The Sy Syms School Journal of Business
The Portfolio would like to thank the Sy Syms Student Council, Dean Nierenberg, and the Accounting Society for their generosity.
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Yeshiva University
Sy Syms School of Business

Office of the Dean

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On behalf of the Faculty, Staff and Administration of the Sy Syms School of Business I offer my congratulations to this inaugural edition of the Portfolio. It is indeed gratifying for all of us at the Sy Syms School of Business to take note of this significant milestone which reflects the ongoing growth and development of the school.

The Portfolio in large measure is in keeping with one of the missions of the Sy Syms School of Business - namely, to provide a medium for the exchange of ideas, concepts, and philosophies between faculty and students.

Once again, my best wishes for the ongoing future success of the Portfolio.

[Signature]

Harold Nierenberg
Dean
To the Editors of The Portfolio:

On behalf of the Sy Syms School of Business, I may congratulate the editors of the Portfolio on their inaugural issue. Creating a new publication and a scholarly business journal is a major accomplishment. The editors should be commended on this historic event. The Portfolio marks another milestone in the growth and development of the Sy Syms School of Business.

May I also extend my personal thanks to the faculty and students who contributed to this journal.

Congratulations.

Ira L. Jaskoll
Associate Dean

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Five Disasters

Aaron Brown

February 4, 1994 was a bad day for investors. The Federal Reserve announced that it would increase the Fed Funds rate from 3% to 3.25%. The Dow Jones Industrial Average fell 96 points, similar declines were seen in stock markets all over the world. Short-term and long-term interest rates increased about 0.25% causing losses for bondholders.

By the end of 1994 it was clear that February 4 had been a much worse day than anyone appreciated at the time. The interest rate increase lit five slow-burning fuses that would explode into five major disasters. Some of Wall Street's brightest stars would end up fired, disgraced, or broke; some would be sued, others investigated by government authorities, still others would face criminal charges.

This was not completely accidental. It later became clear that the Federal Reserve's action was part of a plan that began in September, 1993 and would continue through April, 1994. A major purpose of the plan was to prick speculative bubbles.

1994 looks like a quiet year on paper. Stocks posted a small gain, bonds a small loss. There was no single dramatic event like a stock market

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crash, debt repudiation, or oil embargo. Still, market professionals will remember 1994 as a terrible year in which disaster humbled the proud.

Speculative Bubbles

In one sense this is a common story. The price of something goes up for a while and some people forget it can ever come down. They borrow money to invest and, when the investment declines in value, they cannot repay the loan. They go bankrupt, the people who lent them money are hurt, the investors in the lenders are hurt, the people who lent money to the people who invested in the lenders get hurt, *ad infinitum*. There are fears of a financial meltdown but, at least in the United States, the fire has always burned itself out.

For example October 29, 1929 was another bad day for Wall Street. If the problem merely had been the stock market went down the day would have been forgotten the next time the market rallied. Instead for 75 years “Black Tuesday” has been a symbol of greed, excess, and tragedy because of the scandals it exposed.

Who can forget the Union Industrial Bank of Flint, Michigan? Fifteen employees, including most of the senior management, embezzled more than $3 million to invest in the stock market. While the market was going up in 1928 and 1929, they could spend their profits and return the stolen money at any time. When the market crashed the “league of gentlemen” were forced to confess the crime and go to prison.

Richard Whitney, president of the New York Stock Exchange, shook public trust even further. He was engaging in a similar scheme with money that had been entrusted to him. The crash cost him $2 million he didn’t have. His position of trust was so great that he was able to hide the losses and avoid prison until 1938.

National City Bank paid its president, Charles Mitchell, over $1 million for the first half of 1929. From a pre-crash high of $577 per share, National City Stock eventually fell to $20. Charles Mitchell was charged with a series of financial irregularities. He was eventually acquitted of criminal charges but assessed $1.1 million for income tax evasion.

One persistent myth is that hundreds of investors jumped to their deaths from Wall Street buildings. In fact there is only one verifiable case, a woman who jumped off the 40th floor of the Equitable Building. However two prominent suicides, Jesse Livermore and James Riordan, were probably indirect results of the crash.
U.S. government bonds are among the safest investments available, how could Piper Jaffray lose a quarter of the fundholders’ money in three months? And they weren’t alone, some other government bond funds had similar losses.

The safest government bond funds are government money market funds. Even some of these lost money. Community Banker’s U.S. Government Money Market Fund fell 6% in value before going out of business. This was the first time in history that a money market fund “broke the buck” and returned less money than had been invested. Several other money market funds avoided that fate only because their managers replaced the losses from their own pocket. In June, 1994, for example, BankAmerica replaced $68 million of losses in two Pacific Horizon money market funds.

The problem is in the definition of government bond funds. These funds all had the ability to trade in government bond derivatives as well. One of the simplest derivatives is a forward contract: you agree to buy something at a future date for a price set today. For example you might agree to buy a 30-year treasury bond for $1,000 one month from today. In one month you must deliver $1,000; the counterparty delivers the bond.

Piper Jaffray Institutional Government Income was supposed to maintain an average maturity between 3 to 5 years. That would mean that if interest rates went up 1%, the value of the fund should decline about 3%. But all treasury bonds with maturities between 3 and 5 years have about the same yield. Therefore there is not much one fund can do to distinguish itself from another.

That is why derivatives are tempting to these funds. Suppose you entered into a forward contract to buy a 30-year treasury bond in one month for $1,000. If interest rates go down, the bond will be worth much more than $1,000 and you make a large profit. If interest rates stay the same you still make a profit of about $4 at the interest rates prevailing in 1989 to 1993. But if interest rates go up, the bond will be worth less than $1,000 and you take a large loss.

Win or lose you never actually have to take delivery of the bond (you just settle up for the price movement) so you can keep your portfolio maturity below 5 years. You never own any 30-year bonds, you just enter into forward contracts to purchase them. Then you get out of those forward contracts before delivery.

By entering into these forward contracts, and by using more complex derivatives, Worth Bruntjen earned more money that any other bond manager as long as interest rates were going down. For every 1% interest rates went down, his portfolios made about 15%. In the world of short-term government bond funds, 0.1% is a big difference in yield. So Piper Jaffray Institutional Government Income was everybody’s favorite.

But, of course, interest rates went back up. Now the fund was losing 15% for every 1% increase in yield. Investors sued, claiming they had been misled about the risks. Piper Jaffray replied that they were within the letter of their prospectus but still agreed to repay about 10% of the losses. The Securities and Exchange Commission agreed that investors had been misled.

Disaster II:

Midtown Alliance

The same January 10, 1994 Business Week article quoted another CEO on a hot streak. Michael A. Carpenter of Kidder Peabody & Co. wanted to leverage his success by working with some international partners. He said, “I predict some global alliances in 1994.” On June 22, 1994 he was fired. The only alliance for Kidder? They were taken over by Paine Webber from 53rd Street.

The trouble could be traced back to 1991 when Kidder’s head government bond trader, Joseph Jett, discovered a new kind of trade, the “forward recon.” In 1993 he did $1,700,000,000,000 of these trades for a total profit of $348 million. This was a little under half the profits made by everyone else in Kidder’s Fixed-Income department put together. Mr. Jett was given Kidder’s 1993 “Chairman’s Award” and $11 million in bonus and salary.

Unfortunately the profits disappeared overnight on April 17, 1994. Mr. Carpenter’s boss, Jack Welch, supported him for two months but then fired him. Mr. Carpenter in turn supported his subordinates, but they were soon gone also. Edward Cerullo paid the Securities and Exchange Commission $50,000 to settle charges of inadequate supervision. Mr. Mullin is still fighting his charges.

Mr. Carpenter ended Business Week’s “Hot Streak” article by saying, “You hope for the best but plan for the worst.” Business Week added, “In 1994, the Street is betting that once again, the best is all it will see.” It appears that Mr. Carpenter’s plan did not did not work and the Street lost its bet.

How did Mr. Jett create the profits? Wall Street and small children have many things in common, including a love of putting things together then pulling them apart. Children are generally satisfied with Lego or, at
worst, small household appliances. Wall Street likes to play with treasury bonds.

A treasury bond is issued by the U.S. government. It pays interest every 6 months for a specified period of time, then it repays the principal. For example an 8%, 30-year treasury bond will pay $40 twice a year for 30 years (60 payments in all) plus $1,000 along with the last interest payment.

Lots of investors do not want to buy a whole bond. For example young parents often want investments that will give them college money when their child turns 18. So they would be interested in only one of the 61 payments made by the 30-year treasury bond.

One of Mr. Jett’s jobs as a government bond trader was to “strip” treasury bonds into their component cash flows. The Treasury will do this for you, you send them a 30-year bond and they will send you 61 “strips”—each one representing one of the payments from the bond. Each strip can be sold to a different investor who wants money on a different future date.

It is usually true that the sum of the strip prices is slightly greater than the cost of the bond. That is how the trader makes money. However in the course of business you build up an inventory of unsold strips. Every so often you clean these out with a “recon” transaction. You send the strips to the treasury and they send you back a bond. Then you can sell the bond to reduce your inventory.

A strip transaction is like taking a dollar bill to the bank and getting change. We can imagine someone making money by changing dollar bills for people who have to make telephone calls. If she offered $0.95 of change for every $1.00 bill she would make a small profit.

Of course she would build up an inventory of bills which she would periodically take to the bank and “strip” into coins. However she might occasionally find herself with undesirable change, say pennies, she would take these to the bank and “recon” them into dollar bills. If you add a few zeros, this is what Mr. Jett did for a living.

It is also possible to do forward strips and recons. That means you tell the Treasury today that you will do a strip or recon at some specific future date. It is not a binding commitment but it allows you to change the way you account for the securities.

For example, suppose you have agreed to deliver a $1,000 30-year treasury bond to a customer in 30 days. You do not own such a bond but you own the strips to make it up. Your trading book shows a long position in strips and a short position in bonds. If you recon the strips the positions offset and your trading book shrinks. This increases your computed return
The accounting system recognizes a $0.0002 loss on the original forward trade but a gain of $0.0002 on the offsetting trade with the bank.

The next day our change maker goes to her teller and says, "I'm bringing in $1.7 trillion dollars tomorrow, make sure you have quarters for me." The teller laughs and agrees.

When she enters this trade in the accounting system, it recognizes a $340 million profit ($0.0002 per $1 on $1.7 trillion). There is no customer trade to offset it. Of course the profit will disappear the next day, but all she has to do is repeat the process. By continually rolling over forward strip transactions she can be wealthy, at least by her internal accounting statements.

This appears to be what Mr. Jett did. The Kidder accounting system used different methods for accruing interest on bonds and strips. Although the details have not been made public, my guess is that bonds accrued interest linearly (this is the usual convention in bond markets) while strips accrued geometrically (again the usual convention).

For example, suppose you buy a 9% $1,000 treasury bond with 180 days remaining to maturity and pay $1,000. This bond will pay $1,045 in six months, since it has only one payment it can be considered either a strip or a bond. With bonds we usually assume that the $45 interest payment accrues at a constant rate of $0.25 per day. If we call this a strip it will accrue $0.245 the first day, increasing to $0.255 on the last day. The total interest is the same $45 but the timing is slightly different.

Therefore suppose you call the Treasury and tell them you are going to take this strip in tomorrow to be reconed into a bond. Your accounting system notices that both of these securities have a $1,000 value today but it computes the forward value of the strip you have to deliver at $1,000.245 and the forward value of the bond you get at $1,000.25. So it credits you with a half cent of profit.

Of course tomorrow the market prices of the bond and the strip will still be the same so your profit disappears. But all you have to do is repeat the trade to keep your profit up. This particular example has a defect, bonds with only one payment remaining are accounted for in a different way. But the general principle holds for more complicated forward recon trades.

Disaster III:

The Beauty of Bankers Trust

"They would never know. They would never be able to know how much money was taken out of that."

"Never, no way, no way. That's the beauty of Bankers Trust."

This is part of a November 2, 1993 conversation by two Bankers Trust employees. Investment banks routinely tape-record conversations, in a business where billions of dollars change hands based on oral agreements it is important to be able to prove who said what. However sometimes it is embarrassing as well, Bankers Trust later labeled these comments "crude and stupid" and disciplined the employees.

Bankers Trust was congratulating itself about the ignorance of Procter & Gamble, one of the largest and most successful corporations in America. Until 1994 Procter & Gamble's worst problem was a persistent rumor that they were a company of devil-worshippers with a Satanic logo. In early 1994 Business Week named them one of the "nimble giants," companies that have the financial clout of a heavyweight but the speed and grace of a lightweight fighter.

For years Procter & Gamble had been making money betting that interest rates would go down. However their October, 1993 bet lost $7,500,000. Kevin Hudson of Bankers Trust offered an easy way to erase that loss, a leveraged swaption.

It was pretty simple. Six months from signing the contract an amount would be computed equal to the interest on $17,041,500,000 at the 5-year treasury rate minus the price of $1,000,000,000 face of the 6.25% treasury maturing in August 2023. If this amount is positive, Procter & Gamble will pay it to Bankers Trust; if it is negative Bankers Trust will pay it to Procter & Gamble except that Bankers Trust will never pay more than $7,500,000.

If Procter & Gamble won this bet they could erase the $7,500,000 million loss from the October bet. What if they lost? In fact they lost the minute they signed the contract, Bankers Trust booked a $7,300,000 expected profit on this bet. The loss grew to a staggering $17,000,000 by February, 1994.

Mr. Hudson did not want to break this news to Procter & Gamble. He wanted them to go double or nothing again, this time on a German DM bet. "Let me just get the DM trade done first; then they can ask [how much they lost]," he told his fiancée.

Mr. Hudson sold Procter & Gamble that swap. The next month the two contracts cost Procter & Gamble $196,000,000. Former Procter & Gamble Chairman Ed Artzt said that Procter & Gamble executives were "like farm boys at a country carnival." Unfortunately for Bankers Trust, these "farm boys" had lawyers.
Procter & Gamble did not just ask for their money back, they sued Bankers Trust under the Racketeer Influenced Corrupt Organization Act, asking for $600 million. They claimed that Bankers Trust engaged in organized fraud, cheating Sandoz, Gibson Greetings, Sequa Corporation, Equity Group Holdings, Adimitra Rayapratama, Jefferson Smurfit, Air Products & Chemicals, and Federal Paper Board.

Even if Bankers Trust wins the lawsuit their reputation will not quickly recover from the taped conversations Procter & Gamble got through discovery. Partly as a result of this case, Bankers Trust’s credit rating was lowered. This is another blow, a top credit rating has always been one of their strong suits.

Disaster IV:

Solid as Granite

Ordinary investors buy mutual funds, the rich can buy hedge funds. Because these funds limit themselves to a small group of sophisticated investors, they can engage in exotic risky strategies and avoid most disclosure requirements. In good times the top hedge fund managers, like George Soros, appear to be more powerful than governments.

David Askin, described by Business Week as a “scholarly, soft-spoken, egotistical...[Collateralized Mortgage Obligation] expert” ran a number of these funds including Granite Capital Partners. From 1990 to 1993 he seemed to have discovered the philosopher’s stone of finance: no risk, high return. By the end of March, 1994 his funds had been liquidated and investors lost about 80% of their money.

Mr. Askin, like Mr. Jett, was involved in the putting-together/taking-apart game. Mr. Askin worked with home mortgages instead of treasury bonds.

The process begins when someone buys a house. They generally get a mortgage from a bank, the bank gives them (say) $100,000 to buy the house and they promise to pay $800 per month for 30 years to the bank. A key fact is that they can repay the mortgage at any time by sending the bank the outstanding balance. People do this when they sell the house but also when they can get a cheaper mortgage somewhere else. If interest rates fall, the payment on a $100,000 mortgage might go down to $750 per month so the homeowner takes out a new, lower-payment mortgage and uses the money to repay his or her old, higher-payment mortgage.

Now the bank takes 1,000 of these mortgages and bundles them together into a “pool”. This pool produces $800,000 per month in income, the bank can sell this to investors for (say) $105,000,000. Since the bank only lent the homeowners $100,000,000, they make a nice profit. There are often many intermediaries involved in this kind of transaction but the end result in the same.

This pooling went on for about 20 years from the 1960’s to the early 1980’s before someone (many people claim the credit) got the idea of pulling the pools apart again. Say you bought the pool for $105,000,000. You sell one person the first year’s $800,000 per month for $9,000,000. You sell someone else the tenth year’s cash flow for $2,000,000. Another investor gets the interest payments from the third year for $6,000,000. Then you start getting complicated.

When every scrap of cash has been sold you have $110,000,000—a nice profit. The pieces of the cash flow from the mortgage pool are called “Collateralized Mortgage Obligations.”

The first pieces you sell are choice cuts, investors willingly pay high prices for them. As you cut off more and more of the good parts it becomes harder to sell the remainder. These securities get all the uncertainty from changes in prepayment rates and interest rates, they buffer the high-quality securities. Eventually you are left with “nuclear waste”—cash flows so unpredictably complicated that you almost have to pay someone to haul them away.

David Askin was that sanitation engineer. He bought the cash flows no one else wanted. The only thing he asked was that they were cheap. That guaranteed him a high return. Then he worked his magic to turn nuclear waste into a low-risk portfolio.

He did this through computer models that predicted the behavior of the most exotic collateralized mortgage obligations. He then carefully balanced these dangerous securities so that whatever happened, the losses in one security would be made up by gains in another.

This can be compared to building a house of cards. By itself, a card cannot even be made to stand upright. But if you carefully place hundreds of cards you can build strong, elaborate structures. At least until somebody bumps the table.

Who bumped the table? Interest rates went up so, according to Mr. Askin’s computer model, the prepayments on the mortgage securities should have gone down. However they did not go down right away, probably because the first interest rate increase in five years persuaded homeowners to refinance quickly before rates went up more.
This was a short-term effect, things quickly returned to normal. But before that happened the entire collateralized mortgage obligation market crashed. Mutual funds and public pension funds, stung by adverse publicity and spooked by short-term losses, sold and sold. Even high-quality securities were hit hard, there was no market at all for Mr. Askin’s nuclear waste.

Another superstar investor who was a victim of these events was Michael Steinhardt. He lost $1 billion and said, “The market was a mile wide and an inch deep. I’ve been wrong, and it is an extremely trying circumstance. It’s no fun.” George Soros, the most famous hedge fund manager, lost $600 million. Five major investment houses: Kidder Peabody, Bear Stearns, Citicorp, Goldman Sachs and Bankers Trust were rumored to have huge losses also.

Granite Capital Partners had borrowed money to buy some of these securities in order to further boost investors’ returns. The securities were pledged as collateral. By the end of March the creditors were demanding repayment so the securities had to be sold at huge losses. The funds collapsed.

Disaster V:
Citron’s Last Election
Robert Citron was the treasurer of Orange county, the wealthiest county in California, for 24 years. Over this period he built a reputation as the top municipal fund manager in the country. From 1988 to 1993 he earned 9% on the county’s money, twice what most managers could get. The assets entrusted to him grew from under $1 billion in 1988 to $8 billion by 1994.

Despite this success, in 1994 he was challenged for re-election for the first time. John Moorlach, a Costa Mesa accountant, made a major campaign issue of Citron’s investment strategy. “If you want to make a killing,” he reasoned, “you’ve got to be prepared to be killed. But when you do it with my tax dollars, the question is: Why were you able to do that?”

Although the voters brushed these questions off and reelected Mr. Citron handily, he felt the campaign was stressful. He announced that it would be his last election. He did not know how right he was.

By the end of 1994 he had lost over 20% of the money in his fund. It turned out he was engaging in a classic leverage strategy. He borrowed $12 billion so that he had $20 billion total to invest. In 1993, for example, he could borrow short-term money at 3% and invest intermediate-term money at 5%. That meant he could earn 5% on $20 billion or $1 billion. He had to

The Big Picture
Alan Greenspan, the Chairman of the Federal Reserve Board, had been worried about speculative bubbles and over-leverage as far back as the beginning of 1993. Five years of low interest rates and rising markets had created a dangerous situation. In many respects it was similar to the situation in Japan before their stock market crash.
Japan's market lost over 60% of its value, compared to 20% in the 1987 U.S. crash. Unlike the U.S., Japan did not quickly recover. Instead, interest rates dropped and the economy slid into a long-term recession. These troubles triggered massive loan losses for banks and exposed major political scandals. Eight years later Japan is still feeling the effects.

By February 4, 1994, there was unanimous agreement among the Federal Reserve Board that interest rates had to be raised. Some wanted a large increase, as much as 0.75% to 1.5%. Alan Greenspan held out for a different course, a radical departure from past Federal Reserve policy.

He felt that after five years without an increase, a 0.75% increase would be too big a shock. Instead he wanted to raise interest rates 0.25% per month until the economy slowed to a sustainable level. Usually the Federal Reserve Board does not announce its actions until six weeks after they are made. This time the first 0.25% rate increase was announced immediately and described unanimous.

This immediately caused some pain in two of our five disasters. Worth Bruntjen of Piper Jaffray and Robert Citron of Orange County were both borrowing short term. The increase in their borrowing costs cut into their return. But the pain was minor and caused no immediate panic. The other three disasters were not affected: Joseph Jett of Kidder Peabody was not borrowing money, Procter & Gamble was betting on intermediate and long-term interest rates with Bankers Trust, the Federal Reserve action only directly affected short-term rates, and David Askin of Granite Capital Partners was fully hedged against changes in short-term interest rates. The Federal Reserve's action caused small declines in the stock and bond markets.

But some longer-term forces were stirred up as well. The announcement of the increase along with the comment that it was unanimous suggested there was more to come. Nimble traders started repositioning themselves so that further rate increases would not hurt them. That meant reducing leverage, selling long-term investments, and shorting foreign currencies. Also many homeowners decided that interest rates had hit bottom and were moving up, it was time to refinance.

Some traders were unwilling to do this. It meant accepting a small loss to protect against a larger one later. Worth Bruntjen of Piper Jaffray, Robert Citron of Orange County, and Procter & Gamble all decided to essentially double their bets. If interest rates did not go up further, they would make back their losses from February 4. Worth Bruntjen and Robert Citron both did this by borrowing more money and buying more long-term

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securities.

Procter & Gamble followed a different path that many others adopted as well. They decided to bet that German interest rates would go down and that the US dollar would appreciate against the Japanese Yen. There were good reasons to believe these things would happen but, instead, the reverse occurred. On February 14, 1994, Procter & Gamble entered into another leveraged swap with Bankers Trust to make these bets.

David Askin of Granite Capital Partners noticed that demand for collateralized mortgage obligations was drying up. He had trouble finding brokers to give prices for his securities, he needed these prices to report to his investors.

Normal accounting standards say that the price should be what a willing buyer would pay in an arm's length transaction. Without a willing buyer available it is permissible to report computed prices. This is what David Askin did. After the collapse he was criticized both for accepting unrealistic price quotes from brokers who were trying to prop him up and for reporting computed prices. His critics contended that there were willing buyers, the prices were just much lower than Mr. Askin was willing to accept.

Joseph Jett of Kidder Peabody was squeezed even more indirectly. He had losses on his real trading portfolio so he had to do even more forward recon transactions to compensate. Moreover Michael Vranos, Kidder's superstar mortgage trader, had a $10 billion inventory of collateralized mortgage obligations that were getting hard to sell. More pressure was put on Mr. Jett to reduce his inventory.

Thus in all five cases, people reacted to trouble by doubling their bets to disguise the problem. If the doubled bets had paid off, we might never have learned any of these stories. But the result of this behavior throughout Wall Street was that the players in these exotic strategies were increasingly desperate. In trader's terminology, they had "weak hands" and would be forced to sell out if trouble occurred.

On March 22, 1994 the Federal Reserve Board made their second 0.25% rate increase. The bond market gave up, long-term yields soared. Other events, including the assassination of Mexican Presidential candidate Luis Donaldo Colosio spooked the markets further. With only weak hands remaining in the market there were no deep pockets to sustain prices throughout the panic. Four of our disasters came to light over the next few weeks.

Procter & Gamble was forced to admit the $196 million loss, it had
grown too big to hide. Joseph Jett's forward recon position reached $1.7 trillion, Kidder Peabody finally noticed. David Askin's lenders insisted on being repaid, some funds were liquidated for the creditors, others were taken back by the investors. Piper Jaffray had to report the market value of its position, mutual funds cannot hide losses. Robert Citron enjoyed the luxury of reporting once a year, he managed to avoid exposure until December, 1994.

On April 18, 1994 the third 0.25% rate increase came. This time the stock market was the victim. The Dow Jones Industrial Average had fallen 306 points from its January high just under 4,000. In many ways this was the low point of the year.

The markets posted decent performance in the second half of the year. The stock market ended up about 1%, the long-term bond market down about 3%. 1995 was one of the great years ever for investors, 1996 to date looks almost as good. Many people give credit to Alan Greenspan's "preemptive strike" against leverage. A little pain in 1994 may have saved us from widespread disaster later. Of course Worth Bruntjen, Joseph Jett, Kevin Hudson, David Askin, and Robert Citron may not agree.

The Moral: "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich."

What can we learn from these misfortunes? One important lesson is that finance offers second chances. Few of us get through life without doing something wrong. Often we are betrayed by a momentary impulse—of greed, of anger, of pride. In some fields; like surgery, military operations, or driving a car; this can get someone killed. But in finance it is only money.

The more I study financial disasters, the more I see that the real damage is caused by refusing to admit to a previous mistake. In February, 1994 all five of our disasters could have been averted for a small loss. Worth Bruntjen could have been satisfied with a below-average year for his mutual funds. Joseph Jett could have stopped doing forward recon trades and admitted an $84 million loss. This would not have been good news but it would not have been out of line for a head government bond trader at a major bank.

Procter & Gamble could have terminated their deal with Bankers Trust for a $17 million loss, Bankers Trust could have saved its reputation by being straightforward in February instead of trying to sell another deal. David Askin could have told his investors that it was not possible to value Granite Capital Partners' assets. Robert Citron could have told the county that his fund was going to underperform similar funds by 0.5% per year for the next five years.

We cannot tell for certain what the outcome would have been in all these cases but we can make educated guesses. Worth Bruntjen and Piper Jaffray would have no longer been the hottest bond managers but they would have continued to make money. Joseph Jett might have been fired but he would have kept his money and reputation. Procter & Gamble would probably have terminated their relationship with Bankers Trust and disciplined some employees, but things would never have reached the lawsuit stage. David Askin's investors may have pulled out but it would have been much more orderly with fewer recriminations. Robert Citron would have retired with dignity at the end of his term.

Instead in all five cases people elected to double the bet. If they had won the new bets, no one would ever have discovered their original mistakes. But by losing the new bets they plunged themselves and their firms into disaster.

Remember these cases whenever you are tempted to cover up a mistake with a gamble. If you do this you lose the defense that your original mistake was a momentary lapse. Also think about organizations that you work for or invest in. Are they so unforgiving that employees feel compelled to hide errors? If so they will probably face a disaster sooner or later.

A second moral comes from considering the culpability of individuals and institutions. All of these cases are under dispute and this paper is not the place to make individual accusations or judgments. But we can contrast the accusations to get a sense of the types of behavior that leads to disaster. And we can compare the reactions of the organizations to learn something about how to deal with problems like these.

Joseph Jett and Bankers Trust are accused of knowingly violating laws for their own profit. Both have vigorously protested their innocence. However there is a big difference. If Mr. Jett is guilty then he was a thief. If he knew the forward recon trades did not generate any real profit but inflated his bonus, he cheated his employer. Bankers Trust had a much weaker obligation to Procter & Gamble than Mr. Jett had to Kidder Peabody. Bankers Trust may have crossed the legal line from aggressive sales practices to fraud but that line is neither clear nor sharp.

Worth Bruntjen, David Askin, and Robert Citron are accused of concealing the risks of their strategies from their investors. All three have claimed that full disclosure was made. David Askin has an additional defense, his investors were sophisticated and should have understood his reports. Robert Citron has a different additional defense, he was a government
employee who had neither the training nor the salary of anyone else involved in these affairs. He cannot be accused of misleading people in order to increase his income and he has the most plausible claim of being misled.

How can you avoid these problems? Follow the simple rule: advertise your behavior in inverse proportion to its ethical standard. Charity should be quiet or anonymous, dubious behavior should be clearly and prominently disclosed. If you are not sure whether you should do something, the worst decision is to do it surreptitiously. Do it openly or not at all.

If Joseph Jett was really instructed to do the forward recon trades, he should have documented them and made sure Jack Welch was informed. If Worth Bruntjen thought his investors did not mind the risk of mortgage derivatives, he should have renamed the fund “Piper Jaffray Exotic Derivative Strategies” and sent a notice in large letters with the quarterly reports: “The good performance of these funds in the past is due in part to exotic mortgage derivatives. A large proportion of the fund is invested in these instruments whose value can fall to zero overnight.”

Of course nobody would ever send such a message so, in my opinion, no one should run a government bond fund this way. Just thinking about disclosure makes a lot of decisions easy.

How did the institutions react to these disasters? Kidder Peabody and Procter & Gamble quickly and aggressively investigated their problems. Information was disclosed to the public and regulatory authorities. Piper Jaffray also disclosed the problem and made some restitution. David Askin disclosed the problem and gave his investors several options to recover as much of their money as possible.

On the other hand neither Bankers Trust nor Orange County has taken much responsibility. Bankers Trust has fought for quiet settlements without disclosure and seems to have done little to discipline employees or prevent a recurrence. Orange County has refused to pay for the losses and tried to pin them instead on the federal government, the State of California, investment banks, county employees, and people who lent money to the county. No serious investigation seems to have been made and nobody from Orange County has admitted any responsibility for the losses.

The final moral is about success. Each of these disasters began in success: Joseph Jett’s “Chairman’s Award,” Worth Bruntjen’s stellar record as a manager, Procter & Gamble’s successful bets that interest rates would go down, David Askin’s seeming ability to generate high returns with no risk, Robert Citron’s impressive investment returns. In life success can go to your head, in finance it tends to go to your leverage ratio.
Are Surveys Trustworthy?

Hershey Friedman

One of the major tools of business research, as well as research in the social and behavioral sciences, is the survey. Surveys are used in many important areas, including: political polls, marketing research, behavioral research, economic statistics, and crime statistics. For example, surveys are often used in the area of trademark confusion, i.e. to determine whether there is consumer confusion between two brand names or marks. Surveys are also used in the verification of advertising claims, and survey evidence can help determine the veracity of claims made in advertising such as “three out of four dentists recommend...”

It is generally believed that surveys, if done with a representative sample (and with a reasonably high rate of response), are an objective way of collecting information. Unfortunately, surveys are far from being the foolproof technique some believe them to be. In fact, there are many ways that a survey can be biased. Dishonest researchers can, of course, manipulate the outcome of the survey, if they wish, but such biasing may also be totally unintentional.

Clearly, if accuracy is desired, a great deal of care must go into the words and questions we select for our surveys. Even if we start out with “perfect” questions and an unbiased instrument, people are not always honest in their responses. This is especially true with sensitive and/or ego-involving questions. For example, people tend to exaggerate whether and how much they have given to charity. People tend to be inaccurate as to whether they voted in an election; overreporting of voting typically ranges from 25% to 30%. The public’s responses are not always accurate. People tend to give socially acceptable answers, try to give the “right” answer, try to please the interviewer, and/or are unwilling to admit their ignorance. Thus, it is important, at the very least, to start out with a questionnaire that is as unbiased as possible.

The purpose of the current article is to demonstrate that the survey is not necessarily the objective research tool that many believe it to be. It is hoped that this paper will help researchers conduct surveys with as little bias as possible.

Questioning the Questions

1) The Connotations of Words Used:

The connotations of words used in the individual questions of a questionnaire can affect subjects’ responses. A word may have numerous synonyms, each with its own nuance. The following are some examples of wording problems in various surveys.

Several years ago, researchers working for Burger King asked the public “Do you prefer your hamburgers flame-broiled or fried?” Flame-broiling (used by Burger King) beat out frying (used by McDonald’s) by three to one. This finding was touted in advertising. However, an independent researcher found that the results were dramatically different when the question asked was: “Do you prefer a hamburger that is grilled on a hot stainless-steel grill or cooked by passing the raw meat through an open gas flame.” With this approach, 53% of respondents preferred a grilled burger. Clearly, the words “fried” and “grilled” are not synonyms and neither are “flame-broiled” and “open gas.” Each has different connotations. The word “fried” evokes the image of something placed in oil and dripping with grease and fat. ‘Grilled,’ on the other hand, does not have as negative a connotation as “fried.”

A survey that asked, “Are we spending too much, too little, or about the right amount on assistance to the poor?” found that only 13% felt the U.S. was spending too much. By changing the phrase “assistance to the

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poor” to “welfare” the results were dramatically influenced and 44% felt we were spending too much. The word “welfare” has serious negative connotations to many people in the U.S. and evokes a very different image than “assistance to the poor.”

When the Walt Disney Organization did a survey to determine how moviegoers felt about theaters that showed advertisements, they found that 90% of respondents were opposed to advertisements in movie theaters. The question used was: “Do you want commercials shown in movie theaters?” (90% said “no.”) Gallup asked a similar question: “Do you favor a ban on commercials in theaters?” Only 44% either favored or strongly favored banning commercials in theaters. The use of a strong word like “ban” can have a dramatic effect on the responses of people. The public is generally reluctant to favor bans.

Similar results have been reported with “forbid” and “not allow.” These are not synonyms. More people are willing to “not allow” something than “forbid” it. In a classic study, two questions were compared: “Do you think the United States should allow public speeches against democracy?” with “Do you think the United States should forbid public speeches against democracy?” The results showed that 62% of respondents said “should not allow” but only 46% said “forbid.”

In one survey the question asked was: “Should laws be passed to eliminate all possibilities of special interests giving huge sums of money to candidates?” The results indicated that 99% answered “yes.” A different survey asked: “Should laws be passed to prohibit interest groups from contributing to campaigns, or do groups have a right to contribute to the candidate they support?” This survey resulted in 40% in favor of prohibiting contributions from interest groups. A third survey that used more neutral wording asked: “Please tell me whether you favor or oppose the proposal: The passage of new laws that would eliminate all possibility of special interests giving large sums of money to candidates.” This survey found that 70% of the public was in favor of passing such a law.

The above examples demonstrate the importance of considering the connotations of words when constructing questions to be used in questionnaires. A researcher should do everything possible to use words that are as neutral as possible.

(2) Leading Questions:
The questions used in a survey should be neutral and should not suggest the “proper” response. Sometimes a question can be extremely leading. For example, “Don’t you think that too much money is spent on Medicare?” is obviously fishing for a “yes” response. Ideally, when constructing the question, the researcher should either suggest all the possible alternatives or not suggest any of the alternatives. An example of a less biased question is the following:

What is your opinion about the amount the Federal Government spends on Medicare?
____ Too little money is spent on Medicare.
____ Neither too little nor too much money is spent on Medicare
____ Too much money is spent on Medicare.

Note that the question is neutral and does not suggest a response.

In a lawsuit, the plaintiff used the following question to demonstrate that Donkey Kong infringed upon its copyrighted King Kong name: “To the best of your knowledge, was the Donkey Kong game made with the approval or under the authority of the people who produce the King Kong movies?” Eighteen percent of subjects answered “yes.” This question, however, was considered leading by the judge. When the question was changed to: “As far as you know, who makes Donkey Kong?” no one made the connection with the producer of the King Kong movies.

When the Federal Government redesigned its survey used to measure the unemployment rate, it discovered that it had been substantially underestimating unemployment, particularly among women, for at least a decade or more. Some of the problems with the old method included the following: If a man responded (either in person or to a telephone survey) the question asked was, “What were you doing most of last week? Working or something else?” If, however, a woman responded, the question was: “What were you doing most of last week? Keeping house or something else?” The wording bias caused many women to be misclassified as not being in the labor force since the interviewer often assumed that individuals keeping house were not in the labor force. Another problem (again demonstrating the importance of knowing the connotations of words) was with the word “layoff.” Many individuals use this word to describe their situation even if they have no expectation that they will ever go back to work for their employer and see it as a euphemism for being fired. The question used in the old method was: “Did you have a job or business from which you were temporarily absent or on layoff last week?”
(3) Vague and Confusing Questions:

There is evidence that if a question is too long (and especially if it is part of a telephone survey or personal interview), subjects are more likely to select either the first or last response choice offered. What appears to happen is as follows: Subjects hear this very long question and pretend to understand it. When the subjects are provided with a list of response choices to select from, they act the way subjects do when asked which of a number of nonsense words they remember. Namely, they are more likely to remember the words that are at the beginning and end of the list. Similarly, when a question is not understood in a survey, subjects are less likely to select the middle response category and more likely to select the first or last response categories. A dishonest researcher who desires to manipulate the results of a survey can accomplish this by making the question very long and then asking respondents to choose from several response options. Any response the researcher does not want selected may be “hidden” in the middle of the list.

Questions do not have to be long to be confusing. There are other ways that questions might be confusing. In general, questions with double negatives are more difficult to comprehend than positively worded questions.

A widely publicized poll was found to be wrong in its conclusions about the number of Americans (34%) who believed that the Holocaust may not have actually happened. In the study, 22% of adults surveyed said they thought it was possible that Nazi extermination of the Jewish people never happened and 12% were not sure. The question used in the survey was: “Does it seem possible or does it seem impossible to you that the Nazi extermination of the Jews never happened?” The results were as follows: 12% were “not sure,” 22% said it was “possible,” and 65% said it was “impossible.”

The question used was criticized by various researchers who concluded that the double negative caused a great deal of confusion and the question was not valid. The study was redone by the same organization using a different question and the results were quite different. The question used in the revised survey was: “Does it seem possible to you that the Nazi extermination of the Jews never happened, or do you feel certain that it happened?” The results were as follows: 8% were “not sure,” 1% said it was “possible it never happened,” and 65% said it was “certain it happened.”

The American Thermos Products Company attempted to prevent a competitor, Aladdin Industries, from using the word “thermos” to describe its product. It claimed that the word “thermos” was a trademark, whereas Aladdin Industries claimed that it had become generic. To support its claim, the American Thermos Products Company presented the results of a survey of several thousand subjects which used the following question: “Please name any trademarks or brand names, with which you are familiar, for vacuum bottles or other containers, which keep the contents hot or cold?” About 33% of respondents mentioned “thermos.” The court rejected this question since it focused mainly on trademarks and brand names but did not actually show how many people were using thermos as a generic term.

In a similar case involving the use of the trademark Teflon, the court rejected three different surveys, one that focused on trademark and brand names (used by the plaintiff) and two that focused on common names. The court felt that these surveys were not valid since the results were influenced by the questions used and did not actually demonstrate whether a trademark was being used generically. The court ultimately did rely on a survey used by the plaintiff, which first explained what is meant by trademarks (e.g., Chevrolet) and common names (automobile) and the difference between them. Respondents were then asked whether each of eight names, including Teflon, was a brand name of a common name. The results indicated that the public had the ability to distinguish between trademarks and common names. For example with the product name “STP,” 90% identified it as a brand name and 5% thought it was a common name. The percentages for “aspirin” were 13% brand name and 86% common name. With the product name Teflon, 68% felt it was a brand name and 31% believed that it was a common name. The court felt that this survey clearly showed that the majority of the public still recognized Teflon as a brand name.

(4) The Sequence of Questions:

A researcher who desires to bias a study can accomplish this by first “conditioning” subjects with either negative or positive statements and then following up with an overall rating question. For example, a researcher could start a questionnaire with questions dealing with the Clintons’ alleged involvement in Whitewater, the “suicide” of Vincent Foster, the Paula Jones’ pending sexual harassment suit against President Clinton, and President Clinton’s alleged affair with Gennifer Flowers. The questionnaire might conclude with the key question asking subjects for an overall rating of President Clinton. Clearly, the early questions could prime the subjects
and cause them to be more negative in their subsequent overall evaluation.

The McDonald’s Corporation attempted to block Quality Inns from using the name “McSleep Inns” for their chain of economy motels. The McDonald’s Corporation offered the following survey to back up their claim that this name would cause confusion. The first two questions in the telephone survey were: “If you were driving along the highway and you saw a sign for a hotel called McSleep Inn [the name was spelled out], what would you expect this hotel to be like?” followed by, “And who or what company do you believe owns or operates this hotel called McSleep Inn?” 31% of respondents answered “McDonald’s” in response to the second question.

This survey was criticized by Quality Inns’ expert who argued that the warm-up question was in effect a leading question and helped prompt subjects in their response to the second question. Also, the question only tested the auditory response to McSleep Inn and did not provide a visual cue that is more consistent with the real world. The expert felt that a survey conducted at a shopping mall that allowed the use of visual cues would be superior to the telephone survey.

A second survey was conducted by McDonald’s at several shopping malls. Subjects were asked the following: “Please take a look at this. Here is a photograph of a sign for a hotel you might see if you were driving along the highway [the subject was then shown the McSleep Inn logo that is the subject of registration before the Patent and Trademark Office]. Who or what company do you believe owns or operates this hotel?” In response to this question, 31.9% of subjects replied “McDonald’s.” The United States District Court for the District of Maryland ultimately concluded that Quality Inns was prohibited from using the name McSleep as a trademark.

**Conducting the Survey**

**5) The Surveying Method**

The surveying method can influence the outcome of the survey. Anonymous mail surveys are usually superior to personal interviews or telephone surveys when the questions are of a personal, embarrassing, or ego-involving nature. Various studies have found that with sensitive questions such as abortion, birth control, attitudes toward premarital sex, reading of comics, use of hair rinse, and amount of borrowed money, more people are willing to admit to socially undesirable or less desirable behaviors than with anonymous mail surveys. For instance, in one classic study, Wiseman compared the responses obtained via a telephone survey, personal interview, and a mail survey in a study dealing with the opinions of Catholics. The responses to the three methods were quite similar except for two sensitive issues: legalizing abortion and making birth control information readily available. Catholics responding to the mail survey were more willing to agree that abortion should be legalized and birth control information should be made readily available than were Catholics responding to the other two surveying techniques.

One reason for the difficulty in estimating the number of homosexuals in the United States may be due to this problem. Estimates of the homosexual population range from 10% to 4%, and estimates of the proportion of married women having affairs has ranged from the ridiculously high 70% to the improbably low 5%.

Thus, a researcher wishing to bias a study dealing with sensitive questions, say extramarital affairs, and desiring to show that married couples are faithful to their marriage vows, might purposely use a personal interview or telephone survey rather than an anonymous mail survey. Even an honest researcher might not realize the implications of using the wrong surveying technique for the collection of sensitive information. Father Greeley was criticized by many researchers for using a telephone survey in his study which showed that fewer than 1 in 20 married people had had more than one sexual partner over the previous 12 months. Many researchers felt that a telephone survey was not the appropriate method for asking sensitive questions regarding infidelity, and this may explain why the results were so inconsistent with other studies. One has difficulty imagining someone admitting to a stranger over the phone to having cheated on taxes, cheated on a spouse, or cheated on an exam, even if the stranger claims to be working for a marketing research firm.

A researcher choosing the personal interview method (conducted either in subject’s homes or more often at shopping malls) can further bias a study by the choice of interviewers. The age, sex, race, social status, clothing, behavioral mannerisms, physical training, expectations, and vocal intonations can affect the responses of subjects. Of course, the magnitude of these interviewer effects is a function of the topic of the survey. Furthermore, the interviewer is usually able to obtain more information and better cooperation when interviewing an individual of a similar socioeconomic background which can further bias the study.

Researchers have found that Jewish-looking interviewers interviewing people regarding anti-Semitism will get different responses than will
non-Jewish-looking interviewers. Similar effects have been noted with African-American versus Caucasian interviewers in studies dealing with racism. Studies have found interviewer effects even in telephone surveys. In a study dealing with the public's attitude on various important issues, a significant age of interviewer by age of respondent interaction effect was found. Subjects under 35 were especially sensitive to the age of the telephone interviewer and voiced significantly more conservative views on marijuana, adultery, premarital sex, a female president, and homosexuality when talking to an older interviewer rather than a younger telephone interviewer.

Knowing the above, it is quite easy for an unscrupulous researcher to bias a study. Suppose a researcher is doing a study on drug usage among young people. An elderly, conservatively dressed, female interviewer will probably elicit different responses than will a young, male interviewer who is dressed in jeans and wearing an earring. Thus, researchers wishing to bias the drug usage numbers downward would use the former type of interviewers.

**Conclusion**

Are surveys trustworthy? The answer to this question has to be: not necessarily. The survey is not necessarily the objective tool for collecting information that the public believes it to be. There are too many ways the results can be slanted. The public should not blindly accept the results of a survey without first determining that it was conducted in an unbiased manner as possible.

**Notes**

11. Ibid.
15. Y. Wilamovsky, H.H. Friedman, Di Petro, Epstein, "Does the age of the telephone interviewer affect subjects' responses?" Section on Survey Research Methods, American Statistical Association Proceedings, 1979, pp.427-29
MAKING A "TEAM" WORK:  
TECHNIQUES FOR BUILDING  
SUCCESSFUL CROSS-FUNCTIONAL TEAMS  

DEBORAH KEZSBOM

Summary

This paper presents a paradigm for building productive, empowered quality driven teams, applied successfully within leading-edge corporations. The paper focuses on pragmatic techniques that have produced immediate returns.

Introduction

In spite of all the recent attention given to the importance of teams and the process of “team building,” anyone who has every tried to organize a project knows how hard it can be to get the whole team on board to ensure that everyone knows where the project is headed and agrees on what it will take to succeed. By now, we are aware that creating major improvements in project and organizational processes takes more than skill development; it requires that the team and its organization be managed effectively.

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Making a Team Work 

in applying project management technology. In fact, what it truly requires is a back to basics, low technology, hands-on process of integrated planning; that is, collectively creating a plan that not only defines the functional interfaces, and quality and cost parameters, but a plan that serves as a vehicle for team involvement, communication and subsequently, commitment.

Project management is team management. It is a highly collective, integrated process that requires the application of a variety of participative approaches to blend all the technical and organizational components of the project into a cohesive whole. Laying the foundation for success demands front-end involvement of all the key players in the development of project team plans, schedules, reporting and controlling mechanisms. This Integrated Planning Process (IPP) does not differ radically from other planning processes; that is, we identify goals and strategies for attaining them and how they will be measured. The critical difference, however, is that the Integrated Planning Process (IPP) requires an intensive one, two or three day session at which all key players concerned contribute to and agree on what must be done and accept responsibility for its accomplishment.

Fighting the Elements

Frequently, although people claim they know its good for the organization, there is substantial resistance to taking the time to build an integrated project plan, and an integrated project team. With the global competition, limited resources, and general time pressures experienced by most corporations and government agencies today, most project and team specialists serve on multiple projects, and just don’t have the time for “group planning sessions” or any other additional meeting. In reality, however, they just don’t have the time not to!

In simpler times, a product could be developed and produced by an individual specialist. It was possible that the individual could possess the requisite skills and knowledge that was needed without ever seeking the assistance of others. If other opinions or talents were necessary, time could be taken to meet with individuals on a one-on-one basis and waiting as long as necessary for their expertise and input. But as technical complexity, competition, time and cost constraints grew, one specialist could no longer accomplish the total effort alone, or in an unspecified amount of time.

Today, it has become increasingly evident that the value and depth of the expertise represented by a cross-functional, multi-disciplined team is limitless. Face to face interaction and exchange of disciplinary perspectives
and knowledge if properly integrated, result in a product that is more complete and more readily testable, deployable, manufacturable, or supportable than before. A well functioning, integrated team is able to arrive at a balanced, cost effective product better than any individual effort or better than any sequence of specialized events.

Building effective, successful teams, however, takes more than an intellectual awareness of the value of “teamwork.” Especially in more traditional technically oriented environments such as engineering, manufacturing and construction specialists frequently find working in a team to be an “unnatural” and uncomfortable experience, with little support from within the organization. Little time is available for “team efforts,” and functional specialists feel torn between what they frequently perceive to be a conflict in functional loyalties versus team loyalties.

The Integrated Planning Process (IPP) is designed to be natural to the work itself and works to create committed, well balanced teams. Although to truly result in a successful project and project team, IPP will require competent and continuous follow-through, it is an effective planning process that accomplishes all that is necessary in building a team!

**TABLE 1** A Comparison of the Integrated Planning and Formal Team Building Process. The similarities in both are outstanding.

**STEPS IN THE INTEGRATED PLANNING PROCESS**
- **STEP 1**: Establish a Positive Environment
- **STEP 2**: Define Mission Statement (an objective)
- **STEP 3**: Define the Work via a Participative Work Breakdown Structure Process
- **STEP 4**: Establish Precedence Relationships
- **STEP 5**: Identify Trade-Offs
- **STEP 6**: Present for Approval
- **STEP 7**: Review & Update Regularly

**STEPS IN THE TEAM BUILDING PROCESS**
- **STEP 1**: Establish a Positive Environment
- **STEP 2**: Develop a Sense of Interdependence
- **STEP 3**: Define and Clarify Team Goals
- **STEP 4**: Determine Role Definition
- **STEP 5**: Develop Procedures
- **STEP 6**: Develop a Decision Making Process

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**Making a Team Work**

**STEP 7**: Review Regularly

**Bringing the “Team” Together**

The Integrated Planning Process is initiated by the project team leader. Having the support and understanding of his or her boss and/or a sponsor from the Executive Steering Committee is invaluable. This can be readily accomplished by demonstrating how this process will help to get his or her job done; that is to get the team’s mission accomplished. The project team leader should involve task managers or specialists with primary responsibility to accomplish project team objectives within their function, and at least one level of management above these functional specialists. It is important to bear in mind that when priorities of task managers shift away from your project, it is usually because the immediate superior believes some other project is more important, or perhaps, does not fully understand the importance of your project. That is why it is critical to the success of the team (and to the project) to get the buy-in and commitment not just from task managers, but from functional managers, as well. These individuals need not attend all three days of the team planning session, but will need to have sufficient input into the mission statement and initial Work Breakdown Structure (WBS) to develop a true understanding of the sense of ownership to the project.

An ideal number of members to a team is somewhere near a bakers dozen or 12 to 13 members; however, the project leader should be aware of all who play a critical part on his or her core team. By examining the first two or three levels of the WBS, for instance, the team leader may get some indication of who should be invited to the planning session. If an insufficient representation of project contributors is present, it will indeed be reflected by the gaping holes left in the team's first cut at the plan. In fact, although “hitchhikers” are not recommended, we prefer to see more people than less at that first session. Although a team planning session with 40 or some odd present can be at the very least “difficult”, with the right facilitation you can develop an innovative plan, with the appropriate risk and opportunities identified!

The Integrated Planning Process is not only directed at creating a complete and integrated plan, schedule and identified areas of risk and concerns, but also at building a truly cohesive team. Because this process demands creativity, spontaneity and a thorough understanding of group dynamics, an outsider, who possess a minimum of a management and
technical background, should lead the process. The outsider could be a consultant or a manager from elsewhere in the company. They should not only be aware of project team management process, but perceive to be a facilitator and not be threatening to the positions or livelihood of those present. Further, it is important to establish a positive tone to the session and to prepare the attendees with what shall be taking place. One session we facilitated expected a Project Team Management training workshop and were at first uncomfortable disclosing their plan. After the confusion dissipated, we were able to not only impart critical project management skills to the team, but get down to the nitty gritty and come up with a plan for manufacturing process improvements that made everyone happy. Communication is critical to building an effective and productive team and that communication must start with explaining the objectives and expected end results of the team planning session and focusing the team on the definition of its mission, determining key tasks and responsibilities and developing team roles.

Establish a Common Mission

One of the critical first steps in IPP is for the team to collectively develop a clear understanding of the end result or the team’s mission. “Collectively” is an important concept. Representing the various functional components, each of the project task managers will have a different understanding of the teams mission or intent. When they come together as a team, they should not only have an opportunity to clarify and understand their team goal, but fully understand their jobs or roles as team members.

Agreeing on a mission can be a frustrating and, at time, chaotic experience; but without a clear understanding of where they are headed, there is little point in a team even attempting to plan. The Integrated Planning Process forces the team to stand back and take a good look at what they are doing and where they are going. It forces those with concerns to verbalize these concerns and document them as action items. It forces an individual, such as the team leader to assure the team that these concerns will be addressed and assign responsibility for this task accordingly.

We recommend that the team leader put his or her impression of management’s “vision” for the team on a transparency - and then stand aside! The team leader must be ready to expect challenges, as the team seeks to clarify its own “mission.”

As painful as this first step may be, we have found that some individuals already working in a project for several months, first learn their team and their project’s true mission for the very first time. Once the statement has been thoroughly examined and re-written several times, the team is ready to move forward and plan their actual tasks.

Defining the Work to Be Done

Collective development of a plan will help the team not only to define the work that needs to be accomplished, but will serve to clarify team member roles, responsibilities, and highlight the interdependency needed to get the job done. One method that we find extremely useful in guiding this process is the use of what project managers have long referred to as a “Work Breakdown Structure (WBS)”. The WBS is a technique that analyzes the project from the top down, and then the bottom up into a mixture of functions, product, processes and activities. It’s true intent, in our case, is to give the project team its first real collective chance to build the project and take a “snap shot” of what is to be done. At times we adhere to the strict, traditional numbering process inherent in the WBS. But at other times, we encourage the project team to do what is best for their product or process for what we are really stressing is the benefit of the participative or collective goal.

analysis process.

Using POST-IT notes to their fullest, we spread old fashioned brown wrapping paper across the wall and have the team begin to define the project functions or processes level by level. To make life a bit simpler, we advocate that the project team leader, prior to the actual meeting, take his/her best shot at level 2 or the overall functions and/or processes that must be accomplished. Again, we stress that ownership by one person is never the issue. This is merely an attempt to get the team started. Sub-teams then are formed to show their conception of this higher level, until the group agrees to level that the overall preliminary depiction of the project with which they can all live. From here on, we break off into “branch teams” and begin to analyze our tasks and functions further, stopping only to present our conception to the functions teams, offering them our input, questioning their logic and receiving the same in return.

By the end of the day, what we have fleshed out is a preliminary technical and managerial plan, down to a task level. This is generally perfected in the next day’s session. Naturally, however, the true duration of the session is dependent on the scope of the plan to be developed, the complexity of the project, the number of members on the project team, and outside participating
Developing a Sense of Interdependency

Once the scope of the plan has been established and a WBS illustrating the project plan has been developed, a follow-up session is held to “transform” the tasks outline into a project team schedule. This schedule illustrates not only the task interdependency, but the relationships between the responsible team players. Through the scheduling portion of the Integrated Planning Process, team members further clarify what work there is to be done, how it is to be done, how long it will take to be done, and who is responsible for doing it. This process provides the opportunity for the project team to define the boundaries of the project in relation to time, and identify the critical tasks necessary to accomplish it successfully. Thus, not only are activities described in terms of duration established, but relationships between tasks and people are stressed. Each task identified in the scheduling diagram has one person’s name associated with it, thus reinforcing team roles and responsibilities.

Getting to the “Heart” of the Matter

Now that the team has identified its mission, defined the scope of its work, and established and reinforced its interdependencies, it is now ready to explore and list additional critical success factors and areas that represent risk or put the project in jeopardy. Internal and external opportunities are explored and the risk associated with each is identified. Examples of such factors may be, for instance, incorporating new technologies, being responsive to a new market, or even the effect of a possible reorganization. Opportunities may become new strategies to incorporate into the plan, making it more innovative and creative than before. Risk, further, translates into the need for “contingencies”, which become alternative courses of action. These, too, are incorporated into the plan.

Conclusion

Building high performing cross functional teams requires creating an environment in which team specialists work together under a unity of purpose, as a united front. We have had success in creating high performing, cohesive teams through the Integrated Planning Process because it is directed at:

1. Creating a better understanding of team goals and mission.
2. Creating a better understanding of team member roles and their interdependent efforts.
3. Increasing communication and creating greater support among team specialists.
4. Creating greater collaboration among specialists, and reducing costly competition.
5. Developing the ability to use conflict in a productive, constructive manner.
6. Creating a true sense of “team” spirit and fostering greater interdependency among team players.

As organizations continue to grow flatter and more flexible, increasing numbers of corporations and government agencies will seek methods that not only pull teams together toward a common goal but which allow them to have a clearer understanding of the process and define the work at hand. The Integrated Planning Process (IPP) is such a method.
Goals in Accounting Education

FRIMETTE KASS-SHRAIBMAN

There are three distinct spheres in education. These are called the three domains of education. Each of these domains educates a different part of our students. Each domain has its own objectives and teaching methods. The three domains are: the affective, the cognitive and the psychomotor.

Benjamin Bloom defines the three domains as follows:

1) "The affective domain ... includes objectives which describe changes in interest, attitudes and values, and the development of appreciations and adequate adjustments." 2) "The cognitive domain ... includes those objectives which deal with the recall or recognition of knowledge and the development of intellectual abilities and skills." and 3) The psychomotor domain involves manipulation of motor skills.

Bloom set out to develop a taxonomy of the cognitive domain. His purpose was to clarify the educational goals of teachers so as to "facilitate the exchange of information about their curricular developments and evaluation devices." In the development of the taxonomy he considered (1) the distinctions teachers make among student behaviors, (2) that the taxonomy be logical and internally consistent, (3) that the taxonomy be consistent with present understanding of psychological phenomena, and (4) that the classification be a purely descriptive scheme in which every type of educational goal can be represented in a relatively neutral fashion i.e. there is no value or quality assigned to the classifications. However, there does appear to be a logical progression of increased internalization of learning as the objectives continue in the taxonomy.

I will describe, briefly, Bloom's six classification, or goals, within the cognitive domain. I will show how accounting education is meeting these goals and/or striving to meet these goals. Most of my sources are writings about accounting education from the last seven years. The literature discusses accounting education at the high-school and post-secondary level. Where applicable I will discuss how I've used these techniques as an accounting instructor on the post-secondary level.

1. KNOWLEDGE

Bloom defines knowledge as "the recall of specific facts, universals or processes including knowledge of terminology." Donald J. Guerrieri, an accounting instructor at Norwin Senior High School, North Huntingdon, Pennsylvania, discusses methods of introducing accounting. The single entry method approach involves just adding and subtracting from cash. This method is outdated because the Internal Revenue Service and Generally Accepted Accounting Principles (GAAP) require methods that provide more information.

The journal approach involves teaching how to do journal entries. This method emphasizes mechanics or the "how" without teaching the "why." He says that students without prior business experience found this very difficult to master.

The "I" account method has students posting directly to "I" accounts. This method also involves memorization without understanding.

Guerrieri is not enamored of methods that teach memorization without understanding. He says that although starting with journal entries mimics the order of how real accounting is done the students are just memorizing without having any understanding and students do not master concepts.

He recommends the accounting equation approach which promotes understanding. I feel however that there has to be some memorization used with methods that promote higher objectives. I consistently verbally quiz my students on such basics as the accounting equation, what the normal balance of an account is (debit or credit) and where an account falls...
within the accounting equation. I find that students that know these facts cold are quicker to develop at the higher levels of the taxonomy.

II. COMPREHENSION

Bloom defines comprehension as “the lowest level of understanding. Students can make use of materials being communicated without necessarily relating it to other material or seeing its fullest implication.”

Vernon A. Musselman discusses nine performance objectives when teaching accounting. Among his objectives are:

“To make students aware of the basic methods of processing data,” and “to provide the skills and knowledge necessary to enable students to perform competently on entry-level jobs.”

The beginning accounting student or bookkeeping student should be able to prepare entries and book them correctly. They need not have an understanding of the whole accounting process (all accounting through financial statement preparation and analysis.) Generally beginning students are drilled in the preparation of entries through the repeated use of problem solving.

III. APPLICATION

Benjamin Bloom defines application as the “use of abstractions in particular and concrete situations. The applications may be in the form of general ideas, rules procedures, or generalized methods. The abstractions may also be technical principles, ideas, and theories which must be remembered and applied.”

Clearly this objective should be very important to accounting teachers. It is vital for accountants to be able to apply GAAP to accounting situations. All presentations of accounting data are required to be in conformity with GAAP. The student who doesn’t learn how to apply GAAP will not be able to function as an accountant.

Robert Bloom quotes R.A. Stevenson, of the University of Cincinnati, at a 1922 meeting of the American Association of University Instructors of Accounting: "Most of the difficulties in business education are encountered in the attempt to apply the principles to actual industrial conditions in such a way that students will be able to use the subject matter in situations met with in employment..." Bloom’s entire book discusses the practical applications of accounting education; mainly if the educa-

IV. ANALYSIS

Benjamin Bloom defines analysis as “The breakdown of communication into its constituent elements or parts such that the relative hierarchy of ideas is made clear and/or the relations between the ideas expressed are made explicit...”

John Graham, a professor at Robert Morris College in Pittsburgh, Pennsylvania, discusses in an article the need to refocus accounting education to meet the needs of employers. Beginning accountants need “The ability to solve problems, to analyze business situations, to understand and apply basic economic concepts, and to communicate the ‘language of business’ ... rank high among the qualities which practitioners desire of employees.” Graham specifies several changes in content and methodology on the high school and college level, so that educators can help their students meet the needs of business. Graham’s goals appear to match Bloom’s objective of analysis.

Beverly Ann Soriano, a teacher at Framingham State College, Framingham, Massachusetts, has students obtain the annual financial reports of companies for use in the classroom. She uses the financial reports to teach how the number facts that are generated in the classroom makeup the entire financial report and how they connect and interact.

Joe Thomas and Phyllis Thomas, professors at Middle Tennessee State University, Murfreesboro, Tennessee, identify seven skills to be learned by accounting students. The first skill they identify is “analyzing and interpreting information” and the second skill is “reasoning and problem solving.” They use case studies to help students develop these skills.

V. SYNTHESIS

Bloom defines synthesis as “The putting together of elements and parts so as to form a whole. This involves the process of working with pieces, parts, elements etc., and arranging and combining them in such a way as to constitute a pattern or structure not clearly there before.”

Bloom’s synthesis objective should be the objective of every accounting teacher. It is imperative that our students learn how to take all the data, turn it into entries, appropriately enter the entries into the general
ledger and summarize the general ledger in order to put together financial statements.

Emma Jo Spiegelberg, a teacher at Laramie High School, Laramie, Wyoming, uses computers to “have the students complete an entire simulation...”

Victoria Beard, an assistant professor at the University of North Dakota, Grand Forks, North Dakota, uses a very innovative approach to having her students “synthesize” accounting knowledge. She has her students create their own company. They are required to do all the accounting necessary to apply for a business loan. This includes preparing a full set of financial statements. The students have to be able to synthesize and utilize together all their accounting knowledge.

I used this technique in a course I teach called “Accounting for the Non-Financial Manager.” Professor Beard’s project was a little too technical for my students so I scaled down the project. Overall the students felt that they learned a lot from the project because “it brought it all together.”

Donald Guerrieri uses microcomputer simulations to “Provide the students with the opportunity to relate knowledge acquired from the text with job-related experience.”

VI. EVALUATION

Bloom defines this objective as the ability of students to make “judgements about the value of material and methods for given purposes. Quantitative and qualitative judgments about the extent to which material and methods satisfy criteria.”

David Pecha, Regional Director of the Oklahoma Small Business Development Center at Northwestern Oklahoma State University in Alva, Oklahoma, suggests bringing guest speakers from the U.S. Small Business Administration, Service Corps of Retired Executives and other business development type agencies to the classroom. He believes that the students can learn from these experts how to evaluate a business and the accounting systems within that business.

Phyllis Ohlemacher of the Oil, Chemical and Atomic Union in Denver, Colorado uses small group teaching to teach accounting ethics. As part of this learning experience the students learn to evaluate internal controls within a company and evaluate various business situations.

Thomas and Thomas, in their use of case studies also teach students to evaluate business situations and alternative expansion possibilities. When

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using case studies, numeric answers are not the solution but demonstrate the students ability to evaluate the problem at hand.

I believe that true evaluative skills are acquired with experience. Many states require that accountants perform an internship before obtaining the designation of Certified Public Accountant.

SUMMATION

Benjamin Bloom identified a structured hierarchy of education goals. These goals should be part of every curriculum where cognitive skills are taught.

Accounting, by its nature, is an organized hierarchy of cognitive skills. It is relatively easy for an aware accounting teacher to organize the curriculum of accounting skills and teach them in a manner that parallels Bloom’s hierarchy of educational goals. I believe that I have shown that there are accounting teachers that are trying to achieve these goals.

Eugene P. Whitney, a former professor at Southern Vermont University, says that the ultimate goal of accounting education is “to prepare our students for the business world of today and tomorrow.” Accounting teachers that have not set specific educational goals in their curriculum can easily follow Bloom’s Taxonomy. This will help them set attainable goals for the future.

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Economics of Pollution

Lowell Baron

I. What is pollution?

Pollution is not a new problem. However in the past century it has become an increasingly greater concern for the world. Modern technology has led to the mechanization of the production process in all industries. While the burning of fossil fuels may make these large factories and automobiles more efficient, it also greatly contributes to increased pollution. Air Pollution alone has led to several major problems: 1. poor air quality in urban areas 2. acid rain 3. global warming (the greenhouse effect), and 4. ozone depletion.

A number of pollutants, including sulfur dioxide and carbon monoxide, have led to the deterioration of the air quality. Both of these chemicals have beneficial and negative qualities. Sulfur dioxide can be used as a refrigerant, or as a compound in preservatives. However, it is also a major air pollutant when emitted as a byproduct of electricity generating plants which burn coal and oil. Carbon Monoxide, a byproduct of the transportation industry

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II. Economic analysis of pollution

In this paper I will analyze the problem of pollution and several ways of trying to solve this problem using the study of economics. There is no question that pollution is inevitable in a market economy. The question is how can it be controlled. One major problem of cleaning up pollution is that companies find that they can ignore the environmental damage they cause because it does not directly affect them. The competition in a free market forces these producers into cutting costs. They must offer competitive prices in order to stay in business. This does not allow them to shell out the enormous costs involved in being environmentally responsible. This is where economic analysis steps in. Economists must study the cost benefit analysis in order to find the optimal amount of pollution for the economy and then
devise plans on how to reach that point.

Economists have devised a model to find the marginal cost of reducing pollution. There are two types of costs involved with production. The first is the cost to the producer. This cost, called the Marginal Private Cost (MPC), is the cost of all inputs used in production. The second cost, called the Marginal External Cost (MEC), is the cost of the damage the production does to the environment because of pollution. This cost is not paid by the producer or the buyer, but instead takes its toll on the environment. The assumption is that both of these costs increase as production increases. The sum of both of these costs is the Marginal Social Cost (MSC). This represents the total cost of production to society. (see graph)

The Marginal Social Benefit (MSB) provided by the production is measured by the amount consumers are willing to pay for each additional unit of the product. This measurement is the demand curve for the industry. In a competitive market the producer must lower his costs in order to sell products at competitive prices. To do this he is forced to use the marginal private cost as his supply curve and ignore all environmental costs. At this point the price of the product is lower and therefore the demand facing the industry is higher. Of course, also at this point the environment is ignored and pollution is rampant. This is not economically efficient. The point of efficient output can be found by setting marginal social cost as the supply curve. At the point of intersection between the
demand curve (MSB) and the supply curve (MSC) the most efficient point is reached. Although there is some pollution produced at this point, it is outweighed by the benefit the product has to society. The price is now higher and production is lower as the cost of pollution must be carried by both the producer and the consumer. (see graph)

In the preceding graph, we have calculated the efficient point, that is the point of intersection between MSC and MSB. This occurs when production is at five million barrels and five thousand tons of pollution emitted. If two million more barrels would be produced, a cost equal to area B would be imposed on society (in actual production costs). In addition, the extra two thousand tons of pollutants produced would incur a cost on society equal to areas A and C, or the sum of the Marginal External Cost from five thousand to seven thousand tons. The extra two million barrels produced would provide benefits to the consumers equal to areas A and B (because of greater availability and lower prices). Therefore production of the extra two million barrels would in total cause a net social loss equal to area C (Costs: A,B,C; Benefits: A,B). Alternatively, were production to be decreased to three million barrels, total social loss of the two million barrels would equal areas D, E, and F, while social cost savings would only be E (a
reduction in external costs) and F (a reduction in production costs). Hence a total loss of area D. We can conclude based on these facts that the efficient point for an economy occurs at production of five million barrels, which is accompanied by emissions of five thousand tons of pollution.

III. Possible Pollution Solutions

The question is how can an economy reach this efficient point? The general consensus is that some type of government regulation involving a restriction of free trade must be imposed. The fear is that free trade resulting in increasing growth will lead to higher pollution. For that reason many environmentalists oppose free trade, and the General Agreement on Tariffs and Trade (GATT), the institution which oversees world trade. There is an interesting theory that believes that free trade and environmental protection can go hand in hand. Rather than being harmed by economic growth the environment will be helped, argues this theory, through increased government taxation (on these higher revenues) which can be used for pollution abatement. In accordance with the laws of economics growth and higher incomes will spark a rise in demands. One of these demands will be for cleaner air and other environmental improvements.

Besides indirectly lessening pollution through increased economic growth, free trade can also directly lead to a cleaner environment. For example, Robert C. Feenstra at the University of California at Davis proved in a study that restraints on Japanese automobile exports to the United States forced Japan to shift their exports from smaller to larger, fuel inefficient automobiles in order to raise revenues without increasing the number of units they exported. Had the U.S. practiced free trade Japan would have continued to export its smaller more fuel efficient and environmentally friendly autos.

Although this is a novel approach, many economists disagree and instead believe that the only way to clean up the environment is to regulate free trade. True, free trade may seem to make us richer, however in reality it will only increase environmental costs at such a rate that will only make us poorer. Free trade between nations as GATT proposes is utterly unfair. If one nation were to internalize costs of pollution into its prices it would be at a disadvantage to those nations which ignore the environmental costs of pollution. The most viable solution to this inequity is for the cost internalizing nations to be permitted to levy tariffs on the non-cost internalizing nations; that is to restrict trade.

Within the U.S., the government has attempted to regulate pollution in order to reach the efficient point of pollution. The EPA, Environmental Protection Agency, was founded in 1970 to regulate pollution. The EPA achieves environmental standards by 1) issuing detailed directives 2) setting up universal standards 3) using "technology forcing." Industries must first identify the pollutants that they produce which they disclose to the EPA. The EPA then informs them of the maximum amount of each pollutant they can emit. These regulations must be met over time. For example, in the Clean Air Acts of 1970 and 1977 the EPA ruled that automobile producers must identify harmful air pollutants and gradually meet the standards set by the EPA. To ensure that these rules are adhered to, state automobile inspections were established. In some cases certain excessively dangerous pollutants are entirely prohibited. As of now the EPA has no regulatory program for the problems of acid rain, the greenhouse effect and ozone depletion.

Although the government has attempted to accomplish much with its regulation policies, economists have felt that this has had negative repercussions. According to economic analysis the efficient point of pollution allows for a certain amount of pollution (where MSB = MSC, see graph.) If the standards would prescribe less pollution, then the efficient point, although the net result would be a cleaner environment there would also be a net social loss (equal to area D on graph #2 as previously discussed).

A second fault found with the governments approach to pollution is that of uniform emissions reductions. In a case where the same clean up would have different costs to different companies, the government as of now forces uniform reductions on each of the companies. This is inefficient as the cost could have been reduced much more if the full emissions reductions were placed solely on the company with the lowest costs.

The governments strict policy has brought about technology forcing. By setting regulations of allowable pollution so low, the government has forced producers into using overly expensive and unnecessary equipment. The high cost of this regulation of pollution, is not worth the cost.

One final question regarding government regulation involves the loss of production that will come as a result of less pollution. Many factories would be forced to close down when the extra cost of pollution would send the prices up and people would therefore buy less. The two major fears are unemployment and reduced GNP. But chances are that these fears will not be realized. Although many workers would lose their jobs, many new positions would open up in the field of pollution control technology. The
second fear that GNP will be lowered as less is produced is probably nothing to worry about. Although the price of goods will rise the relative price will be lower and this will increase the quality in such cases as medical care and education. So rather than actually losing GNP, the economy is just adapting in a different way.

A number of solutions have been proposed by economists. The first is that of a pollution tax or that of a Pigovian tax. Theoretically, this would work by forcing producers to pay a certain tax on emissions of pollution. The level of this tax would ideally raise the cost to the producers from MPC to the point where production would equal efficient output. The point of this tax is that the producer may think twice about producing this pollutant because he will be charged more. Rather, the producer may change their system around, where by in the long run with lower pollution costs will be less. The role of computing this exact tax amount falls to the government. Unfortunately, it is very difficult to calculate this exact amount and can only be done through trial and error.

A second proposed solution intended to reduce the cost of uniform emission reduction is that of pollution permits. By granting each firm a specific amount of allowable pollution and giving them the right to sell and trade these allowances, a market will be created. This market, as in any market, will work based upon supply and demand. If one company has more pollution allowances then they need, they would be willing to sell it to another company. They would make a profit, and the other company would be able to produce pollution over their original limit. This would still keep the amount of pollution in the air, set to the standards made by the government.

As of now, under EPA regulations, permit trading can occur in only three settings. Netting allows a firm to trade with itself. Although net emissions can not increase it can produce more of one pollutant and less of another. The objective of bubbles is to limit total emissions from a specific group of factories. The third setting is that of offsets. The EPA will only allow the construction of a new plant, if it can offset the pollution that it will emit by convincing an already existent plant to reduce its emissions. This offset can be bought at a negotiated price.

One of the most intriguing proposals is that of an well known economist, Ronald Coase. He argued that property rights should be bought by either the polluter or the environmentalist at a price agreed on after negotiation. This policy, he claimed, would inevitably bring pollution emissions to the efficient point of output.

In order to understand how this works we will use an example of a plant which emits sulfur dioxide, which affects the homeowners within a one mile radius. The question is who gets the right to the airshed- the plant or the homeowners? If exclusive rights are given to the polluter, he can produce at a lower price and can therefore sell products until the cost of production reaches the price level set by demand (at 8,000,000 products, see graph). At this point pollution will also be extremely high. If, however, exclusive rights are given to the homeowners who will not allow any pollution, the cost of production will rise for the producer and he will only be able to produce until the total social cost reaches the price level set by demand (when external costs are still at zero or at 2,000,000 products, see graph). In order to gain the exclusive rights to the one mile radius airshed both the homeowners and the plant will be willing to pay a price. In order to be persuaded to give up the gains realized by the plant when it emits the sulfur dioxide, the firm would demand at least the price of area B or the amount they will lose with pollution restrictions. Home owners, in order to get the mill to reach this efficient point are willing to pay the amount of social benefit they will lose of the plant is allowed to emit. This amount is equal to area A and B. With sufficient bargaining the homeowners and plant owners would agree on a price between B and the sum of A plus B. The results will be the same if it is the homeowners who buy the rights to the airshed. The homeowners would require the amount equal to area D in order to be persuaded to allow the plant to pollute at the efficient point, while the plant would be willing to pay up to D plus C for this permission. After negotiation the price to be paid by the homeowners would come out between D and the sum of C plus D. Either way the pollution emission level would end up at the efficient point.

(see graph, next page)
Although this plan has wide appeal among economists, it is not practical in most cases. The proposal's use of bargaining can only be effective in cases where the pollution only affects a relatively small group of people. Unfortunately in the majority of cases, where the pollution affects an extremely large amount of people, the bargaining is either unfeasible or too costly.

IV. Pollution Issues Today

Not only does the United States have problems trying to control pollution in its own factories, but the pollution of Mexican plants, which eventually ends up contaminating American airspace, has also become an issue. Mexico has put two huge power plants right by the border with Texas, which produce sulfur dioxide. They emit about 200,000 tons a year which contributes to acid rain, and the wind brings this acid rain up to the US.

Mexico, due to its poorer economy, is unwilling to pay the extra money necessary to clean the environment. Many Americans believe that although a U.S. ban of the electricity generated from these power plants will diminish pollution it will also decrease their market share and the factories will produce less. Mexico feels that it is their right to give off this pollution, especially considering that the United States is the largest pollution emitter on the continent.

In order to solve problems like these, the EPA, in 1990 established the "clean air act". Under this policy the EPA allocates "poll allowances" to power plants. These allowances prescribe fifty percent reductions of sulfur dioxide emissions from each plant by the year 2000. The emissions allowances can be traded between plants. This program seems to be working well, as sulfur dioxide reductions which once cost $1500 per ton, now sell for about $150. Not only are emissions being reduced by 50%, but the EPA feels that many will reduce their emissions more than required amounts. The U.S. is hoping that under NAFTA, they can use this plan in conjunction with Mexico and Canada. They believe that if the American plants provide Mexican plants with anti-pollution equipment, the Mexicans will buy allowances from them.

There are other factors that must be dealt with in pollution allowance trading. The SCAQMD pollution trading plan is based on a couple of assumptions: 1) that it will attain the same level of health protection as command and control regulations and 2) it is the lowest cost way of achieving environmental goals.

A problem with pollution trading is that in certain places where it is traded for example Los Angeles, pollution is still excessive. The proposals also ignore the fact that a pollutants potential impact depends not only on the chemicals in question, but also on the socio-economic characteristics of the community which it is affecting. Since the trading scheme fails to take into account such factors and since it also fails to distinguish adequately between pollutants, it will bring about a racist pattern of pollution in LA. We can already foresee the richer whites forcing the factories to be in the poorer black communities.

There are also other similar problems between neighboring communities. Southern gasoline uses reformulated gasoline which is expected to reduce the level of benzene, on average, in the whole region. The problem is that in communities adjacent to these refineries such as part of LA, substantial increases of pollution and health hazards due to emissions from fuel refineries will be evident.

Many older plants will feel that it is too hard to put in pollution stoppers and this will give them a greater net income in the short run, because they don't have the added expense of the pollution stoppers. In the long run, which the companies don't seem to take into account, they will be more inefficient and have higher operating costs.

The 1972 "clean water act" admitted that a total clean up of pollution
V. Conclusion

Pollution is an urgent issue which must be dealt with today. Although people may try to ignore its ever-increasing danger, there is no question that pollution will bring with it catastrophic consequences. Today’s wealth and luxuries must be sacrificed in order to insure a healthy tomorrow. If these sacrifices include restrictions on free trade and unrestricted production than this is what must be done.

To this end, economists have devised a means of scientific analysis in order to alleviate our environmental problems. Cost-benefit analysis has resulted in the realization that there is an efficient point of production and pollution emission which the economy must struggle to reach.

Although numerous solutions have been proposed, none of them can fully alleviate the problem. Each of the solutions has its own strong points as well as its weak side. The proposal of levying a tax on polluters, although theoretically an excellent idea, is extremely difficult to technically accomplish. Calculating the exact amount of the loan is merely a game of trial and error. The same is true with the proposal of tradable pollution permits. The idea makes sense but is very difficult to implement. Negotiations for property rights, a third proposal, can also be used beneficially, but unfortunately it is impractical in cases where pollution affects a large number of people.

All of these solutions are based on the same idea. We must find a way to force producers to scale back pollution emissions to the efficient point. As every specific case of pollution arises a specific solution must be found. This is the work of the economist - to implement the tools of analysis and apply these theoretical ideas to each and every practical pollution problem which arises.

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Corporate Loyalty

Yehuda Halpert

Introduction

The business world is a constantly changing environment. The key to the success of any corporation is its ability to react to this chaos. Over the course of the last five years the fragile relationship that exists between employees and employers has been stretched to its limits. The deterioration of this relationship has brought about a decrease in corporate loyalty which has in turn reduced production and earnings. Only corporations intent on implementing programs that will impede the deterioration of company allegiance will survive the newest twist of the unsettled corporate world.

There are several strategies that provide an effective solution to the decay in corporate relationships. One of the most efficient methods is the implementation of Self Managed Teams. These teams empower skilled individuals from various departments while enabling them to take a more active role in the decision making process. This corporate decision, to relinquish a certain amount of control to its employees, will lead to improved morale and an increase in overall worker enthusiasm.

Although Self Managed Teams are a new and innovative means of increasing employee loyalty, there are many companies that are uncomfortable with the idea. These risk averse companies would benefit greatly from the implementation of Employee Stock Ownership Plans (ESOP), a tried and proven method of retaining corporate loyalty. An ESOP is a method by which employees are able to participate in the ownership of the firm. By including employees in the ownership of the corporation, their loyalty and dedication is assured, thus increasing productivity and profit.

The third and most popular method utilized by corporations to secure company loyalty is a process known as continuing education. When a corporation assumes an active role in the employees ongoing training, the company is guaranteeing itself a more efficient and effective work force. This policy is a two way street. By employees remaining current in their respective fields they are better prepared to benefit themselves and their company. A well trained employee is capable of making intelligent decisions. This type of empowerment is an ideal method of fostering corporate loyalty.

Another means by which corporate loyalty can be maintained, is by understanding the different motivating factors behind the various levels of management. The comparison of marquee athletes to top executives and role athletes to middle level managers, demonstrates the different techniques used to retain the loyalty of each distinct managerial level. Name recognition and the drive to create a dynasty will cause both a star player and a corporate executive to remain loyal to a single organization. However, when dealing with role players, respect and increased salaries are without a doubt the driving force behind the employees loyalty. Thus we see that by understanding the mentality and needs of different types of management the task of retaining their loyalty is simplified.

Self Managed Teams

In the past few years, there has been an increased loyalty conflict between upper management and middle management. Middle management feels that upper management has violated its long-standing, unwritten, social contract of life time employment with its workers. In the past, upon graduating college, a person could attain a job with a company such as IBM, or Proctor and Gamble and be set for life. This is no longer the case today. In 1983, 79% of middle managers felt secure in their jobs. However, in the last five years, this figure dropped to a rate of 64% and by 1994, this rate stood at an all time low of 55%. These figures prove that this long standing contract has been broken, and a new set of rules have been implemented in its stead. “In its most naked form it goes like this: ‘There

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will never be job security. You will be employed by us as long as you add value to the organization. In return, you have the right to demand interesting and important work, the freedom and resources to perform it well, and pay that reflects your contribution.” (O’Reilly, pg.44) However, these rules are inconsistent and have not been consented to by either level of management. “In fact a project manager from Prudential said these new rules have made relations between upper and lower management far less warm, loyal, and familiar.” (O’Reilly, pg.45)

An example of this problem can be seen in the evaluation techniques used by AT&T to review the productivity of employees. AT&T employees were told that those with the poorest evaluations over a two year period would be discharged. The problem was that each division used a unique evaluation method. Therefore several employees who were deemed to be excellent workers, were perceived by upper management to have been evaluated poorly. This miscommunication led to their subsequent dismissal.

Another obstacle facing corporations today, is the fact that upper management feels that middle management is willing to seek different employment without giving their employers ample warning. This Prudential manager insisted, “...As soon as the economy picks up, he (the manager) will start considering jobs elsewhere.” (O’Reilly, pg.45) In fact, over the last ten years, the average tenure of a middle manager has steadily decreased from almost eight years to just over six years. Thus, upper management has concluded that company loyalty has declined considerably.

Although upper management and middle management disagree on most issues, the one thing they do agree on is that a lack of communication causes a majority of their problems. “James Sullivan, the vice chairman of Chevron, has found candor and communication to be essential in running a highly loyal and profitable company.” (O’Reilly, pg.45) Upper management has the responsibility to interact with middle management and to inform their employees of their progress. In response to these actions, middle management has the responsibility to convey their feelings on how they are being treated. The Chevron corporation is the perfect model to illustrate this concept. Over the past few years, Chevron’s employee morale has not been up to par. In response to this, Chevron has posted current morale statistics with a promise to increase communication which will in turn increase employee morale. (O’Reilly, pg.45) Events that are currently taking place at Intel further exemplify this point. At Intel, there are quarterly business update meetings (BUMs), and twice yearly strategic long range planning meetings where top employees share as much information as possible with middle management. “A key part of every upper manager’s job is to help co-workers facilitate the needs and wants of the company.” (O’Reilly, pg.47)

Reacting to management’s claim that the social contract, (i.e.: life employment), has been broken, upper management has taken it upon themselves to inform middle management that they are in control of their own careers. Although companies will assist their employees by offering courses on up-to-date computer technology, or the latest management techniques, it is the employees’ responsibility to take these courses seriously and actually implement them. “It is up to the employees to own their own employability.” (O’Reilly, pg.45)

In the past, employees have been extremely devoted to the company they worked for. However, due to the breach in the long standing contract, employees no longer feel responsible to put more effort into their work then is absolutely necessary. A technique companies use in order to combat this lack of devotion is to relinquish control and empower middle management. This approach is called Self Managed Teams (SMTs). Companies are realizing that employees who are deeply involved in their work, foster commitment to productivity and lead to corporate success. As companies grow, there tends to be more bureaucracy which suppresses personal initiative. In order to relieve these tendencies, companies now rely upon S.M.T.s. “S.M.T.s are the epitome of the team concept and participative management approach.” (Abbasi, pg. 25) They involve highly integrated and effective teams comprised of several skilled and crossed trained workers who have the power and ability to carry out a well defined function. This gives these teams the authority over how a project gets done, while still leaving upper management with the final say over which project takes precedence and why it is being done. Due to the fact that each individual in each S.M.T. is responsible for all operations in the project, he/she will feel a commitment to the production, and are therefore more likely to be committed to the projects in which they are currently involved. “Since each team is given well defined functions, and is empowered with decision making authority, operations are streamlined, and flexibility, quality and cost savings are added to the operation.” (Abbasi, pg.26) As mentioned earlier, S.M.T.s are cooperative work groups that attempt to attain certain goals for their companies. Therefore, the groups operate with little supervision, and without managers imposing decisions on the group’s members.

Organizations using self managed teams, have almost always reported positive returns.
"Results show that companies using S.M.T.s have had a 30% increase in productivity along with a boost in product quality. They have made tremendous improvements in the setup and tear down time for production machinery compared with conventional practices with no deleterious impact on product quality. S.M.T.s have also reduced administrative overhead such as record keeping, administrative, budgeting, scheduling, and quality control functions previously performed supervisors and support staff. Decision time, and order response time has also decreased due to the breakdown of rigid bureaucratic structures. Finally, they have been reported to increase individual employee’s commitment to their peers and company.” (Abbasi, pg. 28)

Implementing S.M.T.s can be time consuming and costly. However, the benefits received from these groups clearly outweigh the drawbacks. By utilizing self managed teams, upper management has more time to deal with strategic decisions and long range goals instead of having to worry about day to day problems.

Based on the events that are taking place in corporate America today, we see that through increased communication and an emphasis on empowerment, loyalty can be resurrected despite the death of the long standing social contract.

**Employee Stock Ownership Plan**

There are several approaches that have proven to be an effective means of improving corporate loyalty. One of the most proven approaches is what is known as an ESOP, an Employee Stock Ownership Plan. This ownership is facilitated through the accrual of stock in the company based on years of service or other established bylaws. Before establishing an ESOP there are several steps and regulations that must be implemented by the company:

1. The establishment of individual employee trust accounts that receive allocations of stock based on the workers’ pay.
2. All full time employees with a year or more of experience participate in the plan.
3. Upon the completion of four years of employment, an employee is forty percent vested in the program, meaning the employee has a legal right to receive forty percent of the amassed amount of stock contributed by the Corporation.
4. Upon the completion of seven years of service the employee is 100 percent vested.
5. Employees must have reached the age of fifty and can no longer be in the employment of the company before they can receive the value of the stock.
6. The establishment of a trust to enable employees to participate in the firm’s ownership. The trust holds company stock contributed by the Corporation. (Szabo, J. 1994).

ESOP’s are an effective means of retaining company loyalty regardless of the employees’ status in the firm. For years, stock options sole purpose was as an incentive to ensure that upper management would guide the company on a profitable path. However, in the past few years it has been determined that this strategy is equally successful when applied to middle management. The reason this strategy has been successful is clear. When employees come to the realization that not only do they work for their corporation, but are actually part owners of the organization, their entire outlook changes. No longer does the employee view him/herself as one employee among thousands, rather he/she view him/herself as self-employed. Instead of thinking that poor quality work has no effect on his/her weekly paycheck, the employee now realizes that poor workmanship translates into poor sales and a reduction in the value of the employee’s company. This level of company loyalty which is rooted in self interest cannot be achieved by any other means.

The second step in opening communication between management and employees is the establishment of small contact groups. These groups serve two purposes. The first is the relaying of financial information to the employees and the explanation of this financial information. The second purpose is to allow for constant communication between management and the employees, regarding the current status of the corporation. The idea of constant communication is proposed by Mr. David Fagiano, president and chief executive officer of Management Review magazine, “Every member of the top management team needs to be out in the organization talking to small groups.” (Budd, Jr. J. pg. 31) Although the amount of communication is crucial, perhaps more important is the quality of communication. Dr. David Gregory of Dialectics Inc. says, “At this state of reorganization the quality of the communication is the key” (Budd Jr., J. pg. 33). By implementing small contact groups there will be an increase in both high quantity and high quality of communication which will lead to a substantial increase in corporate

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**Portfolio**

**Corporate Loyalty**

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Continuing Education

Although ESOP’s and open book policies are effective ways of dealing with diminished corporate loyalty there are other methods which have proven to be effective. These techniques are necessitated by more complex management problems. A prototypical example would be diminished corporate loyalty caused by downsizing. Corporate downsizing which currently is a business reality, can find its roots in the obsolescence of employees and employees’ skills. If the level of skill can be increased to a point where the employees services once again are beneficial to the corporation, then the company can limit downsizing, or at least ensure the laid off workers that there is still a necessity for their skills on the job market. This idea was stated by Mr. David Fagiano, “To build loyalty, an organization must help employees stay on top of their professions in terms of skills and techniques through education, or they must train them for new jobs if the old ones are becoming obsolete. Organizations... would tell workers that although we can’t guarantee your jobs here, we will become a partner in your continuing professional growth so that you can get a job somewhere else.” (Budd, Jr., J., pg. 31) This approach to employee retraining, which takes into account the employee as well as the employer, will definitely improve the level of company loyalty.

Now that we understand the purpose of retraining, the two questions that remain are how and where the retraining should take place? To answer the question of how to retrain, corporations should identify exactly what types of retraining are necessary. By creating courses that focus specifically on the type of retraining that each individual requires, the organization will save money and the employees will reduce their time commitment.

The next question that needs to be addressed is where the retraining should occur? This decision could have huge financial consequences. The most cost efficient location for the retraining to take place in would be a local university or community college. The reason being, “Often these institutions will help you analyze your company’s training requirements” on top of that “they may even have instructional-systems-design people on their staff that can help put a customized curriculum or structured on-the-job training system together for your firm” (Szabo, J. 1994). Thus, with proper planning and facilities, a continuing education program can be an effective means of procuring company loyalty.

Comparison of Industries

Sports is no longer played solely for entertainment purposes. It is now a multi-billion dollar international business. A comparison can be constructed illustrating the similarities between athletes and businessmen. However, in order to justify the comparison, the transformation of sports from a form of entertainment to a fast-paced world-wide industry must be examined.

In 1980, the Dallas Mavericks paid twelve million dollars to join the National Basketball Association (NBA). Today, because of its international success, the most recent expansion team, the Toronto Raptors, will pay approximately 125 million dollars for the same privilege. This sizable increase can be attributed to the NBA’s tremendous financial success. (Serwer, pg.89)

Secondly, NBA revenues have grown from nearly 200 million dollars in 1984 to over one billion dollars in 1993, and are expected to top 2.2 billion dollars by the end of 1996. (Serwer, pg.89) Merchandising, television contracts and increased ticket prices account for the great majority of this increase. This success has been brought about by the greater access and publicity provided by television and cable coverage.

The recent baseball strike is another perfect example of this transformation. Baseball players are no longer loyal to the game, but rather to their salaries. The U.S. economy lost approximately 500 million dollars due to the recent strike, and this is excluding the countless individuals who were temporarily unemployed because of the work stoppage (caretakers, ushers, etc.). The twenty-eight club owners lost 350 million dollars over the course of the dispute, while players lost 300 million dollars in salary. Major league baseball is currently 60 million dollars short of the 200 million dollars in ad revenue it brought in last year. These are merely the most glaring examples of the sports industry’s conversion from mere entertainment to a fast-growing industry. (Bernstein, pg.32-33)

Based on this understanding two comparisons can now be made; top athletes to top executives, and role players to middle and lower level managers. The techniques used to retain the loyalty of marquee players is remarkably similar to the methods used to maintain the allegiance of top management. Similarly, it is clear that the methods used to preserve role players and middle managers appear to be very much alike. However, to retain the loyalty of each group, one must use vastly different techniques,
due to the distinction in lifestyle and character of each group.

The first comparison takes place between top executives and top athletes. Someone like Mr. Eisner of Disney, or Mr. ‘Ace’ Greenberg of Bears Stearns, is the equivalent of Mr. Jordan of the Chicago Bulls, Mr. Larry Bird of the Boston Celtics, or Mr. Erving ‘Magic’ Johnson of the Los Angeles Lakers. Each executive or superstar is widely known for his success with that particular company or team. When people think of Disney or Bears Stearns, they think of the aforementioned individuals because they have excelled in their respective fields. Each is loyal to his particular company or corporation, not solely because of the monetary incentives, but due in part to his association with the company he currently runs. They will be known as part of a legacy in which they stood out from the rest. Had they changed companies over the course of their successful careers, the name recognition connected to their respective fields of business would have been watered down or even lost.

The same holds true for great athletes. Jordan, Bird, and Magic were paid adequate salaries, but remained with their respective teams for other reasons. Each could have earned larger salaries had he chosen to sign with a different franchise, but instead chose to stay for a different purposes, name recognition and the continuation of a legacy. When sports fans think of the great franchises of the 1980’s and early 90’s, teams such as the Bulls, Celtics, and Lakers come to mind. With each of those teams comes a name, a player who made them great. Had these players shifted teams during their careers, the legacies attached to each player would have never evolved. Each individuals goals were loftier than the monetary incentives offered. Rather than opting for a slightly larger contract they instead remained loyal to the image and tradition of the great players of the past. Similarly, once an executive reaches a certain monetary level factors other than money become of equal or of greater importance; primarily, a need to establish himself as the dominant business force of his time. This goal can be accomplished only through tremendous sacrifice and loyalty to a single corporation.

Contrary to upper management, when dealing with the ‘role’ players or middle level managers, a uniquely different strategy and mentality must be implemented to preserve company loyalty. At this level, monetary incentives seem to be a large factor in loyalty. Additionally, because there is less job stability today then 25 years ago, managers must also be made to feel as if they are appreciated by the corporation.

The difference between lower management and upper management

is expressed by the fact that lower management tends to gravitate toward a higher paying job. To keep these employees loyal, executives must decide who is most important, and compensate them accordingly. A minimal salary increase is a small price to pay for keeping an important manager who is doing the job properly. Additionally, not having to bear the cost of training a new employee makes this strategy more realistic.

The same holds true for athletes. Often, we see role players earning large, multi-year salaries to keep them both happy, and more importantly, loyal to their respective teams. For example, John Koncak, a career role player, received a six year, thirteen million dollar contract from the Atlanta Hawks. Similarly, Chris Dudley, another career role player, earned a seven year, eleven million dollar contract from the Portland Trailblazers. Each contract was constructed with the intent of fostering long-term player loyalty to the franchise. (Taylor, pg.101)

Although money is a large factor in retaining corporate loyalty, making managers feel appreciated is equally crucial. The issue of how to convey this message is difficult. One of the many ways companies have gone about solving this problem is by further empowering their employees. By giving managers increased responsibility they are made to feel as if their contributions are crucial to the success of the corporation. When Mr. Eisenberg, of ‘Bed Bath & Beyond’, spoke to a management class of Yeshiva University students, he illustrated this point by explaining that his managers are constantly on the showroom floor taking an active role in the business. This involvement in the day-to-day activities of the corporation makes them feel both needed and appreciated.

The need for recognition is universal. Role players change teams because of money. However, in addition to money, they must also be made to feel needed and appreciated. Pat Riley, past New York Knicks head coach, went out of his way to instill a sense of importance to several of the role players on his team. For example, Charles Oakley felt that the team needed him to win and gave 110% because of that feeling. Riley would assure him, then reassure him, of this sentiment. This breeds loyalty, and is demonstrated by the fact that the N.Y. Knicks did not lose a single player whom Coach Riley felt he needed to win.

The point here is simple. To retain loyalty in top level executives, there must be name recognition in addition to dollars. However, to maintain loyalty in mid-level managers, they must be made to feel needed and appreciated, in addition to being paid accordingly.
Conclusion

Regardless of the method utilized, whether it be SMT’s, continuing education, ESOP’s or empowerment, a key to any successful business is a program to enhance corporate loyalty.

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The Limited Liability Company

JOSHUA LEVINE

Introduction: The Birth of the LLC

The United States is in the midst of a business entity law revolution. For the first time in two generations, a novel form of “doing business,” the limited liability company (LLC), is becoming available throughout the country. LLCs are not new; they are a blend of the previously existing corporation and partnership law. But this melange has spawned the enactment of new business laws and tax features previously unavailable for United States business entities (Woehlke et. al. 16). A properly structured LLC eliminates certain drawbacks of the general and limited partnerships, S corporations, and professional corporations while combining the partnership’s beneficial federal tax status with the corporation’s limited liability of its owners (Schorr 26).

In December 1994, the Internal Revenue Service (IRS) issued Revenue Procedure 95-10, which outlines when the IRS will act on a ruling request for classification of an LLC as a partnership for federal income tax purposes (Roadmap 247). The purpose of Revenue Procedure 95-10 is

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specified in its first sentence: “This revenue Procedure specifies the
conditions under which the Internal Revenue Service will consider a ruling
request that relates to classification of a domestic or foreign limited liability
company (LLC) as a partnership for federal tax purpose” (1.01). Presently,
fourteen states and the District of Columbia permit the formation of
LLCs. Legislation is under consideration in all three remaining states: Hawaii,
Massachusetts, and Vermont (Wayne, Ciccotello, and Grant 45-46).

The structure of the paper is as follows. First, we will introduce the
terminology that applies to the LLC. With that introduction, we will be able
to then comprehend the characteristics and requirements of the LLC. Finally,
to offer a complete perspective of the LLC, we will compare it to other
common business entities. What will emerge is a sophisticated vision of the
LLC’s niche within the rapidly progressing business world.

Terminology: The Language of the LLC

To understand the mechanics of LLCs, one must first become familiar
with the language of LLCs. Certain terms used to describe the parties
associated with LLCs and documents used to organize them differ from
those used to characterize corporations and partnerships.

Corporations have articles of incorporation; partnerships have
certificate of partnership; but an LLC is formed by filing articles of
organization. LLC statutes typically provide that the articles must state
the LLC’s name and address, the date the LLC is to dissolve, and - in
some cases - its purpose. Depending on the state of organization, the name
must usually contain the words “limited liability company,” or the abbreviation
“LLC,” (Schorr 27; Witner and Simons 22). The LLC will be considered
formed after the articles of organization are filed with the appropriate state
agency (New Kid 344).

Corporations have bylaws; partnerships have partnership
agreements; but the internal operations of an LLC are governed by its
operating agreement. The operating agreement contains all provisions not
in the articles of organization regarding the internal governance of the LLC
and how its members relate to each other (Schorr 27; Witner and Simons
22).

Corporations have shareholders; partnerships have partners; but
an LLC is owned by its members. Members of an LLC may include
individuals, corporations, partnerships, other LLCs, or other entities. Many
LLC statutes permit the articles of organization to provide for classes or
groups of members having such relative rights and powers as provided in
the operating agreement (Schorr 27; Witner and Simons 22). When an
LLC is formed its members do not incur tax. This is because the contribution
of property to a partnership is generally a nontaxable event (Regulation
301.7701-.045). Each member’s basis in the LLC equals that member’s
contributions adjusted for the member’s share of the LLC’s income or losses,
as well as any distributions made to that member (New Kid 340).

There is no limit to the maximum number of members an LLC may
boast. According to an article by Woehlke et. al. in the June 1995 issue of
The CPA Journal, vagaries surround the IRS’s ruling concerning single owner
LLCs. He reports, “The IRS will issue no ruling on single-owner LLCs.
The exclusion of single-owner LLCs leaves open perhaps, the most intriguing
issue involving LLCs. You cannot organize a one-partner partnership; so
how do you classify a one-member LLC? When the interest of one member
in a two-member LLC is redeemed, is the LLC some how magically
converted from a flowthrough entity into an association taxable as a
corporation? In the wake of Revenue Procedure 95-10 this issue remains
open” (18). Upon viewing Revenue Procedure 95-10 however, it seems
that this issue is clear cut. The procedure clearly states, “The [Internal
Revenue] Service will consider a ruling request that relates to the
classification of an LLC as a partnership for federal tax purposes, only if it
has at least two members…” (4.01).

Corporations have directors and officers; partnerships have general
partners; but management of an LLC is vested in one or more managers.
Under most state statutes, members can either designate managers or
become management themselves. Unless otherwise agreed upon, members
manage in accordance with their proportionate interests in the LLC. Many
LLC statutes permit classes or groups of managers having relative rights
and powers as provided in the operating agreement (Schorr 27-28; Witner
and Simons 22).

Corporations have stocks or shares; partnerships have partnership
interests; but in an LLC, a member has a membership interest (Witner and
Simons 22). Contributions to an LLC in exchange for a membership interest
may be made in the form of cash, property, the use of property, services, or
any other valuable consideration. In some states, contributions may also be
made in the form of a promissory note or other binding obligation (Mezzullo
19). As with partnerships, LLC interests are not represented by shares or
evidenced by certificates (New Kid 344).

Distributions of cash to members are generally not taxable income to
the recipients unless the cash distributed exceeds their basis in the LLC. Members of an LLC are usually permitted under state law to customize both distribution of cash and property and allocation of profits and losses to the members. In the absence of any financial provisions in the operating agreement or the articles, distributions are generally made and profits and losses allocated on a proportional basis in accordance with the members’ respective contributions. In most states, unless otherwise provided in the articles or the operating agreement, a member has the right to withdraw on six months’ notice. A withdrawing member is entitled to the fair value of the membership interest (Mezzullo 19).

Pursuant to most LLC statutes, except as provided in the operating agreement, the assignment of a membership interest entitles the assignee to receive the assignor’s distribution and allocations of profits and losses. For the assignee to participate in the management and affairs of the LLC and to exercise other membership rights, the remaining members must unanimously consent to the assignee’s admission as a member (Schorr 27).

The Characteristics of the LLC

Most legal characteristics of LLCs are not new; as we have seen, LLCs are an amalgam of the most desirable attributes of corporations and partnerships based upon the concepts contained in the Uniform Partnership Act, the Uniform Limited Partnership Act, The Revised Uniform Limited Partnership Act, the Model Business Corporation Act, and the Revised Model Business Corporation Act (New Kid 343).

The purpose of the LLC is to provide for the combination of a liability shield that is every bit as good as that of a corporation, and taxation as a partnership. LLCs have been the focus of so much legislative activity and practitioner interest because they can provide the “best of both worlds,” namely the limited liability attribute of a corporation and the tax status of a partnership.

Corporation-like limited liability is obviously a major advantage over the sole proprietorship and the general partnership, where an owner has no liability shield. Additionally, this feature grants the corporation a potential advantage over the limited partnership, where general partners have no liability shield and limited partners risk loss of their shield if they participate too extensively in the management of the business (Tax Advisors 5-6).

The tax advantage of the partnership is that it pays no taxes; it merely files an “information” return with the government specifying how much income the partnership had for the year, and what income is left to flowthrough to the individual partners. Each partner must report his share of partnership income on his personal income tax return. Each partner will then be taxed on his share whether or not it was actually distributed to him during the course of the year (Schantz and Jackson 722).

Unlike a partnership, a corporation is a separate legal entity existing independently and apart from the people that own it. A corporation is recognized as an artificial “person” and is therefore accorded the rights of a person granted in the Due Process clauses of the Fifth and Fourteenth Amendments of the United States Constitution. Because a corporation is a legal entity and not an aggregate of individuals, a corporation must report and pay taxes on its net income. Though it may seem inequitable, the corporate income is then taxed a second time as the shareholders of the corporation report their dividends as income on their personal income tax returns. This unique corporate tax rule is commonly known as “double taxation” (Schantz and Jackson 771). Due to this tax disadvantage, a business entity possessing taxation attributes similar to those of a partnership and limited liability advantages of a corporation would be in great demand. Thus, the LLC.

To be viable, an LLC must be recognized by the IRS as partnership-like in order to receive flowthrough tax treatment. Classification as partnership for federal income tax purposes is based on criteria set forth in Section 301.7701-2 of the Internal Revenue Code (regulations). These regulations identify the six characteristics indicative of corporation status. The regulations state that an entity will be classified as an unincorporated association taxable as a partnership for federal income tax purposes if the entity possesses the first two corporate characteristics: (1) “associates” and (2) “an objective to carry on business and divide the gains among its associates.” In addition, the entity must lack at least two of the remaining corporate characteristics of (3) “limited liability”; (4) “continuity of life”; (5) “free transferability of interests”; and (6) “centralized management.” If the LLC possesses more than two of these four corporate characteristics, it will be classified as an unincorporated association taxable as a corporation. Revenue Procedure 95-10 provides guidance concerning the IRS’s position with respect to each of these characteristics, which will be explained in greater detail below (New Kid 336).

LLCs must be formed under state enabling statutes that explicitly provide for the formation of the entity. Each enabling statute has its own mechanics regarding the formation of an LLC. LLC statutes are typically
either “bullet-proof” or “flexible.” The LLC statutes in the states of Colorado, Virginia, Wyoming, and four others are examples of bulletproof statutes. These state statutes contain mandatory provisions concerning “limited liability,” “transferability of interests,” “centralized management,” and “continuity of life.” These provisions are designed to ensure that an LLC organized under them will be classified by the IRS as a partnership for Federal tax purposes (Schorr 26). However, bulletproof statutes curtail the number of options available in drafting the LLC’s operating agreement (Regulation 301.7701-01).

The other forty-one of the forty-eight jurisdictions that have enacted LLC statutes, including the New York legislation, have “flexible” statutes. They allow an LLC’s organizers broad flexibility in structuring the LLC, and allow the provisions concerning “transferability of interests,” “centralized management,” and “continuity of life” to be varied by the agreement of the owners of the LLC. It should be emphasized, although, that with these flexible statutes there exists the risk that the LLC will not be structured properly from a federal tax standpoint. The costs of such a mistake could be enormous.

“Limited Liability” Characteristic

An LLC will have “limited liability” unless at least one member assumes a personal liability for all the LLC’s obligations and the assuming member or members have aggregate net worth at least equal to ten percent of the total contributions to the LLC. Additionally, the assuming member or members must be expected to maintain at least ten percent of the total contributions throughout the life of the LLC. If this test is not satisfied, the assuming members must be shown to have “substantial assets” that could be reached by one of the LLC’s creditors to obtain finding that the LLC lacks limited liability. However, because a primary reason for using the LLC business form is to limit liability, it is unlikely that many LLCs will be seeking partnership tax treatment by claiming lack of the corporate characteristic of limited liability (Roadmap 248-249).

In general, limited liability means that members and managers of an LLC are not personally liable for the debts and obligations of the LLC regardless of the degree to which such members or managers participate in the management of the LLC. A member’s liability is limited to the amount of capital contributions plus agreed but unpaid contributions. Accordingly, creditors of an LLC may not recover debt from a member if the LLC’s assets are insufficient to satisfy the creditor’s claim. Of course, an owner is always liable for business debts he or she guarantees or co-signs for the business, and for any fraud or torts he or she commits personally (Woehlke et al. 16).

Significantly, each member’s basis will be increased by the share of the LLC’s debt that is allocated to that member. This is because all debts, whether recourse or nonrecourse with respect to the LLC, are by the LLC’s nature nonrecourse to its members because no member is personally liable for the LLC’s obligations. Thus, an LLC’s debt will be added to the basis of all its members in accordance with their membership interests unless a particular member bears the economic risk of loss with respect to the obligation in question, that is, where a member has personally guaranteed an LLC liability, in which case, the portion of the liability for which the member is personally liable must be included in that member’s basis (New Kid 340).

If an LLC operates only in the state of its formation, which obviously allows the formation of an LLC, and it has no products that might produce substantial liability claims in other states, there is no need to worry about the liability shield of the LLC or qualification to do business elsewhere. If, however, the business is to operate in other states besides its state of formation, if one of those other states is Hawaii, Massachusetts, or Vermont (which do not recognize LLCs), the limited liability shield is, under the circumstances, less effective than the limited liability available to a corporation. Thus, limited liability in this situation becomes a disadvantage for the LLC in comparison to a corporation and even perhaps a limited partnership. It may, however, still be an advantage in comparison with a general partnership or sole proprietor (Tax Advisors 11).

The day may come when LLCs will universally achieve the same degree of liability protection as that accorded corporations. This will occur if and when all fifty states and the District of Columbia enact an LLC enabling statute, or at least a statute formally recognizing the limited liability of LLCs organized in other states. Until that day, the limited liability shield for LLCs is a matter of degree. When LLCs are accepted countrywide, however, the LLC will boast a major advantage over the sole proprietorship, general partnership, and limited partnership, and will be equivalent to a corporation in regard to its limited liability protection (Tax Advisors 6).

“Continuity of Life” Characteristic
Prior to the publication of Revenue Procedure 95-10, practitioners were uncertain as to the requirements of the IRS for an LLC to be deemed to lack "continuity of life." Most LLC statutes provided that an LLC would dissolve upon the death, retirement, resignation, expulsion, bankruptcy, or dissolution of a member or the occurrence of any other event that terminates a member's continued membership in the LLC. In other words, an LLC lacks continuity of life if there is an alteration of the identity of the organization by reason of a change in the relationship between the LLC's members as determined under local law (New Kid 336-337). However, Revenue Procedure 95-10 states that an entity will lack continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will result in the dissolution of the entity, even though the remaining members have the right to continue the entity's existence following the dissolution.

The IRS has eliminated much of this uncertainty by distinguishing between member-managed and manager-managed LLCs. If an LLC has member-managers and the operating agreement of the governing statute provides that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member-manager will dissolve the LLC unless continued by not less than a "majority in interest" of the remaining members, the LLC will lack continuity of life under 95-10. If the LLC does not have member-managers and the governing statute or operating agreement provides that the occurrence of the foregoing events with respect to any member dissolves the LLC unless the LLC is continued by not less than a "majority in interest" of the remaining members, the IRS will likewise rule that the LLC lacks continuity of life. If less than all of the above-listed dissolution events are applicable, the IRS will not rule that the LLC lacks continuity of life unless the taxpayer clearly establishes that the events selected provide a meaningful possibility of dissolution.

The foregoing points must be further elaborated. First, the definition of "majority in interest" for the voting requirement for continuity of life is: a majority of capital and income interests in the LLC. This definition is substantially different from the definition that applies to the free transferability of interest test described below. Additionally, 95-10 does not address term limits with respect to continuity of life. As such, a pure term LLC may not avoid a finding of continuity of life in the absence of other termination events (Roadmap 249-250).

Complications in achieving business continuity highlight a disadvantage of the LLC. Corporations usually are created to have perpetual existence. General partnerships, on the other hand, dissolve upon the occurrence of the foregoing events. LLCs generally follow the general partnership paradigm that provides for the entity dissolution upon the departure of an owner for any reason, but engraft on it the limited partnership paradigm for general partner departures that allow the dissolution to be avoided if the remaining owners, or some subset thereof, agree to continue the basis (Tax Advisors 7-8). Lacking continuity of life might be imperative for the LLC in order for it to qualify for partnership tax consequences.

"Free Transferability of Interests" Characteristic

"Free transferability of interests" signifies that owners owning substantially all of the interests in an entity have the power - without the consent of the other owners - to transfer all of the attributes of the ownership interests held by such owners. In the LLC context, free transferability of interests means the power to transfer all voting, management, economic, and other rights associated with an LLC interest to a third party without the consent of the other members. The determination of free transferability raises two issues: (1) the percentage of nontransferring members that must consent to the transfer and (2) the percentage ownership that must be restricted from freely transferring an interest.

Once again, the IRS focuses on the distinction between member-managed LLCs and manager-managed LLCs. Revenue Procedure 95-10 provides that free transferability of interests not exist in LLCs with member-managers if the operating agreement or governing statute provides that members owning at least twenty percent of the LLC's capital, income, gain, loss, deduction, or credit do not have the power to transfer all attributes of membership without the consent of a "majority in interest" of the nontransferring member-managers (Roadmap 250). For example, if an LLC has a member-manager owning 25% interest that is subject to transfer restrictions and the owners of the remaining 75% have no restrictions on the transfer of their interest, the LLC would be found to lack free transferability of interest (Woehlke et. al. 19). This rule applies to LLCs without member-managers by requiring the consent of a "majority in interest" of the nontransferring members.

Unlike the definition applied to the determination of continuity of life, the term "majority in interest" in this context means a majority of the capital and profit interests in the LLC, a majority of the capital interests in the LLC, a majority of profit interests in the LLC, or a majority of members on a per capita basis (Roadmap 250). To be effective in showing the absence of
free transferability, the power to withhold consent with respect to transfers must be meaningful. Consent that is in any way mandated will not be considered meaningful. For example, the power to withhold consent will not be considered meaningful if the consent may not be unreasonably withheld (Woehlke et al. 19).

The prerequisites to obtaining a federal tax classification as a partnership introduce potential disadvantages for LLCs, specifically regarding the restricted transferability of ownership interests requirements. In theory, corporate stock is freely transferable. As a practical matter, however, the right to transfer stock is often significantly limited by the shareholders’ adoption of transfer interests, especially minority interests in a closely held business, and may not be readily marketable.

In general, partnership interests are not freely transferable. However, this restriction is often modified in the case of limited partnership interests. As a practical matter, without such modification, many prospective investors would hesitate to purchase interests as limited partners for fear that they would have no mechanism for “cashing out” their equity at some later date.

LLCs follow the partnership paradigm. Thus, there is an assumption of relative lack of transferability with regard to LLCs that - as in the case of a limited partnership interest - may be modified to provide for some degree of transferability. The degree to which this modification may occur varies depending upon which state’s enabling statute is employed to create the LLC and the approach taken with regard to obtaining partnership tax status. That is, which corporate characteristics the LLC has chosen not to possess. The lack of transferability of ownership interests with regard to LLCs generally is more apparent than real, but is nevertheless fairly considered a disadvantage vis-a-vis the corporation (Tax Advisors 7-8). However, the lack of transferability may be necessary in order to be classified as an LLC.

“Centralization of management” Characteristic

“Centralization of management” must be tested if less than all the owners of an entity have continuing and exclusive authority to make management decisions necessary to conduct the entity’s business without ratification of the remaining owners. Revenue Procedure 95-10 states that an LLC will lack centralized management if either the controlling statute or the operating agreement pursuant to the controlling statute provides that the LLC is managed by the members exclusively in their membership capacity. If the members designate member-managers, however, the IRS will not rule that the LLC lacks centralized management unless the member-managers own, in aggregate, at least twenty percent of the total interests in the LLC (Roadmap 250-251). But even here, the IRS will not rule that centralized management is absent if the relevant facts and circumstances fail to support the ruling. Revenue Procedure 95-10 further states that the IRS will not rule that the LLC lacks centralized management, regardless of whether the foregoing ownership test is satisfied, if the member-managers are subject to periodic elections or the non-managing members have substantially unfettered power to remove the member-managers (Woehlke et al. 19).

Ownership Tests Required For Rulings

In addition to lacking at least two of the corporate characteristics, an LLC must satisfy certain other thresholds in order to receive a letter ruling from the IRS classifying it as a partnership for tax purposes. If a taxpayer requests a ruling that an LLC lacks “continuity of life” or “free transferability of interest,” the member-managers of the LLC, if any, must own, in aggregate and throughout the life of the LLC, at least one percent of each material item of the LLC’s income, gain, loss, deduction, or credit. Similarly, if the taxpayer requests a ruling that the LLC lacks “limited liability,” the assuming members must own, in aggregate and throughout the life of the LLC, at least one percent of each item of the LLC’s income, gain, loss, deduction, or credit (Woehlke 18; Roadmap 251). Special allocations that temporarily cause less than one percent of any such item to be allocable to the required members will not cause the LLC to fail this test provided that the ruling request describes the reasons for such allocation (Roadmap 251). The one percent minimum is reduced in accordance with a formula specified in 95-10 for LLCs with capitalization exceeding $50 million (Woehlke et al. 18). This formula says the member-managers must maintain an interest in each of the required items of “at least one percent divided by the ratio of total capital contributions to $50 million” (4.03). The ruling further states that the computed percentage must be incorporated in the operating agreement. The example given in 95-10 is of an LLC whose total capital contributions are $125 million. There, the interest in each material item must be at least .4 percent, that is, one percent divided by 125/50. In no event besides a temporary allocation, may the member-managers’ aggregate interest at any time during the existence of the LLC in any item be less than .2 percent (Roadmap 251).
Capital Account Balances Test

The LLC must also satisfy a test regarding the capital account balances of the members to obtain an advanced ruling. If the taxpayer seeks ruling that the LLC lacks the corporate characteristics of "continuity of life" and "free transferability of interests", the member-managers must, in the aggregate, maintain minimum capital account balances equal to the lesser of (1) one percent of the total positive capital account balances of all members or (2) $500,000. This rule also applies to the assuming members if the LLC requests a ruling that the entity lacks the characteristic of "limited liability". Furthermore, whenever a non-managing member makes a capital contribution, the member-managers must be obligated, under the operating agreement, to contribute to the LLC an amount as is necessary to conform with the foregoing rule. If no member has a positive capital balance, then the member-managers need not have positive capital account balances to satisfy this requirement (Roadmap 251-252).

Revenue Procedure 95-10 includes a special exception in this area for LLCs having one or more members who contribute substantial services. In these LLCs, the capital account requirement summarized above does not apply to any member-managers. Instead, to meet the minimum capital account requirement, the LLC's operating agreement must provide that, upon dissolution or termination, the member-managers must contribute capital to the LLC up to the lesser of (1) the aggregate deficit balance of their capital accounts or (2) the excess of 1.01% of the total capital contributions of the non-managing members over the total capital previously contributed to the LLC by member-managers. For example, if an LLC is capitalized with $1 million and has one member-manager who contributes only substantial services, that member-manager must be required in termination to contribute up to the lesser of her deficit account or $10,100 (1.01% of $1 million) (Woehlke et. al. 18).

Comparison to the S Corporation

It is often said that an LLC is similar to the subchapter S corporation. From an income tax perspective an S corporation is similar to an LLC, in that it is taxed as a partnership. An S corporation is to some extent a "pass through" entity. It generally pays no tax on its earnings and its profits and losses are "passed through" to its shareholders (Tax Advisors 6). Also, an

Portfolio Limited Liability Company

S corporation still has the other characteristics and advantages of the corporate form of doing business; limited liability, ease of transferring ownership interests, perpetual life, etc. (Schantz and Jackson 774-775). However, contrary to common misconception, an S corporation does not provide "the best of both worlds" as much as an LLC does. An S corporation faces significant constraints that do not apply to the LLC regarding how many may own interest in the enterprise, who can own interest in the enterprise, and how may it structure its finances (Tax Advisors 6).

LLCs may have an unlimited number of members while S corporations may not have more than thirty-five shareholders. In addition, any entity or person may own an interest in an LLC. An S corporation, on the other hand, may not have shareholders that are corporations, nonresident aliens, partnerships, pensions, charitable organizations, or certain trusts. These rigid ownership qualifications severely restrict the opportunities for investors to provide capital for businesses while maintaining limited liability and flowthrough taxation in S corporations (Alternative 358). S corporations are also limited on certain types of income such as rents and royalties which do not qualify for flowthrough taxation. Additionally, S corporations are subject to the "one-class-stock" rule. This requirement precludes flexible allocation of profits, restricts the type of debt the S corporation may issue, hampers efforts to gradually shift control to family-owned businesses, and, in general, makes passive investment difficult to structure. LLCs are not subject to this limitation and may create a variety of ownership interests (Tax Advisors 6).

Lastly, S corporations are restricted from owning more than eighty percent of the stock of other corporations and may not be part of an affiliated group while LLCs have no such limitations. Therefore, LLCs may be used in holding company structures that are not available to S corporations (Alternative 358-359). Failure to comply with the many S corporation rules may result in an involuntary termination of S corporation status and accompanying adverse tax consequences. In contrast, once an LLC is structured to be treated as a partnership for tax purposes, maintenance of the tax status is not generally dependent on satisfying further qualification requirements (New Kid 348).

Comparison to the Limited Partnership

A limited partnership is the entity most closely resembling an LLC. The similarity results from the substantial degree to which LLC statutes
have been modeled after limited partnership statutes. A limited partnership is a partnership consisting of one or more general partners and one or more limited partners. Unlike a general partner who has unlimited liability, a limited partner is liable only to the extent of his investment in the partnership—the limited partner’s assets are not subject to liability. However, in exchange for limited liability, the limited partner forfeits the right to act as an agent of the partnership and to participate in the partnership management (Schantz and Jackson 739).

The distinctions between limited partnership and LLCs have significant ramifications to the owners of the business. The primary difference between LLCs and limited partnerships relates to the limitation of liability for the entity’s owners. Unlike a limited partnership which requires at least one general partner who is personally liable for the obligations of the enterprise, no member in an LLC is required to be personally responsible for the LLC’s obligations. Moreover, LLC members retain their limited liability regardless of the degree to which they participate in the management, whereas limited partners who actively participate in management of the limited partnership jeopardize their limited liability status.

Both LLCs and limited partnerships are treated as flowthrough entities for federal income tax purposes. A substantial difference between the tax treatment of these two business enterprises, however, relates to the basis of the entity owners. As previously discussed, debt that is not personally guaranteed by all members will be considered nonrecourse debt with respect to the LLC members, a portion of which may be included in each member’s basis. In contrast, debt that is recourse to a limited partnership will not be considered nonrecourse debt with respect to all the partners because the general partners will have personal liability for such debt. Accordingly, recourse debt for limited partnerships is not included in a limited partner’s basis unless that limited partner is personally liable with respect to such debt (New Kid 346-348).

The Limited Liability Partnership

Although it is outside of the scope of this paper, I must mention an even newer arrival on the business entity scene, the Limited Liability Partnership (LLP). An LLP is similar to a LLC but is formed under a separate state statute that generally applies to service organizations. Service organizations, such as law or accounting firms, choose this business structure because of the ease with which they, in their current business setups, can

transform and register to obtain LLP status.

However, some business advisors consider the LLP to be a distant second to the LLC. The primary drawback these advisors point to is that less than twenty states recognize LLPs. A second drawback to LLPs is that, except in New York and Minnesota, LLPs only offer their partners liability protection against tort liability. This leaves LLPs formed in states other than New York and Minnesota exposed to unlimited commercial liability (Woehlke et. al. 20).

Conclusion

Presently, many business owners are still choosing to be classified as a corporation. LLCs are relatively novel and business advisors are much more comfortable with the developed business law applicable to corporations. Yet as time passes and business advisors become more familiar with the principles governing LLCs, this may swiftly change (Woehlke et. al. 22).

The issuance of Revenue Procedure 95-10 provided desperately needed clarity in this rapidly evolving field of business and tax law. The increasing demand for LLCs will continue to effect evolution of the LLC body of law over the next several years. In the meantime, the business adviser must consider the IRS’s ruling position and regulations when deciding to use the LLC form.

As stated in the Tax Update published by Richard A. Eisner & Company, LLP, “For most new and existing businesses the LLC form of doing business will have increased benefits with little or no increased risk. While there are certain open issues associated with LLCs, this form of organization should be considered seriously by all businesses, at all stages of a business life cycle.”

Works Cited


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overview
Ronald Perelman is the owner and CEO of MacAndrews and Forbes. This is a holding company for various companies such as Revlon, Marvel, and Consolidated Cigars. All of the companies are fully private except for Marvel. I had the pleasure of meeting and interviewing Mr. Perelman at his MacAndrews & Forbes office on the upper east side of Manhattan.

history
In fifteen years, Ron Perelman took a modest investment in a jewelry company, Cohen Hatfield Industries, and built a powerful portfolio of companies with combined revenues of about $7.8 billion. Forbes estimates his personal fortune at $4.5 billion.

The story of Ron Perelman’s rise to the top of the corporate world coincides with the extraordinary economic expansion of the 1980’s. Unlike corporate raiders who merely bought and resold companies, Perelman built his fortune by rebuilding the companies he purchased.

Yoel Mayerfeld is a finance senior in SSSB. He is the founder and chairman of the Sy Syms Lecture Series as well as Executive Editor for the Portfolio.
Ponrrollo

Toy Biz, MacAndrews & Forbes, owns national distributor those days managed good cash businesses dated now, they competed with Marvel Entertainment, a youth marketing company composed of Toy Biz, Fleer trading cards, Sky Box, and Marvel Comic Books. He also owns New World Communications Group, a television broadcasting, production, and distribution company. Maeco Worldwide - a flavors company, and Meridian Sports - a water sports company, First National Bank, National Health Laboratories, and Consolidated Cigar Corporation, one of the largest manufacturing company of cigars in the U.S., complete the portfolio.

In 1966 Ron Perelman received his Masters in Business Administration from Wharton School of Business. He worked in his fathers business until 1978 when he bought forty percent of a jewelry retailer and distributor named Cohen Hatfield Industries.

After two years, Perelman used Cohen Hatfield to buy a seemingly stammering company named MacAndrews & Forbes for $45 million. In those days MacAndrews & Forbes, a supplier of licorice extract and chocolate, was considered a victim of the upheavals in Iran and Afghanistan where much of the world’s licorice came from. Nevertheless, Perelman managed to turn the troubled company into a profit center in just a few years, and came out with a $15 million profit.

Those first successes propelled him into a series of acquisitions that followed the same pattern. Mr. Perelman would find a company with a good cash flow and an undervalued product, buy the company, strip away all the product lines that did not fit, and build up those that did. He paid $108 million for Technicolor and eliminated everything but the color-processing business which had a steady cash flow. When he bought Consolidated Cigar and Video Corporation of America, he focused on their core businesses until they were successful. Today, Ron Perelman focuses most of his time on his latest acquisition, New World Entertainment. It should soon complete with the three major syndicates - ABC, NBC, CBS. As of now, they have a ten year affiliation contract with Fox. New World Entertainment in connection with Marvel Comics promises to be lucrative. “New World can now be like a mini-Disney with its line of action hero characters,” said Perelman in an interview with Cigar Aficionado magazine.

The Interview

Revlon as a division of MacAndrews & Forbes

Out of all the companies he owns, it seems that Perelman is most involved with his cosmetics company, Revlon. He said that all of the heads of the companies he owns come through his office in MacAndrews and Forbes a few times a month. This is mainly in the middle of the month, so that Perelman can have a hold on the companies in the midst of their monthly processes. As far as his tie with Revlon, he is co-CEO, so all of the burdens of control don’t solely lie on his shoulders. Due to the fact that Perelman is the overall owner, the CEO of these companies is not really significant. The really important decisions come through his office. For example with his second largest company, Marvel, he has meetings with CEO Bill Bevons, a few times a week.

Key phrases in dealing with challenges of the 90’s

Globalization

Mr. Perelman said that every year the world becomes a smaller place. Foreign countries are both supplying and importing products. This is especially true in the Far East, where they are not only one of the biggest consumer areas but within the next ten years will probably become the biggest suppliers in the world.

Reengineering

Mr. Perelman believes very much in flat organizational structures, and keeping varying levels to a minimum. Therefore, he makes sure that all of his companies report to his office, allowing a surface level of communication between all of them. In regard to any tension between departments and levels in his companies, Perelman said that there is always some amount of tension. Some problems do occur, but that is what managers are for. Also, to some extent tension is good in that it keeps people on their toes.

Planning

It is hard to believe that Perelman manages to fit planning into his busy schedule. His approach towards planning takes into account that in
todays ever changing world it is very hard to plan ahead. Each operating unit does its own planning, but it is never for more than three years.

**Diversification of corporate portfolio**

When purchasing companies, Mr. Perelman does not specifically diversify, but rather looks for a good opportunity. “We see if a company is attractive to us, and if it is we buy it.” He felt that General Electric is an excellent model for diversification and all forms of management.

**Research related questions**

Revlon is not giving Ronald Perelman a considerably high return on his investment, and as one writer from the New York Times put it “he should sell it and get out.” According to Perelman, management is spending more time on Revlon than ever before. It is now doing better than ever, and they hope to go public in the near future. (In fact at press time Revlon had recently gone public.) Mr. Perelman said Revlon was not going to get into higher- end products to increase their profits. Revlon’s Operating Strategy comprises the use of cost-leadership strategy for their company. This is a strategy of low price, high volume, and low profit margins on each item. The low prices attract a large number of customers, generating a large overall profit by sheer volume of units sold.

I had read that Mr. Perelman learned most of what he needed to know for business from his experience in his fathers business, but that he also learned from his classes in Wharton. Mr. Perelman feels that they were both equally invaluable. He received the basics and the formal discipline from Wharton, but the trial and error from his father’s business is where he gained his practical experience.

**Perelman’s winning procedure of management**

Mr. Perelman said that he has a fabulous management team. They assist him in purchasing new companies by looking for problems in businesses that they know they are equipped to handle. Management always looks at past decisions and procedures and tries to learn from their triumphs as well as their failures. In a recent article in New York magazine, Mr. Perelman said, “I buy businesses and I manage them.” He explained to me that they evaluate management and they figure out exactly what to do. Mr. Perelman’s exception to buying businesses, is that he will never get involved in any business that he does not fully understand.

**Ron Perelman’s key to success**

Mr. Perelman summed up both the key to his success and advice to current students in one sentence. “You should choose to do something that you love to do, that you love to think about, where you can’t wait to get to work in the morning and you hate to leave at night.” That is what business is for Ronald Perelman.

**Summary**

This interview helped me to understand management and some of its concepts in a practical way. Mr. Perelman shared some valuable insights with me on what it is like to control a huge conglomerate. He explained how he is able to keep a proper hold on things through proper communication, which enhances productivity. Mr. Perelman showed me that its not all textbook solutions for every decision and problem that comes up. You are put into various situations at different times and you have to react in the best manner that suits you at the time.
Dividend Policy

ALLEN SATZ

An Overview of Dividend Policy

Dividend policy is a decision that every publicly held company traded on a secondary market must make. The choice the company must make is whether to re-invest the money back into the company, or pay it out to the shareholders as dividends. There are many questions that go along with dividend policy. For instance, there’s the question of how much to pay out, and when to pay out. Why did the managers decide to pay dividends and not re-invest back into the company? Does a pay-out of dividends in any way affect the price of the stock? What effects does dividend policy have on taxes? There are many decisions to be made when issuing dividends.

If a firm pays out more cash dividends, the stock price will increase. On the other hand, if the firm pays out less cash dividends in order to reinvest the money into the company, the price of the stock will decrease. The "optimal dividend policy" balances out the current dividends and the future growth of the stock. Investment opportunity and other sources of capital are just two factors that will influence dividend policy. Let us begin with an introduction to three theories of dividend policy.

The first theory of dividend policy is called the "dividend irrelevance theory". This theory states that dividend policy has no effect on the price of the stock. This theory was created by Merton Miller and Franco Modigliani (MM). Their claim was that the value of the firm does not depend on how the income is divided between dividend and retained income. It is, however, dependent on the income that they produce. This theory, as all theories do, makes certain assumptions. The assumptions are: (1) there are no income taxes, (2) no stock flotation or transaction costs, (3) leverage has no effect on the cost of capital, (4) all information about the firm's future prospects is known to managers and investors, (5) the split between dividends and retained earnings has no effect on the firm's cost of equity, and (6) the dividend policy is independent of the firm's capital budgeting policy. These assumptions, however, do not hold true for the real world.

The second theory of dividend policy is the 'bird-in-the-hand theory'. This theory rejects the fifth assumption of MM, which stated that dividend policy has no effect on the investors required rate of return on equity. Rather Myron Gordon and John Lintner believe that the required rate of return on equity for investors (k) drops as the dividend pay-out is increased. The reason for this is because investors are less positive about receiving the gains which will result from retained earnings than they are from getting a dividend payment. In short, a dollar now is worth more to investors than the prospects of future growth in the company. MM argued with this notion. They claimed that k is not related to dividend policy, and investors are not also indifferent between capital gains and dividends. According to MM, investors will re-invest their dividends in similar companies. In the long run, the investors will only be worried about the risk of the companies operating cash flows and not about its dividend pay-out policy.

A third dividend policy theory is the 'tax preference theory'. An investor might prefer a low pay-out dividend ratio to a high pay-out dividend ratio for three reasons: (1) The investor is in a high tax bracket. This investor might prefer to re-invest his dividends back into the company, and hope the price of the stock will rise. This way he will increase his capital gains, and not pay high taxes on his dividends. (2) Taxes are not paid until the stock is sold. Therefore due to the time value of money, a dollar today is worth more than a dollar in the future and the taxes that will be paid in the future are worth less. (3) If a person holds shares of stock until the day of his/her death the beneficiary is exempt from taxes when they sell the stock. With all these tax advantages an investor might want a company to hold on to most of their earnings. Investors might even pay more for a low pay-out company than for a high pay-out company of the same type.

We have just seen three different views of dividend theories. Which
one is correct? To ask an even better question, is one theory better than all the rest? The only way to test a theory is through empirical testing. The empirical test results, however, show that either all or none of the theories can be correct. There are two reasons for this phenomenon. First, we are assuming that the only difference from one company to the next is it's dividend policy. Second, we must be able to measure the cost of equity for the sample firms. Neither of these two conditions hold. Therefore, we are unable to determine exactly what effects dividend policy has had on the cost of equity. In turn, these tests have been unable to end dividend policy debates.

Another dividend policy theory is the informational content, or signaling, hypothesis. For example, a company that is expected to increase it's dividends by five percent per year. Even if the company did increase it's dividends by that amount, the stock price still would not change on the day that the increase in the dividends is announced. This is simply because the increase would be expected by the market. However, if the expected increase was five percent and the dividend increased by twenty-five percent, then the price of the stock would increase. On the other hand, if the dividend was supposed to decrease by five percent, and it decreased by more, the stock would decline in value. From this we can deduce that investors prefer dividends to capital gains. Managers only raise dividends if they are expecting higher earnings during the year. Inversely, if they expect lower earnings they will lower dividends. According to MM, when investors see dividends rise they assume the company is expecting a good growth year. This will, in turn, make them want to buy the stock and will raise stock market prices of that stock. However, if the investors see that the dividends of the company are declining, they will assume that the company expects lower earnings than usual. This will cause the investors to want to sell the stock, and that will cause the stock price to fall. The stock price changes, according to MM, is just an indicator of the importance of the information that is released in dividend announcements.

A second factor affecting dividend policy is called the clientele effect. MM believes the clientele effect may offer a possible explanation for stock price changes after an announcement of dividend policy. When a firm sets a particular dividend policy it attracts investors looking for that particular type of policy, that is, their "clientele". For example, if a firm traditionally reinvests it's income rather than paying it out in dividends it will attract investors looking to save on taxes. However, it will not be beneficial to the investor who desires immediate income. This particular investor would

rather a company whose dividend policy consists of paying out more dividends, and reinvesting less back into the company. Therefore a firm should establish a certain dividend policy, which will then attract a specific group of investors. Those who dislike the policy will either sell their shares or not invest at all. Therefore a company should not change it's dividend policy often. Only under circumstances such as economic change and for the purpose of improving the business should the policy be altered. If there are enough investors for the new policy, then the price of the stock will rise. On the other hand, if there are not many investors who approve of the new dividend policy, then the price of the stock will drop.

All the theories mentioned so far, are just that - theories. There is no dividend policy formula. Management must still formulate a dividend policy. Here are some dividend policies that are in use today.

First is the residual dividend policy. This policy states that a firm should follow these guidelines when determining it's pay out ratio: (1) decide on what it wants the optimal capital budget to be, (2) figure out the amount of capital needed to finance that budget, (3) use the retained earnings to supply the equity component to the extent possible, and (4) pay dividends only when there is enough excess income after the optimal capital budget is fulfilled. The dividends should only be paid from leftover earnings. The bottom line is that the investor would rather have the company reinvest the money if it will achieve a greater rate of return than the investor can generate from the dividend.

A second dividend policy that is in use today is called the constant, or steadily increasing dividends. What this policy states is that a firm should establish a certain amount of dividends that should be given during a year. Anytime the company feels it will have increased earnings, it should raise the amount of dividends that are to be distributed. The one rule of this policy is that the dividends should never decrease.

In the stable growth rate system the company sets a target growth rate for their dividends to grow each year. For this to be possible, the company's earnings must be growing at a steady rate. This policy provides the investors with a stable return of income. There are two reasons why a predictable dividend policy is better than a residual dividend policy. First, a varying dividend policy will lead to uncertainty, and in turn, a lower stock price. Second, since many stockholders use dividends for consumption right away, they would enjoy the security of a stable dividend income.

A third dividend policy used mainly by larger companies, is called dividend reinvestment plans (DRP's). Under this policy the investor reinvests
the dividend back into the company and receives more stock of that company. While some DRP's include only already outstanding stock, others incorporate newly issued stock. In either case income taxes are still paid, even though no cash is received. In the outstanding stock plan, the investor chooses to have his dividend reinvested in the company. Then a bank, acting as a trustee, takes the dividend, buys more shares on the open market, and then credits the investors account for that amount of shares. This policy is good for investors who do not need current income. The second DRP, which involves new stock, call for dividends to be invested in newly issued stock. This will in turn raise new capital for the company. An advantage of this plan is that no fees are charged to stockholders, and most companies offer a discount below market value. The company does this to save on investment banking costs, which would have been incurred, if they were selling the newly issued shares directly to the public and not through DRP's.

Another dividend policy, the constant pay out ratio has the company pay out a certain percentage of it's earnings. This causes the amount of annual dividends to fluctuate with each year. This is obviously not beneficial for investors who rely on the dividend as a source of income. A final policy the low regular dividend plus extras, pays out a constant minimum of dividends plus a bonus dividend given at the end of a good year. This relinquishes pressure on the firm to pay out high dividends, and at the same time assures investors of a minimum dividend. The firm can make dividends low enough that it will be able to cover them even in bad years, but when there are extra funds they can pay an extra dividend.

Dividends are paid out usually on a quarterly basis. There are actual dividend pay out procedures. These procedures state the cycle of paying out dividends and who receives them. The first event is the declaration date. On this date the board of directors of the company announce that they will pay a quarterly dividend to all the holders of record by a specific date, and payment will occur on the specific date named after it. Once the declaration has taken place, the dividend payable become a liability to the company, and retained earnings is reduced by the total dividend amount. The second event is called the holding of record date. At the end of this day the company makes up a list of all the stockholders on record as of that date. All transactions that took place that day are included. The third event is called the ex-dividend date. This date is four days prior to the holder-of-record date. If an investor sold their shares prior to the ex-dividend date then the buyer will receive the dividends that are expected. However, if the seller sells the stock within four days of the holder-of-record date, than the seller will receive the dividends. The fourth, and final, event is called the payment date. This is when the company actually sends out all the dividends to the holders of record.

There are still other factors that determine which dividend policy a company will choose. These factors are: (1) constraints, (2) investment opportunities, (3) the availability of other sources of capital, and (4) how dividend policy will effect k.

There are a number of possible constraints which may limit the range of dividend policies available to the company. A bond indenture is one example. A leveraged company may have a contract stating the exact dividend amount which is allowed to be paid. Another constraint is the impairment of capital rule. This rule states that no dividend is allowed to exceed retained earnings. This will protect the creditors from the company going bankrupt or liquidating. In addition, cash on hand can be a factor. If the company does not have enough cash they cannot pay any dividends. This, however, is easy to solve by borrowing. Finally, there is a penalty on firms who the IRS believe are witholding dividends so the share holders would not pay taxes on dividends. A company can pay a serious penalty if it is found to be doing this.

The second factor is investment opportunities. The Investment Opportunity Schedule (IOS), can play a major role in the choice of dividend policy.

A third factor is alternative sources of capital. The cost of selling new stock is one way to raise new capital. If the firm has low flotation costs, it will more readily issue the new stock. Another way to raise capital is through debt. In addition, if management wants to keep control, it will not want to sell new stock. If a proxy fight breaks out, then the dividends will be increased.

A fourth, and final, factor is the effects on k. Here we can consider four points: (1) shareholders who want current income, (2) what the risk might be between dividends and capital gains, (3) the tax advantage of capital gains over dividends, and (4) signaling. For each firm each of these points differ. As we can see, dividend policy is an act of informed judgment, and not something that can be quantified.

**Empirical Results**

This segment will discuss two of the most well known researchers of dividend policy, Merton Miller and Franco Modigliani (MM). What Miller
and Modigliani believed was that dividend policy does not matter and has no
effect on the price of the stock. They did, however, as already mentioned,
make some assumptions which applied to their theory.

Let's take, for example, firm XYZ. The firm is an all equity firm. The
managers of the firm are

able to predict a $20,000 cash flow now ($D_0$), and another $20,000
cash flow one year from now ($D_1$). There is no other net present value
(NPV) projects that it will be able to use for it's benefit. At the current
time, the dividends are made to the cash flow of $20,000. The NPV, therefore,
can be found by discounting the dividends. The firm's value is shown as:

\[ V_t = D_0 + \frac{(D_1)}{1 + r} \]

$D_0$ and $D_1$ are the amount of cash that is paid out in dividends, and $r$ is
the discount rate. We do not discount the first dividend, since it is paid right
away. If we assume that $r = 12\%$, then we can value the firm as follows:

\[ $37,857.14 = \frac{20,000}{1 + 0.12} + \frac{20,000}{(1.12)^2} \]

If the amount of shares that are outstanding is 2,000, then we can
value the shares at:

\[ \frac{$18.93 = \frac{$10 + $10}{1.12}}{1} - \text{Eq. 1} \]

To make this example as simple as possible, we will assume that the
ex-dividend date is the same as the date of payment. After the dividend will
be paid, the stock price will fall to $8.93 ($18.93 - $10).

Let's examine now another possibility for the firm. Suppose the firm
will pay $11 per share right away. This will be a total of $22,000 for dividends.
Since the firm only has $20,000 right now, they must come up with an
additional $2,000. They can raise the extra money by either issuing new
stock or selling bonds. For our purposes, let's say that they issue new shares
of stock. Knowing that the required rate of return is 12\%, the new
stockholders will want $2,240 at $D_1$. This will leave only $17,760 for the old
shareholders. The new dividends to the old stockholders will decrease to
$8.88 ($17,760 / 2,000). This will give us a present value of the dividends
per share of:

\[ \frac{$18.93 = \frac{$11 + $8.88}{1.12}}{1} - \text{Eq. 2} \]

Note that the present value for Eq. 1 and Eq. 2 are the same. This
shows us that changes in the dividend policy had no effect on the value of a
share of stock. This is the work of Modigliani and Miller.

In the previous example we used net present value to determine that
dividend policy has no effect on the price of the stock. Now let's look at
what investors could do to change the amount of cash flows from dividends,
to their desired needs. This will once again show that the dividend policy of

the company is irrelevant, since the dividends can still be manipulated by the
investor.

For example, an investor who would like $10 of dividends per share at
both time periods ($D_0$ and $D_1$). The investor would not be upset if they got
$11 at time period 0 and $8.88 at time period 1. The reason for this is
because that investor can take the extra $1 and invest it at the rate of 12\%,
and receive one year $1.12. After all is said and done, the investor will
receive $11 = $10 + $1.12. Since it will be invested at time period 0, and $8.88 + $1.12 + $10 at time period 1. Let's now take the other
side of the coin, suppose the investor wants the $11 dividend at time period 0
and the $8.88 dividend at time period 1, but the firm wants to pay $10 at
both dividend dates. What the investor can do is sell of shares of stock that
equals $1. What this will do is give him $11 at time period 0. Since he sold $1
worth of stock, he will receive $1.12 less dividends at time period 1. That
will bring his time period 1 dividend down to $8.88. This process is called
homemade dividends. Homemade dividends is a process by which an in-
vester can undo corporate dividend policy by either selling off shares or
reinvesting excess dividends to get the cash flow that they desire.
Marketing By Color
The players, the principles, the pageantry

STEVEN MIODOWNIK

Introduction

LOGIC DICTATES that the color and hue, tint, tinge, and tincture of a product neither enhances nor diminishes its quality. A dark green metallic Bonneville can negotiate a turn no faster than a midnight black one. An igloo cooler painted red and blue can preserve a sandwich no better than one shaded lime green and tangerine. But the human is an emotional being; he is subject to subtle forces that qualify logical thought and cloud perception. Foremost among these silent influencers is color, which can stimulate or stifle interest in a product like no other external factor.

THE MARKETER has only recently learned to harness the power of color, and increased consciousness of color's ramifications has begotten a cottage industry of color analysis and prognostication in which marketing and psychology gloriously intersect: Input from the self-proclaimed "color experts" has become a prerequisite in product production; scholarly color studies perpetually materialize in the nation's respected trade journals; and

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Portfolio

Marketing By Color

Color gurus swap "swatches" at bi-annual color conventions in their quest to prophesy America's future predilections.

THE WEALTH of color literature this revolution has spawned provides us with much information through which to sift. We will attempt to digest the data in several stages. First, we will delve into the psychological significance of each color in the spectrum, including the physiological implications of race and gender in color preference. We will follow that discussion with a survey of the scholarly literature that has appeared in major marketing journals in the past five years. What insights can be gleaned from the scientific studies marketing researchers have recently performed?

FINALLY, we will examine the evolution of color in certain key industries to present the application of the principles established in previous sections. Special attention will be paid to the automobile industry, where the most dollars and hours are expended to create that perfect color.

WHAT WILL ULTIMATELY EMERGE from our findings is the sobering fact that inauspicious color selection can kill an otherwise viable product, while wise color selection can safeguard a product's survival in a crowded marketplace. The critical implication for education is that color training must be implemented in the marketing classrooms of America.

The Colors of the Spectrum

Various studies have proven that each color has a specific psychological effect on human beings. Color can excite or calm. It can be masculine or feminine, invigorating, mysterious, or pure. Color is consequently a powerful tool for shaping customers' feelings and responses; its correct application can hold attention and reinforce the visual and auditory images of words. According to Gerron Vartan, vice-president of San Francisco-based S&O Consultants Inc., "of the four essential elements of packaging - the product name, package structure, graphic design, and color - color has the potential to be the most dominant. A new brand name can use the predominant color in a category to gain immediate association and legitimacy."

Before surveying the color studies marketing experts have performed, we will examine the characteristics of each color in the spectrum.
RED

The qualities associated with red include excitement, vitality, speed, danger, power, danger, strength, passion, love, and warmth. Of all colors, red stimulates the highest degree of emotions. Exposure to a red environment - or even thinking about red - can cause a significant increase in blood pressure, pulse, and respiration. (The February 1995 issue of Supervision therefore advises against a red motif in a doctor’s office.) Muscle reactions take place faster in a red room and laboratory animals grow faster in a red environment. But painting the factory walls red makes workers tire more easily; weights feel heavier, time seems to pass more slowly, and temperatures seem warmer. Red increases the appetite, however, leading restaurants to go for red decors.

Marlboro, Coca-Cola, Campbell's, and Colgate, besides being among America's best-known brands, have red packaging in common. Other brands with red logos or names include Kellogg, Nabisco, Duncan Hines, Betty Crocker, Jell-O, Cracker Jack, Dentyne, Budweiser, Arm & Hammer, and Band-Aid. Experts agree that this is no coincidence: red is warm and bright and not intimidating on packages. Consumers are drawn to red because of the feelings it evokes. Louis Cheskin, a marketing psychologist, called the phenomenon "sensation transference." Cheskin, in repositioning Marlboro in the 1950s, added red to give it an appearance of full flavor and high quality.

At a 1986 American Marketing Association San Francisco chapter meeting, marketer Michael F. Purvis noted that red can mean "strength in cleaning products, sweetness in candies, cookies, and some mixes. In meat, it basically communicates freshness, or it can be medicinal, as in the Red Cross." The versatility of red is consequently astounding.

A 1927 study revealed that females prefer a pure red color above all others with blue as the second preference; the order is reversed in males. Carlton Wagner, a psychologist who tries out his color theories in the marketing world, maintains that within red itself, men favor hot, yellow-based reds and women prefer reds with more blue in them. Ford Motor Company used his advice and painted its male-targeted Mustang GTs and female-targeted Probes in different types of red. (Wagner has received some flack within the medical community for suggesting that some shades stimulate the endocrine and pituitary glands to send chemical signals to the brain.)

Pink, a lighter form of red used heavily in women’s cosmetics, exudes a quality entirely different from red and really deserves its own category.

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Pink is the color of softness, sweetness, naturalness, dependability, substance, comfort, nurturing, and security.

ORANGE

Orange means sociability, playfulness, warmth, and vibrancy. Orange is a food color, communicating a citrus feeling. Significantly, orange denotes "cheap." Wienschnitzel, the 350-outlet hot dog chain, added a touch of orange to its magenta and red color scheme in 1983 and sales immediately rose 7%; consumers had received the message that Wienschnitzel sells cheap hot dogs. The color orange is therefore uncommon in the American product line. Nickelodeon defector Geraldine Laybourne specifically chose orange for her company’s new logo because of its ugliness and uniqueness in the cable television marketplace. Other orange brands include Wheaties, Uncle Ben’s, and Sanka, which also possibly aim to stand out on the shelf.

Experts advise against using orange to mark tools or other non-consumables. Orange-handled scissors were born for safety reasons but persist due to acceptance of orange on that one product. Orange additionally raises the heart rate, so it should not be used in a break area. Nor should company cars be adorned with orange because of the “cheap” connotation. Lesson: orange is great around fast food and other inexpensive products, but dangerous elsewhere.

YELLOW

Yellow brings with it vitality, newness, sunshine, warmth, good cheer, and happiness. By conjuring up “emotional sunshine,” yellow is the color of replenishment. Too much yellow, however, can cause an increase in overall frustration. A pastel yellow is a real attention-getter but it also induces stress. In addition to orange, yellow means citrus. In the meat industry, yellow means poultry, and in some instances it connotes dairy or spiciness. "Yellow" brands include Cheerios, Pennzoil, Kodak, Bisquick, and Nuprin.

Yellow does have its problems, though. Often it does not stand out as much as stronger hues and can lead to confusion. When used on floors or walls, yellow upsets our natural inclination for earth tones to walk on and forest tones around us. Yellow packaging additionally seems to indicate danger: In 1983, Pharmavite Corporation changed its Nature Made vitamins packaging from yellow to beige and brown after studies showed that people were mistaking the vitamins for ant poison.

GREEN

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GREEN
Especially in the “green” nineties, green means freshness, coolness, harmony, refreshment, growth, abundance, spring-time, and environmental friendliness. Green is restful and stress-reducing, and consequently the color of choice on the walls of hospitals, schools, and government buildings. Green makes things seem lighter. Green connotes food, especially vegetables, and is appropriately splashed on the packages of Del Monte and Green Giant. An aura of coolness emanates from the green packages of Seven-Up, Sprite, and Heineken.

Roseann Forde, fashion director of women’s apparel for DuPont Fibers, hypothesizes that green’s current popularity (especially in the automobile industry) is the product of increased interest in environmental preservation and the “nagging feelings of uncertainty” of the economically unstable nineties. She advances that corporate downsizing and financial insecurity increase stress. People consequently reach out for soothing green in clothing, home furnishings, and especially automobiles. The last time green was so immensely popular was during the late sixties, when social unrest was rampant. But during the prosperous seventies and eighties, green virtually disappeared.

Why is green so soothing? It is a prominent color of nature, reminding people of tranquil forests and fertile jungles. By experiencing nature, people in a green environment feel reborn and fresh. Green is consequently used in employee-assistance training; it is featured heavily in the rooms television guests wait in before appearing on a show (“the Green Room”); and it is painted in the areas where theater performers await their cues.

**BLUE**

Blue, like green, emits coolness and calm. But it also means peace, tranquility, trust, reliability, tradition, bonds of association, belonging, and cleanliness. Blue decreases blood pressure, pulse, and respiration. A blue environment helps treat headaches, hypertension, and insomnia. Blue should not be used in the workplace because no stress at all results in little work getting done; blue should be confined to rest areas.

The marketer must note that lighter blues differ from their darker counterparts. Light blue (or faint violet, for that matter) conveys a serene feeling if painted on a ceiling.

Police officers sport dark blue uniforms to convey respect and responsibility, and businessmen don dark blue suits for the same reason. “Prestige blue-green” is a classy color and is the highest indicator of financial success. Blue is associated with water and is heavily displayed on laundry and bleach packaging. It is generally not a food color, although several food brands experimented with blue packaging, including Maxwell House, Van De Kamp’s, and Planters. Blue packaging is especially appropriate for Windex and Downey, though.

Midrange blue is the nation’s favorite color, but men prefer blue more than women. Blacks like blue more than whites do, and advertisers in black-oriented magazines are advised to use more blue than red.

**VIOLET/PURPLE**

Purple is the color of royalty and dignity. It connotes spirituality and sensuality, and is the most restful color. It is not well-accepted for relaxation techniques, however, because it alone is too strong. Purple should rather be employed as an accent color to subtly relax its viewers.

Lighter purples have become increasingly popular in the past couple of years - especially in the automobile industry - as people seek muted earth-tones in which to envelop themselves. Leslie Harrington, co-chairwoman of the Color Marketing Group and color consultant for Benjamin Moore Inc., explains that “the new palette is inspired by nature, the earth, the waters, and the sky.” Hence the current increase in washed-out and faded colors.

**BROWN**

Brown, like green, is a friendly nature color, reminding us of trees, bark, and roots. Like lavender, it is an earth tone. The safety and security associated with this imagery is perhaps the basis for the brown colors of security-guard uniforms. In that respect, brown is like blue in commanding respect.

Using light earth tones in training rooms tends to slightly increase learning rates, while dark earth tones provide a restful environment.

**BLACK**

Black is useful in creating an image of sophistication, elegance, prestige, darkness, mystery, or magic. Predominantly in the automotive industry, black is a power color. The allure of black, however, does not translate well to many other types of products, especially food products. For aforementioned reasons, most marketers resort to the bright reds, greens, and yellows to package their food products. Black is a nonfood color and it communicates neither freshness nor flavor.

But black is slowly inching its way toward acceptability on the
supermarket shelf. Minute Maid broke the black taboo with its unique orange juice containers, and other marketers soon noticed that black can lend elegance and make a dramatic statement. Black then became popular for upscale brand extensions like Miller Brewing Company’s Miller Reserve and the “gourmet” extension of the Folgers line. Black’s image of understated quality was actually first established in 1972, when Spanish winemaker Freixenet distributed its Cordon Negro sparkling wine in a coal-black bottle, despite warnings that black symbolizes death to Americans. Now even lower-end products successfully use black’s differentiating imagery, among them Bon Ton Foods Inc.’s cheese popcorn, and Keebler Co.’s Hooplas! corn chips.

**WHITE**

White is one of the most-used colors on the supermarket shelf because it means pure, clean, mild, light, and recently, generic. But in general, white conveys a sense of virginity, youthfulness, prestige, cleanliness, and buoyancy. White is neutral and thus non-intimidating, and it provides an excellent background for splashes of other colors. Products that have successfully used white include Gold Medal Flour, Grape-Nuts, and Lean Cuisine.

More shaded variations of white include vanilla or faint peach, which if used on walls or ceilings achieve a mood of spaciousness and cleanliness that is crucial in a retail environment.

**The Studies**

Now that we are familiar with the connotations of the different colors, we can proceed to the more sophisticated studies that have recently been conducted. Within their conclusions lie powerful implications for the marketer and consumer alike.

**Red versus Blue Retail Environments**

In 1992, Joseph A. Bellizzi of Arizona State University and Robert E. Hite of Kansas State University simulated retail environments using predominantly red or blue colors. In their report, published in *Psychology & Marketing*, they conclude that “more positive retail outcomes [occur] in blue rather than red environments.” These positive outcomes included more simulated purchases, fewer purchase postponements, and a stronger inclination to shop and browse. Indeed, Bellizzi and Hite hypothesized that blue displays would produce greater purchase rates than red displays based on the psychological studies which found blue more calming and pleasant.

In their first experiment, Bellizzi and Hite subjected 70 adult women to one of two conditions: the subjects were choosing among five similar television sets, but for some the environment was red and for others it was blue. Among the results was the following: 39% of the shoppers in the “red store” postponed selection while only 18% did so in the “blue store.” Shoppers in the red store spent an average of $314 while the blue store’s average was $458. Although not hypothesized, the shoppers in the blue environment chose the highest-priced set more than the shoppers in the red environment.

Next, Bellizzi and Hite subjected 107 undergraduate marketing students to slides of the “interior” of a retail furniture store, which was artificially shaded either red or blue. The students were then surveyed for their response to the visual. As expected, students shown the blue environment expressed a greater intention to shop, browse, and buy in the simulated store. The respondents reported a more pleasant feeling in the blue store than in the red one.

Our discussion in the previous section regarding the pull of “red” products does not necessarily negate these findings. Red packaging does indeed excite and arouse, but perhaps within a blue environment consumers are more inclined to purchase in the first place. Within such a serene setting, red then psychologically attracts, like a matador waving his cape at a bull.

**Pink, Green, Yellow, and White Stationery: Survey Response Rates**

A 1994 study examined - among other questionnaire response rate variables - the effects of color of stationery. Thomas V. Greer of the University of Maryland and Ritu Lohtia of Georgia State University conducted the study because “no conclusive evidence [existed] about the effect of paper color on survey response rates,” although five studies had experimentally analyzed the response effect of questionnaire color. Among the findings of those studies was a more positive response to pink over yellow, and a similar preference for pink over white.

Greer and Lohtia mailed 800 white, yellow, pink, or green two-page questionnaires to potential respondents. All four colors received approximately the same number of responses, however. The authors noted, though, that “other important colors, color combinations, or color sequences may have some potential for affecting response rates and quality of cooperation.” They also suggested that “perhaps there is a seasonality in survey color effects, just as the phenomenon one sees in some consumer
goods."

In a similar 1995 study of the effect of visual stimuli on mail survey response rates, Raymond LaGarce of Southern Illinois University at Edwardsville was surprised by "the strong positive effect of color" as opposed to black-and-white. An attempt to discern between the colors of the spectrum was not made.

Cultural Color Preferences

By comparing the colors of business-to-business advertisements in the United States and Taiwan, Jen-Hung Huang of Taipei's National Chiao Tung University demonstrated in 1993 that the usage of color is affected by culture. He showed that American advertisements employ more brown and less yellow than Taiwanese ones, and he attributed this to the different countries' colors. The author noted that yellow is considered by Chinese and Taiwanese to be the color of royalty, that the Chinese expression "to get to wear yellow robes" means "to become a king," and that at least 5% of Chinese have yellow as their surnames. Common American surnames, however, include brown, white, black, and green. Huang's scientific analysis was a comparison of advertisements in the largest business-to-business magazines in the United States and Taiwan, Business Week and CommonWealth, respectively. Advertisements in CommonWealth were found to employ more yellow than advertisements in Business Week, while those in Business Week used more brown.

In the Japan of 1987, 84% of new cars were painted white. The clean and uncluttered image of white is apparently especially appealing in a conservative Japanese society obsessed with collectivism and wary of individualism. To avoiding standing out in a crowd, white is therefore a color of choice Red is too aggressive, yellow too "fun," and black too formal; white steers clear of such "dangerous" connotations.

By 1990, however, only about 40% of new automobiles rolled off the assembly line awash in white. This acutely reflects a more general Japanese societal trend toward individualism, as more and more metallic blues and Jaguar greens were spotted on the Ginza.

The Sunlight Theory of Color Preference

Rune Pettersson, after contrasting the hues of European, North American, Chinese, and Japanese articles and artifacts with those from cultures in Africa, South America, Central America, and Indonesia, concluded that visual perception is a function of geographic location and technological advancement. It seems the articles of the former cultures employ a wide range of hues while the latter cultures feature only a few bright colors: frequently white, black, red, yellow, green, and blue.

In a 1980 article in Educational Communication and Technology, Pettersson alleged that people residing in the equatorial regions of the planet develop black-and-white and color vision that is quite unlike the vision of humans farther north or south. He attributed the differences in color perception to the angle at which sunlight hits the surface of the earth, thereby affecting reflection and illumination - and color preferences.

In 1956, Faber Birren indicated that the number of relative hours of sunlight in areas of the United States could be used to calculate accurate quantities of consumer goods to stock. For example, white shoes, compared to dark shoes, would sell at about the same rate in Boston, as in Chicago, Nashville, Dallas, and Sacramento. When sunlight is plentiful, the colors favored are strong and bright. Where sunlight is less abundant, the colors preferred are softer and duller. (These regional differences were soon relegated to the history books, however, when increased mobility of the population negated physiological disparities.)

When targeting disparate markets, one must not overlook the geographic sunlight factor. According to Bob Daily, car color expert at DuPont, people in temperate climates embrace pastel colors, while dark colors sell best in more frigid climates. Sometimes, says Daily, the general color scheme of a geographic area will also influence the popularity of colors. Arizonans fancy earth tones because of the rock and sand of the region's desert landscape. Darker colors are popular in financial centers like New York because conservative blacks and grays appeal to business people there.

Red in Yellow Pages Advertising

As yellow page advertising increases in sophistication, use of red ink and white backgrounds is becoming more popular. In 1991, Kathleen J. Kelly and Robert F. Hoel of Colorado State University in Fort Collins analyzed the yellow pages advertising effectiveness of color, among other factors. They noted that the research findings related to color are "conflicting." A 1986 U.S. West Direct telephone survey concluded that 92% of those most attracted to a large advertisement were stimulated by its red ink. However, other researchers noted that red in an advertisement is less effective in spurring a reader to call that firm first. Still others claimed the color red in yellow pages advertisements makes them look "cheap and unprofessional."
After surveying 662 students from Colorado State University and the University of Wyoming who viewed differently sized and colored advertisements, Kelly and Hoel concluded that “the addition of colors... did not produce statistically significant results different from the control advertisements that used only black ink. Advertisements were neither preferred nor disliked when they included the color red.

**Color by Industry**

Let us now proceed to an examination of color usage in various American industries. By hearkening to the color marketing principles outlined in previous sections, we will now be able to comprehend the color trends in these industries and appreciate why certain color decisions were prudently or imprudently made.

**Food**

The current trend in food is blue, cobalt blue to be specific. From the newest landmark shade of M&M plain candies to Arizona Iced Tea’s new ginseng flavor, blue - not a traditional food color - is appearing in peculiar places.

As indicated by the success of Kool-Aid Great Bluedini drinks, Hawaiian Punch Fruit Juicy Blue, Jell-O Berry Blue gelatin mix, and Mejico blue corn tortilla chips, blue has superseded “clear” as the food consumer fad. In pastas, potato chips, and lollipops consumers are being exposed to more blue. Marketers say this is due to blue’s novelty value. Nicki Gondell, a trend forecaster at Ellen Sideri Partnership consequently asserts that “the surreal glare of cobalt blue represents a welcome backlash to the boring earth tones of early 1990s eco-fashion.”

But other phenomena could be responsible for the blue trend. University of California at Los Angeles psychology professor Carole Lieberman posits that recent economic downturns subconsciously turn consumers toward “chiller” colors. In addition, the 1990’s all-natural craze has enticed adults to devour blue tortilla chips and blue pastas (made from blue corn), which appear healthier and more natural. This, says Richard Lawrence of Marketing Intelligence Service Ltd., is also the product of a desire to adopt the simpler gastronomic patterns of the ancients.

**Electronics**

Contrast the bright and bold trend in the food industry with the colors of the electronics industry: bland and dull whites, grays, and blacks. Personal computer purchasers can choose between putty gray, snow white, and black hardware; boom boxes, walkmans, and television sets appear primarily in black, though color breakthroughs have been made in those products; and ubiquitous black cameras line the shelves of the country’s technology outlets.

I.B.M. was a dominant force in setting the color theme for the computer industry, and it mainstreamed the noninvasive and conservative casing colors for computers. The reason: those utilitarian hues blend into the decor, giving the end user ergonomic benefits by keeping his focus on the screen, not the monitor or hard drive casing. Additionally, the professional appeal of grays and blacks is unsurpassed: Gary Podwalny, industrial design manager at Hewlett-Packard Co., notes that in a computer consumers seek “a tool, not a gadget.”

Steven Skov Holt of Frog Design, an industrial design firm in Sunnyvale, Calif., pushed for all-black computers because “black is the color of performance - it speaks to the power and quality of the machine. It is almost imposing, connoting a level of chic.” In 1994, Apple Computer released its Macintosh TV, an all-black computer, to complement other home entertainment components.

Experts note, however, that as computers become even more common as sources of entertainment and forums for communication, a wider palette of colors will become available. Computers will indeed soon be perceived as “gadgets” besides being powerful “tools,” and the trend will be for the trendy.

A veritable spectrum of colors (from lime green to lavender) was experimented with on boom boxes during the 1980s. Greater familiarity with the technology certainly bred a desire for brighter colors (“fashion audio”), but many retailers were burned because they could not accurately predict where the country’s tastes were turning. Still, many personal cassette players and television sets succeeded with color in the 1980s - Sharp offered its QT50 portable radio/cassette player in pink, green, and white in 1984 and Sony Corp. offered 20- and 25-inch television sets in plum, beige, and pearl in 1986. Telephones began appearing in different hues even earlier. This trend could soon be repeated in the computer industry, as marketers offer their customers more choice.

Sometimes successful colors of technology are selected by whim, however. A case in point is the story of the 1994 repainting of United Airlines’ airplanes dark blue and gray due to the CEO’s personal preference. Repainting airplanes takes tremendous financial commitment, and
United Airlines chairman Stephen Wolf realized this when he replaced his fleet's red and orange stripes on fields of white with midnight-blue bellies, dark-gray upper fuselages, and dark, two-tone tails. While the new "stealth" look is unpopular with air traffic controllers who claim UAL's planes are too dark to discern in cloudy weather or at night, and is responsible for greater fuel expenses on the part of UAL due to greater difficulty in cooling cabins, consumer surveys indicate that the color scheme connotes "elegance" and "safety." Apparently, it's image over substance in the area of color marketing.

Automobiles

In a 1988 survey conducted by DuPont Co., eight out of ten new car buyers rated a vehicle's finish as an important factor in their purchasing decision, and more than six out of ten rated the paint job as "very important." With color a significant component of a paint job - along with durability, protection, and paint warranty - the nation's automakers scramble annually to coat their models with the most desirable hues.

According to Bonnie C. Cunningham, color and trim specialist at Ford Motor Co.'s design center, automakers start developing new colors for cars and trucks three years before they will actually be used. Even colors for seat belts, labels used on the car or truck, and paint used under the hood are examined and deliberately planned. Thus, at any given time, colors for three or four model years exist in various stages of development and testing. Auto dealers have even experimented with color preference testing and software.

The three giants of automotive paint are PPG Industries, BASF Corp., and DuPont; the changing color preferences of the nation clearly display themselves on its automobiles. In 1987, the most selected colors in the domestic market were white, then silver, then light blue. Bright red was making a comeback, however, in the Pontiac Firebird and Chevrolet Camaro. Technological advances were allowing new pigmentations to be designed, granting the automakers a wider palette within which to work: pearl, satin mist, and bronze powder were developed for future use. Pearlescent paint - applied in a novel, three-coat process - was first available on the Cadillac Allante. "Soft paint," a urethane-based paint sprayed on plastic trim pieces to give them a more natural and leatherlike appearance, was being developed by General Motors' design staff.

In 1988, taupe first became a popular color in cars. Bob Daily noted then that purple and shades of purple had been influencing fashion for several years. Purple's acceptability was the product of subtle desensitization by the fashion industry.

DuPont paint expert Bob Daily, at a 1988 convention, accurately predicted that through 1990 customer preference for medium grays would remain stable, and that red and blue would rise in popularity. Of 1991's biggest colors, he confidently stated, would be rich, deep brown - the climax of a brown trend that actually began with red-based browns in 1987.

But by far the most significant trend Daily spoke of was a resurgence of fun colors - like those of the 1950s - on fun cars. For luxury and sport-luxury vehicles, though, deep earth tones would rule the day. (Ecology indeed influenced a resurgence of teal, aqua, and jewel-type greens.) Especially by 1995, both dark and light greens would be back "in," though greens rarely dominate the automobile paint palette. With technology the driving force behind color innovations, automakers began experimenting in 1990 with metallics, mica-enriched paint, and thick clearcoats. In 1992, Chrysler Corp. established a color control program to enforce critical color and gloss standards.

Daily foresaw an eventual tailoring of colors to specific vehicles - pickup trucks, minivans, luxury sedans, and economy cars. Daily also noted that color is an integral enhancement of automotive shape: "The shapes are going to be different in the '90s, more aero, more sculpted, more stylized shapes. We'll see color more conducive to those shapes, generally lighter in value, brighter and cleaner, more chromatic." In 1991, Marilyn White, manager of advanced styling for PPG, also looked for 1994's models to be dressed in lighter and brighter hues.

But one comment of Daily's underscores the automotive industry's fierce commitment to color research and development: "There's a lot at stake because a wrong choice essentially wastes the car with that color for at least a model year, maybe two. Worse yet, if an interior is developed around a certain family of colors, and those colors are wrong, you might waste three to four years on that car... Color sells, there's no question about it.

In every consumer products industry in America, color analysis and selection is a crucial product development stage, a yardstick of a company's understanding of its markets, and an investment in the future of that company's precious offerings.
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Ethics of Information Disclosure Strategy

Richard Grossman

The 1970's and the 1980's can accurately be described as the years of fuller disclosure. Corporate financial statements became thicker and more complex; adorned with detailed footnotes and supplementary information. This is a result of an attempt to provide an overall view of an economic entity through its financial statements. The use of consolidated data can still hide many of the details that might be useful in predicting profitability, risk, and growth, which conflicts with the purpose of financial statement disclosures—to facilitate such prediction.

An example which is demonstrative of how the Financial Accounting Standards Board (FASB) has tried to make the financial statements of companies more representative of their operations is Statement No. 14, "Financial Reporting for Segments of a Business Enterprise", which required that corporations disclose data about their operations in different industries, foreign countries, their export sales, and their major customers. This statement required three kinds of disclosures. Firstly, a company must disclose the revenues, profits, assets, depreciation, and capital expenditures of all its reportable industry segments, which are defined as a product or service or a group of related products or services. Secondly, companies with significant operations in foreign countries must separately disclose the results of operations based on geographic area. Finally, companies must report aggregate sales to any customer if they account for more than ten percent of revenues.

Shortly thereafter the Securities and Exchange Commission (SEC) mandated in 1980 that public companies' annual reports include a management's discussion and analysis (MD&A) section that assesses the enterprises' liquidity, capital resources, and operations in a way investors and users can understand. The main goal of this was to make public information about predictable future events and trends that may affect future operations of the businesses. Unfortunately, according to Moses L. Pava and Marc J. Epstein, the goal of the SEC has not been adequately fulfilled.

Therefore, "eight years after the MD&A ruling, the agency issued guidelines on exactly what data it expected companies to incorporate in MD&A statements. It said it wanted each business to provide information about company-specific and industry-specific trends affecting its bottom line. Currently, many in the SEC staff are still not satisfied the agency's original goals are being met."

Many choices are available to managers within the regulated domain of Generally Accepted Accounting Principles (GAAP) which gives managers a wide leeway. For example when computing earnings and asset values, managers can choose among various inventory (LIFO, FIFO, weighted average) and depreciation (accelerated, straight-line) techniques, and one of two methods of accounting for corporate acquisitions (purchase, pooling). In addition to the varying accounting techniques, managers have a considerable amount of latitude in making forecasts and estimates.

These and many other disclosure choices within GAAP have significant effects on the information reported to readers and the decisions made based upon these reports. For example, "General Motors Corp. revised in 1987 the estimated service lives of its plant, equipment, and special tools, as well as the rates of depreciation for automobiles on operating leases to retail customers. These changes increased income by $1,491 million, amounting to fifteen percent of GM's reported operating income for 1987 ($2,569 million)."
Due to the variety of available methods under GAAP, and because significant deficiencies were recognized in financial reporting, auditing became increasingly popular and necessary. The Report of the Committee on Basic Auditing Concepts defines auditing as

"a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users." Auditing was set up in order to provide a system of checks and balances to motivate preparers of financial statements to disclose information objectively.

There are two things which should mainly guide managers within GAAP disclosure choices according to Baruch Lev. The first is, conformity with the accounting practices used by peer companies. Such disclosure will positively affect securities' value by reducing outsider's costs of obtaining information regarding the status of the company within the industry. Secondly it is important "to convey management's message in the most effective and credible manner." Such effectiveness can be accomplished through conservative accounting techniques. Conservatism refers to selecting the method of measurement that yields the gloomiest immediate financial results without allowing accounting techniques and estimates to have an impact on reported earnings and asset values.

Many times managers attempt to give the impression of higher earnings and stock prices through the use of aggressive accounting techniques and the various alternative accounting methods. However, according to Lev, such accounting is known to be symbolic of operational difficulties. Therefore, aggressive accounting can lead to managers obtaining bad reputations and losing credibility regarding communication. For example, "alarmed by sinking credibility among customers and investors, because of rampant manipulation and aggressiveness of financial reporting, executives of more than a dozen software makers (e.g., Lotus Development Corp., Ashton-Tate Corp. and Sybase Inc.) announced on October 9, 1990 the formation of an industry self-policing group—the Software Business Practices Council, aimed at reforming what its members call widespread, misleading and sometimes unethical marketing and accounting practices. These practices "adversely affect the credibility and health of our industry", a council statement says."
and therefore warrants careful attention.\textsuperscript{12} In a study of one hundred U.S. companies, he found that fifty-five had four or less voluntary disclosures in seven years, while only sixteen companies made a disclosure voluntarily in that time. Hence, according to Lev, like other major corporate functions, disclosure strategy should be decided on a cost-benefit basis. If disclosing a specific piece of information will be beneficial to the company then it should be made public; if not, then it should be kept quiet.

The type of voluntary disclosure, referred to by Lev, was found to influence market activity both positively and negatively. For example, "a new product announcement, such as the IBM introduction of the PC-XT, caused an increase in shareholder value in just a few days."\textsuperscript{13} Another example is, "corporate executives' announcement of favorable forecasted earnings caused a two percent increase in stock price in the month of the forecast."\textsuperscript{14} These and other similar examples demonstrate that voluntary disclosure can help companies as well as their shareholders. In addition, without proper disclosure activity a permanent information gap will exist between the company and its shareholding public. Findings show that this gap can be costly, due to the constant desire of shareholders to obtain information on the company. This can cause friction between managers and shareholders, and eventually this conflict can depress market value and the companies' performance.

One of the objectives of disclosure should be to eliminate the misvaluations of firms which exist when the market value of a company differs from its intrinsic value. The source of such misvaluations is the information gap that exists between managers and outsiders which can be mitigated through the use of financial indicator ratios. Another benefit to disclosure is the enhancement of the liquidity of securities through the reduction of the costs that investors must incur to trade in the marketplace.

The demand for a firm’s securities can also be more readily enhanced by providing specific information to certain investors. Such a disclosure would also provide a third benefit, it would help provide a better shareholder mix. By disclosing a certain type of information, the company opens itself up to a specific type of investor. A final goal of releasing certain information is to deter political intervention and to gain a competitive advantage. Regulators are always on the lookout for unusual corporate behavior. The use of conservatism and a full disclosure strategy can help avoid any unwanted investigating by avoiding the gaze of such investigators.

On the other hand, disclosure has costs as well as benefits. These costs can be divided into two types, direct costs and indirect costs. The direct costs are the cost of releasing information, including its verification and the incremental cost of the release itself. The indirect costs are considerable as well, but they can not be easily quantified. These costs include

\begin{quote}
"those resulting from the impact of disclosures on company decisions and activities (e.g., the impact of a negative earnings forecast on supplier’s terms of sales and credit), the competitive position costs (e.g., benefiting competitors by disclosing proprietary information), and litigation costs."
\end{quote}

However, among these costs, managers are most concerned about the potential cost of lawsuits arising from such disclosures; legal counsels frequently advise to abstain from divulging such information. Yet, by the same token this fear does not automatically lead one to conclude that a no disclosure strategy is optimal. There is an old proverb that "no news is bad news" and therefore when investors have reason to believe that managers possess relevant information yet choose not to disclose it, they will suspect the worst and act accordingly.

In addition, a no disclosure strategy would not necessarily prevent litigation. Corporations may be sued on the basis that they had a duty to disclose information without which financial reports would be inaccurate, incomplete, or misleading. Such disclosures would normally be disclosed in the MD&A section, a section that also has requirements which must be fulfilled. Therefore, not disclosing information that may be perceived by managers as negative would not necessarily be beneficial in the long run because the information will eventually become known.

In contrast, Moses L. Pava and Joshua Krausz feel that some of the points made by Baruch Lev are unfounded. They agree with the assumption that disclosure activity needs planning and careful attention by corporate officials, and they also concede to the fact that these disclosures cause profitable gains to the market. However, Pava and Krausz attack Lev’s statement about treating disclosure on a cost-benefit basis. According to them, the idea of using cost-benefit analysis to handle disclosure activities is counter-productive. One of the objectives of disclosure, that Lev enumerates, is to eliminate the information gap that exists between managers and shareholders. However, if cost-benefit analysis is used to implement disclosure techniques, then that gap will only be widened. Another shortcoming that Pava and Krausz point out regarding Lev’s thesis, is about his opinion that there is a need to go beyond cost-benefit analysis. This
inconsistency totally undermines his main idea that disclosure is just like any other major company activity.

Due to these criticism’s, Pava and Krausz offer their own theory to explain the importance of disclosure. They feel that corporate social responsibility plays a major role in the disclosure issue. They opine that there is a moral and ethical factor that should be taken into account in the decision-making process regarding disclosure. They propose the idea that a “moral pull, rather than a self-interested push” is how managers should view the disclosure of information. Also, a cost-benefit approach to disclosure will not provide the economic gains that Lev has predicted will occur. Rather, an ethical component must be taken into consideration when disclosure is practiced by corporations of the business world.

An assumption that underlies a prescription for a voluntary disclosure strategy is that people do act unselfishly. This is an ethical question that can be advocated both for and against, but must be assumed in order to expect managers to disclose information that is not required by GAAP. Too often an ethical dilemma arises where what is good for one party affected by the choice is not good for another party affected by the choice. “It has been said that in such situations, individuals should ask two questions: “What good do I seek?” and “What is my obligation in this circumstance?”

Over time a system of general ethics has been developed to help define what is good for an individual and society, and to try to establish the nature of obligations or duties that individuals owe themselves and each other. Two groups of philosophers arose,

“the ethical absolutists say there are universal standards that do not change over time that apply to everyone. The other group, the ethical relativists, say that people’s ethical judgments are determined by the changing customs and traditions of the society in which they live.”

To some degree both of these are correct, and since no universal set of standards exists to guide managers in their decisions, a six-step framework has been developed for general ethical decision making. The steps are: obtain the facts relevant to the decision, identify the ethical issues from the facts, determine who will be affected by the decision and how, identify the decision maker’s alternatives, identify the consequences of each alternative, and make the ethical choice.

While professional ethics may be designed in part to encourage ideal behavior, they must be realistic. On the one hand, the existence and study of business law hinges on the assumption that if given the opportunity man will act only for his own advancement. This can best be depicted by a quotation of W.C. Fields, who said that “anything worth having is worth cheating for”. Similarly, neo-classical economists believe that practically all behavior is driven by pleasure and self-interest, and any altruistic acts are accounted for as really being an effort to enhance one’s own reputation and to gain social approval.

Nevertheless, Amitai Etzioni feels that there are studies which show that people do acts that would be labeled as authentic altruism.

“Several experiments show that many people mail back lost wallets to strangers. In another study, sixty-four percent of the subjects who had an opportunity to return a lost contribution to an Institute for Research in Medicine did so. The costs are forgoing the found cash, as well as paying for postage, and going to the trouble of mailing the contribution. The reward? Chieflly, the inner sense of having done what is right.”

Whether one believes that people can act unselfishly or not, Pava and Krausz’s suggestion of a voluntary disclosure strategy based on ethics is still feasible. If one believes that people do at times act unselfishly, then it is a understandable and logical to conclude that managers would and should disclose information for similar ethical reasons. However, if one is under the assumption that people are basically motivated by self-interest, then one may think to question the reasonableness and applicability of such a prescription. Nevertheless, even in such a scenario, there is a general belief that mixed together with a self-interested motive is the desire to act in an ethical and socially acceptable manner. Amitai Etzioni supports such a conclusion in his studies; he says that “persons who make donations to charity may act to enhance their reputation and their self esteem, and because it is the right thing to do.”

Both of these methods of disclosure, Baruch Lev’s and Pava and Krausz’s, have their own merits, but Pava and Krausz’s ideas are more ethical and fit better with the conceptual framework of GAAP. One of the main reasons that accounting information is deemed credible by investors is that it is assumed that the information is reliable and neutral. If Baruch Lev had his way, accounting information would be merely a tool for firms to use to hide or inflate profits as the situation deemed necessary. As he states, “the financial reports of companies are the prime source. Managers could serve their own interests by manipulating accounting information as they
saw fit. Even though it may be argued that the managers only work for the shareholders' interest, the fact remains that it usually is not in the shareholders' best interest to be deceived, even if it is intended for their own benefit. In any event, once managers are given control over information disclosure they may use this strategy to further their own agendas.

Even though an information strategy should not just be based on a narrow cost-benefit analysis, some specific strategy for disclosing information must occur. For example, information should be disclosed on a long-term consistent basis, rather than on a haphazard one. Thus, managers should try to form a disclosure strategy that reflects the true worth of the company and increases the company's credibility among investors. This can be achieved by timely, complete, and ethical disclosures of neutral information.

Obviously, this view of a disclosure strategy based on neutrality, is also most consistent with the Jewish belief. This strategy would conform with Jewish thought based on truth. The sages taught that the world rests on three pillars one of which is truth. A strategy that is based purely on a cost-benefit analysis basis will obviously distort the truth if the cost is too high. Also, in Jewish thought there is a principle that a person's actions affect his traits. This means that if a manager begins by manipulating information to help his own interests, he may soon engage in more fraudulent activities. The end result will be that he will deom the company to eventual lawsuits by investors. Conversely, if managers deal with neutrality when deciding on what information to disclose, the atmosphere of truthfulness will extend to other areas of the business as well.

In addition, there is an old proverb that says "power corrupts and absolute power corrupts absolutely". If it is left up to managers to decide what or what not to disclose, this right will be abused because managers can usually be expected to consider their own interests over those of the shareholders. The way to protect the investor from this selective informational flow is to insist that all managers follow the rule of neutrality. This way investors will know that the information that is provided is accurate and not tainted by a manager's own interests. Thus, the integrity of accounting information will be beyond reproach, and the market will be able to function effectively based on this information.

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International Stock Opportunities

Elli Himelstein

Expanded opportunity, above average economic growth, and diversification are just a few of the advantages afforded by investing overseas. With the global changes that have occurred over the last ten years, international investments have become more and more popular. Foreign stock purchases by American investors have hit record highs in the past year. According to the Securities Industry Association, US investors bought a record net $21.6 billion of foreign stocks in the third quarter of 1995. This popularity is primarily due to the large amount of opportunities found in foreign markets. Goldman Sachs shows that almost two thirds of today’s stock opportunities are found outside the United States. Many international markets have also outperformed the American market over the past ten years. The United States shows an average annual stock market return of 13.1%, while Hong Kong has a 27.3% return. Recognizing proper diversification as the key to a strong portfolio, many investors have looked beyond America. Investing in the available foreign markets can help protect your investments from being hurt by any wide swings in one market. With all these benefits it is easy to understand the trend towards foreign invest-

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Once you decide that you would like to invest in foreign markets, there remains the question of how exactly you may go about doing so. Fortunately there are numerous choices available to pick from to enhance your portfolio. Though a little more conservative than the rest, Global Mutual Funds simplify the investing process. In this type of fund the manager has the option to buy stocks or bonds anywhere in the world, including the US. This investment offers broad diversification and inherent safety. International Funds are similar except they do not invest in the US. There are also Global Mutual Funds, which focus on specific industries. Investors who are interested in a specific region of the world, can look at Regional Funds. Unlike the conservative Global funds, a Regional fund can be more risky. However, they are usually focused on high growth areas that may outweigh some of the risk. There is a trade off between diversification and growth opportunity. A Single Country Fund is comparable to the regional fund in risk, and differs only in that it invests in a single country. Perhaps the most highly publicized of all the types of funds is that of the Emerging Market Fund. Here investments are made into newly industrializing economies such as Latin America or Southeast Asia. The popular “Tiger Funds” of Asia have experienced the greatest economic growth of all the regions in the world in the last ten years. These regions, tapped by the Emerging Market Fund, are in the process of developing free market economies, and stand to have a great deal of expansion. Industries that within our own country are seen as mature are only first developing in these areas. This all translates to high growth potential. A final example of foreign investing is in a multinational company. By investing in a multinational company, like McDonalds, you are investing simultaneously in the American market and abroad.

Along with the beneficial parts of foreign investment come considerable risk. Furthermore, this risk often takes on a different form than the risk of domestic investments. Holdings in international stocks will be affected both by currency fluctuations and the general political environment.

Foreign securities are bought and sold in the currency of the country that you are investing in. So when you buy a foreign stock your dollars must be converted to the local currency, and vice versa. One direct result of this is that any movement in local currency brings changes to the value of your investment. Much like a see-saw, when the dollar goes up the value of your foreign investment goes down.

Much of the success of the international market has been brought about by political upheaval. The past years have shown that numerous governments are less stable than the US. This instability clearly affects the value and price of a foreign investment. Economic events in these smaller and less stable countries also effect the market on a greater scale than in the US.

In deciding whether an international investment fits into your own personal portfolio, or that of your company, there are a number of things to consider. While foreign stocks show tremendous growth potential they also tend to fluctuate to a great degree. A short term investment can not afford to be as aggressive as a long term commitment. Experts say that a foreign investment should be held for at least five years. An investor must also become accustomed to the daily fluctuations of international stocks. A foreign investment is a delicate balance between opportunity and risk.
Managing Change
A look at Duquesne Light

SARA EDELBLUM

Machiavelli once said, "In today's rapidly changing environment, there is only one thing more difficult to take in hand, more perilous to conduct, and more uncertain in its success than taking the lead in the introduction of change—and that is managing how to get there..." In today's business world due to the incredible advances in technology, government influences, licensing and code practices, foreign involvement, competition and Management Information Systems there is a constant need for change in all areas of our lives; however, implementing these changes can be both tiresome and difficult for managers. Managers must face employees that are set in their ways and are opposed to change. Getting employee acceptance of a changed system is one of the most challenging factors that a manager must face.

"Those who are unwilling to accept change can, unfortunately become victims of it. Our jobs as managers is to influence and lead others to produce the result we've planned for...," writes Ronald L. Smith, founder and president of Service America. Smith brings up an important issue, if your business does not change along with the times, it will be left at the bottom of the market. Smith adds that there are three general steps to ensure a successful business geared for the future. First, the manager must himself accept the fact that a change is needed and inevitable. The manager must then explain to his employees why the present situation is not good enough for the future of the company. He must convince his employees that the final result will in fact be beneficial to them in addition to the company as a whole. The manager should try to get the employees to feel like they are in on the change process. Feeling "in on things" is one of the top employee motivators. He must also describe to the employees what the end result is supposed to look like in order to prepare them for what they should expect. It is better to give detailed explanations when describing what is going to change and how the change will be implemented. By being honest with the employees there are usually less misunderstandings as to what will take place. The third step in Smith's plan is to develop an action plan. Once the employees have accepted the fact that change must occur, and they understand the end result, the manager must then develop with the employees a process of how the goal can be achieved.

One industry that has become extremely competitive in the past few years is the utility industry. This change has occurred due to the deregulation of the industry by the Federal Regulatory Commission and the consumer's increasing demand for a higher quality of power. One utility company, Duquesne Light, a Pennsylvania based electrical company, responded in a remarkable fashion to the competition. The company implemented a change in their billing process which earned more revenue for the company in addition to increased employee loyalty and unity. Duquesne Light took a model approach in implementing their changes.

In order to keep pace with competition, the finance group at Duquesne Light had to identify ways to enhance the company's revenue and productivity improvement efforts.

One problem that the finance department noted was the five day billing lag (time that it takes to read the customer's meter and send the bill in the mail) that Duquesne had was longer than most other utility companies in Pennsylvania. The finance group realized that if they could combat the billing lag problem, three important benefits would result: 1) boost financial performance and improve cash flow, 2) improve customer service by reducing complaints about the accuracy of meter readings, and 3) change the finance group's attitude about managing improvement.

In the current competitive environment it is crucial for a company to manage their operation efficiently and productively with fewer employ-
ees. In order to attain these goals, it is necessary for close cooperation between the different functions of the company and to have clearly defined accountabilities. The problem that Duquesne faced was that inter-department cooperation and accountabilities were unusual, and had only been used in emergency situations. Teamwork is necessary in a company; therefore, the employees attitudes needed to be changed in order to successfully solve the billing lag problem.

The finance department took an initial attempt to solving the problem. They decided to begin with a study of existing procedures to identify opportunities for improvements. A number of suggestions were presented; however, all of the suggestions were met with objections except for the suggestion to use hand-held electrical meter reading computers. Still, while the hand-held computers would help, they would not eliminate the billing lag. The finance group soon came to the realization that what they really needed was a new strategy; one involving all the people concerned with the company as active collaborators in developing a new solution to the problem.

The problems that people face in big companies such as Duquesne Light are that after a while the work routines tend to stifle individual thought. The result of this being that managers and employees tend to retreat into the confines of their own departments while ignoring the needs of the rest of the company. In their own department they feel safe and secure and have no motivation for change. Before Duquesne could get started with their new plans, there was a necessity in the company to change the way the employees involved in the “billing lag” project felt about their jobs. The departments that would be affected were: finance, regulatory compliance, customer relations and MIS.

The finance group decided that the only way to combat this attitude problem and to get the departments involved in the project was to put together a team of representatives from each department to form a steering committee to develop a workable plan to trim the billing lag time.

Initially, most members of the committee felt that there was nothing that could be done to shorten the billing cycle, and that the system was fine the way it was. The finance department quickly responded by saying that other utilities have a shorter lag time and each day that they would trim from the billing lag was worth $422,000 pre-tax each year for Duquesne. The committee immediately started working on different solutions. The project team found a billing-process rule with decade-old procedures that had never been questioned before. Unlike the first attempt at the project, this undertaking was now it the hands of the people involved.

The project team needed to consider three areas in implementing a change. The first area is the law that utilities must allow twenty days for customers to pay their bills. Duquesne had been offering twenty-one days because a decade ago when the computer system was not working properly, MIS had requested to have an extra day added to the billing period to deal with the system’s bugs; however, managers had forgotten to trim off this extra day once the system became totally functional. The second area necessary for consideration is the procedure for generating bills. For some odd reason, normal readings were held back one day while questionable meter readings were being clarified. By simply releasing the normal readings a day earlier, nineteen out of every twenty readings could be printed and mailed a day earlier.

Thirdly, they had to look at estimated bills. Although the readings are generated every other month, it took the company just as long to process the estimated readings as it did the hand held readings.

The project team decided to take the smart approach to managing by establishing shot term goals. The result was a two month deadline in which they would have to figure out how to cut two days off of the billing lag.

With its 4,400 employees, 180 departments, and 6 levels of management the managers at Duquesne still faced the following barriers:

1. People inherently are opposed to change
2. Dragged out meetings and unconstructed work plans
3. Lack of accountability
4. Weak performance expectations and insufficient challenge
5. Bureaucracy

The project manager drew up a detailed work plan to remove these barriers. The people on the support team found this blue-print to be essential to managing the action plan in the change process; not only did it lay the groundwork for how the change should be brought about, but it also generated the support of all the team members.

The next step was to get the support of all the other departments. The project manager first approached MIS. This initial attempt failed due to the fact that the company’s chairman had recently assigned MIS a massive top-priority project. MIS felt that they were not capable of successfully completing two difficult projects at once.

The project manager attempted one more time to get MIS to support
the project by explaining to them that all they needed to do to trim the billing lag by one day would be to change a single line on the customer’s bill. MIS immediately agreed to the proposal and began to work on removing the line from the bill.

Separating the normal meter readings from the questionable ones seemed more tricky for the managers. The problem that they noticed was not in programming, but rather in scheduling. After observing and studying the MIS department for twenty-four hours, the project manager was able to devise a new schedule that would allow MIS to process the unchallenged bills while not disturbing the department’s other work.

With the estimated bills, the problem seemed more difficult to change due to the fact that the problem occurred with both programming and scheduling. Again, the project manager approached MIS for help; however, it can be very challenging to rewrite ten year old computer programs. The manager was lucky in that MIS had already become enthusiastic about the project, so they immediately rewrote the program to cut two days off of the billing cycle.

The project manager had done a smart thing from the very start of the project. Knowing that the project would ultimately need the approval of the regulatory compliance and customer relations departments, the manager made sure to include representatives from these departments in all the plans. They were given constant updates on the progress and the manager incorporated their suggestions into the master plan. So, by the time they actually had to approve the entire project, they had already seen and approved each part.

Sixty days after the goal was announced to trim off two days from the billing cycle, the days were cut. The project was successful; however the company was not out of the mud yet. The managers at Duquesne now faced a more difficult project- to trim an additional two days from the billing cycle. This time the work plan for the project was developed by representatives from MIS, regulatory compliance, and customer relations right from the start. Because of the success from the initial project, this team faced few of the barriers that troubled the initial group. All of the departments gave their full attention to cooperating on the systems and technical challenges.

Eight months after the project was started, bills were being mailed out to customers by 6:00 A.M. on the day after their meters were read. This new system saved Duquesne 1.7 million dollars a year.

The project that Duquesne successfully completed has long term importance to the company. The project has created a results-focused thirst for change in the finance group, a motivation that has spilled over into the other departments in the company. For example, MIS has taken the step-by-step planning model used in the billing lag case to supplement the timeline charts that the department has been using to plan important projects.

The finance group now has a management process for selecting and launching additional improvement projects, defining new goals, auditing and reviewing progress, providing help when needed, organizing efforts for improvement, getting as many people as possible involved in the improvement, and recognizing and publicizing the success. Included in this process are two retreats a year for the top 30-40 members of finance along with representatives from MIS, customer relations, and other key departments. At this retreat, the participants review what is happening within the company, brainstorm new ideas for future projects, discuss what management can do to improve and other problems and advances that have occurred in the company.

The company now realizes that while technological advances are a help, they are not the solution to many of the root problems of the company. To be an effective company, change is needed. This change must occur. In order to be effective, the changes must be managed well. Duquesne has come to the conclusion that properly managed change can greatly improve a company.

Managers must keep using their skills to make the work place exciting, productive and rewarding for the company. The managers are doing their part toward building a high-performance, service-oriented culture within Duquesne Light. The process that these managers took is truly an incredible example how change can be successfully implemented if managed correctly.

Works Cited


Koonce, Richard, “The ‘People’ Side to Organizational Change”,

Stock Analysis:
American Power Conversion

TAL SHARON

Stock Statistics:
PRICE DATA: (As of Jan. 1996)
Current Price: $10.63
52 Week-
High: $25.88
Low: $9.38
Beta: 1.85

*S&P Ratio: 13.1
5 year High: 55.4
5 year Low: 12.7
5 year Avg.: 27.4
Industry Avg.: 25.9
S&P 500 Avg.: 19.88

Industry: Electrical & Electronic Components

PROFITABILITY RATIOS:

<table>
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<th>COMPANY</th>
<th>INDUSTRY</th>
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<tr>
<td>Return on Equity: 32.82%</td>
<td>21.01%</td>
</tr>
<tr>
<td>Net Profit Margin: 17.3%</td>
<td>3.2%</td>
</tr>
</tbody>
</table>

Tal Sharon is currently a junior finance major at SSSB. He is co-president of the SSSB Max Investment Club.
DEBT MANAGEMENT RATIOS:
COMPANY INDUSTRY
*Current Ratio: 4.55 2.15
*Total Liab to Total Assets: 22.3% 43.4%

GROWTH STATISTICS:
COMPANY INDUSTRY
*EPS 5 year Growth Rate: 61.0% 13.2%
*Rev 5 year Growth Rate: 60.6% 9.8%

FUTURE ESTIMATES:
EPS Estimates:
4th Quarter of 1995: $.20/share
Fiscal Year Ending 12/95: $.79/share
Fiscal Year Ending 12/96: $.96/share
Next 5 years Expected Growth Rate: 24.17%
* Self generated ratios and growth rates

Stock Analysis
American Power Conversion (APCC) is the worldwide market share leader in Uninterruptible Power Supplies (UPS) products and software for networks and similar mission-critical applications designed for use with personal computers, workstations, and other electronic devices. The UPS’s are used to maintain incoming power within an acceptable range and provide back-up powering during outages. The company sells its products, priced from $24.95 to $3,199, primarily through computer distributors.

American Power Conversion’s stock has been traded down to a new 52 week low recently. The combination of the stock being undervalued and its tremendous growth expectations for the future creates an incredible buying opportunity. At the stock’s current price of $10.63 the company’s price-to-earnings ratio (which was figured by dividing the current price by the trailing twelve months earnings) is 13.1. A comparison of its current P/E ratio to its 5 year high and low, 55.4 and 12.7 respectively, show that the stock is undervalued and has a lot of room to grow. Similarly, a comparison of the stocks current P/E ratio to its five year average of 27.4 illustrates this point. With the company expecting to grow over the next five years at

PORTFOLIO
Stock Analysis: APCC
a rate of 20%-30% a year, these price-to-earnings ratios warrant a buy signal. Not only is the stock undervalued in comparison to its own P/E ratio history, but is also undervalued in comparison to its industry and S&P 500 average. The average price-to-earnings ratio for the Electrical & Electronic Components industry is 25.93, well above APC’s current level of 13.1. The S&P 500’s average price-to-earnings ratio is 19.88, also above APC’s P/E ratio. Both of these comparisons only prove further that the market has mistakenly depressed this stock.

In the table on this page is a forecast of revenue, cost of goods as a percentage of net sales, gross profit, and earnings for APC. This forecast was computed by using the FORECAST function in Microsoft Excel. This years earnings are projected to come in at $.88/share, which would produce a P/E ratio of 12.07, slightly below the current ratio. But, 1996 earnings are forecasted to be $1.05/share and $1.22/share in 1997. Based on 1996 and 1997 EPS, APC’s P/E ratio would be 10.12, and 8.71 respectively. With the future growth prospects of this company, these price-to-earnings ratios are very low. Wall Street’s estimates are slightly lower than the ones attained through my forecast, but I think that is because Wall Street has recently lowered estimates because of the concern that American Power Conversion will not be able to sustain its high profit margin. The forecast in this table assumes that the profit margin will grow or at least remain steady. Even if the net profit margin does decrease slightly, (which is what analysts expect) analysts also expect that revenue will grow at a higher rate than forecasted above. They estimate that the company will grow at a rate of 25% a year over the next 5 years. So even if net profit margins decrease slightly, the larger growth in revenues will allow earnings to also grow at a rate at least matching the table above. Over the past 5 years EPS have grown at a 61% annual rate, (figured by taking the average of the growth of earning from each of the past 5 years) while the industry average growth rate is only 13.2%. Revenues for the same time grew at APC by 60.6% annually, (computed the same way as growth rate for EPS) while the indus-
try only grew at a 9.8% annual rate. Based on American Power Conversion's past, I think it has the ability to continue above normal growth in earnings and revenues for the years ahead. In terms of profitability, although they have such a large amount of sales, they are still able to keep their costs and expenses in line. Their profit margin of 17.3% greatly exceeds the industry average of only 3.2%. As mentioned before, this may deteriorate slightly over the next year, which will be due to cost incurred from new marketing and advertising methods and the operation of a new plant in Ireland. APC's return on equity of 32.82% also beats the industry average of only 21.01%, showing American Power Conversion's ability to better manage its shareholders' investments than the rest of the industry.

American Power Conversion has very little, if nothing, to worry about in terms of defaulting on loans or having a problem raising additional capital for further expansion if necessary. The company has only $62,813,000 in debt. Compared to its total assets of $334,536,000 it has a total liabilities to total assets ratio, (computed by dividing total liabilities by total assets), of only 18.78% which is significantly lower than the industry average of 43.4%. Its current ratio also shows its exceptional debt management. Its current ratio, (figured by dividing the company's current assets by its current liabilities), is 4.55, while the industry average is 2.15.

Another factor to consider is that once the public realizes that this stock is undervalued the stock will then move very quickly upwards. This is because it has the most shares shorted than any other stock; 14.78 million shares. Therefore once the stock begins to rise, short sellers will take their profits made on large decline in the stock price this year and get out by buying back the shares they shorted. Since there are so many people shorting the stock, when it moves, it will do so sharply.

In addition to the ratios, forecasts, and short sellers, which all point to a buy signal for the stock, American Power Conversion sells a superior product that is a necessity for everyone, both in a business or at home. Not only is there a necessity for UPS's, but there is also a specific demand for American Power Conversion UPS's. According to a study of MIS professionals by InformationWeek, 74.8% of corporate respondents planned to buy APC UPS products, while only 16% opted for Best Power - the next leading brand, while 1% were considering the Hewlett Packard PowerWise series.

In consideration of all this information, I recommend a STRONG BUY for American Power Conversion, with a price projection of $20-$25 a share in the next 12-18 months.

Editors Note: Price at press time was $10.25.

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Liz Claiborne: Paradise Lost

LEAH TOUBIAN

Picture the following: in 1976, a young, insightful woman and her equally bright husband had an idea to fill a niche in a brand new market. This is what Liz Claiborne and her husband, Arthur Ortenberg, did years ago. It was a new era in woman's fashion history. Liz, born in 1929, and Arthur, born in 1926, created a company who's major goal was to "cloth the working American woman". This was introduced at a time when women occupied new positions in the executive work force. They therefore needed the proper clothing for the office place.

The couple set out with a mere $250,000 to create a company that would soon merit to be listed as second in fashion apparel on the Fortune 500 list. While Arthur Ortenberg took care of the managerial talents, Liz was the "creative force" to the company. She understood that her company must cater to the modern business woman for all her daily activities from office wear, to sportswear, to elegant dinner wear.

Although they started with such a small sum, the couple managed to gain earnings of $2.6 million dollars by the end of the first year. Even

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more impressive, by 1981, when the company went public, they grew to a $117 million industry.

Liz understood that since the company was successful in office apparel, it should expand the market to other areas, such as sportswear. Thus, Liz Claiborne, Inc. became one of the first companies to design moderately priced women’s sportswear. By 1988, the company was a thriving $1.2 billion empire; however, this empire was primarily in department stores, an area with little room for growth. In 1986, the company took advantage of its success and strategically opened a thirteen store chain, which grew over the years. Because the company did not wish to alienate the department stores carrying the Liz Claiborne label, it named the new line separately. “First Issue” focused, as the name indicates, on specialized women’s sportswear that was new, innovative, and most importantly, updated, with new clothes coming in every two weeks. The management agreed that customers were out to buy complete “looks”, not just separate articles of clothing, and they therefore dispersed different ensembles in bright colors. As Jo Miller and Ed Grund, division Co-Presidents, explained this line would cater to a “woman in her mid-twenties to mid-forties. She likes fashion but is not a fashion maven. She’s a competitive shopper who is very knowledgeable about prices and fabrics. This woman is picky and you can’t easily fool her.” The fact that the company had strength to expand and create a new line and new retail stores, shows the success of the company at that time. The company excelled and continually expanded, adding fragrance lines and even menswear; however, in 1990, Liz Claiborne and Arthur Ortenberg shocked the fashion world as well as Wall Street, when they announced their retirement, an event which many analysts believe triggered malaise for the company. The couple claimed that they “intended to leave before we became irrelevant.” At this point, many challenges rose in the company’s structure and progress. No longer were the founders, the people who knew exactly what their company stood for and meant, in charge. This unfortunate event triggered many problems within the company.

By September of 1990, Liz and Arthur severed all ties with their company when they sold off their six percent equity stake for approximately $108 million. After their retirement, Jerome A. Chazen, a man who worked with the founders since the company began, assumed the responsibility of Chief Executive of the thriving company. Chazen knew quite a bit about the company; he helped develop the business of dressing women for careers into a billion dollar enterprise. A promising future lay ahead for Jerome Chazen, because of the hard work that Liz and Arthur invested in their former company. In 1990, the company had practically no debts, and $373 million in cash. Furthermore, the company had the advantage of benefitting from their gradual diversification. In the past, Chazen, under the chief executives’ direction, created and established fourteen separate brands under the company. Most of these lines were doing extremely well. For example, Elisabeth, Liz Claiborne’s larger sized line, quadrupled in its sales to $50 million in 1990. In Liz & Co, another company sportswear line, sales also quadrupled to $34 million in 1990. The only two exceptions to the success were the Dana Buchman line, which did not sell well, for it was considered overpriced by consumers, and Liz Claiborne shoes. At this point, the company was strong enough, thanks to the intelligent business minds of its founders, to weather a minor storm that might arise under the new leader.

However, since the company founders were no longer in the picture, Chazen did have several odds at steak, that could effect the company in the long run, which he had to be made aware of. Firstly, according to Seventh Avenue standards, the fashion district of New York City and home of Liz Claiborne, Inc.’s executive offices, this company was considered middle aged; it had its climactic period of strength and power in the past, and now would need to work at maintaining its place in the market. The company needed to work hard at keeping its original customers, for there had been several cases, as with Benetton and Esprit De Corps where the once loyal consumers outgrew and deserted their brands. Claiborne needed to adjust its fashion style to the changing consumer’s needs. A second major setback for Chazen was that the entire fashion industry was facing a significant slump.

Even though Liz Claiborne and Arthur Ortenberg retired when the company was in its high growth mode, with the market expanding significantly, tougher times lay ahead. There were threatening situations which Chazen needed to closely monitor, so that the company would not sink into a debt that any mid-aged company is threatened to face.

Chazen appeared to have started off on the right foot. In 1989, his first full year as chief executive, sales rose 23% to $1.4 billion. This success occurred in the midst of a period of weakness amongst other apparel companies. In 1992, this company reached its peak of success. Sales were higher than ever before, at a total of $556.9 billion. Management felt confident, due to this peak, and sat back enjoying the success.

However, instead of sitting back passively, the management should
have been planning methods to keep the success up. Consequently, by 1993, Liz Claiborne’s sales fell 32% in a 4.6 sales drop. Due to this decline in sales, the company suddenly “woke up” and attempted to save itself from getting buried in debt. They spent less in retail buying, and also opened new outlet stores to add to the one already established in New York. This outlet was a good way to rid excess inventory; however, I feel that the company should have focused on the real problem, a decline in sales due to problems in production and manufacturing, and not on how to expand the market. A company official stated that the company would see negative results through the second quarter. Samuel Miller, the chief finance official for the company, felt confident enough, despite the loss to ensure that “more favorable business trends and improving results in several of our divisions are expected to enable us to resume our growth during our second half of the year”. This is an example of the overconfidence that Jerome Chazen and his management felt; this overconfidence is what is leading Liz Claiborne, Inc. to its misery.

The situation for Liz Claiborne got worse when Jay Margolis, the former Vice Chairman and perspective successor of Chazen, surprisingly resigned from the entire company and moved to Pepe Jeans. At this time, sales had been slipping indefinitely and the vision for the future dimmed. Margolis helped build the Liz Menswear to a $125 million industry. That very day, as a direct result of this important executive’s departure, shares of Liz Claiborne dropped $1.75 to close at $29.625.

To add to the faltering of the company, in July of 1993, the same month as Margolis’ departure, department store retailers informed the company that sales of the company’s once successful sportswear lines declined significantly. They would therefore order less merchandise for the next season.

By October of 1993 the situation only worsened. Company profits fell more than 40% in the third quarter, with even more bad news expected through the remainder of the year. Even Samuel Miller, who had been confident about the company’s improvement a mere six months ago, admitted that he expected earnings to dwindle even lower. Analysts even hesitated to predict recovery in 1994. As Jerome Chazen admitted regretfully, “We don’t see ourselves breaking out of the malaise that hit us [in mid 1993] until the third quarter. But there should be a rebound in the second half that will provide Claiborne with an improvement in earnings for all of 1994, compared with 1993”.

The company decided to solve its problem by expanding its First Issue stores as well as adding three new outlet stores. I disagree with this tactic, for opening new stores will not solve any problems, rather, it may even create new risks and problems for the already suffering company. Instead of tackling the real problems at hand, the company dealt with expanding its market.

In October of 1993, Robert Bernard, president of Claiborne’s international division, resigned from the company to act as President of J Crew Group Inc. Consequently, net income continued to plunge more that 40% from 64.5 million dollars to 38.3 million, a significant drop.

At one point, between 1985-1991, sales and net income almost quadrupled. Today though, Claiborne seems neither magical nor efficient. Last year, the company had to liquidate $300 million worth of unsold merchandise. What caused these problems? Different people blame the company’s suffering on different things. Chief Executive Jerome Chazen admits that there was some glut from the company; however, he also blames overly optimistic projections by department stores. On the other hand, apparel consultant Alan Millstein claims that “Claiborne has exhausted the market in which it is in”. He further states that Chazen needs to jump start growth. Similarly, many department store buyers feel that Liz Claiborne has lost the touch of style that it used to have. In 1993 Saks Fifth Avenue went as far as dropping Claiborne’s core sportswear lines. As a former Claiborne executive claims: “Liz had an internal sense of style that was very modern, after she left, the merchandise became a little stale”.

A chief cause of the company’s problems is that Claiborne does not reach out to new consumers. Baby boomers, who once rode on Claiborne’s tail, now have mortgages, children, and tight budgets. Many younger women think of Claiborne as a brand for older women. One twenty four year old sales assistant for a Manhattan brokerage firm says that, “Last time I saw Liz, I breezed through and said, ‘there’s nothing really here’”. She plans on spending $600 to $700 on clothes in the Spring of 1994, but expected to look in DKNY and Ann Taylor, two company’s who successfully cater to younger and older working women. In order to keep up these days, Liz Claiborne must follow its competitors’ examples or else it will suffer the consequences as it has been for the past few years.

Furthermore, Liz Claiborne, Inc. fails to listen to the consumers’ needs. One reason for this is that since Claiborne has gone beyond the working woman into petits, Misses, accessories, fragrances, men’s clothes, and more, the management has so much to watch over that it began to loose its focus on the core merchandise. Customers yawned at many outfits, which too often repeated past styles. Many critics believe that
Another aspect of the company’s problems is that consumers cannot tell a distinction between the company’s three core brands, Liz Claiborne Collection, Liz Wear, and Liz Sport. Chazen now vows to set up clear distinctions for each brand. While Collection is for career oriented tailored suits and jackets, and Liz Sport for casual cottons, sweaters and vests, Liz Wear is for basic turtlenecks and jeans. Linda Larsen German, 42, who was recently promoted to head Liz Claiborne Misses and Petite sports wear, now assumes the responsibility of aiding Chazen to create the distinction amongst the core lines. In my opinion, Liz Wear and Liz Sport are similar enough to merge as one unit of casual sportswear. This will prevent the consumer from getting confused or overwhelmed with all the different lines. Merging the two lines would also be beneficial for the management because it would simplify the technicalities of differentiating lines, and would allow them to focus, instead, on creating what the customer really wants to wear.

Liz Claiborne, Inc. is currently taking numerous measures to revive the company so that it can, once again, entice women with stylish, well made, wearable clothing. One measure Chazen took in December of 1993 was shifting leaders in some of its largest divisions. Linda Larsen German, was now to head Claiborne’s petite and woman’s wear. Therefore, Hank Sinkel, who used to head that department, moved up to head domestc sales. Robert Bernard consequentially assumed greater responsibility as president of the International Division. Chazen hopes that, "These appointments are part of an ongoing program to strengthen our management structure."

Whereas in the past the company has promoted managers from within, on April 25, 1994, Chazen surprisingly picked outsider Paul A. Charron to act as Vice Chairman and Chief Operating Officer. Many believe he will be molded into the new CEO, in the coming years. As Mr. Leeds, managing Director of Buckingham Research Group says that Mr. Charron is "one of the best marketing executives in apparel history". This new appointment and reorganization is extremely promising for the suffering company.

Further measures that management is utilizing to heal its ailing company is shortening production cycles so that styles will not become outdated so quickly. Liz Claiborne is even attempting to lower its prices for the general public. Most importantly, Liz Claiborne, Inc. has embarked on a large re-imaging campaign. They have spruced up their boutiques to attract more customers. The company further fired its ad agency, Altschiller Reitzfeld, for it felt that their advertisements failed to stem disappointing sales for the company. Now the company will use ads from its own marketing department. The new ads will not focus on image, rather, they will stress the new, updated line of apparel. Furthermore, as part of Claiborne’s re-imaging campaign, the company will try to persuade department stores to increase staff in the Claiborne sections.

Also, Claibome is forced to close down some of its boutiques and First Issue stores so that they can concentrate on solving the central problem, in its major fashion apparel lines.

I commend the company for finally getting down to the basis of the problem. The management must learn to work together as one large team. By the company feeling like a united family, it will be obvious to the consumers that things are finally improving. I believe that the company should hire more women to head the Woman’s Apparel departments, for after all, they are the ones who will wear the fashions and will therefore know what to produce better than men. The restructuring of management was one of Chazen’s better ideas; he saw that one way was not working and tried to find a better way. Furthermore, the company should primarily focus on strengthening its three major lines instead of focusing on expanding its product lines.

Liz Claiborne has lost much on sales and net profits due to its lack of action at extremely important intervals. The company must catch up to their competition. Although it took a while, the company is finally focusing on its products, and employing a re-imaging campaign which promises improvement for the future. The company’s focus on product is evident to those in the fashion industry; as Barbara Dovolis, a buyer at Dayton Hudson Corporation states, Liz Claiborne is finally "getting back to clothes that look fashionable, but are mainstream and understandable". Although difficult times still lay ahead, Liz Claiborne Corporation has realized that its customer’s needs come first, and that as long as it fulfills these needs, people will remain loyal to this once thriving company.

Notes
1. "Claiborne Slips Into Retailing And Finds The Fit Is Comfortable," Adweek (9/26/88) p.68
4. bid., p.70-71
9. bid., p.B4
11. bid., p.56-57
15. Zinn, Business Week, p.56-57

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Sears Roebuck & Co.
A Marketing Study

MICHELLE STEIN

Sears Roebuck & Company, the one time leader in global retailing, has recently dropped to number three. Sears lost significant market share because they did not change marketing strategies to correspond with the changing marketplace. Today, Sears is struggling, trying hard to once again become number one. The firm has been undergoing many changes. The two most significant changes are the discontinuation of their catalog and their attempt to reposition themselves with the American consumer, highlighted by their new advertising campaign "The softer side of Sears". Sears hopes that these changes will help improve the company and return Sears to its former position.

In 1886, Richard W. Sears was an agent of the Minneapolis and St. Louis railway station in North Redwood, Minnesota. One day, Sears received a shipment of unwanted watches from a Redwood Falls jeweler. Immediately, he purchased them and sold them for a profit. Sears then ordered more for resale. Later in 1886, Sears began the R.W. Sears watch company in Minnesota. The next year, he moved his business to Chicago and put an ad in a local paper asking for a watchmaker. Alvan C. Roebuck answered the ad and was hired. In 1893 the corporate name of the firm became "Sears, Roebuck & Company."

In the 1890's Sears, Roebuck & Company started their famous catalog. "While the earliest catalogs featured only watches and jewelry, the new firm by 1895 was producing a 532 page catalog with many other items." Richard Sears was unparalleled in his grasp of the mail order business. He understood his customers' needs and wants, and he knew how to get them to buy. In 1893, sales topped $400,000. By 1895 sales reached more than $750,000. Shortly thereafter, Roebuck resigned due to health problems. The Sears catalog changed many times throughout its long run. At times, the catalog has been given away free and on other occasions it has cost as much as fifty-cents. One might wonder how Richard Sears put his catalog, or as he called them "wish books", into the hands of thousands at the start of the company. In 1905, Sears wrote to the firm's top customers in Iowa asking each of them to distribute 24 catalogs among friends and colleagues. The top customers sent Sears the names of the people who received the catalogs and when these people sent in orders, the original customers received premiums. Once it was established that this was a successful method, the system was applied elsewhere.

Sears' business grew fast. In 1896, the company outgrew its rented building and moved into a new six story building. In 1906 Sears went public in order to raise money for expansion. Taking into consideration the changes the automobile would bring to rural life, Sears opened its first retail store in 1924. This enabled farmers to drive to buy their merchandise. In 1925, Sears bought Allstate tires and later expanded into auto insurance (1931), life insurance (1957), and auto club (1961). In 1942 Sears began to expand internationally. The company opened a store in Havana, Cuba. Sears continued to expand and opened offices in Central and South America and Europe. In the early Eighties many of its foreign retail operations were sold off. In 1953 Sears joined a Canadian merchandising company and became "Simpsons-Roebuck Ltd." Today it is known as "Sears Canada Inc." In 1981, Sears acquired Dean Witter Reynolds Organization, and Coldwell Banker and Company.

In the late Sixties, Sears decided to upgrade their merchandise and raise their prices. Many shoppers switched to competitors. The problem Sears faced was that their new merchandise was not as good as the merchandise in department stores, and therefore, could not charge department store prices. At the same time, however, they were charging more than their competitors, allowing customers to find better prices for similar goods at stores like Walmart, Kmart and Home Depot. Sears used weekly price-
off sales to make its prices more competitive. Sears was not successful and their market share slid 33% in the Eighties.³

In 1989, Sears attempted a new pricing strategy. It adopted a "no sales, everyday low price" strategy. Sears closed all of its 824 stores for forty-two hours and retagged all of its merchandise. They proclaimed "WE'VE LOWERED OUR PRICES ON OVER 50,000 ITEMS! Sears: your money's worth a whole lot more." At first, this strategy worked, but soon profits began to decline again. Consumers did not believe that Sears' new prices, were the lowest in the marketplace. In 1990, Sears began once again to emphasize "quality" rather than low cost. Sears, Roebuck and Company is now headquartered in Chicago, Illinois. Its main businesses are retailing and insurance. In 1993, Sears revenues from operation totaled $50.8 billion. Earnings were more than $2.3 billion, an all time high.³ In the past couple of years Sears has slipped to the number three spot, after Wal-Mart and K-Mart. However, Sears does business with 70% of U.S. households.⁶

Sears Merchandise Group

The Sears Merchandise Group is located at Hoffman Estates, northwest of Chicago. It is one of the largest retailers in the world on the basis of sales. Sears runs nearly 800 department stores across the U.S. as well as about 1,800 other retail units. Its department stores are divided into seven regions and almost fifty districts. Led by a division vice-president, the seven small regional staffs travel from Chicago each week. "District staffs, headed by general manager have several business managers responsible for certain groups of product lines and other sales support executives. Each individual store's operations are headed by a general manager. The target market for Sears merchandising is women ages 25 to 54 and their families. These households have an average income of about $37,000.⁶

Many have viewed Sears in the past, as a place to buy tools and appliances but not as a place to buy clothing. All those people are in for a surprise. Sears is now emphasizing the store's quality, value priced fashion.⁶ Sears continues to expand its apparel business. To support this endeavor, Sears has recently launched a new advertising campaign, "The Softer Side of Sears." Sears Merchandise Group chairman and chief executive officer Arthur C. Martinez said that "some have called our apparel business, one of Sears' best kept secrets." The goal of this new campaign is to reveal this secret in all its splendor. Millions of customers from all around the nation have been invited to "come see the softer side of Sears." As it stated in the September 1993 issue of Front Lines, Sears' new ads are "bold, playful and sometimes even a little daring." The new advertisements cater to Sears' target customer, hoping to bring in women to see Sears apparel, and to then shop for themselves and their families. The campaign is being reinforced by ribbons for apparel sales associates, badges that read "WELCOME TO THE SOFTER SIDE OF SEARS." As well, the new shopping bags also display the new credo. The new Sears jingle, filled with puns, invites women ages 25 to 54 to take a closer look at a more glamorous side of store they think they know. The ad agency Young & Rubicam, New York developed this new campaign in order to reposition the company in the minds of their consumers. The problem was that "many women don't perceive Sears as the store for them," explained Robert Chiocci of Young & Rubicam. "They know it's a great place for appliances and tools and kid's clothes, but they don't think of Sears as a place for clothes they'd be proud to wear to work or to socialize in."

Notes

⁴"Yesterday and Today," News From Sears, 1993, pp.2-3.
⁵Ibid., 4 - 5.
⁶Ibid., 5-6.
⁷Ibid., 8.
⁸Ibid., 6.
¹⁵A Secret No Longer," Front Lines, September 1993, pp. 4 -5.

Works Cited

Accounting for Environmental Liabilities

Kari Rybak

The 1990's have been labeled the decade of the environment. But when it comes to environmental accounting, many companies have yet to come clean. There is clearly a focused attempt to bring environmental issues to the forefront of discussion and analysis. Companies are striving to become "lean, mean, and green" (Buxton and Nielson 29). Yet, companies have long faced uncertainty as to when and how environmental remediation (clean-up) liabilities should be reflected on their balance sheets. Thus this area of accounting is an important one which can no longer be ignored especially because many people are pointing to the business sector as the last resort to save the planet. One successful entrepreneur described the current situation by saying, "Business is the only mechanism in the planet today powerful enough to produce the changes necessary to reverse global degradation" (Senge 35).

The numbers involved in cleaning up the environment have become very significant and the responsibility is falling on the shoulders of those

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corporations that are making the mess. The Environmental Protection Agency has recently designated some 1200 locations as high priority clean up sites. Estimates for this clean up and those 100-200 new sites that will be added to the list before the year 2000 run at about $500 billion. The clean up will take between 40 and 50 years (Chadick 19). In addition to this Superfund amount, (superfund is a fund of moneys collected from taxes on industries associated with environmental pollution and from other services, earmarked to clean up sites identified as National Priority List sites) companies are spending $23 billion per year for ongoing disposal activities. The cost to clean up air emissions currently runs $25 billion a year. The 1990 Clean Air Act will increase that number by an additional $435 billion by the year 2005. Other significant numbers are the $200 billion that will be spent to clean up asbestos and the $28 billion that will be required to clean up underground storage contamination. The overall known environmental liabilities is expected to run at about five percent of the GNP. This gigantic problem cannot be put under “future expense.” Some means of accounting for these liabilities must be dealt with as a high priority (Chadick 19).

The SEC has taken specific actions against companies to enforce compliance with its environmental disclosure requirements. For example, in 1980 the SEC commenced an action against Occidental Petroleum for failure to disclose pending environmental proceedings. Over W.W.II and the 1950s, Hooker Chemical Company had buried thousands of steel drums containing dioxin, a chemical waste. Twenty five years later it was discovered that these drums had corroded and leaked the toxic gases which by that time were reaching surface water. Hooker at this time was owned by Occidental which was pending action for a $260 million clean up cost (Zuber 43).

This case points out some of the flaws in the accounting system we have today for accounting for environmental liabilities. Can we make a company today liable for something its forefathers did back in the 40’s and 50’s? In the 40’s the business culture considered productivity and prosperity the top priority. There was no clause at that time that even mentioned the environment. Should we be judging the past by today’s standards?

Due in part to past cases such as this one, in 1988, the EPA enacted regulations that require leak testing, installation of corrosion protection and leak detection systems, and insurance against leakage. While the cost of these preventive measures can be significant, it pales in comparison to the cost of a cleanup if the old tanks leak (Zuber 45).

Congress created the Comprehensive Environmental Response Compensation and Liability Act (CERCLA or Superfund) in 1980 to manage the growing problem of uncontrolled or abandoned hazardous waste disposal sites. Under Superfund, the EPA identifies and assesses sites where hazardous substances have been spilled, stored or abandoned. Sites are subsequently ranked after consideration of a number of factors, including the potential number of people exposed, types of exposure, and risk of contamination of drinking water. Sites with the highest rankings receive priority attention from the federal and/or state government to facilitate cleanup. The cleanup process may include excavating and disposing of some surface soil at a cost of a few thousand dollars. It may involve the more expensive procedure of pumping groundwater through filter systems and returning it to the aquifer, as well as removing and disposing of extensive quantities of soil. In the latter case the cost of cleanup can run into millions of dollars for even a small site (Surma and Vondra 51).

Conviction for violating provisions of these statutes can result in fines or remediation costs that could push a company into bankruptcy. Given that environmental liabilities have such a significant impact on a company’s financial health, they should be reflected in financial reports.

In considering the financial reporting implications of remediation costs, it is helpful to review in detail the sequence of events in the EPA’s regulatory process. Typically this begins when the EPA identifies a site as containing hazardous waste which constitutes a potential threat to the public health and safety. The EPA conducts a preliminary investigation to assess the site characteristics and assigns a hazard score (an EPA weighting of various site conditions such as proximity to population and drinking water). CERCLA sites with hazard scores exceeding 28.5 are designated as National Priority List or Superfund sites. The EPA’s preliminary investigation also seeks to identify parties potentially responsible for contamination at the site. Those parties are then notified that they have been identified as Potentially Responsible Parties (PRPs) and typically are requested to pay for a Remedial Investigation and Feasibility Study (RI/FS), which can cost several million dollars and take two years or more to complete. The parties may agree on the allocation of costs for the Remedial Investigation and Feasibility Study and arrange for the study, or the EPA may proceed with the RI/FS and make the initial payment from the Superfund. The study contains a comprehensive analysis of the environmental problems at the site, discusses alternative remediation technologies and their costs, and then makes a recommendation for the most effective technology (Barth and McNichols 180).

At the conclusion of the Remedial Investigation and Feasibility Study,
a Record of Decision (ROD) summarizing the findings and recommendations of the Remedial Investigation and Feasibility Study is filed with the EPA. The Record of Decision also contains estimates of the costs to implement the recommendations. Cleanup costs include capital and operating and monitoring costs; in more recently filed Records of Decision, a present value of the estimated total costs is disclosed. Following the Record of Decision, in the planning and engineering phase, engineers design the cleanup process to meet the remediation standards. Following this phase, bids are received from cleanup contractors, which can represent the actual costs of the intended cleanup if the contractor bids a fixed-price contract. Depending on the nature of the problems at the site and the remediation standards, the cleanup phase may last up to 30 years. The cleanup phase often is followed by monitoring, to ensure that the cleanup meets the remediation objectives and that the conditions at the site do not deteriorate. Throughout the life of a Superfund site, the Potentially Responsible Parties negotiate or litigate their share of the remediation costs and, if they come to an agreement, a consent decree is filed (Barth and McNichols 180).

Several features of CERCLA and the EPA’s guidelines present imposing challenges for estimating a firm’s liability under its provisions. First, the liability is for response to remediation costs, as well as for damages, health assessment and study costs. Depending on the nature of the contamination and the cleanup technology chosen, remediation costs can include initial capital expenditures in the millions of dollars as well as ongoing operating, maintenance, and monitoring costs for 30 or more years. Moreover, cleanup standards are unspecified. Secondly, CERCLA imposes liability on a broad group of Potentially Responsible Parties (PRPs) including the current site owners, the owners at the time the hazardous substances were disposed, and those who transported hazardous substances to the disposal facility. Thirdly, CERCLA liability is strict, retroactive, and joint and several. Under strict liability the EPA need not prove negligence. The law is retroactive in that the liability is imposed for actions that may not have violated the law at the time. Under joint and several liability, which is permitted but not required by Section 9607 of CERCLA, any PRP can be held responsible for the full cost of cleanup if the harm is indivisible; other PRPs, if available, could be sued subsequently for their share of the cleanup costs (Barth and McNichols 181).

Financial reporting guidance for potential obligations to clean up environmentally impaired sites comes from GAAP, particularly Statement of Financial Accounting Standards (SFAS) No. 5: Accounting for Contingent Liabilities and SFAS Interpretation 14: Reasonable Estimation of the Amount of Loss, and from SEC disclosure requirements. SFAS No. 5 defines a loss contingency as an “existing condition, situation or set of circumstances involving uncertainty as to possible loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” SFAS No. 5 requires that a liability be accrued and expense recognized if a contingent loss is “probable” and the amount of loss can be “reasonably estimated.” If a loss is probable and the amount can be measured only as a range, the “best” loss estimates should be recognized. SFAS Interpretation No.14 provides that if all estimates in a range are equally likely, the minimum loss should be recognized . If a liability is not accrued because it is not probable or there is no reasonable estimate then the nature of the liability should be disclosed in the footnotes to the financial statements. SFAS No. 5 also indicates that disclosure of the nature of an accrual “may be necessary for the financial statements not to be misleading” (Johnson 119).

The next question an accountant faces when accounting for the environment is how to depict environmental outlays when they are made. This issue was addressed by the Emerging Issues Task Force (EITF). The EITF reached a consensus on two issues focusing on whether to capitalize or expense costs related to environmental issues. Issue No. 89-13, Accounting for the Cost of Asbestos Removal “permits the capitalization of costs incurred to treat asbestos, provided that they are incurred within a reasonable period of time after the acquisition of property with a known asbestos problem” (Johnson 119).

The most popular EITF is Issue No. 90-8, Capitalization of Costs to Treat Environmental Contamination. This Issue requires that environmental contamination costs be expensed as incurred unless certain conditions exist. These costs are to be capitalized only when:

1. The expenditure extends the useful life or improves the efficiency or safety of the property.
2. The expenditures mitigate future environmental contamination.
3. The expenditures relate to property for sale (Chadick 19).

Issue No. 93-5, Accounting for Environmental Liabilities also deals with these environmental issues. This EITF calls for “an environmental liability to be evaluated independently from any potential claim for recovery and the loss arising from the recognition of an environmental liability to be reduced only when a claim for recovery is probable of realization.” It is not required but is permitted to discount environmental liabilities for a specific clean up site. This can only be done if the aggregate amount of the obligation...
is fixed or determinable (Johnson 120).

Also, corporations typically seek compensation for remediation costs from insurers, although considerable uncertainty remains with respect to coverage for specific situations. The SEC recently issued Staff Accounting Bulletin No. 92, making it inappropriate to present environmental liabilities net of claims for insurance recovery once FASB Interpretation No. 39, which restricts the use of setoff, is effective.

In practice, notification that a corporation is a PRP often has been presumed to satisfy the probability test of SPAs No. 5 according to a Price Waterhouse survey in 1992. Recognition of a liability then depends on estimability, which can depend on the complexity of the site, the remediation alternatives, changes in remediation technology, uncertainty over the cleanup standards, the number and financial viability of other PRPs, insurance coverage, the protracted period over which negotiations or litigation between PRPs or between PRPs and insurers takes place, and the availability of records to establish the amount of contamination by various PRPs to the site. Respondents to Price Waterhouse’s 1992 survey indicated that the following events might trigger an accrual: internal discovery of a problem site (56%); notification by regulatory authorities (22%); consent to conduct a Remedial Investigation and Feasibility Study (16%); completion of the RI/FS (80%); settlement offer by the firm (20%) (Burlando 25).

Following is an example to help clarify the proper accounting procedures for these environmental liabilities:

It could be any company’s nightmare: Company X discovers an abandoned leaking storage tank on property it purchased years ago. The company and the original owner, Company Z, are both named as potentially responsible parties for the site remediation effort and agree to share in the cleanup.

Company X completes a remedial investigation/feasibility study for $500,000, which results in remediation and monitoring costs of $10 to $15 million. It then installs a $3 million water filtration system near the leaking tank to improve its existing plant facility. How should one account for these costs? Here is what should and shouldn’t be done.

Good accounting treatment: Company X considers the estimate of the cleanup costs probable, and no amount within the range was a better estimate than the other. By applying SFAS No. 5, the company’s reporting recognizes the lower end of the range ($10 million) as a liability. The company divides this number by two, since each company is equally responsible, and recognizes the liability, charging $5 million to current-year income and expensing the $500,000 cost of the remedial investigation/feasibility study in the current period (Williams and Phillips 36).

The $3 million water-filtration system is a betterment to its physical plant, with a useful life of 20 years, so the company capitalizes and depreciates its cost over that period. In the annual report, Company X recognizes a contingent liability of $5 million and explains the matter in a related footnote disclosure (Williams and Phillips 37).

For tax-accounting purposes, the company also capitalizes the cost of the water filtration system, the remedial investigation/feasibility study, and cleanup costs. IRS rules state that since remediation is necessary and estimable, the assessment costs and cleanup expenditures, including monitoring, must be capitalized and then depreciated (Williams and Phillips 37).

Bad Accounting Treatment: Company X recognizes the $500,000 cost of the remedial investigation/feasibility study in the current period and capitalizes the costs of the water-filtration system. It gambles that cleanup technology and the applicable regulatory requirements will change in its favor and lowers the $10 to $15 million remediation estimate. The company also believes its insurance carrier will pay at least half of the claim and that too many variables exist to reasonably estimate a liability. To play it safe, the company places $1 million of retained earnings in reserve (Williams and Phillips 37).

Company X doesn’t accrue a probable contingent liability and says in a footnote disclosure that while it can’t accurately determine cleanup costs, it doesn’t expect any adverse effects on the company’s financial condition. For tax purposes, the company properly capitalizes the cost of the water filtration system, but deducts as a current expense the full cost of the remedial investigation/feasibility study because it considers it relatively immaterial and incidental (Williams and Phillips 37).

Although applying existing accounting statements does offer some guidance on how to account for the environment it is still a messy subject. And so in June of 1995, the AICPA’s AcSEC issued a proposed Statement Of Position, Environmental Remediation Liabilities, whose purpose is to “narrow the manner in which existent authoritative accounting literature is supplied by entities to the specific circumstances of recognizing, measuring, and disclosing environmental remediation liabilities.” The exposure draft also contains a discussion of major Federal legislation dealing with pollution control laws and environmental cleanup laws and the need to also consider state and non-Federal legislations. The proposal closes with a section on
how to audit environmental remediation liabilities. The exposure draft (ED) clarifies the application of current authoritative literature, principally SFAS No. 5, Accounting for Contingencies, and FASB Interpretation No. 14, Reasonable Estimation of the Amount of a Loss.

The ED elucidates that the underlying cause of an environmental remediation liability is- in simple terms- the past or present ownership or operation of a site or the contribution or transportation of waste to a site where remedial action must be taken. For accrual of a liability to be required, however, it must be probable that an entity will be held responsible for participating in the remediation process, and the liability must be reasonably estimable.

Once approved this SOP will be the most comprehensive guidance for this type of accounting. It is for this reason that I would like to expand my discussion of it. If approved it will effect companies for years beginning after December 15, 1995. The ED provides that an accrual for environmental liabilities should include incremental direct costs of the remediation effort, as defined, and compensation and benefits costs for employees for the time they are expected to devote directly to the remediation effort.

The ED also says measurement of the liability should include the entity’s allocable share of the liability for a specific site and the entity’s share of amounts related to the site that will not be paid by other PRPs or by the government. Thus, other party’s fair shares that are expected to be contributed would reduce the amount of the joint and several liability reported by the entity. Allocable shares would be based on factors such as the volume or toxicity of waste contributed to the site; whether the party was a site owner, transporter of waste or generator of waste; and statutory limitations on payments by certain kinds of entities (Gill 82).

The guidance requires a distinction between allocation of liability and recovery of losses because loss recoveries would be recognizable only if the likelihood of their realization is “probable” within the meaning of Statement No. 5. Further, recognized recoveries would rarely, if ever, qualify to be set off against an environmental remediation liability under the criteria in FASB Interpretation No. 30, Offsetting of Amounts Related to Certain Contracts.

The distinction implied in the ED centers in spending cash. In a loss-recovery situation, an entity will first have to spend an amount beyond its fair share of the overall liability and then seek to recover that amount from a third party, such as an insurance company or a PRP that refuses to participate in the remediation. In an allocation situation, the entity will not spend cash beyond its fair share of the liability (Gill 83).

For example, assume Enterprise A’s allocable (fair) share of the estimated $20 million cost of remediating a Superfund site is 25%, or $5 million, with the remaining 75% allocated equally to three other PRPs. Two of the other PRPs are participating in the remediation effort and, like Enterprise A, will make payments over time to a trust established to fund the cleanup; a lawsuit will have to be brought up against the nonparticipating PRP to force contribution (Gill 83).

In measuring its liability, Enterprise A would consider the amounts the other participating PRPs are expected to contribute. Any amount expected to be exacted from the nonparticipating PRP is a potential recovery that would not be considered in measuring the liability. It would also not be recognized as an asset because, under the ED, claims that are subject to litigation are not probable of realization. In this scenario, Enterprise A would report a $6,666,667 liability (its $5 million allocable share plus its one third share of the nonparticipating PRP’s allocable share).

The ED says measurement of the liability should be based on enacted laws and existing regulations, policies and remediation technology. Further, it should be based on the reporting entity’s estimates of what it will cost to perform all elements of the remediation effort when they are expected to be performed. The measurement may be discounted to reflect the time value of money if the aggregate amount of the obligation and the amount and timing of cash payments are fixed or readily determinable (Gill 83).

The ED also includes guidance on displaying environmental remediation liabilities in financial statements and on required and encouraged-but-not-so-required disclosures about environmental-cost-related accounting principles, environmental remediation loss contingencies and other loss contingency disclosure considerations (Gill 83).

Since the ED of the proposed statement of position has been available for only a brief time, practitioners are not sure just how it will affect their clients, and management accountants are not sure what it will mean to their businesses. Amy A. Rippe CPA, partner of Arthur Andersen in Chicago and a member of the American Institute of CPAs environmental accounting task force says that she does not expect the SOP to significantly affect most of her clients. One change they would have to notice however, is the proposed requirement that companies accrue all incremental costs, including both internal and external costs relating to remediation. Previously companies typically accrued only external cost, and not the often-considerable costs incurred by internal legal personnel. She also pointed out that the exposure draft “suggests certain benchmarks in the remediation process that may
affect the accrual of liabilities” (Gilr8s).

To a large extent Rippepi said this SOP’s importance could be its ability to “help accountants better understand what environmental remediatory liabilities are all about and help them become better versed in the issues” (Gilr85).

If a company fails to properly report environmental liabilities, the responsible parties expose themselves to future claim that the financial statements did not have adequate disclosure of all material information.

Conversely, though, if the financial statements do contain specific presentation of the exposure for environmental cleanup, it is possible that outsider parties who might not have been aware of these problems may be able to more readily press claims for the cost of cleanup plus additional damages.

Given this dilemma, it appears that due diligence is the operative word. Management must apply appropriate due diligence when it acquires property, when it monitors its operations and disposal methods, and when it discovers an environmental problem.

While companies may seek to avoid the accrual or disclosure requirements, it is unquestionably true that these issues can only become more significant in the future. Thus, it behooves companies to adequately address the accounting and disclosure implications of potential monetary consequences from today’s environmentally-sensitive society.

As is imaginable, the ever present environmental movement has been holding the SEC’s feet to the fire. Adding more clout are banks, stockholders and an increasing number of socially responsible investment funds. Of course, no corporation wants to find itself on Fortune’s next top 10 list for green irresponsibility. Getting an answer to Right-to-Know and Freedom of Information Act inquiries on a company’s actions once took a concerted effort. Now they’re much easier to obtain, courtesy of the information superhighway. The Investor Responsibility Research Center in Washington DC, now offers environmental profiles of the Standard and Poor’s corporate 500 and says institutional investors are very interested in a company’s environmental liabilities (The Economist-Anonymous).

A number of corporations keep one step ahead by proactively issuing “environmental reports” to stockholders and interested parties. Although some environmental groups deride these reports as “greenwash,” others like the reports for their plain-English explanation of the company’s environmental efforts which isn’t available anywhere else (The Econometrist-Anonymous).

Not surprisingly, many companies are scurrying, because to comply with the SEC and GAAP, they must separately show, for example, the amount of ground water contamination and remediation liability and any outstanding insurance recovery claims. Some companies’ balance sheets may weaken, and their income statements may show losses or substantially reduced profits. Shares may be revalued and bond rating agencies could downgrade ratings as companies disclose their current and potential environmental liabilities (Roberts).

Deciphering how all of these environmental costs have been reported in annual reports could baffle a SWAT team of lawyers, accountants and environmentalists. As for liabilities, multimillion dollar ground-water and product liability issues often get little more than a cryptic line in the footnote section of many annual reports. If regulatory history holds true, the SEC will follow the time-honored tradition of giving companies ample time to improve, while targeting enforcement actions against those suspected of unquestionable reporting. The commission has warned it won’t tolerate failure to report actual and contingent liabilities (Roberts).

A different approach towards environmental accounting feels that methods which would encourage investment in prevention should be considered. One approach of Georgina Williams and Thomas Phillips is to require all companies within an industry subject to environmental risks to accrue liabilities according to an industry standard of environmental risk. The accrual could be determined on the basis of an activity level such as production costs, sales, or shipments. An author discussing the Exxon Valdez oil spill, for example, notes that “Exxon’s accountants must have known that every shipment of North Shore crude oil carried with it an associated risk and a potential liability” (Williams and Phillips 39).

A company’s potential liabilities could be accrued up to an industry level of risk. Upon reaching the full expected potential liability, accrual would cease. If and when a liability actually occurred, the accrual would be debited. When a company’s accrual reached the industry level, its expenses would be less than those of another company that had experienced an environmental disaster and thus was accruing a liability continually (Williams and Phillips 39).

Application of such a standard would promote consistency within the industry as a whole, inform investors of a particular company’s potential risk, and reward those companies that act in a socially responsible way and prevent liabilities. But this method does go against many basic accounting methods. Accruals at the industry level would not meet the definition of a

Fair accounting for environmental liabilities is not easily achieved. There are many instances when one corporation places its investors at risk while the other conscientiously tries to protect its investors and ends up penalizing itself because of its method of disclosure. It is not logical to expect one company to be socially responsible and provide adequate reporting for investors, which can affect its share price adversely, when a competitor can legally minimize the extent of its similar environmental problems. There must be guidelines which are strictly enforced to define specifically when a potential environmental liability should be reported and to what extent. Hopefully the existing guidelines will be closely adhered to as we move into the twenty-first century.

The next decade holds much promise as we try to clean up our acts. Accountants are working every day to meet these new environmental challenges and to comply with existing guidelines. Many accountants have already accepted the challenging task and promise to become experts in this area. It is up to the entire accounting and financial community to accept these new reforms and help our environment and society in the process.

**Works Cited**


**PORTFOLIO  Accounting for Environmental Liabilities**


International Business Machine

A look at a team worker

Ari Farkas

History

In 1924, Computing-Tabulating-Recording Company, acquired International Business Machines (IBM) corporation and assumed the company's name. Thomas Watson arrived that year and began to build the floundering company into an industrial giant. IBM soon became the country's largest manufacturer of time clocks, and developed and marketed the first electric typewriter. In 1951, the company entered the computer industry. In the late 1950s, IBM distinguished itself with two innovations: the concept of a family of computers which could all run the same software and a corporate policy dictating that no customer would be allowed to fail in implementing an IBM system. This policy spawned enormous loyalty to "Big Blue", as IBM came to be called.

From the 1960s until the 1980s IBM dominated the global mainframe market. IBM viewed the advent of minicomputers in the 1970's as a threat to the mainframe market and failed to recognize their potential, opening the door for such competitors as Digital Equipment Corporation, Hewlett-Packard, and Data General.

However, in 1981, IBM introduced the highly successful IBM PC, which rapidly became a standard in microcomputing. Nevertheless, the company was less successful in defending its market share against lower-cost producers.

In the late 1980's IBM was the world's largest computer producer and the leading producer of office equipment, including typewriters and photocopiers. The company was also the largest manufacturer of integrated circuits, all of which were used in its own products. The sale of mainframe computers and related software and peripherals accounted for nearly half of IBM's business, and about 70 to 80 percent of its profits.

In the early 1990s, amid a recession in the U.S. economy, IBM reorganized itself into autonomous business units, each more closely aligned to the company's markets. As a result, 40,000 employees lost their jobs in 1992, and more cuts were announced for 1993. After record losses during 1992 and, for the first time in IBM's history, a cut in stock dividends, CEO John F. Akers resigned. Louis V. Gerstner, Jr., was named CEO of the company in April 1993. Under Gerstner the company began to cut costs by shutting plants, selling real estate, and laying off workers.

In 1994, after three years of losses totaling more than $15 billion, IBM finally showed a profit. In mid-1995, IBM agreed to acquire software pioneer Lotus, developer of such programs as Lotus 1-2-3 and Lotus Organizer. Despite these upward trends, IBM is still having problems selling its PC operating system OS/2, which was meant to challenge the dominance of Microsoft's Windows.

The Interview

In order to gain first hand insight into the management and day to day operations of IBM, I arranged an interview with Jane Smith, systems analyst in the Software Solutions Division of IBM. This division is a Strategic Business Unit that focuses on software for midrange and large system companies. The division's products and services help millions of its customers manage data and simplify applications, such as document imaging and work group interfacing. This division also customizes, packages, and distributes software to IBM companies and affiliates around the world.
These products are specifically aimed to allow end users to take advantage of their software in any operating environment. The data management products include such applications as databases that are easily accessible and utilized by all levels of management.

**Individual Empowerment**

At IBM, Cohen has experienced a level of freedom which she never had before. She said the responsibilities placed on her from the first day were enormous. Yet it felt as if the management at IBM was challenging her to perform her best. Cohen praised empowerment for improving her productivity. It helped create within her a sense of product ownership.

**Teamwork**

Today’s software companies no longer consist merely of designers but are made of teams of engineers drawn from all different areas of computing. Cohen said not only was this the case for IBM but also summed up the way IBM design teams work on software. Through cross-functional teams, IBM is able to take advantage of all its factions while still dealing with each project on an individual level. Teams, in general, vary in size from five to a maximum of ten.

**Quality**

In a comparison study of service and technical quality of computer hardware companies, IBM came in at number three out of the thirty-five companies surveyed. Cohen explained that IBM was a very quality committed company. With so many services and products on the market, IBM would lose it’s market share if it didn’t place such a strong emphasis on quality. In all the projects she has worked on customer satisfaction was the ultimate goal.

**Motivation And Recognition**

IBM promotes employee recognition and motivation by opening many opportunities for advancements. Employees are able to direct their promotions into areas which interest them the most.

Another source of motivation provided by IBM is through its full range of on-the-job-training and further education work shops. These are available on site as well as in specific places that IBM has designated for educational purposes. Many IBM employees also go back to school for additional education.
Stock Analysis: Merck & Co.

BRYAN ASHENBERG

Investment Conclusion

Merck, the leading U.S. pharmaceutical company, appears positioned to achieve strong annual growth over the long term. It is generally estimated that Merck will earn roughly $2.70 per share in 1995 and $3.10 per share in 1996. Merck is forecasted to sustain an annual growth rate in earnings per share at 13%, more than 50% above the rate of growth most analysts project for the S&P 500 Index. Recognizing Merck’s strong growth capabilities, increasing investor concern over the general economy, and Merck’s generally recession resistant characteristics, the shares merit a premium P/E ratio. At a price of $66.875 (as of 12/14/95) the shares of Merck reflect a P/E ratio of 21.6 times. Although this is well within historic ranges, it has increased substantially during this past year, and particularly in recent weeks. I believe that the shares of Merck deserve to be considered a core long term investment holding for investors seeking long term capital appreciation with moderate yield. Purchase of additional holdings should be deferred or restricted to weakness.

Summary

Merck and Co. is a research driven pharmaceutical products and services company that is recognized as the outstanding leader in its industry. The company has an extraordinary productive record of prescription pharmaceutical discovery and development. It is a cost-efficient manufacturer, and markets a broad range of generally innovative products intended to improve human and animal health. The company is also a leading manager of pharmacy benefits in the U.S. via its Merck-Medco Managed Care Division. This division’s mission is to encourage the appropriate use of medicines and to suggest disease management programs to pharmacies. Over the long term, Merck is committed to providing effective quality pharmaceuticals while lowering overall health care costs. Concurrently, Merck has portrayed a commitment of providing superior shareholder returns by aggressively managing its enviable business base. The consensus estimate is that Merck should be able to achieve a 13% average annual earnings per share growth rate over the next five years.

Background

Merck is not resting on its laurels. It has the biggest R&D budget in its industry. Its new products, recently released or in the upper stages of development, should enable it to maintain an above average sales and earnings growth record relative to its industry. Merck is also developing new business opportunities through acquisition and joint venture. The company has recognized opportunities in health sectors beyond its historic prescription pharmaceutical stronghold. Merck has reacted strongly to focus on cost pressures that became apparent a couple of years ago. Not only does Merck focus its research on the development of superior products, but it balances this by a real effort to control ongoing costs of treatment to the consumer. Merck stepped up to governmental and consumer cries of uncontrollably high health care costs by promising to keep the level of price increases of its product line to a rate less than inflation. Indeed, despite a more recent moderation in the government’s focus on health care costs, Merck is one of the few pharmaceutical companies that is living up to its
promise today.

In recent years, Merck has recognized opportunities in health care segments beyond its historic focus. It has formed marketing partnerships with several other companies, in order to exploit the untapped potential of pharmaceutical products previously sold by others such as Astra AB, DuPont, and Pasteur Mérieux. It has also begun to develop an over the counter pharmaceutical business in partnership with Johnson & Johnson, a stronger consumer products pharmaceutical company.

Merck is the leading U.S. company and is among the leading companies worldwide in the category of prescription pharmaceuticals. In 1994, sales of ethical drugs (prescription pharmaceuticals for use by humans) accounted for 63%, $9.416 billion, of Merck's total sales of $15.0 billion. Merck experienced a compound rate of growth of 10% during the 1990 to 1994 period despite the maturity of several former key products, which, in line with general industry experience, have faced strong generic competition following the expiration of their patent protection. Today, Merck has a number of major products positioned in chronic-care areas which are still in their growth phase and will be aided by reference through the Merck-Medco operation. Pharmaceuticals that treat cardiovascular diseases account for the largest segment of corporate ethical drug sales, totaling $3.352 billion, approximately 56.8% of sales in 1994. Anti-ulcerants, the second largest category, at $1.566 billion, approximately 16.6% of 1994 ethical drug sales.

Merck is truly a global company. Approximately $4.134 billion, (44% of ethical drug sales) are derived overseas. Europe accounts for roughly half of foreign volume, while Japan contributes close to another third. Merck has become increasingly aggressive in pursuing strategic opportunities to develop markets where it has lacked a presence. In particular, most recently it has been bolstering its involvement in China, South Korea, and Eastern Europe.

Merck’s management is generally perceived to be superior. In a recent uncharacteristic change, the company chose a senior executive officer from outside the corporate ranks. Raymond Gilmartin, previously President and CEO of Becton Dickenson & Co., a medical supply and diagnostic company, took over the helm of Merck. In a transition that seems to be conservative, the company appears to be carrying on the same programs, and maintaining the same goals that have existed prior to Mr. Gilmartin’s appointment. In May 1995, Mr. Gilmartin purchased about $2 million in shares, in the open market. Insider buying by top company officials is generally considered positive.

The acquisition of Medco Containment Services in 1993 reflected Merck’s recognition and aggressive response to the increased importance of managed care, and its impact on the pattern of health care prescriptions in the United States. Medco provides managed pharmaceutical care for health benefit payers, principally in the U.S. Its major focus is to reduce costs, simplify administration, and help improve patient/doctor compliance with specific benefit guidelines and objectives. Medco accounted for approximately $4.102 billion of sales in 1994, approximately 27% of the total. It has significant growth opportunity in developing the managed care market further. In total, prescription drug sales and Medco accounted for roughly 90% of Merck’s 1994 revenues. The remainder is largely composed of animal health and crop protection, at $1.027 billion, with specialty chemicals rounding out corporate revenues at $0.422 billion.

Merck’s current goal is to exploit Medco’s initiative in developing disease management programs that foster improved drug therapy; those initiatives should contribute to improving the health of society. It will also yield significant cost savings to the health care system by not only helping to keep drug costs low, but by reducing the need for hospitalization and surgery by improving the patient results of prescription pharmaceuticals. By directly monitoring patient records, Medco can better control compliance and manipulate prescription therapy to ensure that it is consistent with cost/benefit evidence, the patient’s current and prior therapy, and the patient’s health benefit program. By implication, Merck’s products might be promoted by Medco as often as can be justified as preferred therapies, leading to their substitution into specific patient drug therapies at the expense of competitor’s products. Separately, feedback from the monitoring of these programs could lead to better measurement of the effectiveness of drug therapies in the health care cycle, and help assist Merck in the targeting of its research spending.

Merck’s 1994 research and development budget of $1.231 billion is one of the largest in the industry, and does not include an additional $0.319 billion spent by the company’s joint venture operations. It is interesting to note that Merck’s own 1994 R&D spending totals $9.8 cents per Merck’s shares outstanding and a significant 28% of its pre-tax income. R&D expenditures are estimated at $1.3 billion in 1995, and $1.5 billion in 1996. It is obvious that if Merck ever wanted to inflate its reported earnings, it could momentarily reduce the percentage of its sales that it spends on R&D.

Merck’s R&D effort is highly focused and commercially oriented.
The company has a proven record of speedily developing new innovative products while efficiently shifting its marketing efforts to maximize the commercial potential of these products. The company's stated goal is to discover, develop, and market the first major innovative breakthrough compounds in as many new therapeutic fields as possible. Nevertheless, the company astutely recognizes that this altruistic goal is often unattainable, and therefore its secondary target is to rapidly develop follow-on products to meet new competitors. Interestingly, Medco's hands-on activities can help identify these opportunities early. Merck has increased its spending on fundamental research. After a several year hiatus, it is again positioned to strongly benefit from major new product introductions. Its new product of greatest near term potential is Fosamax, a prescription drug designed to treat osteoporosis, a serious bone mass deficiency that affects many aging women. This product has significant potential. Analysts generally believe that worldwide sales for Fosamax can reach $0.240 billion in 1996 and $1.2 billion by 1999. Drugs under development by Merck including MK-383, a platelet fibrinogen receptor antagonist, MK-639, an AIDS vaccine, and Singulair, an anti-asthmatic, also hold great earnings potential.

**Financial Ratios (data in millions)**

- **Current Ratio:** $6,921.7 / $5,448.6 = 1.27x. This ratio shows the extent that all current liabilities are covered by assets (including inventory) that can immediately be converted to cash in the current time frame. The 5-year historical figure for Merck is 1.36x.
- **Quick Ratio:** $6,921.7 - $1,660.9 / $5,448.6 = .966x. The ratio measures Merck's ability to pay off all of its current liabilities from its cash or cash equivalent assets without relying on the sale of inventories. The previous two ratios are more applicable to bonds, but they indicate Merck's solid financial standing.
- **Inventory Turnover:** $14,969.8 / $1,660.9 = 9.01x. Good inventory management leads to maximum return at minimum risk. A buildup of inventory may indicate mismanagement of inventories, and an inefficient use of resources. Merck has a high turnover ratio which is a positive to creditors of Merck who will not view the inventory as being a great liquidity risk.
- **Days Sales Outstanding:** $2,351.5 / ($14,969.8 / 360) = 56.55 days.

**Portfolio Stock Analysis: Merck**

The faster a company receives payments on its sales, the more productive its management of capital is and the less chance it has for bad debt. Merck has a short collection period, indicating its ability to recover its receivables with speed and to use the funds for something else. Creditors look favorably upon a low DSO ratio.

**Fixed Assets Turnover:** $14,969.8 / $5,296.3 = 2.83x. This measures how effectively the company is using its plant and equipment. Merck operates in an industry where plant and equipment cost is not high.

**Debt Ratio:** (Merck's minority interests were not taken into account in calculating the total debt) $9,508.8 / $21,856.6 = .44%. This ratio indicates the percentage of assets supported by all liabilities as opposed to owner's equity. Creditors prefer a low debt ratio, because there is a greater cushion for creditor losses in the event of bankruptcy. Merck is conservatively managed financially, and not heavily leveraged. Its long term debt to equity ratio is only .103x ($1,145.9 / $11,139.0). The company uses excess cash flow to repurchase stock and increase earnings per share for shareholders. Interestingly, Merck's board just approved a $3 billion treasury stock buy back program. Merck's prior stock repurchase programs completed during the period 1985 through 1994, amounted to $4.7 billion in which it acquired 223 million shares of its stock in the open market.

**Net Profit Margin on Sales:** $2,997 / $14,969.8 = 20%. Merck enjoys a superlative ratio of net income per dollar of sales, a ratio that most companies would envy.

**Basic Earning Power:** $4,415.2 / $21,856.6 = 20%. This number reflects the raw earnings power of Merck's assets before the influence of taxes and leverage. It is another measure of Merck's very high rates of return.

**Return on Total Assets:** Standard & Poor's reports Merck's ROA at 14.4%, slightly higher than my calculated figure of $2,997 / $21,856.6 = 14%. Merck's 5-year historical ROA is 21.8%. The significant decline from the historic average reflects the acquisition of Medco in 1993. However, the current number is a improvement from the 1993 figure, and represents a resurgence in the productivity of Merck's assets in generating earnings. A further increase is expected as the leverage resulting from the Medco acquisition becomes realized.

**Return on Common Equity:** Again S&P's number of 28.4% is slightly higher than my figure of 26.9% ($2,997 / $11,139.0) because S&P calculates the return on average (year end and year beginning) for common equity, and I calculated it according to Brighton's method. The S&P measure...
is a better indicator of this return. Merck's 5-year historical figure for ROE is 44.3%. The acquisition of Medco significantly reduced this return, but further improvement is anticipated from the current level.

**Price/Earnings:** As noted before, with the stock selling at $66 7/8 the ratio is $66.875 / $3.10 = 21.6x. Merck’s P/E has traded in a range of 20x-25x in the early 1990’s, during a period of strong growth. Using the 1996 earnings per share estimate of $3.10, Merck has a forecasted price (assuming a similar P/E range) of $62.00 - $77.50 a share. Current 1997 analysts’ estimates of a $3.55 earnings per share, results in a price range of $71.00 - $88.75 a share, well above the current level of $66 7/8. The current P/E ratio average for the drug industry is 22x.

In 1994 the shares of Merck sold at 9x its Book Value per Share, versus and industry average of 11x. Merck’s 5-year historical average is 4.6x. It is selling at a much higher average because of Medco’s impact. Using the 1995 estimate, Merck currently has a Market to Book ratio of $66.875 / 8.86 = 7.5x. This is a reflection of the company’s very high pretax margins and investors’ beliefs that Merck will have a high rate of return on common equity.

*Editors Note: The price of Merck Co. stock at press time was $60.*