THE TONE AT THE TOP and Ethical Conduct Connection

By Barbara Lamberton; Paul H. Mihalek, CPA; and Carl S. Smith, CMA, CFM, CPA

No company aspires to become the next poster firm for its lack of ethics. Although much debate has swirled around the topic of corporate ethics, few studies have focused on how the tone at the top can pressure accountants to materially alter results—or influence them to choose the ethical path.

To take a closer look at this issue, we conducted a study focused mainly on tone at the top and its effects on the accounting function, but we also asked about the audit function and whether the respondents had a written code of ethics. There's been lots of discussion on how these three issues affect corporate ethics. For example, professional accounting organizations, such as IMA, the American Institute of Certified Public Accountants (AICPA), and the Institute of Internal Auditors (IIA), argue that management's attitude plays a major role in reducing the risk of accounting irregularities. And according to the 1987 *Report of the National Commission on Fraudulent Financial Reporting* (Treadway Commission report), a strong internal audit function also reduces the chances of a major fraud.

So does a written code of ethics foster a strong control environment? Even though the Treadway Commission argued that written codes send an important signal to employees and help communicate expectations, a previous study by Ann Rich, Carl Smith, and Paul Mihalek in 1990 titled "Are Corporate Codes of Conduct Effective?" suggests that written codes are less than effective in terms of fostering ethical behavior. Like our study, the Rich, Smith, and Mihalek study also examined the relationship between written codes and certain management accounting practices.

This topic isn't new, and over the years the profession has issued reports and adopted standards (see "A Brief History of Financial Reporting Integrity" on p. 39). We wanted our study to take the pulse of those out in the trenches today who may or may not be feeling the pressure to materially alter results.

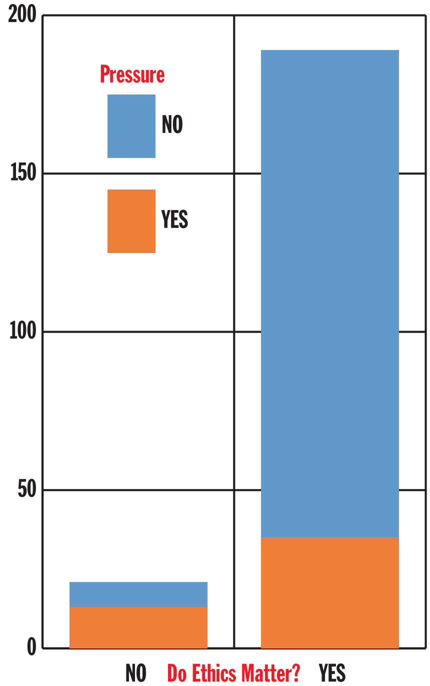
DATA GATHERING

We gathered information from management accountants and financial managers about top management's attitude toward ethics, whether their employer had an internal audit function, and whether it had a written code of ethical conduct. The resulting questionnaire included additional demographic information, such as job title, background, and years of work experience. We also gathered information about each respondent's corporation, such as annual sales, number of employees, and type of business.

To encourage respondents to complete the questionnaire, the data-gathering process was Web based and anonymous. We e-mailed a random sample of 1,500 IMA members, requesting their input, and then gave those individuals who chose to participate a link to a website that featured the questionnaire. Of the 215 respondents, most had more than six years of applicable experience in accounting-related jobs.

While the majority of the companies reported being in business for more than 30 years, 27% reported being in business between 10 and 30 years, and 18% reported being in business less than 10. The sample included corporations of various sizes: 36.8% with annual sales in excess of $250 million, 11% between $100 and $250 million, 15% between $30 and $100 million, 19% between $10 and $30 million, and 17% totaling less than $10 million. Although the random sample included both public and private corporations, the majority were privately held with manufacturing representing the largest type of business at 33% of the sample.

Figure 1: DO ETHICS MATTER TO TOP MANAGEMENT?



TONE AT THE TOP

So how concerned is top management with ethics? More than 90% of the respondents reported that the corporation's top management was either highly or somewhat highly concerned with ethical behavior, which compares to 80% from the earlier study by Rich, Smith, and Mihalek. Our results also indicate that ethically concerned management is more likely to be in corporations with written codes of ethical conduct and an internal audit function.

To determine if there were a relationship between valuing ethics at the top and ethical conduct within the corporation, we asked four questions about pressures to alter performance results:

- Was there general pressure to alter results?
- Were there pressures to manipulate earnings?
- Were there pressures to manipulate accounts for calculating return on investment (ROI)?
- Were there pressures to alter the balance sheet?

Our responses (see Figure 1 for the results) indicated that:

- Twenty-two percent (48 out of 210 respondents) reported feeling pressure to alter performance results and that pressure seems to relate to the tone at the top; and
- Nearly 62% of the respondents (13 out of 21) from corporations reporting that ethics don't matter report pressure to alter or "manage" financial results.

In contrast, in corporations where the tone at the top favors ethical conduct, only 19% (35 out of 189) reported pressure to alter results. Similar results were shown with specific financial reporting measures, such as income, balance sheet, and return on investment.

THE INTERNAL AUDIT FUNCTION

More than 50% of the respondents (108 of 215) reported their corporations had internal audit departments compared to 44% in the 1990 Rich, Smith, and Mihalek study. Of the 108 respondents who worked at corporations with internal audit, 76% (82 of 108) interfaced with the company's internal audit staff, and 93% considered the internal auditors to be very knowledgeable or somewhat knowledgeable about their company. There also appeared to be a relationship between perceived knowledge of the internal auditors and the tone at the top. Nearly all respondents (94%) from companies in which top management placed a high regard on ethical conduct rated the knowledge level of their internal auditors favorably.

We also asked about internal audit's effectiveness. More than 82% of these particular respondents felt that it would be difficult to get the internal auditors to agree to questionable accounting practices, and 61% judged it would be difficult to hide negative information from them.

A BRIEF HISTORY OF FINANCIAL REPORTING INTEGRITY

Although recent corporate scandals have raised awareness of ethical standards, concern about the integrity of financial reporting has a long history. For example, the Foreign Corrupt Practices Act in 1977 required that each publicly traded company establish and maintain an effective internal control system to ensure management's responsibilities and actions could be pinpointed. Ten years later, in 1987, the Treadway Commission's *Report of the National Commission on Fraudulent Financial Reporting* concluded that the corporation's tone at the top plays a crucial role in reducing the likelihood of fraudulent financial reporting. This outcome reinforced the fact that corporate management needs to set the right tone by insisting on a strong system of internal controls to mitigate risk. This report also concluded that top management's ethical values pervade the corporation's accounting practices and represent a critical component of its control environment.

More recently, the AICPA's adoption of the Statement on Auditing Standards (SAS) No. 99, "Consideration of Fraud in a Financial Statement Audit," again reinforced these concepts. Within the last five years, several other events have occurred—the demise of Enron, WorldCom, and others—that further emphasized the need for an increased focus on ethics. And in response to the scandals, Congress passed the Sarbanes-Oxley Act of 2002 that dictated massive changes in the practice of accounting and broadened the responsibilities of top management related to the integrity of the financials. Scandals such as Enron and the others and the resulting loss in wealth brought to the forefront the issue of ethics in the workplace while demonstrating the destructive influence of the pursuit of profits at any cost by some top-management teams. The capital market system in the United States is based, in part, on the investing public's trust in reported financial results. By raising concerns about the integrity of financial results, the accounting scandals created a crisis of confidence among users of financial information while focusing unprecedented attention on the role of ethics among top management.

EXTERNAL AUDITORS

About 70% of the respondents (152 of 210) reported that their positions involved interfacing with external auditors, and 88% rated the knowledge level of the external auditors as high or somewhat high. Similar to the results for internal auditors, there appeared to be a relationship between perceived knowledge of external auditors and the tone at the top. Nearly all respondents (91%) from corporations in which top management placed high regard on ethical conduct rated the knowledge level of the external auditors favorably.

In terms of external audit's effectiveness in reducing the risk of fraudulent financial reporting, 79% responded that it would be difficult to get the external auditors to agree to questionable accounting practices, and 58% reported it would be difficult to hide negative information from them.

ETHICAL CONDUCT AND THE INDIVIDUAL

Since the Rich, Smith, and Mihalek research argued that "…ethical standards come from individuals…," we asked respondents to rate several factors that could help them conduct themselves in an ethical manner given pressure to act otherwise. Almost all mentioned two factors. Both an individual sense of ethics (94%) and a professional code of ethics (90%) were considered important factors that would help an individual resist attempts to materially alter financial results. The results were similar regardless of the tone at the top, the existence of an internal audit function, or a written code of ethics.

ETHICS AT THE TOP MATTER

This study suggests that corporations whose top managers value ethics are less likely to pressure employees to materially alter financial results. Tone at the top plays a critical role in the control environment. And corporations whose top managers value ethics are also somewhat more likely to have their own internal audit department and a written code of ethics.

In spite of the significance of top management's attitude, however, the results also highlight the importance of hiring individuals with a high personal sense of ethics. Virtually all respondents mentioned their individual and professional ethics would play a significant role in helping them resist any attempts to materially alter financial results. Take note, academia. As stated simply in PricewaterhouseCoopers's 2003 "Educating for the Public Trust" report, "To restore the public trust in the accounting profession, the profession also needs to attract students to accounting with a strong personal sense of integrity." ■

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