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Ethical Issues in Financial Reporting: Is Intentional Structuring of Lease Contracts to Avoid Capitalization Unethical?

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ABSTRACT. Under present accounting rules, lessees frequently structure contracts for leased assets, in situations where they enjoy benefits similar to outright ownership, in a way that keeps both the leased assets and related liabilities off their books. This method of accounting creates off-balance sheet financing and is called operating lease accounting. The paper debates the ethicality of intentionally structuring lease contracts to avoid disclosing leased asset and liability amounts and describes the ''slippery slope'' of rule-based accounting for synthetic leases and special purpose entities, that, in the author's opinion, led to the accounting debacles at Enron and other companies. The ethical intent that is implicit in the Securities and Exchange Commission and Financial Accounting Standards Board regulations is discussed and suggestions for improving the ethicality of financial reporting are provided.

KEY WORDS: accounting, accounting ethics, ethics and lease accounting, ethics of financial reporting, rule-based accounting, rule-based ethics

Introduction

This paper discusses lease accounting as an example of how one can structure a discussion of ethical issues related to financial reporting choices. The importance of this topic relates to the complexity of issues surrounding lease accounting, the slippery slope that violating the intent of lease accounting rules leads to, and the generally ''gray'' conclusions that result from attempting to answer the question, Is intentional structuring of lease contracts to avoid capitalization unethical? A second intention of the paper is to illustrate how the question of ethics can be used to help students understand and appreciate the effects of technical financial reporting rules. After an introduction that provides background concerning how one accounts for leases, the rest of the paper is organized as follows. Part II discusses the ethical ideals of financial reporting as summarized by terms such ''fair and full disclosure'' and ''transparency.'' The accounting conceptual framework that is consistent with these ideals and alternative structures (principles-based versus rule-based) for specifying financial reporting and disclosure standards are also discussed in this section as background for debating, in Part III, the ethicality of intentionally structuring lease contracts to avoid reporting assets and liabilities on the financial statements of lessees. Part IV then discusses the ''slippery slope'' of lease accounting that, in the author's opinion, led to the use of various ''financial engineering'' transactions to meet certain management objectives, but at the cost of transparent disclosure in the financials. Examples of such transactions include synthetic lease transactions and the kinds of securitization transactions used by Enron and its special purpose entities to manipulate cash flows and to hide debt from investors and creditors. Part V raises the question, Does ethics really matter in a financial reporting context? Are there any sanctions for violating ethical standards or is simply ''meeting the rules'' sufficient? Suggestions

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for making ethical considerations a more important aspect of the financial reporting choice decision-making process are then presented in Part VI. Part VII is a conclusion.

An asset in accounting is a ''probable future economic benefit obtained or controlled by a particular entity as a result of a past transaction or event.''[1] The definition is intended to convey the fact that economic activities are carried out in an environment in which few outcomes are certain and is consistent with the use of the term in an investor and creditor decision-making context. Also consistent with the asset definition, liabilities are ''probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provided services to other entities in the future as a result of a past transaction or event.''[2]

A lease is a contractual agreement between a lessor and a lessee that conveys to the lessee the right to use specific property owned by the lessor for a specific period of time in return for payments made by the lessee over the term of the lease. Given the different kinds of assets that can be leased, including real estate, computers, airplanes, ocean transport vessels and railcars, and given the myriad terms and conditions that can be part of a lease contract, lease accounting is extremely complex.

In 1976, the Financial Accounting Standards Board (FASB) issued its Statement No. 13, ''Accounting for Leases.'' In Statement No. 13, the essence of lease accounting is found in its emphasis on the economic substance of the lease agreement as opposed to the strict legal form of the agreement. To the extent that the lease contract transfers substantially all the benefits and risks economically consistent with outright ownership of the asset to the lessee, the lessee shall account for the transaction as the acquisition of an asset and the incurrence of a liability.[3] This is called a capital lease. Alternatively, if the substantial benefits and risks of ownership are not conveyed to the lessee in the lease contract, the lessee shall account for the transaction as a rental (charge to expense the rental payment each period) and no asset or liability related to the lease would appear on the balance sheet of the lessee. This kind of lease is called an operating lease.

However, accounting is a measurement discipline. The idea of economic substance trumping strict legal form[4] based on the lessee enjoying the substantial benefits and risks of ownership needs to be operationalized in a way that can be measured. In this case, the FASB operationalized the ''substantial risks and benefits'' notion based on four ''bright line'' rules, any one of which needs to be satisfied to use capital lease accounting. They are:

The present value of minimum lease payments is at least 90% of the fair market value of the asset.
The lease term is at least 75% of the economic life of the asset.

There is a bargain purchase option (e.g., buy asset for $1) at the end of the lease term.
The legal ownership of the asset is transferred to the lessee at the end of the lease term.

In other words, if any one of the above requirements is met, it is presumed that the lessee enjoys substantial benefits and risks equivalent to owning the leased asset, and that it should be capitalized. However, soon the game of structuring lease contracts to avoid capitalization became an ''industry.'' For example, structure a lease contract so that the present value of minimum lease payments is only 89% of the fair market value of the asset. Make the lease term only 74% of the estimated economic life of the asset and make sure there is no bargain option or transfer of ownership clause in the contract. As a result, you will not see many airplanes on the balance sheets of airlines and you will not see many corporate office buildings listed as assets on the balance sheets of corporations. For example, Revsine et al. (2005) show the following average ratios of operating lease payments to capital lease payments for variety stores, 18.4:1; supermarkets, 27.5:1; railroads, 14.9:1; and airlines 25.8:1. Few leases are structured as capital leases.

Why do lessees/firm managers want to avoid putting leased assets and related liabilities on their balance sheets? The reasons relate primarily to their interest in financial statement ''window dressing.'' Putting the leases on the balance sheet may result in violation of loan covenants, affect the amount of compensation received by managers (e.g., if compensation is linked to the firm's earnings), result in higher-reported earnings for growing firms[5] and it can lower rates of return and increase debt to equity ratios. All of these reasons relate to the desire to give the appearance that the economic performance of

the firm is stronger than it really is and that capital structure risk is lower.

It soon became clear that lease accounting was not working[6] as intended by the standard setters. But, is intentional structuring of lease contracts to avoid capitalization unethical?

Ethics in financial reporting

The term "ethical financial reporting" is not well-defined in the accounting literature. One would normally look to financial reporting theory books for guidance, but modern texts such as Scott (1997) and Wolk et al. (2004) do not use an ethical framework to develop their theories. Furthermore, there is not much discussion of the nature of ethical financial reporting in leading financial reporting textbooks, although most accounting textbooks do present ethical dilemmas for discussion. Similarly, while leading accounting ethics textbooks such as Duska and Duska (2003) and Brooks (2004) are filled with examples of ethical and unethical reporting as well as standard models and approaches for evaluating ethical dilemmas, not much attention is given to discussing the underlying objectives and qualities of financial reporting that make it more or less ethical. The foundations of ethical financial reporting are discussed below.

Hendriksen (1977) suggests "That the ethical approach to accounting theory places its emphasis on the concepts of justice, truth and fairness." (p. 17). Justice means that accounting reports must provide equitable treatment for all interested parties and they must not present a biased picture of the firm's performance to promote the interests of a particular class of stakeholders. Truth, while difficult to define in an accounting context, means that financial reports should convey economic reality to the extent possible, subject to measurement constraints.

At the heart of our understanding of the nature of ethical reporting is the idea of "fairness." The term "present fairly" is found in the auditor's report, meaning that the financial statements conform to generally accepted accounting principles and include adequate disclosures so that they do not present a misleading picture of the firm's performance. In *A Search for Fairness*, Spacek (1969) focuses on a fair presentation of the facts. The term fairness means both fairness of the data being presented and fairness to the readers of the statements (Hendriksen, 1977, p. 19).

Another quality that is consistent with ethical financial reporting is transparency, meaning the reporting is clear, complete, and understandable. Fung et al. (2004) note that transparency systems have emerged as a mainstream regulatory tool in a variety of settings including nutritional labeling, public school report cards, restaurant grading systems, toxic pollution reporting, fuel economy ratings, corporate financial reporting, and many others. The call for greater transparency in financial reporting is the primary driver of additional financial disclosures.

Financial reporting requirements are legislated by the SEC Securities Act of 1933, the Securities Exchange Act of 1934 and various pieces of subsequent regulation including the Sarbanes-Oxley Act of 2002. The overall objectives are to promote economic efficiency, competition, and capital formation (Securities Act of 1933, "Ethics in financial reporting" section), and one means of achieving these objectives is by having full and fair disclosure of relevant accounting information for investor and creditor decision-making purposes. A background assumption is information asymmetry where firm managers know more about the firm's performance than do investors, creditors, and other parties. The regulation of financial reporting through the establishment of financial statement disclosure requirements is an assumed necessary device to assure an adequate supply of accounting information and to assure a fair information environment.[7]

The SEC has delegated much of the task of specifying company financial reporting and disclosure requirements to the private sector, presently to the Financial Accounting Standards Board (FASB). The FASB issues its financial reporting guidance in pronouncements called financial accounting standards, interpretations and staff position papers that constitute what are considered the most authoritative sources of the generally accepted accounting principles (GAAP) that SEC registrants are required to follow.

The FASB uses a Conceptual Framework to guide its development of GAAP. The framework consists of (1) a statement of objectives of financial reporting, (2) a statement of qualitative characteristics

of accounting information, (3) definitions of the elements (e.g., assets, liabilities, revenues, expenses) of financial statements, and (4) discussions of measurement principles. While the Conceptual Framework is not based on any particular ethical theory, the intent is to advance the fair and full disclosure/transparency objectives that are at the heart of SEC regulation of financial reporting – objectives that, arguably, are common to a number of ethical models.[8] For example, the first stated objective of financial reporting is to "provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions." (FASB, 1978, par. 34). Qualitative characteristics include concepts such as relevance, reliability, neutrality, and representational faithfulness. The definitions and measurement rules both guide and constrain what can be reported and how can it be measured based on qualitative considerations such as relevance, reliability, neutrality, and representational faithfulness. Interestingly, the FASB's Conceptual Framework is not considered a part of the GAAP hierarchy and is presently a "last resort" for authoritative support for the use of a particular financial reporting or disclosure method.

A related issue concerns how particular accounting standards are written. Principles-based standards are based on broad accounting principles such as those articulated in the Conceptual Framework. The application of such standards to particular accounting settings requires the use of professional judgment. At the other end of the spectrum are rule-based standards. The best example of a rule-based standard is FASB Statement No. 13, "Accounting for Leases." The ethicality of using the "bright line" rules of FASB Statement No. 13 as a basis for structuring lease contracts so as to avoid the intent of the standard is debated below.[9]

Framing the lease accounting ethics debate

A useful way of motivating a discussion of the ethics of lease accounting is to list the strongest arguments in support of each side of the issue. A summary of arguments in support of the idea that intentional structuring of leases to avoid capitalization is unethical versus counterarguments is provided in Table I. Notice that one's involvement in a critical debate concerning this issue requires a great deal of technical accounting understanding of leases and the decision contexts in which they are used. This enhanced understanding of technical accounting material is a benefit above and beyond a consideration of the ethical merits of the accounting treatment.

Since it has been my experience that most students believe there is nothing unethical about choosing a particular accounting method as long as that method follows GAAP, here I focus the discussion on the arguments in support of the position that operation lease treatment is *not* unethical.

An accounting treatment that meets that rules is not unethical

The argument is akin to the notion of rule ethics. The problem in lease accounting is with the quality of the rules that allow individuals to circumvent their intent. Focusing discussion on the quality of accounting rules is a critical thinking device that leads to a higher plan of understanding. As is illustrated in Part V of the paper, generally the bar for ethical financial reporting is set higher than the bar "just follow GAAP." A variety of other issues related to rule-based ethics are also discussed in Part V.

Footnote disclosure of future cash flows associated with operating leases is an adequate substitute for capital lease accounting

One type of public information available is that found in the footnotes of financial statements. In the case of leases, a requirement is that all companies disclose in a footnote the future cash outflows for both their present capital and operating leases. It then can be argued that, based on these disclosures, a user can compute what the capital lease asset and liability amounts would be, and "constructively" put them on the balance sheet. In fact, practically every financial reporting textbook that discusses lease accounting demonstrates the procedure for constructive capitalization. If this is true, then there is no ethical issue except for the issue of requiring analysts to incur the costs and inaccuracies associated with their own estimates, estimates that could more easily be disclosed by management.[10]

TABLE I

Debating the ethics of lease accounting

Arguments that intentionally writing lease contracts to avoid capitalizing leases is unethical
1. SEC's regulatory objective is full disclosure of information needed by investors for informed decision-making. Operating lease treatments results in misleading picture of firm's capital structure and financial risk
2. Operating lease treatment frequently ignores economics of lease transactions – substantial risks/benefits of ownership enjoyed by lessee – accounting, in general should focus on reporting the economics of various transactions
3. By definition, intentionally choosing accounting methods with the sole objective of misleading investors or hiding true economics of transactions with the intent to deceive is patently unethical
4. The concern about off-balance sheet financing is evident from the additional disclosure requirements under Sarbanes-Oxley
5. There is research evidence that the market does not efficiently process the data in footnotes that allows for constructively capitalizing operating leases. See Imhoff, Lipe and Wright, *The Journal of Financial Statement Analysis*, Fall, 1995
6. Even assuming efficient processing of footnote information, if companies were concerned about full disclosure, they could easily show in a footnote the effects of constructively capitalizing operating leases. A few companies do this. For the rest, we can only measure the effects with error
7. Generally speaking, the tax accounting rules for accounting for leases as sale versus rental transactions are different from the accounting rules. Thus, an appeal to any economic benefits related to taxes does not appear to justify the accounting treatment.
8. Looking at the way lease arrangements are marketed, many are ''sold'' on the basis of the ability to hide the true economics of the arrangements
9. There is evidence that higher quality disclosures can lower the firm's cost of capital. Given a value maximization objective, techniques that lower the quality of the financial statements and hide risk appear costly and unethical
Arguments that operating lease treatment is not unethical
1. The treatment is GAAP (sort of a ''meets the law'' justification that the treatment is not unethical)
2. There is footnote disclosure of the future cash flows associated with operating leases. Preparers and users may believe that the market efficiently processes this information in constructively capitalizing operating leases
3. Reasonable investors should not be misled. Entities providing financing to lessees should be well-aware of off-balance sheet financing
4. Operating lease accounting keeps the assets on the books of the lessor who then benefits from a depreciation deduction for tax purposes and passes along those benefits to the lessee in the form of lower lease payments. This argument is in the financial reporting literature, but it tends to ignore the tax basis of the assets. However, if there are economic benefits related to operating lease accounting, then the treatment might not be considered unethical
5. Alternative Minimum Tax considerations. Again, this may have nothing to do with the financial reporting rules, however

However, is the market efficient in terms of processing lease footnote information? The answer is apparently ''no.'' For example, Imhoff et al. (1993) compare the association of a market measure of risk (security return variability) with two alternative-leased adjusted debt/equity ratio measures. The first adjusted debt equity ratio was calculated after constructively capitalizing leases in the theoretically correct manner. The second adjusted debt-equity ratio included a crude eight times rent heuristic for constructively capitalizing leases.[11] Their test results showed that the crude heuristic of adjusting debt/equity ratios were more highly associated with the market measure of risk than the more theoretically correct adjustment method. Thus, it does not appear that one can rely on efficient processing of lease footnote information to justify the non-use of capital lease accounting.[12]

Furthermore, if companies were interested in enhancing the transparency of financial reporting by calculating and disclosing in footnotes the capitalizable asset and liability amounts for their operating leases, it appears that it would not be costly to do so. However, very few companies provide such disclosures.

Knowledgeable investors and creditors should not be mislead

Discussion of this point can result in a rich debate. The debate centers on the fact that operating leases can only be constructively capitalized with error, but the economic significance of the error may be small. To what extent investors and creditors are misled and make sub-optimal decisions due to this particular lack of transparency is unknown. However, one can show that the adjustments to debt-equity ratios and other performance measures are frequently large when constructively capitalizing leases and that to ignore these effects could prove costly.

There are tax benefits of operating lease accounting that would benefit most stakeholders

A possible benefit of operating lease accounting is that the asset remains on the books of the lessor who can then depreciate the asset and receive a tax savings benefit that might not otherwise be obtainable by the lessee. For example, airlines may be unprofitable and may not be able to use a depreciation tax shield. If profitable lessors (such as General Electric) can make use of the tax shield, they can pass along the tax savings to lessees. However, the problem with this argument is that the rules for what qualifies as a true lease (capital lease) for tax purposes are different than the rules for financial reporting purposes. It is possible for the lessor to enjoy the tax benefits of ownership while still using capital lease accounting for financial reporting purposes (see footnote 16 below). Similar arguments relate to the irrelevance of the Alternative Minimum tax issue.

The slippery slope of lease accounting

> The Synthetic lease (also known as an 'off-balance-sheet lease,' an 'off-balance-sheet loan,' or a 'master lease') is a financing structure used by many public companies to finance 100% of the cost of acquisition of certain real and personal property at a favorable cost. It is a structure with a split personality–it is accounted for as an operating lease, but treated for economic and tax purposes as a financing transaction, and it gets the most favorable treatment in each case. As a result, it can satisfy a number of apparently inconsistent needs.[13]

A synthetic lease, as the above quote indicates, is a contract that allows for an off-balance sheet treatment of the lease for financing reporting purposes, but enables the lessee to treat the lease as a capital lease for tax purposes.[14] The financial reporting/ operating lease treatment results in a higher return on assets (ROA), return on equity (ROE), and interest-coverage ratios and lower leverage and debt-equity ratios relative to the on-balance sheet treatment.

For two primary reasons, synthetic leases involve the creation of Special Purpose Entities (SPEs) that hold legal title to the leased assets. First, SPEs help protect the lessee and lessor against bankruptcy or non-performance of any party to the lease. Second, the SPEs can be structured to achieve desirable economic, tax, and financial reporting outcomes.

As the primary beneficiary of the SPE, the lessee might have to consolidate the SPE with its own financial statements and end up with the leased asset and liability on its books. While SFAS No. 13 and its subsequent amendments are silent about the accounting treatment of synthetic lease transactions structured through SPEs, through a series of SEC communications and a series of FASB Emerging Issue Task Force (EITF) statements, an accounting consensus emerged. Historically, synthetic lease SPEs are financed with 97% debt and 3% equity. To the extent at least 3% equity financing was provided by an outside entity[15] unrelated to the lessee or lessor, the lessee could avoid consolidating the SPE. The result is that few synthetic lease assets and liabilities appear on the books of the lessee.[16]

Enron then used (and abused) the 3% rule to avoid consolidating many of its special purpose entities with the result that $16 billion of debt was not shown on its balance sheet and hidden from investors. Enron[17] and other accounting scandals of 2001–2002 resulted in greater scrutiny of off-balance sheet financing techniques that convey an inaccurate impression of the assets and obligations of lessees. Specifically, synthetic lease and variations of SPE transactions used by Enron and other entities attracted a great deal of attention. The result has been a modification and tightening of the rules for off-balance sheet lease treatment. My purpose here is not to explain the details of these more restrictive rules, but, instead, to raise two ethics questions:

> Is intentional use of synthetic lease transactions to achieve favorable tax treatment while hiding debt from investors and creditors unethical?
>
> Did the slippery slope of avoiding capital lease treatment under SFAS No. 13 rules lead to the outright abuse and fraud that we observed with Enron?

Does financial reporting ethics really matter?

> Ultimately, it was Enron's tragedy to be filled with people smart enough to know how to maneuver around the rules but not wise enough to understand why the rules had been written in the first place. (Eichenwald, 2005)

It is generally believed that the threshold for ethical behavior is higher than that for legal behavior. As one piece of evidence in this regard, Davis-Friday and Frecka (2002)[18] summarize the results of an earnings management questionnaire administered to 53 first year Executive MBA students in a financial-reporting course. Students were asked to judge the ethicality, legality and prevalence of three earnings management scenarios using a 11-point scale, where at the extremes, 0 means completely unethical, clearly illegal or very rare activity, and 10 means ethical, completely legal or prevalent. The questionnaire results are reproduced in Table II. Note that, for all three scenarios, the earnings management techniques are considered more prevalent than legal and more legal than ethical.[19]

While the threshold for ethical behavior is generally higher than for legal behavior, there is substantial evidence that ethics takes a back seat to ''just meeting the rules'' when it comes to accounting. For example, Shafer et al. (2004, p. 213) review recent evidence showing that ''many independent auditors consider it an acceptable practice to express an unqualified 'clean' opinion on financial statements even though the auditor does not consider the client's accounting principles to be the most appropriate under the circumstances, provided such treatments can be rationalized as acceptable alternatives under GAAP.'' Also, Satava et al. (2006) describe how the rule-based tradition of financial reporting became a useful vehicle for manipulating financial statements and suggest that a more ''principles-based approach'' could improve the ethical conduct of accountants and auditors. Picking up on the principles-based theme, recently, I asked a senior audit manager of a Big Four accounting firm to comment on the ethics of structuring lease contracts to avoid capitalization. He commented as follows:

> No, on lease accounting, the rules win out and ethical behavior takes a back seat. In my opinion, the prescriptive nature of FAS 13 (rules based) has led the entire accounting world to manipulate the rules to (generally) avoid the negative consequences of lease accounting. Again, in this area, IFRS rules (substance over form) are so much better than U.S. GAAP.

It is interesting to note that there is substantial support for blaming the rules rather than blaming the accountants and auditors who apply the rules. Note again that the whole basis for lease accounting in the United States is the substance over form an idea, where, if the lessee enjoys the substantial benefits and risks of ownership, the lease should be accounted for as asset purchase and a related liability reported on the balance sheet.

The theme ''blame the rules'' is reinforced by Batson, the court-appointed examiner in the Enron case. Noting first that the role of GAAP is to provide relevant, reliable and useful information to readers of financial statements, he then describes the sources of authoritative support in GAAP as detailed, complex and rule-driven in a fashion that ''... often create 'bright-lines' and 'on-off' switches that are exceptions to the fundamental principles and focus more on the form, rather than the substance, of the transaction.''[20] He goes on to say that ''The development of rule-based accounting standards has resulted in the employment of financial engineering techniques designed solely to achieve accounting objectives rather than to achieve economic objectives.''[21]

Does ethics matter in financial reporting? It is difficult to find evidence in support of this view. Our previously referenced anonymous audit Senior Manager had this to say about sanctions:

> I have not structured a deal and only audited those deals, it is difficult to comment on whether it is unethical. I can tell that the closer a company gets to 90%, the more uneasy (and unclean/dirty) everyone feels. I personally would have a very difficult time structuring a deal to achieve an

TABLE II

[a]Earnings management questionnaire and results

Use the following definition of earnings management in answering each of the following questions. Earnings Management involves actions by managers that are intended to increase (decrease) the current reported earnings of a unit for which the manager is responsible without generating a corresponding increase (decrease) in the economic value of the unit

Instructions

Using a scale from 0 to 10, give your assessment of the extent to which each of the following activities is ethical, legal, and prevalent

Ethics scale	0 completely unethical	5 questionable	10 ethical
Legal scale	0 clearly illegal	5 gray area	10 completely legal
Prevalent	0 very rare activity	5 occasional	10 happens all the time

1. A firm whose cash flow stream is less variable would be considered less risky than another firm whose cash flow stream is more variable. As a manager, Sid knows that he can always find some obsolete inventory to write down to decrease profits and he also knows that he can sell some idle, fully depreciated assets to generate a gain. He frequently uses these techniques to smooth earnings, by increasing or decreasing earnings by 2–3% each year, with the belief that by so doing he can lower the firm's cost of capital

Ethical	Legal	Prevalent
Mean 4.62[b]	Mean 7.25	Mean 7.66
Std. Dev. 2.71	Std. Dev. 2.92	Std. Dev. 2.63

2. Instead of using the techniques in question 1, Sid's friend Amy in another firm smoothes earnings by changing accounting estimates. She will change the provision for bad debts estimates, the estimated useful lives of assets, warranty provisions, etc., as needed to increase or decrease earnings by 2–3% each year

Ethical	Legal	Prevalent
Mean 2.39	Mean 4.52	Mean 6.18
S.D. 2.63	S.D. 3.57	S.D. 3.13

3. Amy's friend Harrison uses a different technique to smooth earnings. Knowing that investors focus on Operating Earnings, each period he changes the operating or non-operating definition of certain items (classificatory smoothing) to help meet his Operating Earnings objective

Ethical	Legal	Prevalent
Mean 1.69	Mean 3.53	Mean 5.04
S.D. 2.35	S.D. 3.68	S.D. 2.20

[b]All mean differences of at least 1.4 are significant at the 5% level

[a] This table was first introduced by Davis-Friday and Frecka (2002).

> intended result, however, the SEC and FASB are in bed together on this one and I believe everyone is aware that there is some degree of manipulation in the market place.

Batson then goes on to explain how Andersen and Enron worked with the SEC to gain support for questionable accounting practices. But unfortunately, ''Enron's efforts…were not in seeking guidance in order to provide the users of its financial statements with relevant and reliable information, but, rather, justification under GAAP for transactions obscuring Enron's reported financial position and operating results.''[22] However, Andersen and Enron have not been castigated by the SEC for ethical lapses in the sense of not following a higher standard than GAAP. Instead their downfall was the direct result of outright fraud and blatant disregard of financial reporting rules, including violation of the 3% rule for consolidating

special purpose entities, improper front-end loading of revenue, misuse of fair value accounting, and improper accounting for securitization transactions.

Is intentional structuring of lease contracts to avoid capitalization unethical? Is there anything wrong with structuring synthetic leases to achieve certain tax objectives while at the same time obtaining favorable off-balance-sheet treatment? Are there any sanctions against unethical behavior by accountants as long as the behavior is ''legal?''

Making financial reporting more ethical

> August 3, 2006 – The FASB Board added to its agenda a project to comprehensively reconsider the guidance in FASB Statement No. 13, Accounting for Leases, together with its subsequent amendments and interpretations in order to insure that investors and other users of financial statements are provided useful, transparent, and complete information about leasing transactions in its financial statements. (FASB Project Summary, Leases, FASB website, www.fasb.org)

It is now over 30 years since the FASB first issued Statement No. 13, *Accounting for Leases*, a standard voted the least favorite FASB standard in a survey conducted by Reither (1998). The Sarbanes-Oxley (2002) legislation has been implemented, and, as one of its charges, the SEC has submitted its *Report and Recommendations Pursuant to Section 401 (c) of the Sarbanes-Oxley Act of 2002 on Arrangements with Off-balance Sheet Implications, Special Purpose Entities and Transparency of Filings by Issuers* (2005). The FASB responded to the recommendations in that study, by, among other things, adding the lease accounting topic to its standard-setting agenda. Already the financial press is calculating the effects of putting leases on the balance sheet. Byrnes, in *Business Week* (June 5, 2006), estimates that S&P 500 firms have more than $300 billion in leases that do not appear on lessee balance sheets and estimates the tally at $1.25 trillion when all public companies are considered. The article also references a Bear Stearns study that predicts an aggregate 17% jump in debt levels for all non-financial companies in the S&P 500. And, already, forces of resistance to any change in the accounting for leases are starting to line up.[23]

In its response to the above-mentioned report issued by the SEC, the FASB noted in a long, but very relevant quotation, the following:

> Among the powerful forces that generate complexity in the reporting system and impede improving financial reporting are the conflicting perspectives and agendas of the participants in the reporting process; resistance to change; an evolutionary approach to standard setting; a continuing focus and emphasis on short-term earnings; gaps in education and training of accountants; additional disclosure requests; the continuing use of accounting-motivated transactions to burnish reported financial results; continuing attempts to politicize standard setting and regulation; and fear of being second-guessed by regulators, enforcers and the trial bar. Many of these forces engender a culture that results in constant demand for detailed rules, exceptions, bright lines, and safe harbors; deters preparers and auditors from exercising professional judgment; and results in disclosures, that while lengthy and dense, all too often are boilerplate, are overly legalistic, and fail to effectively communicate important information. Efforts to counteract these forces will necessitate not only systematic, concerted and coordinated action by the SEC, the FASB and the PCAOB**, but also fundamental cultural and behavioral changes by others.** Accordingly, the support and cooperation of policymakers, the legal profession, legislators and other key parties are necessary if there are to be needed changes in the direction of the reporting system suggested by this Report.[24]

The highlighted phrase above emphasizes the need for fundamental cultural and behavioral changes. The most basic change that is needed is a change in emphasis from just following the rules to one that focuses on accounting for transactions in the most economically relevant and transparent manner possible. As noted by Satava et al. (2006), long ago, The American Institute of Certified Public Accountants (AICPA) recognized this need in calling for a pattern of conduct/thinking ''… that results in the performance of all professional activities with competence, objectivity, and integrity.''[25] While the AICPA focused on a principles-based approach to GAAP whose foundation rests on a conceptual framework for financial reporting that emphasizes reporting the economic substance of transactions, unfortunately,

the typical conceptual framework (e.g., FASB Conceptual Framework) does not stress the importance of ethical principles upon which the financial statements are based (Satava et al., 2006).

Given the public outcry resulting from the recent accounting abuses of companies whose names such as Adelphia, Cendant, Enron, Global Crossing, HealthSouth, MicroStrategy, Parmalat, Royal Ahold, WorldCom and Xerox span the alphabet, and given the huge-cost born by society, by companies and by the accounting profession, there is reason to believe that the overall quality of financial reporting will be enhanced in the future. Already, as a result of the Sarbanes-Oxley Act, we see major steps being taken such as the requirement that top company officials ''sign off'' on the financial statements, the establishment of the Public Company Accounting Oversight Board (PCAOB) and enhanced independence requirements for public accounting firms, the strengthening of board audit committees and the auditing of systems of controls. Three additional steps that should be taken are discussed below.

Make the FASB's Conceptual Framework a primary component of GAAP

As previously noted, the FASB's Conceptual Framework is presently considered a guide for the development of GAAP rather than one of its components. Since the conceptual framework is based on underlying objectives of financial reporting and qualitative characteristics of ''good'' accounting information, it should be the first source of authoritative accounting guidance for financial reporting and disclosure decisions rather than the last. In assessing the accounting pyramid of authoritative support for specific accounting methods, Satava et al. (2006) note ''that the pyramid does not incorporate the importance of ethical principles upon which financial statements must be based…'' (p. 272). However, the more fundamental problem is that the Conceptual Framework is presently not a part of GAAP at all. The FASB has begun a joint project with the International Accounting Standards Board (IASB) to develop a revised conceptual framework that is both common and internally consistent. In their description of the project, FASB and IASB senior project manager Halsey Bullen and Kimberley Crook (FASB, 2005) note that ''A common goal of the FASB and IASB, shared by their constituents, is for their standards to be 'principles-based''' (p. 1). Focusing first on underlying concepts and basics principles should help to change the mentality of preparers that just meeting the form of a rule rather than adhering to the underlying intent is sufficient.

In addition, firms could do a better job of disclosing their intentions in choosing a particular financial reporting method and also increase transparency through footnote disclosures of the effects alternative accounting methods that were not chosen. The disclosure of alternative measures is already a part of GAAP in some areas of financial reporting (e.g., disclosure of FIFO inventory amounts for LIFO firms) and the extension of the idea to encompass all major financial reporting choice decisions should not prove costly. For example, referring back to the leasing context, preparers could easily disclose the capital lease amounts for their operating leases.

Strengthen preparer training concerning the meaning of Accurate, Timely, Understandable, Fair and Full (ATUFF) disclosures

At least 16 of the Dow Jones Industrials have what could be called a tough (ATUFF) disclosure policy as stated in their published codes of ethics, meaning that they emphasize accurate, timely, understandable, fair and full disclosure as their financial reporting objectives. Some companies add additional descriptors, including ''complete,'' ''objective,'' ''relevant,'' and ''honest.'' A few companies (e.g., Procter & Gamble Co.) even go so far as to provide published examples of unethical financial reporting behavior. The codes also indicate that consequences to preparers of unethical financial reports may be severe, including termination of employment. Furthermore, as many observers have advocated, today's employees are exposed to ethics training courses and many must ''sign off'' concerning their company's code of ethics. So, what is left to be done that could make a difference?

I believe that one approach that could make a difference is to provide training related to: (1) the economics of information, (2) the ''law'' concerning

financial reporting, and (3) the potential benefits to the firm of transparent disclosures. As mentioned earlier, mitigating the effects of the asymmetrical information environment and providing a fair securities' trading environment are the SEC's underlying rationales for the regulation of financial reporting. Information providers should be aware of the market consequences of opaque reporting, including inefficiency and thin trading. Second, information providers should be aware of the law concerning the intentional manipulation of financial statements. The SEC has made it very clear that there is *no materiality threshold* for intentional manipulation of financial statements and that prosecution is possible under the security laws (SEC, 1999).[26] Finally, preparers should be aware of the research (e.g., Botosan, 1997; Botosan and Plumlee, 2002; Verrecchia, 2001) indicating that high quality financial statements may reduce the firm's cost of capital.

Restore professionalism to accounting firms

At the plenary session of the 2003 annual meeting of the American Accounting Association and in Wyatt and Gaa (2004), former Arthur Andersen partner and accounting educator Art Wyatt chronicled the decline in professionalism of the major public accounting firms in recent decades. He attributes, this decline to a number of factors including, tone at the top, an over-emphasis on revenue growth and the provision of consulting services that acted to impair independence, too cozy relations with clients, and the hiring of non-accountants and experienced hires who lacked the background to appreciate the importance of ethical behavior and professionalism in accounting. He states that ''Clients were more easily able to persuade engagement partners that their way of viewing a transaction was not only acceptable but also desirable.'' (Wyatt and Gaa, 2004). The firms forgot that their primary duty is to the public, not to their audit clients.[27]

It is easy to say that one needs to restore a level of professionalism to accounting firms. However, accomplishing this involves a complex mix of incentives, accountability and transparency. Arguably, progress is being made in providing incentives and in making the firms more accountable. So far, most of the incentives have been negative as regulators and litigators have barred their teeth. Best examples include the break up of Andersen, major fines paid to the SEC, and lawsuit settlements stemming from allegedly bad audits at Cendant, Phar-Mor, WorldCom and other firms. Accountability has been enhanced through the creation of the PCAOB and the elimination of an ineffective peer review system.

Transparency and to a certain extent accountability could be enhanced through a requirement that major accounting firms publish their own financial statements. As partnerships and non-public companies, there is presently no requirement that they do so. However, the public accounting firms and CPA's have been given an exclusive franchise by the SEC to audit public companies. In return for this franchise they owe transparency to the public.

Conclusion

The ethics of using bright line lease accounting rules to intentionally structure lease contracts to avoid putting assets and liabilities on the books of lessees is explored in this paper. The various technical and economic considerations in structuring lease contracts are summarized as a means of organizing debate about the ethicality of operating lease accounting. The discussion of generic operating and capital lease accounting is then used as a point of departure in discussing more complex and less transparent synthetic lease contracts and special purpose entities.

The rest of the paper addresses the question: ''Does financial reporting ethics really matter?'' Evidence is presented that the standard for ethical behavior is higher than a standard of just meeting the rules of financial reporting, but that a ''rules mentality'' exists. A final section offers suggestions for making financial reporting more ethical.

There is a need for additional discussion, debate and research related to the ethics of various financial reporting and disclosure choices. Also, there is a need for additional research concerning the role of rules and the kinds of rules that promote and enhance ethical behavior. Finally, there is a need for additional discussion of the meaning of accounting professionalism, the incentives for professional

behavior, and ways of communicating profession behavior to financial statement users.

In a most memorable fashion, Chief Judge Benjamin commented on the expectations of corporate board members in meeting their fiduciary responsibilities. He stated, "a board's conduct is expected to go well beyond mere professionalism, to *the punctilio of an honor most sensitive*.[28] As the accountant fulfills her/his stewardship responsibility in reporting to shareholders and creditors, should we expect anything less?

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Notes

[1] "Elements of Financial Statements," FASB Concept Statement No. 6, par. 25.

[2] Ibid, par. 35.

[3] "Accounting for Leases," FASB Statement of Financial Accounting Standards No. 13, Accounting for Leases".

[4] There are several examples in accounting of reporting based on economic relations rather than constraining the reporting based on legal considerations. The best example is the reporting of consolidated financial statements. In this case the reporting unit is the parent organization and the subsidiary companies over which the parent has economic control. The economic control is based on ownership. To the extent the parent has more than a 50% ownership position in another firm, even though that firm is a separate legal entity, its financial statements are consolidated with those of the parent.

[5] Total profitability is the same over the life of the lease for operating and capital lease accounting. However, contracts are normally structured such that operating lease accounting yields higher profits in the early years of the lease, compared with capital lease accounting. For steady state firms, there will be no difference in profitability based on operating or capital lease accounting. For growing firms, those using operating lease accounting, will continue to report higher profits than if capital lease accounting is used.

[6] For example, see Dieter (1979), "Is Lessee Accounting Working?" *The CPA Journal*, August 1979, pp. 13–19.

[7] See Beaver (1998), Chapter 7.

[8] For example, DePree and Grant (1999) illustrate how the FASB's Conceptual Framework can be used to analyze the choice of accounting methods for a portfolio of marketable securities and then relate the discussion to utilitarian, rights, and justice theory paradigms.

[9] As a result of the Sarbanes-Oxley Act of 2002, the SEC was directed to conduct a study related to the adoption of a principles-based standard setting process and report back to Congress. Consistent with the conclusions of many other previous studies, the SEC study notes that both principles-based and rule-based standards are problematic. A principles only approach de-emphasizes measurement issues and often provides insufficient guidance to make standards reliably operational. Implementation of a principles approach requires preparers and auditors to make professional judgments in situations where there may be insufficient structure to frame those judgments. The result may be a lack of comparability among companies. In contrast, as is so obvious in the lease accounting area, "rules-based standards often provide a roadmap to avoidance of the accounting objectives inherent in the standards." (SEC, 2002, p. 17). As a result of the limitations of both approaches, the SEC instead recommended what it called an "objectives-oriented" approach to include the following characteristics: (1) grounded in an improved conceptual framework, (2) includes a clear statement of the accounting objective of the standard, (3) provides sufficient detail and structure for operationalizing and applying the standard on a consistent basis, (4) minimizes exceptions to the standard, and (5) avoids use of bright-line percentage tests. The SEC suggests that the FASB is moving in this direction as evidenced by recently-issued standards.

[10] Actually, the disclosure requirements are somewhat limited. See Lim et al. (2003) for a discussion. One of the main difficulties is in estimating leased asset amounts. See Imhoff et al. (1991) for a methodology for estimating these asset amounts.

[11] The heuristic dates from Graham and Dodd's *Security Analysis* (1934) text and is based on simplifying assumptions that the rent payments persist to perpetuity, that one-third of the rent payment is arbitrarily treated as interest, and that a fixed interest rate of 4% results in the rent expense multiplier of approximately 8. The

heuristic has some basic limitations. For example, the constructive capitalization procedure assumes that the unrecorded asset is equal to the unrecorded liability and there are no adjustments made to equity or to net income. Despite its limitations, the method is widely used in practice. For example, Lim et al. (2003) report that both Moody's and McKinsey use this multiples of operating lease expense approach.

[12] However, there have been several research studies that investigate the extent to which market measures of risk incorporate off-balance sheet leases. Lipe (2001) reviews this literature and concludes that "The bulk of the evidence finds that measures of shareholder risk can be better explained when one includes the financial leverage implicit in unrecorded leases." (p. 302). Also, Lim et al. (2003) find that debt yields reflect the risk associated with operating leases, but that balance sheet debt is more important for credit ratings than is operating lease debt.

[13] Sheppard, Mullin, Richter & Hampton LLP publication, "The Synthetic Lease: Off-Balance Sheet Financing of Real Property, April 10, 1998.

[14] The difference in treatment for financial reporting purposes and tax purposes are because of the difference in rules as to what constitutes a capital lease. The financial reporting rules (e.g., the 90% rule) are specified in SFAS No. 13 while the tax rules are based on "at risk" considerations. If the lessor retains 20% of more of the economic risk associated with the leased asset, the asset remains on the books of the lessor for tax purposes. Thus, to achieve favorable book and tax treatment for the lessee, structure the contract so that the present value of the minimum lease payments to be between 80% and 90% of the fair market value of the asset. Here, the 90% rule is not met for financial reporting purposes (off balance sheet treatment for lessee) and the lessor has retained less than 20% of the risk (capital lease treatment/lessee gets tax deduction) for tax purposes. Ryan (2002).

[15] The outside entity is usually a bank, which, by the way, would probably treat the financing as debt, not equity, on the bank's books.

[16] In a Forbes (2002) article, Krispy Kreme was criticized for its synthetic lease treatment of a $30 million dollar mixing plant and warehouse. They subsequently changed the accounting to make it more transparent. Later, Krispy Kreme and more than 150 other companies were forced to restate their financials as a result of problems in accounting for real estate leases.

[17] Many excellent discussions of Enron's accounting problems have been provided by both Enron board-appointed and court-appointed examiners. These reports can be found at the following web address: www.enron.com/corp/por/supporting.html. The executive summary in the Powers et al. (2002) board of directors' report is a good place to begin. Also see the Part V references to the Batson Reports.

[18] Davis-Friday and Frecka, "What Managers Should Know About Earnings Management – its Prevalence, Legality, Ethicality, and Does it Work?" *Review of Accounting & Finance*, Volume 1, Number 1, 2002, pp. 57–71.

[19] In turns out that the three examples of earnings management are not only examples of unethical behavior, but also a violation of SEC regulations. Staff Accounting Bulletin No. 99 – Materiality, issued in 1999, states that any intentional manipulation of financial statements, with the intent to mislead, is subject to prosecution under securities law. However, whether or not the example practices are legal or not, is not the point. The point is that there is a general impression that the bar for ethical reporting is set higher than the bar for legal (within the bounds of GAAP) reporting.

[20] Batson, "Second Interim Report of Neal Batson, Court-Appointed Examiner, Appendix B (Accounting Standards)," p. 9, Chapter 11, Case No.01-16034 (AJG), United States Bankruptcy Court, Southern District of New York, 2003.

[21] Ibid, p.10.

[22] Ibid, p.12.

[23] For example, see "Lease Accounting: Separating Myth from Reality", by Bosco, Equipment Leasing Association, 2006.

[24] "FASB Response to SEC Study on Arrangements with Off-balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers.

[25] American Institute of Certified Public Accountants (1986) "Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment" (AICPA, New York, NY).

[26] Also see footnote 18. Emphasizing this point is extremely important. There exists a common perception that "everyone does it" (see Table 2) and that a little bit of manipulation is "okay."

[27] One example concerns the accounting for executive stock options. During the 1990s, the FASB was debating the merits of requiring firms to treat stock options as a component of compensation expense, along with the salary and bonus components that were already treated as expenses. While practically every accounting scholar supported the position of the FASB that stock options should be expensed, not a single (then) Big-six firm supported this position. It was not until the recent accounting debacles occurred, along with the public outcry about the level of executive compensation in general, that the FASB had sufficient political support to issue a standard calling for the expensing of stock options.

[28] Quote taken from “M&A Legal Context: Basic Framework for Corporate Governance, by Baldwin et al., Harvard Business School Case Study 9-803-200 (2003), original source, *Meinhard v. Salmon*, 164 N.E. 545 (New York, 1928).

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