencies do not place governance on the top of firm evaluation criteria and give the degree of firm leverage a lower priority if the assessed firm has a good governance structure.

The results of this paper suggest that poor internal control decreases a firm’s credit rating, this raises the question of why don’t all firms practice effective internal control. Future research might delve into reasons behind internal control. Only one study, to my knowledge, has examined determinants of internal control (Ashbaugh-Skaife et al. 2007), but their inquiry was focused on what make firms disclose control deficiencies early, rather than creating a profile for those firms with INCWs. Researchers are advised to look at conditions, economic incidents and managerial incentives behind poor internal controls. Also, future research might want to study the market reaction to firm announcements with respect to internal controls. Again, to my knowledge, only one study (Gupta and Nayar 2007) examine such reaction and find that negative stock price reaction is associated with internal control weakness disclosures. However, they use professional data sources (such as Yahoo! Finance), which might not be up to academic standards.

A potential limitation of this study is the relatively short time frame over which I gather data and conduct tests. It is hard to determine how the material weakness disclosures of the first few years of the new Sarbanes-Oxley regime will compare to future periods when both management and auditors are more familiar with the process of implementing, evaluating, and reporting on internal control. In addition, although I attempt to be comprehensive in collecting material weakness disclosures from November 2003 to July 2005, it is still possible that some firms did not discover or disclose their material weaknesses. Depending on the systematic characteristics

of such firms, this could have an effect on the results. For example, it is possible that the materiality thresholds for determining whether or not a firm has a material weakness in internal control vary across sample firms. Future research might attempt to model this materiality decision.

Another limitation of the study is that although it is likely that most ICWs were disclosed by firms over the study period (it is a criminal offense for managers to conclude that controls are effective when they have knowledge of a material weakness), however, the use of the proxy of a disclosure of weakness versus the true underlying existence of a weakness is a limitation of this study. I also acknowledge that there could be other economic variables omitted from the model that are correlated (some positively and some negatively) with credit ratings. I have included all the major economic determinants of credit ratings in the model based on evidence provided in prior research. If there are major economic variables that have been omitted from our model, then these have been systematically overlooked by a vast literature on determinants of debt ratings, and I believe this is unlikely.

APPENDIX

Examples of internal control weaknesses: [Source: *Compliance Weekly*]

Impac Mortgage Holdings Inc.

Aug. 16, 2004

Subsequent to management's identification of the errors in our financial statements and after reporting the error to our independent registered public accounting firm, KPMG LLP (KPMG), we noted certain matters regarding financial reporting and the interpretation of financial accounting standards in accordance with generally acceptable accounting principles to be a material weakness in internal controls as defined under standards established by the American

Institute of Certified Public Accountants. ... Inadequate controls and procedures in the accounting and financial reporting departments for appropriately interpreting and applying accounting principles in order to prevent or detect misstatements of accounting information was a material weakness that was identified.

Dresser Inc.

Sept. 3, 2004

In reviewing our internal control over financial reporting in connection with the preparation of this prospectus, we have identified a number of these specified circumstances, including (a) identification by our auditors of material misstatements in internal drafts of our financial statements that were not initially identified by our internal control process, (b) an ineffective internal audit function and (c) an ineffective control environment. We have evaluated these deficiencies and determined that an additional material weakness in our internal control over financial reporting exists with respect to our ability to properly monitor and account for non-routine transactions and to apply U.S. GAAP in transactions subject to new or complex accounting pronouncements.

In addition, in April 2004, we received allegations that the Dubai branch of one of our U.S. subsidiaries may have engaged in transactions involving the sale of control valves and related parts to Iraq without required authorization. Upon initial investigation, we found transactions by the branch relating to Iraq, Iran and Sudan that appeared to have been undertaken without the required prior U.S. governmental authorizations.

In connection with the above matters, we identified material weaknesses in our internal control over financial reporting that we reported to our Audit Committee and to our auditors. These material weaknesses comprised:

1. a lack of sufficient knowledge and experience among our internal accounting personnel regarding the application of US GAAP and SEC requirements;
2. insufficient written policies and procedures for accounting and financial reporting with respect to the requirements and application of US GAAP and SEC disclosure requirements; and
3. insufficient emphasis by management on evaluating our compliance with US GAAP requirements.

The material weakness identified related to: (1) inadequate preparation and insufficient review and analysis of certain financial statement account reconciliations primarily relating to intercompany account balances between consolidated entities and accrued trade payable balances, (2) absence of documented support for, and review of, certain manual accounting entries and consolidation adjustments and (3) lack of sufficient personnel with appropriate qualifications and training in certain key accounting roles and adherence to certain control disciplines within the accounting and financial reporting function.

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Table 1: Sample selection procedure

Test sample	N	%
Total ICWs on <i>Compliance Week</i> from November 2003 to July 2005	922	100.0
Less: Duplicate disclosures eliminated	(92)	(10.0)
Total distinct ICW entries on <i>Compliance Week</i>	830	90.0
Less: Firms not listed on S&P's <i>Compustat</i>	(70)	(7.6)
Preliminary sample of ICW firms	760	82.4
Less: Firms on S&P's <i>Compustat</i> but with no credit rating (data item 280)	(589)	(63.9)
Final sample of distinct ICW firms during November 2003-July 2005	<u>171</u>	<u>18.5</u>

Table 2: Breakdown of final ICW sample by month of disclosure in *Compliance Week*

Month	Total number of ICW firms in <i>Compliance Week</i>	ICW firms in the sample	%
November 2003	11	6	54.5
December 2003	14	4	28.6
January 2004	23	5	21.7
February 2004	18	4	22.2
March 2004	28	8	28.6
April 2004	39	3	7.7
May 2004	51	8	15.7
June 2004	41	7	17.1
July 2004	36	10	27.8
August 2004	92	11	12.0
September 2004	40	11	27.5
October 2004	63	13	20.6
November 2004	119	22	18.5
December 2004	56	4	7.1
January 2005	27	9	33.3
February 2005	23	11	47.8
March 2005	116	8	6.9
April 2005	58	10	17.2
May 2005	39	5	12.8
June 2005	21	8	38.1
July 2005	<u>7</u>	<u>4</u>	57.1
	922	171	

Table 3: Breakdown of ICWs by type

Category	N	%
Accounting		
Accounting policies	59	34.50
Lease accounting	18	10.53
Inventory-related Issues	11	6.43
Accounting for executive compensation (including stock options)	10	5.85
Taxes	11	6.43
Bank reconciliation	6	3.51
Financial closing	6	3.51
Revenue recognition	5	2.92
Valuation issues	3	1.75
Total accounting related weaknesses	129	75.44
Personnel/Human Resource		
Inexperienced staff	16	9.50
Segregation of duties	7	3.90
Total HR related weaknesses	23	13.40
Others		
Control environment	7	3.80
M&A issues	6	3.40
Board independence	6	3.60
Total other weaknesses	19	10.80
Total sample	171	100.00

Table 4: Breakdown of sample and matched control firms by industry

Industries comprising sample firms	Industry 2-digit SIC	Sample firms		Control firms		Total	
		N	%	N	%	N	%
Mineral industries	10-14	8	4.7	12	7.0	20	5.8
Construction Industries	16-17	5	2.9	1	0.6	6	1.8
Manufacturing	20-39	71	41.5	85	49.7	156	45.6
Transportation, Communication, and Utilities	40-49	28	16.4	20	11.7	48	14.0
Wholesale Trade	50-51	6	3.5	0	0.0	6	1.8
Retail trade	54-59	3	1.8	5	2.9	8	2.3
Finance, Insurance, and Real Estate	60-70	23	13.5	37	21.6	60	17.5
Service Industries	70-87	26	15.2	11	6.4	37	10.8
Public Administration	99	1	0.6	0	0.0	1	0.3
Total		171	100.0	171	100.0	342	100.0

Table 5: Breakdown of sample, matched control, and Compustat firms by auditor and audit opinion in the year preceding the ICW disclosure

<i>Panel A: Breakdown of group by auditor</i>													
Group	Total firms	Big 4		Grant Thornton		Other		None		Total			
		Total	%	N	%	N	%	N	%	N	%		
Sample	171	144	84.2	2	1.2	3	1.8	22	12.9	171	100.0		
Control	171	155	90.6	1	0.6	1	0.6	14	8.2	171	100.0		
Compustat (all firms)	9793	5379	54.9	255	2.6	1866	19.1	2293	23.4	9793	100.0		
Compustat (firms with ratings only)	2080	1817	87.4	13	0.6	38	1.8	212	10.2	2080	100.0		
<i>Panel B: Breakdown of group by audit opinion</i>													
Group	Total firms	Unqualified	Unqualified with Additional Language	Qualified		Adverse Opinion		Not Available		Total			
				N	%	N	%	N	%	N	%	N	%
Sample	171	24	14.0	141	82.5	2	1.2	0	0.0	4	2.3	171	100.0
Control	171	21	12.3	136	79.5	0	0.0	0	0.0	14	8.2	171	100.0
Compustat (all firms)	9793	3476	35.5	4022	41.1	4	0.0	1	0.0	2290	23.3	9793	100.0
Compustat (firms with ratings only)	2080	940	45.2	928	44.6	1	0.0	1	0.0	210	10.1	2080	100.0

Table 6: Credit rating coding scheme and breakdown of firms by credit rating

S&P Rating Score	Assigned Score (model A)	Grade (model B)	Sample firms		Control firms		All <i>Compustat</i> companies with credit rating		
			N	%	N	%	N	%	
CCC+, CCC, CC, C, D, SD	1	Speculative	22	12.87	0	0.00	70	3.37	
B-, B, B+	2		57	33.33	5	2.92	393	18.89	
BB-, BB, BB+	3		45	26.32	15	8.77	482	23.17	
BBB-, BBB, BBB+	4		Investment	30	17.54	68	39.77	648	31.15
A-, A, A+	5			12	7.02	69	40.35	390	18.75
AA-, AA, AA+	6			2	1.17	12	7.02	79	3.80
AAA	7			3	1.75	2	1.17	18	0.87
Total Number of Firms			171		171		2080		
Sample Median S&P Rating Score			15		10		12		
All <i>Compliance Week</i> firms (Nov. 03-Jul 05)			922						
Sample firms as a % of <i>Compliance Week</i> firms (171 ÷ 922)			18.55%						
All (Active US) <i>Compustat</i> firms with credit rating Oct. 05)			2080 (21.24% of 9793 firms in <i>Compustat</i>)						
Sample firms as a % of all <i>Compustat</i> firms with credit rating (171 ÷ 2080)			8.22%						

Firm credit ratings (CRDT_RTNG) are the long-term issuer credit ratings obtained from Standard & Poor's *Compustat* (data item 280), with a higher number indicating better bond ratings. The ratings range from AAA (highest rating) to D (lowest rating—debt in payment default). These ratings reflect S&P's assessment of the creditworthiness of the obligor with respect to its senior debt obligations. For purposes of this analysis, the multiple ratings are collapsed into seven categories according to the schedule provided above. S&P classifies ratings below BBB- as speculative.

Table 7: Variable definitions

Variable	Predicted direction	Calculation
Dependent variable		
CRDT_RTNG _j (model A)		Firm <i>j</i> long-term credit rating obtained from Standard & Poor's <i>Compustat</i> (data item 280). Ratings range from AAA (highest rating) to D (lowest rating—debt in payment default). These ratings reflect S&P's assessment of the creditworthiness of the obligor with respect to its senior debt obligations. For purposes of this analysis, the multiple ratings are collapsed into seven categories according to Table 6. S&P classifies ratings below BBB– as speculative.
INVST/SPEC _j (model B)		Firm <i>j</i> investment grade credit rating status; coded one if the firm's credit rating is BBB or better, and zero otherwise, as noted in Table 6.
Main independent variable		
ICW _j	–	A dummy variable equal to one if firm <i>j</i> is in one of the IC weakness groups (Section 404 weakness, late filer or Section 302 weakness), and zero if firm <i>j</i> is in the matched control sample (no ICWs). A proxy for internal control quality.
Firm characteristics (Control variables)		
SIZE _j	+	Natural log of 5-year average total assets of firm <i>j</i> .
ROA _j	+	Net income before extraordinary items (<i>Compustat</i> #18) divided by total assets.
INDUSTRY _j	+	One if firm <i>j</i> is a financial institution (one-digit SIC code 6) or a utility (two-digit SIC code 49), zero otherwise.
LOSS _j	–	One if the net income before extraordinary items is negative in the current and prior fiscal year, zero otherwise.
OPCASH _j	+	A measure of firm <i>j</i> net operating cash flows, with higher positive figures associated with higher bond ratings.
CVNI _j	–	A measure of firm <i>j</i> income stability with greater variability likely to result in a lower bond rating.
LEVER _j	–	Firm <i>j</i> 's total debt (<i>Compustat</i> #9) divided by total assets.

Table 8: Descriptive statistics for credit rating variables

ICW	N	Variable	Mean	Std Dev	Minimum	Lower Quartile	Median	Upper Quartile	Maximum	<i>All Compustat Firms</i>		
										N	Mean	Median
1 (ICW firms)	171	CRDT_RTNG	2.91	1.22	1.00	2.00	3.00	4.00	7.00	2050	3.57	4.00
	171	INVST/SPEC	0.27	0.45	0.00	0.00	0.00	1.00	1.00	2050	0.54	1.00
	171	SIZE	3.43	0.70	2.10	2.91	3.33	3.79	6.03	2045	3.53	3.45
	171	ROA	-0.01	0.11	-0.56	-0.03	0.01	0.04	1.00	1972	0.03	0.03
	170	INDUSTRY	0.20	0.40	0.00	0.00	0.00	0.00	1.00	2050	0.00	0.00
	171	LOSS	0.36	0.48	0.00	0.00	0.00	1.00	1.00	2050	0.15	0.00
	171	OPCASH	0.06	0.05	-0.08	0.03	0.06	0.08	0.24	1942	0.09	0.08
	171	CVNI	2.33	11.78	-8.52	0.17	0.33	0.69	133.14	1970	0.55	0.29
	170	LEVER	0.33	0.18	0.00	0.20	0.34	0.42	1.01	2022	0.32	0.29
0 (No ICW firms)	171	CRDT_RTNG	4.43	0.90	2.00	4.00	4.00	5.00	7.00	2050	3.57	4.00
	171	INVST/SPEC	0.88	0.32	0.00	1.00	1.00	1.00	1.00	2050	0.54	1.00
	171	SIZE	4.11	0.57	2.95	3.61	4.10	4.54	5.87	2045	3.53	3.45
	171	ROA	0.05	0.05	-0.20	6.38	0.05	0.08	0.20	1972	0.03	0.03
	170	INDUSTRY	0.28	0.45	0.00	0.00	0.00	1.00	1.00	2050	0.00	0.00
	171	LOSS	0.05	0.22	0.00	0.00	0.00	0.00	1.00	2050	0.15	0.00
	171	OPCASH	0.10	0.07	-0.05	0.05	0.10	0.15	0.37	1942	0.09	0.08
	171	CVNI	0.21	2.04	-25.26	0.16	0.26	0.44	4.82	1970	0.55	0.29
	170	LEVER	0.24	0.15	0.00	0.12	0.23	0.34	1.07	2022	0.32	0.29

CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280) (model A), see Table 6 for numeric coding. INVST/SPEC = 1 if a firm's credit rating is investment grade as noted in Table 6, zero otherwise (model B). See Table 7 for other variable definitions.

Table 9: Correlations

Pearson Correlation Coefficients										
Variables	CRDT_ RTNG	INVST /SPEC	ICW	SIZE	ROA	INDU STRY	LOSS	OPCASH	CVNI	LEVER
CRDT_RTNG	1	0.88	-0.58	0.55	0.44	0.25	-0.51	0.31	-0.32	-0.42
INVST/SPEC		1	-0.62	0.52	0.41	0.24	-0.48	0.31	-0.29	-0.41
ICW			1	-0.51	-0.36	-0.08	0.38	-0.34	0.14	0.29
SIZE				1	0.13	0.43	-0.19	-0.08	-0.11	-0.32
ROA					1	-0.03	-0.61	0.39	-0.16	-0.15
INDUSTRY						1	-0.17	-0.42	-0.08	-0.13
LOSS							1	-0.26	0.23	0.19
OPCASH								1	-0.04	-0.07
CVNI									1	0.03
LEVER										1

The upper right-hand portion of each panel presents Pearson product-moment correlations. Notes: Bold text indicates significance at the 0.01 level or better. CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280) (model A), with a higher number indicating better bond ratings. See Table 6 for numeric coding. INVST/SPEC = 1 if a firm's credit rating is investment grade as noted in Table 6, zero otherwise (model B). See Table 7 for other variable definitions.

Table 10: Logistic regression results of the effects of the disclosure of ICWs on firms' credit ratings (dependent variable = CRDT_RTNG) (model A)

Variables	Predicted Sign	Estimated Coefficients		
		Model A1	Model A2	Model A3
Firm characteristics (control)				
SIZE	+	1.444***	1.726***	
ROA	+	3.770***	4.252***	
INDUSTRY	+	0.780***	0.736***	
LOSS	-	-1.525***	-1.658***	
OPCASH	+	12.270***	14.205***	
CVNI	-	-0.024*	-0.027**	
LEVER	-	-3.400***	-3.478***	
Internal control weakness				
ICW	-	-0.968***		-2.705***
Generalized R^2		0.64	0.55	0.36
Likelihood ratio χ^2		327.70***	281.57***	147.21***
Wald χ^2		213.248***	183.26***	120.84***
Sample size		171	171	171

Notes: Table values are coefficient estimates from the following ordered logit models:

Model A1: CRDT_RTNG = f (ICWs, firm characteristics).

Model A2: CRDT_RTNG = f (firm characteristics).

Model A3: CRDT_RTNG = f (ICWs).

***, **, * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively. The Wald χ^2 statistic tests whether the model variables as a whole explain a significant portion of the variation in firms' credit ratings. CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280), see Table 6 for numeric coding.

Table 11: Summary statistics for model variables by credit grade

Grade	N	Variable	Mean	Std Dev	Min	Lower Quartile	Median	Upper Quartile	Max
Speculative Grade	144	ICW	0.87	0.35	0.00	1.00	0.00	1.00	1.00
	144	SIZE	3.34	0.60	2.10	2.88	3.30	3.64	5.11
	144	ROA	-0.02	0.12	-0.56	-0.05	0.00	0.03	0.56
	143	INDUSTRY	0.12	0.32	0.00	0.00	0.00	0.00	1.00
	144	LOSS	0.44	0.50	0.00	0.00	0.00	1.00	1.00
	144	OPCASH	0.06	0.05	-0.08	0.03	0.05	0.08	0.26
	144	CVNI	2.59	13.01	-25.26	0.22	0.46	0.92	133.14
	143	LEVER	0.37	0.18	0.02	0.25	0.36	0.47	1.07
Investment Grade	198	ICW	0.24	0.43	0.00	0.00	0.00	0.00	1.00
	198	SIZE	4.08	0.65	2.38	3.55	4.03	4.51	6.03
	198	ROA	0.05	0.05	-0.03	0.02	0.04	0.07	0.25
	198	INDUSTRY	0.33	0.47	0.00	0.00	0.00	1.00	1.00
	198	LOSS	0.04	0.20	0.00	0.00	0.00	0.00	1.00
	198	OPCASH	0.10	0.07	-0.05	0.05	0.09	0.14	0.37
	198	CVNI	0.31	0.37	-2.93	0.15	0.24	0.40	1.99
	198	LEVER	0.22	0.13	0.00	0.11	0.22	0.33	0.64

Table 12: Logistic regression results of the effects of internal control quality on credit ratings (dependent variable = INVST/SPEC) (model B)

Variables	Predicted Sign	Estimated coefficient
Firm characteristics (control)		
Intercept	?	-5.331***
SIZE	+	1.901***
ROA	+	5.490**
INDUSTRY	+	1.6252***
LOSS	-	-2.224***
OPCASH	+	19.496***
CVNI	-	-0.134***
LEVER	-	-7.458***
Internal control weakness		
ICW	-	-1.296***
Generalized R^2		0.76
Likelihood ratio χ^2		282.47***
Wald χ^2		84.62***
Sample size		171

***,**, * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively. The Wald χ^2 statistic tests whether the model variables as a whole explain a significant portion of the variation in firms' investment-grade ratings. INVST/SPEC = 1 if a firm's credit rating is investment grade as noted in Table 6, zero otherwise. See Table 7 for other variable definitions.

Table 13: Descriptive statistics and correlations for G_SCORE (corporate governance strength) by sample group

ICW	N	Mean	Std Dev	Minimum	Lower Quartile	Median	Upper Quartile	Maximum
1 (Sample – ICW group)	128	8.72	2.26	3.67	7.00	8.67	10.00	14.40
0 (Control – No ICW group)	169	7.91	2.30	4.20	7.25	8.00	9.40	13.20

Table 14: Correlations

Pearson Correlation Coefficients			
Variables	CRDT_RTNG	ICW	G_SCORE
CRDT_RTNG	1.00	-0.581	0.181
ICW		1.00	0.251
G_SCORE			1.00

The upper right-hand portion of each panel presents Pearson product–moment correlations. Notes: Bold text indicates significance at the 0.01 level or better. CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280) (model A), with a higher number indicating better bond ratings. See Table 6 for numeric coding. A dummy variable equal to one if firm *j* is in one of the IC weakness groups (Section 404 weakness, late filer or Section 302 weakness), and zero if firm *j* is in the matched control sample (no ICWs). ICW is a proxy for internal control quality. G_SCORE is the shareholder rights governance score (source Gompers et al., 2003). Lower G_SCORE suggests better observance of shareholder rights.

Table 15: Logistic regression results of the effect of corporate governance strength on internal control quality (Model X)

Variables	Predicted Sign	Estimated coefficient
Firm characteristics (control)		
Intercept	?	-11.33***
SIZE	+	2.087***
ROA	+	21.347***
LOSS	-	-0.525
Main independent variable		
G_SCORE	-	-0.325***
Generalized R^2		0.55
Likelihood ratio χ^2		156.60***
Wald χ^2		71.53***
Sample size		171

***,**, * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively. The Wald χ^2 statistic tests whether the governance attributes added in each model as a whole explain a significant portion of the variation in firms' S&P credit ratings. CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280), see [Table 6](#) for numeric coding. G_SCORE is the shareholder rights governance score (source [Gompers et al., 2003](#)). Lower G_SCORE suggests better observance of shareholder rights.

Table 16: Logistic regression results of the effects of corporate governance strength on credit rating (Model Y) and of the effects of corporate governance strength and internal control quality on credit rating (Model Z)

Variables	Predicted Sign	Estimated coefficients			
		Model Y			Model Z
		Total firms	Sample (ICW firms)	Control (No ICW firms)	
Firm characteristics					
SIZE	+	1.775***	1.441***	1.863***	1.533***
ROA	+	5.503***	0.192	20.428***	4.810***
INDUSTRY	+	0.580*	1.302***	0.189	0.580*
LOSS	-	-1.895***	-2.114***	-0.259	-1.807***
OPCASH	+	12.960***	13.245***	5.214	11.357***
CVNI	-	-0.027*	-0.020	0.013	-0.025*
LEVER	-	-4.027***	-1.277	-5.960***	-3.990***
Corporate governance strength					
G_SCORE		0.136***	0.210***	0.095	0.109**
Internal control quality					
ICW	-				-0.796***
Generalized R^2		0.61	0.50	0.45	0.63
Likelihood ratio χ^2		267.78***	82.65***	91.84***	274.08***
Wald χ^2		176.48***	63.69***	72.43***	177.89***
Sample size		342	171	171	171

Notes: Table values are coefficient estimates from the following ordered logit models:

Model Y: CRDT_RTNG = f(G_SCORE, firm characteristics).

Model Z: CRDT_RTNG = f(ICW, G_SCORE, firm characteristics).

***, **, * indicate significance at the 0.01, 0.05, and 0.10 level or better, respectively. The Wald χ^2 statistic tests whether model variables as a whole explain a significant portion of the variation in firms' S&P credit ratings. CRDT_RTNG = S&P LT Domestic Issuer Credit Rating (*Compustat* #280), see Table 6 for numeric coding. G_SCORE is the shareholder rights governance score (source Gompers et al., 2003). Lower G_SCORE suggests better observance of shareholder rights.

FOOTNOTES

¹ For listed firms that are classified as accelerated filers, Section 404 became effective for fiscal year-ends after November 15, 2004. However, even within this category, for listed firms with market float of under \$700 million, the SEC granted an additional 45 days to file the Section 404 reports if the fiscal year end was on or before February 28, 2005. For non-accelerated filers and foreign listed firms, Section 404 is effective for fiscal year ends on or after July 15, 2007.

² SOX seeks to enhance corporate accountability and financial transparency by: “(a) creating an independent regulatory structure for the accounting industry, (b) higher standards for corporate governance, (c) increased independence of securities analysts, (d) improved transparency of financial reporting, and (e) a panoply of new civil and criminal remedies for violation of the federal securities laws”.

³ Securities and Exchange Commission (2002) “Final Rule: Certification of Disclosure in Companies’ Quarterly and Annual Reports”, RIN 3235-A154, and “Final Rule: Management’s Reports on Internal Controls over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports”, (2003) RIN 3235-A166 and 3235-A179.

⁴ Public Company Accounting Oversight Board (2004) “Auditing Standard 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements”, PCAOB Release No. 2004-001, March 9.

⁵ Specifically, AS No. 2 states:

- A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis (AS No. 2, para. 8).
- A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statement that is more than inconsequential will not be prevented or detected (AS No. 2, para. 9).
- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected (AS No. 2, para. 10).

⁶ Duplicates include those instances where a parent and subsidiary both file with the SEC and report the same material weakness. In these cases, I include only the parent company; further, I found no instances where a parent and subsidiary reported different material weaknesses.

⁷ Past studies have also included the subordination status of bonds to research models to indicate if a bond issue is subordinated to other debt. A subordinated bond typically receives a lower rating than a non-subordinated bond. However, in this study, bonds of all sample firms were of senior status, so this variable was dropped from the analysis.

⁸ Recall that the SIZE variable is measured as the natural log of the 5-year average total assets of the firm.

"The Group-Account, Item Characteristics (GAIC) Method of Learning Financial Accounting," Joseph A. Mauriello, New York University.

The Nature of the GAIC Methodology Several approaches have been employed over the past seven decades to facilitate the learning of the basic course in financial accounting. The most common recent

approach is to interweave the accounting with the policies, strategies, and business practices of public corporations, thereby creating diverse, vast detail. To date, probably 50% of the students find financial accounting to be mystifying and uninteresting, being taught by rote, repetitious examples, and data from annual corporate financial reports. Even the terms of debits and credits, although scientific, are puzzling, defying meaning.

A more effective learning mechanism focuses thoroughly and sharply on the fundamentals of language, underlying standards, rules and methods of application, and pervasive logic. This alternative system is presented in a segmented, organized manner that classifies into groups that are similar as to general nature, specific characteristics, and identical accounting treatment. The methodology proposed by the writer is termed the group-account, item-characteristic (GAIC) methodology of learning financial accounting. The methodology recognizes that the objective of accounting is to translate financial events into items, using standards of classification and valuation for use by internal and external stakeholders. The system is circumscribed, involving the integration of accounts with financial statements as end products.

The Features of the GAIC Methodology

The GAIC methodology of learning financial accounting consists of the following 10 features:

1. The use of a comprehensive chart of accounts showing items under each element, with the items grouped according to their sequence on the financial statements and their similarity with other like items.
2. A single number for each item, whether expressed in a single account or multiple accounts. The multiple accounts, usually two or three for each item, are referred to as primary, additive, and contra accounts. The last two types bear the same account number as the primary account, followed by the letters A and C, designative of the terms additive and contra, respectively. The carrying amount (balance) for each item is the sum of the balances in the primary and additive accounts less the sum of the balances in the contra accounts, termed net debit balances and net credit balances. The coding ends in an even digit for net debit balance items, and in an odd digit for net credit balance items.
3. A simultaneous use of the lay person terms of increase and decrease, and the synonymous accounting terms of debit and credit, either in the early part of the course or throughout the course.
4. An integration of account balances with line captions on the financial statements, using a financial statements-accounts register that associates account number and names with the line captions.

5. An early, thorough presentation of (a) qualitative standards issued by the Financial Accounting Standards Board, and (b) operative standards, essential to the recording and reporting, proposed by the writer.

6. A separate presentation of the rules of classification and the computational methods of valuation that apply the standards to specific balance sheet items and the operational changes expressed in the income statement.

7. An explanation of the types of financial statement analysis, including a recommended statement of ratios to accompany the four traditional statements included in the financial report of the business enterprise.

8. A brief, but thorough glossary of terms at the beginning of each chapter to enhance the understanding of the terms as they are encountered in the subject matter of the chapter. Also, a description of the financial events being recorded precedent to the presentation of the debit and credit components of the entry. The learner is challenged to make the entry, and then to check its accuracy against the official entry.

9. An appendix to each chapter disclosing the accounting practices of public and private business entities, serving as examples illustrative of the accounting fundamentals explained in the chapter.

10. The testing of the student's writing skills by requiring answers to questions, and the student's breadth of knowledge by requiring to exercises and demonstration problems.

Accounting Standards and Rules

The above features of the GAIC methodology are self-explanatory. However, Feature No. 5, concerning accounting standards, merits amplification.

The writer classifies FASB standards into the three categories of the following six concepts, seven principles, and six guide lines, as follows:

Concepts: Entity; going concern; monetary; periodicity; accrual basis; two-fold effect.

Principles: Objectivity and reliability of data; full disclosure; revenue and gain realization; expense incurrence; matching of expense with revenue; loss realization or sustainment; consistency, comparability, and uniformity in reporting.

Guide lines: Relevance of data; substance versus form; probability versus improbability of future materialization of present contingencies; conservatism; materiality; cost-benefit relationship of information.

The foregoing standards are pervasive, philosophical, and logical. The writer proposes an additional two concepts and nine principles that focus on the accurate and thorough execution of the accounting process; in order to validate practically the entire scope of financial accounting, the writer's additional standards are the following:

Concepts: Expectation and intent; chronological representation

Principles: Classification by items and item-account classes; classifications of equity components; cash realizable value; debt discharge value; fair market value; equity ownership and control; original cost; limited life; permanent impairment in value

The above standards are distinguishable from the computational rules, benchmarks, and methods used to establish the values of items and item groups. Reference is to the determination of uncollectible trade receivables; the valuations of inventories, marketable securities, bonds, and long-term notes of varying structure, owned and owed; and the depreciation and amortization of long-term assets.

The Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB), the standard setters for the United States and other countries, respectively, are at present proposing a single set of standards for uniform use world-wide.

Structures of Balance Sheet Accounts

Regarding the structuring of accounts for each balance sheet item classified as primary, additive, and contra, the primary account performs two functions: (1) it describes the balance sheet item, and (2) it reflects the amount or a dominant component of the total amount of the item in accordance with its detailed characteristics. The additive and contra accounts reflect valuation amounts that modify the tentative dollar balance of the item based on financial events. All three types of accounts bear the same account number for the item, since the accounts, combined, reflect the net balance of the item. This numerical coding is in contrast to the general practice of assigning different account numbers to each component item-account.

The account structures of balance sheet items are determined by the nature of value measurements. Thus, accounts receivable stated at cash realizable value are presented in a primary account stating the total uncollected balance and a contra account to reflect the estimated uncollectible amounts. Valuations at fair market value, applicable to equity securities and commodity inventories, utilize a primary account to reflect cost, an additive account to reflect an excess of market value over cost, and a contra account to reflect the excess of cost over market value. Commercial and industrial products are valued at the lower of cost or market value, using a primary account that states the lower of the two amounts, or a primary account to reflect cost and a contra account to show the adjustment of cost to the lower of cost or market value amount.

Ownerships of equities in other entities are valued under the cost or equity method, usually represented by a single primary account. Valuations of assets at depreciated cost and amortized cost make use of primary and contra accounts, whereas permanently impaired assets may be reflected at net value in a single primary account, or in a primary account for the pre-existing carrying amount and a contra account for the impairment. Asset and liability claim items possessing interest components make use of primary, additive, and contra accounts to reflect cost and amortizable premium and discount, and a contra account to reflect the interest on receivables and payables that is combined with principal payable in installments.

Structures of Operational Accounts

The temporary operational accounts are adjectival, being descriptive of the changes in assets and liabilities that impact on equity as a result of business the operations.

The methodology classifies revenue and expense accounts by (1) manner of origin, and (2) presentation, pretax and aftertax. Revenues and expenses originate in three

ways with reference to their inclusion in the present accounting period: (1) at inception, when benefit and detriment from the two categories are restricted to the present account period, (2) by accumulation through the end of the accounting period for revenue and expense accounts recorded by specified time periods that are not coterminous with the end of the accounting period, such as for payroll expense, payroll fringe expenses, interest revenue, interest expense, and utilities; and (3) the conversion of the costs of preexisting assets and liabilities into expense and revenue, respectively, on the basis of time or other index.

Gains and losses that affect net income are segregated into two classes of origin: (1) ongoing valuation, such as for assets stated at market value and for equity interests in other entities, recorded under the equity method, and (2) realization, such as from sales of property other than merchandise and exchanges of unlike-kind assets. Gains and losses are recorded pretax, except for those resulting from (1) discontinued operations and extraordinary items, classified as effects on net income or net loss, and (2) valuation changes of selected items and of unresolved adjustments, classified as other comprehensive income or loss.

Business Ethics

Sound ethics are vital to the accounting, since debit and credit treatments express opposing effects, and therefore are vulnerable to misrepresentation of data and fraudulent reporting. A prime example is the use of debits to reflect both asset increases and expense increases, and of credits to express both liability increases and revenue increases. Other

examples are erroneous classifications of debit and credit balances on the financial statements, and the deliberate smoothing of earnings, that distort financial reporting over a series of years.

The subjective nature of accounting is exemplified in the valuation of trade receivables and inventories, and the service lives selected in determining the amortization of intangible assets having unlimited or indeterminate lives, often motivated to minimize or defer income tax expense. The unavoidable use of estimates and predictions of future item behavior require the application of ethics, accurate reasoning, and unbiased judgment to achieve a faithful representation of financial information.

The highest level of ethics is essential to a credible, acceptable accounting. Proper ethics are dependent on the traits of integrity and honesty on the part of persons who control and are responsible, directly and indirectly, for the accounting. The persons involved must either possess adequate accounting knowledge or be fully informed by accounting professionals of the effects of variable accounting treatments.

Knowledge Imparted by the GAIC Methodology

The writer has prepared a comprehensive representative chart of accounts, summarized below as to the number of (1) items; (2) item-groups, including items dissimilar from all other items, treated as an item group; and (3) accounts. The following is a summary of the percentage relationships among the three categories:

Descriptions	<u>Totals</u>			<u>Similar Category</u>			<u>Dissimilar Category</u>	
	<u>Item- Groups</u>	<u>Item- Groups</u>	<u>Accts.</u>	<u>Item- Groups</u>	<u>Item- Groups</u>	<u>Accts.</u>	<u>Item- Items</u>	<u>Item- Items</u>
Number	140	47	189	130	37	178	10	10

Percentages to

Total:			
1. Items	100%	92.86%	7.14%
2. Item Groups	100%		78.72%
			21.28%
3. Accounts	100%	94.18%	
			5.2%
4. Item Groups to			
Total Items	33.57%		26.43%
			7.14%

The percentage totals of the similar and dissimilar categories reflect the relative degrees of knowledge acquired by the learner. Since accounting focuses on items, and accounts merely describe the activities of items, the fourth set of percentages of item groups to total items show that the similar category contains 3.7 times ($26.43\% / 7.14\%$) the knowledge derived from the dissimilar category, or 78.7% ($26.43\% / 33.57\%$) as shown in the relative percentages of 78.7% to 21.28% for the item groups. This last percentage, if weighted, is even higher, since the dissimilar items are simple in structure, represented by one account for nine items and two accounts for the remaining item.

The percentages are significant in that they indicate that total financial accounting knowledge can be garnered in not more than 30% to 35% of the conventional learning time entailed in using present-day accounting textbooks. The savings in time and the facilitated and thorough learning assures a mastery of the basic financial accounting course, of primary importance to the total accounting curriculum.

The GAIC Methodology - - Summary and Conclusions

The GAIC Methodology is summarized in the following paragraphs, taken from

Financial Accounting Primer, a recently copyrighted work of the writer.

The methodology consists of *clear language* combined with *accounting standards*, applied to *external transactions* and *internal measurements*, constituting events, which create impacts on items comprised of *units*. The *items* and *item-changes* of *increase* and *decrease* create *periodic balances*, determined at *dates* and for *interim periods* within each *fiscal year*, in *primary*, *additive*, *contra*, and *adjunct accounts* appearing in a *comprehensive chart of accounts* designed to reflect most *real-world business situations*, subdivided, first, into *account classes*, and, second, *account groups for similar items*, representing the *three elements* in the *accounting equation*. The *account balances* are summarized in *financial statements* as *end products*, reproducing the chart of accounts with *line captions* and *amounts*, expressing *financial status* at the end of each *accounting period* and *operations* for the *period*. *Numerical codes* and *letter symbols* accompany *account names* as a *part* of the *methodology*, serving as *learning aids* compatible with *accounting practice*, as well as *electronic classroom* and *distance learning*. *Underlying logic* is applied to each *accounting event* and *issue*.

The *item-accounts* form the *accounting spectrum*, from which *knowledge-bearing accounts* are selected to establish the accounts groups of similar items which condense the chart of accounts into *knowledge segments* embracing all accounts, so that *learning* is concentrated on *accounting essence*, consisting of classification and valuation. The result is a *mastery of accounting* which is *scientific*, *all-embrative*, *facile*, *quick*, and *accurate*.

The GAIC methodology avoids the following negative features of the traditional educational process: (1) a nonrecognition of accounting as a science and a language,

resulting in a mechanistic, unstructured presentation of disjointed, fragment examples and illustrations; (2) a delayed, shallow coverage of standards, precluding a full understanding of accounting, and (3) a failure to present the logic implicit in the entire accounting process.

“Integrating Personal Finance Concepts into the Financial Accounting Course,” Andy Lafond, Philadelphia University, Barbara Vinciguerra, Moravian College.

Introduction

There are several studies and key statistics that inform us that financial illiteracy is a growing epidemic in this country. This epidemic is compounded by the fact that America is a consuming society and managing one’s personal affairs has become very complex. “Many parents feel unprepared to teach their kids about money and no one from the schools to Uncle Sam to the private sector has undertaken a meaningful effort to prepare the next generation to handle money” (Simmons, 2006). A recent study conducted by the AICPA found the following: Americans’ personal savings rate has declined each year since 1982, the U.S. savings ratings became negative for the first time in April 2005, the past 20 years show decreasing attention to asset accumulation, and tomorrow’s workforce is not financially prepared. In addition, by 2006 average household credit card debt was \$9,300 (Stein, 2007), 44% of families reported that they did not save any money in the past year (Bucks, Kennickell, et al, 2006), and 21% of workers whose employers sponsor retirement plans don’t participate, while only 57% of workers are saving for retirement at all (Copeland, Employee Benefit Research Institute, 2007). These characteristics are common among people that are financially illiterate.

Results of one AICPA study “indicate that among both student and professional participants, individuals with more positive financial attitudes are happier and have higher financial literacy”

(Stone, et al, 2007). In an effort to increase financial literacy, the accounting profession has put forth a huge initiative through the AICPA's "360 Degrees of Financial Literacy" program and their "Feed the Pig" ad campaign. These programs are aimed at 25-34 year old people "because their need is great and the potential for success is great" (Reynolds, 2006). These young people typically have over \$20,000 in student loan and credit card debt and research shows that education on this topic coupled with "the right motivation, they are likely to change the way they spend and save" (Reynolds, 2006). However, given these facts, many high school and college students are unaware of basic personal finance concepts and most colleges and universities do not require a personal finance course in their curriculum. In a recent survey of business programs accredited by AACSB, only 45.3% of the respondents offer a personal finance course and of those 45.3% that offer a course only 28.4% require the course for a degree (Gold, et al, 2004). This study's results indicate that most students are not getting personal finance education with their undergraduate degree. As accounting educators, we can do our part to improve the financial literacy of our students and at the same time improve the learning experience in the financial accounting course taken by all business majors by weaving some personal finance concepts into the financial accounting course.

Accounting education literature contains numerous calls over the past two decades calling for accounting education to be more relevant. The most recent call for accounting courses to contain more relevance for students came from Albrecht & Sack's (2001) *Accounting Education: Charting the Course through a Perilous Future*. As far as accounting curriculum and content, "educators need to teach classes that are relevant to today's business world" (Albrecht & Sack, 2001) in order to "increase the value of accounting students and prepare them for the fast-changing business world" (Albrecht & Sack, 2001). Turner, et al (2006) found in their study "the more that students realize accounting concepts can apply in their careers, the greater their interest and motivation will be in the class". Another by-product of increased relevancy of accounting courses is the increased attractiveness of the accounting major to students (Heffes, 2001). Certainly, teaching financial accounting with links to personal finance topics would have relevance for students, add value, and possibly increase their

interest in the course and possibly the accounting major. The integration of personal finance topics in the financial accounting course, gives students exposure to concepts they would otherwise not be exposed to in their undergraduate course work, making the learning experience in the financial accounting course more relevant and productive. This approach to teaching the financial accounting course can be supported by the vast amount of accounting education literature which calls for experiential learning and integration of courses to help students see the interrelationship among business disciplines.

Many concepts taught in the Financial Accounting course can be linked to personal finance concepts. By linking the two subjects together through experiential learning assignments, accounting educators can make financial accounting concepts more clear, improve financial literacy, and make the course more relevant and interesting for students. (See Table I for these Linkages).

Some personal finance concepts become more understandable to students if they are able to relate to them personally. For example, the concept of the balance sheet and income statement is more easily related to students through their view of their own personal statement of net worth or their own statement of income and expenses. There are several instances where personal finance concepts can be introduced in the financial accounting course as an ancillary and aide to teaching the traditional financial accounting concepts for a business. For decades, most Financial Accounting textbooks have done this with the coverage of cash and the reconciliation of a checking account. Experience of the authors of this paper are that the “light goes on for the student” when the concept can be related to the student’s own life or experience. The remainder of this paper describes some experiential learning exercises that link personal finance concepts with certain financial accounting concepts.

There are several areas in the Financial Accounting course where personal finance concepts can be integrated and these areas include: financial statements, cash management, accounting for marketable securities, and accounting for current and long-term liabilities.

Financial Statements and Cash Management

In the introductory financial accounting course, the most important concept for students to master is a user's perspective of the four basic financial statements. This entails understanding the difference between an asset, liability, owners' equity, revenue, and expense account. At this introductory level, there is often confusion between what is an asset or expense, and what is a liability or revenue. An exercise in having a student prepare a personal balance sheet and income statement for themselves more easily delineates the differences between each one of these account types.

Students obviously can see that their personal checking account, money owed to them from a friend, investments in a company's stock, and a vehicle are assets and also draw this parallel to the assets of a business such as cash, accounts or notes receivable, marketable securities, and property, plant, and equipment. Students can also see that liabilities such as student loans, automobile loans, and credit card balances are obligations that they personally have, drawing the parallel to accounts payable and notes payable on the balance sheet of a business. In addition, the classification of the balance sheet becomes clearer as students can see which of their assets are short-term vs. long-term in nature, and which liabilities are due within one year or beyond one year. This is a great time to explain to students the danger of considering credit card balances as long-term liabilities, and how they should be treated as a monthly account payable. Students' understanding of his or her personal balance sheet leads to a more thorough understanding of a business's balance sheet as well as a better understanding of their own personal financial picture.

The income statement for an individual also closely parallels the income statement of a business. An exercise having students prepare an income statement for themselves for a given period of time not only distinguishes revenue and expense accounts but also the realization and matching principles governing when revenue and expenses should be recognized and recorded. The student's income from a job and interest earned on a savings account easily translate to the revenue on a business's income statement as well as the earnings process necessary to record that revenue on the income statement. Expense accounts that students typically have such as rent, telephone, supplies,

automobile, insurance, and entertainment expense easily translate over to the income statement of a business and help a student understand the concept that an expense represents the consumption of a resource. Also, understanding net income or loss of a business becomes clearer after students have calculated their own personal net income or loss. See Exercise 1 for an experiential learning exercise that integrates personal financial statements into the financial accounting course.

Another significant part of the Financial Accounting course is the classifying and recording of transactions. It is important for students to know how transactions entered into by a business affect the accounting equation, whether an item purchased is an asset or expense, and whether monies received is revenue or a liability. Students need to understand how their spending affects their net worth. Having students perform basic cash management, by recording weekly or monthly cash disbursements and credit card charges and classifying these cash disbursements and credit card charges as assets or expenses drives home the difference between a capital vs. revenue expenditure and the effect of each disbursement or charge on net worth. See Exercise 1 for an experiential learning exercise that integrates cash management with the classifying and recording of expenditures into the financial accounting course.

Accounting for Marketable Securities

Accounting for marketable securities is a natural for teaching students the basics of investments including the concepts of cost basis, market value, calculating gain or loss on sale, and dividends. Typically the financial accounting course covers the journal entries required to record: acquisition of marketable securities, receipt of dividends, unrealized gains or losses, and disposition of a marketable security. The journal entries require an understanding of cost basis, market value, unrealized gain or loss, and realized gain or loss. In addition to these journal entries, the instructor can teach some practical investment basics by simply taking students to www.yahoo.com. By accessing the “Finance” section of this site, the instructor can retrieve information on the stock of any publicly traded company including the market price of the stock, 52-week price range of the stock, and the dividend history of the company. In addition, concepts such as cost basis, realized vs. unrealized gain

or loss can be discussed. This is an exciting area for many students as many have an interest in the stock market. This area also allows the instructor to show the relevance of accounting to the stock market and makes the material covered in the financial accounting course clearer. See Exercise 2 for a hands-on exercise integrating investment basics in the financial accounting course.

Accounting for Current and Long-term Liabilities

In the financial accounting course both current and long-term liabilities are discussed. Within this area, the difference between a current and long-term liability is covered as well as notes payable and interest expense and accounting activities related to payroll. All of these topics have relationships to topics in personal finance that “hit close to home” with students. In the discussion of the difference between a current and long-term liability students need to understand the use of a credit card vs. the use of a personal loan or mortgage. Credit cards are used for current purchasing needs and should be paid in full as due, whereas loans are used for long-term assets such as education, homes, and automobiles. Students should also be made aware of the negative impact on their credit rating from carrying credit card balances, defaulting on loans, and just using too many different credit cards. In addition, students should know how to obtain and review their own credit report for errors, identity theft, or fraud, and understand their credit score and its potential impact on obtaining a loan. Today’s college students have been referred to as “Generation Debt” (Reynolds, 2006) as they leave college with plenty of student loan and credit card debt. A solid understanding of the different uses of each type of debt as well as their credit rating is important for their long-term financial health.

See Exercise 3 which applies some of these concepts as it requires students to shop for a home, obtain and review their own credit report, use some web sites to research interest rates, calculate a monthly mortgage loan payment, and prepare an amortization schedule for a mortgage loan.

Financial Ratio Analysis

Another very important topic in financial accounting as well as many introductory finance courses is financial ratio analysis. Financial ratio analysis allows a manager, investor, or creditor to

compare and evaluate the financial performance of a company over a period of time as well to other companies in the industry. There are several financial ratios that help evaluate the liquidity, activity (management of inventory and accounts receivable) debt, and profitability of a company. Financial ratio analysis can also be a helpful tool for individuals in helping measure the financial strength and progress of a person towards his or her personal financial goals. There are a few financial ratios that help assess the liquidity (ability to pay bills on time) of an individual. These ratios are the Liquid Assets to Take-Home Pay ratio ($\text{Liquid Assets}/\text{Take-home Pay}$) and the Liquid Assets to Current Liabilities ratio ($\text{Liquid Assets}/\text{Current Liabilities}$), and are very similar to the current ratio used for a business. Liquidity ratios help in forewarning of cash flow needs however they do not tell someone if they have excessive debt. Two ratios that can forewarn someone of having excessive debt are: the Debt ratio ($\text{Total Liabilities}/\text{Total Assets}$) and the Debt-Service Coverage ratio ($\text{Take-home Pay}/\text{Debt Service Charges}$). There is some similarity of this ratio analysis technique to that performed in evaluating a business and translates into tools that individuals can use to determine their liquidity and amount of debt. Integrating the use of these personal financial ratios helps students experience how the use of financial ratios can help them assess their own financial health. This process mirrors the process that a bank or investor uses to assess the financial health of a business. See Exercise 4 for an experiential learning exercise integrating personal financial ratios into the financial accounting course.

Conclusion

In summary, several research studies have called for reform in accounting education. These calls for reform ask accounting educators to make accounting courses more relevant for students. Concurrently, financial illiteracy is a large problem in this country, yet undergraduate students get very little, if any, exposure to concepts in personal finance. This paper demonstrates an excellent opportunity for accounting educators to enhance the financial accounting course by integrating personal finance topics into the course through experiential learning exercises. The integration of personal finance topics into the financial accounting course makes the classroom atmosphere more dynamic, more personal, and therefore more relevant for students, while giving students knowledge and tools to manage their own personal finances. These exercises answer the calls for accounting

education reform, improved financial literacy, and make the teaching of Financial Accounting a more rewarding and enjoyable experience for accounting educators.

Exhibit 1

Exercise	Topic in Financial Accounting	Personal Finance Concept
1	Financial statement preparation	Financial Planning: Personal Financial Statements
1	Effect of transactions on the accounting equation	Cash management
2	Marketable securities	Investment basics including concepts such as cost basis, market value, unrealized vs. realized gain or loss on sale, and dividends

3	Current and long-term liabilities	Reading and understanding a credit report
4	Financial Ratio Analysis	Amortization of a mortgage loan Use of personal financial ratios

Exercise #1 – Personal Financial Statements/Cash Management

- Using your own personal data, prepare a two column listing of (1) your personal assets and (2) your personal liabilities *as of today's date*. Below is a listing of some of the items that you might include. Feel free to include other items not listed here. The listing should be prepared in Excel.

Coins and currency on hand	Clothing
Checking account balance	Hobbies and collections
Savings account balance	Investments
U.S. Series EE or HH bonds	Retirement accounts
Balances on dining meal cards	Unpaid bills
Gift cards	Credit card balances
Furniture	Automobile loan balances
Appliances	Student loan balances
Residence	Other personal loan balances
Automobile	Mortgage loans
Jewelry	

- Total the value of each column and subtract total liabilities from total assets. This is your net worth as of today.
- Re-organize your final listing of assets in terms of liquidity, in other words, by the order of how easily the assets are converted into cash. Re-organize your liabilities in terms of how soon they need to be paid. How able are you to pay your liabilities given the current balances in your asset accounts?
- Track your personal income and spending for the next week. This will detail the cash and other asset and liability inflows and outflows that you experienced during the week. Use the following categories to help organize your income and spending.

Wages	Utilities (Telephone, Internet, Gas and Electric)
Allowances from parents	Leisure and entertainment expense
Cash gifts	Other expenses (Gifts, subscriptions, books, etc.)
Interest income	
Dividend income	
Housing expenses (Rent, Maintenance)	
Transportation expenses (Gas, repairs, loan payments, etc.)	

Food and other consumptive items (Food, household supplies, personal care)
Taxes expense
Insurance expense

5. Re-organize your listing into inflows and outflows of cash and subtract the outflows from the inflows. Did you have a net inflow or outflow? Were all of these items paid in cash, or did you incur additional credit card debt during the time period?
6. Did any of the items from (5) affect your personal balance sheet? In other words, did your cash, other asset, or liability balances change?
7. Update your personal balance sheet to reflect the changes over the past week. How did your Net Worth change?

Teaching Points

1. Ask students to identify how they determined the values for their asset and liability accounts. This is a prime opportunity to discuss the variety of reasonable basis for determining the value of assets (original cost, current value, and appraised value) and the importance of comparability and consistency in financial reporting.
2. The income statement for an individual is prepared on a cash basis. This presents an opportunity to contrast the income statement for a business, which is prepared on the accrual basis. It can also help students to differentiate between the types of income earned.
3. Tracking the weekly expenses presents the opportunity to discuss many accounting and personal finance topics. First, it emphasizes just how hard it is to accurately track your expenses! Additionally, it presents the opportunity to discuss the concept of an expense. You can quite literally explain how spending money on dinner is an expense, i.e. the consumption of the asset, cash. The purchase of clothing can represent the purchase of an asset, which has future benefit. Students also need to consider how using credit cards for purchases impacts their overall net worth. Thus, you can concretely explain the effect of income and expense on net worth. The instructor can have students identify various items on their income statement and consider how they impact the overall increase or decrease in net worth.

Exercise #2 – Marketable Securities

On December 25, 2007, your grandmother gifted you 500 shares of Coca-Cola (NYSE: KO), 200 shares of General Electric (NYSE: GE), and 100 shares of Unisys Corporation (NYSE: UIS) stock.

For income tax purposes, your cost basis in the stock will be the fair market value of the stock at the date of the gift (December 25, 2007).

1. What was the fair market value of each of these stocks (your cost basis) at the date of the gift?
2. What was the total value of this gift from your grandmother?
3. Currently, what is the value of each of these stocks?
4. Have any of these stocks paid dividends recently? If so, how much?
5. What price range has each of these stocks traded at over the past 52 weeks?
6. If you sold each of these stocks today, how much gain or loss would be realized on each stock?
7. If you held (did not sell) each of these stocks, how much unrealized gain or loss would there be on each stock?

Teaching Points

1. Prior to assigning this exercise the instructor should give the students some sample web sites such as www.yahoo.com where the information needed to answer the above question is located. The instructor should demonstrate the use of this web site for another company's stock prior to assigning this exercise.
2. This is a good opportunity to draw the parallel to the handling of investment in marketable securities for a business according to generally accepted accounting principles as it relates to the mark-to-market adjustment needed for GAAP financial statements.
3. This is also a good opportunity to discuss the difference in investments (dividend paying stocks vs. growth stocks), timing for an investor to invest in the stock market, and risk vs. return.

Exercise #3 – Current and Long-term Liabilities

The largest capital expenditure for most individuals/families is the purchase of a home. In addition to the purchase price of the home there are several other issues that need to be considered prior to making this decision. In shopping for a home, there are several web sites that can be used by the potential buyer such as www.realtor.com. In addition, there are web sites such as www.bankrate.com which can help a buyer get a sense as to the monthly principal and interest payment associated with a particular mortgage liability. As part of the mortgage application process, mortgage companies will assess the credit rating/score of the individual(s) applying for the mortgage to determine their eligibility for a loan. Since there are 3 consumer credit companies and each may have a slightly different credit score for an individual, mortgage companies will compare the 3 scores from each of the consumer credit companies and select the middle score and use that score as the individual's credit score.

1. Using www.realtor.com or any realtor's web site for an area which you're interested in living, find a home which you like and would be willing to buy.
2. Go to www.AnnualCreditReport.com and request a free credit report from each of the 3 nationwide consumer credit companies, Equifax, Experian, and TransUnion. Review your credit report for any errors or improprieties. What will a mortgage company determine your credit score to be?
3. Assuming a 20% down payment on your "dream house", how much of a mortgage would you need?
4. Using www.bankrate.com determine the monthly mortgage payment and prepare an amortization schedule for the life of the loan.
5. At the inception of the mortgage loan how much of the mortgage liability is a current liability? How much of the mortgage liability is classified as a long-term liability?
6. How much of the first year's mortgage payments are interest expense?

Teaching Points

1. Ask students what the monthly mortgage payment would be if the interest rate was higher, or the term of the loan was shorter, or the down payment was 10% of the purchase price of the home.
2. This presents an opportunity to teach students the importance of their credit score as well as periodically reviewing their credit score for errors or to catch any acts of identity theft or fraud.

Exercise #4 – Financial Ratio Analysis

Assessing the financial performance of a company through financial ratio analysis is frequently used by creditors to assess the financial health of the company. Individuals can also assess their financial strength and performance through the use of financial ratios. Financial ratios used to assess the strength and performance of an individual or family are: income and the inflation Rate, liquid assets to current liabilities ratio, liquidity ratio, and the debt ratio.

1. Based on the personal financial statements prepared in Exercise 1, calculate the above ratios. Based upon the calculations, evaluate your liquidity and total debt.
2. Your instructor has prepared a comparative analysis of these ratios, removing all names so that individuals cannot be identified. Rank the individuals from strongest to weakest in terms of which individual you would be most willing to lend \$1,000.
3. Which criteria most heavily influenced your decision?
4. What additional information would you like to have in order to make a more informed decision?

Teaching Points

1. This is a great opportunity to demonstrate the usefulness of financial ratio analysis for individuals as well as businesses where the parallel between financial ratios for a business as well as an individual can be made.
2. Use of financial ratios from the lender's perspective can help illustrate more clearly the effect that liquidity and debt have on an individual's financial health and ability to borrow money.

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The Work Product Privilege is Held to Protect Tax Accrual Work Papers from the Reaches of an IRS Summons, Mark Aquilio, St. John's University.

ABSTRACT

In U.S. v. Textron, Inc. the IRS was dealt a significant setback in its attempt to acquire tax accrual workpapers. The court denied its petition to enforce a summons requesting the workpapers reasoning that they were protected by the work product privilege. The court held that the workpapers were also covered by the attorney-client privilege and the tax practitioner-client privilege provided by Code § 7525, but those privileges were waived when Textron provided the workpapers to its independent auditor. It ruled that the work product privilege was not waived as disclosure to the auditor was not inconsistent with keeping the information from an adversary.

Textron, Inc. is of major importance. The IRS has indicated that it will likely appeal the ruling and continue to seek tax accrual workpapers. The IRS and practitioners must be aware of the court's reasoning and the progress and impact of Textron, Inc.

INTRODUCTION

In today's news there is much conversation about privacy and confidentiality. Typically, this conversation centers on the war on terror and the reaches of the Patriot Act or on the intrusion into the lives of celebrities by the paparazzi. In a much less noticed area, the District Court for the District of Rhode Island in *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.C.R.I., 2007) recently

addressed the ability of the Internal Revenue Service (IRS) to obtain a corporate taxpayer's tax accrual workpapers (Workpapers). The court ruled that the IRS could not obtain the Workpapers as they were protected by the work product privilege.

Textron was a much anticipated decision by both the IRS and tax practitioners. Within 24 hours of the court's decision in August, 2007, Don Korb, the IRS Chief Counsel, declared at a news conference at the IRS National Office, "This is a very important case. I'm disappointed in the result. The court's analysis is incorrect. We strongly believe that the documents are not work product. We're not going to change anything because of this case." He went on to state, "Let's see how this case plays out. This victory by *Textron* may be short-lived." He also said, "This could move very quickly. In the meantime the IRS is going to maintain this policy (of seeking Workpapers). We're not going to change anything because of this case." See, NEWS-FEDERAL, 2007TAXDAY, (Aug. 31, 2007), Item #I.7, "IRS Will Not Change Tax Accrual Workpapers Policy Despite *Textron* Defeat; Practitioners Hail Court's Logic."

On October 21, 2007 speaking at NYU's 66th Institute on Federal Taxation in New York Korb said that *Textron* is one of the two most significant litigation-related events during his three-and-a-half-year tenure as IRS Chief Counsel. He indicated that he anticipates the reversal of *Textron* and expressed the IRS' policy of exercising restraint in requesting Workpapers while maintaining the right to do so. Korb indicated that during his time as Chief Counsel, the IRS requested 140 Workpapers from taxpayers and 136 taxpayers complied, two taxpayers settled and two litigated. He stated that the IRS requests Workpapers always as they identify the soft spots in a tax return. See, *Federal Tax Weekly*, No. 42, October 25, 2007, "Korb asserts right to tax accrual workpapers of public companies."

While Korb expressed dismay with the court's decision, tax practitioners praised the decision.

Lawrence Hill, of Dewey Ballantine, a prestigious law firm stated, "This is a watershed victory for corporate taxpayers and an appropriate result from the standpoint of fundamental fairness in the tax system. The work product doctrine was the correct doctrine for the district court to rest its decision on." Furthermore, Jeffrey Paravano of Baker & Hostetler, another prestigious law firm, stated, "The court's decision in Textron is terrific and is correct. The clarity of the court's analysis will help restore balance in adversary proceedings with the IRS." NEWS-FEDERAL, 2007TAXDAY, (Aug. 31, 2007), *supra*.

Since 2002 it has been the policy of the IRS to request Workpapers when a taxpayer seeks a tax benefit from a "listed transaction." The IRS will seek all the Workpapers when the taxpayer has more than one "listed transaction" in a tax year. *Textron* is the first case where the IRS petitioned a court to enforce its summons to produce the Workpapers under its policy.

There is no one definition of Workpapers. Thus, the contents of the Workpapers may be different for each taxpayer depending upon factors such as the substantive issues involved and the arrangement of the files. The Fifth Circuit summed up the broad definition of Workpapers succinctly in *United States v. El Paso Co.*, 682 F.2d 530 (CA-5, 1982). It stated, "This appeal is centrally concerned with documents known to the accounting profession under various names -- the noncurrent tax account, the tax accrual work papers, and the tax pool analysis. Because the nomenclature is not standardized, the IRS chose to request El Paso's version of these documents under a loose descriptive label -- documents analyzing potential tax liabilities or tax problems. No matter what alias is used, however, the documents are of similar nature. It is useful to explain what these documents are before proceeding to determine whether the IRS may have access to them.

... [N]o taxpayer completes a return with the certainty that the IRS will agree with the bottom

line, or the many steps taken to get there. ... The return is filed with the understanding, however, that the IRS may challenge some of these questionable positions and, through settlement or litigation, the corporation may end up owing more taxes than it initially acknowledged.

Business reality compels corporations to recognize on their financial sheets that the return as filed is not the last word in determining the taxes owed. Public companies subject to the securities laws must file financial statements with the Securities and Exchange Commission (SEC), 15 U.S.C. § 781. SEC regulations require that independent accountants verify these financial statements in accord with Generally Accepted Auditing Principles, 17 C.F.R. § 210.1-02(d). To demonstrate to the accountant that a balance sheet does not portray an overly-rosy view of a corporation's financial health, the balance sheet must provide for contingent future tax liabilities. In short, the corporation must set aside an account to cover additional taxes that it may become liable to pay above and beyond the amount indicated on the initial return.

To comply with the securities laws, therefore, companies ... must prepare in-house or have prepared by outside auditors [or attorneys] an analysis of their contingent tax liabilities. The analysis pinpoints the soft spots on the corporation's tax returns and indicates those areas in which the taxpayer has taken a position that may, upon challenge, negotiation, or litigation, require the payment of more taxes. The analysis is known in the trade as the tax pool analysis, the noncurrent tax account, or tax accrual work papers.

Several points are worth noting about the tax pool analysis. First, it is not prepared to assist in filling out a tax return. The tax pool analysis is undertaken only after the return is filed. Although the same corporate employees or outside auditors [or attorneys] may prepare both the return and the tax pool analysis, there is no necessary connection between the two jobs.

Second, the tax pool analysis may be performed either in house or by outside accountants [or attorneys]. It is not essential to consult an attorney to prepare the tax pool analysis.

Finally, the tax pool analysis is ‘prepared for financial reporting purposes alone. . . .’ ... While the analysis must forecast the cumulative results of IRS audit, settlement, and litigation, the tax pool analysis itself is not prepared to respond to a specific charge by the IRS or to any pending or impending lawsuit. The tax pool analysis is undertaken solely to insure that the corporation sets aside on its balance sheet a sufficient amount to cover contingent tax liability.” *Id.*, at 533-535.

Before analyzing *Textron* it is necessary to review the relevant sections of the Internal Revenue Code of 1986, as amended (Code) and the privileges asserted by Textron to protect its Workpapers from the reach of the IRS, namely, the attorney-client privilege, the tax practitioner-client privilege created by Code § 7525, and the work product privilege.

STATUTORY OVERVIEW, ATTORNEY-CLIENT, TAX PRACTITIONER-CLIENT AND WORK PRODUCT PRIVILEGES

Statutory Overview

Code § 7602 provides, in relevant part, “(a) AUTHORITY TO SUMMON, ETC. --For the purpose of ascertaining the correctness of any return, ... determining the liability of any person for any internal revenue tax ..., or collecting any such liability, the Secretary is authorized -- (1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry.” In *United States v. Arthur Young & Co.*, 465 U.S. 805, 816, 104 S. Ct. 1495, 1502, 79 L. Ed. 2d 826 (1984) the Supreme Court viewed Code § 7602 as giving the IRS a "broad summons authority" reflecting a "congressional policy choice *in favor of disclosure* of all information relevant to a legitimate IRS inquiry." (emphasis added).

Code § 7604 authorizes the IRS to petition a federal district court for an order enforcing the summons issued under Code § 7602 when there is noncompliance by a taxpayer. The IRS must establish: (1) that there is a *legitimate purpose* for the investigation pursuant to which the summons is being sought, (2) that the inquiry or the materials sought may be relevant to that purpose, (3) that the information sought is not already within the Commissioner's possession, and (4) that the administrative steps required by the Code have been followed in order to successfully obtain an order under Code § 7604. *United States v. Powell*, 379 U.S. 48, 57-58 (1964). (emphasis added).

The IRS may make a prima facie showing that the Powell requirements have been satisfied "on the face of the summons and by supporting affidavits." *United States v. Freedom Church*, 613 F.2d 316, 321 (CA-1, 1979). Then the burden shifts to the taxpayer to provide evidence that the Powell requirements haven't been satisfied or some other reason to deny enforcement of the summons. *United States v. LaSalle Nat. Bank*, 437 U.S. 298 (1978).

In determining if there is a *legitimate purpose* for the investigation pursuant to which the summons is being sought a facts and circumstances inquiry is necessary. "Ascertaining the correctness of any return" and "determining the liability of any person for any internal revenue tax" as provided in Code §7602(a) are obviously legitimate purposes for issuing a summons. However, it is not a *legitimate purpose* "to harass the taxpayer or to put pressure on him to settle a collateral dispute, or for any other purpose reflecting on the good faith of the particular investigation." *Powell*, 379 U.S. at 58.

With regard to the Powell requirement that the inquiry or the materials sought may be relevant to the *legitimate purpose* for the investigation pursuant to which the summons is being sought, the Supreme Court has ruled that an IRS summons is relevant if the documents sought "might have

thrown light upon' the correctness of ...[the taxpayer's] return." *Arthur Young*, 465 U.S. at 813.

Even if the Powell requirements are satisfied by the IRS, the court may deny the petition for enforcement of the summons pursuant to Code § 7604 if there is a privilege protecting the documents from the reach of the IRS. *See, Upjohn Co. v. United States*, 449 U.S. 383 (1981) (recognizing the attorney-client and work product privileges in tax summons cases). However, when a taxpayer claims a privilege the taxpayer has the burden to establish that they are entitled to the privilege and that it has not been waived.

Attorney-Client Privilege

Federal Rule of Evidence 501 provides that "the privilege of a witness . . . shall be governed by the principles of the common law as they may be interpreted by the courts of the United States in light of reason and experience." The attorney-client privilege is the oldest of the privileges for confidential communications known to the common law. 8 J. Wigmore, *Evidence* § 2290 (McNaughton rev. 1961). Wigmore succinctly summarized the attorney-client privilege as follows: (1) Where legal advice of any kind is sought (2) from a professional legal adviser in his capacity as such, (3) the communications relating to that purpose, (4) made in confidence (5) by the client, (6) are at his instance permanently protected (7) from disclosure by himself or by the legal adviser, (8) except the protection be waived. 8 J. Wigmore, *Evidence* § 2292, at 554 (McNaughton rev. 1961).

The attorney-client privilege was established to protect confidential communications between attorneys and their clients regarding legal advice in order to encourage the full and frank discussions required to provide sound legal advice, which serves to promote the observance of the law and administration of justice. *See, Upjohn Co. v. United States, supra*, and *Hunt v. Blackburn*, 128 U.S. 464 (1888).

While the attorney-client privilege generally is narrowly construed as it may limit the search for truth, it is particularly narrowly construed in the context of tax summonses issued pursuant to Code § 7602. As stated in *Arthur Young*, 465 U.S. at 816-817, “Indeed, the very language of § 7602 reflects ... a congressional policy choice in favor of disclosure of all information relevant to a legitimate IRS inquiry. In light of this explicit statement by the Legislative Branch, courts should be chary in recognizing exceptions to the broad summons authority of the IRS or in fashioning new privileges that would curtail disclosure under § 7602. ... If the broad latitude granted to the IRS by § 7602 is to be circumscribed, that is a choice for Congress, and not this Court, to make.”

Generally, the mere preparation of a tax return is accounting work which may not be protected by the attorney-client privilege "by hiring a lawyer to do the work that an accountant, or other tax preparer, or the taxpayer himself . . . normally would do." However, attorney communications of legal advice in connection with the preparation of a return, such as statutory interpretation or case law analysis or tax planning, may be privileged. See, *United States v. Frederick*, 182 F.3d 496, 500 (CA-7, 1999); *United States v. Davis*, 636 F.2d 1028 (CA-5, 1981), *cert. denied*, 454 U.S. 862 (1981); *Canaday v. United States*, 354 F.2d 849 (CA-8, 1966); and *Olender v. United States*, 210 F.2d 795 (CA-9, 1954), *cert. denied*, 352 U.S. 982 (1957). Regarding the preparation of Workpapers in *El Paso Co.*, 682 F.2d at 539, the court stated, “We would be reluctant to hold that a lawyer's analysis of the soft spots in a tax return and his judgment on the outcome of the litigation on it are not legal advice.”

The attorney-client privilege may be waived in ways as varied as “an express and voluntary surrender of the privilege, partial disclosure of a privileged document, selective disclosure to some outsiders but not all, and inadvertent overhearings or disclosures. See McCormick on

Evidence § 93, at 341-48 (J.W. Strong ed., 4th ed. 1992).” *U.S. v. MIT*, 129 F.3d 681, 684 (CA-1, 1997). As stated in *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1427 (CA-3, 1991) "voluntary disclosure to a third party waives the attorney-client privilege even if the third party agrees not to disclose the communications to anyone else." Voluntary disclosures to independent auditors generally waive the privilege. *See, First Fed. Sav. Bank of Hegewisch v. United States*, 55 Fed. Cl. 263 (Fed. Cl., 2003).

Tax Practitioner-Client Privilege

The tax practitioner-client privilege is conferred by Code §7525. It was promulgated in response to the decision in *Arthur Young*, which refused to create an accountant-client privilege between a corporation and its independent auditor, and made effective for communications made on or after 7-22-98. Code § 7525 provides, in relevant part, “(a) ... (1) GENERAL RULE. --With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.

(2) LIMITATIONS. --Paragraph (1) may only be asserted in --

(A) any noncriminal tax matter before the Internal Revenue Service ...

(3) DEFINITIONS. --For purposes of this subsection --

(A) **FEDERALLY AUTHORIZED TAX PRACTITIONER.** --The term "federally authorized tax practitioner" means any individual who is authorized under Federal law to practice before the Internal Revenue Service if such practice is subject to Federal regulation under section 330 of title 31, United States Code.

(B) **TAX ADVICE.** --The term "tax advice" means advice given by an individual with respect to a matter which is within the scope of the individual's authority to practice described in subparagraph (A).”

With regard to corporations, Code § 7525(b) provides that Code § 7525 does not apply to written communications between the federally authorized tax practitioner and the corporation "in connection with the promotion of the direct or indirect participation of such corporation in any tax shelter (as defined in section 6662(d)(2)(C)(iii))." The privilege is not applicable to a federally authorized tax practitioner's documents or communications related to the mere preparing of a tax return as they are not doing lawyers' work. *See e.g., United States v. KPMG, LLP*, 316 F. Supp. 2d 30 (D.D.C., 2004).

Code § 7525(b) is intended to remove communications by outside tax practitioners attempting to sell tax shelters to a corporate client from the protection of Code § 7525. The House Conference Committee Report relative to Code § 7525(b) states "[t]he Conferees do not understand the promotion of tax shelters to be part of the routine relationship between a tax practitioner and a client. Accordingly, the Conferees do not anticipate that the tax shelter limitation will adversely affect such routine relationships." H.R. Rep. No. 105-599 (Conf. Report to Accompany HR 2676) (June 24, 1998).

Similar to the attorney-client privilege, the tax practitioner-client privilege may be waived. Disclosure to a third party, such as an independent auditor, will waive the tax practitioner privilege as pursuant to Code § 7525 it is based on the attorney-client privilege. *See, United States v. BDO Seidman*, 337 F.3d 802 (CA-7, 2003).

Work Product Privilege

The Supreme Court first recognized the work product privilege in *Hickman v. Taylor*, 329 U.S. 495 (1947). The Court enunciated the rationale for the privilege by stating, "In performing his various duties, however, it is essential that a lawyer work with a certain degree of privacy, free

from unnecessary intrusion by opposing parties and their counsel. Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests. This work is reflected, of course, in interviews, statements, memoranda, correspondence, briefs, mental impressions, personal beliefs, and countless other tangible and intangible ways -- aptly though roughly termed by the Circuit Court of Appeals in this case as the 'work product of the lawyer.' Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten. An attorney's thoughts, heretofore inviolate, would not be his own. Inefficiency, unfairness and sharp practices would inevitably develop in the giving of legal advice and in the preparation of cases for trial. The effect on the legal profession would be demoralizing. And the interests of the clients and the cause of justice would be poorly served." *Hickman*, 329 U.S. at 510-511. As the Second Circuit stated in *United States v. Adlman*, 134 F.3d 1194, 1196 (2d Cir. 1998) the purpose of the privilege is "to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy 'with an eye toward litigation' free from unnecessary intrusion by his adversaries." In addition, the Seventh Circuit stated a purpose of the privilege is "to prevent a litigant from taking a free ride on the research and thinking of his opponent's lawyer and to avoid the resulting deterrent to a lawyer's committing his thoughts to paper." *Frederick*, 182 F.3d at 500.

The work product doctrine was codified for the federal courts in Federal Rule of Civil Procedure 26(b)(3) (Rule) which provides: "Trial Preparation Materials. . . . a party may obtain discovery of documents and tangible things otherwise discoverable under subdivision (b)(1) of this rule and *prepared in anticipation of litigation* or for trial by or for another party or by or for that other party's representative . . . only upon a showing that the party seeking discovery has *substantial*

need of the materials in the preparation of the party's case and that the party is *unable without undue hardship* to obtain the substantial equivalent of the materials by other means. In ordering discovery of such materials when the required showing has been made, the court shall protect against disclosure of the mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation.” Fed. R. Civ. P. 26(b)(3)(emphasis added). In addition, a party asserting the work product privilege bears the burden of establishing that the documents sought to be protected were prepared "in anticipation of litigation." See e.g., *U.S. v. Roxworthy*, 457 F.3d 590 (CA-6, 2006) and *In re Powerhouse Licensing, LLC*, 441 F.3d 467 (CA-6, 2006).

The work product privilege may be asserted to protect against discovery claims made via an IRS summons. The Supreme Court stated, “[T]he obligation imposed by a tax summons remains 'subject to the traditional privileges and limitations.' . . . Nothing in the language of the IRS summons provisions or their legislative history suggests an intent on the part of Congress to preclude application of the work-product doctrine. Rule 26(b)(3) codifies the work-product doctrine, and the Federal Rules of Civil Procedure are made applicable to summons enforcement proceedings by Rule 81(a)(3).” *Upjohn*, 449 U.S. at 398-99.

Courts must determine whether a document was “prepared in anticipation of litigation” in ruling or whether or not the privilege provided by the Rule is applicable. The Second Circuit in *Adlman* set forth a detailed analysis of the two tests that the courts generally utilize to make the determination, namely the “primary purpose test” or the “because of test.” The court started its analysis by stating, “It is universally agreed that a document whose purpose is to assist in preparation for litigation is within the scope of the Rule and thus eligible to receive protection if the other conditions of protection prescribed by the Rule are met. The issue is less clear, however, as to documents which, although prepared because of expected litigation, are intended to inform a

business decision influenced by the prospects of the litigation. The formulation applied by some courts in determining whether documents are protected by work-product privilege is whether they are prepared 'primarily or exclusively to assist in litigation' -- a formulation that would potentially exclude documents containing analysis of expected litigation, if their primary, ultimate, or exclusive purpose is to assist in making the business decision. Others ask whether the documents were prepared 'because of' existing or expected litigation -- a formulation that would include such documents, despite the fact that their purpose is not to 'assist in' litigation." *Adlman*, 134 F.3d. at 1197-1198.

The Fifth Circuit has adopted the "primary purpose test." In *Davis*, 636 F.2d at 1040, the Fifth Circuit denied protection to documents made in the course of preparation of a tax return asserting that the Rule applies only if the "primary motivating purpose behind the creation of the document was to aid in possible future litigation." *See also, El Paso, supra.*

The First, Second, Third, Fourth, Sixth, Seventh, Eighth and D.C. Circuits, have adopted the "because of test" and held that to be prepared in anticipation of litigation the inquiry is whether or not "in light of the nature of the document and the factual situation in the particular case, the document can fairly be said to have been prepared or obtained *because of* the prospect of litigation." *See*, Charles Alan Wright, Arthur R. Miller, and Richard L. Marcus, 8 Federal Practice & Procedure § 2024, at 343 (1994) (emphasis added); *Maine v. Dept. of the Interior*, 298 F.3d 60 (CA-1, 2002); *Adlman, supra* (CA-2); *In re Grand Jury Proceedings*, 604 F.2d 798 (CA-3, 1979); *National Union Fire Ins. Co. v. Murray Sheet Metal Co., Inc.*, 967 F.2d 980 (CA-4, 1992); *Roxworthy, supra* (CA-6); *Binks Mfg. Co. v. National Presto Indus., Inc.*, 709 F.2d 1109 (CA-7, 1983); *Simon v. G.D. Searle & Co.*, 816 F.2d 397 (CA-8, 1987), *cert. denied*, 484 U.S. 917 (1987); and *Senate of Puerto Rico v. United States Dep't of Justice*, 823 F.2d 574 (D.C. Cir. 1987). The First Circuit noted that the Rule does not apply to "documents that are prepared in the

ordinary course of business or that would have been created in essentially similar form irrespective of the litigation." *Maine*, 298 F.3d at 70 (quoting *Adlman*, 134 F.3d at 1202).

The party seeking to overcome the privilege provided by the Rule by establishing “*substantial need of the materials* in the preparation of the party's case and that the party is *unable without undue hardship* to obtain the substantial equivalent of the materials by other means” has the burden of proof. When the documents sought contain the “mental impressions, conclusions, opinions, or legal theories of an attorney or other representative of a party concerning the litigation”, the burden of establishing "substantial need" is greater than it is with respect to documents that are merely obtained by a party. *See, Upjohn*, 449 U.S. at 401-2 (“we think a far stronger showing of necessity and unavailability by other means . . . would be necessary to compel disclosure” of opinion work-product). On occasion courts have accorded nearly absolute protection from discovery to work product consisting of opinions or theories. *See, e.g., In re Grand Jury Subpoena*, 220 F.R.D. 130 (D. Mass, 2004) (collecting cases).

Case law is nearly uniform in establishing that it is more difficult to waive the work product privilege than it is to waive the attorney-client privilege and thus the tax practitioner-client privilege. This is so because the attorney-client and tax practitioner-client privileges serve to preserve confidentiality and to encourage the full and frank discussion necessary to the provision of sound legal advice. However, the work product privilege serves to prevent an adversary from gaining an unfair advantage by obtaining work product prepared in “anticipation of litigation” which potentially could reveal strategy or an assessment of the strengths and weaknesses of a case. Accordingly, the attorney-client and tax practitioner-client privileges are waived by any disclosure to a third party that is inconsistent with a claim of confidentiality, but the work product privilege is waived only by a disclosure that is inconsistent with keeping the work product from an adversary. *See, Adlman*, 129 F.3d at 687 (collecting cases). Furthermore, generally courts have

held that disclosure of work product to an independent auditor does not waive the work product privilege as it does not substantially increase the potential for an adversary to obtain the work product. *See, Textron*, 507 F. Supp. 2d at 152-153 (collecting cases).

U.S. v. Textron, Inc.

In *U.S. v. Textron, Inc.*, 507 F. Supp. 2d 138 (D.C.R.I., 2007), a case appealable to the First Circuit, the court denied the IRS' petition filed pursuant to Code §§ 7402(b) and 7604 to enforce its summons served on Textron Inc. and its subsidiaries (Textron). The court held that the IRS satisfied the Powell requirements and could obtain an order pursuant to Code § 7604 compelling Textron to comply with the summons requesting the Workpapers. While the court ruled that the Workpapers were protected by the attorney-client and tax practitioner-client privileges, it ruled that they were waived by the disclosure of the Workpapers to Textron's independent auditor, namely Ernst & Young (E&Y). The court reasoned that the disclosure was inconsistent with the confidentiality rationale underlying the privileges. However, the court ruled that the Workpapers were protected by the work product privilege and it was not waived by providing the Workpapers to E&Y. It reasoned that the disclosure did not substantially increase the potential that Textron's adversary, the IRS, would obtain the Workpapers.

Facts

The facts in *Textron* are not overly complex. During the IRS's examination of Textron's tax liability for the tax years 1998-2001 and its examination of Textron's 2001 return, it became aware that Textron Financial Corporation (TFC), one of Textron's subsidiaries, had engaged in nine "sale-in, lease-out" transactions (SILOs) involving telecommunications equipment and rail equipment. The IRS has classified SILOs as "listed transactions" because it considers them to be for the purpose of tax avoidance. *See*, 26 C.F.R. § 1.6011-4(b)(2). The IRS issued more than 500 "information document requests" (IDRs) in connection with the 1998-2001 audit cycle

examination. Textron complied with all of the IDRs, except for the ones seeking its Workpapers.

On June 2, 2005, the IRS issued an administrative summons for "all of the Tax Accrual Workpapers" for Textron's tax year ending on December 29, 2001. The summons defined the "Tax Accrual Workpapers" to include:

"[A]ll accrual and other financial workpapers or documents created or assembled by the Taxpayer, an accountant for the Taxpayer, or the Taxpayer's independent auditor relating to any tax reserve for current, deferred, and potential or contingent tax liabilities, however classified or reported on audited financial statements, and to any footnotes disclosing reserves or contingent liabilities on audited financial statements. They include, but are not limited to, any and all analyses, computations, opinions, notes, summaries, discussions, and other documents relating to such reserves and any footnotes. . . ." *Id.*, at 142. Textron refused to produce its Workpapers, asserting that the summons was not issued for a legitimate purpose and in any event the Workpapers are protected by privilege.

Textron's Workpapers for the years in question consisted, entirely, of:

"1. A spreadsheet that contains:

(a) lists of items on Textron's tax returns, which, in the opinion of Textron's counsel, involve issues on which the tax laws are unclear, and, therefore, may be challenged by the IRS;

(b) estimates by Textron's counsel expressing, in percentage terms, their judgments regarding Textron's chances of prevailing in any litigation over those issues (the "hazards of litigation percentages"); and

(c) the dollar amounts reserved to reflect the possibility that Textron might not prevail in such litigation (the "tax reserve amounts").

2. Backup workpapers consisting of the previous year's spreadsheet and earlier drafts of the spreadsheet together with notes and memoranda written by Textron's in-house tax attorneys

reflecting their opinions as to which items should be included on the spreadsheet and the hazard of litigation percentage that should apply to each item.” *Id.*, at 142-143.

Textron’s Workpaper files did not include documents, such as leases, that contain factual information regarding the SILOs and other items that may be listed on the spreadsheet, even though Textron may have possessed them.

Norman Richter, Vice President of Taxes at Textron and Roxanne Cassidy, Director, Tax Reporting at Textron, stated that Textron's ultimate purpose in preparing the tax accrual workpapers was to ensure that Textron was "adequately reserved with respect to any potential disputes or litigation that would happen in the future." The court stated that, “It seems reasonable to infer that Textron's desire to establish adequate reserves also was prompted, in part, by its wish to satisfy an independent auditor that Textron’s reserve for contingent liabilities satisfied the requirements of generally accepted accounting principles (GAAP) so that a ‘clean’ opinion would be given with respect to the financial statements filed by Textron with the SEC.” *Id.*, at 143.

The court summarized Textron’s preparation of its Workpapers as follows: “Each year, Textron's tax accrual workpapers are prepared shortly after the corporation's tax return is filed. The first step in preparing the workpapers is that Textron's accountants circulate to Textron's attorneys a copy of the previous year's tax accrual workpapers together with recommendations regarding their proposed changes and/or additions for the current year. Textron's attorneys, then, review those materials, propose further changes to the spreadsheets and hazard litigation percentages which are returned to the accountants who compile the information and perform the mathematical calculations necessary to compute the tax reserve amounts. The attorneys and accountants, then, meet to give their approval so that the accountants may finalize the workpapers.

TFC goes through a similar process in preparing its tax accrual workpapers but, since TFC does

not have any in-house attorneys, its accountants rely on tax advice obtained from outside accounting and law firms, before meeting with a Textron tax attorney to finalize the workpapers. Once the tax reserve amounts for each item on the worksheets are established, those amounts are aggregated with other contingent liabilities and the total is reported as "other liabilities" on Textron's financial statements." *Id.*, at 143.

Textron allowed E&Y to examine the final Workpapers for 2001 with the proviso that the information was to be kept confidential. Under AICPA Code of Professional Conduct Section 301 Confidential Client Information, E&Y had a professional obligation "not [to] disclos[e] any confidential client information without the specific consent of the client." In addition, E&Y expressly agreed not to provide the information to any other party, and confirmed that it adhered to its promise.

In seven of Textron's eight previous audit cycles covering 1980 through the court's decision in August, 2007, disputed issues had been appealed to the IRS Appeals Board. Three of those issues were litigated in federal court.

Holding and Analysis

The validity of the summons

First, the court rejected Textron's contention that the summons failed the Powell requirements as it lacked a legitimate purpose and therefore was not enforceable by the court pursuant to Code § 7604. The court reasoned that the statements on the summons and the declaration of the IRS manager of the audit that the purpose of the summons is to "ascertain the correctness of the tax returns filed by the taxpayer" made a prima facie showing of a legitimate purpose, which therefore shifted the burden to Textron to "create a 'substantial question in the court's mind

regarding the validity of the government's purpose.' ... In order to carry its burden, Textron 'must articulate specific allegations of bad faith and, if necessary, produce reasonably particularized evidence in support of those allegations.' ...

In arguing that the government's stated purpose is pretextual and that the IRS's real objective is to use the opinions of Textron's counsel and tax advisers with respect to the SILO transactions as a bargaining lever, Textron alleges that the 2001 examination was substantially completed when the summons was issued; that Textron already had provided numerous documents requested by the IRS regarding the SILO transactions; and that the IRS could have requested any additional documents regarding the facts underlying those transactions. However, those allegations are insufficient to establish a bad faith purpose. ...

Nor does Textron's production of other documents relating to the SILO transactions or the fact that the IRS could have requested additional documents by issuing IDRs raise a substantial question as to bad faith. The IRS has discretion to determine the manner in which its investigation should be conducted. ... Accordingly, the IRS is not required to obtain relevant documents by the least formal means possible. ...

Textron also argues that the summons is overbroad because it seeks not only TFC's tax accrual workpapers but, also, the tax accrual workpapers for Textron and all of its subsidiaries. However, the request for Textron's workpapers does not establish bad faith because TFC is a subsidiary of Textron and the IRS asserts that it is seeking to determine Textron's overall tax liability, not just any tax due from the SILO transactions.

In short, the IRS has made a prima facie showing that the Powell requirements have been satisfied and Textron has failed to rebut that showing." *Id.*, at 145.

The attorney-client privilege

After determining that the summons satisfied the Powell requirements the court turned to the issue of whether the Workpapers were privileged. The first privilege that it addressed was the

attorney-client privilege. It held that the Workpapers are protected by the privilege, but the disclosure to E&Y waived the privilege. The court opined, “Here, since the tax accrual workpapers of Textron and TFC essentially consist of nothing more than counsel's opinions regarding items that might be challenged because they involve areas in which the law is uncertain and counsel's assessment regarding Textron's chances of prevailing in any ensuing litigation, they are protected by the attorney-client privilege.” *Id.*, at 147. The court rejected the IRS’ reliance on *Arthur Young* to exclude the Workpapers from the privilege. It stated, “although Arthur Young deemed tax accrual workpapers pinpointing the ‘soft spots’ on a corporation's tax return relevant to examination of the corporation's return, it did not hold the attorney-client privilege inapplicable to legal conclusions of counsel contained in the workpapers. On the contrary, Arthur Young expressly recognized that ‘§ 7602 is ‘subject to the traditional privileges and limitations.’ ... Arthur Young also is distinguishable on the ground that, there, the workpapers had been prepared by the corporation's independent auditor whose ‘obligation to serve the public interest assures that the integrity of the securities markets will be preserved.’ ... By contrast, Textron's workpapers were prepared by its counsel whose function was to provide legal advice to Textron.” *Id.*, at 147.

The court held that Textron waived the privilege when it permitted E&Y to examine the Workpapers. The court rejected Textron’s argument that neither the attorney-client privilege nor the tax practitioner-client privilege was waived by the provision of the Workpapers to E&Y and attempt to distinguish the cases holding that the attorney-client privilege is waived when an independent auditor is allowed to examine the Workpapers on the grounds they were decided before the promulgation of the tax practitioner-client privilege by Code §7525. It ruled that Textron waived both privileges when it provided the Workpapers to E&Y. The court stated, “More specifically, Textron argues that, because it occasionally revises its reserves based on the opinions of the independent auditor, the auditor's review of Textron's workpapers should be viewed as performed in connection with providing ‘tax advice’ to Textron and, therefore, it is

privileged under § 7525. That argument is creative but not persuasive because it ignores reality to describe an independent auditor responsible for reporting to the investing public whether a company's financial statements fairly and accurately reflect its financial condition, as providing 'tax advice' to the company when the auditor seeks to determine the adequacy of amounts reserved by the company for contingent tax liabilities." *Id.*, at 151-152.

The tax practitioner-client privilege

The court ruled that the Workpapers are protected by the tax practitioner-client privilege provided by Code § 7525, but the disclosure to E&Y waived the privilege. It reasoned, "Since TFC's tax accountants participated in advising Textron regarding its tax liability with respect to matters on which the law is uncertain and/or estimating the hazards of litigation percentages, they were performing 'lawyers' work.' Accordingly, that advice would qualify for the privilege conferred by § 7525(a). See 26 U.S.C. 7525(a) (tax advice communications protected 'to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.')." *Id.*, at 148.

The court rejected the IRS' argument that that the written communications from TFC's tax accountants fall within the promotion of a tax shelter exception to the privilege created by Code § 7525(b) as SILOs "are a tax avoidance transaction." The court stated, "That argument is not persuasive because even if the SILO transactions in which TFC engaged are characterized as 'tax avoidance' transactions the communications were not made 'in connection with the promotion' of TFC's participation in them. 26 U.S.C. § 7525(b) (emphasis added). ... Here, TFC's accountants were not 'peddlers of corporate tax shelters' or outside promoters soliciting TFC's participation in the SILO transactions. Rather, they were acting as tax advisers and the workpapers reflect their opinions regarding the foreseeable tax consequences of transactions that, already, had taken place, not future transactions they were seeking to promote." *Id.*, at 148. In any event, as previously

noted, the court ruled that Textron waived the privilege when it permitted E&Y to examine the Workpapers.

The work product privilege

Ultimately, the court held that the Workpapers are protected by the work product privilege and the disclosure to E&Y did not waive the privilege. Following the precedent set in the First Circuit by *Maine*, which adopted the “because of test” set forth in *Adlman*, the court utilized the “because of test” rather than the “primary purpose test” in determining whether the Workpapers were prepared in “anticipation of litigation” as required by Fed. R. Civ. P. 26(b)(3). Utilization of the “because of test” rather than the “primary purpose test” was a crucial decision made by the court.

The court opined, “As the IRS correctly observes, the work product privilege does not apply to ‘documents that are prepared in the ordinary course of business or that would have been created in essentially similar form irrespective of the litigation.’ *Maine*, 298 F.3d at 70 (quoting *Adlman*, 134 F.3d at 1202). However, it is clear that the opinions of Textron's counsel and accountants regarding items that might be challenged by the IRS, their estimated hazards of litigation percentages and their calculation of tax reserve amounts would not have been prepared at all ‘but for’ the fact that Textron anticipated the possibility of litigation with the IRS. If Textron had not anticipated a dispute with the IRS, there would have been no reason for it to establish any reserve or to prepare the workpapers used to calculate the reserve [in order to satisfy the requirements of the securities laws that financial statements filed by publicly traded companies comply with GAAP (which mandate the creation of reserves to meet contingent liabilities)]. Thus, while it may be accurate to say that the workpapers helped Textron determine what amount should be reserved to cover any potential tax liabilities and that the workpapers were useful in obtaining a ‘clean’ opinion from E&Y regarding the adequacy of the reserve amount, there would have been no need to create a reserve in the first place, if Textron had not anticipated a dispute with the IRS that was

likely to result in litigation or some other adversarial proceeding.

Nor can there be any doubt that Textron's belief in the likelihood of litigation with the IRS was well-founded. As already noted, the matters identified in the workpapers dealt with issues on which the law was unclear. Moreover, in seven of Textron's eight previous audit cycles, 'unagreed' issues had been appealed to the IRS Appeals Board, and three of those issues were litigated in federal court. ...

Moreover, even if the workpapers were needed to satisfy E&Y that Textron's reserves complied with GAAP, that would not alter the fact that the workpapers were prepared 'because of' anticipated litigation with the IRS. See *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, 237 F.R.D. 176 (N.D. Ill. 2006)." *Id.*, at 150.

The court rejected the IRS' position based upon the holding in *El Paso* that the Workpapers are not protected by the work product privilege as they were prepared in the ordinary course of business. The court reasoned, "However, *El Paso* is not persuasive because it applied the 'primary purpose' test for determining whether documents are prepared 'in anticipation of litigation' and not the 'because of' test adopted by the First Circuit." *Id.*, at 150.

The court determined that Textron had not waived the privilege by permitting E&Y to examine the Workpapers as the disclosure was not inconsistent with keeping the information from an adversary. The court reasoned, "In this case, too, the disclosure of Textron's tax accrual workpapers to E&Y did not substantially increase the IRS's opportunity to obtain the information contained in them. Under AICPA Code of Professional Conduct Section 301 Confidential Client Information, E&Y had a professional obligation 'not [to] disclos[e] any confidential client information without the specific consent of the client.' Furthermore, E&Y expressly agreed not to provide the information to any other party, and confirms that it has adhered to its promise. ... Even if the AICPA Code coupled with E&Y's promise did not establish an absolute guarantee of

confidentiality, they made it very unlikely that E&Y would provide Textron's 'tax accrual workpapers' to the IRS and they negate any inference that Textron waived the work product privilege." *Id.*, at 153.

The court rejected the IRS' position that the First Circuit's decision in *MIT*, *supra*, necessitated a ruling that the disclosure to E&Y waived the privilege. The court reasoned, "MIT is factually distinguishable from this case. The documents at issue in MIT were minutes of meetings of the MIT Corporation and some of its committees relating to bills submitted by MIT for services rendered pursuant to a contract with the Department of Defense (DOD). The documents were requested by the Defense Contract Audit Agency (DCAA) in order to confirm that the bills were justified and MIT provided the minutes due, in part, to the fact that DCAA 'regulations and practices offered MIT some reason to think that indiscriminate disclosure was unlikely.' ... The First Circuit assumed, without deciding, that the documents were protected work product, but held that the documents had to be produced in response to an IRS summons because disclosure had been made to the DCAA, 'a potential adversary.'

The difference between this case and MIT is that, in MIT, DOD was MIT's potential litigation adversary and DCAA, as DOD's audit agency, had both an obligation to DOD to determine whether the amounts charged by MIT to DOD were correct, and the authority to sue MIT in order to recover any overcharges. By contrast, in this case, E&Y was a truly independent auditor that had no obligation to the IRS to determine whether Textron's tax return was correct and no authority to challenge the return. In this instance, E&Y was seeking, only, to determine whether the reserve established by Textron to cover the corporation's contingent tax liabilities satisfied the requirements of GAAP. Since E&Y was not a potential Textron adversary or acting on behalf of a potential adversary, and, since E&Y agreed to treat the workpapers as confidential, disclosure to E&Y did not substantially increase the likelihood that the workpapers would be disclosed to the IRS or other potential Textron adversaries." *Id.*, at 153-154.

The court also ruled that the IRS failed to satisfy the “substantial need” requirement set forth in Fed. R. Civ. P. 26(b)(3) to overcome the privilege. The court stated, “Here, the IRS has failed to carry the burden of demonstrating a ‘substantial need’ for ordinary work product, let alone the heightened burden applicable to Textron's tax accrual workpapers, which constitute opinion work product. While the opinions and conclusions of Textron's counsel and tax advisers might provide the IRS with insight into Textron's negotiating position and/or litigation strategy, they have little bearing on the determination of Textron's tax liability. ... The determination of any tax owed by Textron must be based on factual information, none of which is contained in the workpapers and all of which is readily available to the IRS through the issuance of IDRs and by other means. The opinions of Textron's counsel, either favorable or unfavorable, would have little to do with that determination, and forced disclosure of those opinions would put Textron at an unfair disadvantage in any dispute that might arise with the IRS, just as requiring the IRS to disclose the opinions of its counsel regarding areas of uncertainty in the law or the likely outcome of any litigation with Textron would place the IRS at an unfair disadvantage.” *Id.*, at 154-155.

CONCLUSION AND PLANNING

Our tax system is dependent upon self-assessment and reporting, which requires taxpayers to disclose the information necessary to properly determine their tax liability. Congress has given the IRS the authority to compel disclosure through the issuance of summonses in order to assure a fair and equitable application of the Code among all taxpayers. In *Textron*, the court assured balance in adversarial proceedings between the IRS and taxpayers and struck a stunning blow to the IRS’ ability to compel corporate taxpayers to turn over their Workpapers. The court opined that Workpapers are protected by the work product privilege and that disclosure of the Workpapers to the taxpayers’ independent auditor does not waive the privilege.

As IRS Chief Counsel Korb has indicated, it is highly likely that the IRS will appeal *Textron* to the First Circuit Court of Appeals and will continue to request Workpapers from taxpayers. After losing in another work product privilege case in the Sixth Circuit, *Roxworthy*, the IRS issued AOD 1007-4, and stated, "The Service will continue to aggressively seek the enforcement of summonses, challenging unjustified assertions of the work product doctrine (and other privileges) in all appropriate cases, including those that would be appealable to the Sixth Circuit."

In *Textron*, the court utilized the "because of test" rather than the "primary purpose test" in determining whether the Workpapers were created in "anticipation of litigation" and thus protected by the work product privilege as provided by Fed. R. Civ. P. 26(b)(3). While it is highly likely that on appeal the IRS will argue the court should have used the "primary purpose test", the court's reasoning appears to be in accord with the standard utilized in the First Circuit and other circuits other than the Fifth Circuit. However, when applying the "because of test," courts must make factual determinations. In *Textron*, the taxpayer had a history of litigiousness with regard to assessments by the IRS. A court might be less inclined to grant work product privilege to Workpapers if the taxpayer did not have a litigious history. In addition, a court might be inclined to analyze each of the documents in the Workpapers to determine if a particular document is subject to the work product privilege rather than view the Workpapers as a whole. Thus, a court might determine that some of the documents were prepared in the ordinary course of business and not protected, but others to have been prepared "in anticipation of litigation" and protected. Therefore, taxpayer's should be advised that it may be worth the extra cost to utilize the services of legal counsel in generating Workpapers in order to secure the work product privilege.

In *Textron* the court distinguished *MIT* and ruled that the disclosure of the Workpapers to E&Y

did not waive the work product privilege. It is highly likely on appeal that the IRS will challenge the court's reasoning in distinguishing *MIT*.

There are a myriad of scenarios under which the holding in *Textron* could be applied. It's feasible that *Textron* might apply to extend the work product privilege to a corporate taxpayer's workpapers generated relative to FASB Interpretation Number 48 (FIN 48). In any event, *Textron* serves to provide balance when there are adversarial proceedings involving a taxpayer and the IRS. As is customary in litigation, the facts of the case may be determinative of whether or not the work product doctrine applies to the taxpayer's Workpapers.

Taxpayers must be aware of *Textron* and no longer accede to an IRS summons demanding their Workpapers without first considering whether they may be protected by the work product privilege.

Both taxpayers and the IRS are eagerly awaiting and anticipating the results of further litigation with regard to the issues decided in *Textron*. In the interim, taxpayers who are served with a summons by the IRS demanding their Workpapers should consider the old adage: "Just say no!"

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Section 2: Selected Abstracts from Concurrent Sessions

Who is a Winner in Volatile Markets? Evidence from Chinese Funds. Yi Yao, Nankai University; Rong Yang, SUNY – College at Brockport; Zhiyuan Liu, Nankai University

Abstract

The proliferation of institutions has drawn an attention in the financial economists' interest on the effect of institutional trading on market volatility for a few decades. Existing research on institutional investors, however, has not considered separating a bull market from a bear market, an important macroeconomic factor, in studying the role of institutional trading in market volatility. In addition, few studies have focused on emerging markets in developing countries. Particularly, who can identify the change in macroeconomic fundamentals, make more rational decisions, and eventually dominate the Chinese emerging stock market, institutions or individuals? Addressing this gap, this study examines the impact of institutional trading on the Chinese emerging volatile markets, from bearish markets (2001-2003) to bullish markets (2004-2006), effectively integrating the institutional (de)stabilizing effect into a more completely developed perceptible. In particular, we investigate the relationship between the level of institutional ownership and a firm's abnormal returns on large market movement days. We find that institutions are able to make quicker and more rational adjustments in their trading strategies as compared to the delayed market reactions due to a change in macroeconomic trend and a supervising regulatory policy issued at the beginning of 2004. Institutions use different trading strategies from bearish markets (2001-2003) to bullish markets (2004-2006), on large market movement days, such as selling against a rising market in bearish markets while continually pushing the entire stock index up in bullish markets. Moreover, institutions successfully predict the tendency of future stock market although the Chinese stock market is more volatile than others. Meanwhile, we find that institutions buy (sell) less than individuals on large price swing days, consistent with the notion that institutions are more rational than individuals in emerging markets. Further, systematic risk in the Chinese stock market is twenty-four times than that in US, reflecting a significant difference between an emerging market and a developed market. Overall, these results indicate that institutions become a winner in the Chinese stock market.

Keywords: Institutions, Returns, Turnover, Volatility, Emerging Markets.

“The Incidence and Capital Market Consequences of Expectations Management in the Post-Regulation FD Period,” Sherry Li, Rider University

Abstract

This paper investigates the incidence and capital market consequences of expectations management (EM) in the post-Regulation FD period. Results show that EM is decreasing after Reg. FD was enacted. Prior proxies of expectations management based on downward forecast revision may overestimate the prevalence of expectations management in the new reporting environment. Firms that beat analysts’ expectations through managerial guidance are able to achieve larger positive earnings surprises at the earnings announcement than the “legitimate beaters”. However, it appears that EM firms are “punished” by investors. The average three-day *CAR* around the managerial guidance date is -10.2%, significantly larger than the average three-day *CAR* of 1.7% around the earnings announcement. Furthermore, the combined investors’ reactions to managerial guidance and the subsequent earnings announcement are more *negative* for EM firms than for firms that do not guide and thus miss the expectations.

Correlation of Performance in Accounting Courses, William E. Bealing, Jr., Bloomsburg University; A. Blair Staley, Bloomsburg University; Richard L. Baker, Bloomsburg University

Abstract

This study examines the relationship between performance in prerequisite courses and performance, as measured by course grades, in subsequent accounting courses. A student’s performance in prerequisite courses was found to have a statistically significant relationship to his/her performance in subsequent accounting courses. The results indicate that a student’s performance in an accounting course is a valid predictor of his/her success in the next course in the accounting sequence. The results indicate that initial success leads to later success and poor performance leads to difficulties in subsequent coursework. The results have implications for student advisement as well as outcomes assessment.

The Influence of Motivation and Attitude on Cheating Among Accounting Majors, Kenneth J. Smith, Salisbury University; Jeanette A. Davy, Wright State University; Donald L. Rosenberg, Towson University.

Abstract

This study examines cheating behaviors among 485 accounting majors at three public AACSB-accredited business schools. Specifically, we examined the simultaneous influence of intrinsic, extrinsic, and amotivational orientation as well as attitudinal characteristics on: 1) reported prior cheating behavior; 2) neutralization tendencies; and, 3) likelihood of future cheating. In line with prior research, we also examined the impact of prior cheating and in-class deterrents on neutralization of cheating behaviors and the likelihood of future cheating, and the potential mediating effects of neutralization on future cheating behavior.

Using structural equations modeling procedures, we conducted an assessment of an expanded version of the Smith, Davy, Rosenberg & Haight (2002) model of cheating behavior and its antecedents. The expanded model included intrinsic motivation, extrinsic motivation and amotivation as potential predictors of cheating behavior. Results supported the differentiation of the theoretical constructs within the specified process model. Tests of the theoretical model supported a number of the hypothesized relations, most notably significant positive relations between an amotivational orientation and each of the two cheating outcomes.

Survey of Student Perceptions: Regarding Integrating Managerial Accounting and Fundamentals of Financial Management, Bruce Leaby, LaSalle University.

Abstract

An overriding goal of business school programs is providing an integrative curriculum enabling students to form stronger connections between related disciplines both in the classroom and later as professionals in the business world. Leaby and Wentzel (2007) describe a conceptual framework in which an innovative curriculum design links *Managerial Accounting* and *Fundamentals of Financial Management* together in a substantive manner. The objective of the linked design is reinforcing the natural connections and interdependencies of accounting and finance to enhance students' appreciation of the inseparable impact of these two disciplines during decision-making. Only anecdotal evidence regarding the success of this linkage however is provided. This current research extends Leaby and Wentzel (2007) by surveying students enrolled in linked managerial accounting and finance courses both at the beginning of the semester

and at the end of the course to investigate whether students' perceptions of accounting and finance changed significantly as a result of the linked course offering. Overall, the preliminary results are encouraging since they generally show students recognize finance and accounting as related disciplines. Furthermore, the results suggest students are more likely to connect the majority of specific topics (e.g., time value of money, ratio analysis, present value calculations, financial performance, cash flow statements, balance sheets, and income statements) to both accounting and finance at the end of the semester than at the beginning, as opposed to a small control group of students in unlinked sections who did not recognize the same list as joint finance and accounting topics.

Auditor Fee Data Concerns: Implications for Future Research, Rebecca L. Rosner, Long Island University; Ariel Markelevich, Long Island University.

Abstract

We examine two issues related to auditor fee data that may potentially impact the conclusions arrived at by researchers in auditor fee studies. First, there are a significant number of companies that report *restated, i.e., corrected, auditor fee data* in the subsequent year's filing. Thus, auditor fee studies using originally disclosed auditor fee data may report results that may have been significantly different had they used restated, i.e. corrected auditor fee data. Second, auditor fee studies that examine samples containing firm-years in which a *restatement of the financial statements* took place/was publicized may be examining fees that include the fees paid for auditing the restated financial statements of a prior period along with the fees paid for the current period's audit. We find that for the entire Audit Analytics database (73,947 firm-years) the restated/corrected auditor fees are significantly higher than the originally reported fees. In addition, we posit and find that the years in which the auditor also audited prior years' financial statement restatements are associated with significantly higher audit fees. This is true because the fees associated with the restatement are reported in the year in which the work was performed rather than in the year of the original financial statements. The implications of these findings are that researchers should: (1) ensure that they include the appropriate fees in their studies, i.e.,—restated/corrected auditor fees versus original auditor fees, and (2) should control for the additional audit work in the year in which the auditor audited the restated financial statements.

Assessing the Frequency of Auditors' Comments Concerning Perceived Client Integrity, Richard A. Bernardi, Roger Williams University.

Abstract

The research examines the comments made by these auditors to questions about what factors influenced their decisions especially concerning client integrity and competence, which are equivalent to documenting one's findings in the audit work papers. The

research uses an established fraud detection case study with a manipulation of client integrity and competence. The participants include 152 managers and 342 seniors from five of the then Big-Six firms. The benefit of using this data set is that the client integrity and competence ratings are a significant factor for materiality decisions, fraud detection, and estimates of the probability of fraud. While client integrity and competence was significant in this study, it did not have the same overriding impact as in the prior studies. While the study uses older data, it also establishes a baseline for future research into this area of auditing. The research suggests that auditors are more comfortable commenting on factors affecting their decisions when the factor confirms their firm's ratings of high client integrity and competence. The data suggest that updating client integrity and competence in this environment is problematic. This research uses an older data set to examine the frequency of comments made by auditors after an auditing case study involving an inventory account that was materially overstated.

A Survey of Financial Management Reforms in the U S Federal Government, Byron Henry, Howard University.

Abstract

Sound financial management practices in the Federal government are essential to insure that taxpayer dollars are used appropriately. However, the lack of emphasis placed on such practices has led to numerous problems. DioGuardi (2003) commented that government accounting and budgeting practices have obscured the reality of Federal government finances. David Walker, the U.S. Comptroller General, recently noted that in addition to the external security threats, America is threatened from within by growing imbalances and the availability of information that is inadequate to address these concerns (Walker, 2004).

Over the years, numerous legislative initiatives to reform financial management practices have been introduced. This paper reviews these initiatives and discusses their impact on the current state of financial management in the Federal government.

A review of the histories of these initiatives suggests that although some progress has been made, there remains much room for improvement.

Public Accountants' Perceptions of Ethical Work Climate, Howard Buchan, SUNY College at Oneonta.

Abstract

The purpose of this study is to consider whether the perceptions of the instrumental dimension of ethical work climate of partners (owners) of public accounting

firms differ from those of employees. Perceptions of ethical climate are based on the theory developed by Victor and Cullen (1987, 1988). Professionals from five public accounting firms located in New York State participated in the study. Findings suggest partners' perceptions of the instrumental dimension of ethical work climate differ from those of employees.

An Empirical Investigation on the Impact of Executive Stock Options on Firm Valuation, Akinloye Akindayomi, University of Massachusetts Dartmouth; Hussein A. Warsame, University of Calgary.

Abstract

The objective of this study is to provide a basic and direct empirical investigation into the impact of executive stock options on the value of the firm. In order to achieve this, we investigate the sensitivity of the findings of Hanlon, Rajgopal and Shevlin (2003) to alternative research design choices as well as earnings management potentials of executives to 'expansively maximizing' their stock option payoffs. In addition, we examined the impact of executive stock options on the firm's cost of capital using the firm's earnings volatility and probability of bankruptcy as proxies, thus providing evidence on the impact of executive stock options on the primary components of firm value which include earnings and cost of discounting the earnings. This study's findings show that using executive stock options could potentially impact positively the value of the firm, as reflected in the coefficient significance of the Black-Scholes measure of stock options on the reported operating income as well as nondiscretionary and premanaged earnings. The empirical evidence on the proxy for the cost of capital, i.e. probability of bankruptcy using Altman (1968) Z-Score, also reinforces these findings, even as volatility increases in executive stock option grants. The results from this study provide testable hypothesis for future research and thus hold promise for future research efforts in the stream of empirical accounting study vis-à-vis compensation research.

An Empirical Investigation of the Defined Benefit Pension Plan Freeze Decision, Cathy Beaudoin, Drexel University.

Abstract

This paper investigates key motivations underlying firms' decisions to freeze their defined benefit (DB) plans. We examine whether DB plan freeze decisions are motivated by: (1) financial accounting considerations; (2) cash flow related incentives; and (3) improving a firm's competitive position. We draw our sample from S&P 500 companies with a DB plan for the period 2001-2006. Using logistic regression models, we compare "freeze" firms (55 firms) with firms that did not decide to freeze their DB plan (276 firms). Our findings indicate that DB plan contribution volatility and improving the firm's competitive position do not impact the freeze decision process as significantly as

management might suggest. Instead, our results imply that the effect of proposed pension accounting changes plays a primary role in the decision to freeze DB plans.

Key words: Defined benefit plans; pension freeze; pension accounting; SFAS 158

JEL Descriptors: C12; C35; M41

The Audit Company of New York: The Rise and Fall of an American Accounting Giant, James J. McKinney, University of Maryland; George C. Romeo, Rowan University.

Abstract

In 1897, early in the establishment of the United States accounting profession, a professional accounting firm was incorporated as The Audit Company of New York (ACNY). Among its early leaders were some of the leading financial men in New York including August Belmont, American representative of the Rothschild European banking family. In the early 1900s, ACNY was probably among the largest three accounting firms in the United States. Significant audit clients included, American Steel Foundries Co., E.I. du Pont de Nemours & Co., Goodyear Tire & Rubber Co., International Business Machines Corp., and Sears, Roebuck and Co. Because of its corporate organizational structure and non-accountant ownership, ACNY quickly became a focus of criticism by other professional accountants. By 1932, ACNY had declined in importance to the eleventh largest auditor of publicly traded companies. In 1933, the ACNY was purchased and merged into the existing practice by a prominent accountant whose practice was later merged into Price, Waterhouse & Co. Using extensive archival research materials, this paper explores this relatively unknown firm's history, leadership, prominence, controversial organizational structure, and relationships with the accounting profession.

Keywords: Audit Company, Audit Corporations, Early American Accounting Firms

Audit Committee Characteristics and Earlier Voluntary Ethics Disclosure among Fraud and No-Fraud Firms, Obeua S. Persons, Rider University.

Abstract

This paper examines specific characteristics of an audit committee which could be associated with the likelihood of earlier voluntary ethics disclosure. The sample includes firms that were investigated by the Securities Exchange Commission for fraudulent financial reporting *before* the Sarbanes-Oxley Act's ethics rule became effective, and their matched no-fraud firms. Results based upon univariate tests as well as a logit and a probit regression analysis suggest that firms which made earlier voluntary ethics disclosure were likely to have a more independent and a larger audit committee that met more often, and were less likely to engage in fraudulent financial reporting. These results should help regulators, investors and

boards of directors to focus on these audit committee characteristics, which could be crucial to not only ethics disclosure but also ethical conduct of a firm. In particular, results regarding the size and the meeting frequency highlight how to further improve the effectiveness of an audit committee. These characteristics may also indicate a firm's propensity to make any voluntary disclosure.

Key Words: audit committee, ethics, fraud, Sarbanes-Oxley Act, corporate governance

Data Availability: The data used in this study are publicly available from the sources indicated in the text.

Quantifying Audit Quality: A Proposal Inspired by Recent Initiatives, Mary Ellen Oliverio, Pace University; Bernard H Newman, Pace University.

Abstract

Audit quality has gained intensive attention since the cascade of audit failures in the concluding years of the last century and the first few years of our new century. The Sarbanes-Oxley Act of 2002 [hereafter identified as the Act] introduced a new oversight strategy as a means of enhancing the quality of audits. To assure quality audits, the PCAOB was charged with responsibility for inspecting registered public accounting firms who perform financial audits for publicly-owned companies in the United States. To date, however, this process has not resulted in measurement of audit quality.

Since 2002, there have been two additional significant initiatives related to audit quality. One was the Federal Government's Single Audit Sampling Project which was reported in 2007; the other, the establishment of the Center for Audit Quality, as an affiliate of the American Institute of CPA (AICPA) in early 2007.

From a reading of these three initiatives, it was evident that while each makes a contribution none is sufficient to determine audit quality of publicly owned entities. This paper includes a review of these initiatives, as well as a general structure for undertaking an objective statistical study to measure audit quality. The task is feasible, but will require several years of well designed efforts.

Initially such measurement must be experimental. With several years of experience with data gathering and careful statistical testing, there will be developed a set of criteria to make reliable and valid judgments about audit quality at the firm level as well as for a specified group of audits, such as those submitted by publicly-owned companies to the Securities and Exchange Commission.

The initial years of efforts at objective measurement should be considered experimental and not result in ranking or rating particular accounting firms. Only after validity and reliability of measurement are established should there be disclosure at the individual firm level.

First Grove Bank: A Case on Loan Fee Amortization According to SFAS 91 for Novel Loans, Victor Valdivia, Towson University.

Abstract

This case study requires the development of SFAS 91-compliant accounting procedures for the amortization of loan fees earned by First Grove Bank, a fictitious commercial bank. This bank traditionally originated primarily fixed-rate, fixed-term loans such as fixed-rate, 30-year mortgages. The amortization of fees earned on such loans was straightforward. However, in recent years First Grove Bank originated a significant number of novel loans such as Adjustable Rate Mortgages (ARMs), ARMs with low introductory teaser rates, loans with balloons, and Interest Only loans. Although, the accounting for fees earned on these novel loans is also subject to SFAS 91, the amortization computations are substantially more involved. This case study shows how to amortize the fees on these novel loans in accordance with SFAS 91.

Keywords: Banking; lending; amortization; loans; loan fees; loan accounting; adjustable rate mortgages; effective interest method; effective yield method; constant interest method; debt; bonds; premium; discount; SFAS 91.

Accounting Faculty Job Search in a Seller's Market, Steven C. Hunt, Western Illinois University; Tim V. Eaton, Miami University; Alan Reinstein, Wayne State University.

Abstract

This research examines accounting faculty job search and selection in the recently tightening academic job market. Surveys were sent to all new accounting PhDs and faculty who relocated during the period 2002-2004. Respondents completed a survey including 37 factors of importance to new PhDs in selecting their initial faculty position and to relocating faculty in leaving their previous position and selecting a new one. Differences were found between those going to doctoral granting programs compared to non-doctoral schools and between men and women. A number of differences were found with the results of previous research conducted in a very different job market. Additionally, a variety of information was also obtained about the interviewing process. The results provide implications for universities looking to hire qualified new faculty and retain existing faculty, as well as for new and relocating faculty interested in obtaining the most rewarding position.

Transparency, Simplicity & Corporate Income Tax, Suzanne Luttman, Santa Clara University.

ABSTRACT

The corporate income tax structure has many disadvantages: double taxation, costly compliance issues, minimal revenue generation, shifting, tax preferences and tax expenditures, complexity, and nonproductive costs associated with creating and implementing tax law (lobbyists, investment bankers, tax preparers, congressional staffers to write the law, accountants, lawyers, and the court system). While eliminating the corporate income tax is one alternative, political reality suggests that conforming the book and tax accounting systems may be a more viable alternative to address the problems of the corporate income tax. This paper discusses the advantages and disadvantages of using pretax book income to compute the income tax for a corporation, its effect on income tax generated, and an option for what to do with the increased tax revenue.

Variability of Book-Tax Differences, Information Uncertainty, and Implied Cost of Capita, Dan S. Dhaliwal, University of Arizona; Robert E. Huber, University of Arizona; Hye Seung "Grace" Lee, University of Arizona; Morton Pincus, University of California, Irvine.

Abstract

We examine the association between variability in book-tax differences (BTDs) and implied cost of equity capital. Then by decomposing the variability of BTDs into two components, one component reflecting variability in economic fundamentals and the other component reflecting over-time variability in earnings management, we investigate whether the latter component, our proxy for information uncertainty, is positively related to firms' cost of equity capital. We conjecture that variability of BTDs is more likely to reflect the variability in the underlying economic activities of a firm and the firm's tendency to manage earnings than the level of BTDs. Consistent with our predictions, the results suggest that over-time variability of BTDs is reliably and positively related to cost of equity capital, whereas the absolute value of BTDs is not. In addition, we find that the information uncertainty due to over-time variability in earnings management is positively related to cost of equity capital.

Tax Reform Tradeoff: An Examination of the Repeal of the State and Local Income Tax Deduction to Pay for the Repeal of the Alternative Minimum Tax, Benjamin Silliman, The Peter J. Tobin College of Business, St. Johns University.

Abstract

The individual alternative minimum tax (AMT) (I.R.C. §55) is a separate federal tax calculation that imposes an additional tax annually on millions of taxpayers. The A.M.T. was enacted in 1969 to require that higher-income taxpayers paid a minimum tax; however, §55 was not indexed for inflation and for many years has become an additional tax burden to millions of taxpayers, most recently middle-income tax filers. Each year Congress has passed one-year “patches,” raising the A.M.T. exemption amount. If the A.M.T. were to be repealed, it could cost nearly \$750 billion through 2016, should the Bush tax cuts expire after 2010, and \$1.3 trillion if the tax cuts are extended (Burman 2006).

In late 2005, The President’s Advisory Panel on Tax Reform presented its final recommendations to the U.S. Treasury Department, which contained several recommendations. One of its more significant proposals was to repeal the A.M.T., which is generally supported on Capitol Hill. However, in order to achieve such an effort, other tax expenditures would need to be repealed, the largest being the itemized deduction for state and local income taxes (I.R.C. §164(a)(3)) (President’s Advisory Panel 83). The deduction for state and local taxes is an itemized deduction that was slated for elimination twenty-two years earlier in the last tax reform debate. The deduction costs nearly \$66 billion a year. This paper discusses the challenges of repealing the A.M.T. by eliminating the deductibility of state and local income taxes. The paper also examines the origin and purpose of the tax deduction, the efforts to repeal §164(a)(3) during the deliberations over the 1986 Tax Reform Act between 1983 and 1986. The paper concludes with an analysis of impact in the U.S. where repeal of the A.M.T. and state and local income tax deduction would be impacted.

Strategic Organizational Culture as a Component of Risk Management, Regan Garey, Immaculata University.

Abstract

In recent years risk management has become an increasingly critical aspect of mitigating the inherent risks of fraudulent, unethical or erroneous transactions from occurring or going undetected. Institutionalizing the positive aspects of the Sarbanes-Oxley Act (SOX) is a multifaceted task that incorporates recognition of the important role of organizational culture. Ethical organizational cultures which are characterized by open communication, collaboration and sufficient

information dissemination are powerful tools that can work in concert with an organization's code of ethics in realizing the goal of accurate financial reporting. This author's findings support the theory that a strategic organizational culture audit could assist management of publicly traded companies subject to SOX in measuring their employees' perceptions about ethical standards, materiality and their roles in complying with this law.

Ethics Mindsets: New and Old, Alan Reinstein, Wayne State University; Martin A. Leibowitz, Yeshiva University.

Abstract

Turn-of-the-century audit failures such as Enron exposed lapses in accountants' professional conduct. The SEC and Sarbanes-Oxley Act responses did little to change a prevailing "rules-based" mindset wherein some CPAs sought loopholes, "bright-lines" and ways to bend rules. To foster a new mindset, the AICPA issued two "principles-based" conceptual frameworks that require members to identify, evaluate, and address ethics "threats" and apply "safeguards" to eliminate or mitigate those threats. This article (1) explains and illustrates ethics threats and safeguards, (2) traces the evolution from rules-based to principles-based ethics standards, and (3) applies framework requirements to two ethics cases.

To navigate the new ethics landscape, CPAs must be versed in the objectives of the AICPA's six fundamental ethics principles. A table summarizes these objectives and comments on their implications.

The Impact of CIO Appointments on Long-Term Performance and Productivity of R&D Investments, Ashraf Khallaf, American University of Sharjah; Terrance R. Skantz, Florida Atlantic University.

Abstract

This study examines whether chief information officers (CIOs) add long-term value to business enterprises consistent with the generally favorable market reaction at the time of the CIO appointment. Changes in firm performance during the second and third years following CIO appointment is examined using accounting measures that are expected to be responsive to increased efficiency and effectiveness. We also examine whether IT management capability mediates the relationship between R&D investments and R&D productivity, adding to our understanding of whether and how enhancements in IT strategies improve firm performance. After controlling for industry performance for out-of-sample firms that did not create or fill an existing CIO position, we find that firm performance increases after the appointment of a new CIO and that the productivity of R&D investments improves significantly. The results suggest that new CIOs improve the way IT is managed and improve the firms' approach to knowledge management.

A Shift in the Income Effect of Changes in Accounting Principles: 1993-2003 Time Period, Jalal Soroosh, Loyola College in Maryland; Hong Zhu, Loyola College in Maryland.

Abstract

Prior studies of both mandatory and voluntary changes in accounting principles revealed *increases* in earnings per share from the 1960s through the 1980s. Furthermore, those studies discovered that more than 50% of changes were voluntary, resulting in an increase in earnings per share of more than 10%. In the 1990s, however, the reporting environment changed in two significant ways. First, pro-forma or “street” earnings became popular for investors, and secondly, FASB shifted to a focus on the balance sheet. The current study investigates whether, under the new reporting environment, managers still attempted to window-dress their reported earnings through old-fashioned changes in accounting principles. We examined the nature and effect of accounting changes for 1,304 companies from 1993-2003. Unlike findings reported by previous studies, accounting changes in this time period *decreased* earnings per share. The *percentage change in earnings per share* had a mean of -50.99% and a median of -4.63%. Further, our research revealed that only about 8% of the changes were voluntary, which is significantly less than voluntary changes discovered by previous studies. Several explanations for the observed shift are offered.

R&D Investment around CEO Turnover, Jing (Crystal) Xu, Boston University.

Abstract

This study empirically investigates whether CEOs manipulate R&D investment around CEO turnover. Prior research mainly focuses on R&D manipulation in the CEO’s final year in office and findings are mixed. In contrast, the abnormal R&D investment in CEO’s early stage of tenure remains relatively unexplored. Using a modified relative R&D ratio, this paper finds that incoming CEOs attempt to invest more in R&D projects in their early years in office, taking the free ride on “Earnings Bath”. Further analysis indicates that the excessive R&D expenditure is primarily associated with incoming CEOs who are promoted within the company and therefore have considerable firm-specific knowledge. Moreover, contrary to expectation, the results suggest that departing CEOs also spend more on R&D investment before CEO turnover. Several possible explanations are discussed.

International Diversification, Industrial Diversification, & CEO Salary, Hwei Cheng Wang, Alabama A&M University; Sekhar Anantharaman, Indiana University of Pennsylvania, Young-I Lou, Nan Hua University.

Abstract

This study examined CEO salary compensation for 2448 CEOs from 1997 through 2002. Based on agency and expectancy theories, this study tests and hypothesizes related to corporate diversification being associated with CEO salary compensation.

The results show that the higher the degree of international diversification, and the higher stock return performance, accounting earnings performance, and firm size, the more CEOs receive in fixed salary compensation. In addition, this study found that salary compensation is better predicted by accounting performance than by stock return performance with respect to salary compensation.

Is FASB 123R Better Accounting for Equity Based Compensation?, John D. Rossi, Moravian College.

Abstract

In December 2004, the FASB issued Statement No. 123 (revised 2004), Share-Based Payment FASB 123(R). FASB 123(R) requires all entities to recognize compensation expense in an amount equal to the fair value of the share-based payments granted to employees. As a result all stock option awards granted to employees will hit the income statement as an expense that will be much larger than the amounts most companies recorded before under the intrinsic value approach. The total cost of these options will typically be recognized as expense over their vesting period.

This paper explores how financial statement users will be provided with more relevant and detailed information about share-based payments entities are providing their executives and employees. It also evaluates the existing most popular option pricing models that is be used to estimate the fair value measurements required by FASB 123(R). Financial statements reveal more about the impact stock options are having on the components of a company's income than was provided through the intrinsic value method and pro forma disclosures most companies were providing under the old accounting rules (i.e., Accounting Principles Board Opinion No. 25, Accounting for Stock issued to Employees and FASB 123, Stock-Based Compensation). Thus, financial statement users will now be able to examine the effects a stock-based compensation plan is having on all of the components of an entity's income and not just its net income and total earnings per share.

Earnings-Return Association in an Emerging Market: An Empirical Analysis from Abu Dhabi Securities Market, Fatima Alali, California State University Fullerton; Paul Sheldon Foote, California State University.

Abstract

In this study, we examine the association between accounting earnings and returns of common stocks, in the Abu Dhabi Securities market (ADSM). The Abu Dhabi Securities market is one of three financial markets in the UAE. The UAE financial markets are highly regulated and influenced by cultural, economical and political factors. These markets operate separately but are integrative. The financial market has rapidly flourished in recent years and has been an attractive hub for many international and local investors. The market capitalization has increased significantly since its inception in 2000. However, the market has seen a bubble burst since the early 2006. An overall market index for Abu Dhabi Securities Market has declined sharply compared to earlier years. Anecdotal evidence from investors and brokers provide that although the market regulators strive to achieve transparency by enforcing disclosure and fair practices to all investors, the market is unpredictable. Using daily common stock returns from 2001-2006, we provide insight on the relationship between stock returns and earnings. We document evidence that stock returns are positively and significantly related to earnings level.

System Integration and Performance Measurement: An Empirical Study of System Integration to Facilitate the Balanced Scorecard in the Healthcare Organizations, Bea Chiang, The College of New Jersey.

Abstract

The Balanced Scorecard (BSC) emphasizes on the use of information system to track a limited number of balanced metrics (measures and indicators) that are closely aligned with organization's goals. This study investigates how system integration in different forms is related to the extent of using the BSC for performance measurement. Follow the prior literature, this study defines the system integration in two perspectives: social integration and technical integration. The extent of using a BSC in performance evaluation is considered in five contexts: determining cost, measuring efficiency, ensuring quality and customer satisfaction measure, promoting continuous innovation, and monitoring contract negotiation. The findings indicate that system integration defined in the study positively relates to the extent of using the BSC in all five decision perspectives. The findings conclude that hospitals need a streamlined, information integration across the continuum of care to better assess the operation results, in both organizational and technical perspectives.

Key Words: Balanced Scorecard, management accounting system, healthcare information system, accounting information system, system integration.

A New Framework for Capacity Costing & Inventory Variances, Massood Yahya-Zadeh, George Mason University.

Abstract not provided

A Preliminary Investigation of the Necessary Skills, Education Requirements, and Training Requirements for Forensic Accountants, Dorothy A. McMullen, Rider University, Maria H. Sanchez, Rider University.

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Abstract

“Forensic accounting,” recently a seldom heard term, has quickly become a hot new area for students, professionals, and researchers. However, given that it is such a new field, there is very little existing research in this area, especially in the area of forensic accounting education. Many schools are rushing to offer courses, minors, and even majors in forensic accounting, yet so far there has been no academic research to investigate the demands of the profession. In this study, we examine the professional community’s perceptions of the necessary skills for forensic accountants, as well as the education requirements and the training requirements considered important to the profession. We developed a survey through interviews with practicing professionals and a review of the limited existing literature. The survey was administered to over 100 fraud and forensic accounting professionals.

Financial Literacy for All, Shifei Chung, Rowan University; Ramesh Narasimhan, Montclair State University.

Abstract

Most accredited universities and colleges in U.S. revised their undergraduate curricula in the '70s and early '80s following the report of the Carnegie Foundation for the Advancement of Teaching in 1977. The most extensive part of the revision were the changes in the general education core which was expanded to require courses in language, literacy, history, communications, diversity issues, social sciences and other similar areas. Most undergraduate programs’ general education core looks very similar in requirements across American universities at this time. However one important missing component is Financial Literacy. The purpose of this paper is to examine some of the recent scandals in business involving personal finance and some published financial data to argue for a required financial literacy course in the general education core for all

undergraduate programs in U.S. The proposed required components of this course are identified in the paper as well.

Keywords: financial literacy, general education core

Double Entry: Linking Introductory Financial Accounting and English Composition, Bruce Leaby, LaSalle University.

Abstract

The Washington Center for Improving the Quality of Undergraduate Education (n.d.) advocates the use of learning communities, or linked courses, to improve student learning and social bonding through enhanced interaction with faculty and other students. Adopting their model, our university requires freshmen to take linked courses (a “Doubles”). One combination not found elsewhere connects Introductory Financial Accounting with English composition through a communication theme. In this unique integrative approach, students learn accounting by having accounting material reinforced via English assignments while some composition concepts are reinforced through accounting. This paper describes the development of this linkage and assessment of the benefits which show Doubles students consistently perform better throughout a semester when compared to a control group. Survey results also suggest students value this experience as worthwhile and view the Doubles as meeting its objectives of fostering better relationships among the students and with the faculty.

Does Separating the Positions of CEO and Board Chair enhance firm value? Steven Balsam, Temple University; Arun Upadhyay, University of Alaska.

Abstract

Separating the CEO and Board Chair positions has been suggested by academics and practitioners as a mechanism to enhance oversight. However, existing empirical evidence on this issue is mixed. In this paper, we present evidence that after controlling for corporate governance and other variables found to influence Tobin’s Q, firms with a separate chairperson have better performance, e.g., higher industry-adjusted Tobin’s Q. Extending this analysis we categorize separate board chairs into independent (Independent Chair), those that have a non-employment related association with the firm (Linked Chair), and those that either are or were an employee of the firm (Employee Chair), generally finding that independent and linked chairs are more likely to increase firm value. Across a variety of performance and efficiency measures we find that having a separate chair has a positive effect. In contrast we do not find any association between the existence of a Lead Director and firm performance.

An Accounting Solution To The Health Care Crisis, Philip F. Jacoby, American University; Brent T. McCallum, American University.

Abstract

The U.S. health care system has major problems in terms of rising costs, limited access, and growing concerns about the overall quality of medical care. In recent years these problems have grown to crisis proportions and significantly impact the lives of most Americans. Attempts to alleviate this crisis have prompted careful reexamination of the current health care system at both the macro (national policy) and micro (individual services) levels.

This paper explores the proposition that accounting academics and practitioners possess highly relevant experience and skills necessary to address the current health care crisis. The paper begins with a brief description of the major shortcomings of the U.S. health care system as well as an explanation of the diverse roles accounting experts currently play in serving clients who are health care users, providers, and intermediaries in the system. We then propose ways that the accounting profession can apply its expertise and experience to help resolve the health care crisis in the public interest. Particular attention is given to the need to develop a highly transparent health care information system, the need for independent assurance with respect to public health care information, and the benefits of this information system in fostering competition, continuous improvement, and innovations such as medical outsourcing. In this way accounting academicians and practitioners can help stem the tide of rising health care costs and enable broader access to high quality medical care.

The Effect of Related Party Transactions on CEO compensation, Steven Balsam, Temple University; Richard Gifford, State University of New York – College at Geneseo.

Abstract

This paper presents evidence on the determinants of related party transactions as well as the association between related party transactions and CEO compensation. Related party transactions can be evidence of poor governance, especially if associated with excessive CEO compensation. In general, we find evidence that related party transactions are positively associated with CEO tenure, and insider ownership, although the results vary by type of transaction. While we find that insider loans, which were prohibited by the Sarbanes-Oxley Act of 2002 (SOX), decline post-SOX, we do not observe similar declines for other types of related party transactions. In fact, we find the employment of relatives increases in the post-SOX period. We also find evidence that related party transactions are associated with excess CEO compensation after controlling for the economic determinants of CEO compensation and other governance factors previously

found to be associated with CEO compensation. When we look at the type of related party transactions, we find evidence consistent with CEO compensation being higher when the CEO has an outstanding loan from company and when one or more relatives of the CEO are employed by company.

CEO Shareholder Conflicts and Large-Scale Information Technology Outsourcing Decisions, James A. Hall, Lehigh University; Stephen Liedtka, DeSales University.

Abstract

We empirically investigate whether high-risk, large-scale IT outsourcing decisions indicate a potential conflict between CEO and shareholder interests. First, consistent with arguments regarding decreases in R&D expenditures (Dechow and Sloan 1991), we argue that CEOs are most likely to endorse large-scale IT outsourcing decisions when they anticipate leaving office prior to any negative repercussions. Second, given that CEOs can manipulate financial reports through IT outsourcing, we posit that large-scale outsourcing agreements are predictive of subsequent accounting scandals.

We support our hypotheses through the examination of 69 firms that announced large-scale IT outsourcing agreements during the period 1994–2003. Specifically, we find that a disproportionate number of large-scale outsourcing contracts were announced (1) during the last full year of a CEO's tenure and (2) by firms in which accounting problems surfaced following the collapse of Enron Corporation. The paper highlights the significant implications of our work regarding IT performance, firm governance and financial reporting.

The Information Content of Sales, Lianzan Xu, William Paterson University of New Jersey; Francis Cai, William Paterson University of New Jersey.

Abstract

This article explores the information content of sales in search of valuation for high tech companies in the 90s and beyond. We find significant association between reported sales and equity valuation in comparison with other value proxies and both in the 90s, the booming days of dot com era, and in recent years.

Assessing Students' Ethicality Using a Corporate Code of Ethics, Obeua S. Persons, Rider University.

Abstract

This study uses a corporate code of ethics as a roadmap to create 18 scenarios for assessing business students' ethicality as measured by their behavioral intention. The study also examines an influence of eight factors on students' ethicality using a logit regression analysis for each scenario and for overall ethicality. These eight factors are gender, accounting major, culture, full-time work experience, accounting work experience, part-time work experience, the number of ethics courses taken, and the number of workplace ethics training. Results indicate six scenarios related to five areas of the code that deserve special attention and increasing course coverage. These five areas of concern are: (1) failure to report unethical behavior, (2) improper use of company assets, (3) conflict of interest, (4) inaccurate accounting records via 'channel stuffing', and (5) trading on inside information. The regression analysis suggests that gender, accounting major, full-time work experience, and the number of workplace ethics training have a positive influence on students' ethicality. That is females, accounting majors, students with more workplace ethics training, and students with more full-time work experience are more ethical than males, other business majors, and students with less workplace ethics training or less full-time work experience. These regression results should help educators and corporate ethics trainers direct more attention to students or entry-level personnel with these characteristics.

Investing in the Gulf Countries: Global Tax Issues, Wagdy Abdallah, Seton Hall University.

Abstract

This paper examines the tax rules and regulations of the six Gulf countries. The purpose of this paper is fourfold: First, this study discusses taxation in the Gulf countries in general and emphasized the essential need for a successful and effective tax planning for multinationals in the preliminary stage of feasibility study to take advantage of low tax rates, tax differences, holidays, tax treaties, and other incentives. Second, the characteristics of the tax rules and regulations of the six Gulf countries in general are analyzed. Regional tax coordination and trends and most of the potential advantages of well designed regional tax planning will be discussed. Third, the tax regulations and rules of each country are discussed separately to help and guide potential investors to determine the most favorable country for particular investment. Finally, this research paper urges MNCs and any potential investor to pay attention to the design of an appropriate strategic tax planning and to look at regional opportunities for cost savings and chances for improvements in making tax affairs more effective for both host countries and investors.

Earnings Management and Cultural Values, Kurt A. Desender, Autonomous University of Barcelona; Christian E. Castro, Inter-American Development Bank (IADB)/ Autonomous University of Barcelona; Sergio A. Escamilla de Leon, Autonomous University of Barcelona.

Abstract

Using theory and empirical data from social psychology to measure for cultural differences between countries, we study the effect of individualism as defined by Hofstede (1980) and egalitarianism as defined by Schwartz (1994, 1999, 2004) on earnings management. We find a significant influence of both cultural measures. In line with Licht et al. (2004), who argue that individualistic societies may be less susceptible to corruption, we find that countries scoring high on individualism tend to have lower levels of earnings management. In addition, we find that egalitarianism, defined as a society's cultural orientation with respect to intolerance for abuses of market and political power, is negatively related with earnings management. Our results are robust to different specifications and controls. The main message of this paper is that besides formal institutions, cultural differences are relevant to explain earnings management behaviour. We think that our work adds to the understanding of the importance of cultural values in managerial behaviour across countries contributing to the literature on earnings management and law and institutions.

Keywords: Culture, Earnings Management, Informal Institutions, quality of financial information, Individualism, Egalitarianism

JEL Classifications: G32, G34, K22, K4, Z13

Corporate Governance & Corporate Dividend Policies in Egypt, Sabri El-Segini, University of Sharjah, United Arab Emirates and Omneya Abd-El salam, American University in Sharjah, United Arab Emirates.

Abstract

This paper, using a sample of top listed Egyptian firms between the years 1998 – 2002, provides additional evidence on signaling theory argument for corporate dividend policies in emerging markets in countries in transitional periods. The results confirm that firms with majority government ownership and lower percentage of external ownership (free float) distribute higher levels of dividend. In the transitional period of the emerging market of Egypt, it is found that despite the majority of government ownership and the closely held nature of the firms, which imply lower agency costs, the payment of higher dividend is considered necessary to attract capital. No significant association was found

between size, profitability or growth opportunities and dividend ratios in Egypt.

Learning the lesson: Do firms become more conservative in financial reporting after financial restatements? Rongbing Huang, Kennesaw State University; Joe Z. Shangguan, Robert Morris University.

Abstract

Financial restatements have become increasingly popular in recent years. In this paper we examine whether firms become more conservative in financial reporting after their restatements. We use four alternative methods to capture accounting conservatism. For a sample of financial restatements identified in two GAO reports (2002, 2006), we find that overall the restating firms' earnings exhibit increased conservatism during the two years following restatements in the sense that economic losses are recognized more quickly and completely than gains. This increase is more pronounced for firms that self-prompt their restatements than firms that are prompted to restate by external parties such as the auditor or the SEC. We also find weaker evidence that the post-restatement increase in conservatism is more pronounced after the SOX enactment in 2002 presumably due to the more stringent regulatory environment.

Value Relevance of Earnings & Non-Earnings Information, Samir El-Gazzar, Philip M. Finn, Charles Tang

Abstract not provided

Institutional ownership, Internal control material weakness & Firm Performance, Li Xu, Alex Tang, Morgan State University.

Abstract

We examine whether a firm's composition of its institutional ownership affects its likelihood of disclosing material weaknesses in its internal control system under SOX 302 and 404 and, hence, its post-disclosure firm performance. The findings indicate that dedicated institutional investors reduce the likelihood of material weaknesses disclosures while transient institutional investors exacerbate the likelihood of material weaknesses disclosures. Firms identified with material weaknesses in internal control have worse operating performance and stock returns in the post-disclosure period than controlling firms, however, the particular types of institutional investors associated with internal control material weakness disclosures have no net impact on post-disclosure firms' performance.

Key Words: Institutional Ownership, Internal Control, Firm Performance

The Relation between Earning Informativeness, Earnings Management and Corporate Governance in the Pre- and Post-SOX periods, Jui-Chin Chang, Morgan State University; Huey-Lian Sun, Morgan State University.

Abstract

We posit that the required disclosure of audit committee independence and the other corporate governance information improves the quality of accounting earnings after SOX. We measure the quality of accounting earnings by the sample firms' earnings informativeness and earnings management. Our findings show significant and positive (negative) relations between earnings informativeness (earnings management), audit committee independence and financial experts on audit committee in the post-SOX period, while these relations were not significant in the pre-SOX period. Also, a fully independent audit committee and a majority independent board complement each other in increasing (decreasing) earnings informativeness (earnings management) in the post-SOX period. More importantly, by comparing the pre- and post-SOX results, we report the magnitude changes of relations between earnings management (earnings informativeness) and Big 4 auditors (dual role of the CEO serves as the chair of the board and overall corporate governance). Overall, our findings indicate that the markets began to value the important role of strong corporate governance in monitoring the quality of accounting earnings after SOX. In addition, we find that the effectiveness of corporate governance in monitoring managerial behavior on earnings management has also increased after SOX.

The Effect of Regulation Fair Disclosure on the Relationship between Analysts' Forecast Performance and Restructuring Events, Rong Yang, SUNY - College at Brockport.

Abstract

Regulation Fair Disclosure (Reg. FD) requires all firms disseminate material information not only to some institutional investors and certain financial analysts, but to all market participants simultaneously. We examine the situation in which firms report restructuring charges, expecting that the resulting complexity could create a setting in which the regulatory effect of Reg. FD would be pronounced because of uncertain earnings signals produced by restructuring activities. We examine how the enactment of Reg. FD affects the relationship between analyst earnings forecast attributes, such as forecast accuracy and forecast dispersion, and the relative magnitude of restructuring charges. Our general finding is that Reg. FD had a negative moderating effect on the relationship between both forecast errors and forecast dispersion and the relative magnitude of restructuring charges. Our study provides additional evidence that Reg. FD had unintended negative

consequences on analyst forecast performance, at least for firms with complex earnings information, such as restructuring firms.

Keywords: Regulation Fair Disclosure, analyst forecasts, forecast dispersion, restructuring charges.

Evidence that Companies are not Analyzing Goodwill for Impairment as Required by SFAS142, David Vance, Rutgers University School of Business Camden.

Abstract

SFAS142 (2001) requires that goodwill be analyzed for impairment and written down if impaired. Impairment analysis is complex and relies on many subjective factors. As a result users are confronted with a “black box” analysis wherein they only know whether goodwill is written down. That gives companies an unprecedented opportunity to manage earnings. The fact that 2,724 companies with \$2.4 trillion of goodwill found less than 0.6% of that goodwill impaired provides some evidence of earnings management.

A reasonableness test for impairment can be developed from first principals. If goodwill has value it and related assets should generate rents. Rents can be measured in terms of return on assets (ROA). If goodwill is not impaired it should generate rent comparable to industry norms.

In this study, 38,519 years of company operations for 48 industries were analyzed to develop baseline industry performance. Approximately 956 of 2,730 companies with goodwill underperformed industry norms by at least 10% providing additional evidence that companies are not following the intent of SFAS142 (2001).

The contributions of this article are to provide evidence that goodwill is not being properly tested for impairment under SFAS142 (2001) and to develop a reasonableness test for determining whether firms a firm’s goodwill is impaired.

Developing Financial Accounting Research Skills, Mary Jeanne Welsh, La Salle University.

Abstract

Reading and understanding financial reporting standards is an acquired skill. This paper presents a project for teaching students how to access financial accounting standards and professional accounting literature to answer a financial reporting question. The “search project” asks students to develop their own financial reporting question, preferably based on their own experiences, and then to document the search process that they undertook to answer their questions. It is based on an exercises used to teach information literacy, applied in an accounting context. This includes framing a research question, accessing

sources, and evaluating sources. The final product is not a traditional research paper, but rather a report on the search process, as well as the search results.

Comedy 101- A simple way to use laughter to increase students' interest in accounting, Raymond J Elson, Valdosta State University; Susanne O'Callaghan, Pace University; John P Walker, Queens College/CUNY.

Abstract

Introductory accounting is taken by all business and a large number of non business students in most universities. Students often find the course material with its discussion of journal entries and t-accounts a bit abstract and cannot wait to complete them and move on to the more interesting non accounting courses. The instructor is challenged to find innovative ways to make introductory accounting interesting and exciting for students. We have a simple solution – humor and the resulting laughter. Using the Internet and other resources we found jokes, interactive puzzles and quizzes that we use to add a bit of fun to the classroom experience. We use these jokes and hooks at various points throughout the semester to add some laughter to the classroom. Students are entertained, relaxed and are now ready to learn accounting.

“Is the Market Valuation of Banks' Loan Loss Provision Conditional on Auditor Reputation,” Gopal V. Krishnan, George Mason

Abstract

We examine how auditor reputation conditions the market valuation of banks' loan loss provision (LLP). The inherent uncertainty associated with and discretion permitted in estimating the LLP, contributes to information asymmetry. The auditor's certification and monitoring roles are expected to influence firm value by mitigating this information asymmetry. We examine two aspects of auditor reputation and quality – auditor type (Big 5 vs. non-Big 5) and auditor expertise in the banking industry. We find a significant, positive association between the discretionary component of LLP and stock return for banks audited by the Big 5 auditors. Further analysis indicates that auditor industry expertise and not auditor type drives this significant, positive association. Overall, our results are consistent with auditor reputation (expertise in the banking industry) mitigating information asymmetry between bank managers and investors and enhancing the informational value of discretionary loan loss provisions.

Key words: *Audit quality; Big 5; Stock returns; Auditor expertise; Loan loss provision.*
JEL classification: G14, G21, M41 and M42.

“A New Use for an Old Classic Approaching Birch Paper Company Case as a Response to Pedagogical Overload,” Athar Murtuza, Wagdy Abdallah; Theresa F. Henry, Seton Hall University.

Abstract

This paper is hoping to demonstrate that one way to deal with the pedagogical overload, constraints of time, and resources available to accounting educators to teach their students an increasing amount of material and a growing number of topics, is to “bundle” the topics that they seek to teach and to use the available technology in ways that would in effect render the physical confinement of learning to assigned time and place in bricks-mortar classrooms relatively obsolete. By pedagogical bundling we mean combining multiple topics when possible in an optimal manner. The paper will show how to do so by using Birch Paper Company case. Even though it is a case associated with transfer pricing with secondary implications for organizational decentralization, coordination among divisions, and performance measurements, it can be used to teach other topics such as alternative models of performance evaluation, stakeholders’ theory, and even ethics.

Data Availability: All data used in this study are available from public sources

The Role of Non-Financial Performance Measures in Compensation Contracts in the Curtailment of Earnings, Salma Ibrahim, Morgan State University.

Abstract

Most executive compensation contracts (specifically bonuses) are based on accounting-related measures such as earnings per share (EPS), growth in revenue, and return on stockholders’ equity. However, the recent trend of account manipulation and earnings management documented in the literature may lead to inequitable bonus payments to the managers or executives. Alternative performance measures that may be used to motivate managers are stock prices or market returns and non-financial measures. In this paper, I examine firms in the S&P 500 index and examine the type of performance measures they use in their short-term compensation. I expect that firms that use non-financial performance measures will have a lower prevalence of earnings management, since these measures are harder to manipulate. The findings are opposite to expectations. The firms that use both financial and non-financial performance measures actually have higher discretionary accruals, specifically accounts receivable accruals, than the firms that only use financial performance measures. The interpretation of these results is that these firms suffer from low earnings quality which makes the accounting numbers less meaningful.

Mapping, Measurement and Alignment of Strategy using the Balanced Scorecard: The Tata Steel Case, George Joseph, University of Massachusetts Lowell.

Abstract

Nobes and Parker (2006) point out that increasingly, global firms have begun to use the Balanced Scorecard due to the inadequacy of a “financial-only” approach to management control and strategy implementation in the global environment. This case describes the Balanced Scorecard (BSC) implementation at Tata Steel of India. The case provides an opportunity to study the application of BSC in guiding and implementing firm strategy in a global and increasingly turbulent environment. With a reputation for strong ethical practices, Tata Steel engages stakeholders and integrates their concerns into strategy. The case illustrates the use of the BSC, particularly the visual representation of strategy maps for integrating strategy (Kaplan and Norton 2004), and the application of a variety of measures (e.g., Schneiderman 1999; Lipe and Salterio 2000; Banker et al. 2004).

The Impact of EVA Adoption on Long Term Shareholder Value: an Empirical Approach, WaQar I. Ghani, Saint Joseph's University; Samuel H. Szewczyk, Drexel University.

Abstract

Our study examines Economic Value Added metric’s link to superior long term shareholder value creation. We assume that EVA adoption brings about a positive change in managerial behavior that in turn leads to long-term value creation. Unlike most prior research that uses only one sample, we employ two samples. The first sample is based on 57 U.S. firms that Stern Stewart & Company has posted on its website and where they claim that these firms have achieved superior financial performance as a consequence of the adoption of EVA for the 1994-98 periods. The second sample is based on 176 U.S. firms’ proxy statements for the 1994-1999 periods in which these firms have described EVA use as a part of their performance evaluation and compensation metric. Our study’s results, using both long-term abnormal holding period returns and analyst forecast based on five-year growth of earnings per share show that EVA adoption has no impact on a firm’s long-run performance when compared to a control sample matched on industry, size and past performance. Our results suggest that firms should view claims about the long-term value of EVA metric with serious skepticism.

Institutional Investing Activities and Firms' Information Environments, Before and After Sell-Side Analyst Coverage Initiation and Termination, Li Xu, Morgan State University.

Abstract

This paper investigates whether analyst coverage initiation and termination are associated with institutions' investing decisions, and separately, firms' information environments. After controlling for simultaneity between initiation/termination and changes in institutional ownership, I find that termination is associated with a decline in institutional ownership. The decline is mainly attributable to quasi-indexer institutions, and is more pronounced when firms are covered, in the pre-termination period, by multiple analysts or by analysts from highly reputable brokerage houses. In contrast, I find no evidence that coverage initiation leads to changes in institutional ownership except for a sub-sample of transient institutions (which are covered by analysts from highly reputable brokerage houses in the post-initiation period), which increase their holdings. I further predict that the impact of initiation/termination of analyst coverage on institutional holdings stems from the information benefits associated with analyst coverage. As predicted, I find that the initiation (termination) of coverage is associated with decreased (increased) information asymmetry.

Are Reconcilable Differences between Segment-Level and Firm-level Earnings Informative? Dana Hollie, University of Colorado at Boulder; Robin Tarpley, George Washington University; Shaokun Carol Yu, Northern Illinois University.

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Abstract

This paper investigates whether the firm-segment reconcilable differences in segment earnings provided under the SFAS No. 131 'management approach' segment reporting regime is more informative than that provided under the SFAS No. 14 'industry approach' segment reporting regime. Firm-segment reconcilable differences (hereafter referred to as firm-segment differences – FSD) are defined as the difference between firm-level and aggregated segment-level earnings. More specifically, we examine the informativeness of FSDs from reporting in the SFAS No. 14 to the SFAS No. 131 reporting regime. Although, we find that FSDs exist pre- and post-SFAS No. 131, we find an overall significant increase in FSDs post-SFAS No. 131. This indicates that aggregated segment-level earnings have deviated further from firm-level earnings subsequent to the adoption of SFAS No. 131. We then disaggregate firm-level earnings into aggregated segment-level and FSD components and find that both aggregated segment and FSD components of earnings are incrementally persistent in predicting

future earnings. We also find both components of earnings are more persistent in the post-SFAS 131 period. Overall, we find that aggregated segment-level and FSD components of earnings do persist into future earnings post-SFAS No. 131.

CEO Incentives and Earnings Management: The Impact of Research Design Choices, Steven Balsam, Temple University; Wei (Alan) Jiang, State University of New York.

Abstract

The goal of this paper is to illustrate the effect of research design choices on conclusions drawn by researchers in earnings management. Researchers have many choices including selection of earnings management variable, e.g., discretionary accruals; model to estimate that variable, e.g., Jones model; use of signed versus unsigned measures; identification of independent variables; and time frame and population from which to sample. As such, we observe a wide diversity in published research. Our goal is to complement and extend the recent work of Hribar and Nichols (2007) who identified issues arising from the use of unsigned measures in tests of earnings management.

Like Hribar and Nichols (2007) we show the impact of these choices utilizing a study examining the relationship between CEO equity incentives and earnings management. While we are able to replicate the results of that study, i.e., find a relationship between earnings management and equity incentives when we use the accrual estimation model, control variables, and time frame chosen by the authors; we find those results are not robust to alternative ways of estimating discretionary accruals, inclusion of additional control variables, or use of a more recent sample period. Given the widespread use of accrual estimation models in the literature, as well as the imperfections in those models, researchers need to be aware the choices they make are likely to influence their findings.

Managing Risk of Credit Card Default, Alvino J. Massimini, LaSalle University.

Abstract

Nationally, at the present time, there is approximately 15 billion dollars of unsecured credit card debt. Credit card companies expect about a 20% increase in 2008 revenues but expect credit card losses to soar to between 8 and 15% of credit card debt. In the past some companies were willing to accept a 5% loss as a cost of doing business which could be built into prices charged for services. But now the fear is credit card debt may become the next subprime meltdown with the negative effect on the stock market and bank losses. The industry may have created the problem of irresponsible purchasing behavior with the mindset of charge now and manage later. Economic downturn historically has been an

indicator of financial instability and credit card default. An average balance of \$7,000 requiring a monthly payment of \$200 assumes a low priority for people in financial distress. Employment in key industries such as manufacturing, computers, steel and petroleum augment the problem during economic downturn or recession. Further a slowing economy may produce negative expectations about the future which can mushroom similar to what occurred in 1987. The reduction in credit card losses which was anticipated from bankruptcy reform a few years ago was short-lived. Credit card delinquencies are rising. Ultimately society pays for those who default through higher prices.

The credit industry itself must be faulted for its aggressive marketing of credit cards to people with limited resources, such as students, young graduates, and those with a bad credit history or bankruptcy. Once in default, a customer is likely to default again within 24 months. It is not farfetched to conclude that overlooking prior history has added to default, bankruptcy and mounting losses.

The credit industry has to be more vigilant in its pursuit of new customers and in reviewing the activity of existing customers. Credit card companies have been using behavior scores to screen and monitor card holders with mixed success. This method has proved faulty. For example, self-employed individuals with an acceptable behavior score often rank high in default cases. A better management plan is obviously needed.

The first step is to develop a profile of high risk individuals :

- Gender and age – either gender between the ages of 20-39, especially if self-employed.
- College students , usually unemployed
- Marital status – divorced or widowed individuals who are attempting to work and maintain a household on a single income.
- Ownership of a new business (within three years from inception).
- Debt level – excluding mortgages, debt of \$80,000
- Early cash advances – over one-half of delinquency cases were represented by individuals who obtained cash advances at an early point after obtaining the card.
- Cards delinquent or missing just one payment.
- Relationship between debt level and reported income – a factor of three is often significant in predicting delinquency danger.
- Nature of items charged – large purchases of “necessaries” are a danger signal.
- Partnerships – mutual agency and the related liability
- Commission employees may be impacted adversely

Although some individuals in the above profile remain solvent, companies have agreed that in combination the above factors will predict default in about 80% of cases. Sadly, individuals may overspend and believe they will be protected under bankruptcy laws. Bankruptcy reform has not changed that mindset. Residents of some states such as Florida feel especially comfortable because of protection under old domicile laws whereby the expensive homestead is protected against attack even if the owner has run up millions of credit card debt. Platinum card holders are even more likely to overspend and become a default risk because the higher credit limit permits purchase of automobiles and other personal and household items. Nationally, about 70% of delinquencies were on nonbusiness or personal credit cards.

As delinquencies increase, careful screening of credit applicants using improved techniques will be necessary if losses are to be mitigated. Of course, state to state experiences must be considered in developing an effective management plan to stem the tide of rising losses. Of course, certain industries present special problems. For example, in the petroleum industry credit card purchases at the pump have produced a default rate of 5%. But 37% of these losses have resulted from counterfeit credit cards and from cards that were reinstated and defaulted again within 24 months. A rising threat has been from identity theft and from falling below the poverty line, making repayment of debt a very problematic issue.

In addition to developing a profile of risky credit card holders and credit card applicants, the following management plan has been developed after interviews with officers in the industry. The plan uses both internal and external factors to develop an effective plan:

1. Compare policies to those of other firms
2. Provide counseling services as to budgeting and cash management. Many holders are not aware of the negative aspects of bad credit or of being declared bankrupt.
3. Frequently pull credit reports to get an external warning of potential future delinquencies.
4. Monitor problem accounts. Cancellation may be necessary when an account is in arrears 90 days. Platinum accounts in arrears pose the greater risk because of the higher credit limits.
5. Monitor closely accounts which have had large cash advances, especially at an early date after obtaining the card.
6. Heavy account activity at an early stage may signal high risk.
7. Frequent use of the card for recurring necessary items are proving to signal danger when only minimum payments are being made.
8. Use cost/benefit analysis for evaluating whether to keep an existing customer or to accept a new credit card holder.

It is believed that the above plan may increase effectiveness of managing credit card losses by as much as 90%.

Clearly, abuse and overspending of credit cards must be controlled if we are to avoid a credit card meltdown nationally.

If companies are willing to accept a 5% loss on \$15,000,000,000 debt or \$750,000,000 which is recoverable from fees charged, a 10% loss would cause the companies to suffer an additional, unexpected \$750,000,000 loss.. Further losses would be even more devastating company to company. Securities which back the companies would decline creating losses for institutions, mutual funds and pension funds. Waiting for future recovery would be a luxury which older pensioners do not have.

The time is now to address the problem and implement a satisfactory plan to mitigate losses.

Evaluating costs & Benefits of an In-house Smoking Cessation Program, Barbara Woods McElroy, Susquehanna University; Daniel Derr, Director Clinical Outcomes Group

Abstract

This study estimates the costs and benefits of a voluntary in-house smoking cessation program offered by a small manufacturing firm with locations in central Pennsylvania and North Carolina. We find differences between the costs of smokers, former smokers, and non-smokers. These differences are generally in the expected direction. However, largely because the sample size is small they are in general not significant. In addition, we find significant correlations between cost and number of cigarettes for those over fifty. Taken together, these results suggest that the program will convey cost savings to the employer.

A Predictive Model of Fiscal Distress in Local Government, John Trussel, Pennsylvania State University at Harrisburg; Patricia A. Patrick, Shippensburg University.

Abstract

This paper investigates the financial risk factors associated with fiscal distress in local governments. We hypothesize that fiscal distress is positively correlated with revenue concentration and debt usage, while negatively correlated with earnings, administrative costs, and entity size. Using logistic regression on a sample of local governments in Pennsylvania, the results show support for some of these hypothesized relationships. The regression model results in a prediction of the likelihood of fiscal distress, which correctly classifies 64% to 78% of the sample as fiscally distressed or not. The model also allows for an analysis of the impact of a

change in a risk factor on the likelihood of fiscal distress. An increase in tax revenues as a percent of total revenues and an increase in revenue growth have the biggest influences on reducing the likelihood of fiscal distress.

KEY WORDS. Fiscal Distress, Prediction

Impact of Board Characteristics on Non-profit organizations, Erica Harris, Steven Balsam, Temple University.

Abstract not Provided

The Deployment of Contemporary Management Accounting Practices and Performance Measurement in Canadian Companies: A Contingency Approach, Raili Pollanen, Carleton University; Ahmed Abdel-Maksoud, University of Sharjah.

Abstract

Effective management accounting and performance measurement systems can provide critical tools and techniques for managing contemporary companies, particularly in competitive global environments. Using a survey of Canadian manufacturing companies, this study investigates the use and importance of shop-floor non-financial performance measures (SFNFPMs) and contemporary management accounting practices (CMAPs), as well as several contingent factors that are significantly positively associated with their use / deployment. The findings suggest that SFNFPMs and CMAPs play important, but still evolving, roles in Canadian manufacturing companies. In addition, the regions and the industries in which the companies operate, along with managerial expertise and skills in some cases, appear to be positively significantly associated with the use and importance of SFNFPMs and the deployment of CMAPs, with the Central and Western regions exhibiting negative significant associations with the use and importance patterns for all SFNFPMs and for several CMAPs.

Section 3: Selected Abstracts from Teaching and Research Forum

Deficiencies Noted in PCAOB Inspections: Implications for Auditing Instruction, Bernard H. Newman, Mary Ellen Oliverio, Pace University.

Abstract

The Public Company Accounting Oversight Board (PCAOB) has responsibility for monitoring public accounting firms who provide audits for publicly owned companies. Among its duties, the PCAOB was charged with “conducting inspections of registered public accounting firms.” A strategy for such inspections was developed that includes reporting deficiencies judged to be significant for supporting conclusions made.

This exploratory review of inspections reviewed deficiencies in inspection reports to identify implications for teaching/training in auditing. As of October 2007, there were seven firms that had had full inspections for three years; four of these were the largest U. S. firms while the remaining three were among the next largest firms. The largest four were not included since these firms had had a limited audit for fiscal year 2003. The remaining three firms’ inspection reports for 2004, 2005, and 2006 were selected for review. While there are some clues that provide a basis for some tentative implications, the inspections are not appropriately designed to draw any quantifiable conclusions.

The PCAOB has taken a supervisory approach to performing inspections. The Board’s approach is expected “through constructive dialogue to improve their [the Firms] practices and procedures.” To date, there has not been revealed the extent to which that improvement has taken place by the PCAOB.

The parts of inspection reports that are made public give some clue about the nature of violations of professional guidance and regulatory requirements. Such public reports fail to provide sufficient information, because audits are seemingly not selected at random for inspection, for a clue about *compliance*, as is noted in the Act. Given the disclaimers provided in each inspection report, the basic inspection of an audit doesn’t appear sufficient to generalize sufficiently to “assess the degree of compliance. . . .”

A first approximation attempt is here provided with some implications for audit instruction, whether in the college and university or in a public accounting firm. Instruction is improvable; the most effective strategies are yet to be determined and reviewed.

Earnings Management and Deregulation: The Case of Motor Carriers, Seong-Yeon Cho, Oakland University, Kevin Sachs, Hofstra University.

Abstract

We examine the discretionary accounting choices of federally-regulated interstate motor carriers during the period in the 1970s when the U.S. government successfully deregulated the industry. We predict that during this period of heightened political cost, motor carriers used income-decreasing earnings management to lessen public perception of excessive industry profits and thus to avoid deregulation.

We test the hypothesis on a sample of publicly-traded, federally-regulated motor carriers using the accruals model of Dechow et al. (1995) augmented as a fixed-effects model (Key 1997, Han and Wang 1998) with a control for performance (Kothari et al. 2005). We compare accruals during the political-cost deregulation period of 1975-1979 against various benchmark periods before and after industry deregulation.

We find no evidence of income-decreasing earnings management during the period of deregulation when compared to all of our benchmark measures from the "before" period. In fact, when before periods are used as benchmarks, our evidence is consistent with income-*increasing* earnings management during the political-cost period. We do however, find evidence of significant income-decreasing earnings management when the "after" periods are used as benchmarks. We offer several possible explanations for our results.

Key Words: Earnings management, Discretionary accruals, Political cost, Deregulation

Why A Micro-Profit Center Manager is More Motivated: Prospect Theory Explains, Eiichiro Suematsu, Saitama University.

Abstract

Some reasons why workers in managerial positions can be motivated when they are imposed profit responsibility rather than cost responsibility will be explored utilizing the perspectives of Prospect Theory. I asked ninety one undergraduate students to simulate themselves as cost center managers and profit center managers, and asked them how much money they would be willing to spend in executing a project. The results supported the hypothesis: the profit center managers will execute their project more aggressively than the cost center managers would. The results also suggested two points: When the probability of success of a project was low, there were no differences in the money amount spent on a project between cost center and profit center. As the probability of success was raised to a middle or high level, the profit center managers were more willing to spend a greater amount of money on the project than the cost center managers.

Evaluating the SEC Review of Commercial Banks: Evidence from Comment Letters, Victor Valdivia, Towson University.

Abstract

This paper examines whether the oversight provided by the SEC over commercial banks during the recent real-estate boom and its aftermath was appropriate or not. The approach followed here is to first identify the variables that are of interest to those who invest in banks, and then to present evidence from comment letters to identify the areas in which the SEC staff focuses during its review of bank filings. These two results are then compared to determine if the SEC's review efforts are aligned with the interests of bank

investors. The results of this comparison show mixed results: in some instances the SEC focuses on the same areas as investors, but in other cases it does not – either because the SEC does not focus on areas of interest to investors, or because the SEC focuses in areas that are not of high interest to investors. Even in cases in which the SEC and investors' interests are aligned, however, investors would benefit from enhanced disclosures. Details of the comment letter process are also examined. Specifically, an analysis is carried out on the attributes of banks that have issues during the SEC's review of their filings, attributes of banks that generated the largest number of issues, and attributes of banks that generated derivative accounting issues. Overall, the paper suggests specific improvements to the SEC review process by identifying areas in which the SEC should focus on, and by suggesting areas of improved disclosure.

Keywords: Securities and Exchange Commission, SEC, Financial Reporting, Annual Reports, 10K, Commercial Banks, regulation.

Identity Theft and the Musical Profession, Peter Oehlers, West Chester State University; Paul Oehlers, American University.

Abstract

Identify theft, transference of someone's identity to commit fraud, is one of the fastest growing crimes in the past decade because more information becomes available on the Internet, and electronic measures. Harris Interactive reports an 80 % increase in the incidences filed from 2002 to 2003, while the FTC reports 9.9 million identities were stolen in 2002 costing approximately \$53 billion.

Music professionals are different than those in many other industries, particularly if they are freelance performers. Musicians are often focused on their art and less concerned with the business aspects of their career. Business managers often have greater access to an artist's personal information than an average individual. Often, they play gigs at clubs where personal information is often provided to the club owner or the booking agent. This information is usually stored in a well-trafficked location (i.e. a business office or behind the bar) and at several different clubs over the course of several weeks where musicians may play. Other musicians who become more successful may hire agents, managers, or other people that have access to personal accounts and information.

Accountants have a duty when auditing to recognize the special intricacies of music industry and the differences of an artist as compared to typical business. In addition, since musicians are at greater risk to have the personal information was stolen, accountants should take measures to minimize the risk and educate the artist. With an understanding of how music professionals are affected, preparation and preventative steps can be taken to minimize the effect on this segment of the population.

The Effect of Undergraduate and Graduate Tax Courses on Student Perceptions of the Ethics of Tax Evasion: A Research Note, A. Blair Staley, Bloomsburg University of Pennsylvania; Donald T. Williamson, American University.

Abstract not provided

Task Control and the Carolina's Tidal Rice Culture of the 1840's, Louis J. Stewart, Howard University.

Abstract

My paper seeks to analyze the control systems and practices of 19th century US slave plantations from a broader social perspective. Large scale rice production required a complex agricultural technology that enslaved Africans brought to the Carolinas from West Africa. Planters delegated supervisory authority to enslaved African foremen. Slave foremen would assign “tasks” to the plantation’s field hands and monitor their performance. The task system rewarded productive enslaved field hands with greater “free” time each working day. Many field hands worked cooperatively with their masters to obtain such jobs as foremen, domestics, or skilled artisans. These skilled slaves generally enjoyed better lives than those available to the field hands. Finally, all slaves who failed to meet task performance standards, racist behavioral expectations, or tried to run away were subject to brutal punishment to enforce broader social controls that supplemented the planters’ task control system.

The Fiscal Aspects of a DOA Structure – The Connecticut Experience, Janet F. Phillips, Daniel S. Hennig, Andrew A. Steel, Southern Connecticut State University.

Abstract

Programs that service the elderly population in Connecticut have been scattered within various divisions of the Department of Social Services which is a huge agency with many other priorities. The splintering of authority over elderly programs and the lack of a commissioner level advocate specifically devoted to elderly services is inconsistent with the change in demographics of the Connecticut population. In response to this situation, the legislature of the state of Connecticut ruled to reestablish the Department on Aging in 2006 to recognize the importance that should be placed on coordinating, strengthening and increasing state provided services to the elderly.

Shortly thereafter, Southern Connecticut State University, through the Sirico Center, was contracted to implement the legislation by developing a practical plan to develop a structure for the DOA by February 15, 2008. The team is comprised of three principal

investigators and a team of professors from Public Health, Nursing, Social Work, Psychology, Marketing and Accounting, some university assistants and students. The required outcome of our project is a report that will contain a recommendation for the functions and responsibilities of the new DOA including the number and type of staff and programs that should be included. As accountants, our explicit assignment was to assign costs to the structure of the new DOA as developed by the research team. The team examined work done by a twenty-member task force, the structure of the DOA in other states, accomplished extensive interviews and focus groups with personnel of all levels and examined historical fiscal information.

The final recommendation from our study group regarding the structure of the new Connecticut DOA will be developed considering the qualitative data gathered through staff interviews and an on line comment survey by the entire team. The costs assigned to these preliminary alternatives by the accounting sub group of the team will be an important consideration in development of a feasible solution on how best to structure Connecticut's DOA and will be presented in the final draft of this paper at the conference.

In conclusion, a significant point in supporting a strong independent DOA is that elderly programs are not currently being run with a comprehensive, timely fiscal reporting system detailing funds received by federal and state sources and expenditures paid out. The most effective and efficient method to run a program is to evaluate the total budget on a by-program basis for both revenue and expenditures in comparison to previous years or forecasted amounts. It seems unlikely that the maximum amount of funding can be received for elderly programs and that existing funds can be spent judiciously where comprehensive financial information is not prepared and utilized by the relevant decision makers.

Costing Methodologies to Unbundle Nursing Costs: Should Nursing Cost be an Independent Predictor of Total Hospital Reimbursement, Expenditures and Financial Performance? Bea Chiang, The College of New Jersey.

Abstract

A critical cost accounting issue relating to nursing costs is that nursing costs are currently average into the daily room rate in the hospitals. As a results, all patients in a given care unit of the hospital are presumed to consume the same amount of nursing care resources. This costing practice creates a mismatch between resources consumption and reimbursement. The objective of this study is to use several alternative costing approaches (Ratio of cost-to-charges, Relative Value Units and Nursing Intensity Weights) to separate the cost of nursing services from the total cost used to establish room and board rate. In addition, this study examines the relationship between nursing costs and total hospital expenditures and financial performance under these three different costing approaches.

Key Words: Nursing Costs, Cost Accounting, Hospital Expenditure, Ratio of Cost-to-charges, Relative Value Units, Nursing Intensity Weights

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Reviewers

A special “thank-you” to the following people who either reviewed papers for this year’s program or helped to organize the blind-review process:

Abdel-Maksoud, Ahmed	University of Sharjah
Badaway, Ibrahim	St John’s University
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Lambart, Tamara	Drexel University
Leauby, Bruce	LaSalle University
Li; Sherry (Fang)	Rider University
Maksy, Moustafa	Northeastern Illinois University
McDowell, Evelyn A	Rider University
McElroy, Barbara Woods	Susquehanna University
Mest, David	Seton Hall University
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Narasimhan, Ramesh	Montclair State University
Nutter, Sarah	George Mason University
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Oliverio, Mary Ellen	Pace University
O’Reilly-Allen, Margaret	Rider University
Philips, Janet	Southern Connecticut University
Pineno, Charles	Shenandoah University
Ryan, David	Temple University
Reinstein, Alan	Wayne State University
Sanchez, Maria	Rider University
Schoenebeck, Karen	Seton Hall University
Smith, Kenneth J.	Salisbury University
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Sun, Huey-Lian	Morgan State University
Trussel, John M.	Pennsylvania State University at Harrisburg
Velayutham, Sivakumar	University of Sharjah
Vera-Muñoz, Sandra	University of Notre Dame
Ya-Fang, Wang	National Chung Cheng University
Yang, Rong	SUNY-College at Brockport

Thursday, April 24, 2008

- 9:00 am – 12:00 pm **CPE Workshop: Accounting Update**
Accounting – (Update) – 3 credit hours
A review of recently issued accounting pronouncements including; FASB 157 – Fair Value Measurements, FASB 159 – The Fair Value Option for Financial Assets and Financial Liabilities, FASB 160 – Non-controlling Interests in Consolidated Financial Statements, FASB 141 (R) – Business Combinations, FIN 46 (R) – Consolidation of Variable Interest Entities, FIN 48 – Accounting for Uncertainty in Income Taxes Tax basis reporting issues and the progress of the lease accounting project and the financial statement presentation project will also be discussed.
Presenter: John Fleming, MBA, CPA, Loscalzo Associates, P.A.
- 1:00 pm – 4:00 pm **CPE Workshop I: Audit Update**
Auditing – (Update) – 3 credit hours
Audit, Review, and Compilation Issues: This program will review implementation issues associated with the new risk assessment standards (SASs 103 through 111), SAS 112 communications issues, SSARS standards 15, 16, and 17, and expected new standards effective in 2009 and 2010. We will briefly discuss the COSO Framework and its importance in understanding a client's internal control system.
Presenter: John Fleming, MBA, CPA, Loscalzo Associates, P.A.
- 1:00 pm – 4:00 pm **CPE Workshop II: Creating a Positive Accounting Learning Environment**
Accounting- (Overview) – 3 credit hours
This seminar will focus on ways to improve instructional effectiveness and assure overall student achievement. There will be a blend of theory and application of pedagogical issues during this interactive session. Among the topics to be discussed are the following; the elements of a successful learning experience – the L.I.M.E. Model, the A.T.A. vs. T.A.T. models of presenting course materials, and the use of technology to improve learning.
Presenter: William Stahlin, CPA, Howe School of Management at the Stevens Institute of Technology.
- 2:00 pm – 7:30 pm **Registration**
- 4:00 pm – 7:30 pm **Exhibits Open in Exhibit Hall**
- 5:30 pm – 7:30 pm **Welcome Reception in Exhibit Hall**

Friday, April 25, 2008

- 7:00 am – 5:00 pm **Registration**
- 7:30 am – 7:30 pm **Exhibits Open**
- 7:30 am – 8:30 am **Continental Breakfast in Exhibit Area**
- 8:30 am – 10:00 am **Session 1: Plenary Session**
Accounting – (Overview) – 1.5 credit hours

Introduction and Welcome

- Brian R. Greenstein, President, Mid-Atlantic Region, Seton Hall University
- Wagdy Abdallah, Program Chair 2008 Meeting, Seton Hall University
- Nancy Uddin, 2009 Program Chair 2009 Meeting, Monmouth University

Shared Experiences: Building a Community Between Academics and Professionals

Panel Members:

- Donald Wygal, Rider University
- Joseph Ragan, St. Joseph's University
- Bette Kozlowski, KPMG, Mid-Atlantic Director of Recruiting
- Sheri Risler, Temple University and Former Partner, E&Y

This interactive panel will discuss possibilities for faculty members and practitioners to work together to pursue a common purpose of enhancing accounting education. The panel brings together noted educators and practice members to explore how each may benefit from the fruits of the other's experiences. With the rapidity of change within our profession a community of academics and professionals is essential for life-long learning. The panelists will share a wide variety of insights from their own experiences and will encourage an active dialog from attendees on issues as they pertain to audience members.

Closing Remarks: Brian Greenstein, Seton Hall University

- 10:00 am – 10:30 am Coffee Break
- 10:30 am – 12:00 pm **Session 2: Concurrent Paper & Panel Sessions**

2A. Financial Accounting and Reporting I

Accounting – (Advanced) – 1.5 credit hours

Moderator: Alan Reinstein, Wayne State University

Who is a Winner in Volatile Markets? Evidence from Chinese Funds. Yi Yao, Nankai University; Rong Yang, SUNY – College at Brockport; Zhiyuan Liu, Nankai University.
Market reaction to Insider Trading and Earnings Management, Loretta Baryeh, Towson University; Peter Dadalt, The University of Rhode Island; Varda Yaari, Morgan State University.

"The Incidence and Capital Market Consequences of Expectations Management in the Post-Regulation FD Period," Sherry Li, Rider University.

- 10:30 am – 12:00 pm **2C. Teaching and Curriculum**
Accounting – (Overview) – 1.5 credit hours
Moderator: Janet Phillips, Southern Connecticut State University
Correlation of Performance in Accounting Courses, William E. Bealing, Jr., Bloomsburg University; A. Blair Staley, Bloomsburg University; Richard L. Baker, Bloomsburg University.
The Influence of Motivation and Attitude on Cheating Among Accounting Majors, Kenneth J. Smith, Salisbury University; Jeanette A. Davy, Wright State University; Donald L. Rosenberg, Towson University.
Survey of Student Perceptions: Regarding Integrating Managerial Accounting and Fundamentals of Financial Management, Bruce Leaub, LaSalle University.
- 10:30 am – 12:00 pm **2D. Auditing**
Accounting – (Advanced) – 1.5 credits
Moderator: Kirsten Fanning, University of Massachusetts
Auditor Fee Data Concerns: Implications for Future Research, Rebecca L. Rosner, Long Island University; Ariel Markelevich, Long Island University.
The Changing Public Reports by Management and the Auditors of Publicly Held Corporations a Comparative Study of a Manufacturing Industry and a Service Industry, Charles J Pineno, Shenandoah University; L. Mark Tyree, Shenandoah University.
Assessing the Frequency of Auditors' Comments Concerning Perceived Client Integrity, Richard A. Bernardi, Roger Williams University.
- 10:30 am – 12:00 pm **2E. International Accounting**
Accounting – (Overview) – 1.5 credit hours
Workshop: "IFRS and U.S. GAAP: Comparison, Convergence, and Substitution?" presented by Obeua S. Persons, Rider University.
- 10:30 am – 12:00 pm **2F. Accounting, Behavior and Organizations**
Accounting – (Advanced) – 1.5 credit hours
Moderator: Fatima Alali, California State University, Fullerton
Towards a Positive Theory of Dysfunctional Behaviors in the Accounting Community, Mohamed Elbannan, Cairo University, Egypt.
A Survey of Financial Management Reforms in the US Federal Government, Byron Henry, Howard University.
Public Accountants' Perceptions of Ethical Work Climate, Howard Buchan, SUNY College at Oneonta.
- 10:30 am – 12:00 pm **2G. Teaching and Curriculum**
Accounting – (Overview) – 1.5 credit hours
Workshop: "Using Online Practice Sets in Accounting," presented by Ferebee Smith, Ivy Publishing.
We will be demonstrating two learning tools which utilize customized online grading. The first product we will be demonstrating is Seaside Marina, an online version of a very successful practice set developed by Ivy Software a number of years ago. Seaside's success is based on two principles (1) ease of use and (2) the manual approach to teaching the financial accounting cycle. The second product we will be demonstrating is Case Music Store Inc. which also utilizes online grading capabilities.

- 12:00 noon – 1:15 pm **Luncheon Program & Awards Presentation**
Accounting – (Overview) – 1.0 credit hours
Speaker: Nancy A. Bagranoff, Dean, College of Business and Public Administration, Old Dominion University and President-Elect of the American Accounting Association.
Distinguished Paper Award: *CEO Shareholder Conflicts and Large-Scale Information Technology Outsourcing Decisions*, James A. Hall, Lehigh University; Stephen Liedtka, DeSales University.
Outstanding Doctoral Student Paper: *An Empirical Investigation of the Defined Benefit Pension Plan Freeze Decision*, Cathy Beaudoin, Drexel University
- 1:30 pm – 3:00 pm **Session 3: Concurrent Paper & Panel Sessions**
3A. Financial Accounting and Reporting
Accounting – (Advanced) – 1.5 credit hours
Moderator: Araya Debessay, University of Delaware
An Empirical Investigation on the Impact of Executive Stock Options on Firm Valuation, Akinloye Akindayomi, University of Massachusetts Dartmouth; Hussein A. Warsame, University of Calgary.
An Empirical Investigation of the Defined Benefit Pension Plan Freeze Decision, Cathy Beaudoin, Drexel University.
Market reaction to Insider Trading and Earnings Management around SEOs, Loretta Baryeh, Towson University; Peter Dadalt, The University of Rhode Island.
- 1:30 pm – 3:00 pm **3B. Auditing**
Accounting – (Advanced) – 1.5 credit hours
Moderator: Byron Henry, Howard University
The Audit Company of New York: The Rise and Fall of an American Accounting Giant, James J. McKinney, University of Maryland; George C. Romeo, Rowan University.
Audit Committee Characteristics and Earlier Voluntary Ethics Disclosure among Fraud and No-Fraud Firms, Obeua S. Persons, Rider University.
Quantifying Audit Quality: A Proposal Inspired by Recent Initiatives, Mary Ellen Oliverio, Pace University; Bernard H Newman, Pace University.
- 1:30 pm – 3:00 pm **3C. Teaching and Curriculum**
Accounting – (Overview) – 1.5 credit hours
Moderator: Gail Sanderson, Lebanon Valley College
First Grove Bank: A Case on Loan Fee Amortization According to SFAS 91 for Novel Loans, Victor Valdivia, Towson University.
An Innovative Model of Determining Financial Status and Income Performance, Joseph A. Mauriello, New York University.
Accounting Faculty Job Search in a Seller's Market, Steven C. Hunt, Western Illinois University; Tim V. Eaton, Miami University; Alan Reinstein, Wayne State University.

- 1:30 pm – 3:00 pm **3D. Teaching and Research Forum**
Accounting – (Overview) – 1.5 credit hours
Moderator: Phil Jacoby, American University
The Effect of Undergraduate and Graduate Tax Courses on Student Perceptions of the Ethics of Tax Evasion: A Research Note, A. Blair Staley, Bloomsburg University of Pennsylvania; Donald T. Williamson, American University.
Task Control and the Carolina's Tidal Rice Culture of the 1840's, Louis J. Stewart, Howard University.
The Fiscal Aspects of a DOA Structure – The Connecticut Experience, Janet F. Phillips, Daniel S. Hennig, Andrew A. Steel, Southern Connecticut State University.
Costing Methodologies to Unbundle Nursing Costs: Should Nursing Cost be an Independent Predictor of Total Hospital Reimbursement, Expenditures and Financial Performance? Bea Chiang, The College of New Jersey.
- 1:30 pm – 3:00 pm **3E. Taxation**
Taxation – (Advanced) – 1.5 credit hours
Moderator: Roland Lipka, Temple University
Transparency, Simplicity & Corporate Income Tax, Suzanne Luttmann, Santa Clara University.
Variability of Book-Tax Differences, Information Uncertainty, and Implied Cost of Capital, Dan S. Dhaliwal, University of Arizona; Robert E. Huber, University of Arizona; Hye Seung "Grace" Lee, University of Arizona; Morton Pincus, University of California, Irvine.
Tax Reform Tradeoff: An Examination of the Repeal of the State and Local Income Tax Deduction to Pay for the Repeal of the Alternative Minimum Tax, Benjamin Silliman, The Peter J. Tobin College of Business, St. Johns University.
- 1:30 pm – 3:00 pm **3F. Accounting, Behavior and Organizations**
Accounting – (Advanced) – 1.5 credit hours
Moderator: Stephen Fogg, Temple University
Strategic Organizational Culture as a Component of Risk Management, Regan Garey, Immaculata University.
Ethics Mindsets: New and Old, Alan Reinstein, Wayne State University; Martin A. Leibowitz, Yeshiva University.
The Impact of CIO Appointments on Long-Term Performance and Productivity of R&D Investments, Ashraf Khallaf, American University of Sharjah; Terrance R. Skantz, Florida Atlantic University.
- 3:00 pm – 3:30 pm **Coffee Break**
Sponsored by Ivy Publishing
- 3:30 pm – 5:00 pm **Session 4: Concurrent Paper & Panel Sessions**
4A. Financial Accounting and Reporting
Accounting – (Advanced) - 1.5 credit hours
Moderator: Loretta Baryeh, Towson University
Is FASB 123R Better Accounting for Equity Based Compensation?, John D. Rossi, Moravian College.
Quality of Internal Control Over Financial Reporting, Corporate Governance and Credit Ratings, Mohamed Elbannan, Cairo University, Egypt.
Earnings-Return Association in an Emerging Market: An Empirical Analysis from Abu Dhabi Securities Market, Fatima Alali, California State University Fullerton; Paul Sheldon Foote, California State University.

3:30 pm – 5:00 pm

4B. Managerial Accounting

Accounting – (Advanced) – 1.5 credit hours

Moderator: Marge O'Reilly, Rider University

System Integration and Performance Measurement: An Empirical Study of System Integration to Facilitate the Balanced Scorecard in the Healthcare Organizations, Bea Chiang, The College of New Jersey.

A New Framework for Capacity Costing & Inventory Variances, Massood Yahya-Zadeh, George Mason University.

3:30 pm – 5:00 pm

4C. Teaching and Curriculum Accounting – (Overview) – 1.5 credit hours

Moderator: Jeannie Welsh, LaSalle University

A Preliminary Investigation of the Necessary Skills, Education Requirements, and Training Requirements for Forensic Accountants, Dorothy A. McMullen, Rider University, Maria H. Sanchez, Rider University.

Financial Literacy for All, Shifei Chung, Rowan University; Ramesh Narasimhan, Montclair State University.

Double Entry: Linking Introductory Financial Accounting and English Composition, Bruce Leauby, LaSalle University.

3:30 pm – 5:00 pm

4D. Public Interest

Accounting – (Advanced) – 1.5 credit hours

Moderator: John Fleming, Loscalzo Associates, PA

Does Separating the Positions of CEO and Board Chair enhance firm value? Steven Balsam, Temple University; Arun Upadhyay, University of Alaska.

An Accounting Solution To The Health Care Crisis, Philip F. Jacoby, American University; Brent T. McCallum, American University.

The Effect of Related Party Transactions on CEO compensation, Steven Balsam, Temple University; Richard Gifford, State University of New York – College at Geneseo.

3:30 pm – 5:00 pm

4E. Accounting, Behavior and Organizations

Accounting – (Advanced) – 1.5 credit hours

Moderator: Tracey Riley, University of Massachusetts

CEO Shareholder Conflicts and Large-Scale Information Technology Outsourcing Decisions, James A. Hall, Lehigh University; Stephen Liedtka, DeSales University.

The Information Content of Sales, Lianzan Xu, William Paterson University of New Jersey; Francis Cai, William Paterson University of New Jersey.

Assessing Students' Ethicality Using a Corporate Code of Ethics, Obeua S. Persons, Rider University.

3:30 pm – 5:00 pm

4F. International Accounting

Accounting – (Advanced) – 1.5 credit hours

Moderator: Athar Murtuza, Seton Hall University

Investing in the Gulf Countries: Global Tax Issues, Wagdy Abdallah, Seton Hall University.

Earnings Management and Cultural Values, Kurt A. Desender, Autonomous University of Barcelona; Christian E. Castro, Inter-American Development Bank (IADB)/ Autonomous University of Barcelona; Sergio A. Escamilla de Leon, Autonomous University of Barcelona.

Corporate Governance & Corporate Dividend Policies in Egypt, Sabri El-Segini, University of Sharjah, United Arab Emirates and Omneya Abd-Elsalam, American University in Sharjah, United Arab Emirates.

3:30 pm – 5:00 pm

4G. Financial and International Accounting

Accounting – (Advanced) – 1.5 credit hours

Moderator: Joe Shangguan, Robert Morris University

A Shift in the Income Effect of Changes in Accounting Principles: 1993-2003 Time Period, Jalal Soroosh, Loyola College in Maryland; *Hong Zhu*, Loyola College in Maryland. *R&D Investment around CEO Turnover*, Jing (Crystal) Xu, Boston University. *International Diversification, Industrial Diversification, & CEO Salary*, Hwei Cheng Wang, Alabama A&M University; *Sekhar Anantharaman*, Indiana University of Pennsylvania, *Young-I Lou*, Nan Hua University.

5:30 pm – 7:00 pm

Reception

7:00 pm – 8:00 pm

Ice Cream Social

Sponsored by AAA Teaching & Curriculum Section.

Free for T & C Section members; \$10 for non-members or join the Section for \$10 and attend the social for free.

Saturday, April 26, 2008

7:00 am – 11:30 am

Registration

7:30 am – 8:30 am

Continental Breakfast

8:30 am – 10:00 am

Concurrent Sessions and Panels

S1A. Financial Accounting and Reporting I

Accounting – (Advanced) – 1.5 credit hours

Moderator: Ramesh Narasimhan, Montclair State University

Learning the lesson: Do firms become more conservative in financial reporting after financial restatements? Rongbing Huang, Kennesaw State University; *Joe Z. Shangguan*, Robert Morris University.

Value Relevance of Earnings & Non-Earnings Information, Samir El-Gazzar, Philip M. Finn, Charles Tang

Institutional ownership, Internal control material weakness & Firm Performance, Li Xu, Alex Tang, Morgan State University.

8:30 am – 10:00 am

S1B. Financial Accounting and Reporting II

Accounting – (Advanced) – 1.5 credit hours

Moderator: Shifei Chung, Rowan University

The Relation between Earning Informativeness, Earnings Management and Corporate Governance in the Pre- and Post-SOX periods, Jui-Chin Chang, Morgan State University; *Huey-Lian Sun*, Morgan State University.

The Effect of Regulation Fair Disclosure on the Relationship between Analysts' Forecast Performance and Restructuring Events, Rong Yang, SUNY - College at Brockport.

Evidence that Companies are not Analyzing Goodwill for Impairment as Required by SFAS142, David Vance, Rutgers University School of Business Camden.

- 8:30 am – 10:00 am **S1C. Research and Teaching Strategies**
Accounting – (Overview) – 1.5 credit hours
Moderator: Jim DiGabriele, Montclair State University
Developing Financial Accounting Research Skills, Mary Jeanne Welsh, La Salle University.
Comedy 101- A simple way to use laughter to increase students' interest in accounting, Raymond J Elson, Valdosta State University; Susanne O'Callaghan, Pace University; John P Walker, Queens College/CUNY.
The Group-Account, Item Characteristics (GAIC) Method of Learning Financial Accounting, Joseph A. Mauriello, New York University.
- 8:30 am – 10:00 am **S1D. Auditing and Teaching**
Auditing – (Advanced) – 1.5 credit hours
Moderator: Robert Dunlevy, Montgomery County Community College
"Is the Market Valuation of Banks' Loan Loss Provision Conditional on Auditor Reputation," Gopal V. Krishnan, George Mason
"Integrating Personal Finance Concepts into the Financial Accounting Course," Andy Lafond, Philadelphia University, Barbara Vinciguerra, Moravian College.
"A New Use for an Old Classic Approaching Birch Paper Company Case as a Response to Pedagogical Overload," Athar Murtuza, Wagdy Abdallah; Theresa F. Henry, Seton Hall University.
- 8:30 am – 10:00 am **S1E. Managerial Accounting**
Accounting – (Advanced) – 1.5 credit hours
Moderator: Mark Aquilio, St. John's University.
The Role of Non-Financial Performance Measures in Compensation Contracts in the Curtailment of Earnings, Salma Ibrahim, Morgan State University.
Mapping, Measurement and Alignment of Strategy using the Balanced Scorecard: The Tata Steel Case, George Joseph, University of Massachusetts Lowell.
The Impact of EVA Adoption on Long Term Shareholder Value: an Empirical Approach, WaQar I. Ghani, Saint Joseph's University; Samuel H. Szewczyk, Drexel University.
- 8:30 am – 10:00 am **S1F. Teaching and Curriculum**
Accounting – (Overview) – 1.5 credit hours
Workshop: "Using CoBit in an Accounting Information Systems Course" presented by Stephen Fogg, Temple University
The various components of CobiT (Control Objectives for IT), developed by the Information Systems Audit and Control Association (ISACA), provides a framework for measuring good practices in an IT environment that complements but does not supplant COSO. Unlike the U.S.-based COSO Internal Control Framework, CobiT has become an internationally-recognized set of standards for good internal control practices. The ISACA organization provides several free publications for use in education, including IT Governance Using CobiT and Val IT Student Book, as well as a model curriculum to aid educators in designing programs in accounting and management information systems. The presenter will give an overview of the CobiT framework and how it can be used in an accounting information systems course and discuss other resources that can be obtained from ISACA.

8:30 am – 10:00 am

S1G. CPE Workshop: Teaching and Curriculum

Accounting – (Overview) - 4.0 credit hours

An Introduction to XBRL

The objective of this workshop is to introduce accounting educators to XBRL (eXtensible Business Reporting Language) and the family of technologies being developed to support business reporting and the “publication, exchange and analysis of complex financial information.” XBRL is an XML (eXtensible Markup Language) specification for identifying and communicating financial information in business reports. XBRL now includes taxonomies for financial reporting in US GAAP as well as International Financial Standards, accounting transactions, and related other business reporting activities. It is being developed by a consortium of over 400 companies and agencies worldwide including the AICPA, all major accounting firms, and most professional accounting organizations. The SEC is currently upgrading the Edgar database to handle XBRL financial reports and is expected to begin the transition to reporting in XBRL format for all registrant companies in 2008. Topics covered in this workshop will include at least the basic XML family of technologies, building and working with XBRL documents, understanding XBRL schemas and taxonomies, classroom applications, and XBRL software tools. No prior knowledge of XBRL is expected. Workshop participants will work with classroom tested applications.

Presenter: Clinton (Skip) White, Professor and MIS Area Coordinator, Department of Accounting & MIS, University of Delaware.

10:00 am – 10:30 pm

Coffee Break

10:30 am – 12:00 pm

S2A. Financial Accounting and Reporting

Accounting – (Advanced) – 1.5 credit hours

Moderator: Nancy Uddin, Monmouth University

Institutional Investing Activities and Firms’ Information Environments, Before and After Sell-Side Analyst Coverage Initiation and Termination, Li Xu, Morgan State University.

Are Reconcilable Differences between Segment-Level and Firm-level Earnings

Informative? Dana Hollie, University of Colorado at Boulder; Robin Tarpley, George Washington University; Shaokun Carol Yu, Northern Illinois University.

CEO Incentives and Earnings Management: The Impact of Research Design Choices, Steven Balsam, Temple University; Wei (Alan) Jiang, State University of New York.

10:30 am – 12:00 pm

S2B. Teaching and Curriculum

Accounting – (Overview) – 1.5 credit hours

Workshop: “Using the Alumni Factor to Enhance the Accounting Curriculum”

presented by Deborah Smiach Zakrzewski, University of Pittsburgh at Johnstown

The workshop will center around the establishment of an Accounting Alumni Advisory Board and its value to a university. One way to create a connection with alumni and current students is to have a venue for both to attend and to participate in. Handouts will include information on creating a mission statement, forming active committee’s and project development. This workshop should be valuable for any faculty looking to form or reinvigorate an accounting advisory board for their department.

- 10:30 am – 12:00 pm **S2C. Teaching and Research Forum**
 Accounting – (Advanced) - 1.5 credit hour
Deficiencies Noted in PCAOB Inspections: Implications for Auditing Instruction, Bernard H. Newman, Mary Ellen Oliverio, Pace University.
Earnings Management and Deregulation: The case of Motor Carriers, Seong-Yeon Cho, Oakland University, Kevin Sachs, Hofstra University.
Why A Micro-Profit Center Manager is More Motivated:Prospect Theory Explains, Eiichiro Suematsu, Saitama University.
Evaluating the SEC Review of Commercial Banks: Evidence from Comment Letters, Victor Valdivia, Towson University.
Identity Theft and the Musical Profession, Peter Oehlers, West Chester State University; Paul Oehlers, American University.
- 10:30 am – 12:00 pm **S2D. Taxation and Public Interest**
 Accounting – (Advanced) – 1.5 credit hours
Moderator: Jim DiGabriele, Montclair State University
The Work Product Privilege is Held to Protect Tax Accrual Work papers from the Reaches of an IRS Summons, Mark Aquilio, St. John's University.
Managing Risk of Credit Card Default, Alvino J. Massimini, LaSalle University.
Evaluating costs & Benefits of an In-house Smoking Cessation Program, Barbara Woods McElroy, Susquehanna University; Daniel Derr, Director Clinical Outcomes Group
- 10:30 am – 12:00 pm **S2E. Not For Profit Accounting and Managerial Accounting**
 Accounting – (Advanced) - 1.5 credit hours
Moderator: Wagdy Abdallah, Seton Hall University
A Predictive Model of Fiscal Distress in Local Government, John Trussel, Pennsylvania State University at Harrisburg; Patricia A. Patrick, Shippensburg University.
Impact of Board Characteristics on Non-profit organizations, Erica Harris, Steven Balsam, Temple University.
The Deployment of Contemporary Management Accounting Practices and Performance Measurement in Canadian Companies: A Contingency Approach, Raili Pollanen, Carleton University; Ahmed Abdel-Maksoud, University of Sharjah.
- 10:30 am – 12:00 pm **S2F. CPE, continued (Continuation of S1F)**
 Accounting – (Overview) - 4 credit hours
- 12:00 pm – 2:00 pm **Mid-Atlantic Region Steering Committee Meeting**

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