

Asset Backed Securities

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Introduction

In a community there are individuals, businesses and government that are at times demanders of funds and at other times suppliers of funds. Demanders of funds are those who need more money to finance projects and businesses. Suppliers of funds are those who have excess funds. They look for opportunities by which these funds could give them returns. As suppliers are entitled to required returns, demanders have to bear the cost of funds. The interaction between these two groups, through the flow of funds, promotes economic activity. As the interaction become more intense and spread among the greater majority of the population, there can be economic development.

Financial intermediaries act as facilitators in the flow of funds. In addition to private placements where demanders and suppliers negotiate with each other, funds can flow through financial institutions and financial markets. Financial institutions like banks, insurance companies, and pre-need companies channel savings into loans and investments. Financial markets- the money and capital markets- provide the venue for trading financial products or securities. Securitization is the process of matching demanders and suppliers of funds by way of the public financial markets rather than through the financial institutions.

Financial product innovations rise from unsatisfied demand for raising funds, and demand for higher earning investments with specific risks, returns, and timing attributes. Asset-backed securities are one of these financial innovations.

History

The idea of asset-backed securities (ABS) dates back to 1970 when the Government National Mortgage Association (GNMA) in the US introduced the mortgage pass through securities. Individual home mortgages were pooled into homogeneous pools. Each pool acts as backing for GNMA



pass through security. GNMA security holders receive principal and interest payments made on the underlying mortgage pool. Mortgages were traded just like other securities in the financial markets.

A second round of innovation came when mortgage backed securities were offered with different effective times to maturity. These are called collateralized mortgage obligations (CMO). The overall pool is divided into a series of classes called tranches. Fast pay tranche receives all principal payments made on the entire mortgage pool until the total investments in the tranche is repaid or retired. Investors in the other tranches receive only interest on their investment. The next tranche then receives all of the principal payments until it is retired and so

on. (Bodie, Kane, Marcus, 2001)

Primitive, derivative or innovative securities are traded in the financial markets. Primitive security offers returns based only on the status of the issuer. Derivative security yields returns that depend on additional factors pertaining to the prices of other assets. Innovation is the continuous creation of new types of derivative securities from the available set of primitive securities. The primary use of derivatives is to hedge risk but it can be used to take highly speculative positions that can increase exposure to various sources of risk.

In the mid 80s, asset backed commercial papers came about. These commercial papers were secured by auto loans, air craft leases, royalties from films, housing and home improvement loans, credit card receivables, student loans, property tax liens, leases and virtually all other forms of debt obligations.

Assets are real or financial. Real assets can be tangible or intangible. Machines, factories, offices are tangible assets. Intangible assets are skills, trademarks, and patents. These real assets are needed to carry out the business. Financial assets or securities, on the other hand are assets used by businesses to obtain the necessary money. Securities are pieces of paper that have value because they are claims on the firm's real assets and the cash that they produce. (Brealey, Myers, 2000)

From mortgage-backed securities in the 70s, financial assets securitization extended to asset-backed securities. It is now a \$400B industry in the US alone. In recent years it has spread to Europe (the largest market outside US), Latin America and Southeast Asia (primarily Japan; Leixner, 1999)

Asset backed securities are present to a limited extent in the Philippines. Currently, it is arousing greater interest among finance managers in both business and government.

Definition

Asset backed securities are financial instruments or products that are issued by a special purpose company that holds a package of low-risk assets whose cash flows are sufficient to cover obligations to the investors.

From mortgage-backed securities in the 70s, financial assets securitization extended to asset-backed securities. It is now a \$400B industry in the US alone.



Structure (Box 1)

A. Basic

The originator creates receivables or purchases receivables that it sells to a Special Purpose Entity (SPE) or Special Purpose Vehicle (SPV), normally a trust. This is done to achieve certain results for accounting purposes and to protect the receivables from claims of creditors of the originator.

The principal originators are usually top quality commercial banks,

savings banks, finance companies and corporations. State owned enterprises and infrastructure projects followed. Weaker borrowers found that they can also use their good assets to access capital markets that were otherwise closed to them.

The SPE securitizes the receivables and becomes the issuer that sells the securities through a public or private offering. Majority of the ABS investors are institutional investors like banks, insurance companies, and pension funds. Frequently a residual interest is created in the Issuer that entitles the Originator to remaining funds after all obligations to the security holders have been satisfied.

During the term of securitization, collection is done by the Originator, deposited and invested in eligible securities in various accounts under the control of the trustee and disbursed by the trustee to the security holders.

B. Two-step

In a two-step structure, the Originator transfers receivables as part contribution of capital to the SPE. The SPE, with one independent director, is a wholly owned subsidiary of the Originator. Its sole business is to acquire, own and sell the receivables to the Issuer.

This two-step structure enhances the "true sale" and "bankruptcy remote" characteristics of the transaction. It is viewed as a sale of receivables rather than a financing scheme to get receivables out of the Balance Sheet and book a profit or loss for accounting purposes.

The Financial Accounting Standards Board (FASB-USA) 25 had virtually mandated the use of the two-step structure to obtain an isolation of assets and therefore a "true sale". Whenever the Originator retains an interest in the securities issued by the Issuer, it is usually for credit enhancing purposes.

Actual structures of ABS are far more complex than the above. It may

involve many more elements and participants. ABS can be issued in a series of complex transfers to other trusts, limited partnerships and limited liability companies, units and sub-units of beneficial interest in the trust, which are actually receivables of the trust. Therein the security holders have no interest, beneficial or otherwise, in the underlying receivables.

Objective

The primary objective of asset securitization is to provide funds for the corporation. It provides a new and relatively cheaper form of financing. To financial institutions with successful loan programs but face capital constraints, it is to remove assets from the balance sheet. By doing so, it frees up capital to support more lending activities.

Benefits

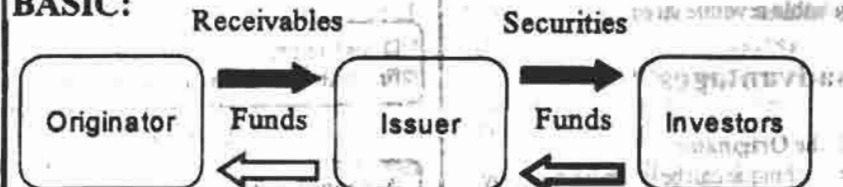
Asset back securities are beneficial to the parties in the transaction- the Originator, the Issuer and the Investor- and the economy.

A. To the Originator

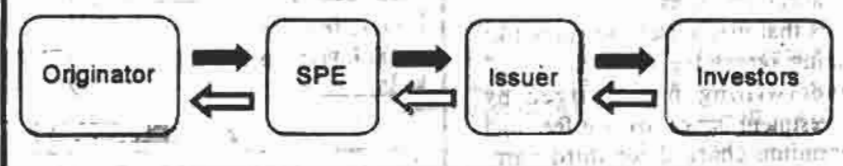
- It allows for an opportunity to free up their capital and fund assets at a lower cost. With more efficient use of equity, return on equity is enhanced. Capital requirements and mandatory reserves for financial institutions tie up their capital.
- Lower costs are possible because investors are satisfied with a lower rate of return. They find a pool of assets more valuable (less risky) outside a company than when they are bundled with the company's other assets. Investors often prefer assets that have been legally removed from the company's ownership and control.
- It provides flexibility to the originator. Raising capital can be secured by a broad range of assets. Any income-producing asset with an adequate performance record and some

Box 1: Structure

BASIC:



TWO-STEP:



diversification of credit risk can be securitized.

- It broadens the base of potential investors because of the higher rating associated with securitized transactions.
- If structured as a sale, assets and debts of the originator are reduced. Risks are transferred, thereby its capacity to borrow is increased.
- The seller continues to earn from the servicing fees, the excess of SPE's revenue over costs, and surplus collateral once the ABS are redeemed.
- Depending on accounting rules, a securitization structured as a sale may allow a seller to recognize an accounting gain (or loss) equal in the aggregate to the present value of any expected future cash flows payable to the seller that will be derived from the assets.
- For privately held companies, disclosure is confined to the characteristics of the assets being securitized and the servicing capability of the originator. It can raise public debt without extensive disclosure of proprietary information.
- Securitization of assets allows the originator to arrange debt issues to fund assets whose payments are perfectly matched to the cash flows on the assets. Funding mismatch risk is transferred to those who are able

to bear it—those who have an opposite mismatch.

B. To the Investor

- Asset backed securities can offer higher return than other equal risk investments.
- The securitization structure can offer far greater liquidity than do the individual loans backing the transaction.
- Investors are provided an opportunity to diversify their portfolios by participating in a different class of assets.
- Unlike corporate bonds, ABS are largely immune from event risk like takeovers, restructuring and other events that effectively alter the credit status of senior unsecured corporate obligations.
- ABS can meet requirements for investments in investment grade securities and triple A paper.

C. To the National Economy

- ABS offer another option for high quality, fixed income securities that can help develop the capital market.
- ABS provide a source of funds for financial institutions and corporations that depend heavily on the extension of credit to their customers.
- ABS provide more funds available for

residential home ownership and infrastructure projects that produce reliable revenue streams.

Disadvantages

A. To the Originator

- The technique can be complex and may require a significant initial investment of managerial and financial resources.
- Costs that may offset the gains like rating agency fees, structuring and underwriting fees charged by investment banks, trustee fees and premium charged for third party guarantees.

B. To the Investor

- ABS may be more complex and less liquid than other debt securities.
- ABS are not risk free. Investors must be aware of some ill-defined maturity of ABS and many other factors that can affect the cushion between cash inflows and contractual payments.

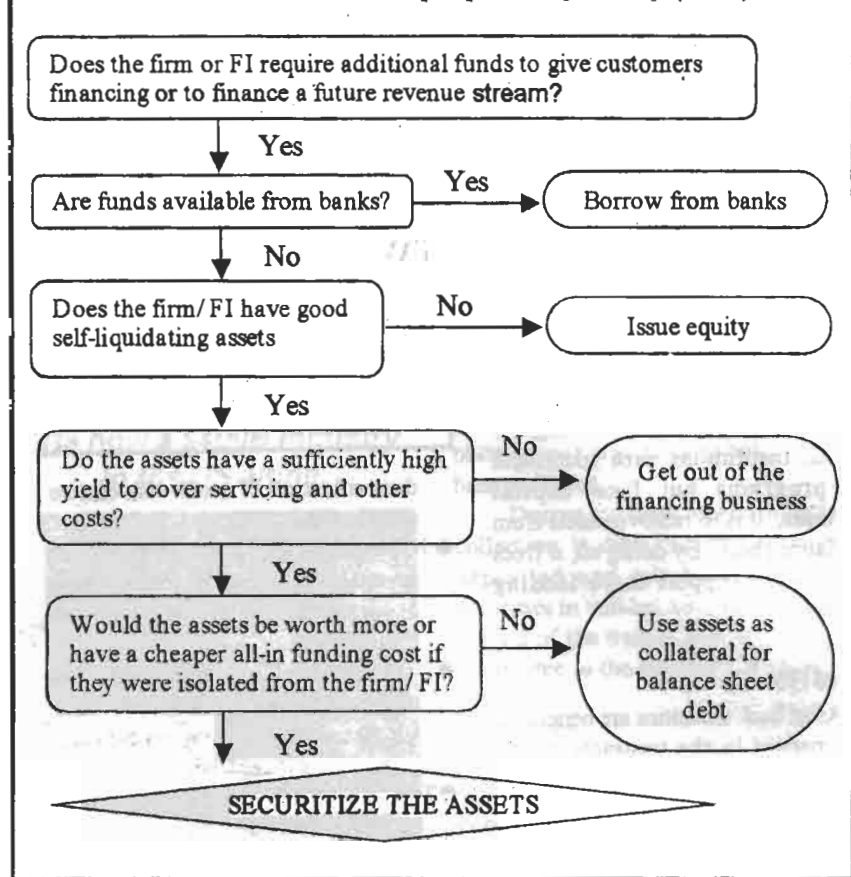
When the right conditions are present, securitization can give borrowers access to funds, offer investors a wide range of high-quality instruments and improve the efficiency and liquidity of the capital market (Giddy, 2000).

The decision flow chart (Box 2) is a guide on deciding whether asset backed securities can work in particular situations:

The following are the criteria that Originators must consider to determine if it is ready for asset securitization:

1. The firm/financial institution (FI) has enough data about the assets to satisfy the rating agencies and financial guarantor.
2. There are regulatory or capital constraints that make freeing up the balance sheet important.

Box 2: Decision Flow Chart as proposed by Giddy (2000):



- The servicing process is adequate to meet the high standards of the ABS.

- The Originator is willing to undertake a complex, time consuming transaction in order to obtain a broader, potentially cheaper, ongoing source of funding.

- The Originator is currently facing a high cost of funding for assets that, if taken in isolation, would be recognized as sound, cash-generating assets.

If the Originator can comply with all of the above, then it can consider

alternative structures of asset securitization.

Developing an appropriate legal structure and managing risks are the two biggest challenges in ensuring the success of an ABS issue (Giddy, 2000).

The form of an ABS can range from illiquid to highly liquid. Illiquid ABS are the non-tradable private placements, less liquid are the tradable private placements, more liquid are the commercial papers, and highly liquid are the public issues, most especially the actively traded ones.

Interest may be paid at fixed or floating rate. The term may be short or long term. Maturity may be fixed, or may

“ When the right conditions are present, securitization can give borrowers access to funds, offer investors a wide range of high-quality instruments and improve the efficiency and liquidity of the capital market . ”

be payable or callable under a variety of conditions. ABS may be denominated in local or foreign currency and may be placed domestically or in other major capital markets or simultaneously in different markets.

The risks to manage are credit risk, sovereign risk, servicer performance risk, interest rate risk, currency risk, prepayment risk, legal risks, liquidity risk, swap counterparty risk, financial guarantees risk.

Credit risk arises from the possibility of default by the underlying borrowers. It is to be remembered that the SPE is normally structured to have no assets or business other than holding the securitized assets.

Sovereign risk arises from the probability of state interference on cross-border cash flows through taxes, exchange controls and other regulations. This is true when underlying assets are in one country and the investors are in another country.

Servicer risk arises from the possibility that the servicer or originator fails in its task to collect principal and interest, follow up on delinquents, maintain statistics on performance, pass on payments in a timely manner and perform other administrative tasks.

Currency risk arises when the assets underlying an issue are denominated in a currency that investors do not wish to hold.

Prepayment risk arises from the possibility that payments are made outside the schedule. This may be done due to refinancing on better terms.

Liquidity risk is the possibility of a cash shortfall at times when interest or principal payments are due. Cash inflow to the SPE may be delayed.

When interest rate or currency swap is part of the deal, swap counterparty risk is possible.

The involvement of rating agencies in the risk management is essential. Most ABS are guaranteed. Investors rely on the high credit standards of reputable institutions whose only business is to provide risk analysis.

Financial guarantees are essential to ABS issues. It elevates or enhances the ABS to a high investment grade rating. The financial guarantor sees to it that the investor gets a well-structured transaction, that the collateral is sufficient to meet all obligations, and that the legal and servicer risks have been minimized. The financial guarantor gives the investor two ways out—either the collateral pays or the guarantor pays.

The financial guarantor will continue to monitor the deal and act to protect itself and the investor long after the issuer and the banker have moved on to other deals. The financial guarantor enables the banker to simplify the distribution of securities to investors and improve the economics of otherwise complex issues by taking the "story" out of the deal. The financial guarantor can pierce the sovereign rating ceiling by giving a borrower of one country a higher investment grade than the sovereign rating.

The proper structure, the most appropriate transfer and management of risk, the ability to make assets to be securitized identifiable, secure and liquid are the ingredients to a successful tradable security.

Regulation

The accounting standards and financial statement presentation for asset backed securities are still evolving. FASB Statement No. 140 amends FASB No. 125 on the proposed accounting for transfers of financial assets.

The additional requirements on disclosures are: an entity's transactions of securitized financial assets during the period, the retained interests in the asset transfers at the end of the period, accounting policies, key assumptions and how they are being applied in measuring the fair value of retained interests, sensitivity analysis or stress tests on the value of retained interests and type of collateral to secure these financial assets.

A quarterly rather than an annual disclosure will provide analysts and

investors with timely information for projecting future earnings and cash flows from retained interests in securitized financial assets and assess more accurately the fair values of the retained interests as well as the aggregate value of the entity itself.

In addition to stricter requirements for disclosure, FASB standard on consolidated financial statements and policy had also be amended. The relevance to securitization is the reporting requirements of SPEs and quasi-SPEs (QSPEs) which may be majority or partly owned by the transferor or originator.

Experience of industrial companies

Minton, Opler and Stanton (1997) made a study of asset securitization among industrial firms—airlines, automobiles, mainframes & microcomputers, retail, tractors, trucks and heavy equipment. Their findings show that firms that begin asset securitization are bound to continue using them.

Among the common characteristics of these firms were they were large firms with high volume of receivables due to installment sales, lease contracts, plain vanilla loans or credit card sales. A security issue was no less than \$100M. The firm's cost of unsecured borrowing was high. They have low EBITDA (earnings before interest, taxes, depreciation and amortization) coverage of interest expense and low market to book value. This means that they were highly leveraged with low earnings and poor growth prospects.

Success of ABS

ABS had been used successfully by many. JPMorgan Chase used ABS to purchase Red Funnel Ferry from Associated British Ports. It was a whole business securitization.

The Italian government securitized social security receivables which sold

like hot cakes in the market. They also entered into securitization of gambling receivables (Euro 3B) and real estate receivables (Euro 2.3B).

The Hanvit Bank of Korea had gone to its 10th securitization deal. The first Korean ABS was backed by documentary credits granted by the bank to its manufacturing clients.

These are just a few among many throughout the world.

Failures

Towers Financial, a Delaware corporation based in New York, sold approximately US\$210M of Abbonds to 27 institutions, presumably backed by health care receivables that it bought from health care service providers through its 5 SPEs. In 1992, the financial statements of SPEs showed US\$300M as bought by Towers for which it paid US\$155M and the balance as a liability to Towers. Court findings showed that Towers overstated receivables generated by it by US\$126M. The value of the receivables was just US\$28.5M and not US\$300M. In the same year, 1992 Towers declared bankruptcy.

Askin Capital Management made wrong investment priorities by investment in mortgage backed securities (MBS) and speculating on interest rates. US\$630M was received in investments on the promise of high liquidity and low leverage. Unfortunately, in 1994, interest rates dropped dramatically. Four Askin SPEs with US\$600M in assets filed for bankruptcy. A series of lawsuits ensued. Askin was barred from the securities by SEC for 2 years and fined \$50,000 without admitting or denying guilt.

Lessons from Past Experiences

From the experience of companies and countries that have gone extensively into ABS, there are some lessons that can be learned. What were the problems and what are some

anticipated problems as the Philippines goes more involved with asset backed securities?

The assets to be securitized must be well defined. Failure to do so can cause overstatement of assets on the books of the Originator. Only the retained interest must be noted in the books. There must be adequate disclosures so that users of financial statements get an accurate picture of the financial condition of the firm. Adequate in the sense that the inclusion of the information will not alter the assessment done by financial analysts nor will it alter decisions made on its basis.

The creation of the SPEs or SPVs is to protect the assets securitized. They assume that these assets are more than enough to satisfy the claims of investors in the future and that they are bankruptcy remote. The existence of a financial guarantor enhances this assumption. The special purpose entity does not hold any other asset. Since this SPE may also be owned by the Originator, conflict of interest may arise.

The process can further be complicated when partnerships are formed and ownership of the assets cannot be easily traced. More so if these complexities are intentionally done to cover shadowy deals.

Innovations in financial products have gone ahead of regulations. In the meantime that regulators are still studying the new product or instrument, its processes and its implications, how is the public protected? And as regulations are in place, do the regulatory offices have the resources to monitor compliance to said regulations?

Top management may not be very knowledgeable on the securitization. Its presentation to them by its sponsors may be biased. The go signal may have been given based on trust of their appointed managers. There may be a case of an agency problem.

We have cited the many advantages of ABS but it can be abused. Its success will only be realized when

there is transparency, good faith, and adherence to ethical standards. It can create value to the firm with due respect to the rights of others.

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The Academic Scorecard

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Introduction

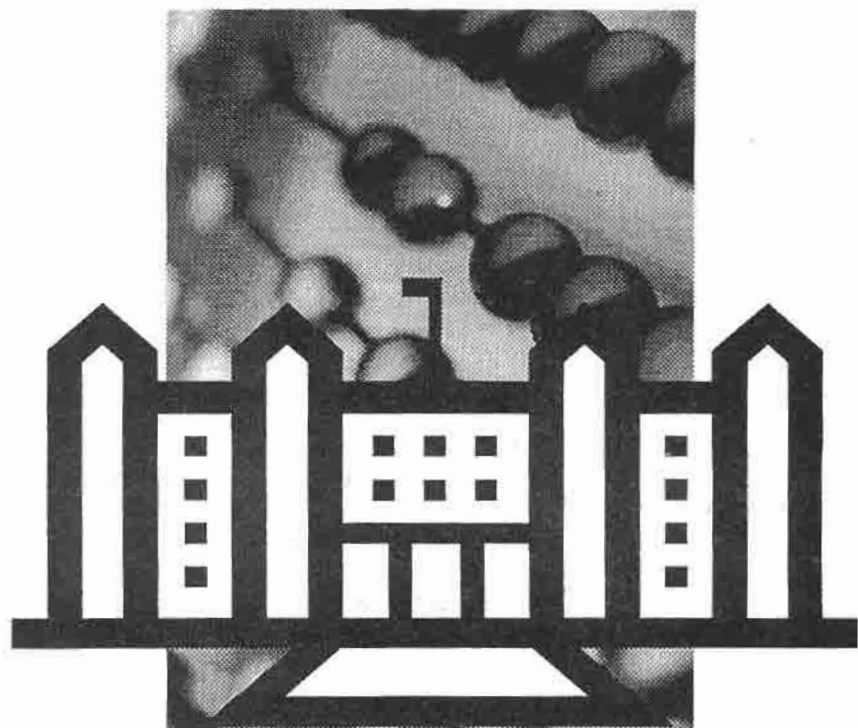
Introducing a creative and innovative performance measurement in an educational setting is very timely. Like other business organizations, these educational institutions do not rely solely on financial measures.

In business, the performance measurement is known as a balanced scorecard. A balanced scorecard consists of an integrated set of performance measures that are derived from the company's strategy and that support the company's strategy throughout the organization (Garrison, 2000). Performance measures used in the balanced scorecard approach are: financial measures, customer measures, internal business measures and learning and growth measures. Learning is necessary to improve the internal business processes; improving processes is necessary to improve customer satisfaction; and improving customer satisfaction is necessary to improve financial results.

This article aims to translate these four measures or perspectives (Kaplan and Norton, 1992) into the school environment. It aims to discuss the following items: the academic scorecard (its nature, perspectives, benefits, goals and measures), issues and implications.

The Nature of the Academic Scorecard

Administratively, the academic scorecard is an important instrument which makes it easier for the strategic goals of the university to be accomplished. It is a very effective instrument in assessing performance. It enables academic units to establish common measures in achieving a common goal.



The Academic Scorecard Perspectives

The four perspectives in the academic scorecard are the academic management perspective, stakeholder perspective, internal business perspective and the innovation and learning perspective (Table 1). The academic management perspective answers the question "How do we look to other University leadership?" The stakeholder perspective answers the question "How do stakeholders see us?" The internal business perspective answers the question "What must we excel at?" The innovation and learning perspective answers the question "Can we continue to improve academic management, stakeholder perspective, and internal business perspective?"

In comparison, the four perspec-

tives of the business scorecard are the financial perspective, customer perspective, internal process perspective and the learning and growth perspective. The financial perspective answers the question "To succeed, financially, how should we appear to our shareholders?" The customer perspective answers the question "To achieve our vision, how should we appear to our customer?" The internal process perspective answers the question "To satisfy our shareholders and customers, what business processes must we excel at?" The learning and growth perspective answers the questions "To achieve our vision, how will we sustain our ability to change and improve?"

Table 1. The Academic Scorecard Perspectives

PERSPECTIVE	GOALS	MEASURES
Academic Management	improve budget performance	budget variances historical view of financial resources
	improve school operations	productivity of information technology and system
Stakeholders	improve management/leadership	student/faculty ratios asset utilization and fast attainment of goals
	quality academic program	ranking in world reports teaching effectiveness
	student centeredness	quality of student services assessment of student needs, expectations, wants and satisfaction upon entrance and exit
	quality of faculty	publications /research funding teaching evaluation sponsored grants and contracts competitive faculty benefits
	value for money	retention or completion of degrees
		return on investment assessment by alumni campus interview opportunities current job status appraisal forms of employers on work competence
		faculty productivity report and teaching effectiveness faculty turnover
Internal Business	improve staff productivity	staff turnover studies on staff productivity
	improving recruitment	value-added change thru entrance and exit data number of students, faculty, staff involved in professional organization and level of leadership provided
	maintain responsibility in the community	social responsibility reports of activities of greater impact trends in volunteering and service-learning
Innovation and learning growth	research productivity	research head count research index market share of publications market share of citations
	improve quality of degree programs	academic program review accreditation financial assistance to students recognition of deregulation and autonomy
	increase student learning	learning outcome measures
	improve quality of students	increased student participation in out-of -classroom learning experiences scores in professional exams
	attract/keep talented faculty staff	salaries, faculty/staff satisfaction teaching awards
	increase education innovations	increase educational technology usage, teaching innovation, new degrees and interdisciplinary collaboration
	develop faculty/staff development	extent of private support; financial aid for faculty /staff increased budget for faculty and staff development more opportunities for faculty/staff development and life-long learning faculty and staff participation and production of scholarly research outputs more awards established which support staff and faculty research and creativity

Benefits of the Academic Scorecard

A well-designed academic scorecard has the following benefits (Metrus Group White Paper, 2003):

- a. It provides focus and prioritizing action and resources.
- b. It brings together crucial elements of financial and non-financial measures.
- c. It improves communication by providing a common language and reliable information about the school's strengths and weaknesses.
- d. It helps the administrators to clarify the strategies and helps them understand interrelationships by showing how improvements in one area impact other areas.
- e. It makes everyone understand the strategy, their role in helping achieve it and how their effort will be measured and rewarded.

Issues

Performance and management issues are encountered in the use of the academic scorecard. Technical performance issues like lack of agreement concerning the adequacy of specific performance indicators, inability of quantitative measures to capture contextual and institutional differences, subjective bias in construction and interpretation of measures are observed in relation and in the use of the academic scorecard.

Management issues like increased efficiency and more effective management, focus on "missions," priorities, and identification of strengths, funding increasingly linked to performance, on various measures, variously defined, increase competition, both within and between institutions, better responsiveness to the needs of public, political, and other stakeholders, possible differentiation of universities into research institutions and teaching institutions, proliferation of external intermediary bodies to administer performance and quality programs and mandate consequences of noncompliance and "poor performance", prolifera-

tion of stakeholders to be accommodated are pinpointed in relation to the use of the academic scorecard.

Implications

The academic scorecard has some implications on faculty and academic departments and on teaching and research. They are cited as follows:

Impact on teaching and research

- performance defined as measurable product (publications, external research funding, job-ready graduates) rather than process (learning, inquiry)
- separation of research and teaching
- focus research and publications
- devaluation of teaching shift of resources to research
- preference for research with measurable outcomes
- shift in pedagogical emphasis as students demand more "relevance"

Impact on faculty and academic departments

- individual projects discouraged in favour of "team efforts"
- resistance to measures
- demands for more productivity

Summary

The designing and implementation of an academic scorecard poses great challenges to the educational institutions in their quest for excellence, productivity and global competitiveness. The academic scorecard becomes an effective instrument in assessing performance and makes it easier to accomplish the strategic goals of the university. We can start designing our own academic scorecard and reap the benefits of its use.

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