The "Carrot" Approach to Accounting Standard Setting

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# THE “CARROT” APPROACH TO ACCOUNTING STANDARD SETTING

**Neal Newman**

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INTRODUCTION

In a statement made December 7, 2006, Conrad Hewitt, the chief accountant at the Securities and Exchange Commission (SEC) said that the issue of complexity in accounting will be addressed by the agency early in the new year and will be a leading topic of work by his office in 2007. The goal in financial reporting is to disseminate transparent, understandable, financial information that fairly presents the financial condition of the reporting company. Often times, however, the information disseminated by public companies is overly complex, quagmired in legalistic form at the expense of true economic substance, and is devoid of conveying true, meaningful and understandable information regarding the company.
The SEC in conjunction with the Financial Accounting Standards Board (FASB) is making yet another attempt to remedy this problem by exploring ways to simplify the fragmented and complex accounting regime under which we are currently operating.4 The goal of this paper is to highlight one aspect of this process that, if not properly addressed, will make this endeavor of a more simplified accounting regime more of an aspiration rather than an achievable goal. The aspect in question is management’s role in the accounting and reporting process.

Corporate management is the faction that is primarily responsible for the financial reporting of their respective companies.5 This dynamic, at times, can put the interests of those who prepare financial statements at odds with the users of such information. The conflict in question stems from the manner by which many high level executives are compensated. With many corporate executives, a significant portion of their compensation is incentive-based; meaning that some portion of their compensation is in some way tied to the financial performance of the company by whom they are employed.6 For example, a corporate manager’s bonuses, stock options, or even continued employment, may be tied to a company’s reported financial performance.7

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.8 This article contends that it is these types of conflicts that 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. Because presently, managers, due to the trappings of IBC, have the incentive to engage in either aggressive accounting tactics that compromise financial statement integrity, or they engage in outright accounting fraud. Consequently, accounting standard setters are forced to draft standards “defensively” in anticipation 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 in the matter. This paper 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 somehow alleviated. The goal of this piece is to explore this dynamic and suggest how this tension may be addressed. This paper’s organization is as follows: Section II sets the backdrop by explaining the link between IBC and financial reporting. Section III then explains 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 this undertaking difficult. Finally, Section V proposes some solutions to the problem of IBC and its adverse affects on accounting standards, the gist of which is to realign management’s incentives with accurate financial reporting.

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

This section highlights the fundamental tension between prepares and users of financial information and illustrates how this tension adversely affects the financial reporting process.
A. The Link Between Financial Statements, Executives, and Shareholders—Some Context

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,” namely the corporation’s employees, includes, among others, its executive officers such as the chief executive officer, the chief financial officer, and the chief operating officer. And the second faction, the “external faction”, is comprised of the corporation’s shareholders. Internally, each corporation has its employees; those that 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 each employee is individually and collectively due to their affiliation with a profitable and stable company.

Regarding the external faction, their stake in the corporation in part is premised upon how that corporation is perceived by the market.11 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, then that 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.12 Having laid the foundation, the focus then is to appreciate how IBC is tied into this equation and, more pointedly, to demonstrate 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 bench-mark or pre-determined performance level. The bench-marks in question can take on a myriad of 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. But the most common forms are the following:

**Stock Options**—Stock options are an incentive-based form of compensation designed to link an employee’s individual fortunes to the corporation’s stock price. 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. 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 have risen between the grant date and the exercise date, then the employee is rewarded monetarily by the increased value in the stock.

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. 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 increase the corporation’s stock price, the value of the shares increase, and the employee is rewarded accordingly.\textsuperscript{18}

**Profit Sharing**—Another incentive-based form of compensation is profit sharing. Profit sharing is more straightforward than the stock option plan. With a profit sharing plan, the corporate manager or executive shares in the corporation’s profits (or more accurately stated, its reported profits).\textsuperscript{19} For example the executive may receive a base salary plus a percentage of the corporation’s reported income.

**Bonus Based**—Finally, the executive may simply receive a bonus tied to some benchmark which 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**

In each of the compensation structures mentioned above, the recurring theme is that all of these forms are tied to the company’s 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 this paradigm which over time have proven to be flawed. Here, the flawed assumption is
that corporate executives and managers will act ethically and honestly when trying to achieve these benchmarks. In those situations where 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 been awarded faces the prospect that he may not earn that bonus this year? What might a CEO do when a third consecutive quarter of stagnant or declining earnings may mean him losing not only his bonus, but possible termination from his present employer?

These hypothetical “what ifs” illustrate the dynamic that has proven to be problematic in a myriad of situations. 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 two less than desirable alternatives: either (1) report poor financial results accurately and face the consequences that may stem from such news; or (2) either engage in aggressive accounting tactics that may distort the corporation’s true economic performance, or misstate the financial results and hope that the misstatements are never discovered.

What IBC unwittingly does in many situations is create a dynamic of “discordant incentives.” 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 them personally.\textsuperscript{21} 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.

\textbf{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 our corporations produce financial statements that fairly present the financial position of their respective companies.\textsuperscript{22} For example, all publicly held companies are required to file quarterly and annual financial reports with the SEC.\textsuperscript{23} Each report must include financial information that is audited by an independent certified public accountant.\textsuperscript{24} Our current accounting regime has an accounting pronouncement, bulletin, or standard for any accounting issue imaginable.\textsuperscript{25} The FASB has at last count, enshrined Generally Accepted Accounting Principles (GAAP) into three volumes comprising some 4,530 pages. Some of the FASB rules run to over 700 pages on how to book a single transaction.\textsuperscript{26} The Sarbanes-Oxley Act was passed in 2002, which, among other things, requires CEO’s and CFO’s 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.”\textsuperscript{27}
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, although are technically compliant, nonetheless distort a corporation’s true economic picture. Or worse, they are choosing to engage in accounting fraud in spite of the well-publicized risks of doing so.

Naturally, this begs the question as to why managers and executives are choosing 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 1990’s, however, that this argument, although sound in theory, was wrong in practice. “CEOs manipulated their companies’ earnings, paid themselves huge amounts of options, and established cozy relationships with their accountants and securities analysts, but they did not acquire bad reputations—at least not until several years later.” 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 is faced with the prospect of what to do with less than favorable results, the two possible alternatives are either (1) report the information accurately; or (2) employ aggressive accounting tactics or engage in outright accounting fraud.

When the executives choose the second alternative, they are taking a calculated risk. They make a risk-reward assessment and conclude 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 these executives actually perform 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 (1)—Accurate Financial Reporting

Executives immediately experience the personal financial consequences of reporting less than favorable financial results in an IBC environment. For example, if the corporation has implemented a profit sharing, bonus, or stock option compensation model, reporting less than favorable financial results reduces the executive’s compensation. With the profit sharing or bonus compensation models, the executive may not be entitled to the profit sharing or bonus part of his compensation if those pre-determined benchmarks are not met. Likewise, under a scenario where the 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 her compensation but also her 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 view that is clouded by myopia, any “blips” on the financial radar screen creates a wave of urgency through that organization with the CEO and her 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. Often times this mandate is given without regard to the means by which this is done as long as the end objective is met.\textsuperscript{31}

2. Choosing Alternative (2)—Employ Aggressive Accounting Tactics or Engaging in Outright Accounting Fraud

Alternative (2) actually involves two possible courses of conduct where the executives can employ either 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 (2) 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 requiring the executive to return any profits made from ill-gotten gains, to considerable jail time.\textsuperscript{32} 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 (2). Why might this be? There has been a myriad of studies that explore the impact of performance-based compensation on misreporting.\textsuperscript{33} Many of the studies in this area 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”. In sum, the study found that the likelihood of corporate misreporting was higher in those instances where a significant portion of the CEO’s compensation was in the form of stock options. 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. The study found that in the years where the firms were required to restate their earnings, on average, 60% of the CEO’s compensation was in the form of stock options. In those instances where no restatements were required, on average, only 46% of the CEO’s compensation was in the form of stock options. The inference suggested by the study being that 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 didn’t say, however, was the motivation behind the CEO’s actions and why they were willing to take such risks in the first place. 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 paper; but merely one of the variables to be considered in the process.

Going back to the question as to why executives seem willing to take the risk of engaging in accounting fraud or reporting financial information accurately, the answer seems to be in the probability of the consequences as between the two alternatives. When a corporate executive chooses to report less than favorable financial information accurately, as discussed above, 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 potential consequences are not a certainty at all. 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 corporations who are regulated by the SEC, which has approximately 3,100 employees. An even smaller number of SEC employees have the task of oversight and regulation of these publicly held companies. 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 less than favorable 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 following discussion delineates the distinction between the practice of employing aggressive accounting tactics versus committing accounting fraud. The two
practices are similar in terms of a manager’s motivation behind employing one or the other; that motivation being to paint their 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 perpetrator if they happen to get caught.

a. Aggressive Accounting Tactics

Aggressive accounting tactics involves engaging in accounting practices that push up against the confines of Generally Accepted Accounting Principles (GAAP). It is important to note that engaging in aggressive accounting 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 will not be on preparing user friendly, clear and materially correct financial statements. Instead, the manager will be focused on being 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 will seek to employ; the end result? Instead of accounting standards that are drafted and designed to provide users of that information with clear, and accurate financial statements that convey meaningful information and give a true depiction of that
corporation’s economic picture, 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 economic position. The executive’s vested personal interest is based on what is purported in those financial statements. Accordingly, that executive’s focus may be diverted from getting the financials “right” to merely keeping them compliant with GAAP while trying to paint his 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**

Similarly, fraudulent accounting tactics is the same idea but taken to the extreme. 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. 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 AFFECT ON ACCOUNTING STANDARDS**

The current accounting and regulatory regime is fragmented, complicated, and extremely costly both with which to comply and through which to navigate. This article contends that the root cause of these phenomena is what will be referred to as the “stick-based” approach that accounting standard setters have either been forced to take or
have chosen to take either due to expediency or belief that such an approach is the most effective means by which to enforce accounting standards.

Instead of accounting rules and guidance that are designed to create a system where the goals and objectives are to present financial statements that are complete, accurate, and fairly represent the financial position of their respective companies, the current regime under which we are currently operating is designed to “reign in” corporate managers who will be as aggressive as possible in those areas of the financial reporting regime that will serve their personal interests such as revenue recognition, assets and inventory valuations and will down play those areas where full and fair disclosure may be adverse to the corporate manager; namely, areas such as expenses, liability and debt obligations. In essence, the current situation is one where, an inherent tension is created in the financial reporting process where the corporate manager will be as aggressive as possible where it’s 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, the corporate manager’s approach to financial reporting is “how aggressive can I be without running afoul of the GAAP regime within which I must operate.” Under this approach, the goal of the executive is not fair and accurate reporting that effectively presents the true economic substance of that corporation, but instead is one of mere technical compliance where the executive tries to be 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, where executives take an aggressive position with an accounting matter that is technically correct but substantively may be 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 mouse-trap, and then management merely counters by making a better mouse. And so this “move//counter-move” between the two factions continues until we find ourselves presently with the currently quagmired, expensive, and complicated accounting regime with which all publicly held companies must contend.

Some examples will illustrate the point.

**A. Accounting for Leases—Operating versus Capital**

One of the potential “Big Ticket” items on a corporation’s balance sheet are expenditures related to the procurement of property, plant, or equipment. These particular items will be used by their respective corporations for considerable periods of time ranging from 5 to 45 years. The cash outlay related to these assets can be considerable. Instead of purchasing these items outright, corporations will typically lease these items 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. The decision between one or the other 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. This election further affects many key financial ratios that analysts use to determine the financial health of the corporation in question. Alternatively, if the transaction is an
operating lease, the corporation need only to expense the lease payments in the period in which those expenses were incurred, with no long-term debt obligation reflected on its balance sheet. The lower the reported debt obligation, the better is 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 that is available, which is contingent upon 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 self-interest of corporate executives and accounting-standard setters creates a conflict. On one side are the corporations and their executive officers that 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. And on the other side are the accounting-standard setters who are pushing for more rigid and onerous standards to capture the “economic substance” of the transaction in question. What resulted from this conflict is Statement of Financial Accounting Standards No. 13 (SFAS 13). SFAS 13 was designed to deal with the competing tensions between the financial statement preparers and the accounting standard-setters. Because of the continual desire by preparers to stretch the parameters within which operating lease accounting treatment can be used, standard-setters were forced to draw lines in the sand that set the outer-boundary within which operating lease accounting treatment would be appropriate. Those lines in the sand resulted in the following four bright-line tests.
Under SFAS 13, a corporation could not employ the more favored operating lease accounting treatment if any one of the following was a facet of the lease transaction:

I. Ownership transferred from the lessor to the lessee at the end of the lease term.\(^{52}\)

II. The lease contained a bargain purchase option.\(^{53}\)

III. The lease term was equal to 75% or more of the estimated economic life of the asset.\(^{54}\)

IV. The present value of the minimum lease payments was equal to 90% of the property’s fair market value.\(^{55}\)

Any one of these criteria trigger capital lease accounting treatment and “colors” the economic substance of the transaction to one where the corporation is deemed to be purchasing the asset outright and therefore required to reflect that economic reality in the accounting for the transaction. Accordingly, the key for financial statement preparers is to structure their long terms 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 in spite of the fact that they may nonetheless be compliant with the governing accounting standard; take the following lease transactions entered into by company A and Company B, respectively.

**Company A:** Company A leases a building where 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. Finally, the lease transaction will not transfer ownership at termination of the lease term, nor does the lease contain a bargain purchase option.
**Company B:** Company B leases a building where 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 termination of the lease term, nor does the lease contain a bargain purchase option.

Comparing these two transactions, in essence, there is 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 1% difference between the two. Likewise, the present value of the lease payments differ by only one percentage point. And neither transaction will transfer ownership or contains 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.\(^{56}\)

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.\(^{57}\) 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 that 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.\(^{58}\)
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 will be deemed to have purchased the item.\(^59\) 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.\(^60\)

This discussion illustrates how a rules-based approach to accounting standard setting can result in very different accounting treatment for transactions that have minute differences in their characteristics. Also, this exercise illustrates how a rules-based approach to accounting standard setting can move financial reporting further and further away from the economic substance of a transaction and can therefore lead to a distorted financial picture in spite of the fact that the corporation has adhered to and complied with the bright-line tests of form then in effect. However, and in defense of the standard-setters that draft such standards, 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 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.

\[B. \textit{Accounting Fraud —the Story at Enron}\]
At the further end of the spectrum is accounting fraud. With accounting fraud, the specter of IBC still drives executives to present the 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 accounting results needed or desired by management to achieve the financial benchmarks they are striving to achieve. For example, creating fictitious revenue can have a more significant financial statement impact than structuring a lease transaction as an operating lease versus a capital lease.

Likewise, however, getting caught engaging in accounting fraud comes with a much higher price to the perpetrators. 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 will help to illustrate.

Enron’s is a story that has been chronicled from many different perspectives, with various aspects of its meteoric rise and fall dissected and analyzed in great detail. 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 the resulting changes the accounting standard setters made 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 their creative use—or more accurately its abuse—of a financing vehicle referred to as a Special Purpose Entity (SPE). This creative type of investment vehicle 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.\textsuperscript{63} 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. \textit{What is a SPE?}

Though SPEs are considered to be complex and complicated entities, the general
premise of a special purpose entity is simple: an SPE is an entity formed for a discreet
and isolated purpose; to adhere to a specific business or economic objective; a simple
premise or starting off point from which the concept builds. In essence, SPEs are formed
when a company creates a legal entity that is separate and distinct from its core operation,
for the purpose of that entity staging a discreet and isolated business venture, operation,
or function.\textsuperscript{64} SPEs narrow the scope of risk to the assets and liabilities placed in it such
that potential investor’s or equity holder’s fortunes will be based exclusively on what
occurs with the assets and liabilities placed within the SPE.\textsuperscript{65}

2. \textit{How Enron Abused the SPE Structure}

Through Enron’s use of SPEs, Enron created revenue where there was none and
reported that their 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).\textsuperscript{66} There are legitimate uses for the SPE which have
common and non controversial uses in our economy. The securitization of accounts
receivable is the most common.\textsuperscript{67} 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.

3. The Dark Comes to Light

Enron filed for bankruptcy on December 2, 2001. Once the investigations into their financial statement engineering commenced, it was then that the full breadth and depth of their fraudulent accounting misdeeds came to light. It was discovered that Enron used several different types of “accounting techniques” to manipulate its financial statements, and one of those techniques involved the manipulation of the SPE in connection with FAS 140. Ordinarily FAS 140 transactions comply with Financial Accounting Standard 140, which sets forth the accounting guidelines related to asset transfers in connection with structured financings. 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. This 36% of Enron’s reported earnings in the year 2000 was not actual money generated through its operations, but funds “engineered” via the use of the FAS 140 SPE transactions.

4. How it was Done

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

Enron, in addition to its core operations, held a number of otherwise illiquid assets that it used in connection with these FAS 140 transactions. One of the ways in which Enron was able to create fictitious revenue was through its creative use of these equity investments. To create a situation where it could manufacture revenue, Enron would form subsidiaries, called “Asset LLC’s,” and transferred its illiquid assets into those subsidiaries. The Asset LLC would in turn issue two classes of stock, Class A shares and Class B shares. The class A shares represented the Asset LLC’s voting interests, whereas the Class B shares represented the economic interest in the LLC. The Class A interests would be issued to Enron, the Class B shares containing the economic interests would be issued to an SPE, generally a Share Trust (Trust) that Enron formed and controlled. 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.

5. Focusing on Cash Flows

But from where was the money coming? For Enron’s facade of prosperity and financial health to work, they still needed an actual and tangible in flux of cash flowing into the corporation. To achieve this, financial institutions, such as Citigroup, JP Morgan, and Merrill Lynch (Lenders) provided cash infusions. The funds that flowed into the Trusts came from two sources. The first was from the Lenders themselves. These were borrowed funds with the Trust as the indebted party. 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.  

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. 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.  

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. Also, depending upon the assets involved, Enron recognized cash flow from these transfers as cash flows from operating activities. 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. 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.  

But, 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.” 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. 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.

7. **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. When these transactions were vetted through a transparent lens, Enron’s transgressions were clear.

8. **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 over $62 billion in assets. In spite of its size, the magnificent accounting fraud that it perpetrated was orchestrated by a relatively small number of individuals; 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.
How did IBC lead to the financial accounting fraud that was exacted by Enron’s executive officers? At the outset, any attempts to show “he did X because of Y” is difficult to say 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 being built here is circumstantial, and quite likely a whole host of factors, not just IBC, drove the actions that the executives took in perpetrating the financial fraud that it did. At the root of Enron’s financial accounting fraud were a select group of high level executives within the Enron organization. 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.92

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 pin. As complex creatures we continually buck behavioral models such as the neo-classical’s “rational actor” when it comes to predicting and anticipating human decision making and actions; especially in corporate settings where a host of factors and variables transcend upon that executive on a daily basis, with each variable effecting his outlook and reactions in unpredictable ways. In the case of Enron and those who were in the “inner-circle” scholars do suggest that the motivations for their actions 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." In that author’s view it was this single-minded pursuit of besting all others that ultimately caused its managers to destroy their firm.\(^9^4\)

The bottom line, at least in Enron’s case, is that for those who sat in the “inner circle,” the lines of what was ethical and proper seemed to blur, and the moves that these individuals made to throw themselves “financial life-savers” while the ship was sinking tells us that their personal financial stakes in the corporation also played some role in the decisions they made and the actions they took. To that effect, 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 long inferential leap.

Starting at the top with Kenneth Lay, the CEO and Chairman of the Board at Enron from 1986 to 2001,\(^9^5\) the time period when Enron’s financial misstatements were most prevalent and during the time directly preceding its bankruptcy filing.\(^9^6\) 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.\(^9^7\) 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.\(^9^8\) 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 to Lay by Enron.\(^9^9\) If during those same periods in which Mr. Lay exercised those stock options Enron had reported its 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 for what he exercised them.

A similar situation existed with Jeffrey Skilling, Kenneth Lay’s successor as Enron CEO until he abruptly stepped down in August of 2001, just prior to Enron’s bankruptcy filing for “undisclosed personal reasons.” 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. Finally, between 1998 and 2001, Richard Causey, Enron’s Chief Accounting Officer before being fired in February 2002 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. Again, there is no unequivocal confession from any of these executives where they state “I helped my company commit financial fraud because I wanted to maximize the value of my stock options and bonus payments.” We can only infer that their personal stakes in the outcome played a role in the decisions they made based on 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 SPE’s Back on the Books**

Much like the outcry from the public that sparked the birth of the Sarbanes-Oxley Act of 2002, a similar panic button was pressed regarding accounting standards related to transactions such as the FAS 140 transactions discussed earlier. In fact, early in his tenure, Chairman of the FASB, Robert Hertz, bore the brunt of much ire on Capitol Hill
as he fielded questions on how the problem of unrecorded liabilities and fictitious revenue funneled through SPE’s would be addressed, with one southern Senator stating, “as Hertz told it ‘imitating the law maker’s distinctive drawl, the senator demanded to know when [the] FASB was going to outlaw the use of these dummy co-poh-ray-shuns.’” Such heat sparked the birth of Financial Interpretation 46 which was later refined to become Financial Interpretation 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’s invests in Company B through stock ownership. Prior to guidance that was developed in the SPE arena, entities would be required to consolidate only in the instance where Company A had majority ownership in Company B through A’s ownership of B’s stock. This test was treated as a bright-line test where consolidation would be required only at the point where Company A was a majority owner of Company B’s stock (i.e., greater than 50 percent).

As a result of this bright-line test, 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 books. 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%. FIN 46(R), among other things, was designed to close this loophole. The first noteworthy change that FIN 46(R) made was to broaden the scope of potential entities that would come under its purview to include any entity that met the definition of a variable interest entity (VIE).

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. 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. FIN 46(R) requires consolidation of a VIE by a party that has a majority of the risks and rewards associated with the entity. 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 outcome of the performance of a VIE, both positive and negative, should consolidate the VIE because such exposure is likely to be indicative of control. FIN 46(R) refers to such a party as the VIE’s “primary beneficiary.”

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. 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 the sole guarantor of debt of the entity. Before FIN 46(R), such an issuer may not have been required to consolidate the other entity based upon voting control. 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.  

**D. Was FIN 46(R) Really Necessary?**

In tying FIN 46(R) back into the theme of IBC, financial reporting and accounting standards, what we have here is a situation where 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 one of those executives profited personally through the inflated stock price and their timely exercise of those options. And finally, on the heels of such pervasive and complex accounting fraud, accounting standard setters again are forced to react to such behavior through the promulgation of “defensive accounting standards” like FIN 46(R). What is problematic here is that the standard is drafted in a defensive manner that casts a wide net with a tight mesh. This design is to insure that “Enron-like” SPE abuse does not re-occur. But at the same time, because of the expanded consolidation criteria, those 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.
As was mentioned earlier, Enron’s departure from GAAP was deliberate. Although it may be hard to acknowledge, especially when the stakes are so high, but company’s that are intent on engaging in accounting fraud, will do so no matter how much standard setting you put in place to stop them; especially when the rewards for fraud outweigh the consequences and there is more incentive for executives to be fraudulent instead of being truthful in their financial reporting. This is the climate and the current corporate culture within which a “simplified accounting regime” would be introduced.

IV. WHERE THE STANDARD SETTERS ARE TRYING TO GO

As was mentioned in the Introduction, the SEC is forming an advisory committee whose aim is to reduce the complexity of the United States Financial Reporting System and make it more “user-friendly” for investors. To date, a significant body of work and study has already been done regarding this issue with a number of proposed changes and reforms already on the table for consideration. What the final recommendations will be once they are submitted remains to be seen, but it is expected that those recommendations will incorporate significant aspects of the work that has already been done. To that effect, one of this paper’s aims is the hope that standard setters will consider the conflict between preparers and users of financial information in their quest to improve the current accounting regime now in place. This paper contends that unless and until that pressure is effectively addressed, any recommendations proposed will be undermined by the executive component that is a part of the process. Because it is expected that whatever recommendations are submitted, will in some form or fashion consider the body of work already completed in this arena, taking a look at 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

In its effort at reforming the accounting and financial reporting framework, the FASB is undertaking a three-pronged effort aimed at revamping the current accounting and financial reporting regime. The first prong involves re-addressing current accounting standards that are considered overly complex and outdated.\textsuperscript{118} The idea here presumably is either to re-write these standards into a more simplified form, or eliminate them altogether. These efforts could be considered along the lines of preliminary “spring cleaning”; a first attempt at eliminating 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.\textsuperscript{119}

(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;\textsuperscript{120} and

(3) The third initiative which is this paper’s primary focus is developing new standards that take a “principles-based” or “objectives-oriented” approach to accounting standard setting.\textsuperscript{121}
The third and final prong involves the FASB undertaking an effort to strengthen the existing “conceptual framework” to provide a more solid and consistent foundation for the development of future principles-based standards.\textsuperscript{122}

\textbf{B. Objectives Oriented Accounting Standards – In General}

Up to this point, this paper’s focus has revolved around indicting the current set of accounting standards and 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 what are referred to as objectives-oriented accounting standards.\textsuperscript{123} 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. So in essence, 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. In essence, objectives oriented accounting standards are standards focused on effective communication of economic substance versus mere compliance with bright-line tests of form.

\textbf{C. Objectives Oriented Accounting Standards– The Detailed Discussion}

Before delving into a more detailed discussion of objectives oriented accounting standards, it is important to appreciate the context and the culture within which these standards will be placed. It must be appreciated that, among other things, a move away
from a rules-based approach 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. 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 and certainty into a world whose boundaries are fluid and therefore 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 providing enough structure and implementation guidance so that preparers have a sufficient roadmap by which to navigate, but at the same time provide for 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 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.”

“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.”

“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.” 127

“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.” 128

“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. Objectives-oriented standards, when properly
constructed, land solidly between the two ends of this spectrum.” 129

“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.”

D. SFAS 141 – Example of an Objectives Oriented Accounting Standard

To that effect, the FASB has already begun drafting new accounting standards with this objectives oriented approach in mind. Statement of Financial Accounting Standard 141 (SFAS 141) is an example of an accounting standard that adheres to the objectives oriented approach of accounting standard setting. SFAS 141 sets accounting standards in the context where one entity acquires another. Prior to SFAS 141, the standard relating to accounting for business combinations was a rules-based standard where the accounting treatment for such combinations were contingent upon the transaction meeting pre-determined bright-line tests of form. Under the 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.

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. 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
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. The implications of such asset revaluations is 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 affects, prior to SFAS 141, would attempt to structure the transaction by using the pooling of interests accounting method instead.

Alternatively, the pooling of interests accounting method perceives the business combination of the two companies quite differently. Under the pooling of interests method, there is no acquiring or acquired companies per se. Under the pooling of interests method, the two companies are treated simply as if the two companies have merged into one. Accordingly, under the pooling of interests accounting method, 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.

Under the standards prior to SFAS 141, corporations would attempt to structure their transactions depending on the accounting treatment that best suited their situation. In some cases that would be the purchase method of accounting, in others the pooling of interests accounting treatment would be most desired. Such alternative accounting treatments were considered problematic, however. The reason being, that with the bright-line tests of form under the former APB Opinion No. 16, business combinations could be afforded very different accounting treatments in spite of the fact that there were
no substantive differences in the transactions.\textsuperscript{140} Again, the fall-out from this is financial statements that presented very different financial pictures through substantially different accounting treatments in spite of the fact that substantively the transactions were quite similar. Such representational inconsistencies were similar to the operating vs. capital lease distinctions discussed earlier.

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 re-addresses an area that was previously governed by a rules based standard and is now governed by a standard that is drafted using the objectives-oriented approach to accounting standard setting. In that regard the standard is drafted to do a number of things; namely (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 the three objectives noted above, at the outset, SFAS 141 starts off by stating its accounting objective which is as follows:

\textbf{OBJECTIVE}

\textit{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.}\textsuperscript{141}
By stating the standard’s objective up front, SFAS 141 does a number of things. First, the accounting standard 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; namely 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 fall collectively and be subject to the mandates of SFAS 141. This statement pre-empts the possibility of using any method other than the acquisition method when accounting for business combinations. Accordingly, the need for bright-line tests, and rule based exceptions where alternative accounting treatments could be considered, are eliminated.

Second, when reading SFAS 141, note that what is not in the standard are any bright-line tests or compliance rules to which one must adhere. The goal in drafting the standard without these bright-line tests of form was to force the financial statement preparer to focus on the accounting standard’s objective which is to account for all business combinations using the acquisition method. Accordingly, the prospect of “financial engineering” is removed from the equation as well. The financial statement preparer no longer considers 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. And 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.142
E. IBC and Objectives-Oriented Accounting Standards – Where the two Fail to Meet

One key facet on which the success of implementing objectives oriented accounting standards is contingent, is that financial statement preparers will exercise proper judgment. Whereas under the rules-based system, both the preparer and the enforcer used the bright-line tests set forth by the rule 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.¹⁴³

Accordingly, the resulting regime would consist of accounting standards that 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 prepares being focused on capturing the economic substance of a transaction rather than being focused on presenting bad financial information in the best light possible. As the compensation and reporting climate currently exists, arguably 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. Prepares who are intent on circumnavigating a rule that is contrary to their financial reporting objective will do so regardless of the standard in place. Granted, however, 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 vs. 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 lot of latitude and, quite frankly, a lot of rope and no clear indication of the point at which the chair gets kicked. With the line blurred under an objectives oriented accounting regime coupled with the ever-present tension that IBC builds into the process, the vision that standard-setters may have for objectives-oriented accounting standards may fall short in practice.

**F. Effective Enforcement as a Counter-Agent**

Proponents of the objectives-oriented approach and the standard-setters that are articulating how this approach would work 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.\(^{144}\) In light of the passage of the Sarbanes-Oxley Act passed in 2002, proponents of the objectives oriented approach are of the belief that rigorous enforcement by these two gate-keeping factions will ensure an overall effective implementation of objectives oriented accounting standards.\(^{145}\)

How this dynamic between objectives-oriented accounting standards and rigorous enforcement actually plays out in practice remains to be seen and will unfold as objectives oriented accounting standards continue to evolve and develop. At this juncture, only historical data can be used to predict future events. And, what that 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 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, for the most part, be successfully implemented resulting in an overall improvement on the current accounting and financial reporting regime described in this paper. The answer therefore depends on how much of a priority sound financial reporting is, and what those involved in the process are willing to do to get there.

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

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?

A. A Proposed Shift in the Paradigm of Accounting and Financial Reporting –

If the true goal of financial reporting is to create an accounting regime that consistently and on a wide spread 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.

B. The “Stick” Approach versus the “Carrot” Approach

Currently the accounting and financial reporting regime (and most legal regimes for that matter) are 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, under the “Stick” approach, 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. Accordingly, under the “Stick” approach, the primary incentive for getting the financials “right” or more accurately, staying within the confines of GAAP, is to avoid the “Stick” to which the preparer may be subject if the violations are discovered.

C. The Problems with the “Stick Approach”

The problems with the “Stick” approach, however, is that it puts pressure on the financial reporting process. The pressure emanates from the fact that the “Stick” approach puts financial statement preparers and financial statement users at odds with each other. Presently, the preparer’s focus is to present the financial statements as favorably as possible, which in some cases results in the preparer engaging in either aggressive accounting tactics which at the very least compromise the financial statement’s economic substance and representational faithfulness, or in the more extreme cases employing fraudulent accounting tactics. 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. What this dynamic creates is a whole mind-set and approach to accounting standard setting that is not based on drafting standards that are written in such a way that results in preparers presenting financial results that effectively convey a corporation’s true economic substance in a way that can be readily understood by the users of such information. Instead we have accounting standards such as SFAS 13 discussed earlier that 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.147

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. Yes, the “Stick” approach may catch some in its net. But again, you have executives playing the probabilities. And the probability of getting caught seems to be much less than the probability that the preparer will suffer immediate and personal financial adversity through the reporting of poor financial information accurately.

Accordingly, the problems 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 in accomplishing wide-spread financial reporting that is focused on “getting it right”.

D. 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 paper 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 that prepare financial statements. Presently, with the “Stick” approach, the incentives are either do it right or not to 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 “Carrot” approach’s aim is to re-align the financial statement preparer’s incentives by creating a positive reinforcement mechanism for getting the financial statements right; 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 prepares spending countless time and man hours figuring out how they can “game” the financial reporting process, the “Carrot” approach, in its most ideal state, would result in financial preparers whose primary focus is on presenting the 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, with respect to accounting standard-setting, standard setters would be relieved from the burden of having to draft accounting standards defensively. Presently, accounting standards such as SFAS 13, for example, 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. 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.

2. What possible “Carrot” Approaches Exist?

The question then is what forms might a “Carrot” based approach take?

a. SUGGESTION—Remove IBC

In presenting the ideas set forth in this paper to various colleagues, many have
suggested that 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 pre-occupation 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’s compensation structure, their 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 be feeling the pressure of presenting the financial
information in as favorable a light as possible and the pressures and temptations to be
aggressive or fraudulent that have been discussed in this paper would still exist.

b. SUGGESTION—“Incentivize” Accurate Financial Reporting

Instead of creating incentives for executives to engage in aggressive accounting
tactics or out right accounting fraud, which this paper argues that IBC does, consider the
prospect of 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 companies’ financial position. In other words, use IBC to reward executives based on the accuracy of financial reports.

**E. How would Incentivizing Accurate Financial Reporting Work in Practice?**

First off, in lieu of granting stock options, a portion of an executive’s compensation would be based on “accurate” financial reporting. The exact percentage would be a fluid one that would range depending on the circumstances. But the amount should be significant enough such that the executive is motivated into giving the exercise appropriate attention and care towards “getting the numbers right”. Something in the range of 20 -25% of an executive’s total compensation would seem appropriate. The next question that comes to mind is who is going to pay for this? One of the lures of stock option grants is that the compensation doesn’t come directly from the corporation’s pockets but through the realization of shares that have increased in value. If executives are paid in part based on accurate financial reporting, this is something that would have to come directly from corporate coffers instead of the market; a prospect that may be met with resistance.

In response, the question goes back to what value is going to be placed on accurate financial reporting? We can take a short look back in history to see the price shareholders have paid on many occasions when the wool was pulled over their eyes as to what was really going on with the companies in which they invested. In hindsight, what would those shareholders have been willing to pay had they known that Enron, WorldCom, or Tyco were in dire financial straights? How much money might many of these shareholders have saved if they knew sooner rather than later that these
corporation’s financial situations was other than what was being depicted in their financial statements? The idea here is to perhaps pay a little bit more now instead of potentially paying a lot more later through failing to act due to misinformation.

1. **What is “Accurate” Financial Reporting?**

   It is acknowledged that 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” in literal terms is a moving target. What is contemplated and hoped for by this proposal is not 100% accuracy in financial reporting, but rather an approach that changes management’s mind-set 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 allowing the preparer to hide behind purported compliance through mere compliance with bright line tests of form which was common place under the rules-based regime. Further, it should be understood and appreciated that, with the new approach to accounting standard setting where an objectives-oriented approach is used, such standards provide extensive implementation guidance such that the preparer nonetheless has a sufficient road-map to follow when accounting for a transaction while at the same time remaining within the confines of GAAP. So, the idea with incentivizing accurate financial reporting, is to direct the preparer’s focus and aim 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 they are accounting for a transaction within boundaries and therefore are 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?

It is important to appreciate that this proposal, if implemented, would not be one mandated by law. Any means other than voluntary compliance would, for obvious reasons, be an invasive encroachment on any corporation and its autonomous decision as to the manner and means by which it will compensate its employees. Accordingly, it is acknowledged that practical implementation of such a proposal would require cooperative buy-in from a number of constituencies to administer and oversee this process; chief among them would be each company’s board of directors, the faction that is responsible for setting executive compensation in the first place. The Board of Directors would make the determination as to whether the executives adhered to the tenants of sound financial reporting and whether they were successful in capturing the “economic substance” in a clear and coherent manner the financial position of their respective corporations. Latitude would be given as to exactly how this determination would be made, but what is contemplated is the board’s audit committee working in conjunction with the corporation’s independent auditors to assess the quality of management’s financial representations as a whole, whether there are areas where management is taking an aggressive position as to a certain transaction 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.

F. Anticipated Opposition to This Approach

This proposed change in approach to accounting and financial reporting goes against the grain of what has been the customary practice in this arena; for all arenas actually. But what it comes down to is how much of a priority is sound financial reporting? The first reaction to this proposed approach of paying for accuracy is that it de-emphasizes performance and instead merely focuses on accuracy. That 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 doing that which they were hired to do in the first place.

Again colleagues have suggested that this is equivalent to rewarding a bank robber for not robbing a bank as it is illegal anyway, or those that would hold-up a liquor store, paying them not to rob the store; an act that is illegal and something that they should not be doing anyway. The equivalent here in this context would be paying the executives not to commit—or trying to insure that they do not commit—accounting fraud, for example. Granted, these are valid points. In response, again it goes back to asking the question, what is most important? And once that is determined, what are the steps that need to be taken to get there? If the goal truly is a better, more accurate, user
friendly, accounting and financial reporting regime where fraud is less prevalent, then those that preside over and are involved in the process would need to take outside the box steps to achieve those goals.

Some equate rewarding financial preparers for accurate financial statements to other criminal activity. But these two behaviors can be distinguished by highlighting some major differences. In the case of the individual who robs a liquor store, the impact of his actions are 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 localized.

In contrast, the actions of a team of executives who preside over a publicly held corporation that literally can have billions of shares outstanding held by millions of shareholders, and thus the impact is broader.\textsuperscript{149} Money for retirement, pensions, college funds are all tied up in these shares. In these instances when the dark of accounting fraud finally comes to light, the impact can be wide spread 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.

\textit{G. Other Objections –}

Another aspect of this proposed change in approach is that a changed emphasis from performance to accuracy would cause corporate performance to suffer. Initially, the whole idea behind things such as IBC was, in theory, to align executive’s interests with shareholders. IBC was contemplated to do just that. Given our corporate climate, it is
not a stretch to conclude that moves away from actions that would seemingly de-emphasize performance would be met with resistance. What would be the incentive for them to perform if the incentives are taken away?

This can only be answered by analyzing whether stock options really provide the incentives it was designed to create. As has been discussed above, many of the assumptions on which the premise of stock options are based is flawed, chief among these is 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 in spite of the fact that 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 a myriad of variables that could never be captured in an IBC model through the use of stock options.

Those that are strong advocates of IBC need to look at the practice with scrutiny and see if it is really doing that which it was designed to do, and more importantly, how is this practice flawed or defective under different scenarios. Perhaps when the bright light is shined on the practice, resistance to changing the practice will not be so adamant. Admittedly, paying executives for accurate financial reporting is still a form of IBC, but one that incentivizes accuracy instead of performance. The observation is an accurate one. But note the difference between the two. Incentivizing an executive based on corporate performance is more of a “wild card” where many variables go into a corporation’s ultimate performance; some of which are under the executive’s control and some of which are not. Financial reporting, on the other hand is more of a closed-ended
proposition, where the executive can hit the mark every time merely through vigilant financial reporting. Accordingly, the pressures that are there in the corporate performance arena, particularly when the corporation is not performing, will never be there 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 hitting that right answer, whatever it happens to be.

**H. What Mechanisms Exist Then to Insure and Maintain Performance?**

Another concern then is what mechanisms exist to insure and maintain performance? The ideal scenario is a situation where 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 one to raise the level of their performance or are there other more effective means by which this can be done? Or will those that are motivated to perform well do so regardless of what additional incentives are added to the equation?

The answer is that the incentive to perform well will always be built into any employer-employee relationship. This overriding incentive is that anyone who does not perform well will ultimately lose their job. This applies throughout an organization, including the CEO. Incentivizing performance through the use of stock options merely creates just another variable that in many cases seems to distract executives from focusing on actual results rather than accounting results.

Accordingly, it is acknowledged that there may always be some incentive for preparers to present financial information in the best possible light; even if the specter of
stock options are removed from the equation. An executive’s performance will always in part be judged based on the corporation’s financial performance. What is hoped for and anticipated by incentivizing accurate financial reporting is that it will have a counteractive effect on this temptation and tendency 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 their motivation for misrepresenting financial information and likewise, incentivizing accurate financial reporting ideally turns the dial in the other direction.

I. The Public Accountants—Isn’t Keeping Financial Statement Preparers in Line the Auditors Job?

At this juncture, astute readers who are familiar with the accounting and financial reporting process as it relates to public companies may be asking about the role of public accountants; the independent auditors? The independent auditors, in theory, 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 express 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’ve been tasked to audit.150

Scholarly articles have been written on the public accountant’s role in the financial reporting process and its effectiveness in insuring financial statement integrity.151 But the public’s perception of their role and what actually happens in a financial statement audit of a publicly held company 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 recorded transaction
through its discerning lens, and insure that the financial statements are 100% accurate. But if this indeed happens, then why does accounting fraud and securities law violations still appear to be so prevalent in spite of the audit function and the role it is supposed to play? On any given day, for example, we hear reports about yet another CEO or CFO being charged with or settling charges related to accounting or financial fraud.\textsuperscript{152} The answer to this comes in appreciating the difference between 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 they completed the important task of financial statement audits changed. In the “early” years, the practice of public accounting was considered a profession that was highly revered, and those that 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.\textsuperscript{153} 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 was not compromised.

The pressures of the marketplace, however, began chipping away at the walls that previously insulated public accounting from the market pressures to which other facets of the economy were subject. The green-eyed monster of envy began to rear its ugly head
and caused the once noble and selfless public accounting professional to ask the question, “what about me?” The counter-part to the accounting professional was the business consultant. 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 lap tops and spread sheets and, with their savvy business advice and expertise, consulted 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 pour 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. Public accountants, believing their expertise and business acumen to be on par if not superior to their consulting counterparts, began engaging in the practice of consulting as well. 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 that performed audits for the large public accounting firms coalesced into what was then eight
major accounting firms, in the 1970’s to the late ‘80’s, which further merged into the “Big Six” from 1989—1998, and are now presently the “Big Four.”

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. 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. The public accountants would lowball the audit bid and perform the audit for only a marginal profit—at a break-even point or even at 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 and profitable. The effect that this dynamic had on the manner and 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, what began to happen then is that 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 accountant in question may be misstated. 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 amount is fairly stated. With these dynamics and factors
playing into the audit process, it is easier to see how companies that are intent on achieving certain accounting results regardless of the actual financial results may do so, 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.”

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. In the short run, prohibiting auditors from providing consulting services in addition to performing the audit is a positive step in improving financial 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. There is now a movement to make changes to this process and improve the end product. This paper looks at one dynamic that is integral to improving this process. It is recognized that IBC that rewards on the basis of financial performance is a component that is entrenched in
our corporate culture and the probability of removing it may be considered remote. But it is hoped that this paper will provide those that are involved with the financial reporting process and the standards that govern this process with a new perspective to a chronic and systemic problem. In many cases, IBC based on financial performance creates the incentive to distort, obfuscate, or in many cases, commit financial accounting fraud. A change to this entrenched process and modification in its approach is needed. The suggested approach is to incentivize financial statement accuracy rather than financial statement performance. Such a modification ideally would take away the tension of the reporting process and put all those involved on the same side of the fence and working toward the same goal. It is acknowledged that what is being proposed here may be considered by some as drastic or untenable. At that point 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. 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.


5 See, e.g., HOME DEPOT INC., 2005 ANNUAL REPORT at 35 of Form 10-K (including an audit opinion note that the Consolidated Financial Statements are the responsibility of the company’s Management).

6 See HOME DEPOT, INC., PROXY STATEMENT AND NOTICE OF 2006 ANNUAL MEETING OF SHAREHOLDERS 32 [hereinafter HD PROXY STATEMENT 2006].

7 See, e.g., *id.* at 33 (noting that potential bonuses, etc. are contingent upon the company achieving certain Earnings Per Share goals).

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

9 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 (citing study by the Committee of Sponsoring Organizations finding that of 200 cases of alleged
financial fraud investigated by the SEC from 1987 to 1997, five out of six involved either the CEO, the CFO, or both colluding in the fraud).

10 *See, e.g.*, Financial Accounting Standards Board, Status of Interpretation No. 46: Consolidation of Variable Interest Entities—an Interpretation of ARB No. 51 (Dec. 2003), AVAILABLE at http://www.fasb.org/st/status/statpg-fin46.shtml [hereinafter INTERPRETATION 46]. FIN 46(R), in essence, broadened the criteria under which an 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.

11 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.

12 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.

13 *See, e.g.* HD Proxy Statement 2006, *supra* note 6 at 33 (noting that potential bonuses, etc. are contingent upon the company achieving certain earnings per share goals).


15 *See, e.g.*, STEVEN M. BRAGG, ACCOUNTING REFERENCE DESKTOP 211–12 (2002).

17 BRAGG, supra note 15

18 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.

19 For a basic definition of profit-sharing see, e.g., BRAGG, supra note 15, at 533


21 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 so that the earnings instead of reporting the actual financial results because the executive stands to lose 25% of compensation unless the benchmark is achieved.

22 Accounting, 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. Herz, Chairman, Fin. Acct. Standards


25 For example, the FASB has over 159 financial accounting standards, 7 financial accounting concepts, and 48 financial interpretations. See FASB Pronouncements and EITF Abstracts, http://www.fasb.org/st/ (last visited Sept. 1, 2007).


28 Prentice, supra note 9 at 784. 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 in the Hollinger International, Inc. case, in which controlling shareholders looted $400 million. See Hollinger Inc. Says S.E.C. May Bring a Civil Lawsuit Against It, N.Y. TIMES, Aug. 31, 2004, at C2.

29 Prentice, supra note 9 at 784.

30 See, e.g., HD Proxy Statement 2006, supra note 6 at 33 (noting that potential awards are payable only if the Company achieves specified levels of average diluted earnings per share).
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.

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, available at http://pubs.bna.com/ip/bna/sld/ef/A0B3Y0N1J6.


See, e.g., id. at 41.

See, e.g., id at 35.

See, e.g., id at 52 (Table 3).

See, e.g., id.


See How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Aug. 7, 2007). The SEC consists of 5 presidentially-appointed Commissioners, four Divisions and 18 Offices. Id. With approximately 3,100 staff, the SEC is small by federal agency
standards. Headquartered in Washington, DC, the SEC has 11 Regional Offices throughout the country. Id.

40 See id. The SEC consists of 5 presidentially-appointed Commissioners, four Divisions and 18 Offices. Id. With approximately 3,100 staff, the SEC is small by federal agency standards. Id.


42 Burkholder, supra note 1.

43 For example, Financial Interpretation 46(R), was enacted following Enron’s abuse of the Special Purpose Entity. FIN 46(R) broadened the criteria under which sponsoring entities would be required to report Special Purpose Entities 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, supra note 10..


45 For example, for its buildings Home Depot’s depreciation ranges from 10 to 45 years; Furniture, Fixtures and Equipment, 3 to 20 years; Leasehold Improvements 5 to 30 years. See id. at 42

46 See generally, FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 13: ACCOUNTING FOR LEASES , ¶¶ 6–7 (1976) [hereinafter FASB No. 13].
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.

FASB No. 13, supra note 39 at ¶ 15.

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.

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*


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 1 year. But the company wishes to receive cash from those receivables today versus one year from not. To address account 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
goes back 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.


69 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.

70 See id. at 39,


73 “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

74 See id. For example, the FAS 140 transactions cited in the report were referred to as Cerberus, Nikita, Hawaii 125-0, and Backbone.


76 See id. at 59–60.

77 See id. at 59.

78 See id.

79 See id. at 60.

80 See id.


82 Batson I at 60

83 See id.

84 See id. at 60.

85 Id. at 61.

86 Id. at 53.

87 See id.
See Financial Standards Accounting Board, Summary of Statement 140: Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a replacement of FASB Statement No. 125,

[NEED TO DOUBLE CHECK THIS – WEB ADDRESS NOT VALID]


See id.


The Houston Chronicle maintains a website that chronicles each executives 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 Aug 8, 2007) [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, Id.


Id.


98 Id.

99 Id.

100 Id. at 7.

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


103 Enron Chronicle Special Website, supra note 92, hyperlink for “Richard Causey” in the “Prosecution Scoreboard” section of the page.


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

*Emerging Issues Task Force Issue No. 90-15: Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions* 1 (1991) [hereinafter EITF 90-15]. Although not stated specifically in EITF 90-15, industry practice had evolved to the point where 3 percent equity investment was sufficient at-risk equity investment to avoid consolidation.

*Interpretation 46, supra* note 10 at 4.

*Id.* at 5.

*Id.* at 13.

*Id.*

*Id.* at 8.

*Id.* at 12.

*Id.* at 13.

FASB Response, supra note 3 at 7.

Id.

Id.

Id.

Id. at 8


Id. at 7.

Id.

Id.

Id.

Id.

Id.

Financial Accounting Standards Board, Exposure Draft: Proposed Statement of Financial Accounting Standards, Business Combinations, A Replacement of FASB Statement No. 141 at 1 (June 30, 2005) [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”) (on file with the Author).

FASB No. 141 Summary, supra note 131 (“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.”).

Id.

See, e.g., BRAGG, supra note 15, at 470–73.

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

FASB Rules Out Pooling of Interests, J. Acct. (July 1999) (“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.”), http://www.aicpa.org/PUBS/jofa/jul1999/financial_accounting.htm.

MEYER, supra note 143, at 353–

FASB No. 141 Summary, supra note 131. (“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.”).

FASB Exposure Draft No. 141, supra note 132 at 1 (defining the objective of the standard).

Id. For Example, see Appendix A: Implementation Guidance A1-A136.

SEC Section 108(d) Study, supra note 123

Id.
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 92, hyperlink for “Jeffrey Skilling” in the “Prosecution Scoreboard” section of the page.

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

See, e.g., FASB No. 13, supra note 39 at ¶¶ 7a–d.

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 6, at 1.

For example, Home Depot’s 2005 Annual Report included its Form 10-K, where the auditor’s KPMG expresses an opinion as to whether Home Depot’s financial statements present fairly, in all material respects, the financial position of The Home Depot, Inc… Find copy of financial statement audit opinion. HOME DEPOT, INC., 2005 ANNUAL REPORT.


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, N.D. Ill., No. 07-C-4483, 8/9/07).”.


154 Id.

155 Id.

156 Id.

157 *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.*

158 *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 & Touch in August. *Id. at 1701–04.*

159 *See id* Presently, the “Big Four” consist of PricewaterhouseCoopers, KPMG, Ernst & Young, Deloitte and Touche.

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.* at 6.

161 The bidding process used by accounting professionals can be described as follows:

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.* at 5.

162 *Id.*

163 *Herwitz & Barrett, supra* note 104 at 229. As noted in the text, the extent to which the auditor 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 companies internal controls to be reliable. *Id.*

164 Craig, *supra* note 166. See also the discussion in Section ___, *supra*.

165 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.