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American Society of Women Accountants

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- An Introduction to Dollar Unit Sampling
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- Integrating the Microcomputer into Managerial Accounting Classes
- Grapevine Politics: An Office Goldmine
- Remarks by Paula Cholmondeley, Director AICPA

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Editor's Notes

Emerging Changes

Changes witnessed by the accounting profession are miniscule compared to those the profession will undergo in the coming years. Monumental shifts in structures and services lie ahead for CPAs and other accountants. The profession will undergo profound change to develop vastly different skills necessary to survive in a rapidly changing world.

Eminent futurist, Hank E. Koehn, chairman of TRIMTAB Consulting Group, spoke on the emerging changes facing our society before members of AWSCPA and ASWA at their joint annual meeting in Los Angeles. According to Mr. Koehn, reality, as it exists in 1985, seems to be a vast restructuring of society. Reality is a survival challenge for some; it is prosperity or worsening conditions for others. It is a time of poverty and a time of affluence. Evidence of this change is seen in banking reorganizations and in the mergers and acquisitions of firms by the large industrial giants.

In the years 1981 and 1982 more new businesses were started than at any other time in history. There also were more failures, but this merely reflects change and risk taking. We are witnessing the decline of a mechanized economy and the emergence of an era of service.

Two organizational structures are with us in the decade ahead. First, the large corporate structure as known today will survive for the next several decades. Any company in existence before 1951 is being managed today, rather than being led. Managers, according to Mr. Koehn, are retainers and they no longer have staff loyalty. Second, the company small in size, growing, and large in dollar billing is important in its effect on the world. Its success depends upon finding and reaching its niche in the marketplace. Many firms, rather than retain many employees, will use "contract" labor hired according to their client's needs. This does not promise long employment, but it can mean satisfying work.

Labor unions are "winking" out. With due process in the work force, workers feel they no longer need an intermediary.

Growth in the 1990's will come from the small organizations. Accountants will change their structural form to serve the future. Large CPA firms will perform the certification function using computerized random audit checks on a twenty-four hour basis. Accounting firms are attempting to evolve beyond the auditing function and into all phases of accounting work and to perform consulting services. Huge billing income will be received from these services. There will be a lot of "Jewish mothering" of clients. Accountants will develop their marketing and public relation skills. Coopers and Lybrand, for example, uses Yankelovich, Skelly and White.

Today's entrepreneurs have rejected the "big" business concept. Technology supports today's business. New companies are forming and the regulatory climate is causing changes in firms not regulated as well as those in the industries being regulated.

This time of change will attract cheap entrepreneurs: the crap shooters, the opportunists who are coming into the banking and health care industries. They will drag their competitors down with them. If you believe you have an opportunist for a client, be careful and sell your services to these entrepreneurs on a COD basis. Mr. Koehn recommends that you take your good customers and look for their strategic vision. Normally, they will not have vision, but instead will have thermostats.

The new entrepreneur has vision and goals. His strategic vision, strategic planning and strategic product/service is likened to the Thanksgiving dinner. First, he has visions of what it will look like, he plans for it, and then delivers the product or service. And it is not $50,000 of two pounds of paper with a lot of nonsense on it.

The message given by Mr. Koehn is to give that discretionary effort — that extra bit of service, to be there when the customer needs you. Clients may expect you to share their belief, to be someone like them. They will expect "human warmth" from their accountant. They will need accountants who can be relied upon for consulting suggestions, who can give more than a standard service. New business will be willing to pay for these services.

For some, today is seen as a time of threat, a time of surviving, a cut-cost time. This is a "window" of time before another time of change appears 70 to 80 years into the future.

Hank Koehn believes today's focus should be on revenue expansion. He believes one's greatest skill will be as a marketing and business development person. These are needed skills by the accountant of the future.

Accounting education will become an experience in which people "learn." Accounting programs will include planning activities, marketing and business development. Accounting will be the core product with different packaging.

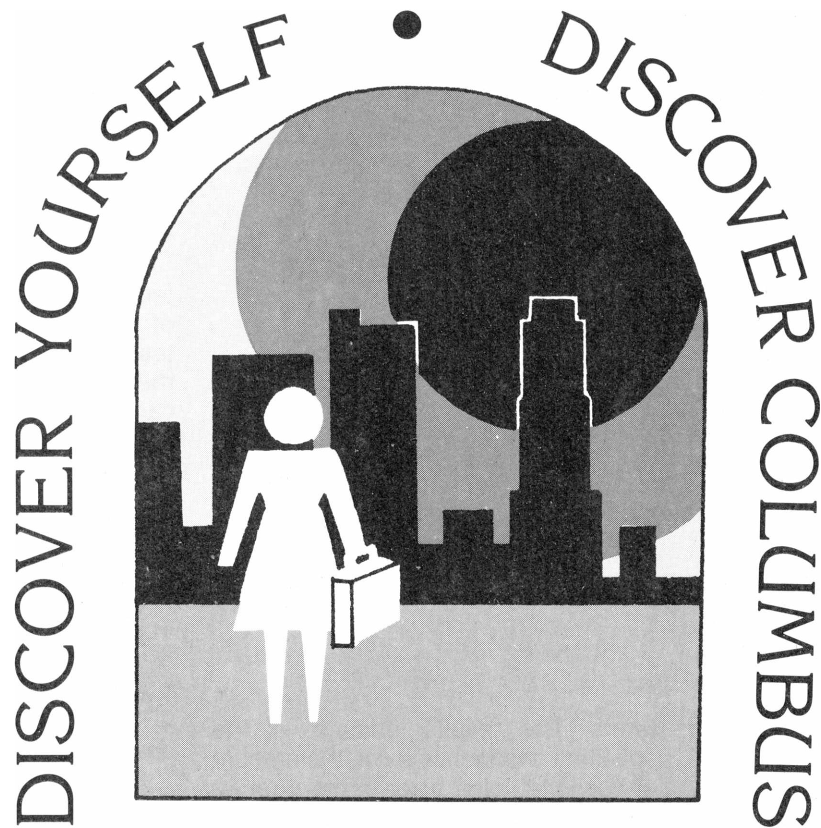
Today is not about yesterday's world. It is a time for all professionals to engage in a redesign of themselves and their companies. It is a challenge for all of us to start the "change" process.

Tapes of Hank Koehn's keynote address speech are available from the national office of AWSCPA, 500 North Michigan Avenue, Chicago, Illinois, 60611.Ω

Glenda E. Ried

I like knowing that the bottom line is all mine when I've put that much of myself on the line.

Hank E. Koehn, Chairman
TRIMTAB Consulting Group



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An Introduction to Dollar Unit Sampling

A Modern, Easy, Efficient Technique

by Janet L. Leichti

Statistical sampling techniques help auditors to make objective audit decisions in a number of audit situations. Two statistical sampling techniques which are widely used are attribute sampling and variables sampling. Attribute sampling is employed in compliance testing for internal controls and variables sampling is used when conclusions in dollar terms are desired. Dollar unit sampling (DUS) is a modern, easy, and efficient statistical sampling technique which enjoys many of the advantages of both attribute and variables sampling. Also, there are several advantages to DUS which are unique among sampling plans.

Overview and Advantages

DUS differentiates itself from other types of sampling by defining the sampling units as the individual dollars in the population rather than using the physical items. For example, a population of 2000 invoices totaling $168,000 contains 168,000 dollar units and 2000 physical units. The dollar units rather than the physical units are selected for testing under DUS and the results of the evaluation are given in dollar terms. The results indicate, at the specified confidence level, the amount of possible dollar error in the population. By comparing materiality, also in dollar terms, to possible error in the population the auditor decides whether to accept or reject the book value of the population as being fairly stated.

One of the advantages of DUS is that the method tends to include large book value items in the sample.[1] While each dollar unit in DUS has the same chance of being chosen, the probability of selection of the physical unit is proportional to the dollar size of the unit. For example, suppose there is a $16,800 invoice in the population of 2000 invoices totalling $168,000 used above. Under traditional sampling methods, each physical unit has an equal chance of being selected; i.e., is a 1/2000th chance of selecting the $16,800 invoice. Under DUS, each one-dollar unit in the invoice could be chosen, so there is a 16,800/168,000 or 10 percent chance that the invoice is selected. If the auditor believes the larger errors are in the larger items, DUS is a good sampling method to use.

A second advantage is that DUS is an efficient statistical technique. Because DUS tends to choose large dollar value items, the method usually tests more total dollars of a population than an attribute or variables sampling plan of the same sample size.

A further advantage of DUS is that the method allows several asset or several liability accounts to be considered as one population for purposes of statistical sampling. For example, several current asset accounts might be added together and one DUS test used to audit them all. Since the sampling unit is the dollar, homogeneity of the sampling unit is maintained.[2]

The ability to begin DUS work at interim dates is another favorable aspect of the method. Auditors can begin testing even before the book value of the population is known, and the work can be completed at year-end. Several other advantages of DUS exist and are pointed out in the following sections.

Selecting a Sample

Selection of the units to be included in the sample is one of the initial steps in a DUS test. Before selecting the actual dollar units in the population which will be tested, the auditor must make several preliminary determinations.

Preliminary Determinations. In any statistical sampling test, the auditor decides on the objectives of the test and defines both the population and the errors. Using the audit of accounts receivable as an example, the objective of the test might be to establish the existence of receivables and to determine whether receivables are fairly stated. DUS can then be used to select individual accounts for confirmation and to evaluate the results. The population would be defined as the receivables at a particular date and an error might be defined as a discrepancy between the book and true amounts.

The confidence level, which is the complement of sampling risk, is also specified at this early stage. Sampling risk is the risk of concluding the population does not contain material error when in fact, there is material error in the population. Sampling risk is generally set at a low level such as 10 percent or 5 percent. For these levels of sampling risk, the corresponding confidence levels are 90 percent and 95 percent.

Materiality for the population being tested is also established. Materiality is the amount of uncorrected error remaining in the accounts which would cause the accounting information to be misleading. The auditor is required by *Statement on Auditing Standards 47* to consider preliminary estimates of materiality when planning audit procedures.[3] Materiality is generally set in relation to the totals of the financial statements. To determine materiality for a specific account or group of accounts, as needed in DUS, the auditor estimates the amount of uncorrected error in the account or group of accounts being tested by DUS, which when combined with errors in other accounts, would cause the accounting information to be misleading. The materiality amount is used in figuring sample size.

Two final items are determined before sample size is computed. First, the number of errors the auditor expects in the sample is estimated. The auditor may refer to prior years' work or perform a preliminary sampling plan of about 30 items to estimate the number of expected errors. Second, the book value of the account or group of accounts being tested by DUS is established.

Sample Size. With determinations of confidence level, materiality, number of expected errors, and population book value, the auditor computes the sample size by the following formula:

TABLE 1
Upper Error Limit Factor Table

Number of errors	90% UEL factor	90% PGW factor	95% UEL factor	95% PGW factor
0	2.31	—	3.00	—
1	3.89	.58	4.75	.75
2	5.33	.44	6.30	.55
3	6.69	.36	7.76	.46
4	8.00	.31	9.16	.40
5	9.28	.28	10.52	.33
6	10.54	.26	11.85	.33
7	11.78	.24	13.15	.30
8	13.00	.22	14.44	.29
9	14.21	.21	15.71	.27
10	15.41	.20	16.97	.26
11	16.60	.19	18.21	.24
12	17.79	.19	19.45	.24
13	18.96	.17	20.67	.22
14	20.13	.17	21.89	.22
15	21.30	.17	23.10	.21
20	27.05	.14	29.07	.19
25	32.72	.13	34.92	.16
50	60.34	.09	63.29	.12
75	87.37	.08	90.89	.10
100	114.07	.06	118.07	.08

Note: PGW is precision gap widening
Source: Leslie, Donald A., Albert D. Teitlebaum, and Rodney J. Anderson. *Dollar-Unit Sampling,* Toronto, Copp Clark Pitman, 1979, back cover.

$$n = \frac{\text{UEL factor} \times \text{BV}}{\text{M}}$$

where:

n = sample size

UEL factor = upper error limit factor (from Table 1)

BV = book value of population

M = materiality for population

The UEL (upper error limit) factor is obtained from Table 1. The upper error limit is the amount of possible error in the population. The UEL factor is read from the table by finding the intersection of the number of expected errors (rows) and the confidence level (columns). An example involving a population of sales invoices illustrates how to use Table 1 and how to compute n.

Assume:

Book value of sales invoices	$168,000
Number of sales invoices	2,000
Confidence level	90%
Number of expected errors in the sample	0
Materiality for sales invoices	$ 5,000

The UEL factor for zero expected errors and a 90 percent confidence level is 2.31. The sample size is then computed:

$$n = \frac{2.31 \times 168{,}000}{5000} = 78$$

Seventy-eight dollar units are selected from a population of 168,000 dollar units. Note that there is a possibility that fewer than 78 invoices will be selected for testing, as two or more dollar units may fall within the same invoice.

Fixed Interval Sample Selection. Once the sample size is determined, the dollars to be tested are chosen. One simple method of selecting sample items is the fixed interval sample selection method.

To apply the fixed interval method, the auditor determines the average sampling interval (ASI) or the number of dollars between the dollar units selected for testing. ASI equals the book value of the population divided by the sample size: ASI = BV/n. In our example, ASI = 168,000/78 = 2154. Every 2154th dollar in the population of sales invoice is selected for testing. In addition to computing the ASI, the auditor must obtain a listing of the population members with a cumulative dollar total after each. With current computer abilities and availability, the client should be able to supply the

TABLE 2
Example of Fixed Interval Selection Method

Sales Invoice Number	Amount of Sales Invoice	Cumulative Total	Sales Invoice Selected	Cumulative Dollar Selected
1	$2,000	$ 2,000	✓	1000 (random number)
2	1,000	3,000		
3	2,000	5,000	✓	3154 (1000 + 2154)
4	6,000	11,000	✓	5308 (3154 + 2154)
				7462 (5308 + 2154)
				9616 (7462 + 2154)
5	50	11,050		
•	•	•	•	•
•	•	•	•	•
•	•	•	•	•
1998	25	166,850		
1999	75	166,925	✓	166,858 (1000 + 77x2154)
2000	1,075	168,000		

Note: Fixed interval or ASI equals 2154.

auditor with a listing of the cumulative totals.

To begin the selection of the sample, the auditor chooses a random number between 1 and ASI. The dollar corresponding to the random number is chosen as the first unit in the sample. ASI is added to the random number to determine the second number. The remaining dollar units to be sampled are determined by adding ASI to the previous total until the auditor has exhausted the population. Table 2 presents an example of fixed interval selection.

In the example in Table 2, assume the auditor chooses 1000 as the random number between 1 and ASI; the first dollar selected is the 1000th dollar of the population. Since the first invoice is for $2,000, the 1000th dollar unit falls in that invoice and it is selected for inclusion in the sample.

The second dollar unit to be selected is 3154 (1000 + 2154). By studying the Cumulative Total column in table 2, one can see that invoice 2 contains cumulative dollars 2001 through 3000 and the cumulative dollars in invoice 3 are 3001 through 5000. Thus, dollar 3154 falls in invoice 3.

The next three dollar units selected are 5308, 7462, and 9616 (see table 2 for calculations). All three of these dollar units fall in the same physical unit, sales invoice 4. This is perfectly acceptable and illustrates why DUS is an efficient sampling method. Although 78 dollar units are selected for testing in this example, no more than 76 sales invoices are examined. The example also illustrates that large invoices have a high probability of being chosen. In fact, any invoice totalling $2154 or more is automatically included in the sample.

Additional dollar units are selected for the sample by adding ASI, 2154, to the previous cumulative total. In this example, the final dollar selected is 166,858 (1000 + 77 x 2154).

Interim Testing. Because of the crunch of year-end work, auditors often try to perform as many audit procedures as possible before year-end. DUS can begin at an interim date even though the auditor cannot determine the total sample size until year-end.

To utilize the formula for sample size given above, the auditor needs the book value of the population. Unfortunately, the final book value is not known at an interim date. Still, ASI can be computed before year-end and used to select sample members even though the total sample size is not known until later.

Recall that

$$ASI = \frac{BV}{n} \text{ or } n = \frac{BV}{ASI} \text{ and that}$$

$$n = \frac{\text{UEL factor} \times BV}{M}.$$

Therefore,

$$\frac{BV}{ASI} = \frac{\text{UEL factor} \times BV}{M} \text{ and}$$

$$ASI = \frac{M}{\text{UEL factor}}.$$

ASI is then used as in Table 2 to select units for testing.

To compute ASI for use in interim testing in the sales invoice example, materiality of 5000 is divided by 2.31, the UEL factor. The result, 2164, is quite close to the ASI computed earlier. After selecting a random number corresponding to a dollar unit between 1 and 2164, the auditor chooses every 2164th dollar for testing. This continues until the dollars comprising the book value of sales invoices at the interim date are exhausted. At year-end, the auditor continues testing through the entire population. At that time, the final sample size is known.

How to Evaluate the Results

Once sample size (or, if performing tests at interim dates, ASI) is known, and the DUS sample is selected, the auditor performs the test procedures and evaluates the results. The achieved upper error limit (achieved UEL), the auditor's best estimate of the possible amount of error in the population, is then calculated. By comparing achieved UEL to materiality, the amount of error the auditor is willing to tolerate in the population, a decision on whether to accept the client's assertion as to the book value of the population can be made. For example, suppose that, in independent cases, the auditor discovers no errors, one large (100 percent) error, one moderate (less than 100 percent) error, and two moderate errors in the sample.

No Errors. Using the sales invoice example, assume that no errors are found in the sample. Although the

sample revealed no errors, there may still be errors in the remainder of the population and this must be estimated. The amount of possible error in the population when zero sample errors are found is termed basic precision (BP). Achieved UEL and BP are equal when no errors are located in the sample.

Achieved UEL is calculated by multiplying the appropriate UEL factor in Table 1 by ASI. In the sales invoice example, the UEL factor for 90 percent confidence and zero errors is 2.31. Thus:

Factor	×	ASI	=	Achieved UEL
2.31	×	2154	=	4976

While no errors were found in the sample, there may be, at 90 percent confidence, as much as $4,976 in error. The auditor may conclude:

> Based on the sample results, and at a confidence level of 90 percent, the errors in the sales invoice population do not exceed $4,976.

One 100 percent Error. Assume now that the auditor finds one $100 invoice which is completely erroneous; it is 100 percent overstated. The achieved UEL is calculated by using the UEL factor for one error at 90 percent confidence and is shown here:

UEL Factor	×	ASI	=	Achieved UEL
3.89	×	2154	=	8379

FIGURE 1
Components of Achieved UEL

Component	How to Calculate[1]	Example[2]
BP (basic precision)—the amount of possible error in the population when zero errors are found in the sample.	UEL factor[3] for 0 errors and selected confidence level x ASI	2.31 x 2154 = $4976
MLE (most likely error)—estimation, based on errors in the sample, of the dollar amount of error in the population.	1.00 x ASI	1.00 x 2154 = $2154
PGW (precision gap widening)—amount achieved UEL is increased because errors are found in the sample.	PGW factor[3] for one error and selected confidence level x ASI	.58 x 2154 = $1249
Achieved UEL (achieved upper error limit)—the amount of possible error in the population.	Sum of the three components	$8379

[1]For one 100% error.

[2]One 100% error, book value of population = $168,000, 90% confidence, ASI = 2154.

[3]From Table 1.

The achieved UEL in this example can be broken down into three components: basic precision, most likely error, and precision gap widening. Each is discussed below and Figure 1 summarizes their relationships.

Basic precision (BP) was explained above and remains at the same dollar level regardless of the number of errors found in the sample. At 90 percent confidence, BP is 2.31 (UEL factor) x 2154 (ASI). For our example population, for any number of errors, BP is $4,976.

Most likely error (MLE) is an estimation, based on the errors observed in the sample, of the dollar amount of error in the population. MLE is calculated by multiplying the number of sample errors times ASI. In the example with one error then, we have:

Number of Sample Errors	×	ASI	=	MLE
1	×	2154	=	2154

This is interpreted as follows: One error was found in a sample of 78 one-dollar units. Since the population is 2154 times as large as the sample, it is most likely that 2154 one-dollar units are in error.

Precision gap widening (PGW) is the amount by which the achieved UEL must be increased because errors are found. As more errors are located, the measure of the possible error in the population becomes less precise. It follows that error is easier to estimate in an accurate population than in one which contains many errors. PGW is calculated by multiplying the PGW factor from Table 1 by ASI. For the invoice example, the PGW factor for 90 percent confidence and one error is .58 and PGW is:

PGW factor	×	ASI	=	PGW
.58	×	2154	=	1249

BP, MLE, and PGW are added together as shown in Table 3 and Figure 1 to calculate achieved UEL. Note that for 100 percent errors, the auditor may calculate achieved UEL in either of two ways: (1) multiply the UEL factor by ASI or (2) calculate BP, MLE, and PGW and then sum.

One Error, Less than 100 percent. Suppose that, in the sample of 78, an overstatement error of $25 in one in-

TABLE 3
Evaluation of One 100% Error

	Factor*	×	ASI	=	Dollar Conclusion
BP	2.31		2154		$4976
MLE	1.00		2154		$2154
PGW	.58		2154		$1249
Achieved UEL	3.89		2154		$8379

*At 90% confidence

TABLE 4
Evaluation of One 25% Error

	Factor*	×	t	×	ASI	=	Dollar Conclusion
BP	2.31		1.00		2154		$4976
MLE	1.00		.25		2154		539
PGW	.58		.25		2154		312
Achieved UEL							$5827

*At 90% confidence

TABLE 5
Evaluation of Two Errors
Taintings of .50 and .25

	Factor*	×	t	×	ASI	=	Dollar Conclusion	Total of UEL Component
BP	2.31		1.00		2154		4976	$4976
MLE	1.00		.50		2154		1077	
	1.00		.25		2154		539	$1616
PGW	.58		.50		2154		625	
	.44		.25		2154		237	862
Achieved UEL								$7454

*At 90% confidence

Note: Tainting factors (t) must be evaluated in descending order.

voice for $100 was discovered. In DUS samples, sample units in error are said to be "tainted," and a tainting factor (t) is computed by dividing the error amount by the book value of the sample item. In this example, it is .25 ($25/$100).

The tainting factor is taken into account when calculating the MLE and PGW components of achieved UEL, but BP is not affected by the tainting factor. The MLE and PGW factors are multiplied by t and then by ASI in finding a dollar conclusion. Table 4 shows the calculation.

Two points about this calculation need to be made. First, when calculating the achieved UEL for zero errors or for only 100 percent errors, it is not necessary to determine BP, MLE, and PGW. Achieved UEL can simply be figured by multiplying the UEL factor in Table 1 by ASI. When calculating achieved UEL in cases where the tainting factor differs from 1.00 (a 100 percent error) however, BP, MLE, and PGW must be computed since the tainting factor affects the results. Secondly, compare Tables 3 and 4, which show the calculations of achieved UEL for one 100 percent error and for one 25 percent error respectively. Intuitively, one would expect that the total estimated error would be higher in a population in which the sample revealed one 100 percent error in an invoice of $100 as compared to a population in which one 25 percent error in an invoice of the same size was found. Note that this is true; the sample of one 100 percent error has an achieved UEL of $8,379 while the one 25 percent error shows an achieved UEL of $5,827.

Two Errors. In DUS samples in which more than one error is found, the errors must be ranked in descending order of the tainting factor to calculate achieved UEL. Assume two errors with tainting factors of .50 and .25 are found. BP remains the same regardless of the number of errors or the tainting factors. MLE and PGW each involve two calculations; one for each error. The PGW factors are applied to the tainting factors in order. That is, the PGW factor for one error is multiplied by the largest tainting factor (.50) and the PGW factor for two errors is multiplied by the second tainting factor (.25). Table 5 shows the calculation.

Comparison of Achieved UEL to Materiality. After computing the achieved UEL, comparison of that figure with materiality should be made. By comparing the best estimate of the possible extent of error in the population to the amount of error the auditor is willing to tolerate, the auditor can decide whether to accept the book value of the population as fairly stated or not. If achieved UEL exceeds materiality, the auditor may request the client to record an adjustment to the account.

Is DUS Appropriate?

Despite the ease of application and the several advantages of DUS, there are situations in which the method may not be the most appropriate. The warnings mentioned below are not meant to discourage the use of DUS, but rather, are discussed to aid the auditor in deciding if DUS is the best method in a particular audit situation.

DUS is especially effective in finding overstatement errors, but is not as well suited to locating understatements. Large accounts, which may be erroneously stated because of overstatements, have a high chance of being selected. In contrast, small accounts, which may be small because of understatement errors, have a proportionately smaller chance of being chosen for a DUS sample. If the auditor is concerned with understatement errors, a sampling method based on physical unit selection is more effective.

Another concern with DUS, closely related to the first, is that DUS fails to locate errors in accounts with zero balances. This is a problem in other sampling techniques as well and auditors utilize methods other than sampling to find large understatement errors. For example, if the auditor is concerned with unrecorded liabilities, vendors with balances at the prior year-end but with zero balances currently might be confirmed.

A further aspect of DUS which should be considered is the assumption that material errors are lurking in the large accounts.[4] If the auditor feels that many small errors are incorporated in small accounts, traditional sampling techniques by physical unit are more appropriate.

A final concern with DUS is associated with one of its primary advantages; the results are stated monetarily. In some instances, error rate conclusions may be what the auditor desires and an attribute method yielding such results should be employed.

Conclusion

This article presents an introduction to understanding and implementing dollar unit sampling. Many decisions and determinations made by the auditor for DUS are also used in other sampling methods, so DUS is not an entirely new technique. Specification of the objectives of the test, definitions of the population and of errors, materiality, confidence level, book value of the population, number of physical units in the population, and number of expected errors are all used in other sampling plans. The principle difference between DUS and other statistical sampling methods is in the definition of the sampling units as one-dollar units of the population rather than as physical units. Two other important differences are: the use of tainting factors in the evaluation of the results and the formal inclusion of materiality in planning the DUS sample.

DUS is easy to understand and simple to use. The method is efficient; it tends to select large physical units for sample members and often tests more dollars of a population than other methods of the same sample size. Several accounts can be audited together using DUS and interim testing is easily implemented and coordinated with year-end audit procedure. The conclusion the auditor draws regarding the fairness of the book value of the population is stated in dollar terms and is statistically valid and objective. Because of the ease of understanding, applying, and evaluating DUS, auditors may expect increased use of the method.Ω

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Financial Planning: The Emergence of a Profession

Tremendous Potential

By Charles D. Gulley

Approximately 20 years ago the practice of personal financial planning was a mere concept in the minds of certain individuals. In the early 1960's and prior years financial planning was provided by practitioners who were motivated by potential sales of a single product. The conception of the client's goals was singular and unrelated. Various professionals were given a portion of the process. For example, investment brokers were given a segment, bankers another segment, accountants, attorneys and insurance agents still another separate piece of the total plan. With this arrangement each professional independently made recommendations, so frequently no one coordinated the client's total planning process. Personal financial planning has advanced to the point that today, in 1986, it is recognized as an emerging profession in the financial services industry.

The Financial Planning Process

Dale S. Johnson of the American College defines the process: "Comprehensive financial planning involves thorough collection and impartial analysis of information on the factual and effective dimensions of a person's or family's total financial situation; the identification of needs; the establishment of specific financial goals; and the formulation, implementation, and continuous monitoring of a comprehensive plan to achieve them."

People must make decisions. Goals must be established that will satisfy their needs, and behavior patterns must be selected that have the greatest likelihood of accomplishing the goals.

The consumer, in today's market place, is confronted with multiple vendors of financial services such as the following:

- Bank trust services
- Accountants
- Investment advisors
- Attorneys (wills, trusts, business agreements)
- Commercial banking (checking, savings, CDs)
- Pension, profit sharing plans
- Home mortgaging
- Life insurance agents
- Property and Liability insurance agent
- Tax preparers
- Mutual Fund salesmen
- Visa, Mastercard, American Express
- Request for charitable donations, bequests
- Friends and relatives offering free advice

The individual may be bewildered by information provided from such diverse sources. The confusion intensifies when the consumer attempts to do something about his financial needs and problems and discovers:

• Each of these providers operates independently of the others.

• Each offers his own expertise or products for an isolated need or problem that is unrelated to the consumer's overall financial condition.

• Each considers himself the professional in whom the client should place his confidence and trust.

Assume that an individual has determined that a selected planning process is needed. The complexity of the situation is recognized. Comprehensive financial planning is designed to relieve the presure on the individual and specialists involved and place it on the financial planner. The planner must have a broad knowledge of the whole financial services industry and its available products and services, a coordinated delivery system and a commitment to serve the client's interests first.

Thus the three essential characteristics of financial planning as a process are:

1. It is comprehensive — it encompasses the client's whole personal and financial situation to the extent it can be established through counseling.
2. It is client oriented and addresses client needs.
3. Its aim is to produce a plan tailored for the individual client that provides an integrated, coordinated system for managing financial resources, enabling the client to assume responsibility and control over his financial condition, and permitting the client to aim for realistic goals and objectives.

The process involves the following steps:

1. Contact individual client or groups for precounseling.
2. Gather complete client information; determine who he/she is, where he/she is, where he/she wants to be, where he/she can be.

3. Develop a financial plan that moves client forward to where he/she wants to be.
4. Present completed financial plan to client with specific implementation schedule.
5. Administer plan.
6. Review plan periodically to evaluate and measure performance.
7. If unacceptable, revise objectives and plan.

Comprehensive financial planning can be viewed as the process that integrates and coordinates the expertise of specialized professionals in financial services for benefit of the client. In this *team approach* to the client's interest each specialization assumes a definable and specific role in relation to the client's overall objectives. The consultative advice and service and product implementation are more professional because they are directed toward satisfying needs and attaining objectives that have been clearly and comprehensively determined in the counseling sessions by the financial planners.

A hypothetical situation can demonstrate the need for a team approach. Assume the data gathering and analysis steps have revealed that the client, a family unit, needs:

- Significant and in-depth analysis and planning in stock portfolio and other investments.
- An analysis of how business interests can best serve personal financial planning objectives.
- A program for funding the college educations of three children.
- New wills for both spouses.
- The structuring of two different trusts for the benefit of members of the family.
- Business interest advisory services concerning business valuation and ultimate transfer of business interests to the children.
- Life and disability income protection and possibly life insurance funding of transfer plans for the business interests.

Seldom is one individual capable of knowing and implementing everything about financial planning and investing. Not many people are knowledgeable in the area of taxes, tax shelters, real estate, oil and gas, insurance, stocks, mutual funds, retirement planning, estate planning and the law. To provide a comprehensive plan and complete service to a client, the service-oriented (as opposed to a product-oriented) planner needs to take a team approach.

The question of objectivity must be addressed. A product oriented firm, e.g., a brokerage house, may put together a CPA, an insurance agent, an attorney, and a tax expert in an office to coordinate a client's complete financial plan. When a brokerage house puts a team of professionals together, these professionals may have an incentive to work separately because of the commissions they may receive. One solution may be to pay a salary to these professionals. Then they would be free to work together in the best interest of the client.

This is not to take the position that product oriented firms cannot do an excellent job of financial planning. Diverse firms within the financial community have identified financial planning as a separate entity with a promising role in the future. However, they must not retain a sales philosophy that is inherently in conflict with the service philosophy that should be foremost in objective financial planning.

Professional Organization and Designations

The present financial planning profession had its beginnings in the late 1960's and early 1970's. The International Association for Financial Planning and the College of Financial Planning were formed. The profession is currently going through a growth stage while reaching for maturity. Literature concerning the profession is being rapidly developed. Professional certification and formal academic programs are being advanced.

The International Association for Financial Planning (IAFP) was founded in 1969 as part of the Society for Financial Counseling. This nonprofit organization is the oldest and largest organization representing the comprehensive planning community. The Association's philosophy, mission and Code of Professional Ethics demand continuing education, a unified approach to the service of the client's financial needs, a dialogue among the professions and the maintenance of a high level of professional ethics. The IAFP membership represents many financial planning disciplines.

CPAs formulate comprehensive, personalized financial plans for clients that include living, retirement and estate planning.

Members include registered investment advisors, stockbrokers, insurance agents and brokers, bankers, realtors, CPAs, attorneys, educators, financial writers and publishers. This list presents a clear picture of the diverse nature of the financial planning community. The organization stands ready to provide potential clients with the names of available financial planners who have exhibited evidence of their experience and qualifications.

The College of Financial Planning in Denver, Colorado offers the Ceritified Financial Planner (CFP) designation program. This is the oldest and probably best known program of its kind. The program has been improved progressively since its beginning in 1972. The objectives of the College are to provide training to persons who are or will be offering financial counseling, investment and risk management advice, counseling related to retirement, tax or estate planning, or general personal financial planning and implementation.

The CFP program consists of six separate parts: introduction to financial planning, risk management, investments, tax planning and management, employee benefits and retirement planning, and estate planning.

In addition to successfully completing written examinations covering the above listed subjects, candidates must meet education, experience and ethical requirements. Over 6,000 candidates have completed the CFP program and over 19,000 candidates are enrolled and actively pursuing the designation.

In response to changes in the financial services community, the American College Board of Trustees, in 1981, officially broadened the aim of their Col-

lege by introducing additional courses and programs. The College, located in Bryn Mawr, Pennsylvania, now offers the Chartered Financial Consultant (ChFC) designation.

The ChFC program requires the completion of ten courses. The following subjects are included:

- Financial Services: Environment and Professions
- Income Taxation
- Economics
- Financial Statements Analysis/Individual Insurance Benefits
- Employee Benefits
- Investments
- Wealth Accumulation Planning
- Estate and Gift Tax Planning
- Planning for Business Owners and Professionals
- Financial and Estate Planning Applications

After the educational requirements have been met for the designation, a comprehensive review of the candidate's experience, business practices and professional ethics is conducted by the Certification Board of the Board of Trustees.

National Applications

Accounting Firms — Using profiles of the Big Eight accounting firms, a pattern can be established as to how the firms are approaching financial planning. Directors of financial planning, usually partners, have been designated on the national level and planning directors have been appointed in each of the local offices. An increasing proportion of their work is in the financial planning field. Young CPAs are being recruited and trained in the specialty and older individuals are being updated. The planners formulate comprehensive, personalized financial plans for clients that include living, retirement and estate planning. Annual follow-up contacts are made with clients. By developing planners through education and making these experts more productive, the firms hope to stay ahead in this growth area. The planning services are a standard fee-only comprehensive practice, involving all stages of the planning process. Implementation is pushed by forging liaisons with outside advisors.

Banks — The challenge facing banks is to convert bank branches from their traditional deposit-gathering role into distribution centers for the new financial services. For some banks, this begins with a new emphasis on marketing already-developed trust department expertise in the much broader market of fee-only financial planning. Examination of profiles from banking giants shows that vice-presidents are being placed in charge of financial planning departments. Staffs of professionals including tax lawyers, CPAs, CLUs and other non-bankers are being assembled. Thus the team approach is evident in this section of the financial empire. The programs are generally operated on a fee basis with no constraints on product selection.

Some accounting firms are creating a separate department for personal financial planning headed by one or two partners of the firm.

Investment Brokers — Major national securities firms have recognized the areas of concern as those of tax guidance, insurance, investments, education and retirement funding and estate planning. Planning departments have been created utilizing questionnaires and interviews for personal data collection. The departments formulate comprehensive, personalized financial plans for clients. The companies are using a sales and educational effort encompassing basic intermediate and advanced levels of accomplishment directed at assisting their account executives in the transition to professional financial planning consultants. The firms are determined to prepare high quality plans and to provide the necessary counseling to execute the plans. Primarily the services are fee-only, since the plans can be purchased for a fee with no further obligation to have the investment firm implement the plan. The potential conflict of interest is recognized if the firm does both the planning and implementation. Special efforts are made to guard against this potential.

Insurance Companies — Over the past decade insurance executives have sized up the modern world of financial services and introduced a number of competitive new products. One of these is financial planning. Selected agents who have shown a strong interest in planning are given a challenging formal training. The training involves both company conducted classes and funding acquisitions of ChFCs and CFPs. After completing the qualification and certification programs, agents begin data collection and offer product guidance. The planning is applicable to anyone and can be as simple or as complex as each situation requires. The process will have independence from product sales to preserve credibility and objectivity. Fee structures have not been fully developed but the fees will probably range from $500 to $1,000. Home office specialists will help with special client situations.

Independent Planners — Over the past 12 to 15 years financial planners have pioneered what is essentially a new industry. The client-centered investment service market promises to become one of America's premier growth industries in the 1980's and beyond. Estimates of the current market size range from $10 billion to over $50 billion in investment dollars, and few observers believe the still growing profession has more than scratched the surface. As we have seen the giants are moving into this field. At the same time other companies are beginning to view the independent financial planner as the bridge for the growing volume of investment dollars. As the financial planning profession enters a new and more competitive phase of market development, the planning firms are relying on the old fashioned entrepreneurial advantages of personal style, clean and objective management, flexibility and close touch with the client. Also by going to outside experts, a planner gets the benefits of broadly based knowledge which the consultant professional obtains by working with a large and diverse clientele. Single planner firms usually grow by division with the founder training and then elevating a protege to associate status. This process can lead to a large firm with large-firm problems. Therefore, more and more financial planners are moving from a proprietorship mode of operations to a corporate structure that

offers more time to serve more clients through the support of salaried personnel.

This market will continue to grow during this transition period and planners will determine how to set up an enduring practice. As they face the new increased competition, potentially higher profits and larger and more demanding customer bases, planners will have to devote more and more of their creativity to planning their own practices. They will increasingly be playing for higher stakes and they will have a chance to win.

Community Applications

Interviews were conducted with some local financial professionals to explore the level with which personal financial planning has penetrated the community. While not exhaustive, the results do give an indication of the level of participation.

Two large CPA firms were contacted. One acknowledged that nancial planning is a topic that many people are talking about, but in their firm the idea is in a conceptional stage. The firm is making an effort to get some staff member designated as Certified Financial Planners. The partner interviewed considers CPAs to be the best qualified to serve as captain of the team. One approach being considered is to create a separate department for personal financial planning headed by one or two partners of the firm. A change would be that the department would offer ideas — selling services. The initial plan would probably involve a program based on an hourly charge for service, eventually going to a fee basis. A recognized need exists to market the services.

The second firm was in a somewhat similar position, with departmentalization being considered as a long-term goal. CFPs are currently being trained with two programs under consideration for development. The first would be comprehensive financial planning, which would involve studying and projecting the client's entire financial life style. The second program would maintain specialty areas and involve recommending specific courses of action, e.g., handling cash flow problems, tax considerations and decisions to buy various investment vehicles.

A trust officer of a large state-wide bank stated that all the bank's trust people were aware of the concept, process and components of financial planning. Two staff officers are pursuing the designation of Chartered Financial Consultant (ChFC). The bank is contemplating establishment of a financial planning division in its trust department. Two approaches are being considered, the first would be to provide financial planning services for the bank's customers, with the purpose of keeping customers and deposits. The question is whether or not the cost of the new service would outweigh the account value. The second would be to establish a separate profit center operating on a fee basis.

The City of Montgomery, Alabama with an estimated population of 183,500, presently has three firms that operate as independent financial planners. A principal of one of the companies stated his firm is three years old. The planning concept is working well for the benefit of clients and the benefits are substantial. The team approach is being utilized, with the planners working specifically with CPAs and attorneys. In-house investment and insurance services are provided. The principals are Certified Financial Planners registered with the SEC as investment advisors and with the National Association of Security Dealers (NASD). The charge for the service is typically in the form of an annual retainer. However some services are provided on a fee basis with others on a fee plus commission basis. It is felt that while the profession locally is not yet large the potential is tremendous.

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Conclusion

The financial services professional of tomorrow will change in a number of ways. First, the planners will have to become better acclimated and more comfortable with using technology. The practitioner will have to get used to dealing with clients in new and different ways. The planner will have an almost limitless amount of information about customers, their portfolio of securities, cash positions, current financial obligations, insurance coverages, real estate holdings, legal documents, and their plans and dreams of the future. The planner will have a large quantity of information about the total financial market and its related products. In addition to knowing how to access this data, the planner must know how to sift through the information to determine which will be of the greatest value to the clients. A thorough knowledge of the products available and an ability to compare the advantages and disadvantages of each will be essential for the planner to be in a position to provide high quality advice and guidance to the client. The quality of service provided should improve and the profession should become stronger, create trust, and establish recognition — thus providing a base for continuing growth.Ω

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The Case for Partial Tax Allocation

Will Enhance Comparability and Add Relevance

by Jerry G. Kreuze and Daphne Main

Accounting Principles Board (APB) Opinion No. 11, "Accounting for Income Taxes," concluded that "comprehensive income tax allocation is an integral part of the determination of income tax expense."[1] Thus, income tax expense includes the tax effects of transactions entering into the determination of pre-tax accounting income for the period even though some transactions may affect taxable income in a different period. Since permanent differences[2] do not affect other periods, interperiod tax allocation is only applicable to timing differences. By definition, timing differences originate in one period and reverse in one or more ensuing periods. Consequently, the Financial Accounting Standards Board (FASB) in its *Discussion Memorandum*, "Accounting for Income Taxes," stated that timing differences reverse.[3]

Although on an individual basis timing differences do reverse, they do not, in all cases, reverse either in total or on a similar timing difference basis. This article will explore the above controversy from numerous vantage points. Attention especially will be given to both the Conceptual Framework project and the cited FASB *Discussion Memorandum*, "Accounting for Income Taxes." Because comprehensive income tax allocation is presently required, the discussion and arguments presented will be directed against the comprehensive method and for the partial income tax allocation alternative.

Permanent Deferral of Tax Credits

APB Opinion No. 11 reviewed the conceptual merits of three different methods of interperiod income tax allocation and required the deferred method. The net-of-tax method was rejected because it conflicts with the general principle of not offsetting related assets and liabilities on the balance sheet. The liability method was discarded because of the inherent problem of estimating both future corporate profits and Congressional action. While empirical studies on the behavior of deferred tax account balances (some of which are briefly summarized below) were based upon the tax credits created under the deferred method, their conclusions would hold equally well under both the liability and net-of-tax methods. These studies refute many of the arguments supporting comprehensive allocation of income taxes.

In one of the earliest and better known studies on the behavior of accumulated tax deferrments arising from timing differences, Price Waterhouse and Company[4] concluded that to ensure fairly stated financial statements for both buyers and sellers alike, interperiod income tax allocation should only be applied to those timing differences which are reasonably certain to affect the flow of corporate resources in the near future.

Addressing only depreciation timing differences, Davidson[5] analyzed the behavior of the deferred tax account balances for both static and steadily growing firms through the use of a simulation. While the static firm followed a constant replacement policy of its original fixed assets, the steadily growing firm increased its investment in depreciating assets at a rate of 5 percent annually. For both firms, an accelerated depreciation method was used for tax purposes[6] and the straight-line method was used for financial reporting purposes. Based upon his findings, Davidson concluded that "there will be no liability for future taxes for static or growing firms if depreciation provisions of the tax laws remain unchanged (or become more generous) and a regular policy of investment in depreciating assets is maintained."[7]

Although Davidson had shown that the existence of future tax liabilities depends mainly on the trend over time of the firm's expenditures on depreciable assets, he provided no conclusions where asset expenditures are lumpy or cyclical over time. In response to this void, Livingstone examined the effects of cyclical set expenditures on the deferral of income taxes which are associated with the use of accelerated depreciation for tax purposes.[8] His simulation model which considered both linear and nonlinear trends in asset expenditures over time yielded information which suggests that even in the presence of severe cycles, a strong growth trend in asset expenditutes produces no repayment of deferred taxes. In fact, if cycles are not severe, even a modest growth rate in asset expenditures may be sufficient

to avert deferred tax liabilities.

While Price Waterhouse, Davidson, and Livingstone engaged in empirical research to determine the conditions necessary for permanent deferral and the extent to which it exists, Buckley compared the growth rate of the deferred tax account to the growth rate of owners' equity and total assets.[9] Finding that the growth rate in the deferred tax account was between 200 to 300 percent per annum greater than in owners' equity and total assets, Buckley concluded that the application of comprehensive tax allocation has resulted in excessive growth of the deferred tax account with resulting higher debt-equity ratios and lower reported earnings.

In a more recent study, Davidson, Skelton, and Weil measured the changes in the deferred tax account for 3,108 firms on the *Compustat* tape for the 19-year period 1954-1973.[10] Of the 18,184 changes observed, 14,288 (79 percent) were increases and 3,896 (21 percent) were decreases. In dollar amount, while the increases were approximately $39.5 billion, the decreases were only $5.9 billion. Or in other words, the dollar increases were more than six and one-half times as large as the dollar decreases.

Finally, an Ernst & Whinney study of 250 companies revealed that deferred taxes rose from 9% to 26% of shareholders' equity during the inflationary 1970's. The above studies amply suggest that "those who argue in favor of blanket tax allocations are on shaky ground."[11]

The 1981 Economic Tax Recovery Act and Inflation

Because depreciation differences cause the largest and most frequent differences between pre-tax accounting income and taxable income for many companies,[12] they have been the subject of much debate. Even when the *Internal Revenue Code of 1954*, which allowed accelerated depreciation for tax purposes, was enacted, estimates of possible future revenue losses to the federal government were being made. The Joint Economic Committee reported "one estimate ... showed the loss attributable to accelerated depreciation methods rising from about $375 million in fiscal 1955 to $2.2 billion in fiscal 1960, falling thereafter until 1969 for a cumulative loss of $19 billion."[13] In addition, the Committee acknowledged that the annual revenue loss would continually grow and never decrease as estimated if a constant increase in new investment was maintained. Similarly, E. Carey Brown predicted "the revenue losses would amount to over $2 billion in the fifth year, over $4 billion in the tenth, nearly $4 billion in the fifteenth, and $2 billion in the twentieth. The revenue loss would then grow at 3 percent per year."[14]

The cumulative impetus of inflation and the 1981 Economic Tax Recovery Act depreciation schedules will both tend to escalate the above estimates of possible revenue losses to the Federal government. Specifically, the Accelerated Cost Recovery System (ACRS) allows companies to deduct the cost of depreciable assets over periods ranging from three to fifteen years. Because these write-off periods often do not correspond with the estimated useful life of individual assets, many companies may be dealing with deferred tax accounting for the first time.

Table 1 contrasts the new ACRS depreciation schedule with the pre-ACRS useful life depreciation schedule for equipment costing $100,000 with a ten-year useful life and a $10,000 estimated salvage value. Although the equipment is depreciated over five years for tax purposes to comply with the ACRS depreciation schedules, it is depreciated over its useful life on the straight-line method for financial reporting purposes. In addition, because the company, prior to the 1981 Economic Tax Recovery Act, depreciated its equipment under the double-declining balance method for tax purposes, that depreciation method is utilized to compute the pre-ACRS depreciation deductions.

The ACRS provides for depreciation at a rate of 15 percent, 22 percent, 21 percent, 21 percent and 21 percent of the cost of the equipment for the years 1, 2, 3, 4 and 5, respectively. It is assumed the company elected to receive a 10 percent investment tax credit which thereby caused the asset's depreciable basis to be reduced by $5,000 (½ of the $10,000 investment tax credit taken) to $95,000, as required under the new ACRS provisions. For each method, the tax depreciation is compared to the straight-line depreciation on both an annual and a cumulative basis. Even though the ACRS cumulative excess depreciation is smaller than the pre-ACRS cumulative excess depreciation for the first two years, for all years thereafter the ACRS cumulative excess depreciation is greater. In fact, at no time in the life of the asset, other than the first two years, is the cumulative excess tax depreciation under the old depreciation schedule greater or equal to that obtainable under the new ACRS depreciation schedule.

Likewise, the turnaround period for the accelerated timing differences, as measured by the year in which the annual accounting depreciation exceeds the annual tax depreciation causing the cumulative excess tax depreciation to decrease, is longer under the new ACRS depreciation schedule than for the pre-ACRS useful life tax depreciation schedule (six years versus five years). This longer turnaround period under the new ACRS depreciation schedules is likely to create greater deferred tax credit carryovers in the future.[15]

Moreover, the cumulative impetus of inflation will tend to further magnify these deferred tax credit carryovers. For example, assume the firm with the asset in Table1 replaced equipment at a constant rate each year, with the $100,000 asset representing this year's annual outlay for new equipment. Assuming a six percent average annual inflation rate,[16] next year's replacement of an asset with the same productive capacity as this year's purchase would require an outlay of $106,000. This $6,000 increase will create higher depreciation deductions in future years. Consequently, it appears that future carryover amounts will be magnified through inflation and the new ACRS depreciation schedules.

This method would provide the fairest possible presentation of periodic net income, assets and liabilities.

TABLE 1
COMPARISON OF TAX AND ACCOUNTING DEPRECIATION

Year	Double-Declining Balance	Straight-Line	Annual excess (deficiency) of tax over book depreciation	Cumulative excess depreciation
Pre-ACRS - 10 year life				
1	$20,000	$ 9,000	$11,000	$11,000
2	16,000	9,000	7,000	18,000
3	12,800	9,000	3,800	21,800
4	10,240	9,000	1,240	23,040
5	8,190	9,000	(810)	22,230
6	6,550	9,000	(2,450)	19,780
7	5,240	9,000	(3,760)	16,020
8	4,200	9,000	(4,800)	11,220
9	3,360	9,000	(5,640)	5,580
10	3,420	9,000	(5,580)	—
	$90,000*	$90,000*		
ACRS - 5 year write-off				
1	$14,250	$ 9,000	$ 5,250	$ 5,750
2	20,900	9,000	11,900	17,750
3	19,950	9,000	10,950	28,100
4	19,950	9,000	10,950	39,050
5	19,950	9,000	10,950	50,000
6	—	9,000	(9,000)	41,000
7	—	9,000	(9,000)	32,000
8	—	9,000	(9,000)	23,000
9	—	9,000	(9,000)	14,000
10	—	9,000	(9,000)	5,000
Total	$95,000**	$90,000*		

*$10,000 salvage value remaining
**$100,000 asset cost less $5,000 (½ of the 10% investment tax credit received), as required under the ACRS provisions.

The Matching Concept

The 1964 Committee of the American Accounting Association on the matching concept defined matching as the process of reporting expenses on the basis of a cause and effect relationship with reported revenues.[17] Similarly the Committee on Accounting Procedure of the AICPA on the subject of income taxes stated that:

> Income taxes are an expense that should be allocated, when necessary and practicable, to income and other accounts, as other expenses are allocated. What the income statement should reflect under this head, as under any other head, is the expense properly allocable to the income included in the income statement for the year. . .The difficulties encountered in allocation of tax are not greater than those met with in many other allocations of expenses.[18]

The authors take exception to the above statements. We believe that income taxes exist only when a business has taxable income for a given year and, further, that income taxes follow rather than precede revenue generating activities. That is, expenses are typically incurred to produce increases in revenues, but income taxes do not bring about revenue increases. No direct relationship exists between the amount and/or the timing of income tax payments and the benefits received. Taxes, rather, are a function of taxable income. In fact, entities incurring the least income often received the most benefits. Moreover, income taxes paid may be refunded in future periods. Such is not the case with other expenses; once incurred, they normally cannot be refunded or recovered.

Just as unrealistic as it is to expect pre-tax accounting income and taxable income to be the same, it is similarly unrealistic to expect income tax expense to be in direct relation to net income. The matching concept thus appears inapplicable to income taxes. Consequently, the FASB should cease its efforts to match elements fundamentally not so related, for by matching elements not relevant to each other, the association is one of misclassification and most likely will misrepresent the true situation.

The Going Concern Assumption

As generally applied, the going concern assumption assumes that the entity will continue in operation long enough to carry out its existing commitments. In lieu of evidence to the contrary, the entity should be viewed as remaining in operation indefinitely under normal circumstances. The going concern assumption is often used as an argument for comprehensive interperiod tax allocation. That is, taxes deferred to the future are recognized currently as liablities because the entity is assumed to remain in operation long enough for future operations to reduce and ultimately eliminate these deferred tax amounts. That logic is suspect, however. Does this assumption necessarily imply continued operation at a profit? If not, then taxes will not be paid but refunded. Even if it does, it is unrealistic to perceive a going concern without increasing or replacing its assets, which would create permanent deferred tax amounts.

Contingencies

FASB Statement of Financial Accounting Standards (SFAS) No. 5 defined a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain... or loss... to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm the acquisition of an asset or the reduction of a liability or the loss or impairment of an asset or the incurrence of a liability."[19] The statement also specified the accrual of a loss contingency if it is probable than an asset has been impaired or a liability has been incurred, that it must be probable that one or more future events will occur confirming the fact of the loss, and the amount of the loss can be reasonably estimated.[20]

Although concluding that disclosure of a loss is preferable to accrual when a reasonable estimate cannot be made, the Board further stated:

> ...even losses that are reasonably estimatable should not be accrued if it is not probable than an asset has been impaired or a liability has been incurred at the date of an enterprise's financial statements because those losss relate to a future period rather than the current or prior period.[21]

In addressing the issue of contingencies and probabilities in financial reports, Herman Bevis criticized *APB Opinion No. 11* for departing from the past philosophy in dealing with contingencies. Recognizing that taxable income for a given year may be lower or higher than pre-tax accounting income and that the income tax payment may also be greater or less than if the tax were levied on pre-tax accounting income, he gave the following account:

> Whether or not tax reductions now must be paid back later is a contingency to be evaluated in each company on the basis of the probabilities. It is most regrettable that the APB did not look at the problem in this light, rather than inventing the deferred credit - deferred charge idea in an attempt to legitimatize a form of income smoothing.... What it has done ... is to arbitrarily conclude that, for every business, 100 percent of the tax increases are cost reductions and ... assets. It is regrettable that they did not recall that it is important that there be neither 'material overstatement nor understatement' in periodic net income. It is regrettable that thought was not given to the admonition that a provision not properly chargeable to current revenues understates current income; that reserves not created on the basis of any reasonable estimates of cost and losses should not be deducted from income; that practical application of a principle rests upon the possibility of making a reasonable estimate of the amount of a claim; and that there are contingencies not sufficiently predictable to be recorded in the accounts.[22]

Statement of Financial Accounting Concepts (SFAC) No. 3 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations... to transfer assets or provide services... in the future as a result of past transactions or events."[23] It can be argued that deferred income tax credits (liabilities) are not, in all cases, present obligations because no duty or responsibility to make future tax payments exists (as a result of past events). That is, deferred tax credits qualify as liabilities on a case-by-case basis only. For example, no future tax payments result from timing differences if future tax deductions exceed taxable revenues. By the common test of liabilities, no liability for future income taxes exists as of the date of the current balance sheet. There is no billing by a creditor; no claim exists by the United States Treasury; no evidence of the decline in an asset value is readily apparent; and no liability will ever exist unless there are profitable operations in the future.

This is not to say, however, that a liability cannot exist, be reasonably estimated, and recognized as of the balance sheet date. That estimate is a contingency to be evaluated by each company on the basis of the probabilities. Thus *SFAS No. 5* should be followed when recognizing future tax liabilities; that is, deferred taxes are contingencies and because the probabilities associated with the repayment of tax reductions vary, each company must be evaluated separately.

Selective Partial Tax Allocation

As previously stated, a selective partial tax allocation method is proposed. Only those timing differences which meet the following qualities would be recognized in the account balances:

1. Must be determined on an individual firm basis.
2. Only those groups of similar timing differences (not on an individual basis, for individual timing differences reverse, but in total, they often do not) that —
    a. are expected to reverse within 3-5 years.
    b. are expected to reverse when a positive taxable income is present.
    c. can be reasonably estimated and measured.

For those timing differences that do not meet the above criteria, footnote disclosure may be warranted if their reversal is reasonably possible. Otherwise, no disclosure of the timing difference is warranted.

The balance sheet would include only those groups of similar timing differences expected to reverse and provide (use) cash within the next 3 - 5 years.

While fully realizing that measurement problems are inherent, the estimations do not appear significantly more difficult than many now being recognized in the accounts. For example, estimated warranty expense and provisions for bad debts are now recognized even though the amounts are not completely verifiable in many instances. Additionally, accountants, since 1975, have been evaluating potential liabilities in light of *SFAS No. 5*. Furthermore, forecasts, being prepared by most business enterprises, would include the required information to help assess if these timing differences should be recognized. Thus, recognizing only those timing differences that will reverse and require (provide) the use of cash within the next 3-5 years would aid present and potential investors, creditors, and other users in assessing the amounts, timing, and uncertainty of prospective net cash inflows to the enterprise (an objective contained in *SFAC No. 1*, "Objectives of Financial Reporting by Business Enterprises"). Clearly, management is in a better position to assess whether timing differences will reverse in the near future than are investors, creditors, and other users. With comprehensive tax allocation, external users are forced to make that determination. And even if these computations are not totally objective, it is better to be imprecisely relevant than precisely irrelevant, as is the case with comprehensive tax allocation.

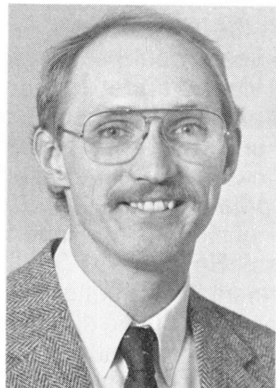
Evaluation of managerial performance would be enhanced by adoption of partial tax allocation. Comprehensive tax allocation obscures a significant element of managerial efficiency, namely the timing of tax payments. These timing

differences often result from conscious decisions of management. Thus, the consequences of such decisions should not be obscured but clearly show so that users can accurately appraise the effectiveness of management. If management succeeds in permanently reducing the income tax liability, then that fact should be reflected in the financial statements to fully recognize its efficiency.

The adoption of a selective partial tax allocation approach would also promote greater international harmonization of generally accepted accounting principles. The United Kingdom has changed its required accounting for income taxes to the partial allocation approach, while the International Accounting Standards Committee now permits, but does not require, a method similar to the partial allocation approach adopted in the United Kingdom.

In summary, because not all groups of similar timing differences reverse (thus, rejecting comprehensive tax allocation) but some similar timing differences do reverse (providing support against the flow-through method of accounting for income taxes), the adoption of a partial tax allocation method would provide the fairest possible presentation of periodic net income, with neither material overstat ement nor understatement. Likewise, the balance sheet would include only those groups of similar timing differences expected to reverse and require (provide) cash within the next 3-5 years, thus meeting the definition of liabilities (assets). Partial tax allocation would enhance comparability between enterprises, faithfully represent the underlying circumstances, and add relevance by enabling users to more accurately predict the amount, timing, and uncertainty of future tax flows. The FASB should reconsider the merits of partial tax allocation.

Even under comprehensive tax allocation, these deferred tax amounts should be discounted (consistent with APB Opinion No. 21), in which case the FASB is in essence adopting partial tax allocation. Discounting amounts that will not reverse in the immediate future (or never reverse) reduces deferred taxes to negligible amounts, thus in effect closely approximating partial tax allocation. The failure to discount deferred taxes created with comprehensive tax allocation makes the financial statements inaccurate, misleading and ignores completely the economic reality of the situation. Ω



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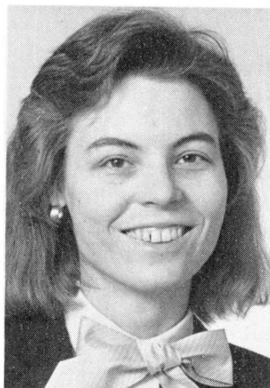

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NOTES

[1]*Accounting Principles Board Opinion No. 11*, "Accounting for Income Taxes," American Institute of Certified Public Accountants, (New York: AICPA, 1967).

[2]Permanent differences arise both from statutory provisions which specifically exempt certain revenues from taxation or disallow the deductibility of specified expenses, and from certain items which enter into the determination of taxable income but never become components of pre-tax accounting income.

[3]*FASB Discussion Memorandum*, "Accounting for Income Taxes," (Stamford, Conn.: FASB, August 29, 1983), par. 116.

[4]Price Waterhouse & Company, *Is Generally Accepted Accounting for Income Taxes Possibly Misleading Investors?* New York, 1967; see also, "Is GAAP for Income Taxes Possibly Misleading Investors?" *Financial Executive* (September 1967), pp. 70, 72, 74-75.

[5]Sidney Davidson, "Accelerated Depreciation and the Allocation of Income Taxes," *The Accounting Review* (April 1958), pp. 173-180.

[6]Although the new Accelerated Cost Recovery System sets both the rate and life for tax depreciation, Davidson's conclusions remain valid.

[7]Davidson, op. cit., p. 177.

[8]John Leslie Livingstone, "Accelerated Depreciation, Cyclical Asset Expenditures and Deferred Taxes," *Journal of Accounting Research* (Spring 1967), pp. 77-94; "Accelerated Depreciation and Deferred Taxes: An Empirical Study of Fluctuating Asset Expenditures," *Empirical Research in Accounting: Selected Studies, 1967* (Chicago, Illinois: University of Chicago), May 1967, pp. 93-133; and "Accelerated Depreciation, Tax Allocation, and Cyclical Asset Expenditures of Large Manufacturing Companies," *Journal of Accounting Research* (Autumn 1969), pp. 245-256.

[9]John W. Buckley, *Income Tax Allocation: An Inquiry Into Problems of Methodology and Estimation*, New York: Financial Executives Research Foundation, 1972.

[10]Sidney Davidson, Lisa Skelton, and Roman E. Weil, "A Controversy Over the Expected Behavior of Deferred Tax Credits," *The Journal of Accountancy* (April 1977), pp. 53-59.

[11]Livingstone, "Accelerated Depreciation, Tax Allocation, and Cyclical Asset Expenditures of Large Manufacturing Companies," p. 251.

[12]William C. Norby, "The Obsolescence of Deferred Tax Accounting," *Financial Analysts Journal* (January-February 1982), pp. 75-76.

[13]Joint Economic Committee, *The Federal Tax System:* Facts and Problems, 1964 (Washington, D.C.: U.S. Government Printing Office, 1964), p. 102.

[14]E. Carey Brown, "The New Depreciation Policy Under the Income Tax: An Economic Analysis," *National Tax Journal* (March 1955), p. 89.

[15]Joseph Weber, "Accounting for Income Taxes — The Debate is Reopened," *Accounting Research Convocation*, University of Alabama, 1982.

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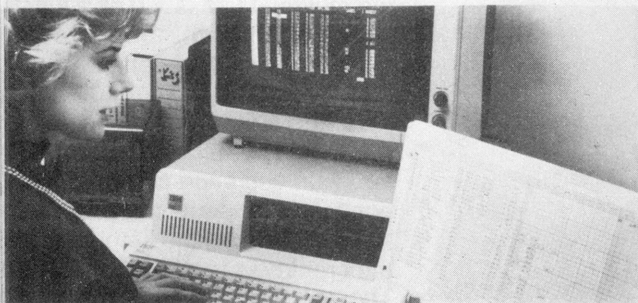

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The Auto Expense Deduction of Employees

Under the Deficit Reduction Act of 1984

by Cherie J. O'Neil and Ramesh Narasimhan

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The new auto expense limitation rules of Sec. 280F are having a profound effect on the employee who uses his or her auto for business. In most cases, the annual depreciation charge for autos purchased or placed in service after June 18, 1984 has been significantly reduced during the first three years of the accelerated cost recovery system (ACRS) recovery period. Furthermore, unless the employee can substantiate a business use of more than 50 percent, no investment tax credit (ITC) will be allowed. The new law also limits the election to expense and imposes new record keeping requirements effective with the 1986 tax year. Employees, who in the past, relied on reasonable estimates to calculate their auto expense deductions will now be required to meet the substantiation requirements of Sec. 274(d).

Under the new law, many different auto expense calculations are possible. In some cases these alternatives result in significantly different annual tax savings, which make selecting the best method a difficult, if not impossible, choice. This article explains the technical provisions of the new law and points out where further clarification is needed.

Record Keeping Requirements

The Tax Reform Act of 1984 (TRA) replaced the "adequate records" requirement of Sec. 274(d) with a new stricter "adequate contemporaneous records" requirement. In response to the public outcry over the need to make daily entries in a log, the contemporaneous recordkeeping requirement was repealed.[1] For 1985, a written log of auto mileage is not necessary. Accurate records are needed, however, to calculate the qualifying business use percentage used in determining the allowble auto expense. While the new law prohibits the Treasury Department from requiring taxpayers to keep a daily contemporaneous log, this is a wise alternative. The Conference Report indicates that oral evidence has considerably less value than written evidence; and that contemporaneous evidence has a greater weight than evidence created at a later time.[2] Furthermore, for tax years after December 31, 1985, the substantiation rules for Sec. 274(d) will apply to transportation expenses (e.g. local travel). Thus, the taxpayer must be able to substantiate: (1) the amount, (2) the time, (3) the destination, (4) the business purpose of the travel expenditure.[3] Such documentation will require written records, but these records will not have to be contemporaneous.

For those employees, who have autos furnished to them by their employer, the substantiation requirements still apply. To obtain a full deduction for the auto, the employer must have a *written* policy forbidding any personal use of the company auto (de minimus use, such as a lunch stop is allowed).[4] If the employee is permitted to use the company auto for commuting to and from work, some appropriate amount[5] must be included in the employee's gross income at year end,[6] unless such commuting is for a bona fide business reason (e.g. for security reasons the employer requires the employee to drive the auto home). The substantiation requirements will not be applied to vehicles which, by their nature, would not be used more than a de minimus amount for personal use (e.g. police and fire vehicles, buses, ambulances, delivery trucks). If the employee is a 1 percent or more shareholder, or an officer, personal use of the company auto constitutes a constructive dividend, taxable to the employee and not deductible by the employer.

Complying With the New Law

Sec. 280F requires the computation of a qualified business use (QBU) percentage for each tax year. For the employee, QBU occurs only when the

Employees, who use their personal auto to carry out their job related duties, will find that the new law requires complex annual calculations of the auto expense deduction.

employee's auto is used "for the convenience of the employer" or as a "condition of employment."[7] This is a significant change from the old law and requires the employee to justify the use of his or her auto in the employer's business. When the auto is used for the convenience of the employee, no deduction is allowed.

For example, if the employer has motor pool with company autos available for employee use, but the employee prefers to use his or her own auto (it is more convenient, or a newer model, or has air conditioning), that use is for the convenience of the employee and no depreciation deduction is allowed. Temporary Reg. 1.280F-6T(a) (4) gave an example of an employee who chooses to use her own auto and receive reimbursement from her employer even though a company auto is available. The use of her own auto is not for the convenience of her employer and is not required as a condition of employment. Therefore, no depreciation deduction is allowed, and the reimbursement is includable in the employee's income. The only offsetting deduction permitted against the reimbursement is for out of pocket costs, such as gas. Assuming that this example will be included in the forthcoming regulations, an employee with access to a company auto may not claim use of his or her personal auto has QBU. There has not been any indication of what kind of substantiation is required to prove that no company auto was available. Perhaps a letter from the head of the motor pool will be needed, or perhaps a notation in the employee's records that no company auto was available will suffice. The Treasury needs to clarify the kind of documenttion that will be required in these cases.

TABLE 1

ACRS Depreciation on a $20,000 Auto with 90 Percent Business Use

IF AUTO PURCHASED:		(6/18/84-4/2/85)		(4/2/85 OR LATER)	
YEAR	ACRS DEDUCTION	LIMIT	DEDUCTION	LIMIT	DEDUCTION
1	$4,500	$3,600	$3,600	$2,880	$2,880
2	6,840	5,400	5,400	4,320	4,320
3	6,660	5,400	5,400	4,320	4,320
4	0	5,400	3,600	4,320	4,320
5	0	5,400	0	4,320	2,160
TOTAL	$18,000		$18,000		$18,000

TABLE 2

SL Depreciation on a $20,000 Auto with 40 Percent Business Use

IF AUTO PURCHASED:		(6/18/84-4/2/85)		(4/2/85 OR LATER)	
YEAR	SL	LIMIT	DEDUCTION	LIMIT	DEDUCTION
1	$ 800	$1,600	$ 800	$1,280	$ 800
2	1,600	2,400	1,600	1,920	1,600
3	1,600	2,400	1,600	1,920	1,600
4	1,600	2,400	1,600	1,920	1,600
5	1,600	2,400	1,600	1,920	1,600
6	800	2,400	800	1,920	800
TOTAL	$8,000		$8,000		$8,000

Limits on the Depreciation Deduction

After the employee has calculated the QBU percentage for the year, the next step is to compute the auto expense deduction. At this point, the limitations of Sec. 280F are applied to the depreciation deduction and the investment tax credit. Out of pocket costs for gas, repairs, etc. and the standard mileage deduction are still calculated in the regular way. If the auto is used 60 percent for business, 60 percent of the operating expenses are deductible. If the standard mileage rate is used, it is still based upon the .205 and .11 cents per mile rates.

Sec. 280F affects: 1) the method of depreciation which can be used, either Accelerated Cost Recovery (ACRS), or straight line (SL) based upon the earnings and profits (E&P) life of five years, and 2) the dollar amount of depreciation which may be claimed each year. The allowable depreciation method depends upon QBU. If it is more than 50 percent, the ACRS method may be used. If it is 50 percent or less, the SL method must be used.[8] The depreciable basis is limited to the auto's cost times the QBU percentage times either the ACRS percentage or the SL percentage, whichever applies. Once the depreciation expense is calculated, it is limited to either $4,000 times the QBU percentage in year 1, if the auto was purchased between June 18, 1984 and April 2, 1985, or $3,200 times the QBU percentage in year 1, if the auto was purchased after April 2, 1985. In the second and subsequent years, the QBU percentage is multiplied by $6,000 if the auto was purchased between June 18, 1984 and April 2, 1985, or by $4,800, if the auto was purchased after April 2, 1985.[9] These limits do not eliminate the depreciation deduction, they simply limit the annual deduction and defer some tax benefits to future years. For a $20,000 auto with a QBU of 90 percent, see Table 1 for the allowable annual depreciation deductions.

In both cases, the depreciation deduction goes beyond the three year ACRS life. In the first case, at the end of year three, the Sec. 280F limits have restricted the allowable depreciation deductions to either $14,400, or $11,520, depending upon the date the auto was purchased. Since the total

TABLE 3

Auto Purchased Jan. 1, 1985 with Varying Business Usage

COST OF AUTO:	$20,000
DATE OF PURCHASE:	JANUARY 1, 1985
MARGINAL TAX RATE:	45%
DISCOUNT RATE:	12%

DEPRECIATION DEDUCTIONS

YEAR	QUALIFIED BUSINESS USE	ELECTION TO EXPENSE 4% ITC	ELECTION TO EXPENSE 6% ITC	NO ELECTION TO EXPENSE 4% ITC	NO ELECTION TO EXPENSE 6% ITC
1	70%	$ 2,800	$ 2,800	$ 2,800	$ 2,800
2	60	3,600	3,582	3,600	3,600
3	60	3,552	3,488	3,600	3,600
4	40	1,280	1,260	1,600	1,579
5	40	1,280	1,260	1,600	1,579
6	40	640	630	800	789
7	40	360	340	0	0
TOTAL		$13,512	$13,360	$14,000	$13,947
RECAPTURE:					
EXCESS DEPRECIATION					
YEAR:	4	3,312	3,300	3,800	3,893
NET DEPRECIATION EXPENSE:		$10,200	$10,060	$10,200	$10,054

INVESTMENT TAX CREDIT

		ELECTION TO EXPENSE 4% ITC	ELECTION TO EXPENSE 6% ITC	NO ELECTION TO EXPENSE 4% ITC	NO ELECTION TO EXPENSE 6% ITC
YEAR:	1	$448	$672	$467	$700
RECAPTURE:					
EXCESS ITC					
YEAR:	2	64	96	67	100
YEAR:	4	43	64	44	67
NET INVESTMENT TAX CREDIT:		$341	$512	$356	$533
PV OF TAX SAVINGS:		$3,888	$4,033	$3,916	$4,068

allowable depreciation deduction over the life of the auto is $18,000, the balance may be expensed in subsequent years. The only limit on the deduction in years four and beyond, is $6,000 ($4,800) times the QBU percentage. A very expensive auto may require seven or more years to fully write-off.

The SL method requires a six year write-off based upon 10 percent in years one and six, and 20 percent in years two through five. If the same auto has a QBU of only 40 percent, the SL, five year E&P mid-year convention method must be used. Table 2 shows the allowable annual depreciation deductions.

For autos purchased between June 18, 1984, and April 2, 1985, which cost more than $28,000, the ACRS limits will defer part of the auto expense deduction into the seventh and subsequent years. For autos purchased after April 2, 1985, which cost more than $22,400, the ACRS limits will defer part of the auto expense deduction into the seventh and subsequent years. The more expensive the auto, the longer the depreciation deducton period. For autos purchased between June 18, 1984 and April 2, 1985 which cost less than $16,500, the allowable depreciation will always be less than the Sec. 280F limits. For autos purchased after April 2, 1985, which cost less than $13,200, the allowable depreciation will always be less than the Sec. 280F limits. No matter what the auto costs, the depreciation deduction is first limited by the QBU percentage, then by the annual dollar limit times the QBU percentage.

The auto price inflation adjustment scheduled to become effective for autos purchased after January 1, 1985, has been deferred to 1989. For autos purchased after December 31, 1988, the $2,400/$4,800 limits will be adjusted for increases in the consumer price index auto component for October of the previous year.[10]

Limits on the Investment Tax Credit

The previous illustrations did not consider the investment tax credit (ITC), which is also limited by Sec. 280F(a)(1). The ITC is the lesser of the cost of the auto times the QBU percentage times the ITC percentage, or $1,000 times the QBU percentage if the 6 percent ITC is elected, or $667 times the QBU percentage if the 4 percent ITC is elected, for autos purchased betwteen June 18, 1984, and April 2, 1985. For autos purchased after April 2, 1985, the ITC limits are $675 times the QBU percentage if the 6 percent ITC is elected, or $450 times the QBU percentage if the 4 percent ITC is elected. However, if QBU is less than or equal to 50 percent, no ITC is allowed.[11] This is a true *elimination* rather than a *limitation* as was observed in the calculation of the depreciation deduction. Thus, the employees must carefully establish the QBU percentage of more than 50 percent in the year of purchase. This points to the need to keep accurate detailed records of auto use, so that the maximum allowable ITC can be taken. If QBU is greater than 50 percent, then the Sec. 212 production or maintenance of income use (e.g. investor use) may be included in the QBU percentage. But, if QBU is less than or equal to 50 percent, then the Sec. 212 use does not qualify for the ITC. For example, an auto with business use of 60 percent and investor use of 20 percent qualifies for an ITC based upon 80 percent of the cost of the auto. But, an auto with 20 percent business and 60 percent investor use will not qualify for any ITC. Recall, that for depreciation

TABLE 4

Auto Purchased May 1, 1985 with Varying Business Usage

COST OF AUTO:	$20,000
DATE OF PURCHASE:	MAY 1, 1985
MARGINAL TAX RATE:	45%
DISCOUNT RATE:	12%

		DEPRECIATION DEDUCTIONS			
	QUALIFIED	ELECTION TO EXPENSE		NO ELECTION TO EXPENSE	
YEAR	BUSINESS USE	4% ITC	6% ITC	4% ITC	6% ITC
1	70%	$ 2,240	$ 2,240	$ 2,240	$ 2,240
2	60	2,880	2,880	2,880	2,880
3	60	2,880	2,880	2,880	2,880
4	40	1,344	1,330	1,600	1,586
5	40	344	1,330	1,600	1,586
6	40	672	665	800	793
7	40	568	554	0	0
TOTAL		$10,928	$11,879	$12,000	$11,965
RECAPTURE:					
EXCESS DEPRECIATION					
YEAR:	4	1,728	1,777	1,800	1,862
NET DEPRECIATION EXPENSE:		$9,200	$10,102	$10,200	$10,103
		INVESTMENT TAX CREDIT			
		ELECTION TO EXPENSE		NO ELECTION TO EXPENSE	
		4% ITC	6% ITC	4% ITC	6% ITC
YEAR:	1	$315	$473	$315	$473
RECAPTURE:					
EXCESS ITC					
YEAR:	2	45	68	45	68
YEAR:	4	30	45	30	45
NET INVESTMENT TAX CREDIT:		$240	$360	$240	$360
PV OF TAX SAVINGS:		$3,362	$3,721	$3,649	$3,752

purposes, a QBU percentage of 50 percent or less requires the use of straight line depreciation. For an auto used 20 percent for business and 60 percent for investment, 80 percent of the auto may be depreciated, but the SL method must be used, and no ITC is permitted.

If the employee has QBU of more than 50 percent, then either the full ITC-reduced basis method, or the reduced ITC-full basis method may be used. When the full ITC of 6 percent is taken, he basis must be reduced by one half of the allowable ITC. Thus, this method will effect the depreciation calculations. While one might assume that the correct basis for the depreciation deduction for a $20,000 auto purchased on February 1, 1985 with a QBU of 80 percent is $15,600 [(20,000 x .8) - (800 x .5)], it is not. The correct procedure is to deduct one half of the ITC before multiplying by the QBU percentage.[12] Thus, the depreciable basis is $15,680 [(20,000 - (800 x .5)) x .8].

When the election to expense is considered, the ITC may be less. Referring to the previous example, when the election to expense is taken, the ITC is $768 [(20,000 - 4,000) x .8 x .06], which is $32 less than the no election to expense method. The basis for depreciation, in this example, when the election to expense is used is $12,493 [(20,000 - 4,000 - (768 x .5)) x .8] which is $3,187 less than the full ITC, reduced basis, no election to expense method. Furthermore, no immediate additional tax benefit is obtained by making the election to expense, since the first year deduction for both the depreciation deduction and the election to expense is limited to $4,000 times the QBU percentage.[13] Thus, no additional deduction is obtained in the first year by making the election to expense, and some of the ITC is lost.

Changes in the Annual QBU Percentage

When the QBU percentage varies from year to year, the employee's annual depreciation deduction also changes. As long as the QBU percentage remains above 50 percent, the ACRS method may be used. But should the QBU percentage decline to 50 percent or less, three things occur. First, the employee may be subject to depreciation recapture. Second, the employee may be subject to ITC recapture. Third, the ACRS method of depreciation is no longer allowed and the straight line method must be used, even if QBU subsequently rises to more than 50 percent. The above order must be followed in making the calculations. Recapture the excess depreciation first, then recapture the ITC, then recompute the basis, if the full ITC is elected and then compute the allowable straight line depreciation.

The depreciation recapture rule of Sec. 280F requires that the prior years depreciation be recomputed using the straight line E&P life method. Any excess depreciation must be recaptured.[14] Refer to the earlier example of the $20,000 auto with a QBU of 80 percent. Suppose that in year two, the QBU declines to 40 percent. The year one depreciation is recomputed using the SL method and is now only $1,600 [20,000 x .8 x .1]. Since the depreciation for year one is $3,600, there is a $2,000 depreciation recapture. The year two depreciation deduction is $1,600 [20,000 x .4 x .2], subject to the limit of $2,400 [6,000 x .4]. Since the actual is less than the limit, the year two deduction is $1,600.

Any decline in QBU triggers ITC recapture. The recapture of the ITC follows the rules of Reg. 1.47-2(e). Thus, a decline in QBU from 80 percent to 40 percent will require an ITC recapture of $400 [(1,000 x .8) - (1,000

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x .4)]. If the auto costs $16,500 or less, the ITC recapture would be based on the cost of the auto, rather than the $1,000 limit. When computing the ITC recapture, it is important to know how to count the number of years the auto was held, because of the varying recapture percentages. If, for example, the auto was purchased on Feb. 1, 1985, and sold on Dec. 1, 1986, the entire ITC must be recaptured since the auto was not owned one full tax year, even though it was owned more than 365 days. Any disposition or decline in QBU is assumed to occur on the first day of the tax year. Thus, in the example, the holding period is counted from Feb. 1, 1985, to Jan. 1, 1986 which is not one full year. If the disposition of the auto or decline in QBU occurs in 1987, the holding period is counted from Feb. 1, 1984 to Jan. 1, 1987, which is more than one full year. In that case the ITC recapture would be 2/3 of the ITC. A change in QBU in 1988 would require a 1/3 recapture and a change in QBU in 1989 would not require any recapture. Thus, to avoid any ITC recapture, the QBU percentage will have to be substantially the same during the first four tax years.

While depreciation recapture is triggered only in the year in which the QBU percentage declines to 50 percent or less, the ITC recapture occurs in any year in which the QBU is less than the QBU of the previous year. There is a de minimus rule mentioned in the committee report,[15] which presumably would not require ITC recapture when there is a small decline in QBU, from 80 percent to 79 percent, for example.

The ITC recapture rule offers some tax planning opportunities for the employee who purchases an auto during the last few months of the tax year. Assume, for example, that an employee purchased a $20,000 auto on December 1, 1985, took one business trip, and then parked the auto in the garage for the rest of the month. Since QBU for the year is 100 percent, the full $675 ITC may be claimed. If the QBU in 1986 is 40 percent, $405 of the ITC must be recaptured. As long as QBU equals or exceeds 40 percent, the remaining $270 need not be recaptured. Thus, the employee receives a net ITC of $270, even though the business use of the auto averaged approximately 40 percent over its useful life. In year two, $1,200 excess depreciation will have to be recaptured. (The ACRS deduction of $3,200 exceeds the straight line deduction of $2,000). Once the ITC and/or ACRS deductions are recaptured, a subsequent increase in the QBU percentage will not reinstate the previously disallowed deduction. Thus, the employee must carefully monitor his or her use of the auto to maintain an acceptable QBU percentage and minimize the recapture potential.

Examples

Tables 3 and 4 illustrate the annual depreciation expense for a $20,000 auto purchased on either January 1, 1985 (Table 3) or on May 1, 1985 (Table 4) with varying annual QBU percentages. In the fourth year the QBU percentage is less than 50 percent. For this year and all subsequent years the depreciation deduction is computed using the straight line method. The depreciation expense for the first three years is recomputed and

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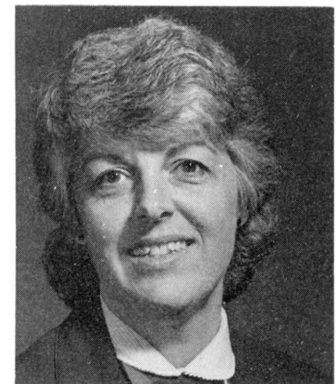

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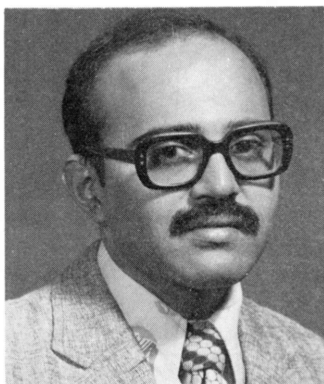
the excess of the depreciation expense over the straight line method is subject to depreciation recapture in year four. In years two through four there is ITC recapture since the QBU in each year is less than the previous year. The examples also illustrate the four methods by which the depreciation expense and ITC can be computed. At the bottom of each column, the present value of the tax savings is computed using a 12 percent discount rate and a 45 percent marginal tax rate. The full ITC method yields the greatest tax savings in present value terms. This holds true when the tax rate is varied from 15 percent to 55 percent and the discount rate is varied from 6 percent to 18 percent. Even if the employee chooses the election to expense method, the full ITC method is still preferable to the reduced ITC method.

Conclusion

The new auto expense rules of Sec. 280F and the substantiation requirements of Sec. 274(d) require the employee who uses his or her auto for business to make complex annual calculations to determine the auto expense deduction. These calculations must be substantiated by the employee by adequate records or by sufficient evidence corroborating the taxpayer's own statement. These new rules make tax planning for the auto expense deduction difficult. The employee must decide whether or not to make the election to expense, whether or not to elect the full ITC or the reduced ITC, and strive to maintain a constant annual QBU to avoid depreciation and/or ITC recapture. As the Department of the Treasury issues new regulations in this area, hopefully the employee's task will be made easier. Once the employee establishes that QBU is more than 50 percent, then perhaps the IRS will let the employee use a constant annual business use percentage in making the subsequent years calculations. By permitting the employee to use the QBU percentage established in year one for all subsequent years, as long as the percentage did not vary significantly, the complex recapture calculations and subsequent recomputation of the annual depreciation expense will not have to be made. This would help employees comply with the law and reduce the possibility of error when making the annual depreciation expense calculations.Ω



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NOTES

[1] U.S. Congress, H.R. 1869, Repeal of Contemporaneous Recordkeeping Requirements Act of 1985, approved by Congress, May 16, 1985, signed by the President, May 24, 1985.

[2] Ibid., House Report 99-67, May 7, 1985.

[3] Ibid., Act Section 1.

[4] Ibid., House Report 99-67, Conference version, May 8, 1985.

[5] Ibid., Act Section 5 directs the treasury to issue regulations by October 1, 1985 to carry out provisions of the act. The temporary regulations, which were withdrawn, indicated a $3 daily amount to be included in income for personal commuting expense.

[6] IRC Sec. 3402 (s) (2)

[7] IRC Sec. 280F (d) (3)

[8] IRC Sec. 280F (b) (2)

[9] IRC Sec. 280F (a) (2) (A)

[10] IRC Sec. 280F (d) (7)

[11] IRC Sec. 280F (b) (1)

[12] IRC Sec. 280F (a) (3)

[13] IRC Sec. 280F (d) (1)

[14] IRC Sec. 280F (b) (3)

[15] U.S. Congress, Tax Reform Act of 1984, Act Sec. 179, Conference Committee Report, July 18, 1984.

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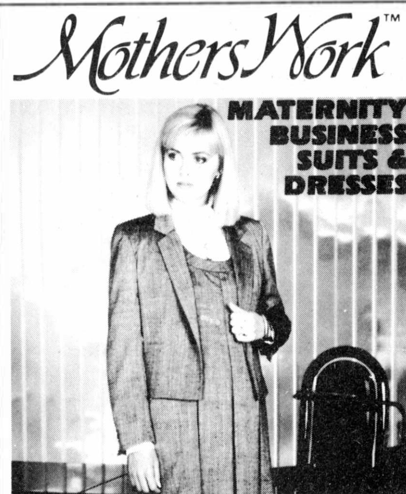

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Harmonization of Accounting Practices in the EEC

A Status Report

By Ula K. Motekat

The European Economic Community (EEC) has the primary purpose of creating a common market for its member states. To attain this goal, the Treaty of Rome (the agreement forming the EEC) lists among its objectives the removal of barriers to the free movement of persons, services, and capital between member states.

The Council of the European Communities realized that financial statements play a crucial role in the movement of capital and that companies can compete for capital on an equal basis only if their financial statements are at least somewhat comparable. Since the preparation of financial statements is governed by laws in most of the member states, the Council set out to harmonize the company laws of the EEC countries.

Greatly simplified, the process of aligning the laws of the member states is as follows: proposals are prepared setting out the issues, the need for agreement, and possible solutions. An exposure draft of a directive is then approved by the European Commission and circulated widely. Responses are actively solicited from all interested parties. These responses are then studied, resulting frequently in major changes. A revised draft is usually issued before the Council of Ministers begins its serious negotiations.

To reach agreement on all the points in a proposed directive, the Council uses various methods to settle the most divisive issues. Sometimes it deliberates day and night until the negotiators are too worn out to hold out any longer. At other times it adopts several alternatives, as it did with the valuation methods in the Fourth Directive. Sometimes it excludes areas from a proposal and makes them subjects of separate directives, as happened with accounting for banks. And, sometimes, the Council evades the issue altogether by agreeing to postpone a decision for a specified period of time, as it did when it set 1995 for reconsidering which subgroups to exempt from the consolidation provisions of the Seventh Directive.

When a directive is finally adopted by the Council of Ministers, the member states are formally notified and are then obligated to change their national laws to conform with the directive. If a member country fails to implement the directive within the period prescribed by the directive, the Commission can take it to court before the European Court of Justice, which can find for the Commission but lacks the power to enforce its decisions.

The process of harmonizing company laws within the EEC has accelerated in recent years, so that there are now eight directives in the final stages of adoption and implementation. This column gives a status report and brief description on these directives, with special emphasis on the two directives of particular interest to U.S. accountants.

To understand the impact of the directives on corporations, it is necessary to be aware of the distinction between public and private companies made in most European countries under current laws. Public companies are permitted to sell their securities on public exchanges. To obtain this privilege they must raise a minimum amount of capital, they must be audited annually, and they must publish financial statements. Private companies may not sell their securities publicly, are usually limited in the number of shareholders they may have and do not have to be auditied nor do they have to publish their financial statements.

The First Directive

The First Directive was adopted in 1968 and is now in force in all member states. It mandates the publication of certain information by public and private companies, such as the articles of incorporation, the names of officers and directors, and the subscribed capital. It also requires the establishment of registries for all companies organized in a member state and protects third parties dealing in good faith with companies aganinst *ultra vires* claims.

The Second Directive

The Second Directive was adopted in 1976 and was to have been implemented by the member states within two years. To date, only Denmark, France, Germany, Ireland, Luxembourg, the Netherlands, and the United Kingdom have changed their laws to comply with it.

The Directive requires that the distinction between public and private companies be a part of their name. It further requires that public companies maintain a minimum capital of 25,000 European Currency Units (ECU). It also establishes rules for the increase

and decrease of capital of public companies, such as stock issues for assets other than cash and the retirement of preferred stock.

The Third Directive

The Third Directive, adopted in 1978, applies to public companies only and regulates mergers between companies incorporated within the same country. Mergers in this Directive are defined as the complete absorption of either one company by another or two companies by a newly-formed third company. Its main purpose is to protect shareholders, creditors, and employees of absorbed companies. It has been implemented only by Denmark, Germany, and the Netherlands, even though a three-year limit was set for compliance.

The Fourth Directive

The Fourth Directive, the first one of major concern to accountants, was adopted in 1978. It set a two-year limit for implementation, extended to five years for certain provisions. Belgium, Denmark, France, Luxembourg, the Netherlands, and the UK have passed the necessary legislation; the other countries are in various stages of doing so.

The Fourth Directive deals with the preparation and publication of financial statements of both public and private companies. It defines financial statements as the balance sheet, the income statement, and the notes thereto. The statement of changes in financial position is excluded. The four areas of most interest to accountants are the valuation principles, the format of the financial statements, the auditing requirement, and the definition of the "true and fair view." American as well as EEC accountants are affected by its provisions.

The valuation practices in use before the Fourth Directive stretched all the way from the German love of secret reserves hidden in undervalued assets to the Dutch acceptance of current values. The Fourth Directive (Section 7) solved this dilemma by sanctioning both historical cost and current values. It explicitly makes the valuation rules subject to some GAAP well known to American accountants, such as the going concern, consistency, and the accrual basis. It also mandates the depreciation of fixed assets and the amortization of intangibles, such as organization costs, goodwill, and R&D over a maximum period of five years and requires that such reductions in the values of assets be included in the income statement.

The format of financial statements was strictly regulated in some European countries, such as in Germany whose 1965 Company Law laid down, line by line, what had to be disclosed in the balance sheet and income statement. The Fourth Directive describes two acceptable forms for the balance sheet (Section 3) and four for the income statement (Section 5). They are usually referred to as the vertical and the horizontal format. All formats require extensive disclosures.

The balance sheet follows general European practice by listing the long-term assets before the current assets. In the horizontal balance sheet the credit side shows the equity accounts first, followed by long-term and current liabilities in that order. The vertical balance sheet subtracts the current liabilities from the current assets to arrive at net current assets first and total assets less current liabilities next. It then lists the long-term liabilities and equity accounts.

The acceptable income statements are three horizontal formats, one starting with all the credit items followed by all the debit items (Article 23) and two starting with the debit items followed by the credit items (Articles 24 and 26), and one vertical format resembling the multiple-step income statement of U.S. intermediate accounting text books.

The audit requirement may be called the "Auditors' Full Employment Act." Most European countries did not require audits of private companies which outnumber public companies several times. Since the Fourth Directive applies to all companies with limited liability, it subjects thousands of companies to audits for the first time, thereby greatly increasing the work load for qualified auditors.

Of special interest is the requirement that "the annual accounts shall give a true and fair view of the company's assets, liabilities, financial position and profit or loss" (Article 2, Paragraph 3). This statement is followed immediately (Paragraph 4) by the admonition that compliance with the provisions of the Fourth Directive might not be sufficient to result in a true and fair view and that additional information must be given in those cases.

The Fifth Directive

The Fifth Directive was first proposed in 1972 and amended in 1983. It is still being debated by the Council of Ministers. The directive deals with the structure and administration of public companies. The major reason for the delay in its adoption is probably the fact that it contains provisions mandating employee participation on the boards of directors of certain companies.

The Sixth Directive

The Sixth Directive was adopted in 1982 and requires implementation by the member states by 1986. It regulates "scissions," i.e. the spin-off of groups of assets and liabilities by public companies to other public companies, which either exist already or are newly formed, in exchange for shares of stock.

The Seventh Directive

The Seventh Directive was adopted in 1983 and should be implemented by the member states by 1988. The subject of this directive is consolidated financial statements. The long delay from the first proposal in 1976 to final adoption in 1983 was caused, first of all, by the need to define the consolidated group. In the U.S. legal control generally has been the criterion used to determine whether or not to include a company in the consolidated group. In Europe, companies have evolved other means of coordinating their economic activities. Two examples illustrate this:

1. The Royal Dutch/Shell Group comprises operating oil and refining companies. Its parents are a British company, the Shell Transport and Trading Company, which owns 40%, and the Royal Dutch Petroleum Company, a Netherlands company, which owns the other 60%. The two parents manage the affairs of the group jointly.

2. Unilever has two parents, the British Unilever plc and the Dutch Unilever NV. The same people serve on the boards of directors of both companies and operate the two companies under one set of objectives. Each company has many subsidiaries but different shareholders.

The first draft of the directive solved these problems by using the economic definition of a group. The final version,

due undoubtedly to American and British practices and International Accounting Standard (IAS) No. 3 on consolidated statements, adopts the legal definition.

This solution, however, did not answer the question of what to do about non EEC-companies within a group. Should consolidated statements be limited to companies formed in EEC countries or should they include all legally related companies, regardless of their domicile? Since it might be difficult to exclude parents and subsidiaries organized in non-EEC countries from a consolidation, the Directive permits the inclusion of EEC companies in world-wide consolidated statements, as long as they meet the conditions of the Seventh Directive. This means that U.S. parents must either publish consolidated statements in conformity with the Seventh Directive or prepare separate consolidated statements for their EEC companies only.

The accounting provisions of the Seventh Directive are surprisingly liberal and frequently allow alternative treatment. For these reasons consolidated statements prepared in accordance with GAAP in this country should, in general, be acceptable in the EEC.

A close reading of the Directive leaves the impression that many compromises had to be made to enable the negotiators to set a minimum level of acceptable financial statements. A few examples of these liberal provisions and permissible alternatives will support this statement.

The Seventh Directive permits, at the option of member states, both poolings and purchases (Article 19 and 20). The rules for poolings are less restrictive than APB 16, requiring only the exchange of at least ninety percent of the shares of the investee for shares in the investor and cash not to exceed 10% (Article 20). Any merger qualifying for pooling treatment under APB 16 will therefore also qualify under the Seventh Directive.

In purchase accounting, the Directive generally follows American practice (Article 19). The only significant departure occurs in the allocation of the difference between the parent's cost and the subsidiary's book value. If cost exceeds both book and fair value, that excess — or goodwill — should be properly described, as is true in American consolidations. If cost is, however, less than fair value, the Directive apparently advocates the allocation of such a difference to the net assets with no positive or negative goodwill remaining. In this case the subsidiary's net assets would be shown neither at book nor at fair value, but at some intermediate amount. What makes this article even more confusing is the fact that the allocation of parent's cost to the subsidiary's book and fair value can be made either at the first balance sheet date or, at the member state's option, at acquisition.

The disclosure of the minority interest also corresponds closely to American practice (Articles 21 and 23). The basis of the minority interest is, however, not specified in the Directive. It should therefore be possible to show it either at book value, as is typical in U.S. consolidated statements, or at the fair value of net identifiable assets, as IAS No. 3 prefers, or at the subsidiary's fair value, including goodwill, as the entity theory advocates.

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Intercompany balances and transactions should be totally eliminated under Article 26, which does not distinguish between upstream and downstream transactions. But member states have the option of permitting companies incorporated under their laws to include intercompany profits if the transactions were made under normal market conditions. The exercise of this option must, however, be disclosed including, if material, the amount not eliminated.

The Seventh Directive also contains some conformity requirements, but they, too, should not cause problems to American parents. One requires that consolidated statements should use the parent's fiscal year or, at the option of Member States, the fiscal year of the most important company or of the majority of companies (Article 27). Another requires that the valuation rules of the Fourth Directive be used in consolidated statements and that all companies use the same valuation rules. Exceptions are only allowed if the effects are not material. Departures from this requirement may be permitted in exceptional cases but must be disclosed in the notes.

As this brief description shows, U.S. parents following American consolidation practices should be in compliance with the Seventh Directive.

The Eighth Directive

The Eighth Directive was adopted in 1984. Its purpose is to regulate the education, professional training, examination requirements, and independence of statutory auditors. It also contains transitional rules for auditors who are qualified under present laws but do not meet the requirements of this Directive.

Conclusion

In addition to these eight directives several others are in various stages of preparation. A proposed Ninth Directive is concerned with the protection of minority interests; a proposed Tenth Directive is dealing with the dissolution of limited liability companies. Other proposed directives deal with the accounts of banks and consultation with workers in large companies or groups of companies. None of these seem to be close to final adoption by the Council of Ministers. Ω

Integrating the Microcomputer Into Managerial Accounting Classes: An Experimental Study

By Michael Y. Hu and Gary Saunders

Release of the report "A Nation at Risk," by a presidential commission, refocused attention on the nation's educational system. Not unexpectedly, a myriad of suggestions for improvement followed the release. An increased role for computers in the educational process was one of the oft repeated suggestions. However, the Secretary of Education, among others, has cautioned that the computer is not a panacea.

The microcomputer represents a new plateau in computer technology as an extremely powerful instrument which can be acquired at a modest cost and can be made user-friendly. Also, the popularity of microcomputers will continue to grow both in the home and the classroom. Microcomputers present, however, a unique challenge to the academic community; i.e., how to best assimilate them into the learning process.

Ijiri [1983, p. 171] points out that one major problem accounting academians must overcome, both from a teaching and from students' learning perspective, is the sudden switch in the mode of thinking. Learning accounting concepts utilizing microcomputers requires a distinctly different approach from learning these concepts through traditional methods. Thorough development of a microcomputer approach to learning will require sustained effort from accounting academians. Alternative methods of integrating the microcomputer must be compared with traditional teaching methods to determine if the learning process is perceptibly improved. This paper reports the results of one such comparison.

Two major research questions were addressed in the study. First, will the use of microcomputer modules, relating to cost-volume-profit (CVP) analysis and operational budgeting, improve the learning process in managerial accounting classes? Second, will students react favorably to the use of microcomputer modules in managerial accounting?

The Modules

Microcomputer modules were developed for CVP analysis and for operational budgeting. Both modules recorded each student's name and the time they spent working with the module to a file. The CVP module began with a tutorial session which presented a derivation of the common forms of the CVP equation. Students were offered a choice of repeating the tutorial or proceeding to the problem-solving portion.

In the problem-solving portion of the CVP module, students were given instructions for entering the information contained in a problem assignment. The module is capable of calculating any of the components in the CVP equations with the exception of contribution margin and contribution margin ratio. After data are entered, the module plots a graph of the cost and revenue functions, prints the form of the CVP equation used, the value of the requested variable and the breakeven point. Students then copy the results onto the problem assignment sheet to be handed in.

The operating budgeting module was developed to generate budgets through the budgeted balance sheet. For use in the managerial accounting classes, however, portions of the module were disabled so that only sales, production and material purchases budgets were available to the student. As this module did not contain a tutorial section, students proceeded directly into the data entering stage. A number of options were presented with regard to factors such as the method of projecting ending inventories, percentage of receivables collected in a period and percentage of purchases paid for in a period. As with the CVP module, the time spent with the module was recorded and students were required to hand in the assignments.

Design

The study was conducted with managerial accounting students at the Kent State University. Computer modules used in the study were developed only shortly before the onset of the experiment. No similar computer exercise/homework had been used in any accounting courses that the students would have taken previously. It can be safely assumed, therefore, that this was the first exposure to the use of microcomputers in accounting courses for students participating in the study.

Four managerial accounting principles classes of approximately equal size totalling 96 students, were contained in the study. The four classes were taught by two instructors, each having two sections. A layout of the design is shown in Figure 1.

In order to balance the possible effect of different instructors on the results of this study, a restricted form of random assignment of treatments was used. One of the two sections taught by an instructor was given a problem to be solved using the CVP computer module, while the other section was taught by the traditional method. Later in the course the assignment of treatments was reversed; the operational budgeting module was used in the class which was taught CVP by the traditional method and the CVP module was used in the class that was taught operational budgeting by the traditional method. In essence, students in each class were assigned one but not both of the computer exercises.

FIGURE 1

Layout Of Design

	CVP	Budgeting
Instructor I		
Section 1	E	C
Section 2	C	E
Instructor II		
Section 1	E	C
Section 2	C	E

E = Experimental, Computer Module
C = Control, Traditional Method

From an experimental design perspective, the treatments were balanced with respect to instructor variation. Both the experimental and control groups for CVP were taught by the same two instructors. The identical concept was extended to the budgeting situation.

Measurement Instruments

Three sets of measurements were taken in the study. First, two separate problems, one on CVP and the other on budgeting, were included in a midterm examination given on the same day for all four classes. In order to ensure consistency in grading, the two problems were graded by a single graduate assistant specifically instructed for the study. Each problem was graded on a scale of zero to 100 possible points allowing partial credit where appropriate. Test scores provided a measure of the relative amount of learning that had taken place, with respect to the experimental and control groups, for the two topics contained in the study.

The total amount of time each student spent on the microcomputer was logged. Time spent was considered a potential explanatory variable in accounting for variation in the test scores.

To measure students' general reactions toward the use of personal computers in accounting courses a set of attitudinal measurements were obtained in a questionnaire survey conducted at the end of the semester. Students were asked to respond to a six-point rating scale, strongly agree to strongly disagree, for each of the five following statements.

1. Working with the IBM PC was an enjoyable experience.
2. Working with the IBM PC enhanced my learning of the course material.
3. Use of personal computers should be continued in future managerial accounting courses.
4. Usage of personal computers should be incorporated in other accounting courses.
5. My attitude towards computers has been measurably changed by this experience with the personal computer.

While the two test scores were related specifically to the treatment variables, the survey questionnaire was designed to measure general attitudes toward the microcomputer and its use in accounting courses.

Results

Correlation analysis was used to detect any relationship between the amount of time each student spent on the computer with CVP or operational budgeting and his/her respective test scores. Results indicated that the two sets of variables were not statistically correlated (at the 0.05 level). For CVP test scores and the amounts of computer time, the correlation coefficient was -0.041 (with a p - value of 0.729). For budgeting, the coefficient was -0.049 (p - value = 0.739). Since the amount of computer time did not help to reduce the variation in the test score, it was excluded from further analysis.

One objective of the study was to examine whether the utilization of personal computer modules in accounting actually enhances learning. Results related to this objective are shown in Table 1. For the experimental group of 48 students who had used the CVP module, the average test score was 82.19 with a standard deviation of 4.42. For the control group, the average was 78.85 (standard deviation = 4.56). The two independent sample t-tests, designed to detect significant differences in the average between these two groups, yielded a p - value of 0.601. Similar results were found for the budgeting module. The averages were 59.00 (standard deviation = 5.92) and 52.27 (standard deviation = 5.90) for the experimental and control groups respectively, with a p - value of 0.423. It should be pointed out that the figures for standard deviation between the experimental and control groups for each computer module were very similar. This is an indication that the control groups were well constructed.

TABLE 1

Average Examination Scores

	Computer	Traditional	
	n = 48	n = 48	p-Value
CVP	82.19	78.85	0.601
	(4.42)	(4.56)	
Budgeting	59.00	52.27	0.423
	(5.92)	(5.90)	

( ) = standard deviation

Though the differences in the averages were not statistically significant, the results contain interesting implications. For both CVP and budgeting, averages of the experimental groups were higher than those of the control. Replication of this study with a larger sample size would probably provide statistically significant differences showing that the computer modules are effective in raising the test scores.

Results from the attitude survey, given in Table 2, indicated that participants in the study expressed very positive attitudes towards the use of computer modules.

Most encouraging was the indication that students found their experience on microcomputers to be enjoyable. More importantly, they have concluded their learning of the course material was enhanced by the computer experience. Future application of personal computers in accouting courses was viewed even more positively by the participants of the study. The above, combined with the results given for the last statement, "My attitude towards computers has been measurably changed by this experience with the personal computer," suggests that the implementation of the microcomputer modules in the

managerial accounting course was successful.

Results further suggest that:

1. Many students who were quite apprehensive towards the computer at the beginning of the semester had their attitudes favorably altered.

2. Experience from this computer exercise was viewed to be very beneficial; and

3. Students in general were eager to spend more time on the microcomputer partly because it was an enjoyable experience and partly due to the fact that they believed they had learned more about the course material through this method of teaching.

Summary

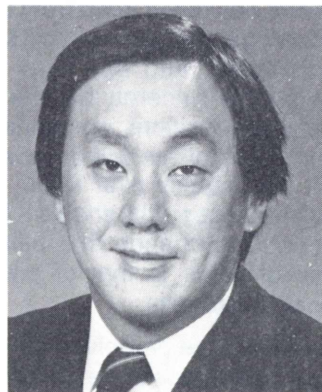
Use of the computer modules in managerial accounting resulted in improved test scores. Those students who completed an assignment on the microcomputer learned the material better than those who did not use the microcomputer. The authors believe that the lack of statistical significance for the differences in average scores is due, in part, to the sample size and that an increase in sample size will result in a significant difference in scores. The fact that scores for the computer groups were consistently higher supports the premise that microcomputer usage enhanced learning.

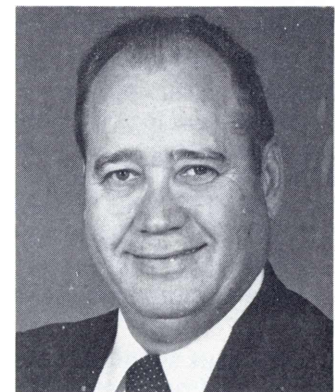
The positive students' attitudes toward the use of microcomputer modules in the classes are encouraging. Even if the differences in test scores continue to not be significantly different, students' attitudes suggest that this attempt to integrate the microcomputer into managerial accounting classes was a success and that use of the modules should be continued. Ω

TABLE 2
ATTITUDE SURVEY RESULTS*
(Percent of Respondents)

	Strongly Disagree	Disagree	Slightly Disagree	Slightly Agree	Agree	Strongly Agree
1. Working with the IBM PC was an enjoyable experience.	4	6	10	21	44	15
2. Working with the IBM PC enhanced my learning of the course material.	13	13	16	39	19	1
3. Use of personal computers should be continued in future managerial accounting courses.	4	5	4	31	44	13
4. Usage of personal computers should be incorporated in other accounting courses.	3	5	6	23	51	13
5. My attitude towards computers has been measurably changed by this experience with the personal computer.	8	13	14	43	19	5

*Percentages in Table 2 are rounded and, therefore, may not sum to 100.





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Grapevine Politics: An Office Goldmine

A Career Management Tool

by Susan RoAne

In the musical "Evita," one of the generals defines politics as "the art of the possible." An awareness of the machinations of the office structure is mandatory for survival. A keen sense of business politics — or savvy — can have a dramatic effect on one's career... whether you are an accountant in one of the Big Eight firms, a smaller firm, or in private practice.

Too often, women are overheard complaining about politics, claiming that "we just want to do our jobs well." Let me share a time-saving technique: WASTE NOT ONE MOMENT LAMENTING ABOUT THE HORRIBLE POLITICS IN YOUR OFFICE/ ORGANIZATION. There is no gathering of three or more persons FREE of politics.

So many of us separate our skills as professionals from those needed to compete politically. The abilities and skills required of an accountant are specific. But every woman in the profession must bring to her position that heightened awareness and series of skills that Betty LeHan Harrigan addresses in her primer for working women: *Games Mother Never Taught You*.

The benefit of heightened political skill is the awareness of how the organization operates, who operates it, the written policies and the *underwritten* rules. Deal and Kennedy shed light on "rules" aspect of organizational behavior in *Corporate Cultures*. Every office has a culture.

Politics has taken a rap from people who don't get the good projects, don't get promoted, and don't get hired. Some people sincerely believe that if they change positions, companies and careers, the politics will go away and they'll live happily ever after. It isn't true of marriages; why should it be true of work? The change that ultimately will be of value is that of practical, political awareness.

We want to be perceived as people who can get things done. *In Search of Excellence*'s authors, Peters and Waterman, mention that those who can cut red tape are valued. No one complains about politics who is a pro at it or who has been the *beneficiary* of some savvy actions.

The drawbacks to your career in accounting for not having political savvy are clear. You may be perceived as:

- Missing a career-management skill.
- Being unpromotable.
- Lacking in awareness and finesse.
- Being a loner, rather than a team player.
- Lacking in common sense, which has been used to describe logic, practicality, savvy, and know-how with a courtesy factor. Good old-fashioned manners are back.
- Untrustworthy of confidences and critical information which can sabotage work very effectively.

There is a one-minute quiz to determine whether or not you possess the sense of politics.

Do events occur in your company or in your division that *continually* surprise you? If so, here are some strategies that you can implement to increase your savvy quotient:

- Observe your colleagues, subordinates and supervisors. Who eats with whom? Works out together? Commutes together?
- Read the body language of your co-workers as names, projects and assignments are mentioned.
- Converse with your co-workers.
- Read the company's annual reports, brochures, newsletters.
- Listen... to conversations in the elevators, staff rooms, nearby restaurants and even the washrooms.

Some may describe this listening strategy as eavesdropping. Unfortunately, most of us were raised to think that such behavior is negative. Through "informal listening" many of us have learned of birthdays, anniversaries, promotions, co-workers' loss of loved ones, etc., and have taken the appropriate steps to acknowledge these events.

> If used properly, the grapevine can be a powerful resource and career aid.

The good old grapevine has received a tremendous amount of bad press, some of which is unwarranted. In fact, if used properly, the grapevine can be a *powerful* resource and career aid.

According to Marilyn Moats Kennedy, author of *Office Politics* and *Powerbase*, the grapevine is an informal communications network that can provide you with a great deal of useful information, including rumors and opinions. We all know that a rumor about mergers and acquisitions or reorganization usually becomes fact within six to eight months.

Michael Korda, author of *Power, Success* and *Charmed Lives* has said that gossip is a type of informal polling system which allows management to test a reaction.

For those of you who consider gossip to be idle chatter for which hard-working professionals do not have time, consider this:

• Informal information is not necessarily personal, vicious gossip. Eighty percent of information in that network is business-related office politics.

• Gossip can be an intentional leak of information you *should* know.

• Conveying a superior attitude about the grapevine could eliminate your sources of information.

• Busy people are not necessarily hard-working. Smart people make time to manage their careers. Cultivating sources of information makes sense.

The grapevine may forecast events through leaks to provide news of the future for the politically savvy who may *need* to know!

Scenario:

You may overhear that your firm is developing a marketing strategy designed to attract engineering and architectural firms. You attend several functions of those professional associations, start connecting and develop a network of potential clients. The market plan is presented, and you have already nurtured leads that turn into major accounts. You get a percentage *and* a promotion. Sounds unlikely? It has happened to an acquaintance with a major accounting firm located in San Francisco.

We are in an information society. Spurning the informal information is the modus operandi of the naive person. None of us wants to be perceived that way. The desired position is one where you have access to information. There are two cautions to heed when operating within the grapevine:

• Listen actively.

• Don't *add* grist for the rumor mill — it could come back to haunt you.

People who are smart about managing their careers know who has formal power, according to their positions and titles. More importantly, they are keenly aware of who has informal power.

How do they determine this? They observe at the office, at meetings and at office parties. They notice who laughs together; they observe facial expressions and body language, or, as Dr. Mary Byrd suggested, use the WDWTW-WWW&H formula (Who's Doing What to Whom-When, Where, Why and How). They know who lunches, jogs or commutes together. They listen to people to discover their values, goals and lifestyles. They learn people's interests, such as who sails, runs, golfs, sings, or makes furniture.

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Susan RoAne, MA, *speaker and seminar leader, has trained thousands of people on career and business management issues. She has taught for major universities, associations and corporations. She has written over 30 columns for the San Francisco Examiner "Careers" series, which she co-designed.*

If you're not already experienced at *cultivating your grapevine*, here are some tips:

• Determine who has access to relevant, powerful sources of information.

• Trade information when it's required.

• Don't fan the flames of gossip with your opinions.

• Observe your co-workers and those with whom they interact or socialize.

• Buy lunch or dinner for those who are prime grapevine sources.

• Recognize that members of your professional associations may have information about your organization.

• Be aware.

The grapevine has Biblical and historical roots and was immortalized in song by the late Marvin Gaye. It is here to stay. Instead of wasting valuable time cursing or questioning the grapevine, cultivate it as a career management tool of the politically savvy and successful accountant.Ω

Remarks by Paula Cholmondeley Director, American Institute of Certified Public Accountants

Before the American Woman's Society of CPAs October 5, 1985, in Los Angeles

I am pleased to be here with you in Los Angeles, sharing in your annual meeting. Sharing is a key word here because that describes the underlying relationship that I hope exists between our organization. We share an interest in helping the profession grow; we share a concern that the services we provide are of the highest quality; we share an interest in assuring that each of us — as individuals — reach our full potential of service and rewards as CPAs.

In asking me here, your president-elect said members of the AWSCPA are interested in becoming more involved in the AICPA. She asked if I would tell the group how to become more active in AICPA activities and describe the path that led me to a vice presidency of the Institute and chairman of the Future Issues Committee.

The American Institute is a sizeable organization and there is a definite hierarchy to its structure and informal guidelines as to how you rise through the ranks. These guidelines are openly discussed, but are not really written down anywhere.

The Institute operates on a budget of over $70 million: it employs 650 (estimated) people — about 87 are CPAs. An elaborate structure of committees, advisory groups and task forces, allows the Institute to fulfill one of its primary roles of setting technical standards. The Institute also carries out hundreds of projects, studies, and other activities designed to provide the factual information necessary for other organizations to make decisions on accounting related topics. Our CPE courses attract hundreds of thousands of participants; our voice on behalf of the CPA profession reaches millions of viewers, listeners and newspaper subscribers. Finally, the Institute is the advocate and defender of the CPA with Congress and other regulatory bodies.

All of this makes it a fascinating organization to participate in. I worked hard to become a CPA and I see the Institute as an organization I must belong to, since they, with their 230,000 members, are the organization with the primary power to ensure that being a CPA continues to mean all it did when I got my certificate. Huge though it may be, there is room within the AICPA for anyone to find a niche, to develop an expertise and to strive to contribute to the sweep of its activities. As a member, you march among 230,000 CPAs, but as a committee member you are a leader; one of 1,600 thrust into a policymaking role that may have a lasting impact on the profession.

Perhaps, the first question to settle is "How should you view participation in the two organizations, the AICPA and the AWSCPA?" I have not read your by-laws or mission statement, but I see the function of the two organizations as different — not in conflict. In fact, I belive they are compatible and supportive of each other. I think each of us has to make a personal decision as to where to spend our time. I have made a decision to ensure that the AICPA is one of the primary organizations I am active in, because I think progress is faster and more is accomplished when you have extensive resources behind you.

The AICPA is an organized entity, rich in traditions, accepted as part of the Establishment, and regarded as the authority on accounting issues. By way of measuring its influence, the AICPA is asked at Congressional hearings for its judgments and insights to explain profession developments. Congress regards the AICPA as the voice of the profession, an gency qualified to speak for its membership of 230,000 CPAs.

If you accept that the AICPA is the key organization in our profession then the next questions are: Working through the Institute, could you do things that are important to you and to AWSCPA? Would your work receive comparable attention — command the same level of priority? Share the same probability of accomplishment? Certainly, a wide commonality of interests links these organizations. The interests of women in the profession are as important to the AICPA as they are to this group. Women comprise 14 percent of

the AICPA membership and 40 percent of the accounting graduates. Our influence , as women, on professional developments grows every year. What we are looking at is the increasing opportunity to influence the profession at a time when the profession itself is going through enormous changes. Our expectations are that the work of CPAs will change enormously with the arrival of new technologies, and procedures created by such agents of change as the advent of artificial intelligence and the shifting needs of users of our services.

Participation in the AIPA is a second step, not a first, for most of those serving on AICPA committees. Appointments in the Institute typically follow years of service to a state society or another professional organization like AWSCPA. Most AICPA committee members have served on a technical committee in one of these other organizations immersing themselves in tax or auditing or accounting matters. Diligence, perseverence and some luck have moved them through the ranks to a position of visibility in their society or association. Gaining this visibility, developing a solid track record in an organization like the AWSCPA is an important requirement to the participation on an Institute committee.

My own story is one of starting in two organizations and earning my stripes with them before moving into the AICPA. One is the National Association of Black Accountants where I worked my way up to positions such as Eastern Regional Vice President and Treasurer. The second is the New York State Society where I started as a committee member on the Printing, Publishing and Advertising Committee and worked my way up to chairman of the International Operations Committee.

In both organizations I found that a willingness to work and to assume responsibility, coupled with your visibility as a woman, quickly brings you to the attention of the organization leadership. While working with these two organizations I was continually referred to various AICPA activities. When I looked at the scope of activities of the Institute, I was struck by the fact that my participation in both of the organizations I mentioned was like playing in one specific pond. Being active in the Institute would give me the whole ocean.

Once you've acquired the knowledge and organizational skills for service and built for yourself a reputation among your peers, in an association such as the AWSCPA, then you are ready for a committee assignment with AICPA.

When I joined my first Institute committee I, along with everyone else, started as a committee member. I had been a leader in the organizations that nominated me, but here I had to earn my stripes all over again.

As a member of a committee, persons are groomed for larger roles within the Institute. The whole structure — AICPA task forces, committees, subcomittees — up to the senior technical committees with their standard setting authority — is constructed of people and people appoint people they know. That's a fact of organization life. Experience, contacts, a willingness to give — these are the elements that lead to AICPA appointments.

The committee assignment process begins with a letter from AICPA that goes out to state societies and other professional organizations about the first week of December. That letter solicits an organization's recommendations of members who have faithfuly served and made significant contributions to the group's work. Nominations are made on forms that call for biographical data showing service completed. They also provide space to name the committee you want to serve on. Forms are due back February 15. Most bear endorsements from state organizations; but they can be self-propelled — that is, you can apply yourself. As the applications filter in to the AICPA, they are dispatched to the staff aides for individual committees, who match individuals to committee functions, and submit their judgements to higher levels of management for review.

Paula H. J. Cholmondeley, CPA, MS, *is currently manager of the Washington, D.C. region for the Westinghouse Elevator Company. She is presently chairman of the Future Issues Committee of the AICPA and is a director of the AICPA Council. She holds a master of science degree in accounting from the Wharton School of Finance, is a CPA in New York and Connecticut, and is a member of the National Association of Black Accountants.*

Between February 15 and the first of June, all the preparatory work on committee selection is carried out. Then, the incoming chairman of AICPA decides on appointments for the year he serves as chairman. If you've sent in a biography, that's all the system expects of you. Sometimes it helps to send a letter of application to the staff aide who is listed in the AICPA Committee Handbook. You might think about telephoning a committee chairman so you can explain why you feel especially qualified for services on his or her committee.

All of that helps in the competitive atmosphere that prevails, remember, there are 1,600 serving on organized, structured committees. Among them, a third leave each year as their tenure expires. That means that with a membership of about 230,000, the Institute has openings every June for between 600 and 700 new committee members. Through the year, other assignments are made as task forces and ad hoc units are formed.

Why does the Institute prefer to appoint its committee members from among those first active with other organizations? First, the issues the Institute deals with are of vital importance to our profession, and the Institute wants to bring the best and the brightest to the task — individuals who have developed experience by working on the issue with other organizations. Second, a committee only meets three or four times a year and yet they must still produce the required results, so each committee member must be an individual to assume responsibility and meet commitments.

The increasing membership of women on committees in the Institute is a manifestation of the upward mobility of women in the profession, but I do not believe that enough of us are currently active in the Institute.

Time is on our side. You may not entirely agree with that, but facts help bear that out. Our most recent survey of the major accounting firms shows there are four times more women CPAs with firms today than in the mid-seventies. The number rose from 5,783 in 1976 to 22,818 in 1984. Just as significant was the increase in numbers of women partners. From a paltry 29, who were partners in 1976, the ranks of women partners grew to 146 last year. Schools and universities

tell us that today's accounting classes are 50 percent women. From that, I conclude we're moving toward center court.

One of my assignments — perhaps the one that offers the greatest opportunity — is chairing the AICPA Future Issues Committee. Our charge is simple, clear and imposing in its instructions: We are asked to identify future problems and opportunities facing AICPA and the accounting profession.

Through a series of interviews with prominent futurists, leaders from various industries and professions — including our own — we have identified fourteen issues we believe will be of watershed importance. The list includes how firms can take advantage of opportunities to expand services and products. Other issues raise critical spects of competition, automation, legal liability and self regulation. Peering into the future is a heady business — especially for CPAs, usually more regarded for their skills as historians than as seers.

In looking at the prospects for women in our profession, we made assumptions: that the future of the profession and its adherents hinges ultimately on the quality of the work performed. Thus, it is important to know if we are recruiting the brightest potential candidates into the profession. Are we reaching out to everyone potentially able to perform in the profession?

We find a variety of reactions to our inclusion of this as one of the key issues for the profession. Some are apprehensive that women may not be as strenuously and single-mindedly career oriented as men. That is clearly a misperception and part of the problem. Others view this as an opportunity to bring new perspectives into the profession.

Flexible hours, flexible workdates, flexible locations — some say — would solve the problem of women working. As a committee, we have concluded that AICPA should form a committee of knowledgeable, dedicated professionals who can explore the issue, sweep aside untested cliches and come up with thoughtful recommendations that help, rather than deter, the women in business.

We have been discussing a practical plan for advancing the interests of women in the accounting profession. It is important that we acknowledge that our cause is advanced by a closer working relationship between the Institute and an organization like AWSCPA. Already, six women have been appointed to chair important committees of the Institute. With more than 200 committees in operation, AICPA can offer us room to expand. But the beachhead is firmly established. You will find, as I have, that the Institute's people are receptive to newcomers, eager to contribute to the worthwhile work of the committees. As our ranks expand, it is only fitting for us to assume an appropriately larger role in the work of the profession.Ω

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PS Form 3526, July 1984 *(See instruction on reverse)*

Partial Tax Allocation from Page 18

[16]This annual inflation rate appears to be quite realistic given the present United States Consumer Price Index (CPI) increases in recent years. Although the 1982 rate was less than 5 percent, the average rate of inflation, as measured by the CPI, for the period 1971 through 1980, has been 9.735 percent annually. For simplicity, it was assumed that the specific price level change was equal to the general price level change for the year in question.

[17]American Accounting Association, 1964 Concepts and Standards Research Study Committee — The Matching Concept, "The Matching Concept," *The Accounting Review* (April 1965), p. 369.

[18]Committee on Accounting Procedure, *Accounting Research Bulletin No. 43*, (New York: AICPA, 1953) p. 88.

[19]*FASB Statement of Financial Accounting Standards No. 5*, "Accounting for Contingencies," (Stamford, Conn.: FASB, March 1975), par. 1.

[20]Ibid., par. 8.

[21]Ibid, par. 59.

[22]Herman W. Bevis, "Contingencies and Probabilities in Financial Statements," *The Journal of Accountancy* (October 1968), pp. 41-42.

[23]*FASB Statement of Financial ccounting Concepts No. 3*, "Elements of Financial Statements of Business Enterprises,"(Stamford, Conn.: FASB, 1980), par. 28.

Reviews

Editor:
Jewell Lewis Shane, CPA
Cincinnati, Ohio 45202

The Female World and Technology in 2020,

by Jessie Bernard, Phi Kappa Phi Journal, p. 8-10. Jessie Bernard's most recent book is *The Female World* (New York: The Free Press, 1981).

In this time of transition to the "Post Industrial" or "Communications Era" from the "Industrial Era," the female world will be viewed from the occupational and family perspective. The female world has always been viewed as both structurally and culturally different from the male world.

In the male world, as a result of the low technology Industrial Era, relationships are based on monetary exchange. Generally, a man's behavior is competitive; self-interest is mandated.

The emphasis in the female world is on altruism, on giving or serving others, on taking care of others. Love and duty are their prime motivators. Structurally, females are preindustrial and took this with them when they entered the job market. As women became more exposed to the industrial world, they did not like what they saw. They could not come to terms set by the era and this hindered their progress in the industrial society.

The post industrial period, though, may be the perfect opportunity for females to impact the job market. This new era, by its very nature of high technology, will require a more collaborative and a communicative society. Women, by their natural socialization process, are prepared for functioning in the new age of communications where people must work closely with each other and share their ideas without the fear of being ridiculed or their ideas being used against them.

Bernard presents two models stated in terms of the "best case" and the "worst case," of what could result in this coming era. The "best case," or Theobold Model, provides a scenario of an environment where people must work closely with each other. In this model, women find the patterns of process and cooperation, required for the Communications Era, easier than men. Serious problems lie ahead with certain male egos as they share a common goal rather than to triumph individually over others. Working together becomes a necessity for success in this new era.

The "worst case," or the Rothschild Model, sees some of the characteristics of the Industrial Era surviving into the post Industrial Era. It sees females emulating the male-type practices of business and it depicts the female entrepreneur as succumbing to the ethos of the Industrial Era. So, instead of operating as a catalyst to create a communications society, the female in the work force will merely bring up the rear.

According to Bernard, in the new communications society, females do not have to come to terms with the male ethos. By their past development in structure and culture, they are already in tune with the new ethos that may very well predominate in the communications society.Ω

Linda M. Kunkel
Lewis-Shane CPA

Letters to the Editor

Stress in Public Accounting

The reason that "frequency and adequacy of personnel reviews" is less stressful for women is that we are not reviewed on a consistent basis with males. Annual reviews for male staff members appear to be more in depth. Their performance will be subject to critical review and problem areas will be discussed. Our interviews, on the other hand, are almost always a verbal pat on the head. "You appear to be doing very well; your salary will be raised to...; and be sure and come in if you have any problems."

I do not believe that CPA firms deliberately discriminate against women in the review process. I do, however, feel that most persons doing the review are uncomfortable discussing critical areas with female staff.

I have never had an annual review that brought up any areas in which I should improve. While I would very much like to believe that this is because I am perfect in every way, I realize that I must personally review my progress with a critical eye and identify areas which need work. Several times I have had to read between the lines at staff meetings to detect criticism that probably should have been leveled only at me being given to the entire staff. This has been a means to get the word to me without "risking" a personal confrontation.

Carole Ann Gibbs Fisher, CPA
Honolulu, Hawaii

Above All — Balance

Amen! I hung this immediately under my three diplomas and in view of my three professional association certificates, AICPA, MACPA, AWSCPA. Thank you.

Susan Grimes Munsell, CPA
Fowlerville, Michigan

October Issue

The October 1985 issue is fantastic! I read the articles on *Corporate Culture, Women CPAs-Pioneers* and *Looking Back* immediately. Rarely do the articles in any magazine grab my attention that way. Please have more like them in future issues.

Sally Czaja, CPA
Darien, Illinois

On hiring: "No one can be right all of the time, but it helps to be right most of the time."
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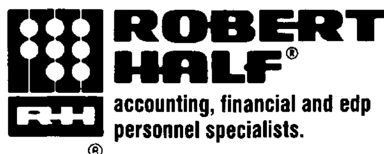

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