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The "Carrot" Approach to Accounting Standard Setting

Neal Newman

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THE “CARROT” APPROACH TO ACCOUNTING STANDARD SETTING

NEAL NEWMAN*

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I. INTRODUCTION

In December 2006, Conrad Hewitt, the chief accountant at the Securities and Exchange Commission (SEC), promised that the issue of complexity in accounting would be addressed early in 2007 and would be a leading focus of work by his office in 2007.¹ The goal in financial reporting is to disseminate transparent, understandable, financial information that fairly presents the financial condition of the reporting company.² Oftentimes, however the information public companies disseminate is overly complex,³ quagmired in legalistic form at the expense of true economic substance, and is devoid of conveying true, meaningful and understandable information regarding the company.⁴

In this regard, the SEC, in conjunction with the Financial Accounting Standards Board (FASB), is making an attempt to remedy this problem by exploring ways to simplify the fragmented and complex accounting regime currently in existence.⁵ The goal of this Article is to highlight one aspect of this reform effort that must be addressed to insure success of the SEC's stated objective of a more simplified accounting and financial reporting system. The aspect in question is management and its role in the accounting and financial reporting process.

Corporate management is primarily responsible for a company's financial reporting.⁶ This dynamic, at times, can put the interests of those who prepare financial statements at odds with the users of such information. The conflict stems from the structure of executive compensation. For many corporate executives, a significant portion of their compensation is incentive-based, i.e. tied to the company's financial performance.⁷ Thus, a

¹ Steve Burkholder, *SEC's Hewitt Says Accounting Complexity is 'High Priority' Issue for Agency in 2007*, SEC. L. DAILY, Dec. 8, 2006.

² Rachel McTague, *Pozen Named to Head SEC Advisory Panel To Address Financial Reporting Complexity*, SEC. L. DAILY, June 28, 2007.

³ *Id.*

⁴ See, e.g., FIN. ACCOUNTING STANDARDS BD., FASB RESPONSE TO SEC STUDY ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 7 (Feb. 2006), available at http://www.fasb.org/articles&reports/fasb_response_sec_study_obs.pdf [hereinafter FASB RESPONSE].

⁵ McTague, *supra* note 2.

⁶ See, e.g., HOME DEPOT, 2005 ANNUAL REPORT 35, available at http://ir.homedepot.com/downloads/HD_2005_AR.pdf [hereinafter HD 2005 ANNUAL REPORT] (including an audit opinion note that the Consolidated Financial Statements are the responsibility of the company's Management).

⁷ See, e.g., HOME DEPOT, PROXY STATEMENT AND NOTICE OF 2006 ANNUAL MEETING OF SHAREHOLDERS 32, available at <http://ir.homedepot.com/downloads/hd2006proxy.pdf> [hereinafter HD PROXY STATEMENT 2006].

corporate manager's bonuses, stock options, or even continued employment, might be linked to the figures reported in its financial statements.⁸

Because of this Incentive Based Compensation (IBC) component, management, in many cases, may be adversely affected if the reported financial results are unfavorable; stock options may not be as valuable for example, or an executive's bonus that is based on corporate profitability may not be realized if certain financial benchmarks are not met.⁹ This Article contends that these types of conflicts create the disincentive for management to report financial information accurately when that information is less than favorable.

Accordingly, this conflict, if not properly addressed, will make the goal of a less complicated accounting regime remain a mere aspiration rather than an achievable objective. The trappings of IBC incentivize managers to engage in either aggressive accounting tactics that compromise financial statement integrity, or to commit outright accounting fraud.¹⁰ Consequently, accounting standard-setters are forced to draft standards "defensively" in anticipation of, and in reaction to, financial preparers who want to push the limits of accounting boundaries as far as possible to further their own personal stakes.¹¹ This Article contends that the move to a more simplified accounting and financial reporting regime can only be achieved when this tension between preparers and users of financial information is alleviated. To that affect, the Article will proceed as follows. Section II provides context and frames the debate by explaining the tension-causing link between IBC and financial reporting. Section III then explores the resulting effect that IBC has had on accounting standards. Section IV then discusses the likely changes to the accounting and financial reporting framework and the potential obstacles that may make such an undertaking difficult. Section V then proposes some solutions to the problem of IBC and its adverse affects on accounting standards, the gist of which is to realign

⁸ See, e.g., *id.* at 33 (noting that potential bonuses, etc. are contingent upon the company achieving certain earnings per share goals).

⁹ See, e.g., *id.* (noting that potential awards are payable only if the Company achieves specified levels of average diluted earnings per share).

¹⁰ Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. 775, 782 n.34 (2006) (citing Tom Horton, *Tone at the Top: There Is Nothing More Important for the Board to Care About, and to Assess*, DIRECTORS & BOARDS, June 22, 2002, at 8).

¹¹ See, e.g., FIN. ACCOUNTING STANDARDS BD., SUMMARY OF INTERPRETATION NO. 46: CONSOLIDATION OF VARIABLE INTEREST ENTITIES—AN INTERPRETATION OF ARB NO. 51 (Dec. 2003), available at <http://www.fasb.org/st/summary/finsum46r.shtml> [hereinafter INTERPRETATION 46(R) SUMMARY]. Interpretation 46(R), in essence, broadened the criteria under which a Special Purpose Entity (SPE) would have to be recorded on a consolidated bases, thereby capturing on the sponsoring entity's books the debt obligation incurred by the SPE. *Id.*

management's incentives by incentivizing accurate financial reporting instead of tying IBC to financial performance. Finally, Section VI concludes by summarizing the argument and re-urging the practice of incentivizing accurate financial reporting.

II. LAYING OUT THE PROBLEM—THE TENSION BETWEEN PREPARERS AND USERS OF FINANCIAL INFORMATION

A. *The Link Between Financial Statements, Executives, and Shareholders—Some Context*

A fundamental tension exists between preparers and users of financial information which adversely affects the financial reporting process. Every publicly held company has essentially two factions whose personal fortunes are tied to the corporation's. The first faction, referred to as the "internal faction," consists of the corporation's employees and includes, among others, its executive officers such as the chief executive officer, the chief financial officer, and the chief operating officer. The second faction, the "external faction," is comprised of the corporation's shareholders. Corporate employees are tasked to produce the goods or provide the services that generate the profits on which the corporation and its factions will subsist. Theoretically, the better the employees are at providing whatever service it is they provide or good they produce, the more money the company makes, and the better off employees are individually and collectively due to their affiliation with a profitable and stable company.

The stake of the external faction in a corporation is premised in part upon how that corporation is perceived by the market.¹² If the market's perception is positive, then that favorable outlook is generally reflected by an increase in that corporation's share price. However, if the market's perception is negative, the poor perception will likewise be reflected by a corresponding drop in the corporation's share price. Within this context, financial statements that show steady increases in profit and consistently meet forecasts will find more favor with investors than financial statements that do not demonstrate such favorable indicators.¹³ The focus then is to

¹² This statement merely recognizes the adage, "perception is reality." In this context, if an investor *perceives* a company to be a sound investment, based on for example what was reported in its financial statements, the stock price will be reflected accordingly even though the true economic reality may be very different.

¹³ Of course, things other than financial performance can affect a company's share price as well such as general industry or market trends which can have either a favorable or adverse affect on a corporation's share price as well. This simplistic model is used simply to illustrate the point.

appreciate how IBC is tied into this equation and, more pointedly, how IBC creates tension in the financial reporting process which may lead to aggressive accounting tactics that distort a corporation's true economic position or even result in accounting fraud.

B. Incentive-Based Compensation

At its most basic level, IBC occurs where all or a portion of an employee's compensation is based on the employee reaching some benchmark or pre-determined performance level.¹⁴ The benchmarks in question can take on myriad forms from particular unit output levels of a division to a corporation's overall profitability. The forms of IBC relevant to our discussion, however, are the ones that are tied to a corporation's financial statements. It is recognized that even in this subset of IBC there can be a number of variations. There are three common IBC forms.

Stock options are an incentive-based form of compensation designed to link an employee's individual fortunes to the corporation's stock price.¹⁵ On a specific date, the grant date, an employee is granted the right to purchase a specified number of shares where the purchase will occur at some designated future point in time, the exercise date.¹⁶ The stock will have a share price on the grant date as dictated by the market. When the exercise date arrives, the employee with the stock option has the right to purchase those shares at the price at which the shares were valued on the grant date. Accordingly, if the value of the shares has risen between the grant date and the exercise date, then the employee is rewarded by the increased value in the stock.¹⁷

The theory behind stock option grants is that the employee will seek to maximize the value of his stock options by working hard between the grant date and the exercise date to increase the stock's value as much as possible.¹⁸ This, of course, is only the theory behind granting stock options. In many cases, the theory and practice of stock option grants come together in harmony and the practice works as contemplated. The employee is granted the stock option, the employee works hard on the corporation's behalf to

¹⁴ See, e.g., HD PROXY STATEMENT 2006, *supra* note 7, at 33 (noting that potential bonuses, etc. are contingent upon the company achieving certain earnings per share goals).

¹⁵ National Center for Employee Ownership, Employee Stock Options Fact Sheet, <http://www.nceo.org/library/optionfact.html> (last visited Mar. 20, 2008) [hereinafter Employee Ownership].

¹⁶ See, e.g., STEVEN M. BRAGG, ACCOUNTING REFERENCE DESKTOP 211-12 (2002).

¹⁷ Employee Ownership, *supra* note 15.

¹⁸ BRAGG, *supra* note 16, at 211-12.

increase the corporation's stock price, the value of the shares increase, and the employee is rewarded accordingly.¹⁹

Another incentive-based form of compensation is profit sharing. Profit-sharing is more straight forward than the stock option plan. With a profit-sharing plan, a corporate manager or executive shares in the corporation's profits (or more accurately stated, its reported profits).²⁰ For example, an executive may receive a base salary plus a percentage of the corporation's reported income.

Finally, an executive may simply receive a bonus tied to some benchmark. This benchmark could be any number of variables, such as gross earnings, sales, net income, or stock price.

C. *The Pressures on Financial Reporting—The Discordant Incentives*

The recurring theme in each of the compensation structures mentioned above is that an executive's compensation is tied to the company's reported financial performance. In theory, tying an executive's compensation to his corporation's financial performance is a good thing. The underlying idea is that the manager now has a vested interest in the company's fortunes with the executive's personal compensation tied to the corporation's fortunes as a whole. Accordingly, the theory is that the executive will work harder to make the corporation profitable while simultaneously increasing his personal fortune at a proportional rate.

The problem with this theory, however, is that there are assumptions built into the paradigm which over time have proven to be flawed. One flawed assumption is that corporate executives and managers will act ethically and honestly while trying to achieve these benchmarks. When the corporation is in fact profitable and there is no earnings pressure on the manager, the IBC model will work as designed, creating a "win-win" situation for the executive and corporation alike.

But what happens when the fickle tastes of the public consumer change and the product that was once a "can't miss" is now on the fast track to obsolescence? What happens when what was thought to be the business model of the future turns out not to be the revenue generating juggernaut it was touted to be? What happens when that corporate executive, who has grown so accustomed to his bonus that he has already spent it before it has

¹⁹ It must be acknowledged, however, that an increase (or fall for that matter) in a company's share price can be primarily or exclusively due to general market or economic conditions that may have nothing to do with the company's performance or the executives that run it.

²⁰ For a basic definition of profit-sharing, see BRAGG, *supra* note 16, at 533.

been awarded, faces the prospect that he may not earn a similar bonus this year? What might a CEO do when a third consecutive quarter of stagnant or declining earnings may mean not only losing his bonus, but also his job?

These hypothetical “what if”’s illustrate the dynamic that has proven to be problematic. What the incentive-based paradigm fails to consider is the “self-preservation” factor of the equation and the “risk-reward” model that many corporate executives appear to be invoking when faced with the two less than desirable alternatives. What IBC unwittingly does in many situations is create a dynamic of “discordant incentives.”²¹ Discordant incentives occur when a corporate executive is faced with the proposition of reporting financial information that, if reported accurately, would have an adverse financial effect on him personally.²² At this juncture, the executive is faced with two alternatives: either (1) report the actual earnings results and suffer the economic harms that stem from such news; or (2) generate the additional revenue needed to make the bonus threshold, even if this entails fraudulent means. Accordingly, an unintentional by-product of IBC is a situation where those that are responsible for financial reporting, namely management, now have a disincentive to report that information accurately because management stands to be adversely affected on a personal level by doing so.

D. The Decision to Engage in Aggressive or Fraudulent Accounting Tactics—Playing the Probabilities

The United States has a complex and layered regime of standard-setters, complex and thorough accounting rules, as well as layers of oversight built into the financial reporting process to make sure that corporations produce financial statements that fairly present their financial position.²³ For

²¹ See, e.g., Natasha Burns & Simi Kedia, *Do Executive Stock Options Generate Incentives for Earnings Management? Evidence from Accounting Restatements 3* (Nov. 2003) (unpublished manuscript, on file with the Author).

²² For example, imagine a situation where 25% of an executive’s total compensation is tied to the corporation reaching a revenue number of \$40 million and they are \$6 million short. The executive has a strong incentive to somehow “manufacture” an additional \$6 million in revenue instead of reporting the actual financial results because the executive stands to lose 25% of compensation unless the benchmark is achieved.

²³ “[A]ccounting, auditing, and reporting guidance has grown to encompass thousands of pronouncements that make up U.S. generally accepted accounting and auditing standards and SEC rules, regulations and interpretations governing financial reporting. These range from major standards on broad topics such as accounting for business combinations, to guidance on accounting practices for specific industries to narrow interpretations and rulings on particular transactions.” Robert H. Hertz, Chairman, Fin. Accounting Standards Bd., *Remarks at the 2005 AICPA National Conference on Current SEC and PCAOB Reporting Developments 4* (Dec. 6, 2005).

example, all publicly held companies are required to file quarterly and annual financial reports with the SEC.²⁴ Each report must include financial information that is audited by an independent certified public accountant.²⁵ Our current accounting regime has an accounting pronouncement, bulletin, or standard for what seems to be any accounting issue imaginable.²⁶ The FASB has at last count enshrined Generally Accepted Accounting Principles (GAAP) into three volumes comprising some 4,530 pages.²⁷ Some of the FASB rules run to over 700 pages on how to book a single transaction.²⁸ The Sarbanes-Oxley Act was passed in 2002, which, among other things, requires CEOs and CFOs to certify that the financial reports of their companies "fairly present[], in all material respects, the financial condition and results of operations of the issuer."²⁹

With this backdrop and the seemingly broad range of checks and balances that surround the financial reporting process, it would seem that a corporate manager would be hesitant to be a part of a willful financial statement misrepresentation. Yet in spite of this, many corporate executives are choosing to push the boundaries set by the accounting standards and are engaging in aggressive accounting practices that, while technically compliant, nonetheless distort a corporation's true economic picture and some corporate executives even choose the more egregious step of engaging in accounting fraud in spite of the well-publicized risks of doing so.

Why do managers and executives choose to take such risks? For a considerable period of time, economists theorized that executives would not engage in such behavior because getting caught could destroy their reputations. It became clear during the 1990s, however, that this argument, although sound in theory, was wrong in practice.³⁰ "CEOs manipulated their companies' earnings, paid themselves huge amounts of options, and

²⁴ 15 U.S.C. § 78m(a)(1) (2006).

²⁵ U.S. Sec. & Exch. Comm'n, *The Laws That Govern the Securities Industry*, <http://www.sec.gov/about/laws.shtml> (noting that audited financial statements is one of the requirements in the financial reporting process) (last visited Mar. 10, 2008).

²⁶ For example, the FASB has over 160 financial accounting standards, 7 financial accounting concepts, and 48 financial interpretations. See Fin. Accounting Standards Bd., *FASB Pronouncements and EITF Abstracts*, <http://www.fasb.org/st/> (last visited Mar. 10, 2008).

²⁷ Walter Wriston, *The Solution to Scandals? Simpler Rules*, WALL ST. J., Aug. 5, 2002, at A-10.

²⁸ *Id.*

²⁹ 18 U.S.C. § 1350 (2006).

³⁰ Prentice, *supra* note 10, at 783; see also FRANK PARTNOY, *INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS* 188-89 (2003). When Officers were controlling shareholders, things could get even worse, as was the case for Hollinger International, Inc., where controlling shareholders looted \$400 million from the company. See *Hollinger Inc. Says S.E.C. May Bring a Civil Lawsuit Against It*, N.Y. TIMES, Aug. 31, 2004, at C2.

established cozy relationships with their accountants and securities analysts, but they did not acquire bad reputations—at least not until several years later.”³¹ The answer to the executive’s actions goes back to the “self-preservation” theory and the “risk-reward” model mentioned earlier. When a corporate executive, faced with the prospect of what to do with less than favorable results, chooses to employ aggressive accounting tactics or to engage in outright accounting fraud, the executive chooses a calculated risk. He makes a risk-reward assessment and concludes that the potential rewards from employing aggressive accounting tactics or engaging in accounting fraud outweigh the risks in doing so. This is not to say that this executive actually performs a statistical probability analysis by calculating the probability of getting caught engaging in accounting fraud. But it does appear as if the driving force behind an executive’s decision-making process includes the perceived likelihood of the consequences that might result from choosing to engage in either aggressive accounting or accounting fraud rather than reporting poor results accurately.

1. ALTERNATIVE ONE—ACCURATE FINANCIAL REPORTING

Executives immediately experience the personal financial consequences of reporting less than favorable financial results in an IBC environment. For example, if a corporation has implemented a profit-sharing, bonus, or stock option compensation model, reporting less than favorable financial results reduces an executive’s compensation. With the profit-sharing or bonus compensation models, an executive may not be entitled to the profit-sharing or bonus part of his compensation if those pre-determined benchmarks are not met.³² Likewise, under a scenario where an executive receives a portion of her compensation through stock options, poor financial results are usually reflected by a corresponding drop in the corporation’s share price and therefore a corresponding decrease in value of the executive’s stock options. Even further, and on a broader scale, an executive whose corporation is performing poorly may face the prospect of losing not only the incentive-based portion of his compensation but also his employment could be in jeopardy as well; especially in this current corporate climate where corporations have less and less patience when they perceive that a CEO is performing poorly. Ours is now a society that seeks immediate gratification. Shareholders no longer seem willing to endure a short-term drop in share price for the prospect of reaping rewards in the long run. With this myopic

³¹ Prentice, *supra* note 10, at 783-784.

³² See, e.g., HD PROXY STATEMENT 2006, *supra* note 7, at 33 (noting that potential awards are payable only if the Company achieves specified levels of average diluted earnings per share).

view, any "blips" on the financial radar screen create a wave of urgency through that organization with the CEO and his executive team being caught in its wake. Consequently, when a corporation's share price falls, the CEO is faced with immediate and unending pressure to return the share price to an upward trend. Oftentimes this mandate is given without regard to the means by which this is done as long as the end objective is met.³³

2. CHOOSING ALTERNATIVE TWO—EMPLOY AGGRESSIVE ACCOUNTING TACTICS OR ENGAGING IN OUTRIGHT ACCOUNTING FRAUD

Alternative two actually involves two possible courses of conduct. Executives can either employ aggressive accounting tactics or engage in outright accounting fraud. Each of these sub-choices comes with its own set of issues. In contrast to the first alternative (accurate financial reporting), alternative two presents a very different set of risks, probabilities and consequences. The corporate executives who choose to engage in accounting fraud potentially face a host of criminal and civil violations that range from returning any profits made from ill-gotten gains, to considerable jail time.³⁴ There should not be much debate as to which of the two alternatives, accurate reporting versus financial fraud, carry the more dire consequences. Yet when corporate executives are faced with the prospect of deciding between one of the two alternatives, many choose alternative two. Why might this be? Many studies have explored the impact of performance-based compensation on misreporting.³⁵ A significant number of the studies are empirical in nature, citing the correlations between performance-based compensation and the corporation's tendency to misreport financial information. One particular study focused on CEO compensation exclusively, citing the fact that "aggressive accounting practices would not be adopted without the explicit or implicit consent of the CEO."³⁶ The study concluded that the likelihood of corporate misreporting was higher if

³³ For example, for a transcript where moderator and panelists are discussing Enron's corporate culture which served as a breeding ground for unethical, and illegal behavior from its employees, see NOW Transcript (Aug. 12, 2005), http://www.pbs.org/now/transcript/transcriptNOW132_full.html.

³⁴ For example, former Cendant Corporation Chairman Walter A. Forbes, convicted in 2006 of conspiracy to commit securities fraud and making false statements to federal securities regulators, was sentenced January 17, 2007 to twelve years and seven months in prison and ordered to pay \$3.275 billion in restitution. Martha Kessler, *Former Cendant Chairman Forbes Sentenced to 12 Years, 7 Months in Prison*, SEC. L. DAILY, Jan. 18, 2007.

³⁵ See, e.g., Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting*, 79 J. FIN. ECON. 35 (2006).

³⁶ *Id.* at 41.

significant portions of the CEO's compensation was in the form of stock options.³⁷ The study looked at the years in which a corporation was required to restate its earnings due to irregularities and years in which no restatements were required.³⁸ The study found that in the years when the firms were required to restate their earnings, on average, 60% of the CEO's compensation was in the form of stock options.³⁹ In those instances when no restatements were required, on average, only 46% of the CEO's compensation was in the form of stock options.⁴⁰ Misreporting occurred most often when the personal stakes were higher for the CEO by virtue of the proportionately higher share of compensation coming in the form of stock options. What the study did not say, however, was the motivation behind the CEO's actions and why they were willing to take such risks. The exact motivations behind human decision making, especially in the high stakes world of public companies, would no doubt make for fascinating literature and reading. Such analysis, however, is neither the scope nor focus of this Article, but merely one of the variables to be considered in the process.

Returning to the issue of why executives take the risk of engaging in accounting fraud or reporting financial information accurately, the answer seems to lay in the probability of the consequences between the two alternatives. When a corporate executive chooses to report unfavorable financial information accurately, as discussed earlier, the consequences can be immediate and certain. But if a corporate executive chooses to employ aggressive accounting tactics, the executive is acting within the law's confines and has committed no violation. Further, in the more extreme case of accounting fraud, the consequences are not as certain. Statistically speaking, the likelihood is low that a corporate executive's "book-cooking" antics will be discovered. In spite of what we would like to believe, our current "Gate-Keeping" regime is ill-equipped to discover accounting misstatements where management is intent on hiding such misstatements. There are over 13,000 publicly held corporations⁴¹ regulated by the SEC, which has approximately 3,100 employees.⁴² An even smaller number of SEC employees have the

³⁷ *Id.* at 35.

³⁸ *Id.* at 36.

³⁹ *Id.* at 52 tbl.3.

⁴⁰ *Id.*

⁴¹ Deloitte, The IASB and the U.S. Securities and Exchange Commission, <http://www.iasplus.com/restruct/restsec.htm> (last visited Mar. 10, 2008) (noting that 1,150 of the 13,000 companies registered with the Securities and Exchange Commission are non-US companies).

⁴² See U.S. Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, <http://www.sec.gov/about/whatwedo.shtml> (last visited Mar. 10, 2008). The SEC consists of five

task of overseeing and regulating these publicly held companies.⁴³ Accordingly, with the odds statistically in the executive's favor, many seem to be taking the calculated risk of engaging in accounting fraud at the risk of what *might* happen versus reporting unfavorable financial information accurately and facing the more immediate and certain consequences of lost compensation at the very least and loss of job at the further end of the spectrum.

Therefore, in theory, IBC appears to be a smart way to align the employee's fortunes with the corporation's. But these compensation forms are based on the flawed assumption that management will try to achieve these benchmarks honestly and ethically. What actually happens in practice is that IBC creates a situation of discordant incentives that force corporate executives to choose between the goal of accurate financial reporting and the corporate executives' own personal fortunes.

3. AGGRESSIVE ACCOUNTING TACTICS VS. ACCOUNTING FRAUD—NOTING THE DIFFERENCE BETWEEN THE TWO

The practices of employing aggressive accounting tactics and committing accounting fraud are similar in terms of a manager's motivation behind employing one or the other, that motivation being to paint a company's financial portrait in as favorable a light as possible. Yet the two practices are unique in terms of their severity and degree of departure from GAAP, as well as the potential consequences to the perpetrators if they are caught.

A. AGGRESSIVE ACCOUNTING TACTICS

Although aggressive accounting tactics involve engaging in accounting practices that press against the confines of GAAP, it is important to note that engaging in such tactics is not a GAAP violation, and employing aggressive accounting tactics will not result in legal consequence to those who use them. However, the discussion regarding aggressive accounting tactics is important because it shows the nexus between the vested self-interest that executives have in financial information that stems from IBC and the accounting standards within which preparers of financial information are supposed to navigate. Because of the vested interest that managers have in presenting financial information as favorably as possible, the manager's focus

presidentially-appointed Commissioners, four Divisions and eighteen Offices. *Id.* With approximately 3,800 staff, the SEC is small by federal agency standards. Headquartered in Washington, DC, the SEC has eleven Regional Offices throughout the country. *Id.*

⁴³ See *id.*

will not be on preparing user friendly, clear, and materially correct financial statements. Instead, the manager will be as aggressive as possible while still remaining within the confines of GAAP.

Because of this tension, accounting standard-setters are forced to draft accounting standards defensively as a counter-measure to the aggressive accounting tactics executives seek to employ. What is the end result? Instead of accounting standards that are drafted and designed to provide users with clear, accurate, and meaningful financial information, the standards produce financial statements that, although compliant with the bright-line tests set forth in the accounting rules, nonetheless are distorted and fail to give a meaningful depiction of that company's true economic position. The executive's vested personal interest is based on what is purported in those financial statements. Accordingly, the executive's focus may be diverted from getting the financials "right" to merely keeping them compliant with GAAP while trying to paint the company's financial portrait in as favorable a light as possible. Illustrations of how this can play out in actual financial reporting will be discussed later in Section III.

B. FRAUDULENT ACCOUNTING TACTICS

Fraudulent accounting tactics is the same idea but taken to an elevated level. Fraudulent accounting tactics occur when the corporation intentionally presents financial information that is a material departure from its true financial position. Some of the more common transgressions are the acts of reporting fictitious revenue, and manipulating various assets, liability, or expenses to boost financial statement results.⁴⁴ In the case of both aggressive and fraudulent accounting tactics, the argument is that the motivation behind employing either tactic is to further the executive's own self interest in what is reported in the financials. Therefore, the tension of IBC can taint the manager's motivations in preparing accurate and useful financial information.

III. THE RESULTING EFFECT ON ACCOUNTING STANDARDS

The current accounting and regulatory regime is fragmented, complicated, and extremely costly.⁴⁵ The root cause of these phenomena is what will be referred to as the "stick-based" approach to accounting standard setting, an approach that to date has been employed either due to expediency

⁴⁴ Matt Krantz, *Capitalizing on Oldest Trick in the Book*, USA TODAY, June 27, 2002, at 3B.

⁴⁵ See generally Burkholder, *supra* note 1.

or the belief that such an approach is the most effective means by which to enforce accounting standards.

Presently, we do not have accounting rules and guidance that are designed to produce financial statements that are complete, accurate, and fairly represent the financial position of their respective companies. Instead, the current regime is merely designed to "reign in" corporate managers who will be as aggressive as possible in those areas of financial reporting that will serve their personal interests such as revenue recognition, assets, and inventory valuations, and will downplay those areas where full and fair disclosure may be adverse to the corporate manager; namely, areas such as expenses, liabilities, and debt obligations. An inherent tension exists in the financial reporting process. The corporate manager will be as aggressive as possible when it is in his best interest to do so and will likewise be as conservative as possible when it is in his best interest to do so.

As a result, a corporate manager's approach to financial reporting is "how aggressive can I be without running afoul of GAAP." Under this approach, the goal of an executive is not fair and accurate reporting that effectively presents the true economic position of that corporation, but instead is one of mere technical compliance with the executive being as aggressive as possible if it is in his best interest to do so. Because of this ever present tension between the preparers of the financial statements and the standard-setters that regulate them, a scenario of "move/counter-move" emerges. Executives may take an aggressive position with an accounting matter that is technically correct but substantively misleading. In reaction to this phenomena, the standard-setters draft additional guidance, interpretations, or standards to curtail the aggressive stance management has taken. The standard-setters make a better mousetrap, and then management merely counters by making a better mouse.⁴⁶ The move/counter-move between the two factions has resulted in the currently quagmired, expensive, and complicated accounting regime presently in place. Some examples will illustrate the point.

A. Accounting for Leases—Operating versus Capital

Some of the potential "big ticket" items on a corporation's balance sheet are expenditures related to the procurement of property, plant, or

⁴⁶ For example, Financial Interpretation 46(R) was enacted following Enron's abuse of the Special Purpose Entity (SPE). It broadened the criteria under which sponsoring entities would be required to report SPEs with whom the sponsoring entity was affiliated on a consolidated basis, such that the sponsoring entities potential debt obligations would be reflected in its financial statements, something Enron failed to do prior to FIN 46(R). See INTERPRETATION 46(R) SUMMARY, *supra* note 11.

equipment.⁴⁷ These items will be used for 5 to 45 years.⁴⁸ The cash outlay related to these assets can be considerable. Instead of purchasing these items outright, corporations will typically lease them on a long-term basis. Accordingly, the method used to account for these long-term lease obligations can have a significant impact on a corporation's financial reports.

The threshold question and major issue with respect to long-term lease obligations is whether the transaction will be accounted for as an operating lease or a capital lease.⁴⁹ The decision is significant. If the transaction is a capital lease, the corporation must account for the transaction as if the corporation is acquiring the asset, which in turn entails reporting a long-term debt obligation on its balance sheet.⁵⁰ This election further affects many key financial ratios that analysts use to determine the corporation's financial health.⁵¹ Alternatively, if the transaction is an operating lease, the corporation need only expense the lease payments in the period in which those expenses were incurred, with no long-term debt obligation reflected on its balance sheet.⁵² The lower the reported debt obligation, the better the corporation's perceived financial health and such perception will produce a corresponding increase in the market price for its shares. As a result, the accounting treatment for any long-term lease transaction becomes a high-stakes game with significant consequences depending on the accounting treatment afforded as dictated by the transaction's nature.

1. THE TENSION DRIVES THE NECESSITY: RULES BASED ACCOUNTING FOR LEASES—STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13

The tension between the corporate executive's self-interest and the desire for accounting standard setters to have meaningful and accurate financial reports creates a conflict. On one side, corporations and their

⁴⁷ For instance, for fiscal year ending January 29, 2006, "Property, Plant & Equipment" (net of accumulated depreciation) represented 56% of Home Depot's total assets. See HD 2005 ANNUAL REPORT, *supra* note 6, at 37.

⁴⁸ For example, for its "Buildings," Home Depot's depreciation ranges from ten to forty-five years; for "Furniture, Fixtures and Equipment," three to twenty years; for "Leasehold Improvements" five to thirty years. See *id.* at 42.

⁴⁹ See generally, ACCOUNTING FOR LEASES, Statement of Fin. Accounting Standards No. 13, ¶¶ 6-7 (Fin. Accounting Standards Bd. 1976) [hereinafter FASB No. 13].

⁵⁰ *Id.* ¶ 10 at 9.

⁵¹ For example, a key analyst ratio is the debt to equity ratio, which measures the amount of debt in relation to the corporation's equity. When a corporation is required to record a lease as a capital lease, this ratio becomes less favorable.

⁵² FASB No. 13, *supra* note 49, ¶ 15 at 11.

executive officers desire the operating lease accounting treatment whenever and wherever allowed because this obviates the requirement that the corporation record the lease as a long-term debt obligation on its balance sheet.⁵³ And on the other side, the accounting standard-setters push for more rigid and onerous standards to capture the transaction's "economic substance." This conflict resulted in Statement of Financial Accounting Standards No. 13 (SFAS 13).⁵⁴ Standard-setters were forced to draw lines in the sand and set the outer boundary for operating lease accounting treatment. Those lines resulted in the following four bright-line tests. Under SFAS 13, the presence of any one of the following would disqualify the transaction for the more favored operating lease accounting treatment:

- I. Ownership transfers from the lessor to the lessee at the end of the lease term.⁵⁵
- II. The lease contains a bargain purchase option.⁵⁶
- III. The lease term is equal to 75% or more of the asset's estimated economic life.⁵⁷
- IV. The present value of the minimum lease payments is equal to 90% of the property's fair market value.⁵⁸

The presence of any one of these criteria triggers the less favored capital lease accounting treatment. The rationale is that any one of these criteria "colors" the economic substance of the transaction to one where the corporation is deemed to be purchasing the asset outright. The aim of SFAS 13 is to have that economic reality reflected in the accounting treatment for that transaction. Accordingly, the key for financial statement preparers is to structure their long-term lease obligations such that none of these criteria are present.

2. HOW THESE BRIGHT-LINE TESTS CAN DISTORT FINANCIAL REPORTING

But characterizing transactions in such a "cookie-cutter" fashion can distort the true economic substance of a company's financial portrait even if it is compliant with the governing accounting standard. For example, take

⁵³ See generally *id.*

⁵⁴ *Id.*

⁵⁵ *Id.* ¶ 7a at 8.

⁵⁶ *Id.* ¶ 7b at 8.

⁵⁷ *Id.* ¶ 7c at 8.

⁵⁸ *Id.* ¶ 7d at 8.

the following lease transactions entered into by Company A and Company B, respectively.

Company A leases a building. The lease term is equal to 74% of the building's estimated economic life. The present value of the lease payments is equal to 89% of the leased property's fair market value. The lease transaction will not transfer ownership at termination of the lease term, nor does the lease contain a bargain purchase option.

Company B also leases a building. The lease term is equal to 75% of the building's estimated economic life. The present value of the lease payments is equal to 90% of the leased property's fair market value. Similar to Company A, the lease transaction will not transfer ownership at the end of the lease term, nor does the lease contain a bargain purchase option.

Comparing these two transactions shows no discernible difference. Both Companies A and B will be leasing an asset for almost three-quarters of that asset's estimated economic life with only a one percent difference between the two. Likewise, the present value of the lease payments differs by only one percentage point. And neither transaction will transfer ownership or contain an option to purchase the asset at a bargain price at the lease's termination. But because of the rules-based bright-line tests set forth in SFAS 13, the accounting treatment available for each of these two transactions and the corresponding financial statement impact of the two will be very different.⁵⁹

Because Company A managed to stay within SFAS 13's bright-line criteria (albeit just barely), Company A will be able to account for its lease transaction as an operating lease. This means that each year, Company A will simply record the lease payments as an expense item in the year those expenses are incurred.⁶⁰ Company A will not be required to record the lease as an asset on its balance sheet in spite of the fact that Company A will be making use of that asset for nearly three-quarters of the asset's life and for essentially the same period of time Company B will be leasing its building. Further, the amount that Company A will be making in lease payments is nearly 90% of the leased property's fair market value. Finally, Company A will not be required to record the corresponding debt obligation.⁶¹

In contrast, SFAS 13 requires very different accounting treatment for Company B's transaction because of minute differences in the transaction's characteristics. First, Company B will be required to capitalize the asset and place the item on its balance sheet as a purchased asset because Company B

⁵⁹ *Id.* ¶¶ 7a-d at 8.

⁶⁰ *Id.* ¶ 15 at 11.

⁶¹ *Id.*

will be deemed to have purchased the item.⁶² This is onerous because of the corresponding debt obligation which will be equal to the present value of the lease payments as measured at the lease's inception.⁶³

In short, this comparison illustrates how a rules-based approach can result in very different accounting treatment for transactions that have minute differences in their characteristics. A rules-based approach to accounting standard-setting can move financial reporting further and further away from the economic substance of a transaction and lead to a distorted financial picture. However, as discussed above, the "push the envelope" culture of financial reporting drives and necessitates such bright-line accounting standards. When managers have vested interests in the outcomes and how such transactions are reported, their focus may not necessarily be on reporting the true economic substance of the transaction, but rather on figuring out how they can present such transactions in the most favorable light possible and still remain within the confines of GAAP. If the accounting and financial reporting regime is to be simplified and improved, this dynamic will have to be taken into consideration.

B. Accounting Fraud—The Story at Enron

At the further end of the spectrum is accounting fraud. With accounting fraud, the specter of IBC still drives executives to present financials in the best possible light. The use of fraudulent accounting tactics, however, seems to occur when aggressive accounting tactics are no longer sufficient to achieve the results needed or desired by management to reach the financial benchmarks for which they are striving. Obviously, creating fictitious revenue, for example, can have a more significant financial statement impact than structuring a lease transaction as an operating lease versus a capital lease. And not surprisingly, engaging in accounting fraud comes with a much higher price. Depending on the type and magnitude of accounting fraud being perpetrated, the accounting standard-setters react with "defensive" accounting standards designed to "reign-in" such practices. But as stated earlier, the end result is accounting standards that are quagmired, expensive, complicated, and are even of questionable effectiveness. The following Enron story will help to illustrate.

Enron has been chronicled from many different perspectives, with various aspects of its meteoric rise and fall dissected and analyzed in great

⁶² *Id.* ¶ 10 at 9.

⁶³ *Id.*

detail.⁶⁴ The following discussion analyzes the nexus between the forms of IBC that Enron executives were receiving and how the prospect of executives losing millions in stock options and other forms of compensation may have spawned innovative forms of accounting fraud. And then finally, the accounting standard setter's reactive changes to accounting standards enacted as countermeasures.

How does a company report that its operations are generating a healthy and prolific flow of cash when in fact they are not? Enron's answer to this question was its creative use—or more accurately its abuse—of a financing vehicle referred to as a Special Purpose Entity (SPE).⁶⁵ This creative SPE use was concocted by a select group of talented Enron executives with the help of their independent auditors Arthur Andersen and its outside legal counsel, Vinson & Elkins.⁶⁶ The only problem was that their motivation was squarely focused on generating a continued rise in the price of its shares through financial engineering and accounting “sleight of hand” instead of focusing on generating revenues from the actual business itself.

1. WHAT IS A SPE?

Though SPEs are complex and complicated entities, the general premise is simple. SPEs are formed when a company creates a legal entity that is separate and distinct from its core operation, for the purpose of staging a discreet and isolated business venture, operation, or function.⁶⁷ SPEs narrow the scope of risk to the assets and liabilities placed in it such that investors' or equity holders' fortunes will be based exclusively on what occurs with the assets and liabilities placed within the SPE.⁶⁸

⁶⁴ See generally ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS (Nancy B. Rapoport & Bala G. Dharan eds., 2004), which has contributions from various authors ranging from accounting insights to ethical perspectives.

⁶⁵ Bala G. Dharan, *Enron's Accounting Issues: What Can We Learn to Prevent Future Enrons?*, in ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS, *supra* note 64, at 117.

⁶⁶ See Final Report of Neal Batson, Court-Appointed Examiner at 39-49 *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Nov. 4, 2003), available at http://141.150.158.82/media/Final_Report_Neal_Batson.pdf.

⁶⁷ For a more detailed description of SPEs, see Harold S. Peckron, *Watchdogs that Failed to Bark: Standards of Tax Review After Enron*, FLA. TAX REV. 853, 857-58 (2002). A special purpose entity (SPE) or vehicle is an entity (usually a limited company of some type or, sometimes, a limited partnership) created to fulfill narrow, specific or temporary objectives, primarily to isolate financial risk. *Id.*

⁶⁸ Bala G. Dharan, *Financial Engineering with Special Purpose Entities*, in ENRON AND BEYOND: TECHNICAL ANALYSIS OF ACCOUNTING, CORPORATE GOVERNANCE, AND SECURITIES ISSUES 104 (Julia K. Brazelton & Janice L. Ammons eds., 2002).

2. HOW ENRON ABUSED THE SPE STRUCTURE

Unquestionably, legitimate uses exist for the SPE, such as the securitization of accounts receivable.⁶⁹ But the SPE structure, because of its nature and form, can be abused by those intent on achieving accounting results that are not rooted in economic substance. A chief example of abuse is Enron. Through SPEs, Enron created revenue where there was none and reported that its operations were generating cash flow that did not exist. Finally Enron failed to report debt obligations that it actually incurred. All of this was done through the manipulation of the SPE structure and Enron's liberal interpretation of Financial Accounting Standard 140 (FAS 140).⁷⁰

3. THE DARK COMES TO LIGHT

Enron filed for bankruptcy on December 2, 2001.⁷¹ Once the investigations into the Company's financial statement engineering commenced, the full breadth and depth of its fraudulent accounting misdeeds came to light. It was discovered that Enron used several different types of "accounting techniques" to manipulate its financial statements,⁷² and one of those techniques involved the manipulation of the SPE in connection with FAS 140.⁷³ Ordinarily FAS 140 transactions comply with Financial Accounting Standard 140, which sets forth the accounting guidelines related to asset

⁶⁹ A common SPE use is the securitization of Account Receivables. For example, a company has \$10,000 of account receivables on its books. The receivables come due in one year. But, the company wishes to receive cash from those receivables today, versus one year from now. To address accounting for this activity, the company forms an SPE, into which the account receivables are transferred. The account receivables have now been isolated from the core operations. The SPE, in turn, issues securities to investors, who buy the securities based on the assessed creditworthiness of those outstanding receivables. The investors, for example, may pay \$9,000 for the securities, which, in turn, is paid to the company. The investors then wait the twelve months for the receivables to come due. When the receivables are paid, the shareholders are entitled to the proceeds. This illustrates the "win-win" situation for all parties involved: the company gets \$9,000 on "day one" instead of having to wait a year, and investors realize \$1,000 profit after paying \$9,000 on "day one" and receiving \$10,000 twelve months later. This is just one example of a legitimate and non-controversial use for SPEs.

⁷⁰ See Second Interim Report of Neal Batson, Court-Appointed Examiner at 39, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. Jan. 21, 2003), available at http://141.150.158.82/media/2nd_Examiners_Report.pdf.

⁷¹ See Second Interim Report of Neal Batson, *supra* note 69.

⁷² See *id.* at 37. Note that the Report explains the six accounting techniques Enron used in its financial manipulation schemes, with the SPE used in conjunction with SFAS 140 being one of the significant ones. The other five are explained in the report as well.

⁷³ See *id.* at 39.

transfers in connection with structured financings.⁷⁴ But, Enron used FAS 140 transactions to boost its financial portrait improperly. For example, in the year 2000, Enron increased its reported net income by \$351.6 million, 36% of its reported net income.⁷⁵ Appreciating the gravity of this statement, 36% of Enron's reported earnings in the year 2000 were not actual money generated through its operations, but earnings "engineered" via the use of the FAS 140 SPE transactions.

4. HOW IT WAS DONE

In sum, Enron inflated its earnings and cash flows from operations by (1) improperly recording transferred assets as sales even though Enron still maintained control of the assets after their transfer; (2) reporting the proceeds from those transfers as cash-flows from operations when Enron should have recorded those items as secured borrowings; and (3) failing to record debt obligations incurred through these transactions. When vetted through a filtered lens, Enron's transgressions were clear. But of course, hindsight is always perfect.

In addition to its core operations, Enron held a number of otherwise illiquid assets that it used in connection with these FAS 140 transactions.⁷⁶ One of the ways Enron was able to create fictitious revenue was through its creative use of these equity investments.⁷⁷ To create a situation where it could manufacture revenue, Enron formed subsidiaries, called "Asset LLC's," and transferred its illiquid assets into those subsidiaries.⁷⁸ The Asset LLC in turn issued two classes of stock, Class A shares and Class B shares.⁷⁹ The class A shares represented the Asset LLC's voting interests, whereas the Class B shares represented the economic interest in the LLC.⁸⁰ The Class

⁷⁴ See ACCOUNTING FOR TRANSFERS AND SERVICING OF FINANCIAL ASSETS AND EXTINGUISHMENTS OF LIABILITIES (A REPLACEMENT OF FASB STATEMENT NO. 125), Statement of Fin. Accounting Standards No. 140 (Fin. Accounting Standards Bd. 2000) [hereinafter FASB No. 140].

⁷⁵ Second Interim Report of Neal Batson, *supra* note 69, at 38.

⁷⁶ "As part of these management efforts, Enron monetized several types of assets in the FAS 140 Transactions, including shares of common stock or warrants to purchase common stock of both publicly traded and private companies, partnership interests, membership interests in limited liability companies formed in connection with relationships between Enron and third parties and interests in trusts formed in connection with other financial transactions undertaken by Enron." First Interim Report of Neal Batson, Court-Appointed Examiner at 59, *In re Enron Corp.*, No. 01-16034 (AJG) (Bankr. S.D.N.Y. September 21, 2002), available at http://141.150.158.82/media/1st_Examiners_Report.pdf.

⁷⁷ See *id.* at 58. For example, the FAS 140 transactions cited in the report were referred to as Cerberus, Nikita, Hawaii (I & II), and Backbone (I & II). See *id.* at 67, 91, 101, 117.

⁷⁸ See *id.* at 59.

⁷⁹ See *id.* at 59-60.

⁸⁰ See *id.*

A interests would be issued to Enron;⁸¹ the Class B shares containing the economic interests would be issued to an SPE, generally a Share Trust (Trust) that Enron formed and controlled.⁸² The Class B interests sold to the Trust were entitled to no voting rights but were entitled, instead, to substantially all of the economic interests in the Asset LLC.⁸³

5. FOCUSING ON CASH FLOWS

But from where was the money coming? For Enron's facade to work, it still needed an actual and tangible influx of cash flowing into the corporation. To achieve this, financial institutions such as Citigroup, JP Morgan, and Merrill Lynch (Lenders)⁸⁴ provided cash infusions. The funds that flowed into the Trusts came from two sources. The first source was the Lenders themselves. These were borrowed funds with the Trust as the indebted party.⁸⁵ The second source was equity investors, "independent" third parties who, coincidentally, were often an affiliate of the lending institution that was a party to the transaction.⁸⁶

The money source stemming from the equity investors was entitled to be repaid the amount of its investment plus an annual rate of return. The amount of the equity interest in the Trust was equal to at least 3% of the purchase price for the Class B interest, plus the amount of fees due to the Lenders. The right of the equity-holder to receive payment with respect to its equity was subordinated to the right of the Lenders to receive the payment that was advanced under the credit facility.⁸⁷ At the closing of the FAS 140 transaction, the Trusts paid the Asset LLC the purchase price for the Class B interests, and the Asset LLC conveyed the full proceeds of the transaction to Enron.⁸⁸

⁸¹ See *id.*

⁸² See *id.* at 60.

⁸³ See *id.*

⁸⁴ *Oversight of Investment Bank's Response to the Lessons of Enron: Hearing Before the Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs, 107th Cong. 7-10 (2002)* (statement of Senator Susan M. Collins, Ranking Member, Subcomm. on Investigations of the S. Comm. On Homeland Sec. & Governmental Affairs), available at <http://hsgac.senate.gov/121102collinsstatement.htm>.

⁸⁵ First Interim Report of Neal Batson, *supra* note 76, at 60.

⁸⁶ See *id.*

⁸⁷ See *id.* at 60-61.

⁸⁸ *Id.* at 61.

6. ENRON'S IMPROPER ACCOUNTING TREATMENT

Enron improperly recorded these asset transfers to the Asset LLC's as sales, which inflated revenue on its income statement.⁸⁹ Also, depending upon the assets involved, Enron recognized cash flow from these transfers as cash flows from operating activities.⁹⁰ With structured financings properly in accordance with FAS 140, the transferring entity must completely relinquish itself from any rights to profits that could be realized from the transferred asset once the presumptive sale occurs.⁹¹ Likewise, the transaction must be structured in a way such that the sponsoring entity is absolved from any potential liability if the SPE fails to realize the payments from the transferred assets.⁹²

Enron's accounting for the asset transfers as sales was not proper for several reasons. First, Enron maintained control of the transferred asset through its ownership of the Class A voting membership interests in the LLC to which the asset was transferred. Second, Enron acted as guarantor on the Trust's behalf through a mechanism referred to as a "total return swap."⁹³ The total return swap was a guarantee of payment in the (likely) event the payment streams from the transferred assets were insufficient to service the debt obligation and repay the Lenders.⁹⁴ Indeed, the share price needed to remain high so that the IBC maintained its value and executives' stakes in the outcome would not be jeopardized. In effect, IBC spawned financial fraud, which then spurred reaction by the accounting standard-setters.

In sum, Enron inflated its earnings and cash flows from operations by (1) improperly reporting transferred assets over which Enron still maintained control as sales and (2) by reporting the proceeds from the sales as cash-flows from operations when in fact they should have recorded those items as secured borrowings. In addition, it was improper for Enron not to record the money received from the Lenders as debt obligations because Enron guaranteed payment of the money through the total return swaps.

⁸⁹ See *id.* at 53.

⁹⁰ See *id.*

⁹¹ FASB No. 140, *supra* note 74, ¶ 5 at 7.

⁹² *Id.*

⁹³ First Interim Report of Neal Batson, *supra* note 76, at 54.

⁹⁴ See *id.*

7. THE PLAYERS BEHIND THE PLAN AND THE INCENTIVES THAT DROVE THEM

At its zenith, Enron was a monolithic company, spanning over 20 countries, employing over 30,000 people, and controlling more than \$62 billion in assets.⁹⁵ In spite of its size, the magnificent accounting fraud that it perpetrated was orchestrated by a relatively small number of individuals. These were individuals who had access to the levers that controlled Enron's financial reporting process, as well as the power and influence to insure that such financial manipulation went undetected for quite some time.

How did IBC lead to the financial accounting fraud that was exacted by Enron's executive officers? At the outset, any attempt to show "he did X because of Y" is difficult to demonstrate with absolute certainty. Without a clear and unequivocal confession, something to the effect of "I helped my company commit financial fraud because I wanted to maximize the value of my stock options and bonus payments," investigations are limited to drawing plausible inferences based on the facts. Admittedly then, the case is circumstantial, and quite likely a whole host of factors, not just IBC, drove the executive's actions in perpetrating financial fraud. At the root of Enron's accounting fraud was a select group of high level executives. Jeffrey Skilling, Kenneth Lay, Andrew Fastow, Richard Causey, and Ben Glisan commanded most of the attention in the headlines in the aftermath of Enron's bankruptcy in 2001. They are also the ones that were most integral in perpetrating the accounting fraud.⁹⁶

To say that Kenneth Lay, Jeffrey Skilling and the other executives involved in the scandal were motivated exclusively by greed or the sole desire for personal monetary gain would likely be an over simplification. As with many issues, the root cause of human behavior and action can be hard to ascertain. As complex creatures we continually buck behavioral models such as the neo-classical "rational actor" when it comes to predicting and anticipating human decision making and actions. This is especially so in corporate settings where a host of factors and variables transcend upon that

⁹⁵ Anastasia Kurdina, *The Collapse of Enron: Managerial Aspect*, <http://www.personal-writer.com/enron/> (last visited Mar. 10, 2008).

⁹⁶ The Houston Chronicle maintains a website that chronicles each executive's role in the accounting scandal and their subsequent convictions and sentencing. See *Enron Corp. – News, Trials and the History of the Scandal*, <http://www.chron.com/news/specials/enron/> (last visited on Mar. 10, 2008) [hereinafter *Enron Chronicle Special Website*]. Skilling, Lay, Fastow, and Causey each got at least five-year prison sentences with Skilling receiving a sentence of twenty-four years. Kenneth Lay's sentence was vacated after his untimely death due to a heart attack, which he suffered in July of 2006. *Id.* (details for sentencing and conviction of these key players can be found by following the hyperlinks for each individual's name under the "Prosecution Scoreboard" section of the page).

executive on a daily basis, with each variable effecting his outlook and reactions in unpredictable ways. Scholars suggest that Enron's high level executives had motives that were less than altruistic. As noted by one scholar,

their job was not just to make money, but to make the most money —to be the superstar firm. For a superstar firm, success did not mean merely doing better than the next firm. It meant destroying the next firm and much of industrial organization along with it and always delivering good numbers.⁹⁷

Thus, in that author's view it was this single-minded pursuit of besting all others that ultimately caused its managers to destroy their firm.⁹⁸

The bottom line, at least in Enron's case, is that the lines of what was ethical and proper blurred. Consequently, the inner circle of executive's moves to throw themselves "financial life-savers" while the ship was sinking tells us that their personal financial stakes played a large role in their decisions and actions. Concluding that the actions of Kenneth Lay and "friends" were at least in part motivated by personal greed or gain would not be a very great inferential leap.

Consider first Kenneth Lay, the CEO and Chairman of the Board from 1986 to 2001,⁹⁹ the time period when Enron's financial misstatements were most prevalent and during the time directly preceding its bankruptcy filing.¹⁰⁰ Lay received approximately \$300 million from the sale of Enron stock options and restricted stock, netting over \$217 million in profit, and was paid more than \$19 million in salary and bonuses.¹⁰¹ During 2001 alone, Lay received a salary of over \$1 million, a bonus of \$7 million, and \$3.6 million in long term incentive payments.¹⁰² Additionally, during the period of August 21 through October 26, 2001, Lay sold approximately 918,104 shares of Enron stock to repay advances totaling \$26,025,000 he had received from a line of credit extended by Enron.¹⁰³ If during those same periods in which Mr. Lay exercised those stock options, Enron had reported its

⁹⁷ William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1286-87 (2002).

⁹⁸ *Id.* at 1287.

⁹⁹ Superseding Indictment at 3, *United States v. Causey*, Cr. No. H-04-25 (S-2) (S.D. Tex. July 7, 2004), available at <http://www.chron.com/content/news/photos/04/07/08/layindict.pdf>.

¹⁰⁰ First Interim Report of Neal Batson, *supra* note 76, at 1.

¹⁰¹ Superseding Indictment, *supra* note 99, at 6.

¹⁰² *Id.*

¹⁰³ *Id.*

financial position accurately, or at least within material limits, Lay's stock options, bonuses, and perhaps his long term incentive payments would likely have been worth substantially less than the amount for which he exercised them.

A similar situation existed with Jeffrey Skilling, Kenneth Lay's successor as Enron CEO until his abrupt resignation in August of 2001,¹⁰⁴ just prior to Enron's bankruptcy filing for "undisclosed personal reasons."¹⁰⁵ Between 1998 and 2001, Mr. Skilling received approximately \$200 million from the sale of Enron stock options and restricted stock, netting over \$89 million in profit, and was paid more than \$14 million in salary and bonuses.¹⁰⁶ Likewise, between 1998 and 2001, Richard Causey, Enron's Chief Accounting Officer¹⁰⁷ received more than \$14 million from the sale of Enron stock and stock options, netting over \$5 million in profit, and was paid more than \$4 million in salary and bonuses, before being fired in February 2002.¹⁰⁸ While there is no unequivocal confession from any of these executives, we can only infer that their personal stakes in the outcome played a role in the decisions they made and the actions they took. But again, the inferential leap is not a very long one.

C. How the Standard-Setters Reacted with the Birth of FIN 46(R); a New Consolidation Criteria, an Attempt to Put SPEs back on the Books

Much like the public outcry that sparked the birth of the Sarbanes-Oxley Act of 2002, a similar panic button was pressed regarding accounting standards related to items such as the FAS 140 transactions. In fact, early in his tenure, Chairman of the Financial Accounting Standards Board Robert Hertz bore the brunt of much Capitol Hill ire as he fielded questions on how the problem of unrecorded liabilities and fictitious revenue funneled through SPEs would be addressed, with one southern Senator asking, when [the] FASB was going to "outlaw the use of these *dummy co-poh-ray-shuns*."¹⁰⁹

¹⁰⁴ *Id.* at 7.

¹⁰⁵ Wendy Zellner, et. al., *Jeff Skilling: Enron's Missing Man—The CEO who Created Its In-Your-Face Culture Has Been Largely Absent from the Inquiry*, BUSINESSWEEK.COM, Feb. 11, 2002, http://www.businessweek.com/magazine/content/02_06/b3769051.htm.

¹⁰⁶ Superseding Indictment, *supra* note 99, at 6.

¹⁰⁷ Enron Chronicle Special Website, *supra* note 93 (follow hyperlink for "Richard Causey" in the "Prosecution Scoreboard" section of the page).

¹⁰⁸ Superseding Indictment, *supra* note 99, at 6.

¹⁰⁹ Tim Reason, *All in the Family: FIN 46 Made Companies Admit Paternity of Special Purpose Entities. But It also Resulted in Some Surprise Adoptions*, CFO MAG, Sept. 1, 2004, available at http://www.cfo.com/printable/article.cfm/3126336/c_3148382?f=options.

Such heat sparked the birth of Financial Interpretation 46 which was later refined as Financial Interpretation 46(R) (FIN 46(R)).

FIN 46(R) addresses situations where one company, Company A, has a financial interest in another, Company B. FIN 46(R) outlines when and under what circumstances the relationship between Company A and Company B is such that GAAP would require the two to be reported on a consolidated basis. The usual investment that would trigger this rule is when Company A invests in Company B through stock ownership. Prior to FIN 46(R), entities would be required to consolidate only in the instance where Company A had majority ownership in Company B through Company A's ownership of Company B's stock. This previous test was treated as a bright-line that required consolidation only when Company A was a majority owner of Company B's stock (i.e., greater than 50 percent).¹¹⁰

As a result of this bright-line test, prior to FIN 46(R) corporations would avoid the consolidation requirement by controlling the entity through some means other than stock ownership and would avoid consolidation, thereby keeping both the assets and, more importantly, any underlying liabilities off Corporation A's balance sheet.¹¹¹ With SPEs, a special niche in the accounting and regulatory framework was carved that made it possible for entities such as Enron to form subsidiaries but nonetheless avoid recognizing those entities on a consolidated basis. Such accounting "sleight of hand" was achieved by relying on yet another accounting promulgation known as Emerging Issues Task Force 90-15 (EITF 90-15). Under EITF 90-15, the sponsoring corporation could avoid consolidation as long as the SPE had an additional "outside" equity investor whose investment in the SPE was at least 3%.¹¹² FIN 46(R), among other things, was designed to close this loophole.¹¹³ The first noteworthy change that FIN 46(R) made was to broaden the scope of potential entities that would come under its

¹¹⁰ See DAVID R. HERWITZ & MATTHEW J. BARRETT, ACCOUNTING FOR LAWYERS 521 (3d ed. 2001).

¹¹¹ For example, the sponsoring company may control the SPE by narrowly defining the scope of the SPEs permitted activities and placing such limitations in the SPEs chartering documents, such as its Articles of Incorporation.

¹¹² FIN. ACCOUNTING STANDARDS BD., EMERGING ISSUES TASK FORCE ISSUE NO. 90-15: IMPACT OF NONSUBSTANTIVE LESSORS, RESIDUAL VALUE GUARANTEES, AND OTHER PROVISIONS IN LEASING TRANSACTIONS 1 (1991), available at <http://www.fasb.org/st/> (scroll down and follow the link for full text of EITF 90-15) [hereinafter EITF 90-15]. Although not stated specifically in EITF 90-15, industry practice had evolved to the point where three percent equity investment was sufficient at-risk equity investment to avoid consolidation.

¹¹³ INTERPRETATION 46(R) SUMMARY, *supra* note 11.

purview to include any entity that met the definition of a variable interest entity (VIE).¹¹⁴

VIEs include SPEs and can be generally described as entities where the equity investment at risk does not provide its holders with the characteristics of a controlling financial interest or is insufficient for the entity to finance its activities without additional subordinated financial support.¹¹⁵ These characteristics are meant to identify arrangements where control of the entity would not be achieved through voting stock ownership but through some other means.¹¹⁶ FIN 46(R) requires consolidation of a VIE by a party that has a majority of the risks and rewards associated with the entity.¹¹⁷ FIN 46(R) also establishes a methodology for determining what party associated with a VIE should consolidate the VIE. Essentially, the requirement is that the party exposed to a majority of the variation in the VIE's performance outcomes both positive and negative should consolidate the VIE because such exposure is likely to be indicative of control.¹¹⁸ FIN 46(R) refers to such a party as the VIE's "primary beneficiary."¹¹⁹

An issuer's involvement or "variable interest" can manifest itself in debt instruments, guarantees, service contracts, written put options, total return swaps, or other instruments.¹²⁰ These arrangements with a VIE can put the issuer in a position akin to an equity holder in that the issuer bears the same risks and rewards of the VIE as an equity holder would. For example, consider an issuer that owns 49% of the voting stock of another entity and is also that entity's sole debt guarantor. Before FIN 46(R), such an issuer might not have been required to consolidate the other entity based upon voting control alone because the 49% ownership falls short of the 51% required for consolidation. But subsequent to the promulgation of FIN 46(R), if this same entity is deemed to be a VIE, then the issuer would be required to consolidate due to the issuer's additional risk of loss from the outstanding guarantee.¹²¹

¹¹⁴ *Id.*

¹¹⁵ CONSOLIDATION OF VARIABLE INTEREST ENTITIES: AN INTERPRETATION OF ARB NO. 51, Interpretation No. 46, ¶ 4 at 3-5 (Fin. Accounting Standards Bd. 2003), available at http://www.fasb.org/fin46r_marked.pdf [hereinafter FIN 46(R)].

¹¹⁶ *Id.* ¶ 5 at 5-7.

¹¹⁷ *Id.* ¶ 14 at 12.

¹¹⁸ *Id.* ¶ 15 at 13.

¹¹⁹ *Id.*

¹²⁰ *Id.* ¶ 2 at 3.

¹²¹ *Id.* ¶ 14 at 12.

D. Was FIN 46(R) Really Necessary?

In tying FIN 46(R) back into the theme of IBC, financial reporting and accounting standards, what existed was an environment in which a select group of individuals; namely the executives at Enron, orchestrated a maze of complex and complicated accounting transactions that had little, if any, basis in economic substance. Each Enron executive profited personally through inflated stock prices and their timely exercise of stock options. And finally, on the heels of such pervasive and complex accounting fraud, accounting standard-setters again were forced to react to such behavior through the promulgation of “defensive accounting standards” like FIN 46(R).

What is problematic, however, is that the standard was drafted in a defensive manner to cast a wide net with a tight mesh. This design was to insure that “Enron-like” SPE abuse would not re-occur. But simultaneously, because of the expanded consolidation criteria, entities that have no nefarious intent behind their SPE use are now likewise saddled with interpreting and complying with FIN 46(R). Simply put, the incentive to cheat results in cheating, which results in more rules to address the cheating, and financial reporting becomes saddled with yet another compliance hurdle that is complicated, complex, costly, and like many laws that are reactive in nature, likely will not prevent what it was designed to prevent.

Enron’s departure from GAAP was deliberate. Although it may be hard to acknowledge, executives who are intent on engaging in accounting fraud will do so no matter how many standards are put in place to stop them. They will do so especially when the rewards for fraud outweigh the consequences. Unfortunately, this is the climate and the current corporate culture within which a “simplified accounting regime” would be introduced. Consequently, the effort to simplify is bound to fail.

IV. WHERE THE STANDARD-SETTERS ARE TRYING TO GO

The SEC is forming an advisory committee to reduce the complexity of the United States financial reporting system and make it more “user-friendly” for investors.¹²² A significant body of work and study has already been done regarding this issue with a number of proposed changes and reforms already being considered.¹²³ It is expected that the final recom-

¹²² McTague, *supra* note 2.

¹²³ See generally FASB RESPONSE, *supra* note 4 (noting where the report chronicles the research and reports that have been produced to date regarding revising and reforming accounting standards and financial statement disclosure).

recommendations will incorporate significant aspects of the work that has already been done. However, standard-setters should consider the conflict between preparers and users of financial information in their quest to improve the current accounting regime. This Article contends that unless and until the pressure between financial statement preparers and accounting standard-setters is effectively addressed, any recommendations proposed will be undermined by corporations' current use of IBC because of the adverse impact such use has on financial reporting. However, because it is expected that whatever recommendations are submitted, will in some manner consider the body of work already completed in this arena, considering that body of work and assessing its feasibility in light of the current corporate culture and IBC will be the starting point.

A. *The FASB's Three Pronged Attack*

The FASB is undertaking a three-pronged effort to revamp the current accounting and financial reporting regime. The first prong involves re-addressing current accounting standards that are considered overly complex and outdated.¹²⁴ The standards will presumably be written in a simplified form, or eliminated altogether. These efforts could be considered along the lines of preliminary attempts to eliminate the currently cluttered accounting standard setting landscape.

The second prong consists of three broad initiatives. These include (1) a massive project to develop a comprehensive integrated codification of all existing accounting literature organized by subject matter that will become the single source for all of GAAP;¹²⁵ (2) an attempt to stem the proliferation of new pronouncements emanating from multiple sources by consolidating U.S. accounting standard setting under the FASB's auspices;¹²⁶ and (3) the third initiative, which is this Article's primary focus, is an attempt to develop new standards that take a "principles-based" or "objectives-oriented" approach to accounting standard setting.¹²⁷

¹²⁴ FASB RESPONSE, *supra* note 4 at 7.

¹²⁵ January 15, 2008 the Financial Accounting Standards Board issued its "FASB Accounting Standards Codification" project. "The Codification includes all accounting standards issued by a standard-setter within levels A through D of the current U.S. GAAP hierarchy, including FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related literature. The Codification does not change GAAP; instead it reorganizes the thousands of U.S. GAAP pronouncements into roughly 90 accounting topics, and displays all topics using a consistent structure." See FASB news release dated 1/15/08. Found at www.fasb.org/news/nr011508.shtml. Last visited May 5, 2008.

¹²⁶ FASB RESPONSE, *supra* note 4 at 7.

¹²⁷ *Id.*

The third and final prong involves the FASB's effort to strengthen the existing "conceptual framework" and to provide a more solid and consistent foundation for the development of future principles-based standards.¹²⁸

B. *Objectives-Oriented Accounting Standards—In General*

Up to this point, this Article's focus has revolved around indicting the current set of accounting standards with its rules-based approach and the distorted and misleading financial reporting that can stem from such approach. One of the initiatives currently being considered as an alternative is objectives-oriented accounting standards.¹²⁹ Generally speaking, accounting standards that are objectives-oriented (as opposed to the rules-based standards discussed in Section II), are standards written in a manner such that the financial preparer is focused on achieving the accounting objective contained in the standard versus merely focusing on complying with bright-line tests of form that are evident with rules based accounting standards. The standard's focus is on representational faithfulness and economic substance as opposed to mere compliance with the bright-line tests of form seen, for example, with the operating versus capital lease accounting treatment decision discussed earlier. Objectives-oriented accounting standards are standards focused on effective communication of economic substance versus mere compliance with bright-line tests of form.

C. *Objectives-Oriented Accounting Standards—The Detailed Discussion*

Before delving into a more detailed discussion of objectives-oriented accounting standards, it is important to consider the context and the culture within which these standards will be placed. Importantly, a move away from a rules-based approach to accounting standards to an objectives-oriented approach is a move away from the safe-harbors under which financial statements and their preparers can find refuge from second-guessing regulators and vigilant enforcers of financial reporting.¹³⁰ A move away from rules-based accounting standards to objectives-oriented accounting standards is, for some, a move away from a regime characterized by structure

¹²⁸ *Id.* at 7-8.

¹²⁹ U.S. Sec. & Exch. Comm'n, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (July 25, 2003), <http://www.sec.gov/news/studies/principlesbasedstand.htm> [hereinafter SEC Section 108(d) Study].

¹³⁰ *Id.*

and certainty into a regime of fluid boundaries which will require both judgment and discretion on the part of financial statement preparers.

As a result, the objectives-oriented approach to accounting standard setting attempts to strike the appropriate balance between sufficient structure and proper flexibility. The approach seeks to provide enough structure and implementation guidance so that preparers have a sufficient roadmap by which to navigate. At the same time, the approach looks to provide enough latitude and flexibility to make sure that the preparer focuses on capturing the "economic substance" of a transaction versus merely complying with bright-line tests of form. With this intended balance in mind, objectives-oriented accounting standards typically involve the following five characteristics:

"First, in applying a particular standard, preparers and auditors are required to focus the accounting and attestation decisions on fulfilling the accounting objective of that standard. This minimizes the opportunities for financial engineering designed to evade the standard's intent."¹³¹ "Second, each standard is drafted in accordance with objectives set by an overarching, coherent conceptual framework meant to unify the accounting system as a whole."¹³² "Third, the objectives-oriented approach eschews exceptions, which by their very nature are contrary to fulfilling a principled objective, create internal inconsistencies within the standard, and, inherently, create a need for more detailed guidance."¹³³

Fourth, the objectives-oriented approach also eschews bright-line tests, which often are a product of the exceptions. These are inherently contrary to any principled objective, because a slight shift in the form or structure of a transaction can cause it to move across the threshold resulting in profoundly different accounting for transactions that are economically similar.¹³⁴

Finally, objectives-oriented standards clearly articulate the class of transactions to which they apply and contain sufficiently-detailed guidance so that preparers and auditors have a structure in which to determine the appropriate accounting for the company's transactions. In general, the possible degrees of specificity to which accounting standards may be drafted constitute a spectrum ranging from the abstract, at one end, to the very specific at the other.

¹³¹ *Id.*

¹³² *Id.*

¹³³ *Id.*

¹³⁴ *Id.*

Objectives-oriented standards, when properly constructed, land solidly between the two ends of this spectrum.¹³⁵

Objectives-oriented standards stand in contrast to rules-based accounting standards, which are characterized by bright-line tests, multiple exceptions, a high level of detail, and internal inconsistencies. The vision underlying a rules-based approach is to specify the appropriate accounting treatment for virtually every imaginable scenario, such that the determination of the appropriate accounting answer for any situation is straight-forward and, at least in theory, the extent of professional judgment necessary is minimized. Ironically, however, significant application of judgment remains necessary in a rules-based environment. The focus of that judgment, however, is not on capturing the economic substance of the transactions or events, but rather it is shifted to the determination of which of the accounting treatments within a complex maze of scope exceptions and often conflicting guidance is applicable.¹³⁶

D. SFAS 141—*Example of an Objectives-Oriented Accounting Standard*

The FASB has already begun drafting new accounting standards with the objectives-oriented approach in mind. Statement of Financial Accounting Standard 141 (SFAS 141) is an example. It sets accounting standards in the context where one entity acquires another,¹³⁷ what is commonly referred to as business combinations.¹³⁸ Prior to SFAS 141, the standard relating to accounting for business combinations was a rules-based standard where the accounting treatment for such combinations was contingent upon the transaction meeting pre-determined bright-line tests of form.¹³⁹ Under the

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ FIN. ACCOUNTING STANDARDS BD., SUMMARY OF STATEMENT NO. 141: BUSINESS COMBINATIONS (June 2001), available at <http://www.fasb.org/st/summary/stsum141.shtml> [hereinafter FASB NO. 141 SUMMARY].

¹³⁸ FIN. ACCOUNTING STANDARDS BD., EXPOSURE DRAFT: PROPOSED STATEMENT OF FIN. ACCOUNTING STANDARDS, BUSINESS COMBINATIONS, A REPLACEMENT OF FASB STATEMENT NO. 141, at 1 (June 30, 2005) (on file with the Author) [hereinafter FASB NO. 141 EXPOSURE DRAFT] (defining a business combination as “a transaction or other event in which an acquirer obtains control of one or more businesses”).

¹³⁹ FASB NO. 141 SUMMARY, *supra* note 137 (“Under Opinion 16, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial results.”).

accounting standards that were in place prior to SFAS 141, there were two potential accounting treatment possibilities: (1) the purchase (or acquisition) accounting method; or (2) the pooling of interests accounting method.¹⁴⁰

The purchase method of accounting requires that Company A account for the acquisition of Company B as a purchase of Company B's assets and an assumption of Company B's liabilities.¹⁴¹ What is significant to the buying company when using the purchase method of accounting is how the assets are valued when ownership is transferred from Company B to Company A. Under the purchase method of accounting, the buying and selling companies come to an agreement as to the purchase price. The purchase price invariably will exceed the amount at which those assets are carried on Company B's balance sheet, as those amounts will be carried at book value (cost minus depreciation), rather than at fair market value.¹⁴² Accordingly, under the purchase method of accounting, the acquiring company will be required to "bump up" the cost basis of those assets to reflect their fair market value.¹⁴³ The implications of such asset revaluations are that the acquiring company will have to record those revalued assets on its balance sheet and depreciate them accordingly. This will result in greater depreciation expense for example, which will result in lower reported income. As a result, companies that were sensitive to such income statement effects, prior to SFAS 141, would attempt to structure the transaction by using the pooling of interests accounting method instead.

Under the second accounting treatment the business combination of the two companies is perceived quite differently. The pooling of interests method has no acquiring or acquired companies *per se*. Rather, under the pooling of interest method, the two companies are treated simply as if they have merged into one.¹⁴⁴ Accordingly, instead of revaluing the assets and bumping them up to their fair market values, the two entities are reported on a consolidated basis, with the asset book values of the respective companies remaining at their pre-merger balances.¹⁴⁵

¹⁴⁰ *Id.*

¹⁴¹ See, e.g., BRAGG, *supra* note 16, at 470-73.

¹⁴² Generally Accepted Accounting Principles requires that assets be recorded at cost and then reduced periodically by the amount of depreciation recorded each period.

¹⁴³ For an introduction to the purchase method of accounting for business combinations, see CHARLES H. MEYER, ACCOUNTING AND FINANCE FOR LAWYERS IN A NUTSHELL 352-58 (3d ed. 2006).

¹⁴⁴ FASB *Rules Out Pooling of Interests*, J. ACCT. (July 1999), available at <http://www.aicpa.org/PUBS/jofa/jul1999> (follow Financial Accounting hyperlink) ("Using the pooling-of-interests method, companies could add together the book values of their net assets without indicating which entity was the 'purchaser' and which was the 'purchased.' When this method was used, investor often had difficulty telling who was buying whom or determining how to evaluate the transactions.")

¹⁴⁵ MEYER, *supra* note 143, at 353.

Under the standards prior to SFAS 141, corporations would attempt to structure their transactions depending on the accounting treatment that best suited their desired outcome. In some cases the purchase method of accounting would be used, while in others the pooling of interests method would be most desired. Such alternative accounting treatments were considered problematic, however, since business combinations could be afforded very different accounting treatments in spite of the fact that there were no substantive differences in the transactions.¹⁴⁶ Such representational inconsistencies were similar to the operating versus capital lease distinctions discussed earlier and resulted in similar objections.

Accordingly, SFAS 141 was drafted to address the issue of inconsistent accounting treatment in the area of business combinations. What is special and unique about SFAS 141 is that it substituted a rules based standard for an objectives-oriented approach to accounting standard setting. In that regard SFAS 141 is drafted to do a number of things: (1) force financial statement preparers to use the same accounting treatment for transactions that are substantively the same; (2) force financial statement preparers to focus on reporting the economic substance of a transaction versus merely focusing on making sure the transaction adheres to bright-line tests of form; and (3) provide preparers with enough implementation guidance so that the standard can be consistently applied with certainty and confidence by the financial statement preparer.

In adhering to these three objectives, SFAS 141 starts off by stating its accounting objective as follows:

OBJECTIVE

This Statement requires that all business combinations be accounted for by applying the acquisition method. A business combination is a transaction or other event in which an acquirer obtains control of one or more businesses (the acquiree). In accordance with the acquisition method, the acquirer measures and recognizes the acquiree, as a whole, and the assets acquired and liabilities assumed at their fair values as of the acquisition date.¹⁴⁷

¹⁴⁶ FASB NO. 141 SUMMARY, *supra* note 137 (“Under Opinion 16, business combinations were accounted for using one of two methods, the pooling-of-interests method (pooling method) or the purchase method. Use of the pooling method was required whenever 12 criteria were met; otherwise, the purchase method was to be used. Because those 12 criteria did not distinguish economically dissimilar transactions, similar business combinations were accounted for using different methods that produced dramatically different financial results.”).

¹⁴⁷ FASB NO. 141 EXPOSURE DRAFT, *supra* note 138, at 1 (defining the objective of the standard).

By stating the standard's objective up front, SFAS 141 clearly defines the scope of the transaction type that comes under its purview. In accordance with the stated objective, all business combinations are now subject to the accounting guidance of SFAS 141. Thus, those business combinations that under the old standard may have qualified for either the purchase or pooling accounting methods depending on the transaction's characteristics will now be subject to the mandates of SFAS 141. Accordingly, SFAS 141 eliminates the need for bright-line tests and rule based exceptions where alternative accounting treatments could be considered.

Indeed, SFAS 141 has no bright-line tests or compliance rules. The goal in drafting the standard without these bright-line tests was to force the financial statement preparer to focus on the accounting standard's objective which is simply to account for all business combinations using the acquisition method. Accordingly, the standard removes the prospect of "financial engineering." The financial statement preparer may no longer consider structuring the transaction to qualify for pooling versus purchase accounting treatment because alternative treatments are no longer available. The focus is now narrowed to purchase accounting treatment only and is applicable and required in all business combinations. Finally, under SFAS 141, there is more than adequate implementation guidance, such that financial statement preparers have sufficient guidance in most scenarios to implement the standard properly.¹⁴⁸

E. IBC and Objectives-Oriented Accounting Standards—Where the Two Fail to Meet

The success of implementing objectives-oriented accounting standards is contingent on financial statement preparers exercising proper judgment. Whereas under the rules-based system, both the preparer and the enforcer used the rule's bright-line tests to determine whether the preparer was compliant, objectives-oriented standards contain no such bright lines. In fact, such bright-line tests are eschewed to prevent the preparer from engaging in the practice of financial engineering.¹⁴⁹

Accordingly, the resulting regime arguably could lead to more abuse rather than less by financial statement preparers due to the wider latitude granted by the process. In sum, the success of objectives-oriented accounting standards is contingent upon financial statement preparers focusing on capturing the economic substance of a transaction rather than

¹⁴⁸ *Id.* (for example, see Appendix A: Implementation Guidance A1-A136).

¹⁴⁹ SEC Section 108(d) Study, *supra* note 129.

on presenting bad financial information in the best light possible. However, given the current compensation and reporting climate, such an assumption is premature at best.

The same temptations that existed under the rules based regime will still exist in an objectives-oriented accounting standard environment. Preparers who are intent on circumnavigating a rule that is contrary to their financial reporting objective will do so regardless of the standard in place. Certainly there are some areas of financial reporting where this is more of a concern than others. For example, SFAS 141 is an accounting standard that “funnels” the preparer into one and only one option when accounting for business combinations which is the purchase method of accounting. But how would a revised standard using the objectives-oriented approach work when dealing with the operating versus capital lease dilemma for example? Removing the bright-line tests set forth in SFAS 13 and leaving the judgment in the hands of the financial statement preparers gives preparers a considerable amount of latitude, and no clear indication as to where the parameters begin and end. The blurred line under an objectives-oriented accounting regime coupled with the ever-present tension that IBC builds into the process may never bring the vision that standard-setters have for objectives-oriented accounting standards into proper focus.

F. *Effective Enforcement as a Counter-Agent*

Proponents of the objectives-oriented approach and the standard-setters themselves suggest that the proper counter-agent in ensuring that objectives-oriented accounting standards are implemented properly are the corporation’s independent accountants and the corporation’s audit committee.¹⁵⁰ In light of the enactment of the Sarbanes-Oxley Act in 2002, proponents of the objectives-oriented approach believe that rigorous enforcement by these two gate-keeping factions will ensure an overall effective implementation of objectives-oriented accounting standards.¹⁵¹

How this dynamic between objectives-oriented accounting standards and rigorous enforcement actually plays out in practice remains to be seen. At this juncture, only historical data can be used to predict future events. And, what that historical data suggests is that even with all the gate-keeping factions through which financial information is vetted, namely internal management, the corporation’s independent auditors, the corporation’s audit

¹⁵⁰ *Id.*

¹⁵¹ *Id.*

committee, and the SEC, accounting fraud has been a prominent fixture of the corporate landscape.

In fairness, the question then becomes whether, in the shadow of the Sarbanes-Oxley Act and the heightened vigilance that stems from that Act, objectives-oriented accounting standards will be successfully implemented. The answer depends on how much of a priority sound financial reporting is, and what those involved in the process are willing to do to achieve this objective.

V. HOW TO APPROACH—WHAT COULD OR SHOULD BE DONE?

Historical data suggests that true and effective implementation of objectives-oriented standard setting may only be achieved when the tension between users and preparers of financial statements is properly addressed. The question that remains, however, is how?

If the true goal of financial reporting is to create an accounting regime that consistently and on a widespread basis creates financial statements that effectively communicate, are representationally faithful, and truly depict the economic substance of their respective corporations, then the overall paradigm that overlays the financial reporting paradigm needs to shift.

A. *The "Stick" Approach versus the "Carrot" Approach*

Currently, the accounting and financial reporting regime is premised on a "stick" approach. The foundational blocks on which the stick approach is built is a model of negative reinforcement. Under the current stick approach, a main motivation for "doing it right" is to avoid punishment or prosecution. Currently, financial preparers are faced with a whole host of civil and criminal penalties depending on the depth, breadth, severity and in some cases the *mens rea* related to an accounting or financial reporting error or irregularity.¹⁵² Accordingly, the primary incentive for getting the financials "right" or more accurately, staying within the confines of GAAP, is to avoid the "stick."

¹⁵² For instance, those that were involved in the Enron accounting scandal received sentences ranging from one year to twenty-four years, depending on their level of involvement and the severity of their transgression. For example, Lea Fastow received a one year sentence for failing to report on her tax return income she received from an Enron side deal, but Jeffrey Skilling received a twenty-four year sentence for various fraud and securities law violations. See Enron Chronicle Special Website, *supra* note 93 (follow hyperlink for "Jeffrey Skilling" in the "Prosecution Scoreboard" section of the page).

B. *The Problems with the "Stick" Approach*

The problem with the stick approach, however, is that it places financial statement preparers and financial statement users at odds. Presently, the preparer's focus is to present the financial statements as favorably as possible. In some cases, this focus results in the preparer engaging in either aggressive accounting tactics which at the very least compromise the financial statement's representational faithfulness, or in the more extreme cases engaging in outright accounting fraud. Under the stick approach, the goal and focus for many financial statement preparers is not on getting the financial statements right, but on not being discovered getting them wrong. This dynamic creates an approach to accounting standard setting that results in financial statements that do not effectively convey a corporation's true economic substance in a way that can be readily understood by the users of such information. Instead, accounting standards such as SFAS 13 are drafted in an attempt to prevent preparers from "engineering" accounting results that are not based upon or focused on their respective corporation's true economic reality.¹⁵³

With the stick approach, preparers have less incentive to report poor financial information accurately. In fact, with the specter of IBC, the executive's incentive is to push the financial reporting envelope as much as possible because of his vested personal interest in what is depicted in those reports. True, the stick approach may catch some in its net. But as discussed above, executives play the probabilities. And the probability of getting caught often seems smaller than the probability that the preparer will suffer immediate and personal financial adversity through the reporting of poor financial information accurately.

Accordingly, the problem with the stick approach is that it requires standard-setters to draft accounting standards from a "defensive" posture in anticipation that preparers will try to push the envelope, or in some cases tear it up altogether. And because of the relatively small enforcement net relative to the over 13,000 publicly held companies that could potentially engage in accounting fraud of one sort or another, a strong argument exists that the stick approach is not the best method to accomplish widespread financial reporting that is focused on "getting it right."

¹⁵³ For example, see discussion on capital versus operating lease in Section III of this paper.

C. *The "Carrot" Approach—A Proposed New Paradigm in the Accounting and Financial Reporting Regime*

1. THE PREMISE IN THEORY

As an alternative to the stick approach, this Article proposes what will be referred to as the "carrot" approach. The idea behind the carrot approach is to create a new set of incentives for those who prepare financial statements. Presently, with the stick approach, the incentives are either do it right or not get caught doing it wrong, and with the overlay of IBC, many financial statement preparers are choosing the route of not getting caught doing it wrong. In contrast, the aim of the carrot approach is to re-align the financial statement preparer's incentives by creating a positive reinforcement mechanism for getting the financial statements right; it is a shift from negative reinforcement—the stick—to positive reinforcement—the carrot.

This paradigm shift ideally would create reverberating effects on the accounting and financial reporting process as well as the accounting standards that define and shape the parameters of that process. First, instead of financial statement preparers spending countless hours figuring out how they can "game" the financial reporting process, the carrot approach would engender the primary focus of presenting accurate financial information, whether good or bad in a manner that is both understandable and is a true and accurate depiction of the corporation's economic position.

Likewise, regarding accounting standard-setting, the carrot approach would relieve standard-setters from the burden of having to draft accounting standards defensively. Presently, accounting standards such as SFAS 13 are drafted in anticipation of preparers trying to account for long-term lease transactions in such a way that presents the financial statements in the best light possible, even if the true economic substance of the transaction is sacrificed as a result. Because of the preparer's motivations behind financial statement manipulation, the standard-setters are forced into the compromise of bright-line tests that, at the very least, draw a line in the accounting sand that indicates where the far end of the boundary lies.¹⁵⁴ With the financial statement preparer's incentives realigned to match the goals of the standard-setters, the need for such defensive drafting would be alleviated.

¹⁵⁴ See, e.g., FASB No. 13, *supra* note 49, ¶ 7 at 8.

2. WHAT POSSIBLE “CARROT” APPROACHES EXIST?

The question then is what forms might a carrot based approach take? Simply removing IBC as a component of executive compensation may create the desired result of alleviating the tension on the financial reporting process. With the prospect of the financial statement preparer having no personal stake in the outcome, at least not one tied to compensation, the preoccupation with the actual results and presenting those results in the best light possible are removed.

Though this idea does have its merits, not the least of which being its simplicity, it is doubtful whether simply removing IBC would take away the tension. Even if incentives were not part of an executive compensation structure, an executive’s fortunes would likely still be tied to the company’s performance as depicted in the financial statements. Accordingly, even if IBC based on financial performance were removed from the equation, executives would still feel the pressure of presenting the financial information in as favorable a light as possible and the pressures and temptations to be aggressive or fraudulent would still exist.

IBC creates incentives for executives to engage in aggressive accounting tactics or outright accounting fraud. An alternative this Article considers is making a portion of an executive’s compensation contingent upon the extent to which financial reports are clear, user friendly, and give a fair depiction of the company’s financial position. In other words, use IBC to reward executives based on the *accuracy* of financial reports. By incentivizing financial statement accuracy instead of financial statement performance, you remove the emphasis placed on performance and you redirect that emphasis appropriately toward accuracy. Thus, the incentive to engage in aggressive or fraudulent accounting tactics is lessened and the incentive for accurate financial reporting is enhanced.

D. How Would Incentivizing Accurate Financial Reporting Work in Practice?

Under this incentivizing approach, in lieu of granting stock options, a portion of an executive’s compensation would be based on “accurate” financial reporting. The percentage would be a fluid one depending on the circumstances, but the amount should be significant enough to motivate the executive into giving the exercise appropriate attention and care towards “getting the numbers right.” 20 to 25% of an executive’s total compensation would seem appropriate.

The next question asks who will bear the costs of this incentivized approach. One of the lures of stock option grants is that the compensation

does not come from a direct draw on the corporation's assets but through the realization of shares that have increased in value. If executives are compensated for accurate financial reporting, this is something that would come directly from corporate coffers instead of the market. Although this may be met with resistance, the question then becomes what value do we place on accurate financial reporting. We can take a short look back in history to see the price shareholders have paid as a result of deceptive accounting. In hindsight, what would those shareholders have been willing to pay had they known that Enron, WorldCom, or Tyco were in dire financial straits? How much money might many of these shareholders have saved if they had known sooner rather than later that these corporation's financial situations were other than what was being depicted in their financial statements? The point here is to pay a little more now instead of potentially paying much more later through failing to act due to misinformation.

1. WHAT IS "ACCURATE" FINANCIAL REPORTING?

Accounting, in many instances, is just as much art as it is science, where for any number of transactions, there can be more than one accounting approach that would be considered acceptable and in compliance with GAAP. Accordingly, this notion of "accuracy" is a moving target. What is contemplated and hoped for by this carrot proposal is not 100% accuracy in financial reporting, but rather an approach that changes management's mindset when it comes to financial statement preparing and reporting. A premise of objectives-oriented accounting standards is that it requires that financial statement preparers focus on reporting the "economic substance" of a transaction rather than mere compliance with bright-line tests of form which were commonplace under the rules-based regime. Further, it should be appreciated that objectives-oriented accounting standards do provide extensive implementation guidance. Accordingly, the preparer will have a sufficient road-map to follow when accounting for a transaction while at the same time remaining within the confines of GAAP. Incentivizing accurate financial reporting attempts to direct the preparer's focus to work within those boundaries and capture the economic substance of a transaction (whether good or bad), instead of focusing on circumnavigating the standard altogether. The implementation guidance within these standards will let the preparer know whether he is accounting for a transaction within boundaries and therefore is capturing the economic substance of a transaction. So when we are talking about accuracy, we are talking about working effectively within the confines of these objective-oriented standards and recording transactions in such a manner that they are a fair reflection of that transaction's economic substance.

2. HOW WOULD RESULTS BE QUANTIFIED? WHO WOULD MAKE THE DETERMINATION?

This carrot proposal would not be one mandated by law. Any means other than voluntary compliance would, for obvious reasons, be an invasive encroachment on a corporation's autonomous decisions regarding employee compensation. Accordingly, practical implementation of such a proposal would require cooperative buy-in from a number of constituencies, chiefly the company's board of directors, the faction responsible for setting executive compensation.

The board of directors would also be responsible for determining whether the executives adhered to the tenants of sound financial reporting and whether they successfully captured the economic substance of the financial position of their respective corporations clearly and coherently. Latitude would be given as to how exactly this determination would be made. But what is contemplated is that the board's audit committee will work in conjunction with the corporation's independent auditors to assess the quality of management's financial representations as a whole. The auditors would determine whether there are areas where management is taking an aggressive position as to certain transactions and whether that position is one that lends more to economic truth or obfuscated distortion. To the extent management adhered to these tenants would be the extent to which they would receive the "financial reporting" portion of their compensation. With the auditors, management, and the board presumably on the same side of the reporting fence with the same objective in mind (economically true financial reporting), the fears of accounting fraud and that such fraud would be missed by the auditors is of less concern.

E. Anticipated Opposition to This Approach

This proposed change in approach goes against the grain of what has been customary in accounting and financial reporting practices. But what it comes down to is the priority of sound financial reporting. Several objections exist

1. The first reaction to this proposed approach of paying for accuracy is that it de-emphasizes performance and instead merely focuses on accuracy. This criticism would be akin to saying, "we don't care if you lose the game, as long as you get the score right." In a system where performance and results ultimately are the bottom line, it would seem that rewarding executives for quality financial reporting would be rewarding them for that which should already be a standard component of their job. While this criticism may be valid, one must remain focused on the ultimate goal and

the means for achieving it. If the goal truly is a better, more accurate, user friendly, accounting and financial reporting regime where fraud is less prevalent, then those who preside over and are involved in the process need to take innovative approaches to achieve those goals.

Another way of looking at this criticism is from a criminal law analogy. In other words, isn't paying executives not to commit financial fraud akin to paying one who would otherwise rob a convenience store not to rob it? In essence, good behavior is being extorted. But these two behaviors can be distinguished by highlighting several major differences. In the case of the individual who would otherwise rob the convenience store, the impact of his actions is localized. The store owner suffers the harm of having his store robbed. There may be some collateral harm to those customers that frequent the store. The store owner may have to charge higher prices for added security perhaps and to offset the cost of theft. But even in this situation, the impact is relatively constrained.

In contrast, the actions of a team of executives who preside over a publicly held corporation that literally can have billions of outstanding shares held by millions of shareholders, impacts considerably more people.¹⁵⁵ Money for retirement, pensions, and college funds are all tied up in these shares. In these instances when the dark specter of accounting fraud finally comes to light, the impact can be widespread and devastating. Because of the higher stakes involved and the potentially far reaching effects, progressive and unconventional approaches may be necessary. Accordingly, creating the incentive for quality financial reporting may be a way to achieve this objective.

2. Another objection to this proposed change is that a changed emphasis from performance to accuracy will cause corporate performance to suffer. Initially, the purpose behind IBC was to align executives' interests with shareholders. Given our corporate climate, it is not a stretch to conclude that moves away from actions that seemingly de-emphasize performance will be met with resistance. What incentives do executives have to perform if their incentives are removed?

This question can be answered by analyzing whether stock options truly provide the incentives they were designed to create. As has been discussed above, many assumptions rooted in stock options as a form of compensation are flawed. The major assumption being that managers will carry out the accounting and financial reporting function with the utmost integrity and focus on quality regardless of whether that news is good or bad, and

¹⁵⁵ Home Depot, for example, had 2,117,846,411 shares of common stock outstanding as of March 28, 2006. HD PROXY STATEMENT 2006, *supra* note 7, at 1.

regardless of whether such actions may have an adverse impact on their personal fortunes. These assumptions are flawed because they fail to consider *all* the variables that go into human decision-making and how that human “decision-tree” may branch in different directions, depending on myriad of variables that could never be captured in an IBC model through the use of stock options.

3. Admittedly, paying executives for accurate financial reporting is still a form of IBC, however there is a great difference between incentivizing accuracy instead of performance. Incentivizing an executive based on corporate performance is more of a “wild card” because many variables go into a corporation’s ultimate performance, some of which are under the executive’s control and some of which are not. Incentivizing an executive based on financial reporting on the other hand is more of a closed-ended proposition, because the executive can hit the mark every time merely through vigilant financial reporting. Accordingly, the pressures that exist in the corporate performance arena, particularly when the corporation is not performing, will never exist for accurate financial reporting. Accurate financial reporting will always be under the executive’s control. The numbers will always have a “right” answer. The incentive will simply be based on reporting those results accurately, whatever they happen to be.

4. Another concern is what mechanisms will insure and maintain performance. Under the ideal scenario, executive performance *and* financial statement integrity co-exist in relative harmony. Achieving this perfect alliance requires delving into what motivates managers and executives to perform well. Is it merely the prospect of compensation or additional compensation through incentive payments that causes executives to raise the level of their performance, or are there other more effective means by which this can be done?

The answer is that the incentive to perform well will always be built into any employer-employee relationship because one who does not perform well will ultimately lose his job. This applies to all positions throughout an organization, including the CEO. Incentivizing performance through the use of stock options merely creates another variable that often diverts executives from focusing on actual results to focusing on accounting results instead.

Accordingly, there may always be some incentive for preparers to present financial information in the best possible light, even if the specter of stock options is removed from the equation. An executive’s performance will always be judged in part based on the corporation’s financial performance. What is hoped for and anticipated is that incentivizing accurate financial reporting will have a counteractive effect on aggressive accounting tactics or accounting fraud sufficient enough to stifle such

practices. The bottom line is executives who are not performing, will, at some point, be forced out. Removing stock options ideally takes away some of the motivation for misrepresenting financial information; likewise, incentivizing accurate financial reporting ideally turns the dial in the other direction.

F. The Public Accountants—Isn't Keeping Financial Statement Preparers in Line the Auditor's Job?

As a final variable to this equation, we should look at the public accountants and their responsibility as auditors of publicly held companies. Independent auditors serve an important role in the financial reporting process. In theory, they act as the "first line of defense" in insuring the integrity of the financial reporting process. They perform this task by auditing the financial statements of publicly held companies and then expressing an opinion as to whether those financial statements "present fairly in all material respects the financial condition and results of operations" of the company they have been tasked to audit.¹⁵⁶

Scholarly Articles have been written on the public accountant's role in the financial reporting process and its effectiveness in insuring financial statement integrity.¹⁵⁷ But the public's perception of an accountant's role and what an accountant actually does are quite different. The public's perceptions as to what occurs with a financial statement audit is that scrutinizing, highly trained accounting professionals descend on a company, vet every transaction through their discerning lens, and insure that the financial statements are 100% accurate. But if this is indeed what happens, then why are accounting fraud and securities law violations still so prevalent? On any given day, the public hears reports about yet another CEO or CFO being charged with or settling charges related to accounting or financial fraud.¹⁵⁸ The answer to this comes in appreciating the difference between

¹⁵⁶ For example, Home Depot's 2005 Annual Report included its Form 10-K, where the auditors (here, the firm of KPMG) express an opinion as to whether Home Depot's financial statements present fairly, in all material respects, the financial position of the corporation. See HD 2005 ANNUAL REPORT, *supra* note 6, at 34.

¹⁵⁷ See, e.g., Gregory L. Paul, *Not Biting the Hand that Feeds You: Public Accounting Firms and Conflicts of Interest*, 34 GOLDEN GATE U. L. REV. 325 (2004).

¹⁵⁸ See, e.g., *Three Former Gas Distributor Execs Sued by SEC Over Earnings, Revenue*, 39 SEC. REG. & L. REP. (BNA) 1262, Aug. 13, 2007, available at <http://pubs.ban.com/ip/bna/SRLR.NSF/eh/a0b4z6j4u0> ("The Securities and Exchange Commission sued three former senior officers of Nicor Inc. Aug. 9 in the U.S. District Court for the Northern District of Illinois, saying they engaged in or approved actions at the company that resulted in the false appearance that the concern had met earnings goals and increased corporate revenues (*SEC v. Fisher*, 8/9/07 N.D. Ill., 07-C-4483).").

what is perceived to be occurring in financial statement audits and what actually occurs.

1. THE "BUSINESS" OF FINANCIAL STATEMENT AUDITING

Over time, the practice of public accounting and the methods and manner by which accountants completed the important task of financial statement audits have changed. In the early years, the practice of public accounting was considered a profession that was highly revered, and those who chose to be a part of the profession carried the torch with reverence and a focus on adhering to the highest levels of professional and ethical standards when engaging in financial statement audits.¹⁵⁹ Time and cost considerations in completing the audits were secondary to the all important task of making sure the audit was performed with a high level of healthy skepticism and the appropriate depth and breadth of coverage to insure financial statement integrity. Further, the relationship between the auditor and the corporation being audited was not, in most cases, adversarial but was at a sufficient arms-length such that the auditor's objectivity and professional skepticism were not compromised.

The pressures of the marketplace, however, began chipping away at the walls that previously insulated public accounting from the market pressures affecting other facets of the economy. Specifically, the rise of envy caused the once noble and selfless public accounting professional to ask the question, "what about me?" The business consultant changed the public auditor's role and prestige.¹⁶⁰ Whereas the auditor was a necessary evil of sorts, something the corporation was forced to tolerate because financial statement audits were mandated by the securities laws, the consultants were seen as "white knights" who rode in with their laptops and spreadsheets and, with their savvy business advice and expertise, advised companies on how to stream-line their business processes, cut costs, and maximize profits. Because of the value added nature of the services these consultants provided, they were able to command superior fees to those of the auditors. Meanwhile the auditors were relegated to the backroom to pore over reams of financial data for the mere purpose of attesting to their accuracy.

This dynamic inevitably caused auditors to shift the practice of public accounting from profession to business.¹⁶¹ Public accountants, believing their expertise and business acumen to be on par if not superior to their

¹⁵⁹ Ianthe Jeanne Dugan, *No Taste for Accounting*, WALL ST. J. May 1, 2002, at 20, available at http://wsjclassroomedition.com/archive/02may/CARE_accounting.htm.

¹⁶⁰ *Id.*

¹⁶¹ *Id.*

consulting counterparts, began engaging in the practice of consulting as well.¹⁶² Accordingly, with this added dimension of consulting and the corresponding riches and notoriety that came with it, the auditor's once sole focus on performing the audit and performing it properly became diluted. Further, the role that the audit function played in the overall relationship between the auditor and the corporation evolved as well. The audit function became a mere commodity for both the corporation and the auditor alike. All public companies needed one, and all public accountants could perform one. The public accountants who performed audits for the large public accounting firms coalesced into what was then eight major accounting firms, in the 1970s to the late 1980s,¹⁶³ which further merged into the "Big Six" from 1989-1998,¹⁶⁴ and are now presently the "Big Four."¹⁶⁵

2. THE EFFECT ON AUDIT QUALITY

Instead of public accountants differentiating themselves on the quality of their audits, the depth and breadth of their account testing, the level of training, and professional expertise of their associates, price became the big delineator.¹⁶⁶ Each firm competed to see who could perform the audit in the least amount of time for the least expense. The firms that excelled at accomplishing this goal would garner the business. As a result, the audit function merely played the role of "loss leader" for the public accountants.¹⁶⁷

¹⁶² *Id.*

¹⁶³ See generally Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before it Unravels*, 106 COLUM. L. REV. 1698 (2006). The eight major accounting firms during the '70's and late '80's were Arthur Andersen, Arthur Young & Company, Coopers & Lybrand, Ernst & Whinney (formerly Ernst & Ernst), Haskins & Sells (merged with the European firm Deloitte Plender Griffiths to become Deloitte, Haskins' and Sells), KPMG (formed by merger of Peat Marwick International and KMG Group), Price Waterhouse, and Touche Ross. *Id.* at 1700.

¹⁶⁴ See *id.* Competition among these public accounting firms intensified and the Big 8 became the Big 6 in 1989 when Ernst & Whinney merged with Arthur Young to form Ernst & Young in June, and Deloitte, Haskins & Sells merged with Touche Ross to form Deloitte & Touche in August. *Id.* at 1701-04.

¹⁶⁵ See *id.* Presently, the "Big Four" consist of PricewaterhouseCoopers, KPMG, Ernst & Young, and Deloitte and Touche.

¹⁶⁶ James L Craig, Jr., *The Business of Public Accounting*, CPA J. (Aug. 1994), <http://www.nysscpa.org/cpajournal/old/15702999.htm>. In the article, accounting professionals discuss the bidding process for audit engagements:

Let's assume we all want the diamond client. We can't compete with Neil on knowledge, so we bid the \$23,000. But suppose it is for a client in an industry with which we are all familiar. If we all bid \$23,000 that is what the client will pay. But if we all bid \$35,000, that is what the fee will be. We beat ourselves up. Why do we do it?"

Id.

¹⁶⁷ *Id.* The bidding process used by accounting professionals can be described as follows:

The public accountants would lowball the audit bid and perform the audit for only a marginal profit—at a break-even point or even a loss—to get the business with the hope and expectation being that once they got their foot in the door, they would be able to sell additional consulting business that would be more lucrative.¹⁶⁸ The effect that this dynamic had on the method by which public accountants performed their audits was detrimental. In sum, the auditor's focus, as it related to the audit function, shifted from "getting it right" to "getting it done." Accordingly, auditors began to devise ways by which they could justify shrinking the scope of their testing and account balance verification protocols by doing things such as "risk assessment analysis," a process by which an auditor limits or extends the amount of effort involved in verifying an account balance based on the determined risk that the account in question may be misstated.¹⁶⁹ As a result of these risk assessment analysis, it is not uncommon for an auditor to test less than 5% or smaller percentages of a given account and conclude that the account is fairly stated. With these dynamics and factors playing into the audit process, it is easier to see how companies can achieve certain accounting results regardless of the actual financial results while circumnavigating the auditors in the process. As one accounting professional noted, "A good crook can fool a good auditor every day of the week."¹⁷⁰

Some would argue that newly enacted provisions contained in the Sarbanes-Oxley Act that now prohibit public accountants from acting in the dual role as accountants and consultants will prevent these breakdowns in the gate-keeping function that in part allowed accounting indiscretions such as those perpetrated by Enron and WorldCom to persist undetected.¹⁷¹ In the short run, prohibiting auditors from providing consulting services in addition to performing the audit is a positive step in improving financial

We as a profession have to find a way to make the audit more valuable. We have made the audit a loss leader to get access to a client. What would happen if we said to clients, we will do an audit, but we won't do consulting? The idea of knowing the client from having done the audit, and being in a better position to do the consulting is not relevant today . . .

Id.

¹⁶⁸ *Id.*

¹⁶⁹ HERWITZ & BARRETT, *supra* note 110, at 229. As noted in the text, the extent to which the auditors will actually look at supporting documentation to verify an account balance is based on their risk assessment and the extent to which they deem that company's internal controls to be reliable. *Id.*

¹⁷⁰ Craig, *supra* note 166.

¹⁷¹ For example, Section 201 of the Sarbanes-Oxley Act expressly prohibits nine types of "non-audit" services in which public accountants regularly engaged prior to the Act's enactment. Those activities are: (1) bookkeeping services; (2) financial information systems design; (3) appraisal or valuation services; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the (Public Company Accounting Oversight Board) determines to be impermissible. 15 U.S.C. § 78j-1(g) (2006).

statement integrity. But healthy skepticism should remain about the overall effectiveness that an audit has in insuring that the financial statements are stated fairly "in all material respects." Presently, audits still remain more of a perceived check on financial statement integrity rather than an actual one. The accounting profession is still one that has evolved into and remains a business rather than a profession. Accordingly, the price pressures and the commodity-like nature of the audit function still remain and therefore the focus of "get it done" versus "get it right" remains as well.

VI. CONCLUSION

For years, accounting standard-setters have been waging the battle against financial fraud and obfuscated and distorted financial reporting. This Article looks at one dynamic that is integral to improving this process. Specifically, IBC that rewards on the basis of financial performance is entrenched in our corporate culture and the probability of removing it may be considered remote. In many cases, IBC based on financial performance creates the incentive to distort, obfuscate, or in many cases, commit financial accounting fraud. Accordingly, this Article provides a new perspective to a chronic and systemic problem of distorted financial reporting. The suggested approach is to incentivize financial statement accuracy rather than financial statement performance. Such a modification would remove the tension in the reporting process and put all those involved on the same side of the fence and working toward the same goal. While some may consider what is being proposed here as drastic or untenable, the question must be asked: what is the goal and what are those involved in the process willing to do to get there? Trying to implement an accounting regime that is supposed to be simplified, more user friendly, and permeated with objectives-oriented accounting standards, can only be achieved by changing the focus of those involved with the process. This Article proposes a novel solution to implement these goals. Until priorities for executives are switched, the tensions that exist now will remain, and the likelihood of achieving the lofty goals being set by the standard-setters will remain just that.

