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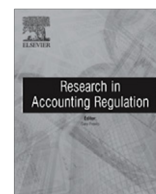

Research Report

Lease transaction structuring, earnings management, and management credibility

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ABSTRACT

Despite recent regulatory concerns regarding off-balance sheet financing, and concerns about lease accounting in particular, relatively little is known about how financial statement users view lease transaction structuring compared to other forms of earnings management. We examine sell-side financial statement analysts' views on lease transaction structuring and its impact on their assessments of management credibility. Although operating leases often act as the prototypical example of transaction structuring, survey responses suggest that lease structuring and related voluntary reconciliations do not raise the same concerns for analysts as do other earnings management activities (which lower analysts' perceptions of management credibility). Our findings are consistent with prior research demonstrating that, with precise accounting standards, managers are more likely to attempt earnings management by structuring transactions, but auditors are also less likely to adjust such attempts, and suggest that financial statement users may also be less concerned with transaction structuring than with other forms of earnings management.

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Introduction

Operating leases act as the prototypical example of structuring a transaction to achieve a preferred financial reporting treatment (Abdel-khalik, 1981; Imhoff & Thomas, 1988; O'Brien, 2005, p. 246). The bright-line thresholds stated in SFAS No. 13 (now Accounting Standards Codification Topic 840) have long required disclosure for operating leases but recognition for capital leases, and prior research has documented that approximately 14% of non-business-combination earnings management attempts involve off-balance-sheet financing such as structured lease transactions (Nelson, Elliott, & Tarpley, 2003, Table 5).[1]

Under SFAS No. 13 and other precise standards, managers are more likely to attempt earnings management by structuring transactions (Nelson, Elliott, & Tarpley, 2002). However, unlike other forms of earnings management that are difficult to identify and distinguish from GAAP (e.g.,

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[1] Although lease constructive capitalization can have an earnings component (e.g., Imhoff, Lipe, & Wright, 1997), the focus is often on the dramatic balance sheet impact (Boatsman & Dong, 2011, p. 2; see, e.g., Imhoff, Lipe, & Wright, 1991). Nevertheless, we use the term "earnings management" in keeping with Schipper (1989, p. 92), in which she refers to "earnings management" more broadly as "disclosure management" and as "a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process)." Healy and Wahlen (1999, p. 368) provide a similarly broad definition in which "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying business of the company or to influence contractual outcomes that depend on reported accounting numbers."

over- or underestimating loan loss reserves) or earnings management that is clearly inconsistent with GAAP (e.g., intentionally misapplying revenue recognition rules), transaction structuring can result in accounting outcomes that are consistent with stated bright-line conditions in GAAP.[2] Perhaps not surprisingly then, auditors are also less likely to require an adjustment for earnings management attempts involving transaction structuring under such precise standards (Nelson et al., 2002). The precise nature of the current U.S. lease accounting standards can also lead to more aggressive lease accounting judgments, in part through the perception that the lease standards' precision provides protection against regulatory second-guessing of the related accounting decisions (Agoglia, Doupnik, & Tsakumis, 2011).

This raises the question of whether there are differential effects on investors' judgments when earnings management is achieved by means of transaction structuring instead of management judgments (Schipper, 2003, p. 68), especially under precise standards such as SFAS No. 13. The question is particularly timely, as multiple standard setters (FASB, 2010; IASB, 2010; FASB & IASB, 2009; IASC, 2000), regulators (SEC, 2005), and users (e.g., Imhoff et al., 1991; Revsine, Collins, & Johnson, 2002; S&P, 2006) have indicated they believe SFAS No. 13 accounting outcomes are inappropriate and that all leases should be effectively recognized (see also discussions in Nelson & Tayler, 2007).

Despite the recent regulatory concerns regarding off-balance sheet financing (SEC, 2005), and about lease accounting in particular (FASB, 2010; FASB & IASB, 2009; IASB, 2010; IASC, 2000), relatively little is known about how financial statement users view lease transaction structuring compared to other forms of earnings management. For example, financial statement users' responses to the recent FASB and IASB exposure drafts for leases (FASB, 2010; IASB, 2010) suggest that "almost all" users not only have the ability to make adjustments to capitalize operating leases but already do so in some fashion (FASB and IASB Staff, 2011, ¶20). Prior academic research also suggests differences in views across these forms of earnings management will likely exist. For example, Libby, Nelson, and Hunton (2006) document that audit partners are willing to allow greater misstatement in disclosed lease amounts than in recognized lease amounts, in part because auditors view misstatements in disclosed amounts to be less material. In a recent survey of audit partners and CFOs of *Fortune 500* companies, McEnroe (2007, p. 150) also reports that capital lease misclassification was amongst the items perceived to be the least reduced by the implementation of the Sarbanes–Oxley Act of 2002 (P.L. No. 107–204, 2002).[3] Consistent with this finding, Agoglia et al. (2011) document managers' perception that the rules-based nature of SFAS No. 13 can provide protection against regulatory second-guessing of lease accounting decisions, even though a stronger corporate governance system can also reduce the aggressiveness of lease accounting decisions under such precise standards. We contribute to understanding this important issue by examining financial analysts' views on lease transaction structuring and its impact on their assessments of management credibility vis-à-vis other forms of earnings management.

Background and research questions

If lease obligations are viewed as debts, users' perceptions of the risk of investing in a company should increase with the amount of its lease obligations, regardless of the accounting treatment. Notwithstanding that lease structuring results in accounting outcomes that are consistent with the conditions currently specified in U.S. GAAP, multiple standard setters (FASB, 2010; IASB, 2010; IASC, 2000), regulators (SEC, 2005), and users (e.g., Imhoff et al., 1991; Revsine et al., 2002; S&P, 2006) have indicated they believe that all leases should be effectively recognized (see also discussions in Nelson & Tayler, 2007).

While some research suggests that capital markets at least partially adjust for operating leases (e.g., De Franco, Wong, & Zhou, 2010; Lee, Ge, & Imoff, 2010; see Lipe, 2001, for an earlier review), other research provides evidence that recognized debts have a stronger influence on investors' judgments than does disclosed debt information. For example, financial statement users are more likely to view various types of obligations (including lease obligations) as debts if they are recognized rather than disclosed (Harper, Mister, & Strawser, 1987; Harper, Mister, & Strawser, 1991; Gopalakrishnan & Parkash, 1996; Munter & Ratcliffe, 1983). Thus, our first research issue relates to how significant sell-side financial analysts believe leases are to the operations of the companies they typically follow, and how often sell-side financial analysts constructively capitalize operating leases in their analyses. We provide descriptive evidence on how sell-side financial analysts view the significance of operating leases and related capitalization adjustments.

Because operating leases are often cited as the exemplar for transaction structuring (e.g., O'Brien, 2005, p. 246), our second research issue relates to the extent of analyst agreement that company management retains the flexibility needed to structure leases as operating leases versus capital leases, and examines analysts' perceptions with regards to applying that flexibility. With managers more likely to attempt earnings management by structuring transactions around precise standards (such as the bright-line thresholds stated in SFAS No. 13), and auditors less likely to adjust such attempts (Nelson et al., 2002), we examine whether lease transaction structuring has an impact on either analysts' stated evaluations of the risk of investing in that company or of the credibility of company management (financial statement users' beliefs about management's overall level of trustworthiness and competence—Mercer, 2004). We

[2] "Transaction structuring" also differs from "real earnings management." Whereas transaction structuring typically involves legally structuring an economic transaction to obtain a preferred financial reporting treatment for that transaction despite a lack of substantive economic differences, real earnings management involves entering into (or delaying) new economic transactions to achieve a particular financial reporting outcome, with resulting differences in real business activities. See Xu, Taylor, and Dugan (2007) for a recent review of the "real earnings management" literature.

[3] Specifically, the misclassification was described as "the classification [of] an otherwise capital lease as an operating lease by having a third-party guarantee the residual value" (McEnroe, 2007, Table 1).

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