

# Ethics and financial reporting assignment

[Art & Culture](#)



Ethics and Financial Reporting AMBA 630 Executive Summary Reacting to a flood of accounting scandals and media outcry, the U. S. Congress passed the Sarbanes-Oxley Act (SOX) in July 2002. It is administered by the Securities and Exchange Commission (SEC). It sought to prevent future cases such as the one witnessed with Madoff Investment Securities, by improving the accuracy of public company financial statements. An important goal of SOX is to make these financials more meaningful (i. e. , transparent) to their intended readers. It sets guidelines for the corporate board of directors, CEOs and CFOs, audit committees, internal audit function and internal control system. . . Boards of directors are now expected to take a more active role in the oversight of their companies, focusing on risk management and internal control procedures. Audit committees, which are a subset of corporate boards, face new constraints on operating networks and committee composition under SOX. CEOs and CFOs of public companies are under the spotlight like never before, due to SOX.

Accountability measures have increased greatly, holding them responsible for the accuracy, preparation, and filing of quarterly and annual financial reports. . The key to gaining the attention of CEOs and CEOs under SOX lies in the severe criminal penalties which may be enforced if fraud is determined. Still, that does not guarantee that corporate management will adhere to SOX legislation. There will always be some executives who feel that they are impervious to the law. They are willing to assume the dangerous risks that are associated with breaking SOX requirements.

Although SOX cannot assure 100% compliance for financial statement issuers, and their independent auditors, it is certainly better than doing

<https://assignbuster.com/ethics-and-financial-reporting-assignment/>

nothing. A. Discuss how this law is likely to affect any 6 of the following 7 issues: 1. Public company boards of directors With the Sarbanes-Oxley Act, boards of directors have adapted to new procedures and new membership requirements (Kelly & Roche-Tarry, 2009). Companies and their boards will now have to face tougher demands in terms of transparency.

Boards of directors are expected to play a more active role in determining the strategic direction of the company. Per the International Chamber of Commerce, the board needs to be able to make decisions in order to limit the risk exposure of the company. Several areas such as financing, investments, dividend and crisis management are concerned (International Chamber of Commerce, 2009). The selection process is under scrutiny a lot these days because it is believed that the members of the boards were not properly selected before.

Instead of focusing on celebrities, athletes or other CEOs, boards should be comprised of a mix of “ functional and industry experts” who have the business’ best interest at heart (p. 6). Their involvement and understanding of the financial environment is crucial, as it allows them to intervene when necessary and choose the audit committee, CEO and CFO judiciously. It is now imperative for boards of directors to focus on risk management and internal control procedures, and to do so, board composition is critical. They should also eliminate any leniency while questioning the CEO and focus on best practices in the company. . Audit committees of public company boards of directors The audit committees have been subjected to new constraints on operating frameworks and committee composition ever since the passage of the Sarbanes-Oxley Act (Sherman, Cary ; Brust, 2009). The audit committee <https://assignbuster.com/ethics-and-financial-reporting-assignment/>

is a subset of the Board of Directors. They are usually in charge of various monitoring functions including financial records, external auditors, regulatory compliance, internal controls and reviewing risk with the senior management team (p. 1).

The audit committee has been impacted by the negative publicity emanating from the various financial scandals, because they failed to ensure the financial statements' compliance with established accounting principles and disclosure standards (ICC, 2009). Audit committees incorporating SOX principles have spent a lot of time on SOX compliance issues, while sometimes neglecting strategy concerns. However, once past the learning curve, they started focusing more on increasing business value (p. 1). They are paying more attention to effective accounting principles and risk, since they have to help restore confidence in corporations (p. ). They need to make sure financial projections are sound and accurate based on earnings and income estimates, before the information is released to the public. They should also assist management mitigate financial risks, as their responsibility is to understand and sign off on management's approach (p. 2). Ever since SOX, restatements have increased (from 50 to 3000 from 2005 to 2007; increasing costs and driving declines in stock prices) and audit committees have needed independent auditors more often to be compliant (p. 3).

These issues need to be resolved once and for all by focusing on the committee's composition (a member of the board of directors of the issuer and independent should be privileged as per section 301 of SOX provisions). They should also include financial experts that will help decipher financial statements in which the audit committee will relay to the board, as well as <https://assignbuster.com/ethics-and-financial-reporting-assignment/>

assess competition's performances (p. 3). 3. The CEO's and CFO's of public companies The SOX Act put CEOs under the spotlight and put additional pressure for results. There is now an obligation to justify the high salaries and benefits in which they have enjoyed uncontrollably.

The same has been noticed for CFOs, who are held more accountable for their actions (Collins, Masli, Reitenga ; Sanchez, 2009). After the passage of SOX, the labor market has also sanctioned CEOs and CFOs issued from firms who had undergone a restatements procedure, since it indicated a failure in their performance and in internal control (p. 1). Accountability measures have increased for both CEOs and CFOs under SOX (section 406), since it specifically names them responsible for the preparation and filing of the annual and quarterly financial reports (p. 3).

The measures are codified with severe sanctions specified for executives implicated in fraudulent financial reporting (p. 3). Accountability standards are higher now and corporate governance mechanisms have been reviewed and upgraded to minimize loopholes. Therefore, CEOs and CFOs of public companies now have to make sure the financial reporting process is fine tuned and respected internally. They are also responsible for having the right competencies and for bringing in results. Lastly, they are the first in line when it comes to the accuracy of financial reports, as they have the means to have them verified and controlled (i. . , the audit committee). Any involvement in financial misstatements has potential disastrous consequences on the careers of both CEOs and CFOs, as these " reputational effects" have long-term negative effects on finding future employment (p. 4).

4. Outside independent audit firms SOX made it unlawful in section 303 to

<https://assignbuster.com/ethics-and-financial-reporting-assignment/>

interfere with any outside independent audit firms' work. It is unlawful to "influence, manipulate, coerce or mislead" any auditor engaged in the performance of an audit (Center for Audit Quality, 2009).

Purposefully rendering any financial statements fraudulent is severely punished under SOX. Therefore, independent audit firms should be able to perform their duties without any oversight from their clients. 5. SOX section 404 on Internal Control Section 404 of SOX pertains to management's assessment of internal controls (Center for Audit Quality, 2009). It requires each annual report to contain an "internal control report", which guarantees that the top management team effectively established and maintained an effective internal control structure and procedures for financial reporting.

It should also contain an assessment (at the end of the fiscal year) stating that the structure and procedures were followed effectively. Moreover, it directs the SEC to make sure each issuer has adopted a code of ethics for its senior financial managers (responsible for the financial statements' integrity and accuracy). It also required the SEC to emphasize prompt disclosure when there are any changes or alterations made to the issuer's code of ethics (Form 8-K). 6. The accuracy of public company financial statements CEOs and CFOs have both been under a lot of pressure to maintain the accuracy of financial statements.

Section 302 of SOX explicitly states that they both need to prepare a statement certifying that the audit report has not been tampered with (Center for Audit Quality, 2009). Anyone not acting in compliance with this section will be severely punished. Moreover, the board of directors and the

audit committee are supposed to be vigilant and sign off on the accuracy of the company's financial statements. Ultimately, it is all of their responsibility; otherwise, their careers and reputations, as well as the company's may suffer from the negative publicity of a restatement.

B. If you believe that legislation can guarantee the accuracy of public company financial statements, please explain why previous laws have failed. If you believe that the reverse is true, please explain why CEO's and CFO's are paying so much attention to this law. We have all heard the saying that "nothing is certain but death and taxes." This certainly holds true in contemplating how legislation might guarantee the accuracy of public company financial statements. There are no guarantees.

The complexity of today's financial transactions (especially when new law is introduced) can lead to financial reporting errors, resulting from misinterpretation of the law. Also, the abundance of accounting scandals that made the headlines over the past decade (e. g. , Enron, WorldCom, Bernard L. Madoff Investment Securities, LLC) tell us that monetary greed is ever-present in the business world. Unfortunately, there will always be business leaders (CEOs, CFOs, Directors, etc. ) who will disobey laws, regardless of the consequences, to enrich themselves and their companies.

The Sarbanes-Oxley Act of 2002 (SOX) was enacted to address many of the issues behind accounting scandals of public companies, which resulted from the unscrupulous and unchecked actions of executive management.

Particularly for CEOs and CFOs, the stiff penalties (criminal and monetary) set by Sarbanes-Oxley Sections 302, 304, 802, 906, and 1102 are intended

to deter corporate fraud (Jackson & Kleckner, 2004). Expanded, tougher enforcement of provisions within the Sarbanes-Oxley Act has caught the attention of CEOs and CFOs for very good reasons. Sections 302 and 906 ???  
CEO and CFO Certifications

In these sections, CEOs and CFOs must certify quarterly and annual reports filed with the Securities and Exchange Commission (SEC). Section 302 mandates that the CEO and CFO of each financial report issuer prepare a statement which certifies the “ appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respect, the operations and financial condition of the issuer” (American Institute of Certified Public Accountants [AICPA], 2009).

Section 906 (a) and (b) provide that the CEO & CFO certify that financial statements filed with the SEC are fully compliant with requirements set forth in the SEC Act of 1934. A SOX violation is treated as a violation of the SEC Act of 1934. Per Jackson & Kleckner (2004), CEO and CFO report certifications claim the following: \* They have reviewed the report. \* Based on their knowledge, the report is truthful and does not omit information. \* Based on their knowledge, the financial statements fairly represent, in all material aspects, the financial position, results of operations, and cash flows. They are responsible for disclosure controls and procedures and have reviewed those procedures within the 90 days preceding the report filing date. \* All material weaknesses in internal controls have been disclosed to the audit committee and the independent auditors. Additionally, all known instances of fraud, material or not, that involve personnel involved with  
<https://assignbuster.com/ethics-and-financial-reporting-assignment/>



internal control have also been disclosed. \* Significant changes to internal controls subsequent to the most recent evaluation have been disclosed, including corrective action with regard to deficiencies.

CEOs and CFOs face criminal penalties here, if found to be dishonest.

Violations of these sections must be “ knowing and intentional” to be subject to liability (AICPA, 2009). Intentional violation of these certifications can result in fines up of to \$5 million, and as much as 20 years in prison. This could occur under Section 906 (c) (1) if the officer “ willfully certifies” financial statements which misrepresent a company’s financial condition (Johnson ; Johnson, 2005). It also provides for a \$1, 000, 000 criminal penalty and 10 years imprisonment for knowingly making a false certification.

In this case, the lesser penalty pertains to a certification which does not meet all of the requirements of the 1934 SEC Act. The prospect of serving a lengthy jail sentence is a huge incentive for business leaders to comply. Section 304 ??? Restatement of Financial Statements If financial statements are restated due to material noncompliance, misconduct, or any other financial reporting requirement, CEOs and CFOs must reimburse the issuer for bonuses or other incentive or equity-based compensation received with a year of issuing such statements.

Also included for reimbursement in this timeframe are “ any profits realized from the sale of securities of the issuer” (AICPA, 2009). The penalties administered in this section are only monetary, but can be very material, since CEOs and CFOs are highly compensated. Sections 802 and 1102 ???  
Data Protection These sections address increased requirements for records

management. A company's auditors are also included in the scope of these sections. Record retention of no less than seven years is required for records pertaining to audits and reviews of financial statements filed with the SEC (Jackson & Kleckner, 2004).

Severe penalties and fines were created to punish those that disrupt an official investigation. Prior to SOX, the government had the burden of proof to show that someone destroyed evidence sought after in a government proceeding. Under SOX, an individual faces an obstruction of justice charge for destroying evidence, if that person "should have known" to keep the evidence for future government inquiries (Del Vecchio & Koehn, 2004).

Record destruction may result in criminal liability, even if no federal investigation is under way when the records are destroyed, or when following an otherwise applicable records management policy.

Per Section 802 (a) "Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under Title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both" (Spurzem, 2009).

Similar to Sections 302 and 906, the prison sentences faced in violation of Sections 802 and 1102 are very severe. They were enacted to ensure that CEO's, CFOs, (and their auditors) comply with these respective SOX

<https://assignbuster.com/ethics-and-financial-reporting-assignment/>

provisions. As stated earlier though, there are no guarantees regarding management's adherence to SOX. Consider this past week, where former CFO Frank DiPascali, Bernard Madoff's right-hand man, pleaded guilty to conspiracy and other charges, which contradicted claims made by disgraced financier Madoff that he acted alone.

DiPascali said that account statements showing the firm was making trades for clients were "all fake" and something "I knew, Bernie Madoff knew and other people knew" (Hays ; Neumeister, 2009). Madoff is serving a 150 year prison sentence for a Ponzi scheme that wiped-out the life savings of thousands of people, wrecked charities, and created great doubt in our financial system, facilitating in part the severe recession from which we are slowly emerging. Per Hays and Neumeister (2009), DiPascali's cooperation with authorities over the past year may earn him some leniency.

He is currently in jail, facing a potential penalty of up to 125 years in prison for securities fraud, money laundering and other crimes. In a complaint filed against DiPascali by the SEC on August 11, 2009, one reason the fraud "was not detected for so long was DiPascali's considerable success in overseeing the creation of large quantities of false books and records that corroborated the fictitious trading" (Hays & Neumeister, 2009). Reference List Brust, R. , Carey, D. & Sherman, D. H. (2009). The audit committee's new agenda.

Harvard Business Review, 87(6), 92-99. Retrieved August 12, 2009, from Business Source Complete database. Collins, D. , Masli, A. , Reitenga, A. L. & Sanchez, J. M. (2009). Earnings restatements, the Sarbanes- Oxley Act, and the disciplining of chief financial officers. Retrieved August 12, 2009, from

<https://assignbuster.com/ethics-and-financial-reporting-assignment/>

Business Source Premier database. Corporate governance (2009).

International Chamber of Commerce. Retrieved August 12, 2009, from web site: <http://www.iccwbo.org/corporate-governance/id3175/index.html>

Del Vecchio, Stephen C. & Koehn, Jo Lynne (2004). Ripple effects of the Sarbanes-Oxley Act. The CPA Journal. Retrieved August 12, 2009, from web site: <http://www.nysscpa.org/cpajournal/2004/204/essentials/p36.htm>.

Hayes, Tom & Neumeister, Larry (2009, August 11). Ex-Madoff CFO pleads guilty in court in NYC. Yahoo Finance. Retrieved August 11, 2009, from web site: <http://finance.yahoo.com/news/ExMadoff-CFO-pleads-guilty-in-apf-790484348.html?x=0>.

Jackson, Craig & Kleckner, Philip K. (2004, September). Sarbanes-Oxley Act: expanded enforcement.

The CPA Journal, 74(9), 13. Retrieved August 13, 2009, from ABI/INFORM

Global database. Johnson, Gary G. & Johnson, Mary Virginia Moore. (2005).

CEOs 1, SOX 0: the case against Richard Scrushy and Healthsouth. Journal of Legal, Ethical and Regulatory Issues, 8(1/2), 35. Retrieved August 13, 2009, from ABI/INFORM Dateline database. Kelly, M. P. & Roche-Tarry, D. E. (2009).

Reshaping your board for hard times. Corporate Board, 30(174), 6-11.

Retrieved August 12, 2009, from Business Source Complete database.

Summary of the provisions