2016

What the Sarbanes-Oxley Act Does Not Include: An Examination of the Importance of Audit Firm Rotation, Audit Firm Credibility and Tone at the Top

Nicole Damaschi
Assumption College

Follow this and additional works at: https://digitalcommons.assumption.edu/honorstheses

Part of the Accounting Commons, Accounting Law Commons, Business Law, Public Responsibility, and Ethics Commons, Corporate Finance Commons, and the Legislation Commons

Recommended Citation
Damaschi, Nicole, "What the Sarbanes-Oxley Act Does Not Include: An Examination of the Importance of Audit Firm Rotation, Audit Firm Credibility and Tone at the Top" (2016). Honors Theses. 3. https://digitalcommons.assumption.edu/honorstheses/3

This Honors Thesis is brought to you for free and open access by the Honors Program at Digital Commons @ Assumption University. It has been accepted for inclusion in Honors Theses by an authorized administrator of Digital Commons @ Assumption University. For more information, please contact digitalcommons@assumption.edu.
What the Sarbanes-Oxley Act does not include: An Examination of the Importance of Audit Firm Rotation, Audit Firm Credibility and Tone at the Top

By: Nicole Damaschi

Faculty Supervisor: Professor Frank Marino

Business Studies

A Thesis Submitted to Fulfill the Requirements of the Honors Program at Assumption College

April 2016
# Table of Contents

- Introduction ........................................... 3
- Audit Firm Rotation ................................ 16
- Audit Firm Credibility ............................... 23
- Tone at the Top ....................................... 31
- Conclusion ........................................... 37
- Works Cited ........................................... 40
Introduction

Natural Gas and InterNorth merged to create Enron, one of the leading companies in the energy commodities sector of the economy. After a few short months, there were over 21,000 employees and revenues soared over $101 million. Although Enron became an innovative company quickly, it expanded into new and unfamiliar markets. The employees of this rapidly growing company lacked experience in the new markets and were ill prepared when it came to handling the fast pace at which Enron operated. Management ignored the risks associated with such rapid expansion and continued to conduct business. To adhere to normal financial reporting standards, Enron hired the well-known accounting firm, Arthur Andersen. Within months, Enron collapsed. How can such a powerful and successful company fail so suddenly and drastically? What exactly happened that destroyed such a large and wealthy company within such a short period of time?

The collapse of Enron is a well-known story that is often associated with the idea of accounting fraud and inappropriate financial reporting practices. There are other companies which have experienced failures similar to Enron’s and one example is WorldCom. WorldCom was the second-largest telephone company prior to declaring bankruptcy. WorldCom’s accounting fraud existed within the assets of their balance sheet. WorldCom listed $103.8 billion in assets as of March 31st 2001, yet the company lacked sufficient funds to pay back the $5.75 billion in bonds and long term debt that was due in the next year (Young and Mollenkamp). These accounting scandals, as well as others, prompted the government to question the credibility and accuracy of financial statements across the nation. The government took legal action in regards to minimizing fraud on the financial statements that a company produces.
Legal action was proposed in Congress by Paul Sarbanes and Michael Oxley when they drafted the Sarbanes-Oxley (SOX) Act. Paul Sarbanes, a Democratic Senator from Maryland, and Michael Oxley, a Republican House Representative from Ohio, composed the first draft of SOX. On July 30th 2002, President George W. Bush signed the act in attempt to standardize reporting practices of public companies and recommend guidelines for preparing financial statements and their review. Overall, the final draft of SOX does three things: (1) describes the new provisions that companies must adhere to while composing financial statements that focus on prohibited auditor activities, responsibilities of executives and management controls (2) discusses the protection of whistleblowers and (3) establishes consequences and punishments for altered documents and the commission of fraud.

Specifically, the Sarbanes-Oxley Act establishes eight major provisions that speak to previous grey areas in the standards, quality and ethics behind producing financial statements. The first major provision of the Act includes the creation of a Public Company Accounting Oversight Board (Spiceland 17). This organization consists of five members and oversees the audits of all public companies. This board ensures that the audits of public companies are conducted according to new, strict standards designed to protect public investors’ interest. The second provision of the Sarbanes-Oxley Act addresses the accountability of the corporate executive of a company (Spiceland 17). Once the financial statements are produced to the company’s best ability, the corporate executives of that company must sign his/her name on the financial reports. This puts the credibility and validity of the executive in jeopardy if fraud were to be exposed within the statements. The purpose of this is to ensure that the executives of companies believe that the financial reports are accurate and are a fair representation of the company’s financial position after considering business it has engaged in during the past month,
quarter, or fiscal year. A third provision focuses on the performance of nonaudit services for a company (Spiceland 17). For example, if a CPA firm performs an audit service for a company, that same firm cannot take part in other services for the company, such as performing accounting or consulting services for the client. The fourth provision that SOX establishes is the requirement to retain audit paperwork for a time period of seven years (Spiceland 17). In the Enron scandal, papers with vital information concerning the business operations were destroyed, making it difficult for investigators to see what exactly Enron and Anderson did and where the company went wrong while recording numerous fatal transactions.

Furthermore, the fifth provision is auditor rotation (Spiceland 17). Companies are required to rotate audit partners every five years. The rotation of auditors helps to eliminate the chance of fraud due to the fact that auditors cannot continuously audit the same companies for an extended period of time. The sixth provision under SOX concentrates on conflict of interest (Spiceland 17). This provision implies that an audit firm cannot audit a public company whose executives have worked for the audit firm or participated in previous audits. The seventh provision deals with the process of a company hiring an auditor (Spiceland 17). The audit firm is hired by the board of directors audit committee of the public company and not the upper management. The final major provision of SOX refers to the concept of internal control (Spiceland 17). Under SOX, public companies must implement effective internal control systems. These internal control systems should monitor cash disbursements and cash receipts within the company the monitoring of the flow of money throughout the business.

The Sarbanes-Oxley Act also addresses the protection of whistleblowers of corporate fraud cases. A whistleblower is an individual “who has and reports insider knowledge of illegal activities occurring in an organization” (Investopedia). SOX felt the need to establish protection
for whistleblowers under this legislation because of the retaliation a whistleblower experiences after exposing the wrongdoings of a company. In SOX, Section 808 is dedicated to protecting whistleblowers in corporate scandals: “No company […] may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee” (“The Act Sections”). SOX allows for whistleblowers to retain their positions within the company despite the fact that these individuals expose illegal behaviors to higher authorities. Section 808 helps to promote fair and accurate financial reporting due to the fact that whistleblowers’ jobs are not in jeopardy for exposing fraud or altered financial statements. While this protection exists by law, it can be difficult to enforce in practice.

A third aspect of Sarbanes-Oxley is the punishment and consequences for creating false financial documents, either through alteration of the financial reports or as a result of fraudulent accounting practices. SOX defines falsification of financial reports in Section 802 when an individual “knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object” (“The Act Sections”). Furthermore, the intentions behind such activities are done in order to sabotage audit reports. The punishments due to altering financial documents and records consist of fine, imprisonment (but for not more than 20 years), or a combination of both (“The Act Sections”). Similarly, Section 807 discusses the penalties associated with intentional fraud within financial statements. For example, fraud occurs when an individual “knowingly executes, or attempts to execute, a scheme or artifice to defraud any person in connection with any security of an issuer with a class of securities” or “[…] to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security of an issuer with a
class of securities” ("The Act Sections"). When an individual commits any fraudulent act, he/she is subject to a fine, imprisonment (but not more than 25 years), or a combination of both ("The Act Sections").

Individuals involved with the American economy view the Sarbanes-Oxley Act as one of the most sweeping financial reforms since the Securities Act of 1934. In a July 2002 New York Times article about politicians’ thoughts on the SOX Act, Bumiller discusses the opinions of President Bush. Despite the fact that Bush signed SOX into law, he was originally opposed to the major provisions brought forth by the act (Bumiller). However, Bush’s view on the subject changed after the second wave of scandals, when he realized that legal action was necessary to address the amount of fraud present in financial reports for public companies. Prior to Bush signing the act, he was criticized for his slow response time to these pressing accounting matters. Bush describes SOX as revolutionary when he says that it will raise reporting standards and put an end to inaccurate profits (Bumiller). Bush also addresses the punishments established by SOX; violators pay the price of their crime under this legislation.

After Bush’s announcement to the public concerning the signing of SOX, many were skeptical about the success the bill would have in the future. For example, shortly after Bush announced the new act, the Democrats criticized it saying, “the new law was a good first step but that it hardly went far enough” (Bumiller). There were still controversial aspects that were left out of the final draft that also have substantial impacts on financial reporting, such as audit firm rotation, audit firm credibility, and aggressive attitudes of top management. In the same article, Harvey L. Pitt, chairman of the Securities and Exchange Commission, agrees with the Democrats when he says that it is a good preliminary action, but implementation will be different because “[politicians have] got [their] hands full” (Bumiller). This preliminary action is a step towards
reestablishing the confidence of accurate financial reports that existed before the several fraud cases. Many deemed the implementation of SOX into public companies a challenge since it aimed to drastically improve financial reporting, something that had not been done since the Securities Act of 1934.

The authors of the act, Senator of Maryland Paul Sarbanes and House Representative of Ohio Michael Oxley, were also hesitant with publishing SOX from the beginning. An article in *The Economist* suggests that Sarbanes and Oxley both feel that the Act should have been written differently and elaborated upon more of the financial reporting characteristics that played integral parts in both waves of the accounting scandals. Furthermore, Sarbanes adds that the context in which the Act was written offered an obstacle due to the immediate demand for a reform in financial reporting regulations (“Five Years under the Thumb”). This pressure justifies the haste with which Sarbanes and Oxley drafted the legislation. The pressure created from the several scandals caused for immediate action, inhibiting Sarbanes and Oxley from addressing some of the more complex and controversial issues in regards to the financial statements of public companies.

Outside of Congress, the initial responses focused on the impact SOX would have on the price of compliance and the stock market of America. The same article in *The Economist* mentioned above discusses the cost aspect of Section 404 due to the fact that implementation expenses tremendously exceeded the original predicted amounts (Five Years under the Thumb). Furthermore, according to *The Economist*, others claimed SOX would weaken the American stock market. American firms would finance through private buyers and foreign firms would begin to sell shares elsewhere as a result of implementing SOX (“Five Years under the Thumb”). Financing through private buyers would weaken the stock market because American firms would
no longer be selling shares; therefore, the control of the companies would be in the hands of those private buyers instead of the stockholders. American firms would stop selling shares due to the fear of possibly misrepresenting the financial positions of the public companies. Many economists, along with others, had reasonable fears with the initial establishment of SOX that were both confirmed and refuted as implementation of the act played out in the American economy.

The results of implementing SOX have been controversial due to the varying opinions concerning the integration of the legislation into the American economy. Many researchers and individuals of American businesses and firms have commented on the several controversial aspects of SOX, which include the cost-effectiveness of adhering to the laws put forth by the act, the protection of whistleblowers in accounting fraud scandals, and the intangible benefits associated with the overall effectiveness of SOX in solving the problems it was originally intended to. There have been numerous studies conducted in order to explore the price tag that comes with complying to the Sarbanes-Oxley.

Since many companies incurred substantial compliance fees shortly after SOX came into existence, studies of corporate governance practices were conducted to offer insight into how SOX had affected public companies. For example, Thomas A. Hemphill, a professor in the School of Management at the University of Michigan-Flint, published an article in 2005 discussing the impact of SOX on directors and CEOs of public companies. The survey from 2005 includes responses from the top 2,000 public traded companies and found that 23% of companies incurred compliance costs between $1 and 5 million, 29% between $6 and 10 million and 47% incurred more than $10 million (Hemphill). In prior years, only 22% of companies had compliance costs of more than $10 million (Hemphill), suggesting that as time went on, the costs
of compliance to SOX regulations increased. This article indicates that the increase in costs were the result of an augmentation in internal audit resources. The results of the surveys conducted also indicated that 77% of directors and CEOs believe that SOX should be revisited by lawmakers (Hemphill). The fact that an overwhelming number of corporate companies feel that SOX could be improved upon sheds light on the dynamic aspect of this piece of legislation. Although it initially addressed a portion of the problems in financial reporting for public companies, there are still parts of the area that remain unregulated by legislation.

Although the majority of companies incurred compliance costs in respect to Section 404, many studies have been conducted to specifically look at how the smaller companies have been affected by regulation. Robert Benoit, President of Lord & Benoit, a SOX Research and Compliance firm, investigated the actual costs for smaller companies to comply with regulations set forth by the SEC and PCAOB. In *The Sarbanes-Oxley Investment: A Section 404 Cost Study for Smaller Public Companies*, Benoit concluded that compliance costs were anywhere from between $15,000 to $162,000 for Section 404(a) Management Assessment (Benoit). Benoit also examined costs of Section 404(b) Auditor Attestations and found that audit fees increased between $7,517 and $86,417 (Benoit). This study concludes that the costs incurred were lower than those predicted for these small companies by the SEC in the beginning, which suggests that Section 404 has been cost effective for both small and large companies.

Furthermore, Ivy Zhang, an academic from William E. Simon Graduate School of Business Administration at the University of Minnesota, explores the costs of SOX in a study titled *Economic Consequences of the Sarbanes-Oxley Act of 2002*. In this experiment, she indicates that some decrease in share prices in the American stock market are a result of the provisions established from Sarbanes-Oxley. Zhang’s study concludes that the costs of the SOX
Act exceeded the benefits from adhering to the act by the astronomical amount of $1.4 trillion (Zhang). Although the goal of SOX was to restore investor confidence in public companies and stimulate the stock market, this study suggests that it had the opposite effect. This number sparked much debate about the actual cost-effectiveness of SOX because the results of this study suggest that the stock market incurred detrimental losses after implementing this act.

On the other hand, there are researchers who feel that implementing this financial reform act is a cost-effective action. For example, Julia Hanna published an article in Forbes discussing this controversial aspect of SOX. Hanna concludes that the institutions, like the Public Company Accounting Oversight Board, and the provisions of the act itself have not been detrimental to the survival of businesses and firms (Hanna). Hanna suggests that since no companies have shut down operations completely since implementing SOX, the additional fees can be considered an initial investment for a company, and a one-time cost. Once the company incurs the costs associated with SOX at the beginning, the firm will not have to pay them again if the methods instituted in response to the act are successful.

Additionally, a survey was conducted in 2012 by the Financial Executives Research Foundation that asked FEI members about costs incurred due to compliance with Section 404 of the SOX Act. According to the survey, when asked if the company experienced an increase or decrease of internal costs within the past three years, 29% reported an increase while 48% reported a decrease (Sweeney). The results of this study demonstrate that costs for a greater number of businesses of complying with Section 404 have decreased recently, suggesting that companies are not suffering cost-wise as much as initially. Companies that experienced an increase attributed it to the large acquisitions and additional systems for internal control, as well as new Information Technology to enhance these additional systems (Sweeney). Firms that
experienced a decrease listed automated controls and reconfiguring the business and financial systems as possible reasons (Sweeney). Also, the survey indicates that 51% companies experienced better internal control after complying with Section 404 and felt that it was worth the added expense (Sweeney). In conclusion, the cost-effectiveness aspect of SOX has affected companies differently as time has progressed after passing the legislation.

Another portion of Sarbanes-Oxley that is under constant examination is the protection of whistleblowers in accounting fraud scandals. Luigi Zingales, a professor of Entrepreneurship and Finance from the University of Chicago, supports the provisions set forth by SOX. Zingales, along with Alexander Dyck and Adair Morse, examine the concept of whistleblowing in their paper titled “Who Blows the Whistle on Corporate Fraud?” throughout 230 corporate fraud cases during an eight year time period between 1996 and 2004. Before the SOX Act was implemented, one-third of corporate accounting scandals had whistleblowers that were responsible for finding fraud, which includes individuals like auditors and industry regulators (Zingales, Dyck & Morse). After integrating SOX into the business practice, the number of frauds reported by individuals responsible for finding errors and misrepresentation rose to 50% (Zingales, et. al). This study suggests that SOX enhanced the protection of whistleblowers in corporate scandals since more individuals were not afraid and were less hesitant to report inaccuracies while examining financial reports.

Conversely, others feel that SOX did not have a substantial effect on the protection of whistleblowers. For example, Richard Moberly discusses the ambiguous protection for this unique group of individuals in his article Why Sarbanes-Oxley Whistleblowers Don’t Win. Moberly states in his examination of SOX that the protections offered to whistleblowers are too broad (Moberly). Moberly also identifies the protection aspect as “burdensome” (Moberly n.p.)
to employers due to the fact that they must not consider whistleblowing an offense in which the employee can be fired (Moberly). The unspecific protection provisions open doors to the possibility of several different interpretations of the same concept, which can potentially result in disagreement on the subject. Furthermore, other researchers have found that the success of whistleblowing in corporate fraud has decreased after implementing SOX from 20.7% to 15.6% (“Five Years under the Thumb”). Despite the fact that whistleblowers are offered protection under this legislation and the number of cases brought to court has increased, it does not automatically result in a successful trial when the fraud case is brought to court.

Finally, academics have conducted studies concerning the intangible benefits for businesses and firms that are related to the implementation of the SOX Act. Ganesh M. Pandit, Vijaya Subrahmanyam and Grace M. Conway published a study that focused on the audit reports of companies listed on the NYSE before and after the SOX Act. The results of the study indicate three areas of improvement in regards to the representation in audit reports that include: an accurate identification of financial experts on an audit committee; a detailed report of auditor independence; and disclosure of the preapproval of nonaudit services (Pandit, Subrahmanyam & Conway). These improvements are important for the fair representation of financial positions of companies; the implementation of SOX has resulted in this positive tangible benefit that will help restore investor’s confidence in financial reporting. Another individual who explores the intangible benefits of the SOX Act is Suraj Srinivasan, an associate professor at Harvard. She states that information provided in financial reports will be used in more efficient ways and the internal control systems for companies have become more efficient as well (Hanna). The adherence to SOX is improving the quality of financial reports, which directly affects the
accuracy of information available to individuals outside of the public companies in the American economy.

In conclusion, the members of the accounting field, as well as those involved with American businesses on a variety of levels have differing opinions about the implementation of Sarbanes-Oxley. Many scholars have also published articles and studies concerning what will happen next in regards to laws about financial reporting. For example, Michael M. MacQueen published a study in 2010 called “Holes in our SOX: Improving the Effectiveness of the Sarbanes-Oxley Act of 2002”. This study explored several possibilities to revise SOX on account of controversies that existed. MacQueen looked for current holes in this Act, which he identified as internal control, or compliance with Section 404, and the control of audit committees and the board of directors during the auditing process (MacQueen). Through this study, MacQueen decides that the importance of the recommendations he offers is immaterial, and the possibility of implementation is unlikely (MacQueen). Eight years after SOX was established, many accountants and scholars began focusing on ways to improve the provisions brought forth rather than critiquing the existing provisions. Despite the fact that MacQueen’s study concludes that there is a poor possibility of revision of SOX to this extent, it represents a new perspective in examining the aftermath of SOX. This study, along with the other studies mentioned previously, demonstrate the controversy and uncertainty associated with SOX and its future benefits. After all, SOX is only 14 years old; many times, the full effects of legislations are not apparent until years after implementation. Was the SOX Act based on fundamental economic and accounting ideals that will no longer pertain to future situations with financial reporting?

Many consider the Sarbanes-Oxley Act to be one of the most sweeping financial reforms since the establishment of the Securities Exchange Act of 1934 that addresses exchanges of
stocks, bonds and debentures. Sarbanes-Oxley was passed in order to attempt to eliminate financial alteration and fraud in financial statements. However, SOX is still a young act with many long-term effects of implementation that are still unknown. With this, many accountants and audit firms describe SOX as a work in progress.

Therefore, this paper focuses on three aspects of financial reporting that SOX fails to address that are vital to fair and accurate financial reporting. One important aspect that plays an integral part in financial reporting is audit partner rotation. SOX specifically mentions a provision that requires audit partner rotation, suggesting that a company may use an audit firm infinitely as long as the partners conducting the audit rotate every five years. A second essential aspect that SOX fails to address is audit firm credibility. There is a provision in SOX that requires the CEO and CFO to sign off to certify that the financial statements produced are an accurate representation of the company’s financial position. However, a problem concerning audit firm credibility surfaces because no single name of individual partners appear on the audit report to certify that the audit conducted has been done so in a manner that follows audit standards. A third but not final aspect that does not appear in SOX is corporate culture through tone at the top. The culture fostered by upper management affects the financial statements. An aggressive, number-driven upper management will go to lengths to make sure that the financial position of the company is reported at what management desires it to be rather than what it actually is. Although it is difficult to audit such an intangible area of the business, upper management is often able to demonstrate culture through strategies like codes of conduct and role modeling in order to display the importance of certain concepts like honesty and integrity within the company.
Although these three ideas were not part of SOX initially, there is a possibility that they can be included in this dynamic piece of legislation later on. However, why were these potential provisions not included in SOX since the beginning? Would including these provisions improve the act and make it more effective in increasing the quality of the financial statements of public companies? The answers to these questions provide insight into grey areas and controversial concepts of financial reporting.

Audit Firm Rotation

In order to understand the concept and significance of audit firm rotation, it is necessary to distinguish the idea from audit partner rotation. Mandatory partner rotation is one of the eight major provisions brought forth by SOX. As stated before, companies are required to rotate audit partners every five years to help eliminate the chance of employees or top management committing fraud. Audit partners are the employees of audit firms in charge of conducting the audit. Currently, a company may have the same public firm audit the financial statements infinitely, as long as the partners change every five years. However, lawmakers and those involved in public accounting have debated over the idea of mandating audit firm rotation. This entails alternating audit firms entirely after a designated number of years instead of partners within the same audit firm.

Audit firm rotation is a controversial idea with many supporting and opposing arguments. Over the years, many politicians and economists have suggested and fought for the concept of audit firm rotation in order to solidify the importance of independence when conducting an audit. According to a review of audit firm rotation published by Corinna Ewelt-Knauer, Anna Gold and Christiane Pott, one major argument in favor of mandating audit firm rotation is to increase
independence in fact (Ewelt-Knauer, Gold & Pott). Independence in fact is one part of the overall concept of independence and is a mental attitude. The auditors on the engagement must be in a position to mentally conduct a credible and honest audit. Furthermore, auditors are not independent in fact if they overlook or ignore accounting methods that are not acceptable under the Generally Accepted Accounting Principles (GAAP). If audit firm rotation increases independence in fact, the quality of audits will increase since auditors will have no personal ties to the company under audit review; therefore, if the financials of the company are not accurate, the auditor will theoretically be more likely to point out the inaccuracies instead of letting them go unacknowledged.

Similarly, Ewelt-Knauer, Gold and Pott also believe that audit firm rotation will increase independence in appearance. Although this is solely based on perceptions, it is just as important as remaining independent in fact. Financial statement users, such as current and potential investors, rely on the concept of independence in appearance. An audit that is independent in appearance assures these investors that the financial statements are an accurate representation of the company that they are currently or will be investing in. The review states that “financial statement users will perceive the auditor to be more independent after mandatory rotation, which will benefit perceptions of the financial statement and market reactions as a whole” (Ewelt-Knauer, et. all). With mandatory audit firm rotation, financial statements will be more credible due to the fact that the auditors are more independent in appearance. The market will trust the initial numbers brought forth in the audited financial statements as well. If auditors are required to rotate after a certain time period, there will be no long-term relationships between the audit firm and client. Short relationships that are strictly for audit or other services will decrease the chance of an auditor overlooking material mistakes within the financial statements.
A third benefit of audit rotation is the resulting increase in market competition. Since audit firms and clients will not be able to form long-term relationships, clients will be looking for new firms to audit their financial statements while audit firms will be looking for new clients to replace old ones. While audit firms will constantly be looking for new clients, rotations will be used for “negotiating lower average costs per hour of audit work” (Ewelt-Knauer, et al.). The corresponding risk of “cutting corners” to decreases costs includes conducting a rushed audit due to lack of resources or time, which may lead to the release of an incorrect audit opinion. In order to attract new clients for business, audit firms will need to lower their costs for performing audits; therefore, audit firms will begin competing more for new clients. There will also be an increase in market competition due to the fact that smaller audit firms will have a better chance against the bigger public firms. Clients will likely consider more firms under mandatory audit firm rotation, increasing the chance that smaller firms will become an option for audit firms if the firm has the resources available.

Although there are benefits under mandatory audit firm rotation, many accountants have eagerly rejected the idea. One of the main arguments against the idea of mandatory audit firm rotation is that it fosters a working relationship between the audit firm and client. It is possible that mandatory audit firm rotation would cause auditors to “be more lenient toward management and less critical of practices of the client” (Ewelt-Knauer, et al.). If auditors are more lenient toward management, the credibility of the audit is sacrificed. The high start-up costs for an audit need to be recovered by the audit firm. If an audit firm publishes a modified or adverse opinion, the client will not be pleased with the results of the audit report. Therefore, it is important that auditors maintain the same level of professional skepticism and conduct the audit with constant integrity, regardless of whether or not the firm recovers the start-up costs for new clients.
A second reason that many public accountants oppose the idea of audit firm rotation is that accountants on the audit teams are not able to develop extensive knowledge of their clients. Extensive knowledge of clients being audited is a major asset in respect to the accuracy and efficiency of the audit. Furthermore, the review indicates that “audit failures most likely occur in the early years of engagement, which could be explained by a lack of expertise on the side of the auditor” (Ewelt-Knauer, et. all). This is an important argument because audits that fail are similar to audits that are not independent. If audit firms are required to rotate after a designated time period, a new audit firm will be conducting an audit with limited knowledge and experience within the company. Continuing audit engagements permit the expansion of an auditor’s knowledge regarding a specific client. This knowledge is the result of a long relationship, something that will not happen if audit firms are required to rotate. Auditors are able to become thoroughly familiar with their clients, allowing them to perform an accurate and more efficient audit than a firm that must learn about the industry and client’s business prior to completing the audit.

A third but not final argument against mandatory audit firm rotation is the market concentration that would result from such rotation. Although there is the possibility that smaller firms might be given a chance to gain more audit clients, there is also the possibility that larger corporations will alternate between the Big 4 firms (Ewelt-Knauer, et. all). The Big 4 are attractive options for audit firms because clients admire the vast “resources and expertise to deal with frequent rotations and hence a great variety in complexity of clients” (Ewelt-Knauer, et. all). If smaller firms are completely eliminated as options for conducting the annual audits for the larger corporations, it is possible that the audit engagement will be passed around between the Big 4 firms after the time limit approaches. Market competition is not healthy in this sense.
because a majority of the audits would be conducted by the same four companies. Although this type of market concentration exists to an extent because of the vast resources that each of the Big 4 firms has available, mandatory firm rotation would further inhibit the opportunities for smaller firms to gain new clients.

Due to the fact that there are many benefits and consequences of audit firm rotation, there is a mixture of countries who require some extent of audit firm rotation and others that have abolished it entirely. A Wall Street Journal article written by Emily Chasan titled “European Parliament Approves Mandatory Auditor Rotation” discusses the recent change in requirements in one of the largest and most developed economic regions. The new stipulation requires certain companies, including European-listed companies, banks and financial institutions, to rotate audit firms every 10 years. In addition to the mandatory firm rotation, tighter restrictions will be placed on certain consulting services and “cap the amount of additional fees auditors can charge their clients” (Chasan). These additional fees are incurred through other services that accounting firms provide for their clients along with the audit. The limitations imposed upon the consulting services and additional fees are another attempt to increase auditor independence. Many times, independence is diminished through the relationships that clients have while an audit engagement is not happening. Furthermore, a restriction in additional audit fees caters to the idea of lower costs incurred by clients. It is hoped that rotating auditors after a 10 year period will decrease the financial burden that clients experience while trying to find a new audit firm because of the increase in market competition.

Chasan’s article also offers insight into the international effect of making audit firm rotation mandatory in Europe. The article states that “U.S. banks that operate subsidiaries in Europe would be impacted, and it could lead to broader changes in the international market for
audit services” (Chasan). Although audit firm rotation has not been established in the United States yet, some subsidiaries of U.S. companies are now affected by it. The new law is expanding the number of companies being exposed to audit firm rotation. Like Chasan writes, it could influence more companies with subsidiaries or other financial connections in Europe to accept and implement mandatory audit firm rotation. This is a progressive step in accounting requirements. Ed Nusbaum, the chief executive of Grant Thornton International, acknowledges the idea that audit firm rotation was not even a question in the previous decade. The concept of audit firm rotation is controversial yet dynamic since more countries are bringing the notion to the table.

Another economically developed country which requires audit firm rotation is China. However, China is different than many other countries when it comes to mandating audit firm rotation because the country has created its own policy in which financial institutions and state-owned enterprises must rotate every three years. Furthermore, in other industries, an auditor cannot engage with the same client for more than five consecutive years. Sally Percy’s article “China’s audit rotation” published in *Economia* explores reasons as to why China has eagerly adopted the idea of audit firm rotation. In the article, James Lee, a regional director of Greater China for the Institute of Chartered Accountants in England and Wales (ICAEW) believes that haste in which the country established audit firm rotation is a method to “improve audit governance, allowing time for the profession to mature” (Percy). According to the article, the accounting profession in China is in its early stages. The notion of audit firm rotation improves the credibility of the audit engagement due to the fact that it is an extra precaution to ensure the audit firm remains independent from the client.
Percy’s article continues with an examination of audit firm rotation in practice. Another reason why China follows mandatory firm rotation is to “loosen the stranglehold of the Big Four accountancy firms on the large audit market in the country” (Percy). As stated previously, one of the arguments opposing audit firm rotation is that it will result in market concentration. So far, the article describes the dominance of the Big Four that still exists: “Despite local firms being invited to tender for the audits of three of China’s largest banks in 2012, the Big Four ended up swapping among themselves” (Percy). This demonstrates one of the problems with audit firm rotation. The Big Four firms are attractive audit firms for companies, both domestically and internationally; therefore, although companies are complying with the mandatory firm rotation provision, only a certain number of audit firms are being considered. Smaller Chinese public accounting firms are not able to audit many companies due to the dominant presence of market concentration in the audit market.

Although there are some economically successful countries that practice mandatory audit firm rotation, a majority of countries do not. One country that opposes the idea of firm rotation is Canada. The Canadian Public Accountability Board (CPAB) published a statement on its view of mandatory rotation that explains why it has yet to be established in Canada. For reasons similar to arguments mentioned before, Canada does not participate in firm rotation because it would “result in a lengthy procurement exercise, diverting resources from audit quality – leading to a ‘race to the bottom’ on audit fees” (Mandatory Rotation and Tendering). CPAB feels that rotating audit firms after a designated time period would be an inefficient practice. Many times, audit firms are able to conduct high quality audits due to the client-specific knowledge fostered from a long term relationship. If the auditors are forced to rotate, the new audit firm will spend valuable time and resources familiarizing itself with the client whereas a repeat audit firm can
conduct the audit immediately and with more knowledge. Furthermore, CPAB believes that mandatory firm rotation will lead to a “race to the bottom” in regards to audit fees. Firm rotation would result in an increase in competition between audit firms since they would need to continuously find new clients. In order to make themselves look more attractive, audit firms would lower audit fees associated with the engagements. As mentioned before, lower audit fees lead to the corresponding risk of lower quality audits.

After examining a combination of countries that participate in and oppose audit firm rotation, it is clear that this idea is still controversial with diverse practices across borders. The countries that switch to required firm rotation all have different experiences. For those under the rule of the European Parliament and China, the unique policies concerning audit rotation are setting examples and giving other countries insight into what switching to mandatory rotation would entail. Others, like Canada, are not fond of the idea because of the damage it might do to the quality of the audit engagements. The controversial views on audit firm rotation shed light on why it was not included in the initial draft of SOX in 2002. However, the wave of countries introducing audit firm rotation as time progress alludes to the fact that the debate is far from over.

**Audit Firm Credibility**

The idea of audit firm credibility is another critical aspect of financial reporting that SOX fails to address. As stated before, one of the major provisions established by SOX focuses on the accountability of upper management producing financial statements for a public company. Specifically, the corporate executive of the company must sign his/her name on the financial reports. The signature attests that the financial statements have been accurately and honestly
produced to the best of upper management’s knowledge and ability. This provision of SOX puts the credibility of the executive signing off on the statements in jeopardy if fraud were to be uncovered later on during an audit.

Although corporate executives are personally responsible for signing off on the financial statements produced for the company, the accounting firms that audit the same statements do not release individual names when signing off on the audit report. This concept does put the audit firm’s reputation in jeopardy in case the audit fails, but the names of the audit partners are protected on the audit reports unlike members of upper management. Therefore, SOX creates a gap between the credibility of corporate executives of public companies and audit firm partners. Although the financial statements are the responsibility of management and the accounting firm is a second set of eyes, it is important to stress audit firm credibility as well. The goal of an audit is to ensure that the financial statements are a credible and accurate representation of the financial position of the company. Furthermore, an accounting firm with numerous audit engagements also adds to the credibility of the firm. Constant audit engagements build the reputation of the firm, increasing the overall credibility.

The reputation of corporations and audit firms is a dynamic topic that SOX fails to address due to the fact that the importance of reputation has changed throughout history. Jonathan R. Macey discusses the shift in the importance of reputation in his book The Death of Corporate Reputation: How Integrity has been destroyed on Wall Street. In Macey’s introduction, he proposes three plausible reasons for a decline in the importance of reputation: (1) individuals involved in the financial industry focus more on their personal reputation instead of their employer’s reputation, (2) participants in the financial markets rely on law and regulation for protection rather than reputation as a whole and (3) the world of finance becomes more
complex as time progresses, which has replaced the historical idea of simple reputation (Macey 1-2). The significance of reputation has diminished because the priorities of participants in financial markets have also shifted. According to Macey, the financial industry has morphed into aggressive individuals more concerned with their personal reputations rather than the success of the company.

Macey begins his explanation of how reputation has changed by establishing what reputation has meant throughout history. Macey begins with the “old economic model of reputation”, an idea where “firms invest in reputation so that customers will do business with them” (Macey 8). In prior years, building a reputation became an important investment for firms due to the fact that a good reputation would attract business and reliable customers. According to Macey, customers valued a firm with a respectable reputation and trusted that the company would conduct business operations in an honest manner. Furthermore, Macey concludes that reputation is an investment for firms through a cost-benefit analysis. A credible and honest reputation will “attract customers who will pay a premium to deal with the company with the good reputation” (Macey 8). The willingness of the customers to pay a premium keeps daily business operations going and contributes to the long-term success of the firm.

Unfortunately, there has been a decrease in the importance that corporations place on a credible reputation. In the current economy and financial markets, Macey argues that the costs of being honest are far more than those to be dishonest (Macey 10). Firms are no longer willing to invest in a good reputation because of the high costs. In upper management’s opinion, there are more important assets for the company to invest in that will generate higher profits instead long-term customer trust. For example, Phil McKinney published an article in Forbes titled “The Real Reason to Invest in Technology” that implies that one major capital budgeting expense that
many companies incur is technological advancement. McKinney identifies the top three reasons why companies are putting their funds toward technology instead of building a reputation: progress—anytime and anywhere, a sense of security, and the need for speed (McKinney). These three benefits of investing in technology allow for business operations to continue uninterrupted and free of security breaches because members of companies can fulfill their responsibilities at any time of day from any location. This article represents the mindset of many firms today because firms are focused on working effectively and efficiently rather than honestly and in ways that build reputation.

The Enron and Arthur Andersen scandal is a noteworthy example of how reputation throughout the accounting industry has diminished. Prior to taking on Enron as a client, Arthur Andersen and Co. emphasized independence and credibility when it came to performing audits and providing other consulting services to its clients. Before Enron’s collapse, “none of its clients, including Enron, accounted for more than 1% of Andersen’s United States auditing revenue” (Macey 130). Because of this small percentage of revenue, it appears that Andersen did not have such a significant financial interest in Enron as a whole. Andersen had a combination of other large clients that kept the accounting firm afloat with a credible and reliable reputation. In 1914, Andersen strived to be the auditor that investors trusted to verify the accuracy of the financial statements of public companies. However, the golden reputation slowly diminished as time progressed while individual reputation took precedence over firm reputation as a whole.

The reputation of Andersen began to decline as its relationship with Enron became more complicated. The team of auditors assigned to Enron led by David Duncan shifted its priorities when it came to the audit engagement. Macey describes this group of auditors as “loyal to the client and not to the firm” (Macey 132). The relationship between Enron and Andersen revolved...
around the reputation of the individuals on the audit team and not the overall reputation of Andersen as an accounting firm. Duncan and his team members prided themselves on the contract with Enron because of the numerous benefits associated with it. The auditors deliberately ignored the aggressive accounting methods of Enron in order to ensure that this relationship continued.

When the auditors continuously overlooked the methods that made Enron’s financial statements grossly inaccurate, Andersen’s credibility and reputation as an accounting firm was destroyed. A credible reputation for accounting firms is crucial because otherwise, “the auditor’s verification function loses its value” (Macey 128). Without a reputable firm conducting an audit engagement, the audit opinion on the financial statements is less likely to be trusted by outside parties, especially current and potential future investors. Therefore, audit firms should spend years building up a credible reputation through issuing high-quality audits of financial statements. Although SOX attempts to strengthen audit firm independence by imposing restrictions on the extent of relationships that can exist between audit firms and their clients, SOX fails to directly address the importance of a credible reputation.

Another instance throughout history that illustrated the decline of audit firm credibility was the collaboration between Lehman Brothers and one of the Big 4 accounting firms, Ernst & Young. A Wall Street Journal article titled “Ernst Accused of Lehman Whitewash – New York Sues the Accounting Firm, Alleging a 7-Year Fraud as It Made $150 Million in Fees” discusses the scandal in which Ernst helped Lehman Brother’s hide its actual financial condition. The scheme revolved around Repo 105, a method “used to shift the assets off Lehman’s books in return for a promise to buy back the securities at a premium days later” (Rappaport & Rapoport).
The cash generated from these transactions was used to decrease liabilities on the balance sheet, making Lehman Brothers appear to be in a better financial position that it really was.

Rappaport and Rappaport’s article explains that the series of Repo 105 transactions sheds light on the close relationship between the accounting firm and its client. The relationship between Lehman and Ernst sacrificed independence due to the employment history of Christopher O’Meara and David Goldfarb. O’Meara, a former partner at Ernst, held the title of chief financial officer (CFO) from 2004 to 2007 of Lehman after heading the risk management division (Rappaport, et. all). In 1994, O’Meara joined the company while it was still a client of Ernst. Goldfarb followed in O’Meara’s footsteps, holding the CFO position of Lehman after serving “as a senior partner at Ernst’s Financial Services practice” (Rappaport, et. all). Since O’Meara and Goldfarb held such high and important positions in both Ernst and Lehman, they were not fully independent during the seven year scheme.

This conflict of interest fostered the working relationship between Lehman and Ernst. The article states that according to securities filings, “Ernst earned more than $185 million in audit and other fees” prior to the bankruptcy of Lehman (Rappaport, et. all). This astronomical number for Ernst’s revenue from Lehman alone sheds light on the fact that Ernst was willing to sacrifice its independence in return for money and a continuous working relationship with such a big client. This case supports the idea that accounting firms are more concerned with pleasing their clients instead of offering a credible opinion on the published set of financial statements. Lehman Brothers sought help from its audit firm for additional financial services that allowed them to disguise its true financial condition during the seven years. Ernst was no longer concerned with the firm’s reputation that should portray independence and credibility, an action that destroys the original intention of conducting an audit.
A third accounting scandal that emphasizes the lack of audit firm credibility is the HealthSouth fraud. HealthSouth was considered to be one of the largest rehabilitation hospital operators in the United States. In 2004, HealthSouth was investigated by the SEC for overstating revenue by $2.5 billion since 1999 (Washingtonpost.com staff). The investigation revealed that the accounting methods of HealthSouth’s capitalizing and expensing certain costs were what caused the company to overstate its profits by such an astronomical amount. The notion of audit firm credibility comes into question with Ernst & Young, HealthSouth’s audit firm.

According to a Wall Street Journal article, several red flags were brought to Ernst’s attention during the audits but the accounting firm was not able to detect the scheme in place on HealthSouth’s books. One major red flag from the audits was when William Curtis Miller, a partner at Ernst, “testified that the firm took no action when told that HealthSouth’s internal auditor was denied access to key HealthSouth books” (Mollenkamp & Carrns). Furthermore, the audit firm received specific information concerning possible fraudulent activity in three accounts, but James Lamphron, another Ernst partner, stated that the auditors “[...] found nothing that was inappropriate” (Mollenkamp, et. all). Despite actions that imposed scope limitations for the audit and tips from employees at HealthSouth, Ernst was unable to find the fraudulent activity and issued incorrect audit opinions over a period of time. When the HealthSouth scandal surfaced, the company fired Ernst as its audit firm. According to the most recent proxy at the time of the scandal, the company “paid the accounting firm $3.6 million for its 2001 financial-statement audit and related services” (Mollenkamp, et. all). HealthSouth paid a substantial amount of money in audit and related fees to receive a credible opinion from the auditors. Unfortunately, at the expense of HealthSouth, Ernst & Young’s reputation and
credibility suffered with the inability to spot a multi-billion dollar fraud although the firm still continues on as one of the most prestigious public accounting firms!

Therefore, the problem of audit firm credibility exists because of the change in values in the accounting industry. The importance of conducting a quality audit has diminished due to the fact that “people are no longer embarrassed to be sued the way they used to be. It is just a cost of doing business” (Macey 23). Macey alludes to the notion that people no longer take pride in their work when doing it the first time. If an unqualified audit opinion is issued for financial statements containing fraud, it is likely that the company which produced the financial statements along with the auditors who examined them will get sued. In prior years, being sued for providing an incorrect audit opinion was embarrassing because auditors were supposed to verify the statements. Now, with legal action being “a cost of doing business,” people assume that audits may be conducted incorrectly, which defeats the original intention of conducting an audit.

The number of accounting scandals that have surfaced since the establishment of SOX shows that audit firm credibility and reputation is still a problem in the public sector. As shown with the Enron scandal, audit partners, like David Duncan, are more concerned with keeping their client satisfied to ensure that the relationship persists and the accounting firm stills earns revenue from the audit engagements. Furthermore, the scandals involving Ernst & Young are an example of when an audit firm fails to remain independent and is unable to assure the public of the accuracy of financial statements. Independence and credible financial statements are the two main products that audit firms have to “sell” to acquire and keep clients. When audit firms are not able to do this, the reputation of the accounting industry and profession as a whole begins to crumble. Furthermore, the fact that these audit firms are still considered to be the most
“prestigious” in the industry diminishes credibility further because the firms are not able to fulfill their fiduciary duties and responsibilities that accompany their titles. In order to help restore investor confidence, the importance of audit firm credibility must be reestablished first.

**Tone at the Top**

The concept of tone at the top is a third and crucial area necessary for accurate financial reporting that SOX fails to adequately address. The concept of tone at the top was discussed in the Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) *Internal Control-Integrated Framework*. This framework consists of five components and 17 principles that play an essential role in effective internal controls. These five components of the COSO framework are the control environment, risk assessment, control activities, information and communication, and monitoring activities. Although each of the five elements is important for evaluating the effectiveness of an organization’s internal controls, the control environment addresses the honesty and integrity of the upper management, in other words tone at the top.

The control environment has five related principles that demonstrate the aspects of tone at the top that SOX fails to address. Sara Lord’s *An Overview of COSO’s 2013 Internal Control-Integrated Framework* lists the principles of the control environment as the following: the organization demonstrates a commitment to integrity and ethical values; the board of directors demonstrates independence from management and exercises oversight of the development and performance of internal control; management establishes, with broad oversight, structures, reporting lines, and appropriate authorities and responsibilities in the pursuit of objectives; the organization demonstrates a commitment to attract, develop, and retain competent individuals in
alignment with objectives; and the organization holds individuals accountable for their internal control responsibilities in the pursuit of objectives (Lord).

Furthermore, Lord indicates that the points of focus for the control environment emphasize the corporate governance aspect of the organization. Overall, the five principles related to control environment set the tone at the top, establish the structure of the business in regards to oversight and reporting, establish the policies and procedures, and finally, enforce accountability through performance measures like rewards and disciplines (Lord). Based on these principles of the control environment, tone at the top is reflected in the board of directors’ and upper management’s attitudes towards the role that honesty and integrity play in conducting daily business operations. These ethics and values filter into the production of the financial statements and are directly related to the accuracy and honesty of these statements.

The first draft of SOX incorporates several aspects of tone at the top. For example, publicly traded companies must have an audit committee as a part of its board of directors. The audit committee must be composed of independent individuals outside of the company, and one of these individuals must be a financial expert. A publication from Gelman, Rosenberg & Freedman titled *Audit Committees: The Roles and Responsibilities* discusses the role of the audit committee as the following: “The primary purpose of an audit committee is to provide oversight of the financial reporting process, the audit process, the system of internal controls and compliance with laws and regulations” (Audit Committees: The Roles and Responsibilities). The role and requirement for the audit committee is an important aspect of tone at the top because this group of executives is highly involved with the financial statements. If the Audit Committee is not independent from top management, conflicts of interests may arise, which may skew the reporting process or result in an audit that is not independent.
Another important aspect of tone at the top that SOX included is the requirement of a code of ethics. Section 406 of SOX defines a code of ethics as “standards necessary to promote (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships and (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and (3) compliance with applicable governmental rules and regulations” (Sarbanes Oxley Act Section 406). Furthermore, the senior financial officers should disclose the existence of the code of ethics and reasons as to why or why not there has been a code adopted. This is also an important part of tone at the top because a code of ethics is a direct reflection of the values and ethical standards of upper management. Public companies governed by senior financial executives with strong senses of morality and integrity hold the accuracy of the financial statements to high importance, reducing the likelihood of fraudulent reporting.

One example of how the tone at the top of an organization can be reflected in the financial statements is by the phenomenon of earnings management. Earnings management is “a strategy used by management of a company to deliberately manipulate the company’s earnings so that the figures match a predetermined target” (Investopedia). Often, upper management will manipulate earnings numbers in both directions to stay on track with predictions from outside parties. Top management will either increase or decrease earnings through several accounting practices, some of which often fall within the range of generally accepted accounting principles (GAAP) and some of which may violate GAAP. Although the accounting practices fall within GAAP, some accountants feel that the methods are too aggressive to represent the actual financial position of the company, creating an illusion for current and potential investors. Organizations that engage in earnings management exhibit a tone at the top that is more
concerned with pleasing investors and meeting predictions than revealing their actual financial condition.

In addition, tone at the top is one of the major factors that contributed to the downfall of Enron. According to a CNN summary of the scandal, “Enron shares were worth $90.75 at their peak in August 2000,” (Enron Fast Facts) prior to the sale of these shares by top management. The price of the shares plummeted to $0.67 a share in January of 2002 after the company “announced massive losses, slashed shareholder equity by $1.2 billion and came under intense pressure from investors” (The Associated Press). Enron found itself in this scandal because of aggressive, self-serving and sometimes improper accounting practices that top management executives accepted and encouraged.

Gregory J Millman’s article “New scandals, old lessons: Financial ethics after Enron” discusses two critical business orthodoxies that shed light on Enron’s tone at the top. The first is that managers should have the mindset of shareholders. Millman’s article quotes Lynn Sharp-Paine, a Professor of Business Administration at Harvard Business School: “‘Enron shows the dangers or risks involved in trying to align everybody’s financial interest’” (Millman). Professor Sharp-Paine explains that the various groups financially involved with Enron created the obsession with the company’s financial success. The different groups, such as the managers, investors, legal and financial advisors and accountants, were all under the pressure of stock prices, a direct reflection of Enron’s projected and perceived financial position.

The second business orthodox in which Enron’s tone at the top failed was that managers should also have the mindset of entrepreneurs. Millman’s article explains the problems associated with Enron’s slogan, which included “that everybody was always to ask ‘why’”
This slogan often prompted executives to ask “why not?” regarding important business decisions. Enron emerged as an energy commodity that sold natural gas and electricity. As Enron grew and became a leader in its industry, the company turned itself into an investment fund, offering investment instruments like stocks and bonds. Enron employees sold these derivatives with little knowledge and experience, fostering an aggressive entrepreneurial image. With this aggressive and care-free attitude, it is easier for executives to seek opportunities that others have overlooked. However, this creates a problem because entrepreneurs can sometimes be too aggressive as a result of confidence, sending the company into unknown territories of business. Enron’s upper management became entrepreneurs but failed as it could not keep up with the changing business operations.

The combination of the previously mentioned business orthodoxies along with a lack of a company code of ethics or conduct emphasizes the importance of tone at the top when producing financial statements. Millman’s article further explains that Enron did, in fact, have a code of ethics but it was ineffective because it did not “address what happens when the core business is under attack” (Millman). Once Enron felt that pressure of the stock prices, the company began to crumble and upper management disregarded the existing code of ethics. The tone at the top of Enron changed when conflicts of interest arose, causing the executives to overturn the policies during high-pressure times.

Another example of financial statement fraud in which tone at the top had a significant influence was the WorldCom scandal in 2001. An article published by the Association of Certified Fraud Examiners explains management’s role in preventing fraud in the workplace using a WorldCom employee as an example. Walt Pavlo was the Senior Manager in Billing Collections for the company and his primary responsibilities including customer payments,
credits and account reconciliations (Association of Certified Fraud Examiners). Pavlo became a victim of upper management pressure when he felt the need “to constantly achieve revenue growth in the company” (Association of Certified Fraud Examiners). WorldCom was a company full of executives driven by numbers and would do anything to achieve that. An article published in the *Los Angeles Times* titled “WorldCom Execs’ Conduct Detailed” discusses Bernard Ebbers’ attitude towards a corporate code of conduct: “The report stung Ebbers for resisting efforts to establish a code of conduct at WorldCom. Ebbers was said to have described it as a ‘colossal waste of time’” (Barakat). Ebbers’ lack of desire to establish such a code of conduct indicates that WorldCom’s tone at the top did not value honest financial statements and pressured Pavlo and other employees to follow suit.

As a result of WorldCom’s demanding and crooked tone at the top, Pavlo began to manipulate numbers on his own discretion. Through various meetings with superiors and colleagues, Pavlo learned to hide uncollectible debt. Concealing uncollectible debt increases a company’s assets and profits because there is a higher net receivable and lower bad debt expense. Pavlo’s actions display the importance of tone at the top because “he felt that he was doing his job and making his employers happy by altering the company’s financial data” (Association of Certified Fraud Examiners). WorldCom’s tone at the top tricked its employees into thinking that altering the financial position of the company was acceptable despite the fact that it was not the truth.

The collapse of Enron and WorldCom are examples that illustrate how essential a proper tone at the top is for the survival of a company. The tone at the top of a company demonstrates what the organization values and how it carries on conducting business. The values and ethics brought forth by an organization’s tone at the top directly affect the financial statements. The
strong connection between tone at the top and accurate financial statements is something that SOX fails to address. This also sheds light on the fact that upper management also affects financial statement credibility through the culture that the executives create in the workplace.

**Conclusion**

The Sarbanes-Oxley Act of 2002 took the financial reporting world by storm in an attempt to restore investor confidence in the financial statements of publicly traded companies. Although this piece of legislation addressed problem areas such as audit partner rotation and the protection of whistleblowers, the ideas of audit firm rotation, audit firm credibility and tone at the top were excluded. After an examination of these three concepts, one can conclude that these ideas are also essential to restore investor confidence in financial statements and should be considered in the future.

The initial reactions to this sweeping financial reform indicated that SOX was a short term response to an important problem in financial reporting. Therefore, one future reform that should be implemented is audit firm rotation. Although there are several costs associated with this idea, the benefit of increasing independence outweighs such costs. Independence is crucial to the success of an audit and restoring investor confidence in the audited statements. Lawmakers can use other countries that engage in audit firm rotation as an example when implementing the rotation of audit firms. To alleviate some of the burden of costs associated with starting up a new auditor-client relationship, audit firms should rotate after a period of five years. Five years is a time period in which firms will not feel like they are constantly switching clients but will still be able to remain independent. The audit firms will be able to enjoy some of the benefits of no audit
firm rotation, such as being able to gain client-specific knowledge without jeopardizing the independence of the audit through a historical relationship.

Another area that should be incorporated in SOX in the future is audit firm credibility. As stated before, the decline in importance of audit firm credibility diminishes the foundation of the accounting profession as a whole. In order to restore the original importance of audit firm credibility, audit firms should be punished for actions that sacrifice factors of credibility. For example, audit firms that collaborate with the upper management of a client in a fraudulent scheme should be suspended from practicing for a designated time period and such should be strictly enforced by the SEC and PCAOB. Suspension would help to emphasize the importance of credibility again. An authority should be able to decide the exact details of punishment, depending on each situation. The threat of punishment would help restore firm credibility because of the consequences it would have on the success of the firm.

Finally, tone at the top should be monitored to an extent because of the correlation between the company’s values and the accuracy of its financial statements. Although tone at the top is company-specific, there are factors present throughout all companies that influence upper management’s tone. For example, an authority can implement a provision that builds upon Section 406 of SOX that would require all companies to have a code of conduct that addresses certain areas. Although a code of conduct is necessary to portray the company’s attitudes and values, there is no regulation as to how in-depth the code of conduct needs to be. An authority should establish certain topics and areas in which companies should focus their codes of conduct on. Furthermore, there should be punishment for not implementing and following the code of conduct. Following the code of conduct is more important because it shows that the company is conducting business in an ethical and appropriate manner. In addition to the code of conduct,
companies may offer annual seminars to remind employees of the details of the code of conduct. Other activities that foster an anti-fraud environment include anti-fraud training programs. If organizations are required to participate in a certain number of activities to establish a more ethical tone at the top, companies may feel less pressure to engage in fraudulent reporting. There will also be more equality among organizations and the economy as a whole. A second way that tone at the top can be positively affected throughout all companies is through a stronger presence of outside independent directors. For example, the audit committee must be composed of such outside and independent directors, including one financial expert. However, stricter requirements can be established in order to ensure that the directors chosen are actually independent from the company and have no other financial interest in the performance of the company. Therefore, these three areas address the fact that accurate financial reporting is two-sided. Although the audit firm’s primary responsibility is to provide credibility to a set of financial statements, upper management of a company also has a responsibility to produce accurate financial statements to the best of their ability and knowledge.
Works Cited


Tone at the Top: How Management Can Prevent Fraud in the Workplace. N.p.: Association of Certified Fraud Examiners, n.d. PDF.

