

Housing

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needing controls are not as obvious as temperature changes. Formal development and documentation can help.

Sarbanes-Oxley requires new reporting to investors on the effectiveness of internal controls. These new requirements exposed the truth about controls. Documentation does not support evaluations by managements and auditors. As a result, documentation of controls is now done on a crash basis by smart people lacking business school background on what constitutes good internal controls. Required reporting has been delayed one year.

The requirement is controversial because compliance is expensive. Audit fees have increased dramatically and companies are investing heavily in compliance. Many managers wonder if we are preparing for the possible or the improbable.

Auditors

Auditors are a separate, complex problem. Auditors assure investors about the reliability of financial reports, but auditors know there is an "expectation gap." Auditors cannot accomplish everything expected. Auditors work from a risk model that weights costs of finding problems. The model accepts undiscovered reporting problems when the cost to find them is too high. When the expectation gap becomes a problem, the argument is about auditor negligence, so difficult to defend in hindsight. Accounting firms manage this risk through contracting, legal defense, settlements, stop loss organizational structures, and insurance. If these fail, partners melt into other firms, leaving the damage behind.

Confidence in auditors has suffered. Auditors proudly proclaim their own self-regulation, administered through the American Institute of Certified Public Accountants. Firms use self-inspections and peer reviews. But many suspect they easily pass each other's work, failing to identify serious deficiencies and independence issues.

The past haunts the accounting profession. Investors are troubled by self-regulation and audit quality. Large firms face huge litigation claims and their nonaudit practices are viewed with suspicion. Smaller firms do not want to assume the responsibility. Sarbanes-Oxley established

the Public Company Accounting Oversight Board to qualify and register firms before they can audit public companies and to inspect the practices of firms. But with four firms auditing 99 percent of all public company sales, there is doubt about meaningful regulation. Regulation is premised on fear that failure by any of the four will result in restructuring the profession and may require change in our assurance model.

Conclusion

The problems are difficult, but not addressing them leaves open doors to those who will take advantage of any opening. The overwhelming majority of honest managers and competent professionals are embarrassed and maddened by the actions of those who caused the dramatic changes now being implemented. How can so few cause so much damage for all? Most business people can, and do, make decisions every day against temptation, greed, arrogance, and self-interest.

Knowing the great damage caused by a small minority, the majority must balance that harm with humble, generous service, recognizing that each decision leaves a trail showing a willingness to be open and honest. ◀

The jobless recovery has not deterred people from buying homes over the past year and this is expected to continue in 2004. Low interest rates resulted in housing affordability hitting a thirty-year high early in 2003, although rising home prices reduced affordability slightly as the year progressed. Home prices increased about 10 percent for the nation over the past twelve months, pushing the median home price to over \$177,000.

The high levels of housing affordability due to low interest rates allowed people to qualify for home mortgages that would not have otherwise qualified, increasing the current homeownership rate to about 68 percent. Many existing homeowners also took advantage of the lower interest rates to purchase larger homes. The average home size has increased steadily in recent years, perhaps partly due to the feeling that one's home is an investment that may be less risky than the stock market.

Will housing remain strong in 2004? We believe that housing starts will continue near the same level of about 1.7 million to 1.8

Table 1
Housing and Interest Rate Forecast

<i>Housing (in thousands)</i>	2000	2001	2002	2003	2004	2005
Total Starts	1,573	1,601	1,711	1,786	1,700	1,658
Single Family	1,232	1,272	1,364	1,445	1,381	1,358
Multi-Family	341	330	347	341	319	300
New Single Family Home Sales	880	907	977	1,065	994	985
Existing Home Sales	5,158	5,282	5,595	5,986	5,712	5,653
<i>Interest Rates</i>						
Fixed Rate	8.1%	7.0%	6.6%	5.9%	6.3%	6.8%
ARMs	7.0%	5.8%	4.6%	3.8%	4.2%	5.5%
Prime Rate	9.2%	6.9%	4.7%	4.1%	4.1%	5.6%

Source: National Association of Homebuilders

Indiana

million starts (single and multi-family). While a rise in interest rates will dampen housing starts, the continued economic recovery should offset this. And assuming the stock market continues to rise, consumers will feel wealthier and thus more willing to purchase a first home or buy a larger home. Younger people who have been renting or “doubling up” with their parents will be more inclined to purchase a home as the economy improves, and any increase in job growth will be positive for home sales. **Table 1** summarizes the housing and interest rate forecast from the National Association of Homebuilders (www.nahb.org).

The increasing rate of homeownership has taken somewhat of a toll on multi-family housing. The result is declining rental rates and rising vacancy rates as people switch from renting to owning. Yet despite the weakening fundamentals for multi-family housing, investors have put a huge influx of capital into this market, rediscovering the benefits of diversifying their portfolio with real estate. Large institutional investors have bid up the price of real estate to record levels compared to their income. Investors are willing to purchase apartments at much lower rates of return than previously, due to lower return expectations for all asset classes, as well as low interest rates, allowing investors to get very favorable financing. ◀

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After a long period of uncertainty fed by mixed economic signals, more and more economists are dancing to the tune that the jobless recovery of the U.S. economy is finally turning around. In Indiana, however, clear support for a change in the song's key from minor to major has yet to emerge.

From its May 2000 peak at 3,014,400, total employment in Indiana has fallen by 5.1 percent (154,600 jobs) to 2,859,800 in September 2003. As shown in **Figure 1**, employment at the national level continued to grow for nearly a year after Indiana employment began its downhill slide; since Indiana's peak, U.S. jobs have declined by only 1.4 percent. Moreover, in the past fourteen months, national employment has been relatively flat, slipping by only 0.2

percent, while Indiana's payrolls have shrunk an additional 1.6 percent.

Losers and Gainers

The largest portion (61.3 percent) of the jobs lost since Indiana's employment peak has been in manufacturing—a drop of nearly ninety-five thousand jobs. The manufacturing sector now accounts for 20 percent of all nonfarm jobs in Indiana, down from more than 22 percent in early 2000. Two factors are largely responsible for this shrinkage: manufacturers moving production to places where labor is cheaper (largely overseas) and improvements in productivity. Although much attention has been paid to the outsourcing issue, significant increases in productivity have enabled many factories to hold, or even increase, production volumes without having to replace laid-off workers. In this environment, substantial growth in Indiana factory payrolls is unlikely in the short term.

As shown in **Figure 2**, other sectors losing substantial numbers of jobs include professional and business services (21,600 jobs, or 14.0 percent of the total decline since May 2000) and retail trade (19,800 jobs, or 12.3 percent). Both losses reflect the general impact of a sluggish economy, as businesses and consumers cut out discretionary spending when money and jobs are scarce. On the bright side, employment in educational and health services has actually increased by 17,300 jobs during Indiana's general employment downturn; this sector now accounts for 12.2 percent of all Hoosier jobs. Government was another sector showing significant growth during this period, adding a total of 3,100 workers to payrolls that now account for 14.7 percent of all jobs in the state.

It's All Relative

As **Figure 3** reveals, Indiana ranks near the bottom of the nation in job growth the last two and a half years, with a 5.1 percent loss since the state's employment peaked. Only Michigan lost a larger percentage of its workers, and only four states (Michigan, Ohio, New York, and Illinois) lost larger numbers of workers during this period. On average, employment throughout the nation shrank by 1.4 percent, with losers outnumbering gainers about three to two.

Figure 1
Relative Change in U.S. and Indiana Employment, May 2000 to September 2003

