Tone At The Top – Part I

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I. Overview

In its October 1987 Report, the Treadway Commission noted a number of factors that cause fraudulent financial reporting to occur, and also made a number of recommendations to assist companies and their advisors to avoid fraud. The area on which the Treadway Commission focused in particular was on "tone at the top." As the Treadway Commission found:

> [t]he tone set by top management – the corporate environment or culture within which financial reporting occurs – is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.[1]

In the nearly 20 years since the Treadway Commission issued its Report, there have been many examples of companies that ignored the counsel of their auditors and attorneys, disregarded their own internal procedures, and proceeded instead to engage in inappropriate and unlawful conduct. In many of these examples, the answer to the question of why the company acted as it did can be found by analyzing the tone top management set for subordinates. As these examples demonstrate, the perfectly appropriate messages sent by top management to be aggressive and creative can go awry when top management overlays those messages with the exhortation that the company must "make the numbers" at all costs.

In this article, we discuss some recent cases in which tone at the top caused the company to engage in violative conduct. We also discuss attributes of a consistently positive and appropriate tone at the top.

II. The Treadway Commission's Findings

The Treadway Commission made a number of findings that resonate as clearly today as they did in 1987, when it issued its Report. The Treadway Commission found:

> fraudulent financial reporting usually occurs as the result of certain environmental, institutional, or individual forces and opportunities. These forces and opportunities add pressures and incentives that encourage individuals and companies to engage in fraudulent financial reporting and are present to some degree in all companies. If the right, combustible mixture of forces and opportunities is present, fraudulent financial reporting may occur.[2]

The Treadway Commission listed a number of incentives for fraudulent financial reporting, including:

- The desire to obtain a higher price from a stock or debt offering or to meet the expectations of investors;
- The desire to postpone dealing with financial difficulties and thus avoid, for example, violating a restrictive debt covenant; and
- Personal gain: additional compensation, promotion, or escape from penalty for poor performance.[3]

The Treadway Commission also identified a number of situational pressures on the company or an individual manager that may lead to fraudulent financial reporting, including:

- Sudden decreases in revenue or market share;
- Unrealistic budget pressures, particularly for short-term results. These pressures may occur when headquarters arbitrarily determines profit objectives and budgets without taking actual conditions into account; and
- Financial pressure resulting from bonus plans that depend on short-term economic performance. This pressure is particularly acute when the bonus is a significant component of the individual's total compensation.[4]

In addition, the Treadway Commission identified a number of scenarios that present opportunities for fraudulent financial reporting when the fraud is relatively easy to commit and when detection of the fraud is less likely to occur. As the Treadway Commission found, these opportunities frequently arise from:

- The absence of a board of directors or audit committee that vigilantly oversees the financial reporting process;
- Weak or nonexistent internal accounting controls. This situation can occur, for example, when a company's revenue system is overloaded from a rapid expansion of sales, an acquisition of a new division, or the entry into a new, unfamiliar line of business;
- Unusual or complex transactions. Examples include the consolidation of two companies, the divestiture or closing of a specific operation, and agreements to buy or sell government securities under a repurchase agreement;
- Accounting estimates requiring significant subjective judgment by company management. Examples include reserves for loan losses or the yearly provision for warranty expense; and
- Ineffective internal audit staffs. This situation may result from inadequate staff size and severely limited audit scope.[5]

The Treadway Commission made several recommendations to public companies to help reduce the incidence of fraudulent financial reporting. Addressing the issue on two levels, the Treadway Commission recommended that top management should:

- For "Level One," establish the appropriate tone, the overall control environment in which financial reporting occurs. To establish an appropriate tone at the top, management should consider taking the following steps:
  1. identify and understand the factors that can lead to fraudulent financial reporting, including factors unique to the company;
  2. assess the risk of fraudulent financial reporting that these factors create within the company; and
  3. design and implement internal controls that will provide reasonable assurance that fraudulent financial reporting will be prevented or detected.[6]
- For "Level Two," maximize the effectiveness of the functions within the company that are critical to the integrity of financial reporting: the accounting function, the internal audit function, and the audit committee of the board of directors.[7]

III. Recent Examples Of Problems With Tone At The Top

There have been many well-publicized frauds that were directed by senior management at large public companies such as Enron, Tyco, and HealthSouth. The following cases describe a few lesser-known instances in which tone at the top was cited as the cause for inappropriate or unlawful conduct.

A. Fannie Mae

The Office of Federal Housing Enterprise Oversight ("OFHEO") reported in May 2006 that "[a] combination of factors led Fannie Mae senior management, through their actions and inactions, to commit or tolerate a wide variety of unsafe and unsound practices and conditions."[8] As OFHEO found:

> During the period covered by this report, the corporate culture of Fannie Mae encouraged a perception of the Enterprise [Fannie Mae] as a low-risk financial institution that was so well managed that it could hit announced profit targets on the nose every year, regardless of the state of the economy, and that compensated its senior executives appropriately for its extraordinary performance… This report demonstrates that the image of Fannie Mae communicated by [the CEO] and his inner circle and promoted by [Fannie Mae's] corporate culture was false. This report also describes how senior executives worked strenuously to hide Fannie Mae's operational deficiencies, significant risk exposures, and improper earnings management to smooth earnings from outside observers.[9]

OFHEO found the following:

- Fannie Mae's financial success gave senior management steadily increasing amounts of money to use in efforts to influence the regulatory and legislative process[10];
- Fannie Mae's senior management pursued a "strategy of opposing, circumscribing, and constraining OFHEO" in an effort to eliminate oversight and essentially regulate itself[11];
- Fannie Mae's senior management sought to conceal earnings management by employing accounting rules that, as Fannie Mae's COO stated, "work for us," but did not comply with GAAP.[12] Under its self-imposed favorable accounting rules, Fannie Mae's senior management managed earnings through the use of a "non-recurring earnings piggy bank" that enabled Fannie Mae to make up shortfalls[13]; and
- Fannie Mae's senior management "devoted an inordinate amount of time and effort to managing reported financial performance, at the expense of other goals and objectives associated with safety and soundness and internal control, so that Fannie Mae's reported EPS would hit announced targets. That tone at the top permeated all levels of Fannie Mae, and $6.46, the EPS goal, became the corporate mantra – everything else was secondary to hitting that target."[14]

Consider the following quotation from a speech that Fannie Mae's Senior Vice President for Operations Risk and Internal Audit gave to Fannie Mae's internal auditors to encourage them to support senior management's goal of doubling Fannie Mae's EPS by 2003 to $6.46:

> By now every one of you must have 6.46 branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46 . . . After all, thanks to Frank [Fannie Mae's former CEO], we all have a lot of money riding on it . . . We must do this with a fiery determination, not on some days, not on most days, but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%. Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals.[15]

Part II of this article, which will appear in the July issue of The Metropolitan Corporate Counsel, *will continue with four more recent examples of "tone at the top," describe common denominators among the cases and, finally, offer substantive possible solutions.*

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1 *The Report of the National Commission on Fraudulent Financial Reporting (the "Treadway Commission Report") at 32.*

2 *The Treadway Commission Report at 23.*

3 *The Treadway Commission Report at 23.*

4 *The Treadway Commission Report at 23-24.*

5 *The Treadway Commission Report at 24.*

6 *The Treadway Commission Report at 32-33.*

7 *The Treadway Commission Report at 31.*

8 *Report of the Special Examination of Fannie Mae (the "Fannie Mae Report") at 1.*

9 *The Fannie Mae Report at 33-34.*

10 *The Fannie Mae Report at 34-35.*

11 *The Fannie Mae Report at 35-37.*

12 *The Fannie Mae Report at 38-39.*

13 *The Fannie Mae Report at 40-41 & n.25.*

14 *The Fannie Mae Report at 42.*

15 *The Fannie Mae Report at 42.*

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