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## **DOCTORAL RESEARCH**

The main emphasis in this edition of doctoral research review is on finance: both public and private and from the viewpoints of both investors and investees. We commence with Hartl's survey of risks and returns to corporate bondholders during the period 1950-1974. Traditionally, investors have considered well-rated corporate bonds as a safe and lucrative investment and, with respect to safety at least, Hartl's research confirmed this. It was another story, however, with respect to returns. On the average, investment grade bonds returned only 2.71 percent over the twenty-five year period reviewed—which could be a significant finding for those investors attracted to corporate bonds because of the unprecedentedly high yields in recent years. We shift the focus from the lender to the borrower and from the domestic to the overseas markets and look at the Brazilian experience with private external borrowing. Moura's research examined portfolio capital behavior in a large developing country, concentrating on private sector active borrowing in external financial markets, and found strong interrelationships between the stock of foreign debt and the level of domestic income.

From the private sector, we move on to examine borrowing at the macro level. Feldstein's study of New York's municipal debt structure during the period 1962-72 highlighted the key role played by the mayor in deciding how to finance the operating and capital needs of the city. Using a variety of data sources, including eight case studies, Feldstein showed that the traditional use of property taxes and long-term financing for operating and capital needs were, time after time, rejected in favor of the politically expedient issue of short-term debt. Municipal debt is, of course, an integral part of public budgeting. Once again we travel overseas: this time to review Shahroodi's study of the Iranian budgetary system during the years 1960-1976 when it progressed from a typical line-item structure towards a more program budget orientation. However, the system still had a long way to go towards reaching program budget status and Shahroodi's recommendations for improvement included increased involvement by the people and by the parliament.

For a change of pace, we conclude with two studies of issues involving CPAs: Smith's research on the development of the concept of privileged communication between a CPA and his client and Kimbell's study of third party liability in the performance of the audit function.

*Investor Experience in Corporate Bonds, 1950-1974* (University of Arkansas, 1978; 39/6, pp. 3725-6-A)<sup>1</sup> by Robert James Hartl. The major objective of this study was to help investment decision-makers by providing them with historical information about the risks and returns to corporate bondholders. Risks were classified as: (1) call risk (the risk of early redemption); (2) interest rate risk (the risk of rising interest rates); and (3) default risk (failure to meet principal and interest payments.) Bond returns promised were compared with the return realized: the latter category including both paper capital gains and losses and coupon interest. As a secondary objective, the author was also interested in developing trend or characteristics information from the historical structure of the corporate bond market and this was used as background for the risk-return research.

The study covered the time period 1950 through 1974, years earlier than 1950 being excluded on the grounds that earlier periods would not be representative of current economic conditions. For purposes of researching market structure, all United States corporation bonds, regardless of type, were included. Only straight bonds of non-financial corporations which Moody's Investors Services Inc. rated investment quality were included in the risks and returns analysis.

With respect to the structure of the corporate bond market, it was found that the relative importance of publicly issued and privately placed bonds has varied considerably. Also that there is a concentration of corporate bond ownership in the hands of individuals, life insurance companies, and pension funds.

In reviewing risks and returns, three distinctions were made: long-term versus short-term maturity; industry of issue (industrial, public utility, and transportation); and investment quality (Aaa, Aa, and Baa ratings). The research findings were that, with respect to maturity, short-term corporate bonds provided greater realized returns and incurred less risk than long-term bonds. Differences were not large when the type of industry was considered. However,

<sup>1</sup>*Dissertation Abstracts International* volume and page references.

greater returns and, at the same time, greater risk was associated with transportation bonds. In practically every instance, risk and return were inversely related to investment quality.

The research findings were that interest rate risk was more significant than either default or call risk. Default experience was insignificant: especially with respect to investment quality issues. For bonds originally rated Baa or higher, no material contractual defaults were identified, with the exception of a few railroad issues. Call risk was greater in that about 12 per cent of all investment quality issues were retired prior to the original maturity date. A significant research finding was that the average annual return on investment grade corporate bonds was only 2.71 per cent despite the fact that corporate bonds have been considered by investors to be a lucrative and safe investment medium.

*Private External Borrowing: The Brazilian Experience* (Stanford University, 1978; 39/6, pp. 3727-8-A) by Alkimar Ribeiro Moura. The research objective was to analyze the process of capital transfer to a large developing country, using the Brazilian experience as a case study. The emphasis was on behavior of portfolio capital with special focus on the emergence of the private sector as an active borrower in external financial markets.

The background to the study is the fact that in order to accelerate its rate of growth of output, Brazil's economic policy has, since 1964, and particularly after 1967-8, been oriented toward the absorption of foreign real resources. Inflows of autonomous capital (foreign direct investment and/or portfolio investment), as well as changes in the country's stock of external assets and liabilities, have constituted the financial counterpart of this movement of goods and services. During the period 1968-74, the economy expanded vigorously and the inflow of foreign financial capital was of such magnitude that, of all developing nations, Brazil became the largest recipient of resources from OECD countries and international agencies.

The research included the following basic steps: determination of capital flows; construction of a portfolio distribution model; and derivation of a system of reduced-form equations. The basic determination of capital flows was made from demand conditions in the borrowing economy. The portfolio distribution model, constructed to explain how a Brazilian firm might select the optimal composition of its liabilities given that it had access to both foreign and domestic credit, took into consideration some of the mechanisms

for adjusting to foreign-capital inflows to the domestic economy. Independent variables were: the level of domestic income, the monetary base, the Eurodollar rate, the expected rate of change in the price differential between Brazil and the United States, the level of foreign reserves, and the current account balance. The dependent variable was the desired stock of foreign liabilities held by Brazilian firms. To estimate the equation, ordinary least squares regression techniques were used with quarterly observations for the period 1969-1976.

The theoretical hypotheses underlying the model were, in general, confirmed. The stock of foreign debt was found to be highly sensitive to the level of domestic income, other explanatory variables including: the level of monetary base; the Eurodollar rate; and the expected rate of change in the price differential between Brazil and the United States.

*The Politics of the Municipal Debt Structure in New York City (1962-1972)* (Columbia University, 1976; 39/9, pp. 5644-5-A) by Sylvan Gary Feldstein. Municipal debt has become increasingly important as a claimant on limited revenue resources of cities and the objective of this study was to learn about the politics of choosing city finance methods. For the ten-year period reviewed, New York City raised billions of dollars through funded and temporary financing mechanisms without significant political opposition. The major finding was that the city's mayors played a dominant role in municipal debt decision making without conflicts with or challenges from such other power centers as: politicians, bankers, and bond investors. Further, that given the alternatives of raising taxes or reducing personnel and services, the mayors to an increasing degree used debt to finance municipal operating expenses. The data base consulted by the author included the city comptroller's reports, finance department documents, budget director statements, books and articles, interest group documents, personal interviews, and eight case studies. The case studies were the following: (1) the decision, in 1965, to borrow money to finance city employee pensions (Borrow-Now Pay Later for Pensions: 1965); (2) the 1969 decision to use bond money to finance anti-poverty training programs (Financing Manpower Training Programs, 1969); (3) accounting for the police parity settlement in 1971 through the capital budget (Police Parity Payment: 1971); (4) bond money subsidies in 1971 and 1972 to stabilize the subway fare (Saving the 30¢ Subway Fare: 1972); (5) the 1965 change in the New York

State's local finance law allowing the mayor to borrow additional funds (The Revenue Gap; Spring, 1965); (6) the city's issuance of short-term debt in 1969 for the New York City Housing Authority (Using Capital Notes for the Housing Authority: 1969); (7) reasons for the change in the "budget note" finance law in 1971 that allowed the mayor to issue additional notes (Raising the Budget Note Limit: 1971); and (8) why the mayor relied upon short-term borrowing for the city's middle-income housing program instead of issuing long-term bonds (Low Rents, Short-Term Financing, and the City's Middle-Income Housing Program).

*The Iranian Budgetary System and Patterns of Government Expenditures, 1960-1976* (Syracuse University, 1978; 39/8, p. 5070-A) by Mohammed Reza Shahroodi. The Iranian budgetary system is the subject of this study: its origin, evaluation, integration with economic planning, and present shortcomings. The research also sought ways of further improving the system within the framework of program budgeting. Following analysis of the budget system, the author examined various individual components: revenues and expenditures; sources of deficit financing; relative shares and growth of expenditure categories, and also looked at the factors which influenced the growth of government expenditures over the last two decades.

Until it was integrated with economic planning in 1965, the Iranian budgetary system had been based on a traditional model since its inception in 1911. That is, it was concerned only with measuring revenues and expenditures without considering the related economic objectives. Further, unbalanced economic growth over this period could be traced to the fact that government investment projects, carried out by various government enterprises with conflicting objectives, were excluded from the budget. After 1965, the system underwent some drastic changes which led to improvements in the scope and contents of annual budgets. Despite the fact that these changes were referred to in the context of program budgeting, they in fact fell short of such a system and, unless these inadequacies were remedied, the author felt that there would be continued failure to meet goals.

The following recommendations were offered for improving the budgetary system: (1) more effective coordination between the groups on matters of program objectives, investment decisions, pricing policies, and budgetary procedures in order to avoid conflicting objectives and waste in public organizations; (2) the devel-

opment of a series of output measures for evaluating program performance; (3) multi-year budgeting, using alternative macro-economic assumptions, in order to provide consistency between successive annual budgets; (4) cost-benefit analysis of public programs to ensure efficient resource allocation; and (5) increased public involvement in the budgetary process and parliamentary control over the budget.

*An Investigation Into Accountant-Client Privileged Communications in the Courtroom* (University of Arkansas, 1978; 39/6, p. 3664-A) by George Stevenson Smith. The purpose of this study was to analyze the development of the concept of confidentiality, or privileged communication, between the certified public accountant (CPA) and his client. This broad goal was organized into the following activities: (1) tracing the historical development of privileged communications in the accounting profession and contrasting and comparing it with the experience of other professions, such as law, medicine, and ecclesiasticism; (2) analyzing state statutes, by way of court cases, which have established this privilege for CPAs; (3) determining the attitudes of CPAs, attorneys, and clients of CPAs toward the right of the accounting profession to have privileged communications, and its effect on the relationships between these three groups; (4) determining, through surveys and interviews, the position of State CPA Societies concerning sponsorship of legislation granting privileged information rights to accountants; and (5) arriving at a conclusion as to whether the accounting profession should support CPA-client privileged communications.

Research commenced with a review of the pertinent literature, court cases, and state laws. Privilege legislation had its origins in the early part of this century when accountants began to seek legal means of enforcing membership practices. A great deal of diversity was found in the way in which such statutes were enacted and interpreted by state-level courts. A Likert-type questionnaire, mailed to 1,800 randomly selected members of the American Institute of CPAs, attorneys listed in the *Martindale-Hubbell Law Directory*, and corporations listed in *Standard & Poor's Register of Corporations*, was used to assess attitudes towards the concept of privileged communications. The response rate, from all three groups together, was 64 per cent, all indicating sympathy for CPA-client privilege in the courtroom—this sympathy being most strongly expressed with respect to the tax area.

The null hypothesis was that there was no significant difference in attitudes as measured by statement mean scores of the groups.

The statistical analysis used ANOVA and Chi-Square. If a statement appeared on all three questionnaires and a significant relationship was found, a *t* test was used for making a multiple non-independent significance test among the three means. The analysis showed that the potential for disagreement existed most strongly between the CPAs and clients. Based on these findings, the following recommendations were offered: (1) that the CPA-client privilege should be restricted to tax practice; (2) that the effort to confine privilege in state statutes to the tax area should be initiated by the American Institute of CPAs; and (3) that the accounting profession should, at both the state and federal level, attempt to achieve CPA-client privilege in the federal tax area.

*The Nature and Extent of Auditor Liability to the Third Party in the Performance of the Audit Function During the Period 1972 Through 1976* (Louisiana Tech University, 1978; 39/7, p. 4341-A) by James Albert Kimbell, Jr. The research goal was to determine the status of auditor liability to a third party, usually an investor, in the performance of the audit function during the period 1972-76. The following research questions formed the basis for the study: (1) what is the current status of auditor liability to the third party for gross negligence?; (2) what is the current status of auditor liability to the third party for ordinary negligence?; (3) What constitutes aiding and abetting under the federal statutes?; (4) is scienter a necessary requirement for bringing an action under the federal statutes?; (5) what constitutes reliance under the federal statutes?; (6) what is the current status of the "purchaser-seller" requirement of Rule 10b-5?; (7) how have the courts interpreted the "in-connection-with" requirement of Rule 10b-5?; (8) how have the courts interpreted the question of "particularity" in pleadings?; (9) how have the courts interpreted the question of materiality under the federal statutes?; (10) does auditor compliance with generally accepted auditing standards discharge auditor responsibility to third parties?; and (11) what are the critical problems of auditor liability for the future?

Research on these questions was carried out by reviewing common law and statutory law case rulings and consulting with General Counsel of the "Big Eight" public accounting firms. The bases for findings, suggestions for additional research, and suggested implications of the study emanated from the courts' interpretations and rulings during the period 1972-76. The research findings were that the courts have increased the auditor's responsibility to third



parties through their interpretations of the federal securities laws, and that the greatest area of remedy for third parties has been the auditor's aiding and abetting of an injury. The extent of such liability has, however, been limited by legal requirements of particularity in alleged misrepresentations, the limitation of those alleged to be injured purchasers or sellers, and the requirement of knowledge (scienter) on the part of the auditor. The author suggests that: there is a need for continually monitoring court rulings to determine whether auditor-third-party liability has changed and the extent and reason for any such change.; that the auditor should communicate the intent of the audit function and auditor's certificate; and a consensus standardization of auditing procedures and disclosures as well as a review of the intent and language of the auditor's certificate.