PORTFOLIO

The Sy Syms School Journal of Business

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The Portfolio would like to thank Cheri Ochs and Simcha Gissinger , the presidents of the 1997 - 1998 Sy Syms School of Business and their respective boards for making this edition of the Portfolio possible

YESHIVA UNIVERSITY
SY SYMS SCHOOL OF BUSINESS

OFFICE OF THE DEAN

May 6, 1998

Dear Students,

Congratulations to all on this edition. It is very exciting to see that the mission of the Sy Syms School of Business- namely, to promote a medium for the exchange of ideas between faculty and students continues in this fashion.

As I have indicated on a number of occasions, this has been a wonderful year for the Sy Syms School of Business. The publication of this issue of the Portfolio serves to enhance the accomplishments of the school this year.

On behalf of the Administration, Staff and Faculty of the Sy Syms School of Business, my best wishes for the continuous growth and success of the Portfolio.

Harold Nierenberg, Ph.D.
Dean

YESHIVA UNIVERSITY
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May 6, 1998

Congratulations on the 1998 edition of the Sy Syms School of Business Portfolio. A key measure of the growth and development of a business school is through the independent research and scholarly publications done by its faculty and students.

This journal affords the opportunity to present a sample of what we have to offer. I want to personally thank the editors for all their efforts an hard work in producing such lovely publication.

Sincerely yours,

Ira L. Jaskoll

Associate Dean

PORTFOLIO

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The Multicultural Context of Brand Loyalty

Dr. Frederick A. Palumbo

INTRODUCTION

A brand is a trademark or a distinctive name of a product or manufacturer. It is a name, term, sign, symbol, design or any combination used to identify the goods and services of a seller. A brand name performs many key functions:

1. It identifies the product or service and allows the customer to specify, reject or recommend.

2. It communicates messages to the consumer. Information provided could include statements regarding their users' style, modernity or wealth (*The Economist* 2 July 1994, pages 9-10).

3. It functions as a piece of legal property in which the owner can invest and through law is protected from competitor trespass.

Brand names convey the image of the product; 'brand' refers to a name, term, and symbol, sign or design used by a firm to differentiate its offerings from those of its competitors, to identify a product with a particular seller. Branding adds value to products and services. This value arises from the experience gained from using the brand: familiarity, reliability, and risk reduction; and from association

with others who use the brand.

A brand is both a physical and a perceptual entity. The physical aspect of a brand can be found located on a supermarket shelf or in the delivery of a service. The perceptual aspect of a brand exists in psychological space - in the consumer's mind (American Demographics, 1994). A successful brand has a recognizable name which signals specific attributes to the consumer (quality, elegance, and value). The ability to make a consumer repeatedly seek out and buy one brand over another even when others offer coupons or lower prices is *brand loyalty*.

Traditionally, marketing's main goal had been targeted at increasing sales by attracting a steady stream of new customers. The focus of marketing is now being shifted towards a company's existing customer pool. Customer loyalty programs are designed to turn one-time buyers into brand loyal customers (i.e., turning one-time buyers into customers who will purchase the product over and over again). Customer retention is critical since it has been shown that it is up to five times less expensive to sell to a loyal customer as it is to create a new one. Management consultants explain that companies that improve their customer retention programs by a mere 5 percent can expect to gain a profit rise anywhere between 20 percent and 125 percent (McDonald, 1994). Nonetheless, companies accept the fact that there are some customers who are not worth keeping: An ideal customer is of adequate size with reasonable demands and with the capability of becoming a long-term customer.

Not all products, though, have the possibility of creating brand loyalty. Simple commodity products experience low customer retention. Consumers usually purchase a lower price product when shopping for paper products such as paper towels, toilet paper, and facial tissue. Frozen vegetables, frozen entrees, and cat food have been found to have the least brand loyalty. Products with strong brand loyalty include mayonnaise, soft drinks, and bar soap.

A perfect example of how important brand loyalty is for some products is the beer industry. When beer drinkers are asked why they drink a certain brand of beer, they inevitably always say that it is

because of the taste. Blind taste tests, however, have shown that beer drinkers often have different taste reactions the second time. This indicates that beer consumers are actually being sold on the image of the product and not the product itself (American Demographics, 1994). Brand image also contributes heavily to a luxury product's success; few people buy luxury names they do not know. Also, penetration levels of any brand are strongly affected by its awareness level and the relationship is strong between awareness and purchase (Dubois and Paternault, 1995).

The catalog industry is another example of an industry that reaps in great benefits from loyal customers. According to direct mailers, loyal program members order merchandise twice as often, spend as much as three times more money, and are up to five times more profitable than non-members. These loyalty program members can account for up to one-half of all purchases, even though they represent only 10 to 15 percent of a catalog company's customer base (Chevan, 1992).

INTERNATIONAL BRAND LOYALTY

Brand and brand loyalty problems are magnified in the international marketplace. In today's global market, a brand's marketing strategy must compete head-on, not only with regional or national brands but also with international competitors' marketing strategies. This adds an entirely new dimension to a company's marketing strategy when it comes to identifying, attracting, and retaining a market.

Brands have staying power due to the promotional efforts expended by companies to create awareness and image for their brands. Standardization of both the product and brand are not necessarily consistent; a regional brand may have local features or a highly standardized brand may have local brand names. As a result of separate marketing, Unilever sells a cleaning liquid called Vif in Switzerland, Viss in Germany, Jif in Britain and Greece, and Cif in France. It would be very difficult to create a Eurobrand since each brand name is well established in each local market.

Brand names often are difficult to standardize on a global basis. Johnson's Pledge furniture cleaner is called Pronto in Switzerland and Pliz in France while retaining its American brand name in the U.K. Translation problems could render the translated version obscene or with a negative connotation (local slang or idioms). The brand name could already have been registered with another local or international company. Yet, many brand names are worth their weight in gold. Anyone's list of the top ten global brands would have many of the same companies: Coca-Cola, Sony, Kodak, Disney, Nestle, Toyota, McDonald's, IBM, and Pepsi-Cola. Global brands carry instant recognition and especially for international travelers represent a risk avoidance strategy versus using local brands. European consumers buy American, for its quality, prestige, and American image. Goodyear sells its tires in Germany with images of Indy Cars. Budweiser has made a name for itself as a premium brand with an American ad campaign. Europeans also pay premium prices for American goods: $7 for a six-pack of Bud in the United Kingdom vs. $3 in the U.S. European teenagers wear baseball caps (backward of course) and football jackets over their basketball T-shirts. Jack Daniels and Southern Comfort have prospered as American Brands (Milbank, 1994).

The Japanese lean towards pastoral names or female names for their car models: Bluebird, Bluebonnet, Sunny, Violet, Gloria versus animals and power names for American car models: Mustang, Cougar, Cutlass. The first sports car Nissan sent to the United States was named Datsun Fair Lady. Seeing a fiasco in the making, the name was changed to 240Z. Branding, however, is not a guarantee for success in the global market (Onvisit and Shaw, 1989). Some restrictions on brand names exist: "med" in France is limited to medicated products, thus potentially causing firms to adjust brand names.

The lack of success of Suchard's entry into the UK market demonstrates that if you are a powerful marketer in one country, you can't literally transfer those brands and still expect them to be a success. The UK chocolate company Thorntons experienced

difficulties in France. Cadbury followed a fragmented branding approach, retaining the brand names on the various companies it has acquired in Europe (Littler and Schlieper, 1995). Coca Cola uses Coke Lite as a brand name instead of Diet Coke in France since the term 'diet' is restricted due to medical connotations and suggests poor health.

CROSS-CULTURAL BRAND LOYALTY – UNITED STATES

One of the advantages for American companies is the fact that the United States is one big melting pot. Before investing monies in international research, companies should do their preliminary research at home before trying to define the type of research to be conducted abroad. By identifying similarities between immigrants in the United States and the people from their home countries, much of the preliminary work can be completed before going into foreign markets to conduct research. A company can eliminate major dislikes and be prepared to further investigate their likes.

For example, a new study found that ethnic minorities spend more money per household on groceries than the general population. African-Americans spend an average of $66 per week on groceries, while Asian-Americans spend $87, Hispanics $91, and the average U.S. household spends only $65. One explanation given for the larger purchases from minority families is that they tend to have larger families. Another explanation, which should be considered by marketers, is that minorities tend to purchase more brand products and spend more on quality products (Richard, 1994). Minorities are also known to be less cynical about advertising messages because they are actually seeking out information about the product; information that the general public may take for granted.

Another study shows that African-Americans spend about $350 billion annually, Hispanics about $200 billion a year, and Asian-Americans about $120 billion a year (Loro 1994). When reaching for the Hispanic market, door-to-door sampling is preferable to direct mail, in-store and newspaper sampling programs. The

Hispanic culture, along with the Asian culture are very much into building relationships for business. This type of contact builds stronger ties with the consumer and products (Loro 1994). Although some cultures (e.g., Hispanics) do not respond well to coupons, other cultural groups such as African-Americans do. This is one way of building brand loyalty; by reaching a group of people who have not been contacted before.

U.S. products that are *international* tend to pursue a policy of standardized branding (Rosen, Boddewyn, and Louis 1989). The majority of U.S. brands do not. The apparent standardization is the result of extensive distribution of a few brands worldwide (Coke) rather than wide distribution of many brands.

EUROPEAN BRAND LOYALTY

Through a survey administered to adults in England by BMRB International, over half of Britain's most affluent shoppers do not follow the trend of switching brands, but find a brand they like and stay with it: 61 percent of the adult shoppers "tended to agree" with this philosophy of brand loyalty. Another finding that may be alarming to retailers is that fifty percent of the respondents do not believe brands are better than own-label. When asked whether they looked for the lowest price, 8.2 percent responded affirmatively while 2.7 budget for every penny spent on household shopping (Marketing, 1995).

There seems to be a trend in the UK to create brand loyalty through coupons. According to NCH Promotions, the overall UK market grew by 5.15 percent in 1995 due to retailer funded coupons (Walker 1996). Catalina Corporation has developed electronic coupon checkouts in the UK market, the most sophisticated point-of-purchase technology in the country. According to Catalina's Managing Director, "Catalina is able to drive categories and brands, increasingly without wastage." Some ad agencies, however, feel that Catalina is only able to facilitate short-term brand switching.

In March 1996, NatWest became the first UK Bank to issue promotional vouchers via 1,000 cash machines to its customers. Each

voucher, besides carrying the promotional message from advertisers such as Buena Vista Home Entertainment, SeaFrance and the Guardian, also carried the NatWest brand name. According to research, 67 percent of bank customers were likely to use the promotional vouchers dispensed from ATM machines along with their cash (Walker 1996). Other banks are expected to follow NatWest's footsteps. Manufacturers are excited about profiling customers who make cash withdrawals and targeting them for further coupon promotions.

P&G in the UK adopted a new strategy. Instead of concentrating on promotional activity and advertising, the company has allocated budgets to fund low prices in order to build brand loyalty and promote its label's growth in the UK market (Richards, 1996). In other words, P&G is forcing customers to switch brands to get the best value. Contradictory to the belief of companies such as Catalina, P&G has taken a diametrically opposite view, claiming that coupons and other promotions create confusion, decrease customer loyalty and increase system costs. On the other hand, there is an argument that only strongly established brands like P&G can afford to use price cuts as a means of increasing brand loyalty. Lesser known brands may not achieve the same result.

BRAND LOYALTY IN JAPAN

The Japanese worship brand names, the perfect solution in a society where individual preference is muted. Once a designer name or brand logo catches on, the scramble begins. As soon as consumers are confident the logo means status or prestige, they will snap up anything that sports the reassuring logo. The Japanese have taken this fanaticism a step further. They do not rush out and buy just any recognizable brand; they buy catalogs filled with photographs of accepted brand products. Before making a purchase, many consumers must consult a reference work to guarantee its prestige. Different reasons for this brand loyalty exist according to age groups. The main reason the older Japanese rely heavily on brand names is that in their formative years (during WWII and the years of postwar

poverty) goods were scarce and few opportunities existed. Unsure of exactly what they wanted, they opted for the safety of a famous name. Young Japanese consumers tend to prefer brand names because of their fashion consciousness. Consumers associate product quality, safety, and reliability with the image of the company that produces it. They need to see the company as trustworthy and reliable in order to evaluate a brand favorably (Nishikawa, 1990).

This hierarchical concern with brands can be seen in the way the various Suntory brands have occupied different positions in society. In the early 1960s, the best selling Suntory was a light whiskey called Red; a few years later, Kaku was priced higher. The most premium brand was called Old. Later on, priced even higher for senior executives, came Suntory Reserve. When a Japanese salaryman selects a Suntory brand, he does so solely according to his position in the company. Suntory Old dominates the Japanese market in the middle level. Reserve is what you drink when you reach high management (Fields, 1984).

When Nabisco went to Japan, consumers there found the Oreos too sweet, so the amount of sugar was reduced to give them a more bitter taste. Some consumers still found them too sweet and told Nabisco they "just wanted to eat the base" without the creme. Nabisco added a modified Oreo without the creme, Petit Oreo Non-Creme Cookies, which consisted of single wafers without the creme. Coca-Cola changed Diet Coke to Coke Light in Japan; Japanese women do not like to admit to dieting in Japan because the idea of diet implies sickness or medicine.

BRAND LOYALTY IN OTHER COUNTRIES

In Cambodia beer drinkers display little brand loyalty. This has driven beer manufacturers to engage in all kinds of tactics to reduce brand switching among consumers such as give aways, ring pull or bottle top competitions, point-of-purchase promotions and billboards (Business Asia, 1996). Name changes are not necessarily voluntary. In India, because of a ban on the use of foreign brand names, hybrid brand names are the norm: Maruti-Suzuki, Dcm-

Toyota, Kinetic-Honda, Lehar-Pepsi (Asian Advertising and Marketing, March 1992, page 23).

Air travel is an essential means of transportation in Australia. The deregulation of the airline industry in 1990 caused the entry of Compass Airlines into the Australian market. Compass was able to give better prices and unrestricted fares to consumers, thus capturing 20 percent of the airline market. Threatened by Compass, both Australian and Ansett Airlines launched frequent flier programs to increase brand loyalty among consumers (Browne, Toh, and Hu, 1995). Philips, the Dutch electronic company, is focusing its marketing effort on Central Asia. Its current strategy is to set up a strong presence in Asia, build brand loyalty for its labels among distributors and customers, besides establishing a reputation at the top end of the electronics market (Crossborder Monitor, 1995).

CREATING BRAND LOYALTY

Three recommendations for creating brand loyalty are suggested by Edmondson (1994):

1. Give your brand a good cause. By associating a brand with a good cause, the product is distinguished from the competition by adding a benefit. Consumers will feel that by purchasing the product, they are also helping a good cause.

2. Get permission, then get personal. Get to know the customer. By knowing the customers, companies can always keep in touch with them and inform them of special offers or promotions. But...get their permission first. The strategy may backfire when you contact customers who get annoyed if direct promotional literature is sent to them. An example of this type of mishap is a jewelry company that sent out mailers to customers who had purchased a high-ticketed piece of jewelry. The jewelry company sent out promotional literature and mentioned the fact that an expensive piece of jewelry had been purchased recently by the receiver. Wives of some of the men who received the mailers did not know of the purchases, which left some very angry men.

3. Sell with information, not hype. We live in a world of

information, but what customers actually want is knowledge. So not only do consumers want substance, but they also want entertainment, and as if that was not enough, they also want it on their own terms.

BRAND LOYALTY MARKETING

Ten basic principles to build enduring, profitable growth for brands and their companies are recommended by Light (1994):

1. The pillars of Brand Loyalty Marketing are the four basic elements that every marketing plan should contain to be effective in creating brand loyalty. Those elements include a) identifying b) attracting c) defending and d) strengthening brand loyalty. In addition, a company should be able to determine whether the marketing efforts are helping or hindering brand loyalty.

2. Brands don't have life cycles. Although products go through life cycles, brands do not necessarily experience them. The value of some brands even increases over time, which has been the case with companies such as Levi's and Coca-Cola.

3. Build leadership based on brand loyalty. A company can become a leader through brand loyalty. A loyal customer can be nine times as profitable as a disloyal one. It makes smart sense to target loyal customers.

4. Be a leader in every market in which you choose to compete. When a company decides to go into a market, it must do so with full force. The profit received from market leaders is three times as much as for market followers.

5. Avoid undermarketing leaders. To maintain a lead in market share, a company must support marketing to the fullest. Reaching the top only means that the real job has just begun. Maintaining a top position requires more work than reaching the top.

6. Be a pioneer. Leaders are usually associated with pioneers. Most leaders in industries are usually also innovators and creators of products. To maintain this position, companies must invest heavily in research and development. Pioneers are faced with the heavy cost burden of research and development, whereas companies that copy or clone are not.

7. Know the value of your customers. A company must determine the value of their existing customers. They should note their likes and dislikes, as well as their purchasing power. Knowing the value of the customers allows companies to better adapt products for a better acceptance of their loyal customers.

8. Keep your loyalists sold. By learning more about customers, a company has a much better chance at keeping these customers. It is not enough just to keep customers; a company must work to keep them satisfied as well, and aware that they are satisfied. Satisfied customers translate into loyal customers.

9. Sell on quality, not on price. The basis for even having loyal customers is quality. The primary focus of a marketing plan should be the quality of the product, and not how inexpensive it is.

10. Branding policy is business policy. Building brand loyalty will endure profitable growth as well as volume.

CONCLUSION

A global brand is one that is perceived to reflect the same set of values around the world. The same set of values or brand character forms the key in global brand strategy (Chevron, 1995). According to Omelia (1995), successful global brands must anticipate cultural trends, styles and evolving consumer values in order to appeal to customers across international boundaries. A product's relevance to its customers dictates its global potential. Brands that have a large disparity in consumer regard and image are not as likely to find a standardized global positioning to become a global brand. Successful multicultural advertisers have secured brand loyalty from culturally diverse consumers by tailoring the brand's image to reflect individual cultures. With regards to brands, creation or maintenance of a global brand is highly dependent upon the existing status of the brand. If the company has maintained independent brand names for the same product for numerous countries, it becomes more difficult and chancy to implement a single global brand name. If the product has been adapted in various countries to accommodate local tastes, the creation of a single global brand is not recommended. For example, according to a commentary on beer consumption by McCann-Erickson

Worldwide, "To Brazilians, beer is a soft drink, to Germans, good beer is the one that's locally brewed, to the English, lager beer is a new product, to Americans, beer is a boy-meets-girl drink, to Australians, beer is a man's drink."

European retailers are moving away from distributors of packaged goods and becoming consumer marketers with their own private labeled brands (Adweek February 14, 1994: 38). Private labels, or manufacturers' "own-brand" (for example, H.E.B. Brand in Texas) have shaken up the packaged goods industry in North American and Europe. They have claimed 31 percent of the United Kingdom's grocery sales and 21% of Canada's, according to Datamonitor and A.C. Nielsen, respectively. Interestingly enough, "own-brands" sell comparatively weaker in less developed countries such as Argentina and India due to the lack of large supermarket chains. As a matter of fact, private labels have barely even affected the Hong Kong market where high disposable income has created high-price brand loyalty. Other countries such as South Africa and Japan on the other hand have felt the influence of private labels (Levin, 1995).

The success of private label products can be considered negatively correlated with the country's economic status. When a country's economy is doing well, then its citizens tend to favor the brand labels. But when the economy is bad, consumers are often willing to substitute brand labels with private labels. Therefore, private label sales tend to be highest in countries either still in a recession, or just climbing out of one such as the United Kingdom.

Brand loyalty also can vary across cultures. Chinese consumers tend to be more brand loyal and tend to purchase the same brand or product other members of the group recommend since they tend to be members of a small number of reference groups. Hispanics tend to be more brand-loyal, more likely to use familiar stores, and more likely to be price and promotion conscious than non-Hispanics. This could be due to relatively low income levels and large family sizes (Saegert, Hoover, and Hilger, 1985). One explanation for greater brand loyalty and the corresponding less tendency to buy

private label brands could be that the purchase of prominent brands connotes the assimilation of ethnic consumers into the mainstream economy. Many new immigrants are familiar with many brands from their native experience, and continue to use those brands from risk avoidance as well as the emotional experiences to which they may be connected in the homeland. Colgate toothpaste holds a 70 percent market share due to its dominance in Latin America. However, Crest, though holding only 15 percent of new immigrants, has nearly twice as many of the acculturated Hispanics.

The cultural context of brand loyalty can be explained easily through the use of Hofstede's dimensions. Power distance is the willingness to accept that those with power are entitled to it and those without power ought to accept the way things are and just go along. This is an Asian cultural tendency. Big market-share brands are the kings of their brand world and consumers from cultures with high power distance tend to believe in them implicitly: the dominant brand has achieved what it has because it is the best and one should not question it. The power dimension is related to uncertainty avoidance (risk). A third dimension is individualism-collectivism, the degree to which one's individual beliefs are submerged to fit in with the greater good of what is acceptable in society as a whole. Asian cultures tend to be highly collective. This collective orientation has implications for consumer attitude formation and brand loyalty and ensures the survival of the dominant brand (Robinson, 1995).

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Financial Ethics

Professor Aaron Brown

The other day I heard the sad news that a former student had embezzled money. The person who told me this added, with a smile, "I guess you taught him too well, Professor Brown." Although the remark was intended as a mild joke, it bothers me enough to write this essay.

The logic of the joke is that finance is the science of getting as much money as possible; that someone who steals money is practicing good financial principles; that theft maximizes net present value. In this view, finance and ethics are in opposition. Finance teaches you to take as much as possible, ethics restrains you to take only what is fair.

This view disparages both ethics and finance. Ethics are not leashes or cages that prevent us from doing what we really want; they are a guide to a good life for others and ourselves. The field of finance is not ethically neutral. It is based on deep and valid ethical principles.

Every profession has ethical dilemmas that are hard for outsiders to understand. Military officers kill innocent civilians, lawyers defend people they know to be guilty, doctors allow patients to die. Yet there are limits to these decisions. In wartime the military

might drop a bomb on a city, killing thousands of innocents, in order to destroy the enemy's morale. But a soldier who shoots a single enemy civilian can be court-martialed for murder. A lawyer is supposed to use his or her best efforts to win acquittal for a guilty client, but is not supposed to allow any false testimony. A doctor is allowed to write, "do not resuscitate," on a patient's chart but, except in Oregon, is supposed to avoid euthanasia.

These professional codes might conflict with a practitioner's personal beliefs. If those personal beliefs come from a divine source, or even from deep personal conviction, they must overrule the professional code. So in that sense professional codes are subsidiary ethics, admitted compromises designed by fallible humans. Nonetheless they are important achievements in their own right.

In my experience, more ethical lapses result from miscalculation than from misunderstanding fundamental principles. Ethical challenges can arise unexpectedly and we are often forced to make rapid decisions with incomplete information; we may be tired, distracted or tense. Even when the right action is clear, it may be difficult to accomplish. Professional codes are designed with the demands of the profession in mind and can be more directly useful than more fundamental, but more general, rules.

Professional codes also allow people of differing beliefs to work together harmoniously. In professional life, we often represent other people. We then must ask whose ethical principles should be honored? For example, suppose you work for a corporation that has the opportunity to increase profit through a marketing scheme. You consider the scheme to be deceptive but the shareholders do not. Do you have the right to give away the shareholders' money to protect your conscience?

Obviously if your beliefs prevent you from doing an effective job for your principals, the only solution is to resign. But for the minor everyday conflicts that arise, a professional code is a useful compromise. You agree to do everything within the limits of the code to advance your employer's interests; your employer agrees not to ask you to step outside the code. This allows the organization to

be efficient while everyone's ethical beliefs are respected.

Net Present Value

Finance is a very simple field. Decisions are made by reducing all considerations to money, computing the risk-adjusted net present value of the resulting cash flows and picking the highest-value option.

A common and foolish objection is that this ignores every value except money. The fallacy in that argument is that money is only the accounting device. A proper financial analysis includes every relevant effect of the decision, including such things as danger to human life, harm to the environment or stresses on a community. The only thing that finance demands is that we quantify each of the aspects we wish to consider.

This approach has two effects. First, it reduces all problems to one dimension. Many decisions involve balancing many competing considerations; financial analysis collapses everything along one axis. Second, it separates decisions. It calculates the most efficient way to do things, the way that makes the most money. It does not ask what you want to do with that money. You could be using it to do good or evil or just spending it for your own pleasure.

A more complete ethical analysis of a decision would consider all considerations in balance. And it would follow the decision through to the end. An action that might be unethical if done for your own pleasure might be ethical if done for a greater good.

So financial analysis is a limited analysis. Those limits mean that it can be wrong sometimes. But those limits allow the application of powerful mathematical tools for decisions. For many problems, the resulting consistency, computational power and precision are more important than the reduction in ethical completeness.

More Than Money

Another common objection to financial decision making is usually stated, "you can't put a monetary value on. . .". The sentence

can be completed with "human life," "loyalty," "honor," or, if you have more florid inclinations, "the dreams of an innocent babe," "the need of the human spirit to soar with the eagles," or "the deepest yearnings that have infused men's souls since creation."

There are two interpretations to this objection. The first is that the named quality has infinite value. This is a dangerously naïve view. Suppose we say that human life, for instance, has infinite value. Then we can never make any decision that in the slightest way risks human life. We cannot get up in the morning nor go to bed at night.

Every day we have to make decisions that risk lives. Every product could be made safer. Every person could visit a doctor more often. Every risky activity could be outlawed. At some point we have to decide: This product is safe enough, it is not worth spending money to make it safer. We must say enough money has been spent on healthcare, it's time to allocate funds for other needs. We must allow people liberty and the pursuit of happiness, even at some risk to their lives.

Honorable people can disagree about when to say these things. But refusing to ever consider them is foolish, a do-nothing morality. Some people err by holding life too cheap, but it is also an error to hold it too dear.

Therefore we trade life for money every day. But it is done inconsistently. Sometimes many lives are sacrificed for tiny amounts of money; other times, huge amounts are spent to eliminate a minuscule risk to a small group of people.

Some of these inconsistencies are done in the name of justice or some other higher good. For example, the government might spend more money to avoid executing an innocent person than it is willing to spend to save a dozen lives through a vaccination program.

But far more often these inconsistencies reflect selfish and unjust priorities. Freed from the necessity to be consistent, we can put huge values on the lives of ourselves, our families and friends, and small values on the lives of strangers. We can insist that the government spend billions to protect us against tiny risks while

voting against cheap programs that could save hundreds of lives far away from us.

This is why I am suspicious of people who claim infinite value for anything. Infinite value means the cost does not matter. I think the cost almost always matters. People who do not want you to count up the cost have usually arranged things so that they get the benefit and you pay the costs. Financial logic demands consistency. If human life has a value, put a number on it and apply it equally. This admittedly can lead to some unethical decisions; we must guard against these situations. But far more often, it prevents unfairness and inefficiency.

This is why I say that financial ethics are an important human achievement. Although they can give the wrong answer in some situations, they more often do good by clarifying complex situations. Even when they give the wrong answer, it is seldom as wrong as the answer that would prevail in their absence. As soon as we claim that we have a moral principle that overrides the need for consistency, everyone else will discover overriding concerns of their own. The resulting compromise will probably be far worse than the simple, consistent answer we started with.

Illegal Trades

A second interpretation of the "you can't put a value on. . ." does not claim infinite value. Rather it says that certain things cannot be exchanged for other things. We have no problem thinking of human relations as transactional. We "earn" respect, "repay" loyalty and "return" affection. We demand "reciprocity" in our friendships and a "level playing field" in society; "fairness" in all dealings and "balance" in our relations with others.

But while these things can be traded for each other, for example we are loyal to those who are loyal to us, we cannot exchange them for other things. We despise people whose loyalty is for sale for money. We disapprove of trading, say, friendship for love, love for sex or sex for money. A person who risks her life to save other lives is a heroine, a person who risks her life for lesser

reasons may be considered a fool.

This objection is correct. There are things that cannot be traded except for themselves. There is nothing mystical about this and it is not because these things are enormously valuable. The things that cannot be traded are things that do not add up.

That Doesn't Add Up

Money adds up. If I spend $20 for an oil change for my car, and it saves me a $1,000 repair, I have saved $980. But justice, for example, does not add up. If I commit a small injustice to prevent a larger one, I have not increased the stock of justice in the world. For example, if I lie so that a rich innocent person is held liable for some damages; when if I had told the truth a poor innocent person would have been liable; I have sinned against justice. The world is less fair, not more fair. Justice does not add up.

Therefore, we cannot simply put a monetary value on justice and throw it into our calculations. This is not because justice is too valuable to be measured in money, or because it has some mysterious essence that disappears in contact with filthy lucre. It is because justice is non-linear, it does not add up.

I believe that there are more complex mathematical rules than addition that are suitable for analyzing justice. Others disagree and feel that justice is beyond mathematics entirely. But no one seriously contends that justice can be computed through addition only.

Outside Analysis

Therefore we must deal with the things that do not add up outside financial analysis. We do not even consider decisions that are manifestly dishonest, unjust or reckless. After we complete the analysis we ask if the result is the right thing to do. In other words, we use all the normal ethical rules for everyday decisions.

Suppose, for example, we are designing a car. We could spend $10 per car to add a safety feature that will prevent one driver in 100,000 from dying in a collision; $1,000,000 per life. We could also spend $10 per car to make our car less dangerous to other cars in

a crash; this will prevent the same number of deaths to people in other cars. Financially, the decisions are equal; we should do both or neither. But other considerations apply. We owe a duty to our customers; this might lead us to consider their lives more valuable than the lives of others. On the other hand, we could argue that the people who buy our car know the risks; they choose to get a cheaper, more dangerous car. But people in other cars have no choice in the matter; their innocent lives should assume more weight.

There is no doubt that these other considerations are important and must be weighed. But do not overdo it. Once you declare something outside the financial decision making process, you must resign yourself to inconsistency. For example, you might vote against a plan to spend $100 million on foreign aid that would save 10,000 lives, a price of $10,000 per life. But that does not mean you would agree to murder your best friend for $10,000 or for $100 million.

Of course, refusing to murder is the right decision. But it is inconsistent in the sense that you are willing to let 10,000 people die to save an amount of money that is not worth one person's death. This means that economic resources will not be optimally allocated to save lives. To put it another way, more people will die and more money will be spent than necessary.

It's Cold Outside

Once you remove something from the financial decision making process, you end up with fewer resources dedicated to it. So you should think carefully before you declare something so important that you are willing to be inconsistent about it and thereby get less of it. It is not that human life is too important to include in financial decision-making; it is that it is too complicated. We care more about the way the decision is made to end a life than we care about the life itself.

A deliberate decision to kill a specific individual is almost always wrong; however important our motives for murder. However, inaction that allows many unspecified people to die is usually not

wrong; however trivial our reasons for inaction. There is a specific injunction against murder; there is not an equally strong positive injunction to save lives wherever possible.

This makes decisions about human life self-referential. The rightness of our decision depends on how we make it. Did we select a specific person or merely allow an unspecified person to die? Was it action or inaction that caused the death? Self-referential considerations cannot fit into a simple mathematical analysis.

Sometimes it is unclear whether something should be thrown into the financial decision making process or kept outside. Suppose a company is considering laying off workers to increase profits. One of the considerations in this decision is loyalty. The company owes some duty to workers who have served it over the years, who have made plans based on their employment, who have given their own loyalty to the company. But this is not an absolute duty; the company also has a duty to make money. They owe this to their shareholders and, in a larger sense, to everyone since a company that consistently loses money cannot survive.

So trade-offs must be made between loyalty and profits. Someone must determine who will stay and who will go; how much severance and other benefits will be paid; what efforts will be made to have voluntary attrition rather than firing.

A financial analyst might argue that the company should carefully define loyalty, put a price on it and factor it into all decisions. The degree of loyalty the company owed would be measured by things like years of service, things given up to help the company and so forth. This would lead to consistent decisions that would minimize the amount of disloyalty as measured by the narrow definition above.

Most people would reject this approach. Loyalty is too complex, important, intangible, sacred to have a price. That is probably true. But my cynical expectation is that their plan for allocating pain would favor groups they liked. Management is usually very considerate of managers, less careful of workers. People are apt to see the virtues of those that look and think like they do; but

only the faults of people who are different.

Moreover, once the requirement for consistency is removed, a political fight will result. The winner will not be the most loyal or the most careful moral thinker; the winner will be the one with the best political skills and the strongest power base. In my experience, the financial analyst's plan, despite its insensitivity to higher things, would produce a fairer result than a free-for-all.

Bold or Careful

Financial decision making is bold. It always gives a consistent answer. That answer may be wrong. More general moral reasoning may not be able to answer, or may not be able to give a consistent answer or may take a long time and lots of careful thought to get an answer. But that answer should always be right, at least to the extent that humans can be right.

I believe that one can err on either side of this issue. Someone who always demands a quick, clear answer will be wrong a lot. But someone who never demands such an answer will not get much done. In some fields it is better to do nothing than be wrong; but in others it is always better to do something. Finance is the art of mobilizing economic resources, failure to decide means resources are wasted.

Moral rules tend to be conservative. When in doubt, do not sin. But aggressiveness has a place in life as well. I do not think our only reason for being is to protect our consciences; we were meant to build and strive as well. Yes, this sometimes leads to error but mistakes are part of life. People who never make mistakes accomplish little.

Easy to Use

Real ethical decisions, at least in business and professional life, are complex and uncertain. A useful response must be quick and must be intelligible to people of widely varying moral background. Financial decision making provides such a response.

Consider a decision to market a new product. There are thousands of aspects of that decision, each with both economic and

ethical issues. Many of these aspects are uncertain. There is no practical way to evaluate each ethical issue. Even if we knew the answers, there is no way to net them out; and there is no way to balance them against the economic considerations.

This situation can lead to two opposite errors. Some people will simply dismiss all ethical concerns; "business is business" is a phrase these people like. Other people will insist on coming to an overall moral judgment. But since things are so complex and uncertain, they will be unable to come to a complete one. This will put them in extreme danger of rationalizing; of doing what they want and cloaking it in the name of morality.

Almost any practical business decision can be attacked as deeply immoral, or praised to the skies, depending on your inclination. Very few people have the mental rigor to do anything but come to the conclusion they wanted in the first place. Avoiding this error would require a deep knowledge of ethics, a complete familiarity with all aspects of the business decision and the mental power to integrate these without prejudice.

This is why an easy-to-use ethical standard is a great human achievement, even if it is sometimes wrong. It is far better than rationalizing or ceding the decision to people too arrogant to admit doubt.

Charles Goren invented a point-count method for bridge bidding. Most contemporary experts ridiculed the scheme. The art of bridge bidding was too complex to be reduced to a single number. But they overlooked one thing. Goren's system allowed any beginner to get close to the correct contract. It was often a trick or two off, but without it beginners did much worse.

With all the randomness of bridge as played by beginners, Goren's system was as good as any expert system and far easier to use. Therefore it was immensely popular and forms the basis of almost all bridge bidding today (including most expert systems). Pretty good and easy-to-use is a powerful combination; it often beats perfect-in-theory.

Financial decision making is the ethical counterpart of

Goren's point-count bidding. It can take you near the correct answer with a minimum of effort. And effort is important in business. You will not have the time or resources to consider everything; you must allocate your energy. Better to make a hundred pretty-good decisions than one perfect one.

Universally Accepted

Business organizations require the cooperation of all kinds of people. Between suppliers, employees, customers, regulators and other concerned parties; you will find representatives of every major religious and irreligious tradition; every personality type; every social strata. All of these people will understand money. Some will not understand English, some will not understand the law, and most will probably not understand your ethical principles. The only way to get them to cooperate with a decision is to analyze it in terms of money.

One danger of this is assimilation. Money is the lowest common denominator of human relations. If it becomes your moral guidepost you will not stand for much. If you do all the things everyone tells you are right, you will end up living a life that no one thinks is right.

But there is another danger on the other side. If you refuse to communicate with people different than you, you will miss out on a lot. If you choose to isolate yourself from the world, that is your right. But I do not believe you have the right to participate in the broader world without making an effort to understand its diversity. If you sell something to someone, or hire them, or engage in any other economic transaction; you have some duty to communicate with them.

History is full of disasters that occur when two cultures meet. Often these are caused by people with the highest motives: missionaries and people claiming to work for social improvement. Traders have only low motives, making money. Yet traders often form the basis of true communication between the cultures; forge the links that can lead to peaceful co-existence; learn to respect the similarities and differences of people.

Final Words

Financial decision analysis is a tool. Tools can do useful work; tools can cut your thumb off. You have to know when and how to use them.

But do not despise tools by holding them against impossible ideals. A knife may not cut perfectly straight, sometimes it cuts the wrong thing, and sometimes it cannot cut at all. But knives are useful, nonetheless.

So learn your finance and use it with confidence and some small pride. Do not jettison all your other knowledge; do not rely on finance completely; do not let money be your only guide. But you will accomplish more in life and avoid many ethical traps if you know a net present value when you see it.

Fraud in Financial Statements

Debbie Zucker

As investors in stock, we assume that the companies that we invest our money into and put our faith in will not deceive us. Unfortunately that is not always the case and there are many instances when management fraud is discovered, but it is too late. What follows is a myriad of lawsuits against both the company itself and the auditors who failed to detect the schemes early on. Why do companies produce fraudulent financial statements? How do they get away with it, and how can it be prevented?

The Auditor's Responsibility to Detect Fraud:

AU 316 of the AICRA Professional Standards, about the auditor's responsibility to detect errors and irregularities, discusses the issue of fraud in detail. The primary difference between the terms errors and irregularities is based on the underlying cause of the misstatement. The term "irregularities" in this case refers to intentional misstatements or omissions of disclosures that cause the financial statements to be misleading, also known as management fraud. It also includes defalcations, the misappropriation of assets.

When an auditor assesses risk at the beginning of an audit, part of this risk involves the fact that there may be a material

misstatement. Bearing this in mind, the auditor "should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to financial statements" (AU 316.05). This does not mean that an auditor is required to authenticate documents. This means that the auditor should exercise due care and professional skepticism when planning the audit so that he can achieve reasonable assurance that he will detect all material errors and irregularities. The auditor cannot guarantee that all material misstatements have been detected.

In order to detect fraud, the auditor is required to exercise professional skepticism in both the planning and performance stages of the audit. When an auditor approaches an audit, his degree of professional skepticism may change based on his risk assessment. The auditor's risk assessment should be affected by his understanding of the internal control structure. When an auditor assesses audit risk he must consider the management characteristics. If management is dominated by a single person the risk of fraud may be higher and thus, the auditor's assessment of risk may be higher.

The auditor must also take into account the operating and industry characteristics of the company. For example, if the organization is decentralized and there is inadequate monitoring this may give the auditor more reason to be concerned and will thus affect the auditor's assessment of risk. The auditor may also consider certain business/entity factors. There may be difficult accounting issues present, or there may be transactions or balances present which are difficult to audit. All of these factors, as well as many others can create a higher possibility of fraud and should affect the auditor's assessment of risk.

The auditor's whole approach to the financial statements should be one of professional skepticism. The term professional skepticism means that the auditor "neither assumes that management is dishonest nor assumes unquestioned honesty". Rather, the auditor observes conditions and obtains evidential matter (including information from prior audits) and objectively evaluates them in order

to determine whether the financial statements are free of material misstatement. The auditor particularly takes note of the management's integrity, since management can direct subordinates within the company to record transactions and conceal information in a fraudulent manner.

The auditor's overall judgment of risk does not only affect his professional skepticism; it can also affect the staffing, extent of supervision, and scope of the audit. If the auditor assesses risk at a higher level he will approach the audit with a higher degree of professional skepticism and will take greater measures to detect fraud. This is determined in the planning stage of the audit.

When planning the audit, if the auditor concludes that there is significant risk that the financial statements are materially misstated, he should adjust the nature, timing, and extent of procedures to be done during the audit. The auditor should realize that management's selection and application of significant accounting policies might be misused, especially those related to revenue recognition, asset valuation and capitalization versus expensing.

In the performance stage of the audit, the auditor must continue to maintain an attitude of professional skepticism. If conditions during the audit differ from the auditor's expectation and may have an adverse effect, the auditor must consider the reason for that difference and may have to reconsider the planned scope of the audit procedures. This may happen under various circumstances.

When the auditor performs analytical procedures those differences may be revealed. In addition, confirmation requests may disclose significant differences or the auditor may have received fewer responses than usual. The transactions selected for testing may not be supported by the proper documentation or may not be properly authorized. Supporting records that should be readily available may not be produced immediately when requested. Audit tests may detect errors that were not disclosed to the auditor right away, yet were known to client personnel.

The third step of the audit is the evaluation of the audit test results. During this stage the auditor should consider the quantitative,

as well as the qualitative aspects of matters concerning any significant differences between the accounting records and what the auditor has discovered through the application of auditing procedures. The objective of the auditor is to reach a conclusion as to whether the financial statements are materially misstated on the whole.

If the auditor does discover that an item is materially misstated he should consider whether it will affect the overall financial statements as a whole. This is because the auditor's objective is to decide whether the financial statements, taken as a whole, are materially misstated. If the auditor determines that the effect of the irregularity on the financial statements is immaterial, it does not mean that he should not make note of it. He should refer the matter to the appropriate level of management, at least one level above those involved in the statements. He should also make sure that the irregularity has no implications for any other parts of the audit.

If the auditor determines that an audit adjustment is an irregularity and it actually is material or has potential to be material he must take a number of steps. First, the auditor must consider the implications it will have for the remainder of the audit. Second, he should discuss the issue and do further investigation with an appropriate level of management. The management should be at least one level above those who are involved. Thirdly, the auditor should obtain "sufficient competent evidential matter" that the material irregularities exist.

Whether an irregularity is material or not has an important effect on the report given by the auditor. If he concludes that an irregularity has a material effect on the financial statements, he should insist that the statements be revised. If they are not revised, he should give an adverse or qualified opinion. But, if the auditor cannot come to any conclusion about whether the possible irregularities are material or not, he should disclaim or give a qualified opinion. He should also communicate what he had found out to the audit committee or the board of directors. (1)

Assuming that an auditor follows the steps of an audit and is

careful in his performance of the audit, recording all irregularities and presenting them to the appropriate people, fraud should never go undetected. Over the past several years however, fraud within all types of corporations has grown. As a result, many investors have lost money, managers have lost jobs, major companies have filed chapter 11, auditors have been sued and have lost faith in their clients, and most important, companies and their management have lost their integrity.

Example of Financial Statement Fraud:

An Auditor Takes The Blame - The Phar Mor Inc. Lawsuit:

During the same month that Robert Eisner was sued, another accounting firm, Coopers and Lybrand was found liable for securities fraud involving its client, Phar Mor, Inc. Coopers and Lybrand first started auditing Phar Mor's financial statements in 1984. At that time the company was a very small six-store offshoot of Giant Eagle, a Pittsburgh-based supermarket chain. Eight years later, the drugstore chain had 311 stores and had become a big success story in the American retail industry. Many outside investors were interested in the company because it had the potential to become the next Wal Mart.

The secret behind Phar Mor's success came from Mickey Monus, the company's founder. The drugstore would appeal to customers because the non-pharmaceutical items were extraordinarily cheap, even though the stores may not have carried every brand, size, or flavor of a certain item. All of those items would be bought in special, high volume deals with suppliers and then marked up a flat 20%.

The strategy however, just didn't work. Most discount stores such as Kmart have about a 25% gross profit margin, while non-discount drug stores have a 40% gross profit margin. But, due to Phar Mor's 20% markup, which was a percentage of the sale price, its gross profit margin was a mere 16.5%. This meant that a small drop in gross profit margin, even one as little as 1% could have drastic effects on the company's net income.

In the late 1980's after Phar Mor opened stores beyond its base in Ohio and Pennsylvania, the company ran into problems and management realized that the strategy just could not work. This was because the drugstore started running into competition from national chains, such as Wal-Mart. As a result the company was forced to cut prices and it began selling loss leaders (such as cans of Coke for 35 cents). In 1988, Jeffrey Walley, the company's vice president of finance discovered that the gross profit margin had dropped to 15.5%. He knew that it would be extremely difficult to stay profitable and warned management of this fact in a memo.

Walley was right in fact, and the company did not remain profitable. The gross profit margin fell far below 15.5% by 1991. Top management however, had their own way of dealing with the problem. Under the guidance of Michael "Mickey" Monus, and the company's chief financial officer, Patrick Finn, Phar Mor recorded in its annual financial reports a steady gross profit margin of 15.5% and a net operating income of $2 million in 1989 and $399 million in 1991.

Between 1989 and 1992 the company opened almost 200 new stores and raised 658 million in private placements. Phar Mor Inc. was able to sell itself to investors, such as Sears, Westinghouse, DeBartolo, and Equitable, as a profitable corporation, when in reality it was losing money. In fact, the company's net operating income in 1991 alone was a loss of $145 million and in 1992, $238 million.

Monus and Finn were able to hide the losses by carrying losses on the ledgers as inventory. To increase profits on paper, they lowered expenses by converting them into assets. They lowered the expenses by moving expense entries, such as advertising, into inventory. At the end of the fiscal year they spread those "assets" out among the hundreds of Phar Mor stores, in order to fool the auditors. Monus and Finn hoped to eventually reduce or wipe out the decreasing profit margin with money from vendors who were willing to pay Phar Mor "under the table" in order to carry their products exclusively. (2)

Another method used to commit the fraud was understating

the amount of accounts payable by holding disbursement checks. They also overstated inventory and recorded consigned inventory as owned inventory. Furthermore, they recorded revenues and receivables from vendors at budgeted, rather than actual amounts. All throughout the scheme, Coopers and Lybrand never caught on. (3)

The fraud was eventually revealed by accident. Giant Eagle and Phar Mor CEO David Shapira discovered that an $80,000 Phar Mor check was used to pay travel expenses for a basketball league that Monus supported. He had actually taken about $15 million from the company for himself and the basketball league. After investigating the check, Shapira discovered that the problem went far beyond $80,000. Finally, in April of 1992, one of Monus' subordinates taped a Saturday morning meeting regarding Phar Mor's upcoming audit and how they would hide the fraud from the auditors. Almost four years later, the recording of that meeting helped convict Monus on 109 felony counts of fraud, embezzlement, and tax charges.

When the lawsuits began, the majority of them were centered around the accountants who should have detected the fraud. In August of 1992, Phar Mor and Shapira, Giant Eagle's CEO and the new controller of the company at that time, fired Coopers and Lybrand, declared bankruptcy and sued the accounting firm. In addition, hundreds of Phar Mor investors, suppliers, lenders, and landlords filed suit against Giant Eagle and Coopers & Lybrand for negligence and fraud. Coopers & Lybrand faced about $1.5 billion in claims in about 40 separate state and federal lawsuits.

The accounting firm defended itself by pointing a finger at Phar Mor and Giant Eagle. The auditor's lawyer attacked David Shapira in particular, and "strongly suggested" that he was aware of the fraud at Phar Mor all along. The proof was that Shapira visited all of the company stores, talked to managers, and spoke to Mickey Monus daily. In addition, Giant Eagle's general council, Charity Imbrie, sent Shapira a memo about suspected problems at Phar Mor. When he received it, he tore it up and told her to destroy all copies. The lawyer threatened to put Shapira on the stand. The threat worked

because the next day Phar Mor settled with Coopers & Lybrand.

By attacking Phar Mor, Coopers was able to take the attention away from the firm itself and the accounting issues. They were able to do the same thing when they defended themselves against the Phar Mor investors. Coopers' lawyers called the plaintiffs greedy investors. For example, Westinghouse maintained a close relationship with PharMor which the lawyers claimed gave it access to much more information than just the audited financial statements. One Westinghouse representative even attended Phar Mor meetings. In addition, to improve its 1990 financial results, Westinghouse sold its Phar Mor stock to Mellon Bank subsidiary Allomon Corporation and recorded a profit. It then bought the stock back for the same price a few days later, after the quarterly reporting period ended.

The plaintiffs were finally able to point a finger at the accounting firm when it was time to discuss accounting issues. The plaintiffs pointed out numerous problems with the Coopers & Lybrand audit. Every year, Coopers & Lybrand tested gross profit margins at only four out of a hundred Phar Mor stores, even after they failed to confirm Phar Mor's gross profit rate of 15.5%. Furthermore, the accountants never bothered to look through the company's general ledger, which was full of false accounts to cover up the Phar Mor's failures. They had also never examined the company's manual check log. The check log showed evidence of the payments that Monus had paid to the World Basketball League. The jurors felt that Coopers & Lybrand did not ask enough questions at Phar Mor.

The jurors had decided that the auditors did not perform a Generally Accepted Auditing Standards audit. There were too many inconsistencies in Phar Mor's books that were ignored by Coopers & Lybrand. Another big question was whether the plaintiffs had relied on the Cooper's audits. In the end, it only made sense to believe that the corporate plaintiffs did use the audited financial statements to make their investment decisions. Even if the particular investor had strategic reasons for making his investment, a big corporation is not going to invest its money without first looking at financial statements. That is why, in the end, Coopers & Lybrand was penalized for

performing incomplete audits and lost the case. (2)

Michael Monus was sentenced to twenty years in federal prison and Phar Mor Inc. was forced into three years of bankruptcy protection. The company was reorganized and then bought out of bankruptcy in 1995 by an investor group. In September 1996, the company merged with ShopKo Stores Inc., and became part of Cabot Noble Inc., a then newly created publicly traded holding company. (4)

Why Fraud Goes Undetected and How It Can Be Prevented:

If the methods used to conceal frauds are pretty simple and not very original, how could a fraud reach the magnitude of the one committed at Phar Mor Inc.? The reason lies within the overall corporate environment Phar Mor. Fraud can flourish within a company if the overall corporate environment has flaws and weaknesses. Phar Mor is an example of a company, which lacked very basic controls and management principles. As a matter of fact, prudent management and the lack of basic internal controls are very common, and found in all types of companies, both large and small.

Internal Controls:

The reason that many corporate environments are weak is because they have weak internal control structures. Internal controls are the policies and procedures established by a company's board of directors and management. They are designed to provide reasonable assurance that the company's assets are safeguarded. They also ensure that the transactions recorded in company books and records are authorized by the appropriate level of management, recorded on a time, and in the proper period.

Some important internal controls are segregation of duties, timely reconciliation of general ledger accounts, periodic physical inventory counts, proper review and authorization by management, as well as proper support and documentation of all transactions and journal entries. It is also important to note that even if a company seems to have strong internal controls formally written out in policies

and procedures manuals, they may not actually be put into practice, which makes such a company susceptible to fraud.

Phar Mor Inc. was a rather large company with over 300 stores and thousands of employees and lacked many of the basic internal controls. For example, many manual journal entries and manual checks did not pass through the "normal" system and did not have the proper authorization, explanation, or documentation. Such manual transactions prevented auditors from tracing the fraud.

The Audit Committee:

One other very important internal control is a formal internal audit function within a company, which reports to outside directors. (3) The role of the audit committee is to protect the interest of shareholders. As a result, sometimes the audit committee is required to adopt a "probing attitude" and question management's judgment. It may also sometimes have to adopt positions that disagree with those of management. For this reason, according to the Public Oversight Board, in order for an audit committee to be effective, it should consist solely of outside directors, who are not employees of the company.

A study done by Price Waterhouse for the Institute of Internal Auditors called "Improving Audit Committee Performance: What Works Best" felt that in order for an audit committee to be effective the members of the committee must have expertise in accounting, internal controls, and auditing. In fact, many failed financial institutions had audit committees whose members were not experts in financial management. A CPA on an audit committee might make the committee more aware of financial reporting, accounting and auditing issues. Studies showed that companies with financial reporting problems were much less likely to have a CPA on their audit committees. (5)

According to two US accounting professors, in order for a corporate audit committee to be effective, it must have external directors, accounting and finance expertise, and frequent meetings. Dorothy McMullen of New Jersey's Rider University and K.

Raghunandan of the University of Massachusetts came to this conclusion after comparing companies with financial reporting problems with those who do not. The problems included either SEC enforcement actions or material restatements of quarterly earnings. Only 67 percent of companies with problems had audit committees that consisted of solely outside directors. Eighty-six percent of non problem companies only had external directors. The National Commission on Fraudulent Financial Reporting also supports the concept of external directors in the audit committee. (6)

The New Standard:

Although an audit committee is essential in preventing fraud in financial statements, the question still remains as to why so many frauds still go undetected by outside public accounting firms. The accounting industries fraud detection rules simply did not work. As a result of the multitude of lawsuits being faced by public auditors the Private Securities Litigation Reform Act came out in 1995. Set to go into effect in December 1997, it imposed a new requirement on independent certified public accountants. (7)

The new act requires auditors to look for a lengthy list of possible risk factors found in previous cases of fraud. The auditor should look to see if management is being too aggressive and pursues overly ambitious targets. He should make sure there is not a sharp difference between reported earnings and cash flow. If risk factors point to a greater chance of fraud, the auditor is then required to delve even more deeply into the matter.

However, according to some critics, the new standard still will not be able to improve audit procedures. The only way an audit can be carried out in the most ideal manner is if the auditor has integrity and skepticism. Therefore, the new standard could be of no help. What it will do is help the good auditors remain good, but the bad ones will still remain bad.

Other critics feel that the problem with the new standard is that it fails to address the real problem, which is the fact that management and their auditors often have a very close relationship.

Sometimes accounting firms don't ask tough questions because they are trying to sell tax and consulting services, which are more lucrative, to the same companies that they audit. In addition, sometimes audit firms just walk away from potentially troublesome clients, rather than deal with the problem at hand, in order to prevent greater legal liability. (8)

In the end, even the toughest auditing standards are unable to stop most frauds. If a manager has the intent to break the rules, he will find a way to fool even the most careful, diligent auditor. That is why companies like Phar Mor managed to get away with their fraudulent scheme. We can only hope when we chose to invest in a company's stock, that the auditors will continue to approach every audit with professional skepticism and that management will have the integrity it needs to enforce strong internal control and accounting practices.

Endnotes

1) AICPA Professional Standards, Volume 1, As of June 1,1996. AU 316, pg 245-250.

2) Emily Barker, "Knocked Off Balance", The American Lawyer, Jul/Aug 1996, pg 52.

3) Robert Rock and Julie Severson, "Demystifying Corporate Fraud", National Association of Credit Management, Business Credit, Jul 1996, Vol. 98, no.7, pg 26.

4) Doris Hajewski, "ShopKo Phar Mor join $1 billion merger deal", Milwaukee Journal Sentinel, Business, pg 1, Sept 10,1996.

5) Dorothy McMullen and K. Raghanandan, "Enhancing Audit Committee Effectiveness", American Institute of CPA's, Vol. 182, no.2, pg 79, Aug 1996.

6) "Study pinpoints factors affecting corporate audits", The Accountant, Oct 1996, pg4.

7) "Auditor's duty to blow the whistle under the litigation reform act", New York Law Publishing Company, Oustide Counsel, pg 1, Feb 9,1996.

8) Mark Maremount, "Bean Counters Get An Early Warning System", The Corporation, Accounting, #3505, pg 68, Dec 9,1996.

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Discrimination in the Workplace

Cheri Ochs
Rachelle Butler

Legislation barring discrimination against members of minority groups has been in existence in the United States for at least two centuries. The Fifth Amendment of the US Constitution (1791) states that "no person shall be deprived of life, liberty or property without due process of the law." The Thirteenth Amendment, in 1865, abolished and outlawed slavery. This law has been expanded in its applications in the courts to bar racial discrimination as well. The courts have relied on the Fourteenth Amendment (1868), which states that it is illegal for any state to "make or enforce any law which shall abridge the privileges and immunities of citizens of the United States," to bar discrimination on the basis of sex, national origin and race (Dossler, 34). Unfortunately, it was not until the 1960's that the US government began to confront issues of equal employment.

Title VII of the 1964 Civil Rights Act states that an employer cannot discriminate on the basis of race, color, religion, sex or national origin. Title VII applies to discrimination on the part of the employer of all public and private employers of 15 or more employees. It also includes all private and public educational institutions, the federal government, and state and local governments.

Public and private employment agencies are barred from failing or refusing to refer for employment any individual because of race, color, religion or national origin. In addition, joint labor-management committees established for selecting workers for apprenticeships and training cannot discriminate against individuals.

The Equal Employment Opportunity Commission, instituted by Title VII, consists of 5 or more members appointed by the President, to receive and investigate discrimination complaints and sue on the behalf of the complaintee.

Affirmative Action requires the employer with contracts of over $50,000 of 50 or more employees to ensure equal opportunity in their company and take steps for the purpose of eliminating the present effect of past discrimination.

Equal employment opportunity strives to ensure that anyone regardless of race, color, sex, religion, national origin or age, has an equal chance for a job based on his or her qualifications (Dessler, 43). In contrast, affirmative action employers make the extra effort to hire and promote those protected groups. Affirmative action embodies specific actions in dealing with recruiting, hiring, promoting and compensating that are designed to eliminate discriminating policies or actions within the company (Dessler, 43).

Even with the numerous acts passed subsequent to the Civil Rights Act of 1964, discrimination against these protected groups is still prevalent in the workplace. With the passing of the Civil Rights Act in November of 1991, the controversy over discrimination escalated even further.

Before the passing of the Act, the Equal Employment Opportunity commission (EEOC) received over 60,000 complaints. Yet, only a minute fraction- less than 700 were actually filed and proceeded to court. Employers were not at all threatened by accusations of discrimination; they would suffer minimal setbacks as a result. The new act, however, may be powerful enough to move employers to action to correct any wrongdoing.

The Civil Rights Act of 1991 expanded the legislation to include women, minority groups, and the disabled. For the first time,

women can collect compensation for all kinds of discrimination ranging anywhere from sexual harassment to bias against pregnancy. The claims can extend from "malicious bias, inconvenience, to even emotional pain"(Lee, 1).

Victims of racial harassment benefit enormously from the new act which overturns a 1989 Supreme Court decision; they can now receive unlimited damages. Furthermore, the new act removes a sizable burden from the side of the employee. Juries will now decide in cases of bias claims, not judges, and juries often prove more sympathetic to employees (Lee, 1).

The employer must now be prepared not only to lose the case, but also, according to the new act, to "pick up the tab for the winner's expert witnesses...expert witnesses don't come cheap" (Lee, 1). In fact, in the past, lawyers have refused to accept such cases due to their high costs. The new laws of the 1991 Civil Rights Act significantly improve the odds not only of the employer acquiring legal representation, but also of his winning the case.

Discrimination in the workplace is a broad subject that spans over general areas. In this paper, we have chosen to elaborate on a few of these areas of discrimination.

Ageism

The Age Discrimination in Employment Act states that it is unlawful to discriminate based on age, especially those individuals over the age of 40.

"Ageism", discrimination based on an individual's age, is becoming more visible in the workplace as several members of the workforce begin to "age". Workers 55 and over are the fastest growing segment of the workforce and companies are slow to adapt to this phenomenon. Many companies perceive older workers as unadapatable, unmotivated, and costly (Capowski, 1).

Ageism is a bias that is much more subtle than other discriminations such as racism and sexism. But ageism is not a new occurrence, so why are we first beginning to hear about it now? It is a result of the Baby Boomers who are now coming into their 50's and

are forced to confront this issue (Capowski, 2). According to Cathy Fyock, president of Innovative Management Concepts, Baby Boomers have "long influenced the direction of this country" and now they want to change the long standing perception of aging (Capowski, 2). Even though the Baby Boomers are considered "older", they don't feel old and do not want to be treated in that manner. Don Davis, vice president of senior community services employment at the National Council on Aging stated that "age discrimination will be the civil rights issue of the next decade's mostly because an increasing number of the people who fought for civil rights in the 1960's are now middle aged" (Capowski, 2).

While many cultures turn to their elders for their guidance wisdom, America is extremely youth oriented. This is even more evident now with many corporations instituting early retirement programs for their employees. The rationale seems "to be pure economics...Get rid of the older, more expensive worker and find younger, cheaper replacements" (Capowski, 1).

Many companies have this unfounded belief that older workers cost employers more because of "perceived higher healthcare costs", when in truth, if this were the case, then many retirement programs would not include healthcare benefits (Capowski, 2). Furthermore, by having employees on your payroll longer, it postpones the company's obligation to pay out pensions until later on (Capowski, 2).

There are many myths that have been ingrained in our society, which perpetuate age discrimination. The most prevalent myth is, "you can't teach an old dog new tricks" - but studies show that a person's capacity to learn can exceed their 70's. We also have the mentality that once employees reach a certain age, they become unmotivated, when in fact many older workers prefer to continue their jobs rather than retire. Many employers make the assumption that older workers plan to retire soon and are passed over for job-related training and higher educational programs. This reflects upon the employees which in turn can result in unmotivation on their behalf (Capowski, 4). Denise Lofius, manager of workforce

education, Workforce Programs at the American Association of Retired Persons, believes that it is the company's responsibility and obligation to ensure that all employees are given an opportunity to receive training and encourage everyone to take it (Capowski, 4).

Companies are only looking at the momentary bottom line, rather than the effects of laying off their long time employees. Besides the most obvious loss of experience and skill that occurs when older employees are let go, "studies confirm that older workers are more often motivated, more committed, more loyal, less apt to call in sick, and less prone to accidents on the job ..." (Capowski, 3). Companies do not look far enough down the road to realize how vital their older, expert, experienced and loyal employees are, and how they will be needed to fill up the workplace as their replacements represent a smaller workforce (Capowski, 3).

According to Helen Dennis, a lecturer at the Andrus Gerontology center at the University of Southern California and author of 14 Steps in Managing an Aging Workforce, "There is enough research that says older workers are dependable, they can change, they can learn. What we haven't come to grips with is that research and management practices are not always related" (Capowski, 3).

McDonald's is one company that set precedence with its innovative corporate policies that value and encourage older workers. In 1986, McDonald's took proactive steps and created the McMasters program. Although the program is no longer officially in existence, according to a McDonald's spokes person, they now employ over 40,000 seniors at McDonald's all over the world (Capowski, 3).

What measures can companies take to combat ageism and bring about change in the workplace? According to USC's Dennis, the most crucial vehicle for change is education. "That's increasing awareness, increasing knowledge, increasing problem solving, and that's moving in a proactive way. And that's all very business like...To believe it will get done out of the goodness of people's hearts is naive; it has to be declared a priority by management" (Capowski, 6). Dennis feels that although we are dedicated to

creating diversity in the workplace, many companies fail to figure in age as part of the equation. "Yet she is optimistic that as the Boomers advance further into decision making positions, they won't tolerate age discrimination" (Capowski, 7).

Dr. Kathryn Jordan, President of Employment Counseling Services Inc., takes a different stance on the issue of ageism. In her article titled, "Ageism in the Workplace: Fact or Fiction," she states that although many middle aged job seekers may experience that finding a job has become a harder task than when they were younger, "the sense of 'ageism' is complicated by several closely related themes." One "related theme" is that naturally, over an individual's professional career, they move up the corporate ladder. As their responsibilities increase, the number of jobs related at that level decreases. This is why higher level executives have a longer and more challenging time searching for a position that best suits their qualifications (Jordan, 1). Another unfortunate strike against the more experienced worker is that many employers may opt not to hire over-qualified employees because they tend not to be long term employees (Jordan, 1).

Dr. Jordan believes a "second closely related theme is tied to change and experience." An employer's preference is always to hire an individual with experience directly relevant in their workplace because it is believed that this will facilitate a smooth transition for the employee into his or her new position and there will be no loss of productivity. Often many older employees will have experience which may lie in fields which are no longer in demand and if their skills are not promotable, they do not have any competitive edge over other applicants (Jordan, 2).

Dr. Jordan believes that the key to counterbalance "ageism" in the workplace lies in the older employees "marketability". The job seeker needs to use "skillful marketing and sales strategy" in order to overcome the discrimination of ageism. The employee should focus on certain important points, which emphasize their skills:

* "A strong work ethic; the willingness and energy to work hard.

* The ability to work hard both in team situations and independently.
* Ability to adapt to the changing environment and examples of new technological skills and/or continuing education experience in the field.
* Persuasive and accurate communication skills with examples of written and oral communication projects.
* No plan for retirement.
* Excellent health, evidenced by a healthy lifestyle" (Jordan, 2).

Dr. Jordan advises, "It is a matter of playing to your strengths and defending against possible objections to your credentials in all phases of the job search process" (Jordan, 2).

Women

In general when people hear of discrimination in the workplace, they automatically think of women. Many studies have been performed, such as one done by a bipartisan federal commission which completed a three-year study in November of 1995 on discrimination in the workplace. It was noted in the final report that: "minorities and women still face barriers to advancement in corporations: the so-called glass ceiling." (Witt, 14).

As explained in the commission's report, "The 'glass ceiling' is a concept that betrays America's most cherished principles. It is the unseen, yet unbreachable barrier that keeps minorities and women from rising to the upper rungs of the corporate ladder, regardless of their qualifications or achievements." According to the research done, women are being under represented at the "highest levels of corporate America." It says that 95-97 percent of the senior managers in the Fortune 1000 industrial and Fortune 500 companies are men while only five percent of the senior managers in the Fortune 2000 industrial and service companies are women. Fifty-seven percent of the workers on the panel, known as the Glass Ceiling Commission chaired by Secretary of Labor Robert B. Reich, were women. According to the commission, this makes the statistics "all the more telling" (Witt, 14)

This is not so according to another study cited about a year later. This study, packed with facts and figures, misspells the "Glass Ceiling" myth. Diana Furchtgott-Roth and Christine Stolba performed a study entitled "Women's Figures: The Economic Progress of Women in America", published by the Arlington, Va.-based Independent Women's Forum and the Washington, D.C.- based American Enterprise Institute.

Results of this study would put smiles to the faces of those people who feel that they have heard enough about the "Glass Ceiling." This is "the countervailing force," referred to as the " Glass Floor" - "that, regardless of women's income, seems to keep their share of total wealth up to- and beyond- male levels" (Brimelow, 47).

What happened, one may ask, to the data stating that women on average earn 72 cents for every male dollar? The authors of the study prove that figures such as those are misleading because they do not keep into consideration a woman's education, part or full-time status, experience, or other job and demographic characteristics. Once these factors are accounted for, one will notice a change in the wage gap. It is much smaller and is "narrowing- especially for younger women" (Brimelow, 47).

The study shows through charts and figures that the wage gap continues to shrink due to the rise in the number of women continuing on to higher education. More and more women these days that are entering the workplace are coming in with Ph.D.s and other professional degrees. The remaining part of the gap, they say, is not due to discrimination at all - in fact - it is due to the women themselves - "to factors like motivation-such as a perhaps sensible refusal to place work above personal life" (Brimelow, 48).

What the study tries to clear up is that the wage gap "has not affected women's share in aggregate personal net worth - assets minus liabilities" (Brimelow, 48). It may seem that women are making less or own less assets because female heads of households do own less wealth than male heads on average; however, since there are more women, their ownership as a whole is greater. Overall, women owned 53% of total net worth, about their proportion of the

population. "Among the 3.4 million Americans that the Internal Revenue Service regards as the top 'wealth holders' ($600,000 plus gross assets in 1989), just over 40% are women. But their average net worth is higher" (Brimelow, 48).

According to the *Harvard Business Review,* "The number of women in the workforce today nearly equals the number of men." A closely related gender issue is discussed by a gender-equity consultant and co-author of Women and the Work/ Family Dilemma - Deborah Swiss; the issue is if the women in the workforce and in those top management positions feel that they are given the same opportunities as men and are receiving equal treatment. Deborah Swiss performed a study by compiling data from a five-page survey filled out by 325 professional women and in depth interviews with 40 of the participants. Her results led to the following statistics: 25% of her women occupied senior management positions, more than 50% felt that it had taken them longer than their male counterparts with the same credentials to advance up the corporate ladder, and 68% felt that they were "held to a higher standard than their male coworkers" (Rheem, 14).

The results surprisingly showed that although many organizations have officially changed their policies towards women, these new policies are not being put into practice. As Deborah Swiss said, "Many companies have now committed to gender equity in glossy print" (Rheem, 14). What needs to be done is a change in the attitudes and methods of educating the personnel.

Many of the women in the panel share the view that the "CEO's message of equal opportunity didn't filter down to line management. Even if the CEO is firmly committed to diversity, there may be a whole level of managers beneath him who aren't comfortable working with women" (Rheem, 14). In addition, almost 75% of the women felt that once a woman has a child, her coworkers no longer consider her as committed to her job. Despite these concerns, women are still continuing to rise to the top. According to Deborah Swiss, this is due to the fact that instead of blaming the system, women are "finding ways to fix it" (Rheem, 14).

Disabled

Throughout history, individuals with disabilities have been discriminated against socially and economically. For this reason, it was necessary for federal law to create the Americans With Disabilities Act and the Rehabilitation Act of 1973. These acts prohibit discrimination of the disabled. As long as the individual is otherwise qualified, equal opportunity for employment should be granted.

These Acts were primarily established in order to promote equality and opportunity for all U.S. citizens. In the past, the disabled were considered unable to contribute and participate in society. According to national polls, people with disabilities had been considered an "inferior" group throughout the country, suffering disadvantages in all aspects of society. Individuals with disabilities were faced with restrictions and limitations in their pursuit to become self-sufficient and gain acceptance in society.

Under these laws, the disabled individual receives the protection of their civil right of equality. Those entitled to the benefits of this law are individuals with "a physical or mental impairment that substantially limits one or more of the major life activities of such an individual..." This definition includes anyone with a history of a condition.

A more recent act in favor of Americans with disabilities was enacted in 1991. It is an amendment protecting qualified disabled applicants and employees from discrimination "in hiring, promotion, discharge, pay, job training, fringe benefits, classification, referral, and other aspects of employment on the basis of disability" (Web2). It is clear that the disabled in the workplace have come a long way.

An example of a situation where a group of disabled workers felt as though they were being discriminated against occurred in Orange County, California. A group of 300 disabled workers were temporarily suspended from their jobs that included food handling and childcare, when a hepatitis A epidemic broke out. This strain of the virus spreads through contaminated food and physical contact. The County's Health Care Agency came out with work restrictions

after the hepatitis breakout. These restrictions prohibited workers from being allowed back to their office until they could prove that they were immune to the disease through a blood test. The restriction came out after seventeen developmentally disabled workers contracted hepatitis A.

On behalf of the disabled workers, a class-action lawsuit was filed against the Health Care Agency for allegedly discriminating against the developmentally disabled workers. After the county denied the discrimination allegations, they rescinded the work restrictions. A Sacramento group, Protection & Advocacy Inc. "alleged that they had unfairly targeted the disabled" (Maharaj, 1).

The county's Health Care Agency settled by agreeing to review its policies on such diseases and to implement training seminars that would teach issues involving people with developmental disabilities. As a result of this lawsuit, there was a formal stating and realization that "some employers have, apparently, refused to continue to employ people with disabilities" (Maharaj, 2). As a result of settlement, the county plans to write letters to such employers "to underscore that the Health Care Agency, by its investigation and issuance of work restriction orders, did not intend to suggest that developmentally disabled workers as a group present an unacceptable risk as workers" (Maharaj, 2).

A new problem for employers has arisen since the new federal ruling passed on April 23, 1996. Employers have been accused of violating the Americans with Disabilities Act when they refused to hire an employee based on a doctor's physical exam. The new federal ruling which keeps employers from refusing to hire workers with some disabilities was a victory for the Equal Employment Opportunity Commission. However, this ruling has posed many problems for workers who decide to "err on the side of caution in rejecting workers with some disabilities out of fear that they may be injured or injure others" (Taylor, 1). It can be a tough call for employers. They can find themselves stuck at a point where their only choices are either to be potentially liable for worker's compensation or to be liable for violating the rights of workers with

disabilities.

An example of a situation exhibiting this type of discrimination occurred when Texas Bus Lines Inc., a bus company of Austin, Texas denied a 345-pound woman employment as an airport shuttle driver. The employer said that his refusal to hire was based on the physician's report on the woman. The doctors opinion was that: "the woman could not move quickly enough at that weight to respond adequately in emergency situations" (Taylor, 1). The woman in this case was granted "summary judgment." The judge, U.S. Magistrate Judge Frances H. Stacy, indicated that there was "an inadequate assessment of her job duties by the doctor and the company" (Taylor, 1).

Even though, many employers may strongly disagree with such a decision, they choose to go along with it because of the high costs of pursuing such a case. "The costs of the settlement are less than further litigation," says Timothy Mashbum, of Austin's Felts & Mashbum, the attorney for Texas Bus Lines Inc. (Taylor, 1).

Homosexuals

Since the initiation of Title VII of the Civil Rights Act, there has been subsequent legislation to ban other types of discrimination such as the Age Discrimination in Employment Act (1967) and the Americans with Disabilities Act (1990); however, there has not been a federal law passed that would prohibit workplace discrimination based on sexual orientation (Kovach, 15).

According to a poll completed by the Wall Street Journal, 66% of CEO's from Fortune 500 companies indicated that they would hesitate in giving a management position to a homosexual person (Kovach, 15). In another study, it was recorded that 16-44% of gays and lesbians themselves have experienced some type of discrimination in employment due to their sexual orientation (Kovach, 15).

The Employment Non-Discrimination Act (ENDA) is the "next step on this journey of justice by banning discrimination based on sexual orientation," said Senator Ted Kennedy (D-Mass.)

(Reynolds, 1). This Act would make it illegal for employers of fifteen or more employees to fire, hire, promote or compensate according to one's sexual orientation - referring to gays, lesbians and bisexuals (Kovach, 15). This means that employers could not discriminate against employees because of their real or perceived sexual orientation or because of the sexual orientation of those whom they associate with. The act also does not allow for preferential treatment such as quotas; however, it does not require employers to grant benefits to their employees' same-sex domestic partners (Reynolds, 3).

A formal federal sexual orientation anti-discrimination statue does not exist. However, about twenty-five percent of Fortune 1000 corporations have created a set of rules to stop discrimination against gay and lesbian workers in addition to eight states and the District of Columbia (Reynolds, 1). There are many that agree with the goals of the legislation. "Deputy White House Press Secretary Arthur Jones said the Clinton Administration agrees in principle with the legislation' s goals. "President Clinton feels that people should be able to get and keep a job based on their abilities, rather than on some irrelevant characteristics," Jones added.

On the other hand, there are many people who do not want to get involved and those who believe that these are not the types of "rights" people should be fighting for. For example, one corporate lobbyist said: "I have healthcare reform, OSHA reform, labor law reform and a dozen other pressing issues to work on. Personally, I don't relish getting caught in the crossfire of this running battle between the gay rights movement and the religious right. I just wish it would go away" (Reynolds, 2). There is something to be said for this. Opponents of EDNA contend that the act is about special rights but not the type of rights people in the workforce should be fighting for. "The issue is not job discrimination; it's whether private businesses will be forced by law to accommodate homosexual activists' attempts to legitimize homosexual behavior," said Robert Knight of the Family Research Council. "The bill essentially takes away the rights of employers to decline to hire or promote someone

disabilities.

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who openly acknowledges indulging in behavior that the employer or its customers find immoral, unhealthy and destructive to individuals, families and society" (Reynolds, 3).

The bill not only deals with discrimination based on sexual orientation, but also deals with providing remedies for reinstatement and punitive damages. The act, however, does not apply to members of the Armed Forces. The writers of the act felt that the issues having to do with gays in the military is being dealt with in other congressional acts; they included this idea in the bill itself (Kovach, 15).

Religious organizations find themselves in a sticky situation. In addition to the many religious groups who do support the bill, there are those who feel they cannot because it would go against the basic principles of their religion. On one hand, they want to be "politically correct," but on the other hand, they are not willing to "threaten the basic values they are trying to impart" (Kovach, 35).

Since the bill does not exempt church-run, for profit business, just like any other business with 15 or more employees, the religious group would have to conform with the legislation. Religious-run businesses such as children's summer camps, the Boy Scouts, publishing houses, bookstores, and television and radio stations all must be included. A major fear of these religious organizations is the idea that by conforming to the legislation, they would weaken their message about homosexuality and bisexuality that have been trying to impart (Kovach, 15).

Reverse Discrimination

There is a new strain of discrimination that has emerged in the US and it is what we have labeled "reverse discrimination". "Here in the United States, white, European, physically able, heterosexual men have traditionally defined the workplace norms and standards by which all other group members are judged. Some of those standards have been the socialization of the white men to be physically strong, competitive, aggressive, direct, dominant, knowledgeable and emotionally restrained" (Blank, 1). Oh, how times have changed.

Many employers have instituted affirmative action plans that extend preference in hiring, promotions and layoffs to minorities and women. Some affirmative action plans are court ordered or required by federal law, others have been adopted voluntarily by employers who want to deal with the under utilization of minorities and women in the workforce. Affirmative action is a government policy designed to rectify past injustices in employment opportunities. It emphasizes reaching out to minorities and women who are qualified to do the job (Blank, 5).

But sometimes those plans are challenged as "reverse discrimination" against non-minorities. They base their argument on a section of Title VII of the Civil Rights Act that states that employers are not required to give preferential treatment to any group or individual.

An article written in September 1994, in the publication Management Review titled "The White Male: An Endangered Species?" interviewed men in various occupational fields on the subject of the white male being subjected to discrimination. Here we highlight a few of these testimonies:

An account executive in a brokerage house says, "I know there's been discrimination in the past and things have to change, but the remedy seems to be all at the expense of the white man. I've seen too many terrific white guys passed over for a job or promotion just to make room for a woman, black or a Latino who doesn't have as much experience. Why do we have to pay for the atrocities of slavery and every other social injustice?"

A newspaper writer says, "Yes, we're mad, scared and pained by the changes of the past 30 years-the women's movement and civil rights laws make us feel as if we're being eclipsed by everyone. There's a real sense of loss and status. In my head, I know some of these changes are needed, but don't expect me to go gently into the night."

A mid-level state manager says, "We're on the other end of the stick now-we see ourselves knocking ourselves out and not getting recognition or promotion we deserve. Why should I bother killing myself at work? Many of us are just lowering our sights and accepting the situation. To protest is like shoveling sand against the tide. The real loser is the company I work for, since I'm just not trying as hard as I used to."

A food service manager states, "If we talked about others the way we're talked about, we'd be considered bigots." Another white manager adds, "We're now the new victims: one lousy system of stereotyping has been traded for another. White heterosexual male-bashing has become fashionable."

The 90's have been a "transitional time for gender roles in our society...with sex roles increasingly blurred" (Blank, 1). At one time, men and women were socialized with the mentality that only men should "hold jobs requiring physical strength and dexterity," as well as being the gender to dominate the superior positions of organizations. As diversity refaces America's workplace, "the sense of loss and disorientation experienced by many white men today is creating new dilemmas" (Blank, I). " Many men express the feeling that physical strength is an essential part of manhood and say that if women can demonstrate the same strength, the feel 'de-manned'" (Blank, 2).

Men feel that they are forced to tolerate discrimination from their female colleagues:

• A sales manager says, "We're told by many women 'You're not one of us. You don't get it.' But if that's true, how can we ever communicate honestly or supervise each other effectively."

• A section chief in a government agency describes an incident when he opened a door for a female colleague and she said,

"Are you trying to make a political statement?" The man says he was really struggling with how to act because he grew up in a traditional home and was taught to be polite and courteous to women. (Blank, 3).

The fear of men being subjected to a sexual harassment suit has become so volatile that men feel that they must go to extremes to not only protect themselves, but to cover all bases as to not even remotely find themselves in any kind of predicament. Some men are unsure and wary of how to act when a woman flirts with them. An account executive says, "I feel like I could be entrapped. I'm not taking any chances" (Blank, 4). Some sales executives have come to the opinion that their best option is to never even be alone with a woman, especially subordinates because all kinds of rumors in their place of work can escalate as a result. Senior managers are recommending that only female senior managers serve as mentors for the younger women (Blank, 3).

Other issues in terms of discrimination involving men stem women in positions of power and the men are the subordinates. "These days women in positions of power, or at least a few of them, are engaging in sexist behavior, while men, constrained by codes of workplace conduct and competing for jobs that were once theirs alone, are frustrated, angry and looking for someone to take it out on" (Gross, 1).

It appears that there has been a role reversal and women, who have tirelessly fought sexual harassment by their colleagues and superiors, are now doing the harassing. "The same laws that have crimped the conversations and habits that men once brought from the locker room to the workplace, are now affecting female managers as well" (Gross, 1).

Judy B. Rosener, a professor of management at the University of California at Irvine, defends this behavior by saying, "To get ahead, you must be just like those at the top, and generally that's based on the straight, white male model" (Gross, 7).

Experts even argue that sexual remarks directed at men rather than women are "less malevolent" (Gross, 7). Freada Klein of Klein Associates and a consultant in this field, says that men are more likely to feel flattered by such comments whereas women feel fear and threatened that the sexual remarks may lead to sexual assault (Gross, 8).

Laura E. Nathan, a sociology professor at Mills College believes that the problem goes even further. "Women's insults against men go unremarked upon: women's accusations are too readily believed, and male opinions are too rarely heard" (Gross, 8).

Diversity

One of the most perplexing issues facing corporate America today is how to diversify. "While many executives tend to think of diversity simply as a program, it is not. Diversity must become an integral element in corporate culture. For diversity to succeed, it must be carried out from the top down" (Petty, 23). Full commitment toward change must stem from top management-lead by example. Everyone from the CEO and downward must receive diversity training. The only way to deal with discrimination is to possess the ability to recognize it. Following completion of the training, a standard of performance must be established and if any employee should violate the standard, they must be fired (Petty, 23).

Many of the nation's largest firms can attest to having diversity programs within their organization, but many of these programs have been unsuccessful in their attempt to curb discrimination in the workplace (Verespej, 1).

There are 3 reasons as to why diversity programs and diversity training programs
have failed to make more of a difference in reducing racial, ethnic, religious, gender and
sexual discrimination in the workplace:

• "Not enough corporate CEOs see harassment or discrimination as a compelling enough business issue, it doesn't always receive the

top-management support it needs to succeed.

• Most companies address issues of harassment by sending managers and employees to day-long training courses, unlike those managers might attend on quality or problem solving.

• Corporate arrogance often gets in the way of the self examination that needed to make zero tolerance of harassment and discrimination part of the corporate culture" (Verespej, 1).

Training alone cannot bring about the change needed in the workplace unless there is commitment from top management coupled with a "zero tolerance" attitude (Petty, 23).

Alan L. Rolnick, an employment law attorney for Constangy, Brooks & Smith, who is special counsel to the American Apparel Manufacturer's Association believes, "You can never convince me that things will just happen if top management walks it and talks it. Everyone in a company knows when the company is just going through the motions with its policies. When the organization makes it clear that it is unacceptable, it won't happen" (Verespej, 2). But along with increasing the awareness of diversity, comes the organization's responsibility to put it into action.

When a company establishes the zero tolerance attitude, it must not waver from it and it especially cannot treat an individual in upper management differently. Freada Klein, president of Klein Associates Inc. states, "The biggest mistake CEOs and top management makes is to treat improper behavior in the context of the value the individual. When they do that, the message is loud and clear from top management that the organization doesn't take this seriously. You must deal with harassment and discrimination with an unwavering consistency, even if it means you have to fire someone who has been a terrific contributor to the bottom line" (Verespej, 3).

The results of implementing diversity into the corporate culture looks very promising. "The future employment base will be made up largely of minorities, including Hispanics, Asians, African Americans and women. If a company is going to attract the best talent, it must know that it is culturally diverse and committed to equality" (Petty, 23). In addition, the business environment is

changing even more with a change in the American customer base, which will soon rely on its growth from minority groups. In order for companies to remain competitive in the future, they will encourage diversity within their environment because "no one wants to do business with a company that discriminates " (Petty, 23).

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Investment Analysis: Brylane Inc.

Simcha Gissinger

Recommendation: Buy
One Year Price Target $72.4

Valuation

The one year price target of $72.4 is 20 times my 1998 EPS estimate of $3.62. This would mean growing EPS 34.6% over 1998, which would be far lower than the 43.7% and 55.8% EPS increases in 1996 and 1995 respectively. This price target may be conservative, because it assumes that the current immense growth rate will probably slow over time, and therefore leaves the P/E at a discount to the growth rate. Current EPS growth is well in excess of the current P/E of 20.4. Other catalog retailers tend to trade at a P/E that is at a 40% premium to their long term growth rates. The fact that the company has not been public that long, and that Wall Street analysts have underestimated earnings every quarter since it has been public is reflective of the fact that Wall Street is yet to fully grasp the company's earnings ability. With each earnings surprise, target prices and earnings estimates have been raised. As the company's earnings

grow, it can pay off more debt with its free cash flow, which lowers its interest expense and deleverages the company. This, in turn, enables the company to continue growing its earnings, and will continue to lower the debt/equity ratio, which will probably attract investors.

The Business

Management averages more than 20 years in the industry, and has demonstrated its willingness and ability to aggressively maneuver the company, through its acquisitions of KingSize and Chadwick's, which virtually doubled the size of the company. Current demographic trends such as an aging population, and an increasing proportion of the population being overweight should benefit Brylane, as it is the major player in the not so competitive special sizes market, (having both the largest and second largest catalogs serving the large-sized woman), and its primary customers are baby boomers. Brylane can now utilize the economies of scale that will occur when it combines its fixed expenses with those of Chadwick's. One such example is customer service, where Chadwick's will no longer have to outsource the overflow of customer service and sales calls during peak times. Furthermore, the company's size will give it bargaining power that should result in cost and buying efficiencies. Sales should benefit from the introduction of deferred billing and other promotional programs, (such as cable television advertising), that have demonstrated significant results for the catalogs that they have been tested on, and will now be implemented for other catalogs. As Brylane successfully segments the 20 million names of Sears's credit card customers that it was provided with, it should see a material increase in sales. Catalog circulation has been rising, up 22%, 2% and 23% over the first three quarters of 1997 respectively, which implies both aggressive marketing techniques, and increasing customer lists. Given that Brylane apparel is generally basic, value-priced and not very fashion sensitive, the company shouldn't be at much risk if there is an economic downturn. It also has little, if any exposure to Southeast Asia. Brylane should see benefits from

providing customers from its new/newly acquired catalogs with private label credit cards. Ninety-one percent of Brylane's 1996 sales were charged using a credit card, and about 64% were charged to one of the company's private label cards. Brylane estimates that private-label credit cardholders spend 40% more than customers who use other bank cards and 140% more than cash paying customers

Industry

In 1996 catalog sales increased 18%, while total apparel sales increased only 5.8%. Catalog sales are presently only 6.3% of total industry sales. Brylane feels that this ratio could grow to 20%-25% of industry sales, as today's consumers are very time-constrained. The industry has been hot this year. Year to date to Oct. 31, the S&P Retail (Specialty-Apparel) Index rose 47.2% versus 23.5% for the S&P Super 1500. Over the course of 1996, Consumer Consumption increased 2.5% on a Personal Income rise of 5.5%, and a Disposable Personal Income rise of 5.0%. S&P projects that during 1997, Consumer Consumption should rise 3.6%, with Personal Income and Disposable Personal Income rising 5.8%, and 5.3% respectively. This would clearly benefit retailers.

Risks

Brylane runs the risk of cannibalization between its different catalogs. The company estimates that the cannibalization rate is presently 15%. Management will be satisfied with any rate below 20%. The company enjoys relatively little competition in the special sizes arena, but as it begins to rely more heavily on revenues from the regular size market, (particularly from Chadwick's), it could experience lower margins and price squeezes. While the fact that Brylane has not experienced the same operational problems, as some of its competitors such as Hanover Direct, would seem to indicate good management by Brylane, operational troubles in the industry may be a foreboding of problems that will permeate the entire industry. Freeman Spogli & Co., and The Limited Inc. presently own 25% and 15% of Brylane, respectively. Should they choose to further

liquidate these positions, the stock may feel pressure. The low current ratio is also a concern, as it raises questions about Brylane's liquidity. Additionally, while e-mail catalogs are not presently a major threat to the company, it is possible that they may pose a problem at some point down the road.

Leveraged Buyouts

Avi Goldin

The Leveraged Buyout Craze of the late 1980's created a frenzy in the finance industry unparalleled in it's scope and impact. Billions of dollars in commissions were earned, and huge companies changed ownership in one of the most exciting times in investment banking history. The impact of this trend transformed the financial industry in a dramatic way. Although the trend has subsided, it is an important one to understand.

What is a LBO?

A leveraged buyout refers to the transaction that takes place when an organization takes over the decision making process of a company by acquiring enough shares of the company to assume control. The term "leveraged" refers to the fact that most of the capital used to acquire the company is financed through debt.

LBO's most commonly occur when the market undervalues a company in terms of its equity. Simply, it means that the market price of the company's stock is worth less than the value of all the assets of the company. The most common type of LBO is where a Financing Group will buy the company for the purpose of selling off all or some of its pieces. Many times, the group will sell what they

feel are the weaker parts of the company and keep the one or two parts that they feel can keep up a positive cash flow.

For example: suppose a company has 10 million shares outstanding that the market values at $20 a share. This places the market value of the company at $200 million. Now suppose that the corporate raider determined that he could sell off all of the parts of the company for $250 million. This theoretically could result in a profit of $50 million profit just by buying and selling the company! Of course nothing works as simply as that. In order to get the shareholders to sell their shares, the raider typically is forced to offer a slight premium over the current stock price, say $22 a share. This lowers his profits to $30 million- still quite a tidy sum. In addition, speculation about takeovers will drive the share price up forcing the raider to pay even more for the company.

Once a company is targeted as a candidate for a LBO a chaotic series of events are put in to motion. If the board of the company is opposed to the option of a takeover, one series of events follow. Any candidate with a respectable bid has to, by law, be considered by the board. This can result in a bidding war between the prospective buyers. The board of the company has the legal responsibility to look out for the best interest of the shareholders. This requires them to go out and solicit bids in an attempt to find the highest one. Sometimes the board will also look more favorably on a management-backed bid rather than turn the company over to strangers.

Who does a LBO?

There are three types of groups that attempt LBO's. They are management-backed bids, unsolicited bids and employee ownership bids.

In a management bid, the current management of the company is part of the takeover group. In effect, the managers, along with a financial institution, buy the company from the shareholders, replacing equity (stock) with debt (loans and bonds). Having management on their side gives this team a great advantage over

competitors. First, only management knows exactly how much the company is truly worth in terms of undervalued assets and hidden values. This information is critical in knowing how high they can go with the bid and still make a profit. Lack of this knowledge can lead to an overbid or an underbid. Second, management with all of their experience in running the company will have the best knowledge on how to cut costs and trim the fat.

The second group is one where a financial institution attempts to buy the company without having management on their side. In this case an outside firm sees an opportunity to purchase what they consider to be an undervalued company and sends a bid to the board.

The third group is where the employees of the company get together and attempt to purchase the company. This is called an Employee Stock Ownership Plan (ESOP). Like the first group, ESOP's have distinct advantages over other groups. Workers who are owners are more motivated to make the company a successful enterprise and also will be willing to accept the necessary salary and benefit reduction necessary to make a post LBO company profitable.

How is a LBO financed?

Even in an undervalued state, companies tend to be rather expensive to buy. This leads to the question of how the takeover group raises the necessary funds to make the bid. LBO's are financed through a web of different debt and equity instruments that reduce the amount of cash outlay to a small amount.

There are four different levels, or types of debt used in financing a LBO. The first level is called Senior Debt. Senior debt typically takes up 50-70% of the total financing. It is issued by banks and is the safest of the loans in that it has first claim on the assets of the company in the event that the company defaults on the loan. The first part of Senior debt is a revolving line of credit. A revolving line of credit is a straight loan whose amount is based on the liquidation value of the company's inventory and accounts receivable- its most liquid assets. The term of the loan is generally one year with renewal positions. The interest on the loan is typically 1-1.5 points over

prime.

The second instrument under senior debt is called Senior Term Debt. This is a loan, also from a bank; based on a percentage of the market value of the companies' land, buildings, machinery and equipment- it's next most liquid assets. The term for this type of loan is typically 5-8 years with interest ranging 1-2 percentage points over prime. The reason for the higher interest on this loan is because there is slightly more risk, in that the assets backing up the loan are not as liquid.

Once the venues of senior debt have been exhausted the group will turn to the next level, subordinated debt. The status of subordinated debt is secondary to the senior debt. Subordinated debt generally takes up 15-30% of the total financing. It is a loan by insurance companies and subordinated debt funds based on the predicted cash flow of the company, after senior debt interest payments are paid out. Because it is more risky than the senior debt, the interest that the lender receives can be as high as 3-7 points above the prime rate.

Another type of subordinated debt is junk bonds. With Junk Bonds, a brokerage house will take on a large portion of subordinated debt and then break it up into bonds that they in turn issue to their clients. These bonds have high returns because of the risk involved in being subordinated debt- hence the name junk bonds.

The last piece of the financing puzzle is the part that is actually put up by the purchasing company. This takes up around 10-20% of the total debt financing. This investment is completely unsecured in terms of the assets of the company, but these are the people who now have total control over the company's functions. They are given 1) voting rights 2) dividend rights 3) trading rights 4) appreciation rights 5) liquidation rights 6) hypothecation rights 7) information rights. An equity investor usually seeks a 30% - 40% annual return on his investment, but there are absolutely no guarantees on his money.

The reason for the wide ranges in the possible interest for each level, and the wide ranges in percentages of each debt

instrument used, is the risk involved in each particular company being taken over. For a solid blue chip company, more of the upper levels of debt will be issued at the lower interest rates. For a more risky company, however, banks and other institutions would not be willing to invest as much and they would demand the higher interest rate. This will force the group to turn to the lower levels of debt, at high rates, in order to secure the amount of financing needed to fund the buyout.

Using this structure, the purchasing group is able to secure the company, only having to put up $20-$40 million of the total $200 million.

So now that they have the company, what to do with it? In an ESOP and a management-backed takeover, the company runs pretty much as it had before. There is a lot of cost cutting as the company struggles to meet the demands of the debt payments, but otherwise it is business as usual - with new owners. If an outside group is the one to take the company, the group has a number of options. One option is to sell off all of the pieces of the company separately and earn a quick profit. Another option is for the group to sell off those parts of the company that they term as the weaker ones and keep the stronger parts that keep up a positive cash flow. Often buyout firms will amass a portfolio of solid companies and use the money they earn from them to finance other LBO's

What are the problems?

So what happened to LBO's? Why is it that so many politicians and business authors decried LBO's as destroying the country? To answer this question we turn to two big indicators- the difference between equity and debt and the health of the company after the LBO.

One of the main reasons that LBO's are able to work is because the cost of debt is cheaper than equity. Why? Because it is tax deductible. While that might not sound like such a big deal in reality it can have an enormous impact. Take the following example. A company is taken over. Prior to the takeover, the company was

very well run and was generating $50 million in sales per year. While the company was financed by equity, that $50 million would then be taxed with the remainder of the money split between retained earnings and dividends paid to shareholders. After the takeover, the company now has about $200 million, from our previous example, worth of outstanding debt that it has to pay interest on. Since interest is tax deductible, the 30-40 million dollars worth of interest that it owes comes out of the $50 million in income before the government gets its share. So in effect, a company that used to pay taxes on $50 million now only pays taxes on $10 million. In some extreme examples, the company can be so leveraged, with so much debt, that not only does it pay no taxes, but it qualifies for a rebate on taxes previously paid because it can claim a loss. Corporate tax income makes up a large part of Federal Tax income for the government. The impact of this lost revenue for the government trickles down and ends up hurting common taxpayers. This whole tax trick is one of the main reasons that LBO's work.

The second main problem with LBO's is the status of the companies after the takeover. All raiders will tell you that the companies are still well run and profitable. The truth is that many companies once they are taken over are forced to cut so many costs that it is impossible for them to stay profitable and end up bankrupt. This hurts the economy and results in loss of jobs and other functions. Similarly if the company fails and is unable to make the payments on it's loans, the banks that lent the bank the money bears the brunt of the collapse.

The leveraged buyout craze of the late 80's is attributable to a number of factors. Interest rates were pretty low making the cost of the debt cheaper than normal. Also with corporate profits on the rise many companies were seeking high rates of return by collecting widely disparate companies under one corporate umbrella. The most famous example of this was the buyout of RJR Nabisco by Kohlberg, Kravis, Roberts & Co. After peaking in 1988 merger activity faded with the recession that hurt a lot of post LBO companies. With the revival of the stock market, merger activity has returned with a

vengeance, but more in the form of mergers using stock and capital; than LBO takeovers.

Anti-Takeover Defensive Measures and their Effects on Shareholder Wealth

Daniel Cohen

Introduction

The takeover wave of the 1980s prompted a deluge of literature in the financial journals on the subject of mergers and acquisitions. The subject of the essays often surrounded the question of the ethics of "corporate raiders" and the takeover battles in which they were involved. Much of popular sentiment tended to view these "raids" as the pillaging of the American business arena for companies to acquire and then dismember piece by piece for a quick profit. The merger mania of the 1980s was seen by many as a blight on our economy a symptom of a larger problem of greed and gambling that was beginning to rot the core of American society

The announcement of a hostile takeover bid became a common event on the takeover front. A typical scenario involved a company acquiring a large block of a target company's stock (5%) and filing with the SEC that it intended to make a bid for the company. At this point, a full-fledged battle often occurred, as the

target company's management did everything it could to prevent the takeover. Defensive tactics, including targeted share repurchases, selling of crown jewels and corporate charter amendments were used in order to reduce the value of the target company and/or make it less appealing to the acquirer.

Dann and DeAngello document attributes and stockholder wealth effects of restructuring announced by 33 target firms in direct response to explicit hostile takeover attempts in 1962-1983. This amounts to 19.3% of hostile takeover bids during the period and 35.8% of such targets during the period of 1980-1983. This suggests an escalation in the use of asset and ownership restructuring such as the issuance and repurchase of voting stock, acquisitions and divestitures as a means of takeover defense.

Amending the corporate charter (shark repellents) is a strategy that has been used increasingly to defend takeovers. These amendments generally impose new conditions on the transfer of managerial control of the firm through a merger, tender offer or replacement of the board of directors. One type of charter amendment is the supermajority amendment, which requires shareholders of at least 75% and sometimes even 90% of the voting power of outstanding capital stock for all transactions involving a change in control. Another type is the fair-price amendment, which is essentially a supermajority amendment with a clause waiving the supermajority amendment if a fair price is paid for all purchased shares. Fair price is usually defined as the highest price paid by the bidder during a specified period and is sometimes required to exceed an amount determined relative to accounting earnings or the book value of the target. A third charter amendment is the known as classified boards. This strategy delays transfer of control in a takeover. For example, a nine-member board could be divided into three classes with three members standing for election to a three-year term each year. This would force a new majority shareholder to wait at least two annual meetings to gain control of the board of directors. Finally, the board of directors can authorize the sale of a new class of securities with special voting rights to friendly parties in a control

contest. Other strategies include the abolition of cumulative voting where it is not required by law, reincorporation in a State with more favorable takeover laws, antigreenmail amendments, and lock-in amendments which that make it difficult to void previously passed anti takeover amendments by requiring supermajority to change.

The aforementioned value reduction strategies raise questions about the motives of the target company's management. Is management acting in the interests of shareholders or in their own selfish interests - perhaps to simply avoid losing a job? Does the concept of a Golden Parachute simply reward incumbent management or is it an effective method of defending a takeover? Is the selling of crown jewels damaging to stockholders or, perhaps, beneficial in the long run? The notion of a conflict of interest is one that has been explored in much of the literature. This paper will clarify some of the literature written on the tactics used in defending hostile takeover attempts, raise the issues faced by the target company's management, and clarify some of the areas of conflict of interest.

Article Review

Share repurchase and takeover deterrence (Bagwell)

A strategy commonly used by companies anticipating a hostile takeover bid is management's repurchase of a specified percentage of common shares of stock outstanding. Examples of this tactic include Dayton Hudson's offer to repurchase 15% of its stock in 1987 and Polaroid's 1989 $1.1 billion buyback in an attempt to foil overtures by the Roy E. Disney family. (Bagwell, 72) Generally this tactic is explained as a method of increasing the percentage of voting stock owned by management, thereby making the purchase of a voting majority more difficult. This explanation is not the only significant result of a share buyback.

The standard finance methodology has always been to assume a common valuation for all investors when studying share repurchases. In this case, the repurchase of shares by the corporation has no effect on the net profitability of a takeover. While it reduces

the cost of the target firm, it also decreases the benefit of the takeover to the acquirer. However this standard approach must be reevaluated in light of the fact that shareholders do not possess homogeneous valuations. When the assumption is made that shareholders possess heterogeneous valuations, the effect of a share repurchase can clearly be seen as a deterrent to takeover. Since those tendering their shares in the repurchase will be those with the lowest valuations, the repurchase skews the distribution of the remaining shareholders toward a more expensive pool, thereby raising the cost of takeover.

Corporate financial policy and control (Dann and DeAngelo)

An examination of 39 defensive restructurings enacted by 33 exchange listed firms yielded the following conclusions: (1) Stockholder wealth declines on average by a statistically significant 2-3% at announcement of restructuring plans, (2) Approximately 50% of sample restructurings represent attempts to create a consolidated block of voting securities or to enhance the proportionate voting power of a block already in place, (3) At least *25%* of the restructurings were attempts to deter a specific bidder, (4) Managers very rarely put the restructurings to a stockholder vote and even went to great lengths to avoid doing so, (5) There is little evidence of a systematic relationship between restructuring type and eventual outcome of the contest for control, (6) Hostile bidders rarely prevail when the restructuring is put into effect, (7) Target shareholders generally experience significant wealth gains over the period from contest initiation to outcome, but these gains are much smaller when incumbents retain control, and (8) Target shareholders generally lose larger tender premiums when a hostile bidder withdraws its bid due to managerial resistance. (Dann and DeAngelo, 87-88)

The study performed by Dann and DeAngelo focused solely on responses to explicit takeover gestures. This was accomplished by finding situations in which a bidder announced a tender offer not conditional on target board approval (hostile) and target management publicly opposed the takeover. Only four types of corporate asset and structural defensive measures were taken into

account; namely, acquisitions, divestitures, issuance and repurchases of voting securities. The study did not examine any structural barriers that were enacted in anticipation of a takeover threat, as these would be extremely difficult to identify. In addition, the study did find that there was an agreement to support a white knight proposal because defensive restructurings in this case are more of a contract with a third party than a defensive measure.

The analysis attempted to isolate the abnormal share value change (prediction error or P/E) in the target's stock price for the period immediately surrounding announcement of the planned restructuring. The authors typically used the day of the publication of the Wall Street Journal article that first reported management's plans and the immediately prior business day - on which the plans were actually disclosed to the public. Any longer period of time would be less reliable because it would include more noise by taking into account other factors that are not readily identified or isolated. In fact, the study rejected 8 restructuring announcements in which there was a simultaneous announcement of other company specific information for fear that the effects of the restructuring announcement would be difficult to isolate.

The results of the study average, announcements of planned restructurings in asset and ownership structure result in losses of 2-3% for target company shareholders. The results showed that the mean prediction error of the sample was 2.33% and the median P/E was -2.73%, which indicates a tendency towards wealth reduction of the target company's shareholders. In addition, 23 of the 31 announcements had negative prediction errors (74.2%). The authors believe that the decrease in shareholder wealth may even be understated due to the fact that the study only focused on stock price changes subsequent to a formal announcement of restructuring. It fails to take into account the effect of the market's anticipation of a restructuring.

The interpretation for the price declines surrounding announcement of a restructuring in response to a hostile takeover seems to favor the theory of management entrenchment. Managers

of the target firm do not necessarily act in the benefit of shareholders, but rather pursue strategies that will allow them to remain in control of the company. The negative shareholder wealth effect possibly stems from the fact that the corporate restructuring is an inferior policy choice and reduces the likelihood of a takeover actually occurring. This entrenchment view is further supported by the fact that in the sample firms, management rarely put their plans to a shareholder vote. A plausible explanation for this is that management feared a shareholder veto because the defensive structure changes were not necessarily in shareholders' best interests.

Another interpretation for the shareholder wealth declines is that implicit in every corporate restructuring is the message that the target company's expected profitability is not as high as was originally thought and therefore warrants a lower stock price. However this theory is flawed for two main reasons which point to the entrenchment theory. First, if it were true that previous expectations for the company were too high, it would be illogical for management to reveal this through announcement of an asset restructuring. It would be more logical to simply accept the takeover premium and cede control of the company. In addition, studies of announcement of corporate restructurings outside the realm of a takeover possibility indicate, on average, price increases for the company announcing the restructuring. This negates the theory that inherent in announcement of a restructuring is the message that the firm's expectations will not be met.

Takeovers: folklore and science (Jensen)

Much has been written in response to the large amount of criticism of the takeover movement. Defenders of takeovers argue that they are the logical outgrowth of competitive struggles in the free market. Mergers and acquisitions serve to enhance shareholder wealth in the majority of cases and therefore are beneficial to society. Much has been written about the use of aggressive antitakeover tactics on the part of the target management. In his attempt to dispel beliefs that resistance to takeovers is bad for shareholders, Jensen

uses a number of powerful arguments and evidence.

On average, on failure of a tender offer, target companies don't immediately lose the 30% average gain in price that they earned when the offer was made. The stock price of the target company generally stays in place presumably in anticipation of future bids. Targets that receive another bid within two years generally experience another run-up in price of 2O% whereas those that don't receive another bid lose the entire initial price increase. This argument suggests that resistance to a specific takeover attempt (but not resistance that will make the company so unfavorable to all potential bidders) will generally lead to an even greater appreciation in stock price for shareholders of the target firm. Jensen also shows that in a study of 140 companies that switched states of incorporation to a state with more favorable anti-takeover laws (generally Delaware) there was no evidence of price decline at the time of the change. Furthermore, two studies (100 and 388 companies) of the adoption of anti-takeover amendments such as supermajority clauses indicated no negative impact on shareholder wealth

There are cases when resistance to takeover has a negative impact on shareholder wealth. One case is when a supermajority provision is established that grants effective power to a manager stockholder to block a merger. For example, the market value of H.P Scherer fell 33.8% when shareholders adopted an 80% supermajority merger approval provision. Since the wife of Scherer's CEO owned 21.1% of the stock, she had the power to block a proposed takeover by FMC. In fact when the supermajority provision was approved by R.P. Sherer's shareholders, FMC withdrew its bid and the price of Sherer stock plummeted. Another instance in which resistance to takeover is damaging to target shareholders is in the use of targeted share repurchases (greenmail) and standstill agreements. In these cases, abnormal declines are generally observed in the market value of the purchaser's stock price whereas the seller usually experiences large, abnormal gains.

Golden parachutes, shark repellents, and hostile takeovers (Knoeber)

Knoeber gives a unique perspective towards tender offers and golden parachutes and shark repellents. Although tender offers are necessarily beneficial to both shareholders and managers by the argument that neither would willingly enter into a situation which was not beneficial, the same logic can be applied to anti-takeover measures. Shareholders would not approve a measure such as a golden parachute or shark repellent if it were not in their own interest to do so. A resolution to this seeming paradox is established when one considers golden parachutes and shark repellents in a unique light.

Knoeber (1986) begins by positing that the most effective method of compensation and a deferred portion to be paid at a later date when a true appraisal of the manager's performance can be made. The deferred compensation would most likely be implicit and in an amount to be determined only at that later date. The sum of the deferred payment acts as a bond that accrues to the manager as time goes on, payable at a later date. The board of directors has incentive not to renege on its commitment to the deferred payment for fear of developing a bad reputation, leading to difficulty in attracting good managers in the future. The manager has incentive to remain with the company as well. The manager does not know the full value of his compensation and will not leave because the deferred portion may be greater than his value.

When a tender offer is made to the shareholders, there is incentive for the shareholders to accept it. A tender offer is virtually anonymous. In addition, the acquiring board of directors has no reason not to renege on the deferred compensation agreement because they would not be perceived as reneging on a commitment that they made to a member of their company. The acquiring company now has the ability to use the amount of the deferred portion as they wish. However, when a golden parachute or shark repellent is in place, the scenario will not play out in the same manner.

Shark repellents and golden parachutes remove the shareholder

opportunism. A golden parachute simply acts as a bond that accrues to the manager and is payable should a takeover occur. If the bond is large enough, the acquirer may be able to capture the deferred compensation due to the manager, but will lose the amount of the golden parachute. Shark repellents make a takeover more costly and add incentive for the acquirer to carry out the acquisition in a friendly manner. The advantage of these anti-takeover defenses to current shareholders is that it conveys the assurance to managers that a tender offer will not succeed. This is important because it is the only way that managers will agree to a method of compensation that centers on a large deferred portion. This in turn is important to shareholders because it allows them to pay the manager after a period of time, allowing for accurate assessment of his value instead of using an imprecise estimation up front.

Targeted share repurchases and top management changes (Klein and Rosenfeld)

Generally, during the period immediately surrounding the announcement of a targeted share repurchase the stock price of the announcing firm declines (Klein and Rosenfeld, 493). This has led to the theory that management is acting in its own interests by making greenmail payments and not in the interests of shareholders. A contrasting theory of management actions is referred to as shareholder interest theory and states that management acts in the interest of shareholders. In the case of a greenmail payment, management fends off a potential acquirer in order to take the company private or raise the stakes for another bidder. A practical difference between these two theories is that of whether there will be turnover among managers in the period following the greenmail payment. According to the management entrenchment theory, top executives will be more likely to be forced out of their positions of power by unhappy shareholders. On the other hand, if management is acting in the best interests of shareholders there should be no increase in turnover following a greenmail payment.

This study found a large occurrence of CEO turnover following a

greenmail payment. In a study of 73 firms that made greenmail payments, 27.4% experienced top management changes within 12 months of &C stock repurchase. In the two years prior to the share repurchase 10.1% of the same firms had top executive turnover. This is partially because internal corporate forces work to keep management in check. However, this evidence cannot be viewed in a vacuum. The management turnover cannot be attributed solely to the greenmail payment. Generally greenmail payments are made at around the same time as other events including takeover attempts, proxy fights, and especially hostile takeovers which are characterized by parties who feel that the can run the company more effectively than current management. In fact, firms that paid greenmail experienced events such as lawsuits between shareholders and management, proxy fights, and takeover attempts in 10 of 2O cases where there was a top management change. Whereas, 13 of 53 greenmail firms that didn't experience a top management change had these events. This suggests that greenmail payment is related to the occurrence of other events that act as a proxy for poor management performance. The implication is that greenmail is just one of a series of events that result in the replacement of top management.

Poison pill securities: stockholder wealth, profitability, and ownership structure (Malatesta and Walkling)

Anti-takeover defenses can be segregated into two different categories - those subject to a vote by shareholders and those not subject to vote by shareholders. A Poison pill defense is an example of an anti-takeover defense that gives shareholders special rights and privileges if the issuing firm becomes the subject of a takeover bid and is not put to shareholders for a vote. According to Malatesta and Walkling, there are four variations of the poison pill defense. These are preferred stock plans, flip over plans, back end plans and voting plans. Each serves to make a hostile takeover more expensive to the bidding firm.

One hundred and eighteen firms that used a form of poison pill defense through March 1986 were studied in relation to the

management entrenchment and the shareholder interest theories. The results of the studies yielded significant descriptive information about firms issuing poison pill securities. First, firms adopting poison pills are likely to have been or become the subject of a takeover bid. Second, the costs and benefits to management of adopting a poison pill are related to the amount of stock that the managers hold in their own companies. Managers adopting poison pills should hold little stock. Third, the improved management hypothesis states that takeover targets are poorly managed. For this to be true, the company would have performed badly relative to industry averages in the period preceding the takeover bid. This was studied by analyzing accounting profitability ratios for the 1 and 3 years before the 118 firms adopted the poison pills. The data confirmed the hypothesis. In the year immediately preceding the adoption of the poison pill these firms underperformed other firms in the same industry by a statistically significant amount. These findings provide compelling evidence that managerial interests play a rather large role in the choice whether or not to adopt a poison pill defense.

Defensive changes in corporate payout policy: share repurchases and special dividends (Denis)

Denis documents the effects and motivations behind management's use of special share repurchases and special dividends as a takeover deterrent. In the case of a share repurchase, generally management does not sell their shares and therefore a greater percentage of the voting power is transferred to management. As opposed the ordinary shareholders that receive cash dividends, management generally receives special dividends in the form of extra shares of voting stock. In both cases the effect is the same, namely to concentrate voting power in the hands of the incumbent management.

Although the effect on voting control is the same in either case, the impact on shareholder wealth is vastly different. Repurchases are associated with a significant decrease in wealth for target shareholders whereas special dividend payments generally increase

shareholder wealth. Another effect of the special payouts is that firms remaining independent after announcing a defensive payout tend to make substantial structural changes subsequent to the conclusion of the control contest. These target firms generally do a lot of restructuring directly tied to the previous control battle and defensive payout. This suggests that corporate control activity serves as a disciplinary force even in cases where the bidder is thwarted. Whatever the effects of the special payouts, the evidence indicates that they are effective in defending takeover attempts. Of the 49 firms that announced special payouts, 37 actually implemented them. Of those 37, only 3 were eventually taken over.

The study isolated cases in which there had been a disbursement to shareholders during the course of a corporate control contest or in response to the threat of a change in control. These defensive payouts took different forms including open market purchases (10 cases), repurchase tender offers (16 cases), special dividend payments (9 cases), and exchange offers of debt securities and cash for shares (7 cases). Abnormal returns on the day before and the day that the announcement of the payout appeared in the Wall Street Journal. The results showed that the target firm share price tamed an average abnormal return of 1.88% during this period. The possibility that the announcement of takeover activity could have influence these returns was then considered and firms for which this announcement was the first indication of takeover activity were eliminated. For the remaining firms that had had a previous about takeover activity, the abnormal return averaged -0.83% for the announcement period. When the firms were classified as either dividend payouts or share repurchases, the abnormal returns were 2.66% and -1.62%, respectively. Firms that had no other announcements during the two day period were then separated and the results showed that for these "clean" firms repurchases resulted in -1.45% abnormal returns and special dividend announcements yielded 8.94% abnormal returns. Finally, the cumulative abnormal returns (CAR) over the entire period, beginning 40 days prior to the announcement of the takeover contest and ending at the outcome of the control struggle, were

studied. Firms that remained independent experienced a 15.95% CAR, firms in which control was acquired by the hostile bidder experienced 28.73% CAR and firms in which a third party took control experienced a CAR of 29.85%.

The above empirical results support the theory that management does what it needs to do in order to remain in control. This contention is supported by the fact that many of the firms used other anti-takeover defenses which are associated with share price declines such as litigation (23 firms), poison pills (10 firms), greenmail (6 firms) and charter amendments (2 firms). An alternative explanation for the negative cumulative abnormal returns is that they are the result of a failed attempt by management to get a higher bidder. However, there is little evidence to support this theory. A third explanation is that the announcement of a payout signals to the market the lack of higher value alternatives. This explanation appears implausible because the blended premium of the formal offers (in cases where one was made) averaged 36.4% greater than the pre-contest price of the shares.

Greenmail, white knights and shareholders' interest (Shleifer and Vishny)

There is much skepticism in the literature, both finance and legal, about the payment of greenmail by target firms. Much of the literature even calls for an outright abolition of management's right to make targeted share repurchases because it serves only to entrench incumbent management at the expense of shareholders. However, Shleifer and Vishny reexamine this view. Their position is that defensive tactics, particularly greenmail can be used to raise the takeover premium and therefore are certainly in shareholders' best interests. A greenmail payment will often entice other bidders to join the control contest because it increases their likelihood of a takeover. Another gain from the use of greenmail is the signaling effect. The payment of greenmail transmits a message to the market that the target firm does not yet have a white knight and this in turn encourages a bidding contest. The falling share price associated with

the period surrounding a greenmail payment may simply be due to the signal that there is no white knight. Another benefit from the payment of greenmail is that it can potentially be used to compensate bidders that don't even know the full extent of their gains in the event of a takeover.

Shark repellents and stock prices: the effects of anti-takeover amendments since 1980 (Jarrell and Poulson)

Shark repellents are almost always subject to a vote by shareholders and have changed considerably since they were first introduced. Their popularity has increased since the invention of the fair-price amendment, which is simply a supermajority voting approval requirement on transfer of control, only if the board does not approve the transfer or if a "fair price" is not offered. The study by Jarrell and Poulson (1987) analyzed 649 anti-takeover amendments proposed between January 1979 and May 1985. Four hundred and eighty seven fair price, 104 super-majority and 58 classified board or authorized preferred stock provisions were included in the sample. This is a larger sample than most studies on anti-takeover amendments have been. The results included a -1.25% abnormal return for the overall sample, -0.65% for fair price amendments and almost -3.00% for other types, lending credence to the management entrenchment theory.

Insider composition of and institutional holdings of the stock are important for understanding both the economic effects and how the amendment got the majority of shareholder votes for approval. Institutional investors are assumed to vote more rationally than less informed shareholders and therefore value reducing amendments should theoretically occur in firms with large insider and small institutional holdings than the average firm. The study's results bear out this hypothesis and indicate that those amendments having the largest effect on stock price (non-fair price amendments) generally occur in firms with the lowest percentage of institutional holders and the highest percentage of insider shareholders.

Managerial control of voting rights: financing policies and the market for corporate control (Stulz)

In general, management ownership of equity is thought to increase the value of the firm. Some state that larger managerial equity ownership helps align incentives of managers with those of outside shareholders. Others explain that it conveys information to the market about managers' private valuation of the firm. Management can change the percentage of voting rights that they control by buying/selling shares, altering the capital structure of the firm, modifying the corporate charter and with the acquisition of clienteles favorable to management. Stulz's research is based on the premise that takeovers are always a threat and therefore should always affect managers' actions. A corporate change of control affects managers differently than it does shareholders. The study attempts to show that the premium offered rises and the probability of a takeover's success declines as the percentage of voting rights controlled by management increases. This is explained as the motivation for management increasing its percentage of voting rights subsequent to an explicit takeover bid.

Conclusion

Arguments for managerial takeover resistance strategies are grounded on the desirability of creating an auction for the target, the coerciveness of tender offers, and the bargaining role of management. On the other hand, those opposed to the use of defensive actions on the part of management cite increased costs of takeovers and the resulting inefficiency in the operation of the market for corporate control as reasons why they should be outlawed.

There is a wide range of antitakeover defensive tactics. Ranging from golden parachutes to asset restructuring, from share repurchases to poison pills, these measures represent management's attempt to keep a hostile bidder at bay. The obvious question as to the motivation of the target company's management remains without a conclusive answer. Much of the literature points to the management entrenchment theory that states that management is

simply attempting to hold on to its grip of power at all costs -even at the expense of shareholders. simply attempting to hold on to its grip of power at all costs -even at the expense of shareholders. Others argue and attempt to prove that defending a takeover often raises the premium offered for shares tendered and is therefore in the best interests of the target company's shareholders. Many of the articles cited have attempted to understand the motivations of management by studying the financial ratios, insider and institutional ownership, and management changes subsequent to the takeover bid. Others argue that although there may be a drop in the price of shares in the target company at the time of the announcement of resistance to a takeover, the drop in share price is simply a result of the information that is being leaked to the market - namely that the target company does not have a white knight.

In addition, some of the literature reviewed presents some of the less obvious effects antitakeover defenses. For example, Bagwell illustrates that share repurchases raise the premium offered for shares of the target company by skewing the distribution of shareholders toward a higher price. Knoeber argues that golden parachutes are used to reinforce the commitment between a top-level manager and the firm.

In the late 1990's we have seen an increased wave of takeovers in corporate America. As a result, competition has become fierce whenever a company is put into play. Recent examples have been the bidding war for ITT by Hilton and Starwood Lodgings, the fight for MCI by GTE, Worldcom, and British Telecom. Each of these mergers followed intense bidding for the target company.

Future research involves studying the takeovers of the 1990's and beyond. Most of the articles surveyed in this paper were written in the 1980's and focused on takeovers at that time. There have certainly been innovations in the types of antitakeover defenses used by management. In addition, the motivations for management may have shifted. The management entrenchment and shareholder interest hypotheses must be reexamined to determine whether they still hold true. Although the evidence presented from the takeovers of the

1980's has leaned towards the management entrenchment hypothesis, perhaps it has shifted towards the betterment of shareholder wealth in the 1990's.

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American Express Company: Financial Operations Review And Future Prospects

Solomon Mardakhayev

Introduction

The objective of this report is to utilize financial statements analysis to evaluate and assess the financial position of the American Express Company in comparison to its industry. Furthermore, a discussion of the company's current operations, its future prospects and some of the issues facing the company going forward is included.

American Express is a leading provider of diversified financial and travel-related services, offering products such as charge cards, travel, financial planning and international banking. The primary SIC code # 6712 classifies American Express under the industry of diversified holding companies, the industry used in this research for comparative purposes. After reviewing the consolidated financial statements of the American Express Company for operating year 1995, the following presentation is made on its financial condition.

Financial Ratio Analysis

Data based on the consolidated financial statements of the American Express Company for the operating year 1995 and Dun & Bradstreet Industry Norms and Key Business ratios for the holding companies industry with total assets over $50,000,000 (SIC code # 6712).

	American	Holding Co. Industry
Profitability		
Gross Profit Margin	69.70%	29.90%
Net Profit Margin (NPM)	9.80%	7.00%
Return on Assets (ROA)	1.50%	3.00%
Return on Equity (ROE)	21.30%	8.00%
Liquidity		
Quick Ratio	1.00	1.10
Current Ratio	NA	1.90
Asset Management		
Asset Turnover	0.15	0.42
Receivables Turnover	0.85	10.9
Days Sales Outstanding	426 days	66 days
Capital Structure		
Total Debt/Equity	0.231	0.461

The most important segment of the financial operations, the profitability results, demonstrates a strong performance by the company in comparison to the rest of the industry. For the year ended in 1995, American Express consolidated net income increased 13% to $1.6 billion on total revenues of $15.9 billion as compared to $1.4 billion and $14.3 billion, respectively, for 1994. As stated in the management's discussion and analysis section of the 10-K report, the 1995 increase in revenues was driven by growth at the American Express Financial Advisors unit, and in several Travel Related Services businesses, including the Consumer and Corporate Card lines of business. The growth in earnings per share and net income was also due to further reduction in cost structure and in the number of shares outstanding resulting from the continued reengineering program launched in 1992. The gross profit margin (measured as a percentage of total revenues less interest expenses and provisions for

losses and benefits to total revenues) is significantly higher than the industry average of the holding companies, reflecting the nature of the services' business where cost of goods sold is immaterial. More importantly, the favorable comparison also holds true in respect to the net profit margin, as the company was able to achieve a 9.8% return after taxes on its total revenues, which is well above the industry median of 7%. The ROE for the American Express was even more phenomenal in comparison to the industry, which underscores the company's ability to earn high returns on its equity. The only item that did not meet the comparison successfully was the ROA figure, which was about 1.5% versus the industry average of 3.0%. The basis of the impressive results represented above is the emphasis of the company on strengthening its operating performance by cutting costs and pursuing growth opportunities in high margin businesses. The unfavorable ROA figure was partially dragged down by relatively poor asset utilization and reflects the intensely competitive and highly cyclical nature of the financial industry.

The liquidity and solvency situation of the American Express is near the lower end of the industry average. The current ratio (measured as current assets divided by current liabilities) comparison cannot be made since there aren't any inventory accounts for service companies, which reduces the total amount of current assets. Nevertheless, the investor should be cautious of the low figure otherwise derived for the current ratio, which measures how well the company is positioned to meet its maturing expenses within the next twelve months of the operating cycle. In terms of asset utilization, American Express seems to have difficult comparisons in its asset turnover, receivables turnover and collection period measurements. These numbers reflect poor asset and receivables management and the company would benefit from a more efficient structure. The low total debt to equity ratio (measured as the proportion of total debt to total assets) suggests a conservative capital structure position and a higher degree of financial leverage could lead to a boost in the growth rate of earnings per share.

Product Mix and Diversification

American Express has effectively diversified its assets and operations through the products and services it offers and its geographically diversification across the international borders. Product
mix and geographic diversification are important factors in determining the company's ability to generate future revenues and also serve as a measure of the risk exposure the company faces. The table below graphically demonstrates the breakdown of products and geographical operations, their growth and the impact on revenues.

	1994	1995	Yearly Growth
Products and Services:			
Travel Related Services	$10,256.00	$11,542.00	12.54%
IDS Financial Services	$3,270.00	$3,691.00	12.87%
International Banking	$652.00	$643.00	-1.38%
Geographic Region			
United States	$10,801.00	$11,916.00	10.32%
Europe	$1,858.00	$2,098.00	12.92%
Asia/Pacific	$1,220.00	$1,294.00	6.07%
Rest of the World	$1,028.00	$1,487.00	44.65%

Current issues and future prospects

At the recent annual shareholders meeting, Harvey Golub, Chairman and CEO of the American Express Co., outlined some of the issues facing the company and gave a positive view of the important charge and card business. Mr. Golub pointed out that a key focus for the company has been building up the card business. Currently, there are franchises or network arrangements in 20 countries as the company continues to execute its international strategy. Furthermore, the expansion of revolving credit products has been launched in a number of markets. Domestically American

Express has been rolling out co-branded cards, small business cards and stored value cards and hopes to continue on the strength of these business segments. At the same time, the company has maintained and improved its credit quality despite the deteriorating industry conditions. As a recent article in the Wall Street Journal pointed out, American Express' credit card operations have outpaced its rivals in 1996 because it allied with other firms to target overlooked markets and it offered incentives.

On the other hand, American Express faces legal battles with the major players in the credit cards market. To increase both the attractiveness of the American Express network and the number of Cards outstanding, in May 1996, American Express invited banks and other qualified institutions to issue cards that would bear an American Express logo and would be accepted at all merchants that accept the American Express Card. However, because of rules and policies of VISA USA, Inc. and MasterCard International, banks that are members of these organizations in the United States are prohibited from issuing American Express-branded cards. These rules and policies are currently under investigation by the Antitrust Division of the United States Department of Justice.

The Travel Related Services unit (TRS) continued to expand its interactive service offerings on the Internet in 1996. As a result of that, American Express has announced that card members will now be able to access their account information on the World Wide Web and have access to innovative financial and travel services online. This indicates the company's commitment to growth and expansion through new market channels and its ability to meet customers needs. TRS anticipates further significant electronic payment product developments in 1997, which may include increasing use of Card acceptance over the Internet, stored value cards, "smart cards" or other card-based or electronic forms of payment. Although the company believes that TRS is the leading issuer of travelers checks, the growth in sales of this product faces competitive pressures from the many new forms of competing payment instruments, such as credit and debit cards and national and international ATM networks.

TRS's retail travel network of more than 1700 owned and representative offices is important in supporting the American Express brand and providing customer service throughout the world. TRS is developing ways to better serve the travel consumer, including 1-800-type services, and on-line products and services discussed above. More recently, changes in the travel agent compensation structure, such as the limits on airfare commissions, have been imposed by airlines in an environment of heightened competition, which has caused some independent agencies to go out of business. Consolidation of travel agencies is likely to continue as agencies seek to better serve national and multinational business travel clients and negotiate more effectively with the airlines with respect to computer reservation systems and compensation and pricing arrangements. Customers may increasingly seek alternative channels to make travel arrangements, such as on-line vendors or "ticketless" airline services that require booking directly with the airlines. It is also expected that travel agencies will continue to look for expense reduction opportunities. TRS has been actively developing new cost-effective ways to serve travel customers through exclusive partnerships with major corporations and ticketless travel providers.

American Express Financial Advisors unit is very important to the company's overall operations and has turned in another record performance. American Express Advisors has undertaken a major initiative to improve advisor retention and client satisfaction. In connection with this program, American Express is testing certain computer-based tools for advisors and is implementing certain organizational changes, including a new field management structure, asset-based compensation and a new recruitment and selection process. In addition to marketing through a dedicated sales force, AXP Advisors is seeking to broaden the products and services it offers and is actively pursuing alternative approaches to distribute its financial planning services, including networking arrangements with community banks, credit unions and lending entities. On the other hand, American Express faces the challenge of intense competition, as recent growth in the market has increased the number of

competitors in the industry. Some competitors are larger, more diversified and offer a greater number of products, and may have an advantage in their ability to attract and retain customers on the basis of one-stop shopping.

American Express Bank Ltd. offers products that meet the financial service needs of three client groups: corporations, financial institutions and affluent individuals. AEB's five primary business lines are commercial, correspondent and private banking, personal financial services and global trading. In part because of a structure that lacks scale in many markets, AEB continues to focus on initiatives to reduce and control its expense base worldwide. Additionally, the banking industry is in a stage of consolidation and this might affect the company in either way.

Conclusion

Based on the above discussion, American Express is well positioned for future profitability, given its strong financial condition and the recent success in executing its growth strategies. The company's growth strategy is focused on three principal themes: strengthen the charge card network, broaden the offering of financial services and expand its international presence. The strong brand recognition of the American Express, combined with co-branding, expanding merchant coverage and rewards innovations programs should continue to boost the charge-card business. The Financial Advisors Unit should continue to be positively affected by the growing demand for personal financial services by the maturing baby-boomers generation. The company's continued efforts in controlling costs and integrating technology to achieve operational efficiency should also have a favorable effect. In conclusion, it is reasonable to expect the market will grant a higher valuation to the shares of American Express Co. given the bright outlook for the company and the business services industry.

Sources of Information and Reference

The following publicly available sources of information were

consulted in doing this research project:
Consolidated Financial Statements of American Express for operating year 1995 (Annual Report, 10-K, 8-K etc.)
Dun & Bradstreet Industry Norms and Key Business Ratios
S&P Company Reports
Bloomberg Information Database
Wall Street Journal
Yahoo Internet Finance

ACCOUNTING FOR BUSINESS COMBINATIONS

Ishai Grunfeld

INTRODUCTION

APB opinion No.16, paragraph 1, defines a business combination a follows:

> A business combination occurs when a corporation and one or more incorporated or unincorporated businesses are brought together into one accounting entity. The single entity carries on the activities of the previously separate, independent enterprises.

There are two generally accepted accounting methods for business combinations: the pooling method and the purchase method. The two are not alternatives for one another, such that no part pooling part purchase accounting is permissible for the same business combination. A business combination is accounted for under the pooling method if it meets a set of prescribed criteria. Otherwise, such a combination is accounted for using the purchase method.

The underlying assumption of the pooling method is that the business combination was not an acquisition of one entity by another, but a union of ownership interests through the exchange of equity securities. Thus, no acquisition price is recognized or recorded since

no theoretical distribution of resources occurred via the combination. The assets and liabilities are recorded by the pooled entity at their book values. Retained Earnings are also recorded at their combined total (subject to certain restrictions) of the separate retained earning figures of the pooling enterprises. Income for the pooled entity is the earnings for the entire accounting period of the combining enterprises. The reported income for the entities for prior periods must be restated as income of the combined entity.

The purchase method is the default method of accounting if the criteria of combination for the pooling method are not met. Under the purchase method, an acquisition of one entity by another is assumed to have taken place. The acquisition price is allocated by the acquiring company to the assets received and liabilities assumed at their fair values. Excess cost over the net asset value of the target entity is recorded as goodwill and amortized over a maximum period of 40 years. Retained earnings could decrease as a result of a purchase method combination but never increase. Income is reported as combined from the date of the business combination forward. It is not restated for past periods, as it is under the pooling method.

HISTORY OF POOLING AND PURCHASE

The late 1940s saw an increased rate of business combinations during which two methods of combination were developed namely, pooling and purchase. In those early days the pooling method was simply defined as a combination of similarly sized firms in a pooling of interests. The purchase method, on the other band, was seen as an acquisition with a buyer and a seller. The first official pronouncement for business combinations was issued in 1950 and was named Accounting Research Bulletin No.40 "Business Combinations". It provided few guidelines to distinguish between pooling and purchase combinations. It basically stated that a pooling combination was one in which (1) the firms combined are of similar size and (2) no change in management takes place. The wording was vague, however, and the pronouncement proved ineffective as a guiding statute.

In 1957 ARB No.48 superseded the previous pronouncement. It reestablished the grounds for pooling, permitting a pooling combination even when one company is 19 times as large as the other. Still, as was the case with ARB 40 the new pronouncement provided little guidance as to the criteria for pooling. As a result, many business combinations in the 1950s and 1960s were structured as pooling despite their lack of pooling stockholder interest.

In response to growing criticism by the accounting community and abuse by the business community the pooling method was revamped in 1970 with the issuance of APB 16. The extensive criteria prescribed by the pronouncement vastly reduced the number of pooling combinations.

The conceptual framework of the pooling method, however, still remains a controversial topic. Primary in the issues of contest is the assumption under pooling that no acquisition has taken place. The concerns of Arthur Wyatt in "A critical Study of Accounting for Business Combinations," and "Discussion of Purchase versus Pooling of Interest: The Search for a Predictor, as well as Catlett and Olson in "Accounting for Goodwill" was echoed in the 1989 article in the CPA Journal by Richard Dieter, "Is Now the Time to Revisit Accounting for Business Combinations?" in which he states: "In almost all business combinations that are accounted for as a pooling of interests, an economic event has taken place whereby one entity has acquired another. To not account for these very significant transactions at their economic value further erodes the credibility of the continuing financial statements."

FORMS OF BUSINESS COMBINATIONS

There are four types of business combinations: statutory merger, statutory consolidation, stock acquisition and asset acquisition.

Statutory Merger - occurs when according to the by laws of the companies involved and state laws, one corporation (surviving company) acquires all of the voting stock of another corporation (target company). The target company is then dissolved while the surviving company retains legal title over all the assets of the target

company. For example, Co.A acquires through a combination of cash and debt issuance, the voting stock of Co. B. Co. B is then dissolved while its net assets are retained by Co. A.

Statutory Consolidation - occurs when based on the by laws of the companies involved and state laws, a newly formed corporation issues its stock in exchange for all the voting stock of two or more of the corporations, which upon transfer of their stock are dissolved. For example, Co. C, a newly created corporation, issues its stock to existing companies A and B in return for their voting stock. Companies A and B are then dissolved leaving only Co. C.

Stock Acquisition - occurs when a corporation purchases part or all of the voting stock of another corporation and, in so doing attains an ownership interest in the acquired corporation's assets. Unlike a statutory merger or consolidation, however, the corporation whose shares were purchased remains a separate legal entity and is not dissolved. Depending on the portion of voting shares bought, the acquiring company becomes a minority interest (50% or less of outstanding voting stock) of a majority interest (greater than 50% of outstanding voting stock). If a majority interest is acquired, then a parent subsidiary relationship ensues. (1)

APB No. 16 considers a stock acquisition that creates a parent subsidiary relationship a business combination, despite the fact that no dissolution of the target company takes place. The language of the opinion, as previously quoted in the introduction, necessitates only that the combination result in a single entity whose management carry on the operation of the previously separate and independent enterprises. Thus any one of the following combination types is acceptable:

1. One or more corporations become subsidiaries
2. One company transfers its net assets to another company
3. Each corporation transfers substantially all its net assets to a newly formed company

Acquisition of Assets - occurs when a company acquires assets

directly from another corporation. The advantage of this type of combination as opposed to a stock acquisition is that the acquiring company can choose its desired mix of assets and liabilities. It can opt to purchase only assets and assume no liabilities or any other proportion of assets to liabilities it chooses.

THE POOLING METHOD

The operating assumption by which the pooling method is implemented is that it is possible for a company to combine with another entity through an exchange of equity securities without there being a purchase of one entity by the other. In APB opinion No.16 a list of 12 characteristics is prescribed that if present in a business combination mandates the use of the pooling method of accounting. The 12 characteristics or conditions are grouped into three categories and are summarized below:

Attributes of the Combining Companies

1. Autonomous
2. Independent

Manner of Combining Interests

3. Single transaction
4. Exchange of common stock
5. No equity changes in anticipation of combination
6. Shares may be reacquired only for a purpose other than combination
7. No change in proportionate equity
8. Voting rights excersisable immediately
9. Combination resolved at consummation

Absence of planned transactions

10. Issuing company does not agree to reacquire shares
11. Issuing company does not make deals to benefit former stockholders
12. Issuing company does not plan to dispose of the assets of the

combining companies within two years after the combination. (2)

Attributes of Combining Companies

1. *Autonomy* - Each of the combining companies must not have been a subsidiary of another corporation within two years of the time the combination is initiated. The date of initiation is the earlier of the date at which a public announcement of the exchange ratio is made or the date the shareholders are informed of the exchange ratio. The exchange ratio is the number of shares issued by the issuing company in return for the number of shares tendered by the combining company.
2. *Independence* - Each of the combining companies must not own more than 10% of the other companies at the date the combination is initiated.

Manner of Combining Interests

3. *Single Transaction* - The combination is consummated in a single transaction or completed within one year. If it is delayed for more than a year, the pooling method may still be used, if the delay was caused by a factor beyond the control of management.
4. *Substantially All Rule* - The issuing corporation must issue voting stock similar in type to the majority of its outstanding stock in return for substantially all the common stock (90%) of the other combining company.
5. *Static Equity* - The combining companies may not change their equity interest in common stock in anticipation to combination within two years before the initiation of combination or between the date of initiation and consummation of combination. Examples of change in common stock interest in anticipation of combination include distribution to stockholders of newly issued stock, retirement of shares and exchanges.
6. *Reacquisition of shares* - Reacquisition of common stock by the combining companies ispermitted only if it is done in the normal course of business and not in contemplation of combination.

7. *Static proportionate equity interest* - The equity exchange effecting combination should not dilute the equity interest of stockholders.
8. *Voting rights unrestricted* - The stockholders in the combined company are not restricted by a time period to exercise their voting rights.
9. *Combination is concluded at consummation date* - No provisions should be pending post consummation date.

Absence of Planned Transactions

10. Issuing company enters into no agreement to reacquire directly or indirectly the common stock issued in the combination.
11. The issuing company does not agree to benefit stockholders in financial arrangements such as loan guarantees.
12. Within 2 years after the combination the combined corporation may not dispose or plan to dispose of a significant portion of the assets of the combining companies, unless such disposal is in the ordinary course of business or its purpose is to eliminate redundancy in operations.

Application of the Pooling Method

The following section will illustrate the application of the pooling method for merger and consolidation combinations. In such cases, as well as in asset acquisitions, there is only one surviving accounting entity post combination. A parent-subsidiary combination, on the other hand, involves a more complicated accounting, since both entities must issue separate financial statements and the parent company must issue a consolidated financial statement.

Stockholders Equity

Since it is assumed under the pooling method that no

acquisition took place, the sum of the assets and liabilities of the combining companies at book value is recorded on the balance sheet of the combined company. No fair value estimations take place in a pooling method. Stockholders equity for the combined company must take into account the stock issued in the combination by the issuing company. The combined capital stock figure must equal the total par-value of the outstanding stock of the combined company. The combined retained earnings are usually a simple sum of the separate retained earnings balances of the combining companies. However, if the capital stock of the combined entity exceeds the total paid-in capital of the combining companies then the retained earnings amount of the combined entity is reduced by the residual while the combined entity would have no additional paid-in capital. Was the situation the reverse, such that the combined company's paid-in capital was less than the total paid-in capital of the combining entities, then the difference would be recorded as additional paid-in capital for the combined company. The total retained earnings of the combined company would simply be, in such a case, the sum of the respective retained earnings balances of the combining companies.

Merger/Stock Holding of One Combining Company Held by Another Combining Company

If the combined company owns stock in the surviving company then the stock must be treated as treasury stock upon combination. Stock held by the surviving company in the combined company should be accounted for as retired stock in the combination.

Treasury Stock in pooling

If the surviving corporation issues treasury stock in a pooling combination, it should account for the stock as retired stock. In that way the stock can be treated like newly issued stock.

Combined Earnings and Expenses

A pooling combination requires that the income statement of the combined company show a net income figure that accounts for the

earnings of the combined companies from the entire accounting period regardless of when, during that period, the actual combination took place. The journal entry for both a merger and a consolidation showing the incorporation of revenue and expenses of the combinee company or companies into the records of the combined company is as follows:

Expenses	xxx	
Revenue		xxx

This entry can be done simultaneously with the acquisition entry:

Assets	xxx	
Expenses	xxx	
Capital stock		xxx
Additional paid-in capital		xxx
Retained Earnings		xxx
Revenue		xxx

Included within the expenses of the period of combination are combination expenses such as finders fees, accounting fees, issuing costs, lawyers fees, etc. This treatment is dictated by APB Opinion no.16

Disclosure Requirements Under the Pooling Method

APB No.16, paragraph 64 requires in the notes of financial statements following a pooling combination the following disclosure:

1. The name and a brief description of the acquired company.
2. A statement that pooling treatment has been used.
3. Description and number of shares issued in the exchange.
4. For the separate companies, revenue, extraordinary items, net income, changes in stockholders' equity, and the amount and handling of intercompany transactions for the portion of the current period before the date of the combination.

5. A description of any adjustments of net assets or income related to changes in accounting procedures.
6. A description of the impact of a change in the fiscal period of a combining company.
7. A reconciliation of revenue and income previously reported by the stock-issuing company with the restated amounts reported for those periods for the combined company.

Furthermore, if a significant part of the assets of the combining companies are disposed of, then a material profit or loss must be separately reported in the income statement as an extraordinary item.

PURCHASE METHOD

The purchase method is the default approach to any business combination that does not meet the criteria of the pooling method. Under the purchase method it is presumed that an acquisition took place of one entity by another. Accordingly, the asset and/or liabilities received by the purchasing company are recorded by their fair value rather than their book value. The fair value is determined by the amount of cash spent or the market value of other assets disbursed.

Application of the Purchase Method

A purchase combination can take the form of any pooling combination. In other words it can be a merger, consolidation, asset acquisition or parent-subsidiary combination. To illustrate the application of the purchase method, assume that Exult Corp. issues 10,000 shares of stock at $10 par value in return for the net assets of Deck Corp. The market value of the stock at the time of combination is $25/share. The journal entry for Exult would be as follows:

	Debit	Credit
Investment in Deck	$250,000	
Common Stock		$100,000
Additional paid-in capital1		$50,000

For convenience in accounting for the combination, it is efficient to record the purchase as investment in the target company regardless of the type of acquisition or the eventual dissolution or continued existence of the target company. If dissolution does take place then Exult would allocate the fair value of the net assets acquired over the assets and liabilities received. Any excess of cost of acquisition over fair value of net assets is recorded as goodwill. If instead of dissolution, however, Deck Corp. remains a subsidiary of Exult then the investment account is allocated only in the consolidated financial statements.

Cost Allocation of Purchase Price

Allocating the purchase price over the assets and liabilities of the acquired company presumes that a purchase price was reached. The process of evaluating the worth of a company is complicated and subtle. Determining the fair value of assets and liabilities for allocation has been made somewhat easier by the guidelines set forth by APB Opinion no.16. (3) The guidelines are generally described below:

- Marketable securities - net realizable value (4)
- Merchandise inventories and finished goods - net realizable value less reasonable profit.
- Work-in-process inventories - same
- Raw materials - current prices
- Receivables - present values determined at current interest rates less an allowance for uncollectibility.
- Plant and equipment - current replacement costs for similar capacity if the assets are to be used and net realizable value for assets to be sold.
- Other assets, including land, natural resources and nonmarketable securities appraisal values
- Identifiable intangible assets appraisal values
- Liabilities - present values determined at appropriate current interest rate.

Fair values, under APB Opinion No.16, must be found for all identifiable assets and liabilities of the company, even if they are not on the books. An asset could for example, still be operative but completely depreciated and therefore no longer on the balance sheet, regardless it still must be appraised and assigned a fair value.

Determining the Purchase Price

The value of a company can be determined in several ways. Rarely is the net asset value as indicated on the balance sheet a good indicator of a company's market value, since book values are usually substantially outdated as estimation of worth, and are given to accounting play like depreciation. Two primary ways of evaluating a company's worth are (1) if it is a public company to find trading value of its stock either as a final sum of value or as a starting point for estimation of worth and (2) find the present value of the company's expected cash flows.

The latter method can be illustrated in a stock valuation formula:

$$Vo = \Sigma\ CFt/(1 + kt)^{\wedge}t$$

Where Vo is the present value of the asset or stock; CFt is the expected cash flow at time period t; Kt is the required rate of return for each period's cash flow; and n is the number of periods over which cash flow is expected to be generated. (5)

Once the fair values of the assets and liabilities have been found, a comparison must be made between the cost of acquisition (purchase price) and the total fair value of identifiable net assets. If the cost of acquisition exceeds the net fair value, it is allocated to net assets according to their fair values and then to goodwill. Goodwill is then amortized over a maximum of 40 years. If the net fair value, however, is greater than the cost of acquisition then it is assumed that there must be a reason that the company is worth less than its net fair value indicates, and that reason is termed negative goodwill. APB Opinion No.16 paragraph 91 explains the accounting for negative goodwill:

> An excess of cost should be allocated to reduce proportionately the values assigned to noncurrent assets (except long-term investments in marketable securities) in determining their fair values. If the allocation reduces the noncurrent assets to zero value, the remainder of the excess over cost should be classified as a deferred credit and should be amortized systematically to income over the period estimated to be benefited but not in excess of forty years.

Costs of Combination

In the purchase, method the cost of combination is differentiated as direct and indirect costs. Direct costs, other than the purchase price, include accounting, legal, consulting and finder's fees. These costs are added to the investment in target account. The indirect costs include management salaries, depreciation and rent are expensed. Registration and issuance of securities should be debited form additional paid-in capital.

Example: Direct costs come to $65,000, registration costs come to $12,000.

Investment in target	65,000
Additional paid-in capital	12,000
Cash	77,000

Contingencies of Purchased Business

FASB Statement No.38 amends APB Opinion No.16 in regard to preacquisition contingencies. It states that the acquiring company must quantify the contingency within an "allocation time period" of no more than a year, if it is to be included in the cost of acquisition. Otherwise any adjustments made are recorded in income.

Disclosure Requirements Under the Purchase Method

APB No.16, Paragraph 95 requires the following disclosures in the notes of the financial statements following a purchase combination:

1. The name and a brief description of the acquired company.
2. A statement that purchase treatment has been used.
3. Information on the total cost incurred in making the purchase. When an exchange of stock occurs, the number of shares issued and remaining to be issued should be disclosed, along with dollar amount assigned to the shares.
4. The portion of the year for which operating results of the acquired company have been included.
5. A description of the plan for amortization of goodwill and the amortization method.
6. Information on any contingent payments or ommitments and their accounting treatment.

Pro forma financial statement data also should be presented to provide statement readers with a better understanding of the potential operating impact of the business combination. At a minimum, supplemental information should be provided to show:

1. Operating results as if the acquisition had been made at the start of the period.
2. When comparative financial statements are presented, operating results for the preceding period as if the acquisition had occurred at the start of that period.

POOLING AND PURCHASE COMPARED

Financial statement differences between the purchase and pooling methods provide substantive advantages to pooling combinations. The result has been a preponderance of pooling combinations prior to the restrictions of 1970 (APB No.16) and a significant percentage of pooling combination thereafter. A study cited in Accounting Trends & Techniques, 1994 page 53 shows the breakdown of pooling versus purchase combinations between 1990 and 1993.

	1993	1992	1991	1990
Pooling Combination	21	17	16	10
Purchase Combination	200	182	160	190
Total Combinations	221	199	176	200

The predominance of purchase over pooling accounting between 1990 and 1993 is decidedly caused by the restrictions of APB Opinion No.16. The interesting thing about the study, however, is that it points to the substantial proportion of business combinations that were structured as pooling of interests combination despite the hefty prerequisites placed in their way. As John Anderson points out in the Journal of Accounting Research, Autumn 1975, page 343:

"It would seem that if the purchase treatment was desirable, it would be relatively easy to violate one or more of the conditions for pooling, forcing the transaction to be accounted for as a purchase. Given the continued existence of large numbers of poolings after the passage of Opinion 16, one might conclude that management's are very careful about meeting the pooling criteria." John Anderson continues to explain that management's choice of pooling over purchase falls in line with profit maximizing behavior.

In order to clarify how pooling permits higher profits than the purchase, we must analyze the differences the two methods have on financial statement items.

Differences in Net Assets:

Because under pooling, net assets are carried over at book value, as opposed to fair value under purchase, postcombination expenses are not as severe as they are under purchase. This is because the higher net asset value recorded on the books under purchase translates into higher cost of goods sold, depreciation and

amortization (goodwill) expenses than are present in pooling.

Differences in Return on Stockholder Equity:

The pooling method provides for a lesser increase in stockholder equity than the purchase method. This coupled with higher earnings under pooling leads to a higher return on stockholder's equity.

Sale of Pooled Assets:

The lower recorded value of assets under pooling than purchase, allows management to realize greater earnings through the sales of these assets.

Price Earning Ratio:

The combining of earnings under pooling along with the small issuance of stock relative to the purchase method allows a pooled company to increase its price earnings ratio dramatically, and perhaps even the price of its stock. An efficient market however should be able to dismiss such increases in the P/E ratio without movement in stock price. A study by Hong, Kaplan and Mandekler concluded that pooling has no abnormal effect on stock prices.

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Paragraph 88

Net realizable value is the estimated selling price of assets in the ordinary course of business less reasonably predictable costs of completion disposal. ARB 43, Chapter 4, "Inventory Pricing," paragraph 8.

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Computer Viruses: Prevention, Detection and Treatment

Oleg Lukyanov

Viruses are characterized by their ability to reproduce and spread. They first must be "imported" and executed by an authorized user; the attacker typically dupes an unsuspecting individual into accepting and executing the virus.1 The malicious code may be buried in what are presented to be otherwise useful utilities (e.g., spreadsheets, text editors), which then operate with the user's own authorizations to cause harm. The offending code may be present in a code segment the user "touches," which then attaches itself to the user's program, without the user ever realizing that he is importing a virus.2 For instance, a virus may be implanted in system library utilities (e.g., sort/merge routines, mathematics packages) and servers.

While a virus is normally considered to be limited to the authorizations of the user who is executing the code, the virus can clearly exploit any flaws in the system that would allow the user to enter privileged state (although, such attacks are more correctly seen as traditional penetration attacks).3 If the user who executes the infected code has system privileges (e.g., a system administrator), then the virus will be able to do even greater damage, depending upon

the specific privileges available to it. The critical point is that viruses depend upon their ability to exploit the legitimate capabilities of authorized users. In order to be successful, a virus must replicate and infect other programs without detection.

As with their biological namesakes, computer viruses come in a variety of types. Their missions can be modification or theft of data, or denial of service. Their methods of attack will be as numerous and varied as the weaknesses manifested in systems. Thus, perfect and universal solutions are not likely.4 There can be no single solution developed capable of preventing any and all virus attacks. However, we are not powerless against combating viruses, containing their effects, or limiting their capability to do damage. The defenses against viruses are both technical and procedural. A variety of valid defenses against a large class of malicious code when applied effectively can severely limit both the scope of the attack and the extent of the damage. Therefore, a central policy enforcement mechanism for the computer system is needed in order to mediate the actions of all system users and user processes. Such policy must constantly be invoked (i.e., unbypassable, mediates each and every access) and self-protecting (i.e., cannot be modified by user code). The result of requiring architectures that provide such mechanisms would be to limit the ability of hostile code to crash the system. Some fundamental protection mechanisms are required that provide protection of the system programs and data from unprivileged users. Many existing systems (e.g., PCs running DOS) lack even these basic protections required, thus allowing a virus executed by any user to infect any part of the system, even those most basic to system operation and integrity.5 In a proper server or network workstation OS, we expect that there will be no fundamental design flaws that allow the security mechanisms to be circumvented. Thus, in the absence of penetration paths, a virus would be limited to attacking users on an individual basis. This means that the rate at which the virus could propagate and the damage it could inflict would be reduced.

It can be argued that a virus capable of infecting each and every user

in the system (one that was present in the text editor, for instance) would be reasonably effective at accomplishing some missions (e.g., denial of service). However, it is still true that a strong and self-protecting network, at a minimum, forces a virus to infect users one at a time.6 This type of a network can also prevent some forms of attack and assure the existence and protection of the audit data by which viruses may be detected and traced. A well designed network represents the central protection mechanism that a virus must overcome in order to initially infect the text editor.

Among the fundamental principles that provide the foundation to any decent network is strong network policy enforcement. Discretionary Access Control provides the mechanisms that enforce user-defined sharing, also known as "need-to-know." This control requires that it be possible for the owner or manager of each data file to specify which users may access his data, and in what modes (e.g., Read, Modify, Append). Clearly, such a mechanism provides control over both acquisition and modification of data by viruses. In order for the malicious code to carry out its mission, it would have to be executed by someone who already possesses valid permissions against the data being targeted. If that user is not the owner, then the capability of the attack code to do harm would be limited by the allowed permissions (e.g., if the user who was being attacked had "READ-ONLY" access, the attack code could copy the data, but could not modify or erase it). While discretionary access control mechanisms provide relatively weak protections, they do constitute a hurdle that a virus must overcome, thereby slowing the rate at which the virus can propagate.7 Mandatory Access Control provides those mechanisms that enforce corporate policy dealing with the sharing of data. Examples of such policies are: "only members of the payroll staff may read or change payroll data," and "classified data may only be accessed by those having the appropriate clearances." A good network policy requires computer systems to be capable of enforcing MAC as well as DAC. That is, the system must be able to enforce those more formal rules dealing with either, or both, levels of sensitivity and categories of information (e.g., payroll, medical, R&D, corporate planning). Thus,

the ability of a user to access and manipulate data is based upon the comparison of the attributes of users (e.g., "member of payroll department," "member of R&D staff," "management," or "clearance level") with the attributes of the data to be accessed (e.g., payroll data, R&D data, classification level). Because it is required that the system control and protect these attribute designators (or, "labels"), they constitute a "hard barrier" for a virus, effectively limiting the scope of what it may do. In a properly designed and implemented system a virus would be unable to effect any changes to the labels. This means that a virus that is being executed by someone in the PAYROLL department would be limited to doing damage strictly within the set of data that is labeled accordingly. It would have the potential to modify or destroy PAYROLL data, but not access R&D or MEDICAL data. In short, MAC is an extremely strong mechanism, which prevents any process, including a virus, from making properly labeled information available to users who are not authorized for the information. Systems that achieve this level of security essentially guarantee that information will not be "compromised," i.e., no malicious code can violate the restrictions implied by the labels.

Collection of audit data is a traditional security mechanism that provides a trace of user actions such that security events can be traced to the actions of a specific individual. This security measure would require a system to be able to create, maintain, and protect an audit trail of accesses to the objects it protects from modification or unauthorized access or destruction.8 Because an effective virus depends upon its ability to infect other programs without detection, audit data provides the basis not only for detecting viral activity, but also for determining which users have been infected (i.e., by identifying which user is responsible for the events in question). Clearly, the collection of data is merely the foundation for detection. To fully implement a sound program, audit reduction and analysis tools are also required. Considerable advancement in this area is reflected by the recently developed intrusion detection systems; sophisticated real-time audit analysis and event-reporting systems,

some based on artificial intelligence (or, "AI") techniques. These provide extensive capability for detecting a variety of anomalous behaviors, and thus can be "tuned" for known or suspected viral patterns. While the available systems are still largely developmental, the early results are quite promising.

While it is certainly important to identify the correct set of security features that are needed in a system, it is equally important to provide the assurances that the features work as intended, are continually present, and are uncircumventable. Such assurances are provided by the hardware and software support for the features, and the hardware and software design. There is a need for adequate hardware support for security mechanisms. Even at the lowest level of trust, fundamental protection mechanisms are required to provide protection of the systems' programs and data from unprivileged users.

As an example of the gain to be realized by the right choice of system architecture, type-enforcement architectures are worthy of special note. These systems provide the potential for extremely fine-grained control of executing code, such that a virus would be incapable of performing any action that is not explicitly allowed by the type-enforcement mechanism. Because all access to data and resources is via a common, central mechanism (i.e., the type manager), protection only needs to be focused on the code authorized to manipulate the data and resources, rather than attempting to protect all user programs. To illustrate, such systems could easily enforce the following set of access rules, that a bank for example, might wish to enforce:

♦ Tellers may make changes only to those accounts for which they are authorized.

♦ They may only make changes to specific fields (e.g., may not change the account number, depositor name).

♦ They may only make the changes authorized between the hours of 9:00 a.m. and 5:00 p.m., Monday through Friday.

♦ Transactions that exceed $1,000 require the authorization of a supervisor, while transactions that exceed $5,000 require the authorization of the bank manager.

The capabilities of a virus that attached itself to a teller's process in such a system would be, somewhat circumscribed.

A virus that is executed by a user with privilege (i.e., a user that is permitted by the system to circumvent some part or all of the system's security policy) provides an enormous threat to the entire system. It would be able to circumvent the normal controls that protect other users' programs and data. In many systems, the virus would also be able to circumvent the controls that protect the system itself from modification.

Least Privilege is a familiar concept in the computer security community. It deals with limiting damage through the enforcement of separation of duties. It refers to the principle that users and processes should operate with no more privileges than those needed to perform the duties of the role they are currently assuming.9 That is, a user who may take on more than one role or identity (e.g., administrator and unprivileged user), should only be given the authorizations needed at the moment, rather than all the privileges he can assume for all roles that may be assumed. This is in contrast to many current systems that support only a single, all-powerful system administrator (particularly, the UNIX role of "superuser" and NT role of "Administrator"). A good system administrator should limit the capabilities of privileged users to those capabilities necessary to accomplish the prescribed task.10

Identification and authentication ensures that only authorized users have any access to the system or information contained on the system. Also, it forms the basis for all other access control mechanisms, providing the necessary user identification data needed to make decisions on requested user actions. While passwords are the oldest and perhaps the most familiar form of personal identifiers used to authenticate users to computer systems, also available today are biometric techniques and "smart card" devices.

While technical measures are necessary for controlling what code segments a process may access, what actions it may take, and the conditions under which it can operate (i.e., what goes on inside the computer), total system security also involves effective site security

procedures and system management. This is particularly true because poor procedures can negate the positive effects of some of the technical controls. As an example, audit data collected by the system, and the availability of even the most sophisticated audit analysis tools are of little value if the audit logs are never reviewed, or if action is never taken as a result of questionable activity.11

Historically, passwords have been among the first targets on which an attacker would focus attention. This is because they have traditionally been an easy target with high payoff potential. A person's password is often the key to all his data and authorizations. Attacking the password file is akin to targeting a safe that holds the combinations to all the other safes in a building. Thus, good password management and practices can go a long way toward limiting virus attacks. A virus counts on its ability to infect other programs. Thus, either the target must import the virus and execute it as his own (i.e., with his own privileges and authorizations), or the virus must be able to "become" the user to be infected by invoking his password. If the virus cannot successfully log in as an arbitrary user (e.g., by stealing or guessing valid passwords), then it is limited to attempting to fool users into executing the virus code. The trivial ease with which user passwords can be guessed and entire password files can often be attacked is nothing short of shocking.12 Truly effective countermeasures to such attacks are easy to implement and relatively inexpensive. They often amount to not much more than sensible management.

A virus represents code that was not intended to be part of a program or the system. Thus, procedures for maintaining valid and known system configurations for validating and approving shared code (e.g., software library routines), and for distributing approved programs and media (e.g., diskettes) can provide further obstacles to viral infestation.

While there may be some commonality across computer sites, it is also true that each site will offer its own unique set of problems. Thus, operational procedures typically need to be tailored to fit the needs of the particular environment, and defenses against viruses will

need to be designed into the procedures that govern the day-to-day operation of the site. As an example, recovery from a known or suspected virus attack might require a clean copy of the system. This, in turn, implies procedures for verifying the source and correctness of the backup copy, protecting it from modification until it is to be installed, and for installing it safely. Likewise, management policies and procedures dealing with the importation of code can also provide a measure of resistance to viruses. The establishment of the policy will tend to heighten awareness of the danger of bringing unknown software into the work environment, while effective procedures for controlling the importation of software will make it more difficult for a virus to be introduced.

While a computer system may provide a variety of security-related mechanisms, they must be used correctly if any measure of protection is to be achieved.13 Large, complex systems offer a special challenge, because there are typically a variety of configuration options, and they can support a large number or users, which may be grouped into different "communities" and classes, each with unique attributes, security restrictions and privileges, and with a different view of the system. This translates into a particularly difficult job for the system security administrator; it is imperative that he get everything right simultaneously. There will be many opportunities to configure the system such that needed security features are not active, or that the choice of options invalidates the action of a security feature that was activated. The second case is probably worse, because the security administrator believes that he has activated a security feature when, in fact, he has inadvertently caused the desired protection mechanism to be rendered ineffective.14 In short, the desired security characteristics of the system, while achievable, can easily be lost in the complex detail of configuring and maintaining an operational environment. Thus, it is critical that there be support for the system administrators so they may be able to make effective use of the available security features of, and configure and provide life-cycle support for, the level of policy enforcement needed. Such large networks would demand that the vendor provide the purchaser of the

product a "Trusted Facility Manual," a document that describes, in a single volume or chapter, all the security mechanisms supported by the system, and provides guidance on how to use them.15 It is a document aimed explicitly at the system security administrator, and as such, it provides the information necessary to fully understand system security mechanisms, how to use them properly, and the potential harm of poor implementation and configuration choices (e.g., insufficient auditing).

Virtually every shared-resource system available today provides facilities for users to specify some level of protection for their data. These may be in the form of User/Group/World mechanisms, Access Control Lists (ACLs), or other features that allow users to specify how, and with whom, information is to be shared. In order to be effective however, the features must be used properly. The users need to be cognizant of the protection features that are provided to them, and understand how they operate. In any size network, user awareness is crucial. A competent network administrator should provide users with documentation which would outline to them the security options and mechanisms available to users (i.e., the Security Features User's Guide).16 While, most user-specifiable protection mechanisms are not proof against determined hostile attack (at least, not in most current implementations), such protection features do provide a barrier that a virus must overcome; it is clearly easier to steal or damage files that are not protected than those that are. It is certainly easier for a virus to escape detection if no system-enforced prohibitions exist against the actions it is attempting to carry out.

The mission of a virus can be classified as one or more of the standard threats to information security, namely, unauthorized modification, unauthorized disclosure, and denial of service. Technical as well as procedural and administrative countermeasures exist that address these threats, and thus limit the success of malicious code attempting to carry out such attacks.

Identification and authentication, discretionary access controls, process isolation, and auditing are relevant countermeasures for the virus whose mission is to destroy or modify user data. Likewise,

least privilege, trusted path, and auditing will also serve as valuable countermeasures against the virus whose mission is to destroy or modify system programs and data structures. Identification and authentication, mandatory access controls, and discretionary access controls provide effective countermeasures against viruses whose mission is to cause unauthorized disclosure of information. Because infection requires that the virus be able to modify or replace some existing program, all of the technology and procedural countermeasures that are designed to prevent unauthorized modification of programs will make it harder for a virus to attach itself to legal user processes. The current technology in computer security provides only very limited countermeasures against denial of service. Identification and authentication mechanisms ensure that only authorized users have access to system resources, while auditing allows the system administrator to determine to what extent particular users use or abuse system resources. These controls thus ensure that a virus can attack only those system resources that the infected user is allowed to use, as well as keeping a record of utilization that may make virus detection easier.

Clearly, there are no universal cures; no single set of procedures and technical measures guaranteed to stop any and all possible virus attacks. Specific mechanisms tend to be designed to combat specific dangers, in the same way that vaccines are developed to combat specific diseases. Thus, preventive measures are intended to raise the cost of attacks, or to make it less likely that a specific class of attack will be successful.17 While viruses can exploit any and all flaws in our computer systems and networks, they tend to be classes of attacks with which we are already familiar. Thus, while there is valid concern for our vulnerability to virus attacks, a dispassionate analysis shows that our previous experience in computer security is relevant - the protective measures and technology we have developed are directly applicable, and provide a good baseline for making headway against these attacks. In addition, good environmental controls are critical; while technical measures are necessary for controlling what data and resources a user process may access, what actions it may

take, and the conditions under which it can operate (i.e., what goes on inside the computer), total system security also involves effective procedures and system management. On the one hand, it may be argued that viruses present no new technical challenges. The attacks they carry out are the attacks that have been postulated virtually since the advent of time-sharing. However, the intellectual process is such that one determines a threat, or attack scenario, and then develops specific countermeasures. Thus, the classical approach has led us to consider attacks and develop responses on an individual basis. A virus not only propagates, but may also carry out any or all known attacks, thus potentially presenting us with a universal set of attacks in one set of hostile code.18 However, what is truly revolutionary about viruses is that they change the way in which we will have to view the processing and communications support available to us, in the same way that "letter bombs" would cause us to radically change the way we viewed the postal system, (i.e., from beneficial and useful to hostile and potentially dangerous). Where we have previously put great confidence in our computing resources, we will now have to consider those resources as potentially hostile. Also viruses will cause us to change our view of the very intellectual environment - the sharing of software can no longer be as casual as it is today. The communications explosion confronts us with a more complex, richly interconnected computing and communications environment. In this environment, viruses are the concern. This means that, while our previous experience is extendible to the new threats, R&D is still needed. While there is considerable debate over whether or not viruses present a completely new set of problems, there is certainly no disagreement concerning our abilities to combat them. Most will concede that today we have, at best, only partial solutions. Perfect solutions may be possible, but a better understanding of the root technical issues, development of theory, and testing of countermeasures is required before we can know for certain. In short, viruses and other forms of malicious code are seen as an extension of classical computer security threats into the current computing and communications environment. The capabilities we have already

developed to combat the threats of yesterday apply perfectly well against viruses, but are not perfect solutions. If we are to develop still better solutions, R&D in this area is critical.

Today, the threat of viruses is even greater since organizations are providing Internet access to their employees.19 To prevent viruses from infiltrating corporate networks connected to the Internet, a company must disallow the downloading of certain file types such as *.doc or *.xls files and executable code such as *.exe files, or any other file extensions that may have executables or other file types that often contain viruses in them (for example *.zip and *.tar files). Also, other file types of applications that come bundled with Visual Basic must be prevented from entering (a.k.a. files created by Visio, MSword, Excel and other such applications).

Today, email has become a necessity, yet it posses a great deal of danger since people often send each other file attachments which may be contaminated by viruses. This means that these files must not be opened and the malicious code that they may contain must not be executed. This is where useful email virus scanning utilities by Mcafee and other vendors come in. They scan all email attachments before the attachment is opened and therefore the threat of getting the system infected through someone else's file is eliminated. Here, it will be noted that web access must be monitored and thereby employees will be forced to download and use only those Internet files that they need. Other packages which are sometimes included with firewalls or at times sold separately will monitor all TCP/IP traffic that is coming to the corporate network from the outside and they will terminate and delete any suspicious packets that do not look "normal". Such products work well because they exterminate potential viruses even before those viruses enter the system. Some anti-virus email software will check email files before they even reach the SMTP gateway. Such products ensure purity of data and applications. When one shops for anti-virus products he should look for products that have a utility that will run in the background checking files for viruses whenever any action is performed on a file. Such monitoring utility would prevent an infected file from infecting

the system because it would check the file before it would let the system perform any action upon the file in question. Therefore, a virus would be prevented and cleaned even if the user neglected to manually check this file or program before attempting to access it.

Since new viruses are debuting every day, a good anti-virus protection program must have the capability to add more virus definitions to its list of already existing viruses and thereby "upgrade" itself to protect the system from newer viruses. It is a necessity to update the virus definitions in an anti-virus package at least on a weekly basis. This process could even be automated through a short preprogrammed routine which would let MIS employees do other work at that time and therefore save a company valuable financial and time resources. Also, use of floppies must be fully eliminated on a good network and data should be stored on a shared network drive instead.20 This would greatly reduce a threat of a virus being passed around on a floppy from one employee to another. A system must be backed up regularly and a company needs to have a disaster recovery plan where in a case of a total systems and network crash, the data and the network applications could be restored as swiftly as possible. Servers must have separate duties. A corporate machine that runs SQL server must not run an Internet server on it as well. This way Internet users will have no way to access the data stored in the SQL databases and if one server crashes, only that server and the applications that it runs on it will crash while other servers with different missions will keep running. The only real way to prevent the most viruses that a system administrator possibly can is to be paranoid. This way the system administrator will be able to close up the maximum amount of paths available to a virus in order to infect a system. This paranoia is good when a system administrator uses it wisely and sets up multiple traps for potential viruses thereby almost guaranteeing that that a potential virus will be caught and eliminated at one of those traps set up for it.21

When it comes to dealing with viruses the most important aspect is prevention and good network architecture planning. A well designed and administered network will set up effective rudimentary measures

to prevent a virus from infiltrating the network servers as well as individual systems.22 Therefore, by proacting, we prevent viruses from reaching systems and therefore we will save money by not losing data, software, hardware, and financial resources to viruses. By setting up effective virus protection policies and preparing for the worst, we will save by being prepared for potential attacks on our network.

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