TONE AT THE TOP

INSIGHTS FROM SECTION 404

By Dana R. Hermanson, Daniel M. Ivancevich, and Susan H. Ivancevich

Senior management's tone, competence, and reliability are essential to reliable financial reporting. The new internal control audit reports required by Section 404 of the Sarbanes-Oxley Act (SOX) provide interesting new insights into internal control weaknesses related to senior management.

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ISSUES WITH MANAGEMENT TONE CAN BE PERVASIVE BECAUSE OTHERS IN THE COMPANY SOON LEARN THAT THE COMPANY DOESN'T CARE ABOUT ETHICS.

As far back as the Treadway Commission's *Report of the National Commission on Fraudulent Financial Reporting* in the late 1980s, many have recognized the importance of "tone at the top" as a fundamental ingredient of reliable financial reporting. If senior management's ethical tone is deficient, then almost no amount of detailed control procedures will be effective in preventing fraud and abuse. Similarly, *Fraudulent Financial Reporting: 1987-1997—An Analysis of U.S. Public Companies*, sponsored by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), found that top management was implicated in the vast majority of accounting frauds. The authors called for a renewed focus on tone at the top.

Since these two reports were published, we have seen unprecedented levels of senior-management-driven accounting fraud in large public companies: Enron, WorldCom, Adelphia, Tyco, and others. In response to these massive frauds, the Sarbanes-Oxley Act requires, among other things, the auditor to express an opinion on the client's internal control over financial reporting. The logic behind this edict (found in SOX Section 404) is that financial reporting will be more reliable and management override less likely if the company's internal control system, including the control environment, is sound.

Auditors issuing opinions on internal control effectiveness must consider a variety of issues, including senior management's competence and ethical tone, in assessing the effectiveness of controls. Given these evaluations, the Section 404 audit reports provide an opportunity to examine the following questions:

1. Do auditors' Section 404 reports provide evidence of material weaknesses in internal control due to problems with senior management's tone, competence, or reliability?
2. If so, what specific senior-management-related weaknesses are cited, and what remedies are companies using to address these problems?

We believe that the answers to these two questions will provide important insights into corporate vulnerability to senior-management-related weaknesses and the methods used to remediate such weaknesses. The results should contribute to the efforts of auditors, directors, and management accountants.

SECTION 404

Under SOX Section 404, if the auditor identifies any material weaknesses in internal control, then he or she must issue an adverse opinion and describe the nature of the material weaknesses in the audit report. The Public Company Accounting Oversight Board (PCAOB) states in Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements," that:

"A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

Section 404 now applies to "accelerated filers," or the largest public companies. (Those with under $75 million in public float haven't yet implemented this provision.)

AUDIT ANALYTICS

The Audit Analytics database (www.auditanalytics.com) classifies material weaknesses into several categories, one of which is "senior management competency, tone, [or] reliability." We analyzed the material weaknesses in this category from 2005 through early 2008. During this period, audit firms issued adverse internal control opinions to 93 larger public companies because of weaknesses with senior management's competence, tone, or reliability (14 companies appear in the sample twice, as they had the same material weakness in two years; therefore, there are 79 unique companies represented.)

These 93 observations are the basis for our analysis. The companies' fiscal year-ends range from December 26, 2004, to December 31, 2007, and the audit report dates range from March 2, 2005, to April 7, 2008. Some may

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Table 1: Companies with Material Weaknesses Related to Senior Management
(n = 93)

Panel A: Company Size ($000s)	
	MEDIAN
Market Value (n = 76 due to missing data)	$686,864
Revenues (n = 77 due to missing data)	$543,361
Assets (n = 77 due to missing data)	$939,486

Panel B: SIC Codes	
	N
1000-1999 Mining and Construction	6
2000-3999 Manufacturing	27
4000-4999 Transportation and Communication	10
5000-5999 Wholesale and Retail	8
6000-6999 Financial, Insurance, and Real Estate	17
7000-8999 Services	25
Total	93

Panel C: External Audit Firm	
	N
Big 4	75
Other National Firms	9
Local Firms	9
Total	93

Panel D: Total Number of Material Weaknesses	
Median number of material weaknesses per company	4
Range of material weaknesses per company	1–20

view the sample of 93 as small, but it's important to remember that auditors won't accept clients if management is obviously corrupt. So all 93 companies had passed their audit firm's client acceptance screening process, but they later turned out to have senior-management-related weaknesses.

Arguably there are many more public companies with management issues that cause them to encounter some difficulty in attracting a reputable auditor. In addition, Audit Analytics includes information on the following number of accelerated filers: 2,867 in 2004, 3,908 in 2005, 4,270 in 2006, and 4,309 in 2007.

If we divide the 79 unique companies by approximately 4,000 accelerated filers, just under 2% of the large companies subject to Section 404 to date have had a material weakness related to "senior management competency, tone, [or] reliability." Financial statement fraud also affects a very small percentage of U.S. public companies, but with devastating consequences.

The 93 sample companies are relatively large, with median revenues of more than $500 million and median assets of more than $900 million (see Table 1). The companies are primarily manufacturing or service firms with Big 4 auditors. The median company has four material weaknesses in internal control, with a range of one to 20 weaknesses per company. Clearly many of these companies have numerous control problems beyond issues with senior management.

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Table 2: Most Common Material Weaknesses Related to Senior Management

TYPE OF WEAKNESS	NO.	SELECTED EXAMPLES
Poor Management Tone—General	**41**	Tone at the top
		Poor management attitude toward financial reporting
		Failure to provide proper ethical tone
		Failure to foster integrity and high ethical standards
		Failure to set control consciousness
		Failure to set proper attitude toward control awareness and compliance
		Failure to set high standards for ethics, integrity, accounting, and corporate governance
		Pressure put on accounting employees by senior management to ignore internal controls
Management Override of Controls	**31**	Management override of controls
Ineffective Control Environment	**22**	Ineffective/lack of controls over compliance with Code of Ethics
		Ineffective controls to prevent or detect fraud
		Ineffective entity-level controls
		Ineffective control environment
Lack of Appropriate Communication	**22**	Lack of communication regarding importance of controls
Executive Fraud	**17**	Transfer of funds to CEO's bank account
		Falsified records and misappropriation of assets
		Earnings management
		Embezzlement
		Alteration of reports under instruction of CFO
		Falsified management reports
		Improper stock-based compensation activities
		Wire transfer fraud
		Payroll fraud
		Improper payments to foreign government officials
Improper Review/Authorization	**17**	Inadequate procedures for proper authorization of transactions
		Inadequate review of transactions and financial statements
		No reviews and no documentation of reviews
		No documentation or support for recording transactions
		Inadequate review of accounting by management
		Lack of approval and documentation regarding loan to CEO
		Lack of adequate controls over authorization and approval of transactions
		Ineffective management review and approval controls
Poor Emphasis of Internal Controls	**13**	Inadequate control consciousness of certain individuals
		Failure to support strong internal controls
		Nonpromotion of effective internal controls
		Ineffective emphasis of internal controls
		Management did not complete assessment of internal controls
Ineffective Oversight and Monitoring	**11**	Ineffective oversight and monitoring of internal controls
		CFO not working with CEO to oversee and monitor complex transactions
Ineffective Whistleblowing Programs	**7**	Insufficient monitoring of whistleblower procedures
		Failure to address concerns raised by employees
		Failure to maintain effective whistleblowing program

Note: The wording above is quoted or adapted from Section 404 reports.

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SENIOR-MANAGEMENT-RELATED WEAKNESSES

Our categorization of material weaknesses is necessarily judgmental, and we tried to capture only those weaknesses related in some way to senior management.

Leading the way, with 41 instances, is an overall poor management tone (see Table 2). For example, some reports cited problems with management's tone, attitude, ethical standards, or control consciousness. In addition, some senior managers put pressure on accounting personnel to ignore internal controls. Such issues with management tone can be pervasive because others in the company soon learn that the company doesn't care about ethics.

Management override of controls is the next-most-cited issue (31 instances). A 2005 publication, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention*, published by the American Institute of Certified Public Accountants (AICPA), warns audit committee members that because management implements internal controls, management is almost always capable of overriding the controls. If management override is possible, then fraud is possible.

Two of the next issues, ineffective control environment (22 instances) and executive fraud (17 instances), are closely related to the first two items. An ineffective control environment reflects such issues as ineffective controls to target fraud, poor entity-level controls, or a general weakness in the control environment. In many cases, poor management tone logically leads to an ineffective control environment, and management tone is a component of the overall control environment. Executive fraud typically involves override of internal controls to commit a bad act. In this sample of companies, the bad acts include theft of company resources, falsified/altered reports, and bribery.

Lack of appropriate communication regarding controls (22 instances) mirrors some of the concerns related to management tone. Instead of management's attitude regarding controls, here the issue is inadequate communication to the employees about the importance of controls. In an environment where management doesn't talk about the importance of controls, many employees won't perceive controls to be important.

The next issue, improper review/authorization (17 instances), is a more specific weakness, often reflecting inadequate controls over transactions and their recording in the accounting system. This lack of reviews or approvals by appropriate management can make fraud or misappropriation much easier to commit.

A smaller number of reports cited problems with poor emphasis of internal controls in the organization (13 instances), deficient oversight and monitoring of controls or transactions (11 instances), and ineffective whistleblowing programs (seven instances).

In summary, several of the categories reflect mind-set/attitude issues, such as management tone, lack of appropriate communication, and poor emphasis of internal controls. In such cases, the message within the company is, "Management does not care about controls, so why should we?" This can create a very dangerous corporate culture, one that's ripe for fraud and abuse. Some other categories reflect bad actions that demonstrate that control problems exist, such as management override and executive fraud. Here, the damage has occurred. Finally, other categories reflect problems in more specific control areas, such as authorization and whistleblowing.

COMMON REMEDIES

Many companies with adverse internal control opinions from the auditor will describe in management's report how the company is addressing the weaknesses. Again, we used judgment in an attempt to capture those remedial steps most related to senior-management issues (see Table 3).

By far the most common remedy is getting rid of the bad apples. We found 166 instances (across 52 companies) of firing, resignation, or hiring of key personnel. CFOs, vice presidents, and CEOs are most likely to be involved in management turnover. Apparently in many cases, the board of directors concludes that the problems with senior management can't be fixed with the same team in place, and the new senior management's job is to clean up the mess. This drastic step can have the advantage of signaling to employees and outside stakeholders that the board is very serious about creating a new culture of ethics and sound control in the company.

A number of companies are working to implement general improvements in their internal controls (38 instances). These efforts include making management more responsible for controls and establishing controls to detect management override.

The third most common remedy is improved training in the company (24 companies), often to promote the importance of controls, compliance, ethics, and fraud prevention. Such efforts may target the problems created when management hasn't set the right tone and hasn't communicated the importance of controls throughout the company.

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Table 3: Most Common Remedies to Address Weaknesses

TYPE OF REMEDY	NO.	SELECTED EXAMPLES
Turnover of Personnel:		Firing, resignation, or hiring of personnel
Chief Financial Officer	29	
Chief Executive Officer	20	
Controller or Assistant Controller	14	
Senior Management	21	
General Counsel	12	
Vice President	22	
Chief Accounting Officer	10	
Chief Operating Officer	7	
Division Head	7	
Other	24	
Improvement of Internal Controls	**38**	Expanded management accountability for and emphasis of internal controls
		Creation of internal control financial review program
		High priority on the improvement of internal controls/commitment to improving internal controls
		Establishment of controls to detect management override
		Focused efforts to improve internal controls in highest risk areas
		Establishment of control evaluation process
		Making management responsible for failures in the control environment
Enhanced Training	**24**	Establishment of accounting training program
		Training of employees on compliance with Code of Business Conduct and Ethics
		Implementation of a fraud training program
		Enhanced compliance, training, and review programs for employees
		Comprehensive re-education program with respect to company's Code of Conduct
		Enhanced training of management on setting proper tone for the organization
		Establishment of annual ethics training for all employees
		Training programs and presentations for all employees and management on internal control
		Improved ethics, compliance, and financial reporting education and training for all employees
		Training of all employees on the Foreign Corrupt Practices Act and Code of Business Conduct and Ethics
Improved Compliance	**17**	Requiring management to reconfirm that they are not aware of any violations of laws
		Establishment of an executive/corporate compliance committee
		Enhanced corporate-level compliance framework
		Requiring annual certifications of compliance with Code of Conduct by employees
Changes in Reporting Lines	**12**	Reporting of accounting information directly to corporate accounting and not through operations
		Changes in reporting lines for executives
		Requiring division controllers to report results of plant review to chief accounting officer
Changes to Internal Audit Function	**11**	Appointment of new Vice President/Director of Internal Audit
		Expanded role and resources of internal audit
		Establishment of a new internal audit function
Whistleblower Procedures	**11**	Continue enhancing whistleblower procedures
		Commitment to ensuring whistleblower mechanisms are in place
		Changing whistleblower hotline and training employees on whistleblower procedures
		Communication to employees on how to report unethical behavior
		Improved procedures and processes for investigating and resolving allegations of wrongdoing
Strengthened Communication	**11**	Commitment to improving communication
		Strengthened executive management communication
		Improved communications from senior management
		Improved communications and reporting
Better Oversight of Internal Control	**8**	Improved management and oversight of internal control
		Strengthened oversight role of independent directors
		Enhanced CEO and CFO oversight of disclosures
		Increased oversight of internal control by corporate controller

Note: The wording above is quoted or adapted from Section 404 reports.

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AS SEVERAL RECENT FRAUD CASES ILLUSTRATE, PEOPLE ARE TOO OFTEN INCLINED TO LOOK THE OTHER WAY OR SIMPLY TRUST THAT SENIOR MANAGEMENT'S MOTIVES ARE ALWAYS PURE.

Seventeen companies report that they are improving their compliance efforts. This may include the creation of a compliance committee as well as annual certifications by managers and employees regarding compliance with the code of conduct.

Finally, other companies are changing reporting lines (12 instances), making changes to the internal audit function (11 instances), enhancing their whistleblower procedures (11 instances), strengthening communication in the company (11 instances), or trying to improve oversight of controls (eight instances) in more targeted efforts to overcome their control weaknesses.

CHALLENGE FOR MANAGEMENT ACCOUNTANTS

Senior management is the major driver of financial reporting quality. If senior management doesn't value controls, engages in override of controls, or commits fraud, the costs to the organization can be staggering, including bankruptcy. The classic financial statement fraud pattern in recent decades involves an aggressive CEO who cares little about controls and drives his/her employees to "make the numbers" no matter what, often by overriding controls and coercing others to go along with the fraud.

Based on our analysis of recent Section 404 reports, we find that auditors identify senior management problems as material internal control weaknesses in nearly 2% of the large companies audited from 2005 to early 2008. The weaknesses often relate to poor management tone/attitude, bad actions by management, and specific control weaknesses. The remedies often involve senior management turnover, control improvements, and corporate training.

Because of the incidence of senior-management-related material weaknesses, it's critical for management accountants to be aware of what is happening in the executive suite. While this may be challenging, management accountants may determine that something is amiss if, for example, they experience pressure to record entries with very limited documentation or to "revisit" accounting estimates as reported income is being finalized. In such instances, management accountants need to ask questions and then be ready to take action if it becomes clear that senior management is manipulating the financial statements. This action might include calling the company's whistleblower hotline or contacting an audit committee member or auditor about the concerns. As several recent fraud cases illustrate, people are too often inclined to look the other way or simply trust that senior management's motives are always pure.

While the accounting fraud problem will never be completely solved, we hope that the reforms of Sarbanes-Oxley, including the highlighting of certain management-related problems in Section 404 reports, will contribute to more reliable financial reporting in the future. Management accountants need to be on the alert for signs of trouble and be willing to take action when trouble is found. ■

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Managing risk has become an essential element of corporate strategy. By combining a continuous strategic planning process, a Strategic Business Services department focused on Enterprise Risk Management responsibilities, balanced scorecards, the tying of all metrics to processes, and other tactics, the United Illuminating Company (UI) creates a foundation for successfully managing risk from an organization-wide scale down to individual projects. UI's integration of strategic planning with ERM, along with the implementation of a process-based organization, has made it a model for identifying and sharing ERM best practices.

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Now that the $700 billion bailout passed by Congress in October is being implemented, what will happen next? The public outcry in response to the poor business decisions, lack of oversight, excessive executive compensation, and golden parachutes that led to the current crisis points to more reform on the horizon. The short-term implications of the bill won't affect many companies outside the financial services industry, but the longer-term effects may result in dramatic changes. Consolidation of commercial lenders and underwriters, accounting provisions regarding fair value accounting, and restrictions on executive compensation are just a few issues in play.

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A company's tone at the top is frequently cited as an important factor in establishing an effective ethical culture throughout the organization, yet senior management members continue to be the driving force behind many of the accounting frauds still making headlines. That's one reason Section 404 of the Sarbanes-Oxley Act requires an auditor to express an opinion on its client's internal control over financial reporting. These statements can provide important insight into how vulnerable companies may be to fraud and other misdeeds by senior management as well as the methods used to remedy potential weaknesses.

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