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Legislated Ethics: From Enron to Sarbanes-Oxley, the Impact on Corporate America

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ABSTRACT. This paper explores the financial reporting scandals of the past decade and the resulting U.S. legislative attempts to impose ethical behavior and control the incidence of new reporting problems via the Sarbanes-Oxley legislation. We begin with a brief historical perspective followed by assertions of ethical consequences of legislation with discussions of key recent corporate scandals, the motives for the frauds, and the consequences. Ethics related provisions of the Sarbanes-Oxley Act are discussed with the potential impact of the legislation on the likelihood of similar future frauds and accompanying prognosis for future corporate ethical behavior.

KEY WORDS: Corporate culture, corporate ethics, financial reporting fraud, financial reporting regulation, internal control, Sarbanes-Oxley Act

Enron, WorldCom, HealthSouth, Adelphia, Parmalat, Elan, Andersen… the list goes on and on. In the past three years the world economic system has witnessed in monetary terms the largest dollar level of fraud, accounting manipulations and unethical behavior in corporate history and certainly the most economic scandals and failures since the 1920s. Unlike the Savings and Loan failures of the 1980s, the current ethical crisis is broadly based and spreads across industries and countries. In July, 2002 the U.S. Congress responded with the Sarbanes-Oxley Act which legislates ethical behavior for both publicly traded companies and their auditor firms. Can a government legislates ethical behavior or does the corporate or firm culture determine individual and group actions? This paper explores that question through review of the recent corporate scandals along with the requirements of the Sarbanes-Oxley legislation.

"Historical perspective" Section presents a historical perspective on previous attempts to legislate corporate ethical behavior followed by discussion of some of the largest recent corporate financial reporting scandals and the underlying unethical and fraudulent actions in "Recent corporate frauds" Section. "Sarbanes-Oxley Act of 2002" section outlines specific provisions of the Sarbanes-Oxley Act as the most recent attempt to legislate ethical behavior followed by discussion of the potential outcomes. "Basic premises for ethical financial reporting" Section of the paper develops a framework positing four premises of corporate management's behavior followed by conclusions on the likely impact of the current attempts to legislate ethical behavior.

Historical perspective

> The historical perspective illustrates that the frauds and failures of recent years are not a new phenomena.

The 20th century witnessed the growth of enormous international corporations and very large international Certified Public Accounting (CPA) firms. This

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growth has not been without struggle, controversy and regulation. Corporate fraud, unethical management behavior, and questionable financial reporting have surfaced repeatedly throughout the century with resulting regulation and studies calling for ethical behavior. Table I presents a summary of key regulatory acts of the century that attempted to impose ethical conduct on the U.S. securities markets, corporate America and the CPA profession. The early legislation was aimed at financial institutions and the security of the monetary system. However, the most sweeping legislation followed the excesses of the 1920s.

The 1920s were a period of industrial growth with a corresponding surge in stock prices. A new economy of automobiles, oil, steel, radio communications and expensive real estate drove market prices to unprecedented levels (Pearlstein, 2002). Accounting standards were developed privately, often poorly defined and unregulated. As a result, they were subject to manipulation with accurate financial reporting easily compromised to drive stock prices, meet loan covenants or attract new investors. The unregulated securities markets were characterized by short sales, fraudulent trading practices and margin purchases that pushed investors and management to attempt to drive prices in search of even higher returns. The incentives for management to engage in unethical practices were driven by personal gain, ego and greed illustrated by opportunistic and exploitative executive behavior to achieve personal objectives. The results were famous frauds such as the Ponzi scheme, fraudulent financial reporting, unsubstantiated market values and the crash of 1929.

The Securities Acts of 1933 and 1934 were the U.S. Congress' response to the 1920s and the first broadly based attempt to elicit ethical behavior by corporations, the securities markets and the accounting profession through legislation. The Acts established the U.S. Securities and Exchange Commission (SEC), regulated securities trading, mandated common accounting standards and required CPA firm audits of publicly traded companies. These Acts signified a landmark change in corporate accountability and provided the foundation for growth of the CPA profession as external auditors. Prior to the Sarbanes-Oxley Act of 2002, the SEC Acts were considered the most significant pieces of legislation in the history of both the CPA profession and U.S. corporate financial reporting.

The 1933 and 1934 SEC Acts did not solve the systemic problems. Between 1934 and 2002, there were many instances of ethical transgressions in U.S. corporate financial reporting. The 1960s were marked by real estate scandals filled with creative accounting and the 1970s saw international frauds and bribery resulting from numerous unethical behaviors. This time the regulatory response was the 1977 Foreign Corrupt Practices Act. The Act imposed new ethical standards on corporations dealing in foreign countries, attempted to curtail bribery and illegal payments and precipitated increased audit procedures (Shearman and Sterling, 2001). The SEC proposed management attestation of internal control systems following the Foreign Corrupt Practices Act, but under pressure from corporate America the requirement was dropped.

The 1980s experienced the failure of real estate driven savings and loans as well as widespread Wall Street corruption, fraudulent reporting, insider trading and junk-bond schemes (Vickers and France, 2002). By 1991, the FBI had budgeted more than $125 million to pursue cases of financial fraud in the S&L industry (U.S. Congress: Senate, 1992) and the Big Six CPA firms paid $1.6 billion to settle fraudulent reporting charges levied against them by the federal government (Arthur Andersen et al., 1992). Zimring and Hawkins (1993) argued that deregulation of banking with relaxation of regulations created conditions that made regular fraudulent practices the norm. The Federal Deposit Insurance Corporation Improvement Act in 1991 (U.S. Congress, 1991) dealt directly with the fraud in savings and loans and required attestation of internal control in financial institutions. Litigation resulting from the savings and loan failures precipitated the Private Securities Litigation Reform Act of 1995 (U.S. Congress, 1995) that attempted to limit CPA firm liability and was the first requirement for auditors to report fraud externally to the SEC.

In addition to legislation, unethical actions of the 1970s and 1980s precipitated the National Commission on Fraudulent Financial Reporting (Treadway Commission, 1987) report calling for ethical behavior by corporations. The report made numerous recommendations to prevent fraudulent financial reporting including strong recommendations for internal control systems. Emphasis was placed on the tone at the top, ethics

TABLE I
U.S. legislation attempting to prevent behaviors viewed as unethical

Legislation	Timing	Ethical focus	Requirement	Result
Owens-Glass (Federal Reserve) Act of 1913	1913	Banking failures due to inadequate or fraudulent reserves	Rules for operations of banks including maintenance of reserves, financial reporting requirements	Creation of Federal Reserve System, in part, for more effective supervision of banking activities. Required annual independent audits of Federal Reserve Banks and Board
Glass-Stegall Act of 1933	1933	Conflict of interest and fraud by banks	Prohibited commercial banks from engaging in investment banking. Similarly, prohibited investment banks from engaging in commercial banking directly or through employees, officers, or directors	Intended to keep banks from selling securities to pay off loans made by the bank to failing company or country
U.S. Securities and Exchange Act of 1933	1933	Prohibited deceit, misrepresentations, and other fraud in sale of securities	Required disclosure of relevant information through registration of securities	Made commitment of fraud in conjunction with sale of securities (registered or unregistered) illegal
U.S. Securities and Exchange Act of 1934	1934	Insider stock trading, manipulation of financial markets, fraudulent financial reporting	Self-policing by stock exchanges and National Association of Security Dealers, filing of quarterly and audited annual reports by registered companies	Established CPA as the independent outside auditor of published financial statements. Provided for civil actions by the SEC and private investors for fraud, insider trading, and market manipulation
Investment Company Act of 1940	1940	Abuses in investment companies (principally mutual funds investing in stocks of other companies) including conflicts of interest	Periodic disclosure of structure, operations, financial condition, and investment policies Established fiduciary responsibilities of investment company's directors and trustees	Registration of mutual fund management companies and disclosure of transaction between the management company and affiliates
Foreign Corrupt Practices Act	1977	Bribery of foreign government and business officials. U.S. political campaign contributions by U.S. corporations	Required companies to design and maintain internal control systems and detailed records which accurately and fairly reflect financial activities	Made payments to officials of foreign government, companies, or their agents in order to obtain business illegal. Established direct link between internal audit function and board of directors

TABLE I
Continued

Legislation	Timing	Ethical focus	Requirement	Result
FIDCA improvement act	1991	Fraud and conflict of interest on the part of officers and directors of failed savings and loan institutions	Required report by officers on internal control over financial reporting and compliance with federal law. Required independent auditor attestation on management reports on internal control and compliance	First instance of separate management assertion with respect to internal control and auditor attestation of management's assertion
Private Securities Litigation Reform Act	1995	Frivolous litigation against SEC companies for alleged wrong-doing	Required lawyer to make specific allegations of wrong-doing but also required outside auditor to notify SEC of serious financial wrongdoing	Outside auditor must report evidence of serious financial wrongdoing to board of directors and then to SEC if board does not take appropriate action
Sarbanes-Oxley Act (See Table IV for detailed analysis of content)	2002	Fraudulent financial reporting	Regulates CPA profession and service provided to external public company audit clients, and legislates control requirements, corporate management certifications, audit committees responsibilities, and corporate culture changes	Significant civil and criminal penalties for certification by management of inaccurate financial statements or inoperative internal controls. Established increased oversight responsibilities for audit committees of board of directors. Requires external auditor certification of internal controls

education and codes of conduct. However, the Treadway Commission focused more on employee fraud, not management fraud, and centered on detection, not prevention, providing no clear effective strategy for preventing management fraud (Tipgos, 2002). Following the Treadway Report, the SEC once again proposed management attestation of internal control systems as well as disclosure of responses to auditor recommendations, but they backed down under pressure from corporate America. In 1992, the Committee of Sponsoring Organizations of the Treadway Commissions (COSO, 1992) again responded to the ethical problems of the 1980s with their framework for internal control framework guidance.

The 1990s brought an unprecedented era of fraudulent reporting and unethical corporate management behavior. The dot.com phenomena, a new economy of technology, communications, day-trading, a roaring bull market, and a surge of initial public offerings often creating instant wealth made this period unlike any time in history. The use of incentive-based compensation schemes provided the incentives, and continued development of computer technology and the transfer of records from paper to machine paved the way to countless opportunities for fraudulent financial reporting.

A new round of corporate failures began in the late 1990s and early 2000s. The unethical actions of corporate leaders led to bankruptcies and restatements of a magnitude unimagined in prior decades. Since 1997, more than 10% of U.S. public companies have restated their reports resulting in market capitalization losses in excess of $100 billion (GAO, 2002). In the twelve-month period ending June 30, 2003 alone, 354 companies restated earnings (Huron Consulting Group, 2003). The sheer size of the failures dwarfed previous scandals. "It is not that our leaders are worse than ever, it's just that the bad ones can do more damage than ever before, and on a spectacular scale" (Morris, 2002).

The response this time was the Sarbanes-Oxley legislation (Sarbanes) of 2002, which is the focus of this paper and is discussed in detail in "Conclusion" Section. Will Sarbanes be different or will unethical and fraudulent management behavior continue resulting in more corporate failures? The parallels of the 1920s, the 1980s and the past decade are strong and raise serious doubts as to whether ethical behavior can be legislated. "Recent corporate frauds" Section discusses some of the most glaring illustrations of ethical misconduct and fraud in corporate America to set the stage for U.S. legislature's perceived need to respond with the Sarbanes-Oxley Act in 2002.

Recent corporate frauds

> "Losses from financial frauds total approximately $200 billion dollars. On Enron alone those losses are more than two times the aggregate losses suffered when the stock market crashed in 1929." (Turner, 2002)

Enron

Enron's failure will most likely go down in history as not only one of the most spectacular financial failures, but also as a turning point in professional accounting regulation and corporate financial reporting. It was the driving force behind the Sarbanes-Oxley legislation. However, it was only one of many corporate failures resulting from unethical and fraudulent behavior that led to landmark legislation.

Table II presents a summary of significant recent corporate and accounting frauds. The unethical behaviors represented in Table II include fraudulent financial reporting (most common), obstruction of justice, theft of assets, unauthorized loans to senior management, bribery, manipulation of markets, perjury, and insider trading. The types of fraud were pervasive, extended over years rather than single episodes, and involved very large sums of money. The most consistent common element across all these firms is the involvement of senior management in the frauds including members of the Board of Directors, the CEO, the CFO, and other key executives.

The tone at the top has been cited as the primary driver of corporate ethical conduct by many professional sources (e.g., AICPA, 2002; COSO, 1992; Treadway Commission, 1987). Ethicists have long argued that tone drives the corporate culture (Buchholz and Rosenthal, 1998, p.177). Sweeney (2003) argued that the tone at the top sets the corporate culture and in many cases was a root cause of the unethical conduct and fraudulent

TABLE II
Example companies charged with financial irregularities

Company	Industry	Fraud	Activity	Participants	Outcome
Sunbeam–1996–1997 ($60 million)	Consumer durables	Fraudulent financial reporting	Understating inventory value, underreporting cost of goods sold, recognizing revenue from undelivered goods, bill and hold sales, channel stuffing, and establishing false reserves in 1996 to improve 1997 income	Senior management including CEO	CEO and CFO settled SEC civil charges , termination of senior management, barred from serving in senior positions in public companies
Waste management – (1997) ($1.7 billion)	Trash collection and disposal	Fraudulent financial reporting	Misrepresentation of asset lives and salvage values, overvaluation of landfill site assets, excess reserves, and reporting expenses as assets	Senior management	Senior management sued for fraud, settled insider trading charge. Company settled civil litigation for $457 million.
Global crossing (2002)	Telecommunications	Fraudulent financial reporting	Overstatement of revenue from barter transactions	Senior management	Chapter 11 bankruptcy, congressional investigation, SEC charged senior management with fraud
Xerox – (1997–2000) ($ 1.5 billion)	Office Equipment	Fraudulent financial reporting	Booking revenue from foreign subsidiaries before earned and failure to appropriately classify lease assets	Senior management for South America	$10 million fine
WorldCom/MCI -(2002) ($3.8 billion income and $400 million in loans, alleged $11 billion in revenue)	Telecommunications	Fraudulent financial reporting	Reporting of line rental expense as capital lease asset, underreporting of line rental expenses, and off-books loans to CEO	Senior management	CEO charged with fraud, CFO and other financial executives plead guilty to criminal fraud, active jail sentences

Andersen (2002)		Obstruction of justice	Destruction of documentary evidence after SEC launch of Enron investigation	Andersen legal department and professional staff	Convicted of obstruction of justice Firm dissolved
Healthsouth (2003) ($4.2 billion overstatement of income)	Healthcare delivery	Fraudulent financial reporting	Reporting non-existant assets and under reporting revenues	Senior management	Guilty pleas by over 25 of senior financial managers, CEO charged with civil and 85 counts of criminal fraud
Tyco (2002) ($600 million)	Diversified manufacturer	Theft of assets, unauthorized loans to senior management, and fraudulent financial reporting	Unauthorized loans and payments to senior executives	Senior management including CEO, CFO, and chief legal officer	Senior management indicted for corruption, conspiracy, grand larceny and falsifying records. CEO and CFO pleaded innocent. Six month trial ended with hung jury
Adelphia Communications 2001 ($3.1 billion including $300 in unauthorized cash withdrawals and loans by founding family/senior management)	Cable television	Theft of assets Fraudulent financial reporting	Unauthorized payments and loans to principle owners, inflated capital expenditures, hidden debt	Founding family/senior management	SEC/Department of Justice indictment
Parmalat 2003 (estimated 8.0 billion euros overstatement of assets and 500 million euros diverted to family accounts)	Dairy products	Fraudulent financial reporting, looting of company	Reporting non-existent assets (Cash)	Founder/family/senior management	
Ahold NV-2003 (Over statement of income by at least 900 million euros)	Groceries and food distribution	Management fraud in S and European subsidiaries	Overstating income in subsidiaries in part by recognizing manufacturer rebates and special discounts prior to sale of goods	Subsidiary management	CEO and CFO of company resign

TABLE II
Continued

Company	Industry	Fraud	Activity	Participants	Outcome
Cendant	Diversified services				
Enron (Over $1 billion)	Energy	Fraudulent financial reporting, bribery of foreign government officials, manipulation of energy markets	Overstating income by hiding losses, and understatement of liabilities by transferring debt to related companies	Senior management	Guilty pleas by senior financial management, indictment of CEO
Imclone Systems Inc. 2002	Biotechnology/ Pharmaceuticals	Insider trading, perjury, insider trading, and obstruction of justice	Sale of owned shares by senior management ahead of announcement of bad news	Senior management, family, and friends	CEO pleaded guilty, friend convicted

activities. He cites two common characteristics: overly aggressive financial performance targets and a can-do culture that did not tolerate failure (Sweeney, 2003).

In this culture, what often began as questionable accounting adjustments grew into massive fraud in an attempt to fix each quarter's numbers to close the variance between income targets and actual results. The classic slippery slope of unethical behavior prevailed as otherwise honest people came to believe they were acting in the best interest of the company and consented to participating in unethical and fraudulent behavior. Personal gain, ego and survival were perhaps all motivating factors for the individuals involved. The impact of senior management on the corporate culture and resulting frauds are illustrated by taking a closer look at three of the biggest scandals: Enron, WorldCom, and HealthSouth.

Sims and Brinkman (2003) provide an in-depth analysis of the culture at Enron. They describe how Jeffrey Skilling, former CEO, set the tone at the top by creating a culture that would push limits and where employees were expected to perform to a continually increasing standard. Bartlett and Glinska (2001) quoted employees stating "...it was all about an atmosphere of deliberately breaking the rules..." Complex accounting strategies and manipulations were utilized to meet ever-higher expectations.

The Enron issues were relatively sophisticated requiring knowledge of difficult accounting regulations and an understanding of ways to manipulate the rules. Approximately 3000 non-consolidated special purpose entities were created to move debt off the balance sheet, complicated hedge and derivative transactions were improperly accounted for, related party transactions were improperly disclosed (or not disclosed at all), and the accounting for the sale of Enron's stock in exchange for notes receivable was questionable.

Enron's slippery slope got steeper. It started as utilization of accounting rules to the company's advantage. It then progressed to fraudulent reporting and, finally, to destruction of documents. Numerous people were involved with many having full knowledge of the fraudulent accounting. One mid-level executive, Sherron Watkins, tried to blow the whistle but was ignored (Morse and Bower, 2002). Control systems failures were evident in both

the corporation and in their external audit firm, Andersen, as the warnings of Sherron Watkins and others within Andersen went unheeded. The result was the then largest corporate bankruptcy of the century and the resulting demise of Andersen.

Unprecedented levels of Enron related litigation are underway including lawsuits brought by investors, the SEC, the U.S. Justice Department, pension plans, and employees (SEC, 2004a). Major investment firms including Citibank and J.P Morgan already have paid $135 million and $120 million, respectively, to settle SEC charges that they aided Enron in the fraud (Forbes, 2003). Fifteen former executives were criminally indicted and seven have pleaded guilty. Andrew Fastow, the former CFO, pleaded guilty to fraud in January 2004 and negotiated a ten-year prison sentence (CNN Money, 2004). He will be a major witness against the former CEO Jeffrey Skilling. On February 19, 2004, the U.S. Justice Department charged Skilling with 42 counts conspiracy, fraud, and other security laws violations (Flood, 2004).

WorldCom

At WorldCom, CEO and founder, Bernie Ebbers, set the tone at the top. Richard Breeden, former chairman of the SEC, says Ebbers ''scoffed at ethics and controls...real men only worry about revenue growth'' (Sweeney, 2003). In the WorldCom culture, promotions were given to those who claimed credit for things they did not do, were willing to twist reality, and promised what they could not deliver. Trouble began at WorldCom when they failed to meet the revenue expectations communicated earlier to the investment community. In 2004, the CFO pleaded guilty stating that he and the CEO met concerning the problem. The CEO refused to meet with the investment community to announce the shortfall. Rather, the CFO said he was instructed by the CEO to fix the problem. Allegations are that the CEO was keenly aware of the likely impact on share price and was more concerned about $400 million he had personally borrowed from WorldCom secured by WorldCom stock (Padgett, 2002).

The WorldCom unethical and fraudulent accounting practices resulted in a $9 billion dollar restatement... the largest in U.S. history. Recent evidence now places the total fraudulent reporting at $11 billion (Perrotta, 2004). Over a five-year period, accountant's at WorldCom systematically altered records, often after the books were closed, to meet analyst's expectations. According to the WorldCom indictment, CEO Ebbers, CFO Sullivan and others created a process called ''close the gap'' which identified improper accounting adjustments and then instructed staff to carry out the manipulations. Initially reserves were used to absorb expenses. When the reserves ran out a variety of accounting frauds were used to enhance revenues and decrease expenses. For example, costs for annual operating leases for lines were capitalized as assets to reduce expenses (SEC, 2004b). Unlike Enron, this did not involve manipulation of complex accounting rules, but rather a straight-forward capitalization of expenses.

Members of the financial staff including the CFO, the controller and head of general accounting have pleaded guilty to fraud and the CEO has been charged with securities fraud (Washington Post, 2004). David Myers the former controller told a U.S. district judge that he was ''instructed on a quarterly basis by senior management to ensure that entries were made to falsify WorldCom's reported actual costs and therefore increase WorldCom's reported earnings. ''I knew there was no justification or documentation'' (Taub, 2002). Accounting managers were given promotions, raises, and made to feel responsible for the likely collapse of the stock price if they did not manipulate the books (Pulliam, 2003).

The WorldCom corporate culture encouraged unethical behavior both by appealing to individuals' sense of promoting the greatest common good for the workers, shareholders, and community and by raising fears of losing their jobs if they did not comply with requests to falsify records. Arguably, many of the financial staff at Enron may not have had the knowledge to recognize the sophisticated transactions as fraudulent. However, WorldCom staff knew it was wrong and went along with the schemes anyway (Pulliam, 2003). Again, an individual, Cynthia Cooper, blew the whistle to the audit committee and started the resulting disclosure of the fraudulent financial practices (Ripley, 2002).

HealthSouth

HealthSouth is perhaps the most egregious illustration of unethical and fraudulent behavior. Recent estimates indicate the accounting fraud may have manufactured $4 billion of false earnings (MSNBC, 2004). Once again, the tone at the top led to a slippery slope of unethical actions. According to the SEC indictment, senior officers would present actual results to the CEO each quarter and, if they were short of expectations, he would tell them to fix it. The accounting personnel then convened in "family meetings" and discussed what false accounting entries to make to inflate earnings. The focus was on altering the contractual adjustments account (common in health care to recognize differences between gross billings and what health care providers will pay) to increase net revenue. The adjustment was balanced by falsifying fixed assets accounts. To further the fraud, many of HealthSouth's accounting personnel were prior employees of the auditor, Ernst and Young, and knew adjustments they could make that would not be detected in audit procedures. If the auditors did question an entry, the HealthSouth accountants created false documents to support it (SEC, 2003c). The CEO Scrushy personally profited selling 7.7 million shares of stock when the price was artificially inflated by accounting numbers as well as bonus payments and salary payments.

HealthSouth's ethical problems also existed at the Board level. Three directors' had significant ties to the company: one earned $250,000 in consulting fees, one owned expensive resort property with the CEO, and one had a $5.6 million contract to install glass at a HealthSouth hospital. The same three served on the combined audit and compensation committee (Lublin and Carms, 2003).

The SEC accused former HealthSouth management of fabricating $2.74 billion in earnings and charged them with fraud, reporting violations, and internal controls violations. Fifteen financial employees have pleaded guilty. Scrushy has been indicted on 85 counts and he has pleaded not-guilty (Bassing, 2003). Scrushy was the first CEO to be charged under the Sarbanes-Oxley Act for signing a false certification of financial statements. Scrushy's attorneys have fought the charge with a rebuttal that Sarbanes is unconstitutional and should be repealed (National Accounting News, 2003). Meanwhile, Scrushy has become a religious talk show host (CBSNEWS, 2004).

All three of these cases illustrate a corrupt tone at the top that emphasized making the numbers at the expense of doing the right thing. Collusion, top management pressure on employees to act unethically, personal greed and gain, audit failures, and a corrupt corporate culture were common across these corporations. Similar patterns can be seen in the other companies listed in Table II. Is it possible for legislation to prevent further unethical and fraudulent behavior in corporations like we have witnessed in these cases? The U.S. Congress has attempted to do so with the Sarbanes-Oxley legislation of 2002. However, the regulations are aimed not only at corporate America but also at the CPA firms who perform their audits. The major international CPA firms have demonstrated similar ethical problems. Before we discuss the specific provisions of the Sarbanes Act, we present a brief review of the most notable recent ethical issues raised by actions of CPA firms.

The big five...no, the final four: ethical failure in CPA firms

> "Too many CFO's are being judged today not by how effectively they manage operations, but by how they manage the street. And, too many auditors are being judged not just by how well they manage an audit, but by how well they cross-market their firm's non-audit services." (Levitt, 2000)

The corporate ethical failures of the past decade have taken their toll on the U.S. public accounting profession. Table III links a number of the major financial reporting scandals to their respective external auditors along with the related litigation against the CPA firms. One conclusion that may be drawn from Table III is that none of the firms have been immune from scandal and all have been subject to litigation.

All of the Big Five were subject to criticism in the 1990s for inadequate audit procedures, a strong focus on increasing the breadth and volume of consulting services, providing internal audit services to external audit clients, and utilizing the accounting rules to the

TABLE III
Sample of recent CPA firm involvements in financial irregularities

Firm	Client	Charge	Outcome
Andersen (1997)	Waste management	SEC: False and Misleading audit reports	Paid $256 million three partners agreed to anti-fraud injunction, a civil penalty and a bar from appearing or practicing in front of the SEC as an accountant Company settled class action for $457 million
Andersen (1996–1997)	Sunbeam	Shareholder Suit: Concealing material adverse non-public information from the public	Paid $110 million. No admission of fraud or liability.
Andersen (2002)	Enron	Destruction of documents, obstruction of justice	Paid $40 million in shareholder suit Convicted of obstruction of justice Firm dissolved
Andersen (2002)	Worldcom/MCI	Improper audit procedures	Court held Andersen would have uncovered fraud if it had done required review procedures, audit opinions materially misrepresented company financial position
Ernst and young (2003–2004)	Healthsouth	Shareholder Suit: Alleges auditors knew about the fraudulent accounting	Investigation in process
Ernst and Young (2003)	Private tax clients	Created and marketed alleged illegal tax shelters	Paid $15 million to settle a U.S. Internal Revenue Service investigation into its sale of tax shelters
Ernst and Young (2003)	Peoplesoft	SEC's conflict of interest charges and lack of independence in software installations	SEC sought to bar E and Y from accepting new publicly traded clients, repay fees Ongoing investigation
Ernst and Young (2003)	American express, American airlines, Continental airlines	Conflict of interest and potential lack of independence resulting from "profit sharing" under exclusive travel contracts	Ongoing investigation
Ernst and Young (2003)	Nextcard inc.	Obstruction of Justice and Alteration and destruction of documents	Civil and criminal charges against E and Y employees Guilty plea by one employee
KPMG (1997)	Xerox	SEC charged four KPMG partners with fraud. Allege fraudulently allowed company to manipulate accounting practices to fill a $3 billion gap between actual and reported results	KPMG denies charges and rebutting in court
KPMG (2003)	Private tax clients	Created and marketed alleged illegal tax shelters	Ongoing investigation
PWC (2003)	SmarTalk teleservices inc	SEC annual report contained materially false and misleading financial statements	Paid $1 million neither admitted nor denied wrongdoing
PWC (2000)	Microstrategy	Fraudulent accounting	Three top executives fined PWC not charged
Deloitte (2003–2004)	Parmalat	Fraudulent financial reporting	On-going
Deloitte (2003)	Reliance Insurance Company	Knew of company condition prior to signing audit, contributed to failure	On-going Deloitte denies charges
Deloitte (2003)	Manhattan Investment Fund	Improper audit procedures	Paid $32 million in settlement

advantage of audit clients rather than focusing on underlying economic substance. Articles in the business press such as "AccountingWars" (Business Week, 2000), "Lies, Damned Lies, and Managed Earnings" (Fortune, 1999) became widespread. Arthur Levitt, then chairman of the SEC, reprimanded the CPA profession for flaws in revenue recognition practices, utilization of "cookie-jar" reserves, and capitalization of in-process R&D. He also expressed strong concerns about a perceived lack of independence (Levitt, 1998). Based on his concerns, Levitt predicted an Enron, just not specifically by name (Business Week, 2000). Arthur Wyatt, a former FASB member, argued that greed became a driving force within the accounting firms just as it did within many corporations. He further argued, "the cultures of the firms – changed from a central emphasis on delivering professional services in a professional manner to an emphasis on growing revenues and profits" (Wyatt 2004, p. 49).

In June of 2000, the SEC believed that the potential for ethical failures was sufficient to justify proposing new regulations on auditor independence to impose limits on services to audit clients to avoid conflicts of interest. The proposal would have banned external auditors from providing the same non-audit services to audit clients that Sarbanes banned two years later (Business Week, 2000). The proposal met with strong opposition from the Big Five, the American Institute of Certified Public Accountants (AICPA), and corporate America and resulted in a compromise regulation in November, 2000 which permitted information systems design and implementation consulting as well as limited internal audit outsourcing to continue as long as fees were disclosed. The Sarbanes-Oxley Act of 2002 subsequently has prohibited these services.

Under the 2000 SEC regulations, Andersen continued providing significant consulting services to Enron in addition to external audit services. Total Enron-based revenue was $55 million in 2000 with $27 million from consulting services. As Enron collapsed, so did Andersen. Within six months of the Enron bankruptcy filing, Andersen was found guilty of obstruction of justice but they also admitted failures in internal processes to ensure quality audits and professional integrity (Hecht, 2003). The tone at the top and culture in Andersen had parallels to the previously discussed corporate cultures. Andersen had placed great emphasis on growth with evidence suggesting that client satisfaction and growth may have been more important than ethical financial reporting (Byrne, 2002).

The remaining Big Four continue to have ethical and financial reporting problems. A critical question is, can the U.S. and global economic systems afford to lose another major accounting firm? If not, can the Sarbanes-Oxley Act promote the ethical behavior necessary for survival? The relevant provisions of Sarbanes are discussed in "Sarbanes-Oxley Act of 2000 Section.

Sarbanes-Oxley Act of 2002

> "Today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. This new law sends very clear messages that all concerned must heed. This law says to every dishonest corporate leader: you will be exposed and punished; the era of low standards and false profits is over; no boardroom in America is above or beyond the law." (Bush, 2002).

Almost two years have passed since the signing of the Sarbanes-Oxley Act (Sarbanes), and the scandals and restatements continue. We are still witnessing corporate misconduct and failure, as well as unethical actions in hedge funds, the stock exchanges, and mutual funds. Sarbanes takes a strong punitive approach to regulating public accountants, corporate management, and investment houses calling for an ethical tone at the top as well as an ethical corporate culture. Sarbanes is very inclusive and prescribes expected behaviors, ethical responsibilities, and certifications that carry heavy penalties if violated. Our discussion focuses on the provisions of Sarbanes that have direct implications for corporate and accounting firm ethical behavior. These provisions are outlined in Table IV and the major points are discussed next.

Corporate ethical provisions

Sarbanes primary focus is on regulating corporate conduct in an attempt to promote ethical behavior and prevent the fraudulent financial reporting

TABLE IV
Key behavioral provisions of Sarbanes-Oxley for issuers and auditors of financial statements

Title	Section	Subject	Content
I. Public Company Accounting Oversight Board	105	Investigations and disciplinary proceedings	Investigation procedures, disciplinary hearings, and sanctions of firms and associated persons
II. Auditor Independence	201	Prohibited services	Prohibits external auditor from engaging in nine specific non-audit services for the audit client
	203	Partner rotation	Mandates lead and reviewing partner rotation every five years, other audit partners must rotate every seven years
	206	Conflicts of interest	Prohibits employment of CEO, Controller, Chief Accounting Officer or equivalent by firm's audit firm within one year of employment
III. Corporate Responsibility	302	Corporate responsibility for financial reports	CEO and CFO must certify "the appropriateness of the financial statements and disclosures" and that the "financial statements and disclosures fairly present (...) the operations and financial condition of the issuer."
	303	Improper influence on conduct of audits	Unlawful for officer or director of firm to take any action to influence, coerce, manipulate, or mislead any auditor engaged in performing the audit for the purpose of reporting materially misleading financial statements
	304	Forfeiture of certain bonuses and profits	CEO and CFO shall "reimburse the issuer for any bonus or other incentive-based or equity-based compensation received" or "profits realized from sale of securities of the issuer" during the twelve months following the issue or filing of statements requiring later restatement
	305	Officer and director bars and penalties	SEC may prohibit any person violating section 10b of 1934 Act from acting as officer or director of any issuer if person engages in conduct which "demonstrates unfitness" to serve
	306	Insider trades during pension fund blackout dates	Prohibits purchase or sale of stock by officers, directors, or other insider during black out periods
IV. Enhanced Financial Disclosures	402	Enhanced conflict of interest provisions	Includes prohibition of personal loans to directors or officers
	404	Internal control reporting	Management must issue an annual report with auditor attestation on the effectiveness of internal controls and procedures for financial reporting

TABLE IV
Continued

Title	Section	Subject	Content
	406	Code of ethics for senior financial officers	Requires issuer to disclose if it has adopted a code of ethics for its senior financial officers and the content of the code
V. Analyst Conflicts of Interest	501	Treatment of security analysts by registered securities associations and national security exchanges	Requires securities associations and securities exchanges to adopt conflict of interest rules
VIII. Corporate and Criminal Fraud Accountability	802	Criminal penalties for altering documents	Felony to knowingly destroy documents to "impede, obstruct or influence" existing or contemplated federal investigation. Requires retention of audit papers for five years. Extends statute of limitations to five years from fraud or two years from discovery
	806	Protection for employees of publicly traded companies who provide evidence of fraud	"Whistleblower protection" for employees of issuers and accounting firms who disclose employer information to parties in a judicial proceeding involving fraud claim
	807	Criminal penalties for defrauding shareholders of publicly traded companies	New crime for securities fraud with fines and up to 10 years imprisonment
IX. White Collar Crime Penalty	903	Criminal penalties for mail and wire fraud	Penalty increased from 5 years to 10 years
	906	Corporate responsibility for financial reports	Penalties for willfully and knowingly filing fraudulent financial reports include fine up to $5,000,000 and/or up to 20 years in prison
XI. Corporate Fraud and Accountability	1102	Tampering with a record or otherwise impeding an official proceeding	Establishes criminal penalty of up to 20 years and fine for destroying or tampering with documents with intent to impair use in official proceeding or otherwise impede official proceeding
	1105	Authority of the Commission to prohibit persons from serving as officers or directors	Amends SEC Acts of 1933 and 1934 to allow SEC to prohibit persons subject to a cease-and-desist preceding from serving as an officer or director
	1106	Increase criminal penalties under Securities Exchange Act of 1934	Increases maximum penalties under SEC Act of 1934 to $25,000,000 fine and 25 years imprisonment
	1107	Retaliation against informants	Provides criminal penalties for "whomever knowingly, with intent to retaliate, takes any action harmful to any person' for Whistle blowing." Penalties up to 10 years and $250,000 fine

failures of the past decade. The legislation applies to the Board of Directors, the Audit Committee, the CEO, the CFO, and all other management personnel that have influence over the accuracy and adequacy of external financial reports.

Section 301 addresses the responsibilities of the Board of Directors' Audit Committee. Corporate audit committee responsibilities have increased significantly. In some of the recent ethical failures, the audit committee was directly involved, perceived as too closely tied to the corporation, or oblivious to financial reporting situations (Lublin and Carms, 2003). Under Sarbanes, audit committees are directly responsible for appointment and compensation of the external auditor and must approve all non-audit services provided by the external auditor. Audit committee members must also be independent which means they may not receive fees from the company other than for board service and may not be affiliated in other ways. The audit committee must provide a mechanism for direct communication of unethical behavior within the organization by employees and the external auditor and must establish appropriate procedures to facilitate this communication.

Additionally Sarbanes requires all audit committees to have a financial expert on the committee or disclose why they do not have such an expert. One of the concerns was the ability of audit committees to understand fully the financial reporting issues and recognize unethical or fraudulent behavior. Thus, at least one member of the committee must have significant financial training and knowledge.

Much of the legislation is aimed directly at senior management. Section 302 is probably the most significant provision for CEO's and CFO's requiring certification of the financial statements. Both the CEO and CFO must sign and certify personally that the company's financial report does not contain any known untrue material statement(s) or omit a material fact(s). In addition, they must attest that they are responsible for establishing and maintaining internal controls, that disclosure is made of any changes in internal controls and they have evaluated the effectiveness of the internal controls within 90 days prior to the report. Certifications of financial statements were required beginning in August 2002 with management reporting on the effectiveness of internal controls extended to year ends after November 20, 2004 for large companies (SEC, 2003b).

The consequences of failing to certify statements or signing false statements are severe. CEO's and CFO's are subject to a 5 million dollar fine and a 20-year prison term. Violation of the certification regulation falls under federal court jurisdiction without option for parole. As discussed earlier, HealthSouth's former CEO, Scrushy, was the object of the first major indictment under this legislation (National Accounting News, 2003).

Sarbanes provisions 303, 304, and 306 further promote ethical conduct by the board of directors, corporate executives and key employees. It is unlawful for an officer or director to take any action to influence or mislead the external auditor. CEO's and CFO's must forfeit bonuses and profits when earnings are restated due to fraud. Executives are prohibited from selling stock during blackout periods and are prevented from receiving company loans unavailable to outsiders. These provisions directly reflect the unethical and fraudulent activities witnessed at Enron that precipitated the legislation.

Sarbanes takes a much stronger consequences (jail-time) approach to legislating ethical behavior than the U.S. has experienced in past regulation. Key provisions of the Act: raised the maximum penalty for securities fraud to 25 years, raised maximum penalties for mail and wire fraud to 20 years, created a 20 year crime for destroying, altering or fabricating records in federal investigations, and required preservation of key financial audit documents and e-mail for five years with a 10-year penalty for destroying such documents. As with CEO/CFO certification, these criminal charges fall under federal jurisdiction. Under the Sentencing Reform Act of 1984, parole for federal offenders was abolished (Murphy, 2002). In response to requirements of Sarbanes, the Federal Sentencing Commission promulgated emergency guidelines in November 2003 to ensure that corporate criminal sentences are sufficiently severe to "deter, prevent and punish such offenses" including longer sentences for larger dollar losses (Robinson and Lashway, 2003). Robinson and Lashway provide an example under the new guidelines: "assume the CFO of a Fortune 500 company is convicted after trial of participating in a complex accounting fraud that causes $150 million in losses. Further assume the CFO directed six

members of the accounting staff in carrying out the fraud''. The CFO now faces a sentencing range of at least 30 years to life with no possibility of parole, even if it is a first offense (Robinson and Lashway, 2003). The guidelines also require that anyone convicted of obstruction of justice serve a mandatory prison sentence.

Sarbanes not only legislates strong punishment for wrongdoers but also prescribes guidelines for corporations to establish an ethical culture in order to maintain a high level of integrity. The tone at the top is cited as key to an ethical corporate culture. Section 406 requires public corporations to have a code of ethics for senior executives or to state in their annual report that they do not have such a code as well as why they do not. The code must be available to the public. Under SEC rules, detailed guidance for the content of the code is provided including: promotion of honest and ethical conduct, full and fair disclosure, compliance with laws, internal reporting for violations, and accountability for adherence to the code (SEC, 2003b). Whistleblowers are protected under Section 1107, and individuals who retaliate against whistleblowers are personally liable and face penalties up to 10 years.

Accounting firm ethical provisions of Sarbanes

Sarbanes has changed the basic structure of the U.S. public accounting profession. The first section creates the Public Company Accounting Oversight Board (PCAOB) imposing external independent regulation on the profession and ends self-regulation under the AICPA. The Act applies to all CPA's serving U.S. publicly traded clients. A majority of members of the five-member PCAOB board are not and can never have been CPAs. This Board now sets auditing standards and conducts inspections of CPA firms. The Board also is responsible for disciplinary actions against CPAs and for setting the ethical tone for the profession. A recent quote from the Board Chairman William McDonough makes their ethical expectations clear to the profession: ''I expect that you, as members of a regulated profession, know what the rules are. I expect that you are following those rules, both in their letter and their spirit. If you depart from those expectations – that is, if you break the rules, if you ignore the spirit of the law even while meeting the letter – woe be unto you. There will be consequences, and they will be grave'' (McDonough, 2003).

Section 201 of the Act is a direct response to the conflict of interest issues arising from the consulting and external audit services provided to Enron by Andersen. This section has a very significant impact on the CPA profession. Most other professional services auditors historically performed for their audit clients (Table V lists the restricted services) are prohibited. Board of directors approval is required for any services provided by the external auditor in addition to the external audit that are not specifically prohibited by Sarbanes. Evidence to date indicates that corporate boards are reluctant to approve even permissible tax services by their external auditors. Sam DiPiazza, CEO PricewaterhouseCoopers, testified that PWC had lost 20% of its U.S. tax work since the passage of Sarbanes (DiPiazza, 2003). The prohibited services mirror the SEC proposal of 2000 with one significant addition: the PCAOB now has the authority to determine any other impermissible services. This gives the PCAOB complete control to regulate the independence and thereby conflicts of interest in the attest function.

To further strengthen independence, Section 203 mandates audit partner rotation. The lead auditor must rotate off an audit every five years with a five-year time out. Other audit partners must rotate after seven years with a two-year time out. The intent is to keep auditors from getting too close to their clients and to inhibit unethical or fraudulent collusion between auditors and clients. Prior to the Act, suggestions were made for mandatory audit firm rota-

TABLE V
Prohibited services by External Auditors for Audit Clients under Sarbanes-Oxley Act

Bookkeeping
Financial information systems design and implementation
Appraisal or valuation services, fairness opinions
Actuarial services
Internal audit outsourcing services
Management functions or human resources
Broker or dealer, investment adviser or investment banking services
Legal services and expert services
Any other service the PCAOB determines impermissible

tion and Sarbanes required a study to further examine the feasibility of rotation of audit firms. The GAO concluded in November 2003 that mandatory firm rotation was not the most efficient way to strengthen auditor independence or improve audit quality considering additional costs and institutional knowledge (GAO, 2003).

The final conflict of interest issue addressed by Section 206 is the well-known practice of corporations hiring their external auditor's staff as financial managers, controllers and CFO's. It has been a long standing and common practice for auditors leaving public accounting to accept employment with an audit client. This was especially true at HealthSouth. Section 206 now prohibits such employment within a one-year period of the audit. SEC regulations are more restrictive. They prohibit employment in a management position overseeing financial reporting matters of the lead partner, the concurring partner, or any other member of the audit engagement team who provided more than ten hours of audit, review, or attest services within the one-year period preceding the start of the audit (SEC, 2003a).

Basic premises for ethical financial reporting

> "We have learned the same thing again and again: financial fraud does not start with dishonesty, your boss doesn't come to you and say, 'Let's do some financial fraud'. Fraud occurs because the culture has become infected. It spreads like an unstoppable virus." (Young, 2003)

The preceding description and analysis of fraudulent financial reporting as well as regulatory responses suggests four premises.

> Premise 1: History suggests that legislative attempts to impose ethical behavior in corporate financial management and reporting have failed.

As demonstrated in this paper, the almost one hundred year history of U.S. legislation attempting to impose transparency, integrity, and honesty as underlying values in corporate management and financial reporting has failed to prevent periodic systemic ethical failure. They often have proven effective for a time. However, management and their external auditors have responded to legislated behaviors by finding new ways to obscure results; defraud shareholders, customers, or suppliers; and hide failure. In the latest wave of corporate fraudulent reporting, the SEC history of fines for offending corporations and civil proceedings against senior management evidently were not effective deterrents. Occasional U.S. Department of Justice criminal proceedings resulting in light sentences in federal white-collar crime prisons also were not effective deterrents.

> Premise 2: Corporate controls in an IT world cannot and will not prevent corporate fraud.

There is a tendency to believe that the advent of large, complex, sophisticated electronic information systems for financial reporting and operations can limit the potential for wide-spread unethical behavior in financial reporting. The financial reporting frauds, errors, and restatements including those identified in this paper raise serious doubts about the progress companies have made in using IT to improve the accuracy, reliability, and integrity of financial data and financial reporting. The failures chronicled in this paper can be traced to three IT weaknesses: internal control systems are built on a set of assumptions that have proven invalid; internal controls are difficult to design, implement, and document in today's complex business environment; and internal audit has assumed a much less significant role in many corporations at a time that systems have become more difficult to audit.

Assumptions underlying IT controls do not reflect the business environment existing in the previously discussed corporate failures. IT controls are designed to ensure the integrity of data assuming the data reflect actual transactions, are correctly captured, and are appropriately classified. Controls are designed into the systems to limit the potential for inappropriate access, guarantee the numerical integrity of data transmitted and processed, and prevent unauthorized modification of software, data or reports. The underlying assumption in control design is that fraud will be deterred by (Carmichael, 1970)[1]

- Threat of exposure;
- Independent individuals reporting irregularities;
- A low probability of collusion because asking is too risky;

- Records and documentation providing proof of actions and transactions;
- A lack of inherent conflict between performance goals and the production of reliable information;
- Senior management that will not override the system.

Simons (1999) argues that these behavioral assumptions still form the foundation for most internal control systems. The unethical and fraudulent behavior at WorldCom, Enron, HealthSouth, and Andersen as well as the other frauds in Table II question the veracity of IT assumptions. Senior management involvement, collusion, fraudulent documentation, and lack of individual reporting were evident in most cases. Thus IT controls based on these assumptions did not prevent failures and there is no reason to expect them to prevent future failures.

The complexities of today's business environments make high quality IT controls much more difficult to design, implement, and maintain. The average $1 billion company has 48 different financial systems and uses 2.7 different ERP systems. (Hackett Group, 2004). Typically, these systems do not communicate electronically. Rather, companies still make wide spread use of hand consolidation of disparate systems on electronic spreadsheets making entries difficult to document, control, and audit. Furthermore, the growth of off-balance sheet transactions has removed many transactions from the domain of the formal information systems. IT control systems are further complicated with attempted integration of financial reporting systems and tax systems.

In our current state, the IT controls may provide more opportunity for unethical and fraudulent behavior than they prevent and create the opportunity to make the fraud bigger through mechanization. For example, HealthSouth employees were able to enter a large number of small transactions for assets at a large number of widely disbursed facilities with each transaction small enough to be under the external auditor's dollar threshold for the asset. The magnitude of this fraud ($800 million) would have been difficult without IT (SEC, 2003c).

Finally, there has been less emphasis on the internal audit function. In the 1990s many corporations shrunk or disbanded internal audit groups and outsourced all or part of the internal audit function to their external auditors or other consultants. Even those who did not outsource internal audit and/or development of internal control systems struggled with the maintenance of internal control across business units and across geographic regions. The shrinking role of internal audit, less attention paid to internal controls, and the difficulties of auditing complex, disparate systems came at a time when the incentives for management to engage in fraudulent financial reporting had never been higher given the heavy reliance by corporations on performance-based pay at multiple layers in the organization.

> Premise 3: A strong corporate culture as the context and imbedded corporate ethical values as the driver of behavior are a necessary condition for "fixing" financial management and reporting.

"A corporation's culture is what determines how people behave when they are not being watched." (Tierney, 2002)

Solomon (1992) reminds us that business ethics is not a set of impositions and constraints but rather is the motivating force behind business behaviors and that virtues are social traits even though they are reflected in individual actions. In the business context, the set of social traits form a key component of the corporate culture. Schein (1999) describes corporate culture as the "sum total of all the shared, taken-for-granted assumptions that a group has learned throughout its history" from mission and goals to deep underlying assumptions about the nature of truth, human nature, and human relationships. Kotter and Heskett (1992) emphasize that corporate culture should be built on "doing the right thing" on behalf of corporate constituencies including customers, employees, suppliers, and stockholders. Common to all is the need for the organization's leadership to nurture culture in ways that imbed virtue in the set of assumptions underlying the culture. Schein (1992) suggests that corporate leaders communicate the organizations values and ethics (and thereby the assumptions underlying the culture) by the focus of their attention and also by what they ignore.

Morris (2002) provides a discussion of three corporate trends that emerged with regard to the ethical behavior of both corporate leaders and their

auditors that provide some insight into how unethical behavior has grown in the face of corporate codes of ethics and external penalties for fraud. First, there has been a growing attitude that ethics is just a matter of having rules and playing by the rules. It became a game to see who could most creatively stay within the letter of the law while bending the rules for personal gain. The acceptable practice was to do what was technically correct regardless of the moral correctness of the action. Second, people were more concerned about externals than internal matters. The drive for personal happiness became focused on external wealth and success rather than internal satisfaction. And third, the panic for quick results replaced patience and more modest expectations.

Kotter and Heskett (1992) emphasizes that corporate culture should be built "doing the right thing" on behalf of corporate constituencies. Turner (2002) argues that "...we need a cultural change". The excesses of the 1990s have led to too many businesses, playing too close to the line. And, often the line has been crossed. Waters and Bird (1987) conclude that it is easier to influence ethical behavior through culture than through bureaucratic rules. Dobson (1990), arguing from a global perspective, suggests that when there are managers and employees that do not have the desired ethical attitude, the result is a weak set of beliefs and a non-ethical culture. He further argues that the resulting changes will result from economic needs rather than ethical ones. Thus, failure to build a strong culture, or building a culture that tolerates inappropriate behaviors, allows the inappropriate behaviors to spread across the organization in ways that makes significant fraud not only possible but likely (Levitt, 1998). The failures at Enron, Worldcom, Tyco, Healthsouth, and many of the others reflect unethical values at the very top of organization accompanied by a culture accepting of unethical behavior. The results are well-chronicled here and elsewhere.

It is important to recognize the stark difference between a strong culture (usually characterized by a strong leader as in our examples) and a strong ethical culture. Kotter and Heskett (1992) conclude that there is a positive relationship between strong culture and economic performance but it is modest. Furthermore, "with much success, that strong culture can easily become arrogant, inwardly focused, and bureaucratic." (Kotter and Heskett, 1992, p. 24). The long-run successful corporation is characterized by norms and values that reflect caring deeply about their customers, employees, and stockholders, a deep commitment to leadership and other engines that can help firms adapt to a changing environment. At the same time, the culture must be intolerant of arrogance in others and in themselves (Kotter and Heskett, 1992). The firms we have reviewed reflect strong cultures exhibiting great success for a time, arrogance, and an inability to deal with changing economic circumstances in a positive, ethical, constructive manner. They reflected a strong but unethical tone at the top which reached through the organization. The end result was failure.

We have documented a variety of settings in which the very people who might be expected to establish a strong culture with strong ethical values reaching across the organization have been at best contributors and more frequently instigators of unethical or fraudulent behavior. Similarly, the Treadway Commission (1987) found that a significant portion of companies committing financial reporting fraud had founders and Board members who retained significant ownership. COSO (1999) found that 72 of the 200 fraud cases they examined appeared to involve the CEO and the companies' Boards were dominated by insiders. Thus, a strong culture is not the same as a strong ethical culture. Repeatedly, strong cultures emerged in the 1990s (Enron, WorldCom, Health South) that were not built on doing the right thing so much as achieving the "right outcome." These cultures proved unable to support appropriate ethical behaviors when these organizations encountered difficult times. As we move forward, it is our conclusion that the responsibility for ensuring an ethical culture must rest not only with the CEO but also with an independent Board of Directors. The Board must be responsible for the values and ethics they seek in officers of the corporation to ensure a culture that supports, nurtures, fosters, and attracts individuals of high personal integrity. The Board must provide the oversight necessary to ensure that ethical behavior is noticed and rewarded. Similarly, the culture must encourage the departure of those who violate the ethical principles regardless of their other contributions to the organization.

The Board of Directors must also assume increased responsibility for the control environment.

Virtually all frameworks posited for establishing and maintaining the integrity of financial reporting begin with the control environment (see COSO, 1992; COBIT, 2000; for examples). COSO (1992) identifies key indicators of the control environment including integrity, ethical values, Board of Directors participation, management philosophy, and human resource policies and practices. The indicators of significant deficiencies include insufficient oversight by senior management, a passive audit committee, no code of conduct or one that does not address conflicts of interest, related party transactions, illegal acts by the management and the Board, an ineffective whistleblower program, and an inadequate process for responding to allegations or suspicions of fraud. The financial frauds identified in Table II reflect some or all of the deficiencies identified in the COSO(Committee of Sponsoring Organizations of the Treadway Commission) framework and few of the key indicators of a good control environment.

> Premise 4: Compliance with laws, internal controls, and corporate cultural norms must be built on both predictable rewards for 'right' behaviors as well as swift delivery of significant sanctions for inappropriate behaviors supported by strong societal sanctions.

> "No one should be entrusted to lead any business or institution unless he or she has impeccable personal integrity. Top rung executives have to ensure that the organizations they lead are committed to a strict code of conduct. This is not merely good corporate hygiene. It requires management discipline and putting in place checks and balances to ensure compliance." (Gerstner, 2002)

Solomon (1994) argues that the free market "requires protection from rule breakers, those who would take advantage of its freedoms and commit fraud or extortion." He argues, further, that such rules and sanctions are necessary for the protection of markets. In the 1990s, civil and criminal penalties for fraudulent financial reporting resulting from the Securities Acts of 1933 and 1934 proved to be ineffective deterrents. Arguably, the societal penalties for fraudulent financial reporting under the 1933 and 1934 Securities Acts were not severe enough to deter fraudulent behavior in the 1990s. HealthSouth's Mr. Scrushy is charged with telling employees in 1997 that earnings had to meet market expectations until he could sell his stock. He subsequently sold 7,782,130 shares of HealthSouth stock (SEC, 2003c). Potential personal sanctions were irrelevant in determining behavior at HealthSouth. Under the 1933 and 1934 Acts, the most likely outcome was a fine, a prohibition from serving as an officer or director of an SEC company, and, occasionally, a light sentence in a "white collar" jail. Just as clearly, Scrushy either believed he would not be caught or the potential penalty was insufficient to deter the action.

Corporate codes of conduct have been suggested or required for corporations since the Foreign Corrupt Practices Act of 1977. They also have proven to be a limited deterrent to unethical behavior. Whistleblower programs, with access to the Board of Directors for corporate wrongdoing, were recommended by the Treadway Commission as early as 1987, yet few whistleblowers have come forward. Unethical behavior has continued with the magnitude and number of frauds growing throughout the 1990s (KPMG, 2003).

Despite codes of conduct and penalties, greed, personal gain, and pursuit of power prevailed in many of the cases of the 1990s. The financial frauds corresponded to an exponential growth in executive compensation. The Institute for Policy Studies 2003 CEO Compensation Survey compares CEO compensation in the late 1990s and early 2000s with compensation in the early 1980s. Results indicate a dramatic increase in absolute and relative CEO compensation during the period. They report that average CEO pay was 42 times average production-worker pay in 1982 but had grown to 530 times average production-worker pay by 2000. Further, stock options or other performance-based pay had grown to 80 percent of CEO compensation (Anderson et al., 2003). Our premise is that legislation, controls, and cultural norms did not deter corporate unethical behavior by some because of the potential for enormous personal gain. In too many cases, senior management's greed overcame personal integrity and was unchecked by adequate penalties for unethical/illegal behavior. CEO's and CFO's, and in more limited cases corporate boards, did not have the personal integrity and companies did not have the ethical cultures in place to overcome the potential for personal gain in light of very limited

potential external sanctions. Or, simply stated, for many CEO's the expected benefits from stock options, position, and power were greater than the expected cost of civil or criminal penalties if caught and if punished.

When otherwise good people do bad things in a financial reporting context, a more utilitarian approach may well be the way to control behavior (if not, values). Where management is driven by ego or greed, deterrence must be focused on outcomes... making the cost of unethical behavior exceed the potential gain from the behavior. Petrick and Scherer (2003) make a similar argument for an interdependent moral and legal framework in their discussion of Enron. There are three required components. First, corporate cultures and codes of ethics must deliver swift and meaningful sanctions for unethical behavior including separation from the organization. Second, internal controls including effective whistleblower programs must make the probability of discovering unethical behavior high. Third, external penalties for unethical or illegal behavior must be greater than the rewards realized from engaging in the behavior.

Three changes in U.S. laws for societal penalties have come together to potentially make the punishment exceed the payoff from fraudulent reporting. First, Sarbanes increases the penalties for fraudulent reporting including management certification of results and internal controls to a maximum of $25 million and 20 years, and imposes new sentencing penalties for other fraudulent actions (Table IV). Second, revised federal sentencing guidelines issued in 2001 substantially increase penalties for economic crimes, doubling penalties for crimes involving multi-million dollar losses. The effect is to remove judicial discretion in imposing sentences for white collar crimes. Sentencing guidelines were further strengthened in 2003 at the direction of the Sarbanes-Oxley Act (Robinson and Lashway, 2003). Third, 1984 legislation eliminated parole in the federal justice system (U.S. Department of Justice, 1997). The maximum reduction in sentence for good behavior is 15 percent of the sentence. For example, in March of 2004, a former senior director of tax planning at Dynegy Corporation was convicted of wire fraud, securities fraud, conspiracy, and mail fraud. He was sentenced to 24 years and four months of which he must serve a minimum of 20 years and 10 months. His crime – illegally disguising corporate debt in 2001 which the prosecution alleged caused $500 million in Dynegy stock losses. The judge in the case said, "I take no pleasure in sentencing you to 292 months. Sometimes good people commit bad acts, and that's what happened in this case" (ABC News, 2004).

Having argued the necessity of appropriate sanctions for fraudulent behavior, Solomon (1994) suggests that laws, regulations, and associated penalties can only help prevent behaviors already viewed as inappropriate by those subject to the laws and regulations. Thus, they compliment an ethical culture rather than replace the need for carefully nurturing a cultural built on "doing the right thing."

Conclusion

This paper has documented the failures of laws, corporate internal controls, and corporate culture to deter unethical and fraudulent financial reporting. None, taken alone, have stood the test of time in guaranteeing appropriate corporate ethical behavior. Sarbanes broadens and deepens sanctions and penalties for unethical management behavior but does not address the relationship between management behavior and rewards. Sarbanes also calls for much greater focus on internal controls by senior management. Internal control systems, including IT controls, can help reduce the opportunity for fraudulent or unethical behavior but cannot eliminate it in a world where nearly 50 percent of large corporations still use spreadsheets in some aspect of financial reporting (Hackett Group, 2004). Finally, corporate ethical failures arguably appear more likely to occur in very successful companies lacking a solid ethical foundation when economic conditions change as witnessed by our case studies and the work of Kotter and Heskett (1992). It is the combination of a strong ethical corporate culture (beginning with the Board of Directors), controls, laws, rewards, and penalties that provide a context for obtaining ethical and transparent financial reporting.

We believe research exploring the interactions between and among corporate culture, internal controls, societal controls, and rewards/sanctions will provide better answers than we now have for improving corporate financial reporting.

Note

[1] Douglas Carmichael is now the Chief Auditor and Director of Financial Standards of the PCAOB (PCAOB, 2003).

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