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# RECENT TAX LAWS AND TAX PLANNING FOR SMALL BUSINESSES

**Janet L. Dye, University of Alaska Southeast**
jfjld@uas.alaska.edu

## ABSTRACT

*Congress has passed several major tax bills in the last few years which reformed retirement plans, added health savings accounts, mandated electronic filing by businesses, extended earlier tax cuts, changed the "kiddie" tax and altered estate taxes. While the new laws limited some of the common tax minimization techniques currently in use, they also created new possibilities for tax savings. This paper examines the ramifications of these changes for tax planning by small business owner*

# THE IMPACT AND EFFECT OF THE SARBANES OXLEY ACT ON THE INTERNAL AUDIT PROFESSION: CHIEF AUDIT EXECUTIVES' PERSPECTIVES

**Raymond J Elson, Valdosta State University**
relson@valdosta.edu
**Michael Lynn, AXA Technology**
Michael.Lynn@AXA-Tech.com

## ABSTRACT

*The Sarbanes Oxley Act of 2002 (specifically Section 404) requires management to assess the effectiveness of internal financial controls and instructs auditors to report on whether the controls are adequate or have material weaknesses. The Sarbanes Oxley Act ("SOX") has increased the focus on internal audit departments as a key partner in assisting management and the board of directors (especially audit committees) in fulfilling their corporate governance activities. Using a questionnaire, we conducted a study of chief audit executives (CAEs) within the insurance industry to obtain their perspectives on the impact and effect of SOX on their departments and profession. We were primarily interested in their involvement in the initial implementation and ongoing SOX compliance efforts, and any change in their departments' missions. We were also interested in the CAEs opinions on the role of internal audit in the future especially in light of SOX.*

*We received feedback from 35 (35.4 percent) CAEs representing organizations and audit departments of various sizes. The results showed that most internal audit departments were impacted by SOX in that they allocated significant resources to assist management in the initial Section 404 compliance efforts. The CAEs expected to expend similar efforts on future compliance efforts. Some departments also increased their mission to include corporate governance activities such as reviewing the company's ethics and business conduct and legal and regulatory compliance; areas not previously included in audit plans. CAEs could not fully articulate the future role of internal audit and no clear vision was provided. Responses received included expecting the function to remain unchanged, assisting management and the board of directors in corporate governance activities, and becoming more involved in enterprise risk management efforts.*

*Clearly internal audit departments were impacted by SOX and their missions continue to change to address emerging risks in the organization. However, the future role of internal audit was not clear perhaps because organizations continue to adjust to the new regulation. We recommend that researchers continue to focus on understanding changes in the internal audit function within organizations and its continuing evolution in response to SOX and other regulations.*

# DO FIRMS MANAGE THEIR EARNINGS PRIOR TO FILING FOR BANKRUPTCY?

**Robert Leach, University of South Carolina – Aiken**
**Paul Newsom, Valparaiso University**

## ABSTRACT

*We investigate the earnings management behavior of firms that file for bankruptcy and find that firms, which eventually file for bankruptcy, attempt to manage their earnings in order to make their financial statements appear more favorable overthe years prior to filing for bankruptcy. Eventually, as the need to file for bankruptcy becomes imminent, they reverse their earnings management. More interestingly, the earnings management behavior of those bankrupt firms convicted of fraud versus those not convicted of fraud is different. Whereas non-fraudulent bankrupt firms reverse their earnings management prior to filing, fraudulent bankrupt firms do not. We also compare the earnings management behavior of bankrupt firms to an industry matched control sample. We find that the control firms do not engage in similar earnings management, even though they too are experiencing similar stock price performance and are of similar size.*

# USING THE SEC "BULLY PULPIT" TO ALTER REPORTING BEHAVIOR: THE CASE OF ARTHUR LEVITT ON IN-PROCESS RESEARCH AND DEVELOPMENT

**Gyung Paik, Brigham Young University**
**Jacob Findlay, Deloitte Touche**

## ABSTRACT

*In 1998, Arthur Levitt, then chairman of the United States Securities and Exchange Commission (SEC), claimed (and warned) in a public address that companies making an acquisition frequently allocated overly-large amounts of the purchase price to in-process research and development (IPR&D) instead of goodwill. (The result was a one-time charge in the first year followed by several unrealistically rosy years of earnings that were not disturbed by the amortization of goodwill.) This study investigates the impact of Levitt's warning by showing that in the three years after his claim the amount firms allocated to IPR&D dropped significantly and the amount allocated to goodwill and other intangibles increased significantly. Moreover, more-profitable firms began taking bigger IPR&D charges and less-profitable firms began taking smaller charges. This study illustrates the effective use of a "regulatory bully pulpit" to promote compliance with regulatory requirements.*

**Keywords:** Financial Accounting, regulation, in-process research and development (IPR&D), earnings management

## AUTHORS' NOTES

We wish to thank Ted Christensen, Richard Dalebout, Peter Johnson, and Kay Stice at Brigham Young University.

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

# BUT DOES STYLE REALLY MATTER?

**Grady Perdue, University of Houston—Clear Lake**

**ABSTRACT**

*Ever since the groundbreaking work of Harry Markowitz (1952, 1959), investors and professional portfolio managers have sought to reduce the risk of portfolios by seeking out improvements in diversification. Following Aesop's still sage advice to "not put all of your eggs in one basket," investors have regularly searched for the means to better diversify. Investors now seek to diversify across international boundaries, between asset classes, and within asset classes.*

*One of the means of diversification within asset classes is to diversify between styles of investing. Today many investors seek not only to invest in equities, but they make significant distinctions between value and growth investing. Distinctions are also made between large, middle and small capitalization companies. This use of style investing in a portfolio is so common that style boxes have become a well-accepted mechanism to explain the orientation of the portfolio strategy being employed by the investment manager.*

*But does style really matter? How much risk reduction is really obtained by shifting a portion of the equity assets allocated to a core holding (such as the S&P 500 index) to a targeted style-based allocation, such as small capitalization value or middle capitalization growth? And if there is any risk reduction in the portfolio resulting from such a reallocation, is the risk reduction substantive enough to justify the added search and management costs associated with adding the style-based allocation?*

*This study analyzes the implications for risk reduction that result from shifting assets from an equity core allocation to targeted style-based equity allocations. This analysis starts with a basic portfolio comprised of an equity index (the S&P 500), a domestic bond index, and a cash allocation. Then various allocations are made from the equity core allocation to targeted style-based equity market indexes that represent various sub-sets of the equity market (e.g., small capitalization value or middle capitalization growth). The impact on total portfolio risk resulting from these targeted style-based allocations, are then analyzed.*

# THE EFFECTS OF SARBANES-OXLEY ON EARNINGS FORECASTS

**Ronald A. Stunda, Birmingham-Southern College**
rstunda@bsc.edu

## ABSTRACT

*This research tests whether there is any impact on voluntary earnings disclosures released after the implementation of the Sarbanes-Oxley Act of 2002. In July of 2002, the Sarbanes-Oxley Act was signed into law. This act applies in general to publicly held companies and their audit firms and provides for greater restrictions on, among other things, audit firm quality control and the attestation process of accounting related data. Many believe this Act will tighten controls over the quality of accounting information released to the public. Others have a more narrow view that the Act will bring about a higher quality of earnings release, and therefore reflect less bias by the reporting company. This study assesses the impact of Sarbanes-Oxley on voluntary management forecasts in terms of bias and information content. Voluntary forecasts in a "pre" Sarbanes-Oxley environment are compared to voluntary forecasts of the same companies in a "post" Sarbanes-Oxley environment. Findings suggest that forecasts tend to significantly differ during a " post" environment. There tend to be more conservative forecasts issued in a "post" environment than in a "pre" environment. In addition, the voluntary forecasts issued in a "post" environment contain significantly more information content when compared to a "pre" environment. With increasing numbers of publicly-held firms implementing the Sarbanes-Oxley rules, these findings have practical implications on users of forecast information.*

# ACCOUNTING FOR CONTRACTS ON EQUITY INSTRUMENTS OF AN ENTITY APPLYING INTERNATIONAL ACCOUNTING STANDARDS 32

**Sankaran Venkateswar, Trinity University**
svenkate@trinjity.edu

## Introduction

International Accounting Standards 32 (IAS 32) establishes the principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities. IAS 32 applies to contracts to buy or sell a non-financial item that can be settled net in cash or another financial instrument, or by exchanging financial instruments, as if the contracts were financial instruments, with the exception of contracts that were entered into and continue to be held for the purpose of the receipt or delivery of a non-financial item in accordance with the entity's expected purchase, sale or usage requirements. (paragraph 8)

## Definitions

A *financial instrument* is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

A *financial asset* is any asset that is:

a. cash
b. an equity instrument of another entity
c. a contractual right:
   (I). to receive cash or another financial asset from another entity; or
   (ii). to exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
d. a contract that will or may be settled in the entity's own equity instruments and is:
   (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
   (ii). a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own financial instruments.

A *financial liability* is any liability that is:

a. contractual obligation
   (i). to deliver cash or another financial asset to another entity: or
   (ii). to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
b. a contract that will or may be settled in the entity's own equity instruments and is:
   (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii). a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

An *equity instrument* is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. (paragraph 11)

The paper illustrates the application of IAS 32 on accounting for contracts on equity instruments of an entity.

# THE IMPACT OF SARBANES-OXLEY ACT ON COSMETIC EARNINGS MANAGEMENT

**June Y Aono, University of Hawaii at West Oahu**
**Liming Guan, University of Hawaii at Manoa**

## ABSTRACT

*This study examines the mitigating effect of Sarbanes-Oxley Act on cosmetic earnings management, referred by Kinnunen and Koskela (2003) as earnings manipulative behavior to round earnings such that they result in an upward bias. This behavior reports income numbers to achieve key cognitive reference points represented by N x 10k. Using Benford's law, our analysis compares the distribution of second digits in reported annual earnings for publicly listed U.S. companies between the two-year periods before and after the year 2002 when Sarbanes-Oxley Act went into effect. Our empirical results suggest that, in the two-year period prior to the Act, there was evidence of cosmetic earnings management. However, such behavior in manipulating earnings has noticeably decreased in the period after the Act. This finding is consistent with the notion that Sarbanes-Oxley Act has a deterring impact on corporate America's manipulative behavior to report earnings that achieve certain key reference points.*

*Key words: Sarbanes-Oxley Act, Cosmetic Earnings Management, Benford's Law*

*Data Availability: Data used in the study are from public sources and are available upon request.*

# ECONOMICS FACTORS AND REAL ESTATE VALUE

**Stephen C. Caples, McNeese State University**
**Michael E. Hanna, University of Houston-Clear Lake**
hanna@uhcl.edu

## ABSTRACT

*Two very important economic factors impacting the changes in real estate values are the employment levels and mortgage interest rates. Specifically the value of single-family residential property was studied. To investigate the impact of these variables, data were collected from 1979 to 2005 on residential sales in a medium-sized city in Louisiana. Included were the selling prices, asking prices, interest rates, number of people employed, and the unemployment rate for these years. The selling prices were adjusted for inflation before the statistical tests were performed. The objective was to determine how the final selling price of a house is impacted by the above economic variables. The data was analyzed and the results confirmed the original hypotheses concerning the variables.*

# A REVIEW OF INDIVIDUAL, BUSINESS AND CORPORATE TAX REVISIONS PROVIDED BY THE TAX INCREASE PREVENTION AND RECONCILIATION ACT

**Janice L. Klimek, Central Missouri State University**
klimek@cmsu.edu

## ABSTRACT

*Congress recently passed the Tax Increase Prevention and Reconciliation Act. Two major components of the law affect individuals. The first is a two-year extension of investor tax breaks for capital gains and qualified dividend income. The second is a one-year extension of alternate minimum tax relief for individuals. In addition to the individual components, the Act also contains provisions that affect both business and corporate taxpayers.*

*The changes that affect businesses and corporations include an extension of increased Section 179 expensing limits, revised limitations on the amount of Section 199 domestic production deduction allowed. It also provides for a two-year extension of the "active financing exemption" and adds some temporary exceptions related to controlled foreign corporations (CFCs). The law allows an alternative 5-year expensing treatment for certain costs incurred in creating or acquiring musical works and copyrights, instead of the previous income forecast method of accounting for these expenses. Corporate effects include a simplification of the active business test used in tax-free corporate spin-offs.*

*To fund the tax relief described above, the Tax Increase Prevention and Reconciliation Act includes several revenue-raising provisions. The provisions include a modified schedule of estimated tax payments for corporations with assets of over $1 billion and required partial payments to the IRS with offers in compromise. It denies tax-free treatment to certain spin-offs involving disqualified investment corporations and requires amortization of certain geological costs over 5 years instead of 24 months for major integrated oil companies.*

*This presentation will describe in detail the most important tax changes enacted as part of the Tax Increase Prevention and Reconciliation Act. In addition, the impact of such changes on taxpayers will be addressed. This review is important to all investors, to individuals who may potentially be subject to the alternative minimum tax, to taxpayers who own businesses and to corporations because of possible changes in expenses allowed under the new law. Academics who teach taxation will also benefit from a review of the new tax provisions.*

# A COMPARISON OF INCOME PRODUCING STRATEGIES FOR RETIREES

**Jo Lynne Koehn, Central Missouri State University**
koehn@cmsu.edu
**Janice L. Klimek, Central Missouri State University**
klimek@cmsu.edu

## ABSTRACT

*Historically, a "secure seat" in retirement was built on the legs of retirement savings, Social Security, and private pensions. Recent developments are impacting all three legs, making the retirement stool less steady. Securing retirement savings has challenges for fixed income savers and equity investors. Low interest rates have curtailed income levels for fixed income investors. Equity investors are being advised to lower expectations. Retiring employees are discovering that pension benefits may not be distributed as promised. This article compares two income production strategies available for near-retirees. A traditional fixed annuity approach is contrasted with a laddered savings bond strategy.*

*In financial planning, every client's needs are unique. Therefore, the best income generation strategy for each client will depend on the individual situation. The two basic strategies compared in this paper are not equally suitable for all retirees. The retiree will have to actively manage which bonds (and in what denominations) should be redeemed to maximize earnings given prevailing interest rates. There is no guarantee of lifetime income with the savings bond approach. However, there are no fees to the savings bond strategy. In addition, the retiree does not lose principal associated with unredeemed bonds at the time of death, so substantial assets may remain at death for distribution to heirs.*

*Another retiree may not prefer as much involvement with the income generation process on a month-to-month basis during retirement. A one-time purchase of an immediate fixed annuity upon retirement (or perhaps an enhanced annuity insurance product) may be appealing. Even though fees, surrender charges, and inflation-related risks exist, the retiree will gain the security of a lifetime income stream. Risk-averse retirees may be willing to exchange their savings for an annuity with such an income assurance.*

*This comparison of income producing strategies is important to near-retirees because it details the positive and negative aspects of two popular methods of achieving financial stability in retirement. Academics who teach taxation, investments and financial planning will also benefit from a review of these strategies.*

# BULLETPROOFING SPECIAL ALLOCATIONS

**Michael L. Holland, Valdosta State University**
mholland@valdosta.edu

## ABSTRACT

*Partnerships are attractive investment vehicles because they are not taxable entities and because partners generally have the ability to allocate any item of income, gain, loss, expense or deduction among themselves as they wish.*

*The ability to allocate losses, or for example, all depreciation deductions to one partner has, however, lead to taxpayer abuses. To curb these abuses, Congress and the Internal Revenue Service (IRS) have placed limits on special allocations. The congressionally mandated criterion is that the allocation have "substantial economic effect." The criteria for successful special allocations continue to evolve in Regulation Section 1.704 and case law. Although the Regulations are lengthy and difficult, the benefits of properly structuring the special allocations can be well worth the effort.*

*The Regulations provide that the determination of substantial economic effect consists of a two part analysis that is made at the end of the partnership taxable year to which the allocation relates. First, the allocation must have economic effect. Second, the economic effect must be substantial.*

*To have "economic effect" a partner's capital balance must be adjusted for allocations and distributions and the liquidation of a partner's interest must be based on the readjusted capital account balance with any deficit balance restored by the partner.*

*To be "substantial", there must be a reasonable possibility that the allocation will materially affect the dollar amounts to be received by the partners from the partnership, independent of tax consequences. The economic effect is not "substantial" if, at the time the allocation becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences of the allocation were not contained in the partnership agreement; and the after-tax position of no partner will be diminished. Therefore, allocations that clearly help one partner while not adversely affecting the others are very suspect if the results are predictable. Allocations could be held to be insubstantial if partners are in different tax brackets and the allocations are made to take advantage of the rate difference or if a predictable income stream is allocated to a partner for two years (with the subsequent two years to the other partners) so that the partner's expiring net operating loss deduction can be utilized (a timing shift). An allocation which provides a larger share of tax-exempt income to a higher bracket partner probably lacks substantiality (a rate shift).*

*This paper will discuss the regulatory requirements and the opportunities for successfully shifting tax benefits between partners as well as opportunities for successfully shifting the timing of tax liabilities (tax deferral).*

# THE CHANGING BOARD OF DIRECTORS: NEW REGULATIONS AND FIRM PERFORMANCE

**Sharon K. Lee, Western New England College**
slee@wnec.edu
**Loring R. Carlson, Western New England College**
lcarlson@wnec.edu

## ABSTRACT

*With the enactment of the 2002 Sarbanes-Oxley Act, more attention has turned to the composition and size of corporate boards of directors. The Securities and Exchange Commission and stock markets have created stricter rules and guidelines concerning the structure and independence levels of corporate boards. The directors are responsible for ensuring that management acts in the best interest of the shareholders. Many believe that independent directors would be more likely to effectively monitor and perhaps challenge management if needed. The presence of outside or independent directors may decrease agency costs experienced by most firms, and should increase the overall performance and value of the firm. With the new regulations, we have seen an increase in the number of independent board members and a decrease in the average size of boards.*

*This study of S & P 500 firms shows that firms with the most independent boards in the sample perform significantly better than firms with less independent boards. Specifically, firms with boards that are composed of at least 75% independent directors have significantly higher firm performance, as measured by industry-adjusted Return on Assets (ROA) measures. These higher-performing firms also have significantly lower insider ownership holdings. In existing literature on optimum board sizes, using samples before the new regulations, there is an inverse relationship found between board size and firm performance. However, in our sample that inverse relationship between board size and firm performance is not found using our recent sample. With the overall increase in independence levels, it appears that boards have become more objective and efficient in their monitoring of management, irrespective of board size.*

# MANDATORY AUDIT FIRM ROTATION: EVIDENCE FROM ILLINOIS STATE UNIVERSITIES

**Trisha N. Simmons, Southern Illinois University, Edwardsville**
tsimmons@siue.edu
**Linda M. Lovata, Southern Illinois University, Edwardsville**
llovata@siue.edu
**Michael L. Costigan, Southern Illinois University, Edwardsville**
mcostig@siue.edu

## ABSTRACT

*Section 207 of the Sarbanes-Oxley Act of 2002 commissioned the GAO to conduct a study of audit firm rotation. That report surveyed stakeholder groups and was issued in November of 2003. The report identified strengths and weaknesses of mandatory audit firm rotation as specified by the various constituencies, but made no specific recommendations. Instead, they suggest that the SEC monitor the effectiveness of other provisions of SOX and revisit the role of mandatory audit firm rotation at a later date if necessary.*

*The State of Illinois requires all its agencies to be audited annually by the Illinois State Audit Act who hires special assistant auditors. The special assistant auditors are external, independent certified public accountants who conduct financial and compliance audits of the state agencies. By law, the each agency must change special assistant audit firms every six years. This provides a unique opportunity to investigate the behavior of auditors in a mandatory audit firm rotation environment.*

*The State of Illinois issues a report summarizing the audited financial statements not only by number of findings, but also repeated findings, along with a brief description of the most significant findings. Data for fiscal years ending June 30, 1994 through 2005 from these "Report Digests" were obtained from the Illinois Office of the Auditor General for each of the nine universities. There were thirteen full audit cycles to compare amongst the nine universities. Although the standard rotation policy is every six years, there were four separate instances where the auditor changed after only four years. These unscheduled changes were to establish a staggered rotation schedule to allow the Illinois Auditor General's office a reprieve from having to coordinate the bid process for all nine universities in the same fiscal year. The sample, therefore, includes seventeen mandatory auditor rotations.*

*The results of this research indicate that more findings are reported the in the first year under the new auditor. This implies that auditors in the first year do have the expertise to adequately audit the university. It may be that a fresh look initiates different audit findings or that auditors are more rigorous in the first year of an audit. Also, the fewest number of findings are reported in the last year of the audit prior to mandatory audit firm rotation. This suggests that either the auditor is less diligent in the last year or that over the course of the auditor's tenure, the university was able to correct prior audit findings.*

*The mandatory audit rotation requirement of the State of Illinois allows us to investigate audit behavior in this environment. Due to the bid process required by the State, the behavior may differ in a corporate setting, but this research suggests that the number of audit findings changes over the life of an audit cycle with more findings reported early in the cycle and fewer before the auditor change is inevitable.*

# GAIN ON SALE ACCOUNTING: THE IMPACT ON SELECTED FINANCIAL RATIOS

**Roberto Marchesini, University of Houston-Clear Lake**
**Joseph McCormack, University of Houston-Clear Lake**
mccormack@uhcl.edu
**Jan Morris, University of San Diego**

## ABSTRACT

*In June, 1996, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities.1 This document develops accounting standards for sales, securitizations, servicing of receivables and other financial assets, and for extinguishment of liabilities. Although the transfer of assets in which the transferor has no continued involvement was never too controversial a topic, in recent years new instruments have appeared in the financial markets that have stretched the concept of involvement. For instance, pledges of collateral, recourse, servicing, and options written or held are all transactions listed in SFAS 125 that require continuous involvement by the transferor. The transfer of these assets raises the question of whether the transfer should be considered a sale of all or part of the assets or a secured borrowing. The effect of the decision to treat the transfer as a sale or a secured borrowing on financial analysis, particularly on selected financial ratios, can be significant.*

*Although one could take issue with the accounting treatment offered this type of transaction, it is important to recognize the distortions introduced in a direct comparison between a firm that retains its assets/receivables and one that securitizes them. For a firm that holds its receivables for investment, an increase in "sales/originations" will have a positive effect on earnings. The increase, however, is initially less than that for a firm using gain on sale accounting. The profitability of the sales/origination transaction is spread over its average life, which is typically greater than one year. For a firm that uses gain on sale accounting, the profit, from what is essentially a multi year receivable, is taken immediately.*

*Overall, it would appear that different accounting methods have created profound differences for firms that do and do not avail themselves of the asset backed markets. Such differences constitute a challenge for the financial analyst and may create some initial confusion for direct firm comparisons. Industry standards will become less useful until they are separated for the two accounting methods.*

# THE CHANGE IN THE BEHAVIOR OF ODD-LOT SHORT SELLERS

**Barry R. Marks, University of Houston-Clear Lake**
**Joseph P. McCormack, University of Houston-Clear Lake**
mccormack@uhcl.edu

**ABSTRACT**

*Technical indicators of individual investor behavior using odd-lot short selling have been widely studied. Contrarians employ these indicators in their investment strategies because they feel that individual investors who utilize odd-lot short selling tend to get into or out of the market at precisely the wrong times. These technical indicators have even appeared in popular investments textbooks. The current study indicates that these indicators are no longer valid indicators of individual investor behavior.*

*Daily odd-lot short selling is examined for the period 1970 through 1995 using a generalized autoregressive conditional heteroscedatic (GARCH) model. Results for the period 1970 through 1985 are consistent with previous studies of individual investor behavior. Both a day of the week effect and a turn of the year effect were present. Additionally, odd-lot short selling was significantly related to the previous day's price change.*

*Results for the period 1986 through 1995 differ significantly from the earlier period. The evidence indicates that individual investors no longer dominate this market. Professional traders now dominate this market. Neither the day of the week effect nor the turn of the year effect were statistically significant, and odd-lot short sales were not related to the previous day's price change.*

# MANAGING PENSION EXPENSE FOR MANAGED EARNINGS: WHY FASB IS RETHINKING PENSION STANDARDS

**Paula Diane Parker, University of South Alabama**
dparker@mchsi.com
**Martha Lair Sale, Sam Houston State University**
msale@shsu.edu

## ABSTRACT

*Recent studies provide convincing evidence firms manage reported earnings to achieve certain capital market reporting objectives. However, there is little empirical evidence on what levers firms use to manage their reported earnings.*

*This paper presents evidence that pension expense is an active lever used by firms to manage bottom-line, reported earnings. Firms with actual reported earnings in a neighborhood relatively close to their capital market earnings benchmark are selected for testing. Based on a proxy for premanaged earnings, firms hypothetically missing their capital market earnings benchmark are predicted to reduce their actual pension expense to increase actual reported earnings, whereas firms hypothetically beating their capital market earnings benchmark are predicted to increase their actual pension expense to reduce their actual reported earnings.*

*Both groups of firms are predicted to manipulate reported earnings in the direction that will move them closer to their capital market earnings benchmark than they would have otherwise been. Results suggest both groups of firms use pension expense as a lever to manage actual reported earnings. These findings support those users and regulators who currently support revisions in pension standards.*

# PREDICTORS OF DEBT CAPACITY

**Gregg S. Woodruff, Western Illinois University**
gs-woodruff@wiu.edu

*Gregg S. Woodruff is an assistant professor of Accountancy at Western Illinois University. His research and consulting interests are in the areas of forecasting, tax planning, and valuation. Gregg has a forthcoming publication in the Journal of Legal and Tax Research.*

## ABSTRACT

*Knowledge of debt capacity is useful for firms seeking to minimize credit risk and the cost of debt (interest rate). This knowledge is also helpful for financial institutions in deciding who to lend to and at what rate. This paper identifies the important predictors of debt capacity, namely: industry group (highlighting asset specificity); sales variability; the proportion of property, plant & equipment over total assets; and the depreciation method. These factors explain a significant portion of the variation across firm in the proportion of debt a firm is willing (and is allowed by the financial market) to carry as compared to its total assets.*

# EARNINGS MANAGEMENT PRACTICES FOR KOSDAQ VENTURE IPO FIRMS

**Soon Suk Yoon, Chonnam National University**
yoonss@chonnam.ac.kr
**Hyojin Kim, Ph.D. Candidate**
**Chonnam National University**
**Gary Miller, California State University-Bakersfield**
gmiller5@csub.edu

## ABSTRACT

*We empirically investigate earnings management practices for venture firms when they go public. In comparison to the Korea Stock Exchange (KSE), the Kosdaq market imposes relatively less stringent listing regulations. If firms satisfy Kosdaq venture criteria, the listing requirements become even more lenient. Accordingly, we hypothesize that the different institutional listing requirements will have different earnings management implications for IPO (initial public offering) firms. More specifically, we hypothesize that Kosdaq venture firms will have stronger incentives to manage earnings as compared to Kosdaq non-venture firms and KSE firms when the firms go public.*

*Two methods (mean difference tests and graphic approaches) were used to test the differences in earnings management practices between the Kosdaq venture IPO firms and two control samples. The results for the tests indicate that the Kosdaq venture IPO firms employ more aggressive earnings management practices than the control sample firms in the IPO year.*

*Key words: Initial public offerings, Kosdaq venture firms, Kosdaq non-venture firms, KSE firms, earnings management and accruals.*

# SELECTION OF ACCOUNTING SOFTWARE TOOLS FOR SMALL BUSINESSES: ANALYTICAL HIERARCHY PROCESS APPROACH

**Sharad K. Maheshwari, Hampton University**
**Michael P. McLain, Hampton University**

## ABSTRACT

*This paper focuses on the need of a structured methodology for evaluation and selection of small business accounting software tools. There are competing accounting software tools available for small businesses. This research considered three such tools namely QuickBooks by Intuit, Peachtree by Sage Software and Microsoft Office Small Business Accounting by Microsoft Corporation. Every accounting software tool is not the best suited for every possible need of a small business. Furthermore these tool change with the time therefore their quality and applicability changes with time. This creates a need of an easy and systematic method for evaluation of these software tools. The paper presents an analytical hierarchy process (AHP) (Saaty, 1980) based scheme, which allows quantifying the qualitative decision criteria involved in selection of the accounting software tools for small businesses.*

## INTRODUCTION

Several different software tools are usually available for a given business application extending from simple word-processing to sophisticated business simulation needs. This is also true for accounting software tools. These tools are developed and marketed by different vendors. Most software packages for small business accounting support a common group of features which a small business might expect to use. Despite these common features, the software tools differ substantially in their cost, performance, support structure and other features. Each package possesses its own strengths and weaknesses. This poses a difficult question for small businesses of selecting the right software tool for accounting. The problem becomes more difficult if one considers the relatively low level of technical skills of the majority of small business owners both in the area of accounting and computer technology.

When buying accounting software packages, small businesses may have to depend upon the expert reviews of packages published in various journals, opinion of friends, opinion of employees, or recommendation of consultants. The accounting software reviews are often published in accounting trade journals like CPA Journal, Journal of Accountancy or The Accounting Review. The reviews are also available on several online sites as well as computer magazines line PC Magazine and Software Review.

No matter which opinion or review a small business follows it will leave some questions unanswered. Furthermore, each reviewer or other user has his or her own biases build into his or her opinion. Thus no review or opinion alone can be sufficient to evaluate the specific needs a given business.

## MOTIVATION

Most common of evaluation methods for accounting software tools, especially for small businesses, is carried out in two ways. First method is individual package review. A reviewer may provide a qualitative survey of the features and performance characteristics of an accounting software tool. For example, it may assess how well a software tool has treated taxation or cash flow forecasting etc. The reviewer then ranks the tool for each of the area been considered. Second method is comparative evaluation. Here two or more software tools are evaluated. It may provide a comparative qualitative rating on various features and performance characteristics. However, these reviews can't achieve the following:

Provide no mechanism of matching needs of the individual business such as understanding and knowledge of an accounting tool, compatibility with existing software packages, specific business needs like inventory, cash flow management, and future plans of business, and
Provide no clear mechanism of ranking multiple packages once the user's needs are established.

Therefore a need of more comprehensive and easy to use evaluation technique exists in the area of accounting software for small businesses. This research proposes a methodology which can alleviate this gap. It utilizes a hierarchical model to select an accounting software package for a business user. The model combines both user needs and software evaluation/review data to select an alternative out of a potpourri of available software tools. The model employs Saaty's AHP technique (Saaty, 1980).

## ANALYTICAL HIERARCHY PROCESS

The AHP has been developed by Saaty (1980). This technique has been widely used in areas like economic planning, government policy, conflict resolution, project selection, etc. A comprehensive review of the AHP applications is conducted by Zahedi (1986).

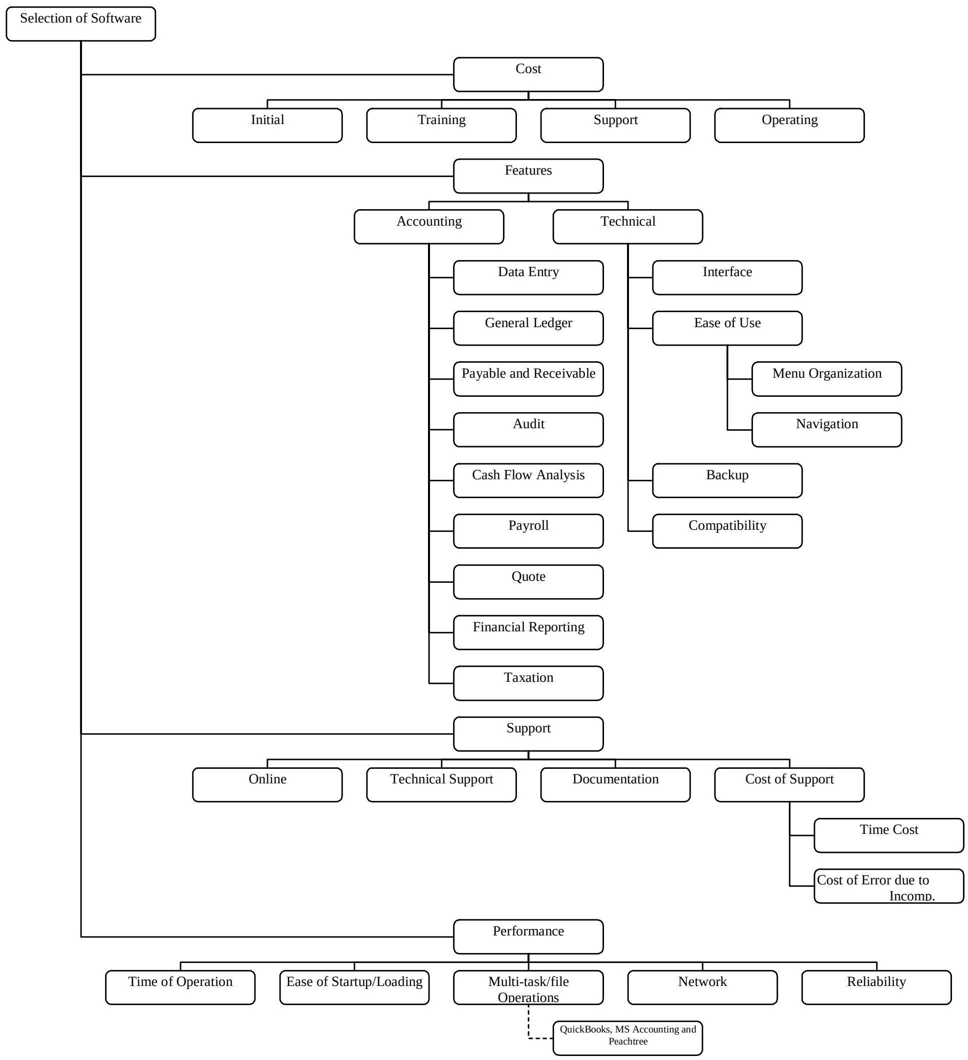
The AHP provides a comprehensive structure to include decisions maker's intuitive or even irrational values ( e.g, a decision maker may believe cost is twice as important than speed of the package without providing sound logic for his belief) about a component of decision making process. These values need not be consistent in the beginning of the decision making process. The AHP finds out inconsistencies during the evaluation.

The AHP divides the decision making process into several levels of intermediate criteria which affect the final decision. The criteria of evaluation are ranked at every level by the decision makers using a pair-wise comparison. All the inconsistencies of such comparisons are handled in a formal manner in the AHP. The solution process of a decision making problem using the AHP involves following five steps. The process is taken from Zahedi (1986) with some modifications:

1. Setting up decision hierarchy by breaking down decision problem into a hierarchy system with several levels. For example, technical aspects, cost aspects and benefit aspects may form three component of software selection process. At the next level, the technical aspects may divided into hardware needs, performance aspects, support needs, etc.
2. Collection of the data for pair-wise comparison of all components at a given level of the hierarchy of decision making. This will vary according to the evaluator's particular situation. For example, in a given case memory need and disk space may be equally important.
3. Develop the priority matrix. Calculate 'Eigen value' of the matrix and then calculate the principal vector. The principal vector represents the relative weight of the decision elements at a given level.
4. Calculate consistency index (CI). If CI is less than 0.1 then continue to the next step or else go to Step (2). This is to make sure that decision maker's pair-wise comparison stay with allowable limits of inconsistency.
5. Aggregating the relative weights (as calculated at Step 3) of every level of the decision hierarchy to arrive at a set of rating for decision alternatives.

## MODEL FOR SMALL BUSINESS ACCOUNTING SOFTWARE SELECTION

The accounting software package evaluation and selection model developed in this research is a four-level model. This means that there are four major stages of the decision making in the process of the software selection. These levels are discussed below and are illustrated in Figure 1.




Level 1--Main objective: Selection of a small business accounting software package.
Level 2--Major criteria: Cost aspects--These criteria are cost of package, cost of training, cost of support, cost of updates and cost of operating.
Features aspects-This level includes two main category of features namely accounting and technical features.
Support aspects-The support could be very important for small business as skill set of small business could very significantly. The paper considered online support, technical support, documentation and indirect cost of support.
Performance aspects--These aspects include factors which may be different for individual business. A business may or may not have a need of networking or multi-task/file operations depending upon its size and needs. The factors considered here are time of operations, ease of startup and loading, multi-task operations, networking capabilities, and reliability of the software.

Level 3--Sub criteria: Accounting features-This is the largest area. The paper considered ease of data entry, general ledger, account payable and receivables, audit trail, cash-flow forecasting, payroll functions, order quote generations, financial reporting and taxation. A business will have chance to change the pair-wise ranking of each weight to determine what is more important to its own situation.
Technical features-The features considered here could also change according to business need. It includes computer interface, ease of use, backup and recovery of data and compatibility.
Indirect Cost of Support-The factors considered here include time it take to receive support and the cost of error caused by improper support.
Level 4--Sub criteria: Ease of Use-This is a difficult term to define in computer software evaluation. It means different things to different users. The paper includes two common ease of use features, menu organization, and ease of navigation.

## EXAMPLE

The paper has considered three packages-QuickBooks, Microsoft Small Business Accounting and Peachtree. The pair-wise importance ranking was obtained through consultation with two users. The pair-wise importance rankings used here are suggested by Saaty (1980.) Table 1 provides a level 1 pair-wise ranking used in this study.

## ANALYSIS

Trial version of ExpertChoice 11 was used to carry out the analysis. The basic analysis using AHP ranks the accounting tools in the following order Peachtree, QuickBooks, and MS Small Business Accounting. Overall inconsistency was 0.07. Ideally one would like to see no inconsistency (0.00) in the results. However, in a multi-level decision making insistency of less then 0.100 is considered acceptable (Zahedi, 1986.). Table 2 shows the final result where Peachtree was marginally preferred over QuickBooks 35.6% to 34.5%. MS Small Business Accounting came out third with 29.9%. (At every level percentage must add to 100%.) If one looks into raking of level two factors cost, features, support and performance, cost came to be most important factor with 42.9% and support came out to be least important at 7.3%.

**Table 1. Pair-wise Ranking of Level-One Factors.**
**Goal-Selection Of Accounting Software Tool**

| | Cost | Features | Support | Performance |
|---|---|---|---|---|
| Cost | 1 | 1 | 4.5 | 7 |
| Features | 1 | 1 | 4.5 | 6 |
| Support | 0.22 | 0.22 | 1 | 0.5 |
| Performance | 0.14 | 0.17 | 2 | 1 |

Each business has to make it own pair-wise rankings to determine what is applicable to them. ExperChoice 11 also provides possibility sensitivity analysis. The sensitivity analysis shows that current decision will is hold true for various ranges of level two factors. It shows that the importance rating of cost factor could change between from 24.9% to 66.1% still Peachtree will come as number one choice. The choices will change to QuickBooks if the cost factor's importance rating is below 24.9% and it change to MS Small Business Accounting if cost factor's rating go to up to 66.1% . Summary of these ranges is provided in the table 3.

| Table 2. Ranking of the Accounting Tools under Consideration | | | |
|---|---|---|---|
| Factor | QuickBooks | Peachtree | MS Acct |
| Cost | 0.274 | 0.321 | 0.406 |
| Features | 0.388 | 0.385 | 0.227 |
| Support | 0.418 | 0.418 | 0.164 |
| Performance | 0.418 | 0.348 | 0.234 |
| Overall Ranking | 0.345 | 0.356 | 0.299 |

| Table 3. Sensitivity Analysis of Level-One Factors | | |
|---|---|---|
| Sensitivity Analysis | | |
| Factor | Lower Bound | Upper Bound |
| Cost | 24.90% | 66.10% |
| Feature | 7.50% | 87.00% |
| Support | 0.00% | 100.00% |
| Performance | 0.00% | 20.90% |

## CONCLUSIONS

The paper has presented a generic scheme to evaluate and select accounting software tools for small businesses purposes. The scheme is flexible enough to include changes according to the particular needs of a business. It included four major factors cost, features, support and performance. The pair-wise weights were assigned on the experience of two accounting professionals. It found that Peachtree is marginally better than QuickBooks. However, if support is any consideration Peachtree is the best accounting tool.

## REFERENCES

Provided upon request.