

Corporate Resistance to Government-Imposed Internal Control Regulation

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Abstract

This paper presents an institutional critique of corporate resistance to government-imposed internal control reporting in the U.S. The analysis begins with the legislative history of the Foreign Corrupt Practices Act of 1977 and concludes with the Sarbanes-Oxley (SOX) Act of 2002 and related SEC regulations. The legislative and regulatory history of this period documents how the American Institute of Certified Public Accountants, American Bar Association, Financial Executives International, and other industry groups defeated proposals for mandatory management and auditor reports on internal control. In response to intense lobbying pressure from industry and the White House during the pre-SOX period, the SEC delegated most internal control initiatives to the private sector. The resulting industry self-regulation failed to effectively curb management's head-in-the-sand attitude toward internal control. Moreover, the absence of mandatory internal control reporting made it difficult for prosecutors to establish management's involvement in the accounting and internal control violations at their companies. The paper concludes by considering whether the SOX-related internal control regulations entail a fundamental change in institutional values, or whether the ongoing corporate resistance to government-imposed internal control regulation will render the investor protection measures largely ineffective.

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1. Introduction

The Foreign Corrupt Practices Act (FCPA) of 1977 required U.S. SEC registrants to devise and maintain a reasonable system of internal accounting controls and reasonably detailed accounting records. The FCPA's objectives were to provide reasonable assurance that executives properly authorize all company transactions, prepare their financial statements in conformity with generally accepted accounting principles, and maintain accountability for their companies' assets (15 U.S.C. § 78m(b)(2)). Despite these regulations, accounting scandals during the late 1990s and early 2000s revealed systematic corporate governance and internal control failures, and more than 900 U.S. corporations restated their financial statements from 1997 to 2002 (U. S. Government Accounting Office, 2002). The \$11 billion fraud at WorldCom, Inc. epitomizes these corporate governance and control failures. Former WorldCom Chairman and CEO Bernie Ebbers reportedly described efforts to establish a corporate Code of Conduct as a "colossal waste of time" (WorldCom, Inc., 2003, p. 19). WorldCom's fraud was enabled by an ineffective and disengaged board of directors, audit committee, and compensation committee; poor or nonexistent documentation for recording transactions and accounting adjustments; senior management intimidation and deception of those who sought access to incriminating financial data; and apparent lack of due professional care by the independent accountants (see Appendix for details).¹

These governance and internal control failures raise several troubling questions. Why did the FCPA and subsequent internal control regulations fail to effectively curb executives' head-in-the-sand and it's-not-my-job attitude toward accounting and internal control? Were the regulations substantially flawed or just poorly enforced? Are any regulatory flaws attributable to the conscious and deliberate actions of self-interested parties, or merely the result of honest mistakes of well-intentioned government and industry leaders? To answer these questions, we document and analyze the legislative history that shaped the mix of state-based and private-sector internal control regulations in the U.S., from the FCPA to the Sarbanes-Oxley (SOX) Act of 2002 and related SEC regulations. We examine the legislative history through the lens of institutional theory.

An institutional analysis is appropriate because the internal control regulations we examine span more than 25 years. While the specific individuals who shaped the internal control regulations at different specific times may have been influential in part because they had a certain "charisma" (cf. Jonsson, 1994), an institutional analysis examines how those individuals' actions were enabled by habitual patterns of thinking and by the specific and enduring functional roles different individuals played in their respective organizations at different times. In addition, our analysis is primarily historical rather than theoretical, inasmuch as we emphasize the particular institutional processes of internal control regulation

¹ Ebbers maintained before and during his criminal fraud trial that he did not know about WorldCom's accounting fraud, but eventually he was convicted in March 2005. Other well-compensated telecommunications executives have fared better. Gary Winnick, former Chairman of Global Crossing, sold more than \$700 million in stock as compensation for his executive talent, months before Global Crossing filed for bankruptcy. Joseph Nacchio, the former Chairman and CEO of Qwest Corporation, received \$300 million in stock compensation, the value of which was inflated by Qwest's \$2.5 billion accounting fraud. Winnick escaped both criminal and civil charges. Nacchio escaped criminal fraud charges but as of May 2005 he still faces civil fraud charges.

as the outcomes of “distinctive constellations of material and ideological forces” (Puxty, Willmott, Cooper, and Lowe, 1987, p. 275) that existed in the U.S. during the 1976-2003 period. This period of internal control regulation revealed serious conflicts between state-based and private sector modes of regulation, with the private sector dominating the internal control regulatory landscape until SOX (2002). In other settings, different modes of regulation may dominate depending on the specific issues and countries involved (Puxty et al., 1987, pp. 288-290).

Radical institutional theory² predicts that the more powerful players in a contested arena will permit technological innovations only to the extent that they believe the innovations will not undermine their power and status (Bush, 1987; Waller, 1987). Our analysis of internal control regulation in particular examines the tactical strategies employed by corporate executives and their representatives -- e.g., the American Institution of Certified Public Accountants (AICPA), the American Bar Association (ABA), and the Financial Executives Institute (FEI)³ -- to defeat proposals that arguably would have increased the regulatory, legal, and public scrutiny of corporate conduct. These players sought to maintain their legitimacy with the U.S. Congress and regulators by promising to promote effective industry self-regulation, claiming that self-regulation would produce the most efficient and effective corporate governance and internal control practices. Despite industry’s promises, several costly corporate scandals occurred throughout this period, and each was enabled by massive and avoidable corporate governance and internal control failures.

We document that the individuals and organizations who sustained the myth of effective industry self-regulation were not merely passive onlookers, but instead actively sought to influence key legislative and regulatory outcomes. Indeed, as Covaleski, Dirsmith, and Samuel (2003b, p. 423) noted, institutional rules constrain and enable individual behavior, but the affected individuals also will attempt to construct and change those rules. Earlier versions of institutional theory emphasize compliance with norms and other requirements to secure rewards and avoid punishments (e.g., DiMaggio and Powell, 1983; Meyer & Rowan, 1977; Meyer & Scott, 1983)⁴. In contrast, radical institutionalism and other recent versions of institutional theory emphasize noncompliance with norms and how relations of power and interest shape cultural and technological outcomes. We employ radical institutionalism’s concepts of corporate dominance and processes of cultural change (subordination, contamination, emulation, and mystification; Bush, 1987; Dugger, 1980, 1989a; Veblen, 1918) to examine how the dominant players controlled and manipulated the development and diffusion of internal control technology from 1976 onward. We also employ Oliver’s (1991) typology of agents’ strategic responses to institutional processes

² Radical institutionalism traces its intellectual origins not to Marxism, but to the writings of Veblen (1899, 1918) and the student, civil rights, and women’s liberation movements of the 1960s (see Dugger, 1989b). But it shares the Frankfurt school’s goal of explanatory critique, by linking theory with policy in several steps: it demonstrates the existence of a problem, obstacles to solving the problem, how false beliefs or unmet needs sustain unjust social arrangements, and ways to remove the obstacles (cf. Bhaskar, 1979, 2002; Chouliaraki and Fairclough, 1999, p. 33; Collier, 1998).

³ The Financial Executives Institute (FEI) is now called “Financial Executives International”.

⁴ Although DiMaggio and Powell’s (1983) coercive isomorphism recognizes that “Organizations compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as economic fitness” (p. 150), DiMaggio and Powell paid little attention to power and interest (Oliver, 1991, pp. 149-150; see also Perrow’s (1985) critique of Meyer & Scott, 1983 and Meyer & Rowan, 1977).

(acquiescence, compromise, avoidance, defiance, and manipulation) to more specifically identify the means by which elite players influenced the legislative and regulatory outcomes.⁵

The empirical data for our analysis include the legislative history of the FCPA (1977), SEC (1979-1988) internal control proposals and policy statements, the 1988 FCPA amendments, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, various AICPA and US General Accounting Office (GAO)⁶ proposals, and SOX (2002) and related SEC regulations. The FCPA (1977) was the first U.S. securities legislation to impose explicit internal control responsibilities on corporate management. SOX (2002) was the first legislation to require all public companies to issue mandatory management and independent account reports on internal control. Throughout the 1976-2002 period, the accounting industry and business executives vigorously opposed mandatory internal control reporting. We use multiple legislative, regulatory, and private sector initiatives to corroborate our conclusions about the socio-political origins of the FCPA and subsequent internal control regulations. Similar to Covaleski, Dirsmith, and Rittenberg (2003a, p. 330), we also examine press coverage of the internal control initiatives to further corroborate our conclusions.

The dramaturgy and rhetorical arguments used by the opponents of government-regulated internal control require more than a literal interpretation of their propositional content, partly because successful communicative action is predicated on auxiliary assumptions that are not fully realized in actual legislative processes. For example, not all participants joined the internal control debates as equal partners committed to the goal of reaching mutual understanding through non-coercive communication. Institutional theory facilitates a critique of the validity claims of truth, legitimacy, and sincerity embedded in the participants' speech acts (Habermas, 1984, 1987). Specifically, institutional theory guided our interpretation of the deep structural and symbolic meaning of individuals' behavior, and it guided our analysis of the network of ideology and power relations that shaped the discourse surrounding the FCPA (1977) and subsequent legislation.

Our analysis shows that the internal control provisions of the FCPA continued to allow corporations to be organized and managed in such a manner that the executives who benefited from corporate wrongdoing would not easily be held accountable for their actions. Three features of internal control regulations in particular made it difficult to prosecute executives for accounting violations at their companies. First, the FCPA and subsequent regulations held executives criminally liable for accounting and internal control violations only if prosecutors could establish that the executives committed the violations knowingly. Second, the statutory regulations did not require management and external auditor reports on internal control. Third, the private sector failed to develop reasonably effective internal control self-regulation. Government-mandated internal control reports or effective industry self-regulation could have provided management with more timely knowledge of accounting and internal control problems at their companies, and they could have made it easier for prosecutors to establish management's knowledge and intent in cases of alleged accounting fraud.

⁵ Various methods (such as survey questionnaires) exist to identify individuals who are perceived as having "charisma", power, or other elite status in accounting regulation arenas (see Jonsson, 1994). We operationally define "dominant" and "elite" players simply as the spokespersons and chairpersons of the major organizations that the publicly available archives indicate participated in (and influenced the outcomes of) the debates over internal control regulation.

⁶ The General Accounting Office (GAO) is now called the "Government Accountability Office".

The remainder of this paper is organized as follows. The second section provides an institutional perspective on corporate resistance to internal control regulation. The third section discusses the public archival material and methods used to document the U.S. legislative and private sector initiatives before SOX (2002). The fourth section examines the legislative history of FCPA (1977) to explain how the Act's provisions failed to inform executives of the internal control weaknesses at their firms, and how the Act failed to stop executives from falsely (yet in many cases successfully) denying that they knew or should have known about the accounting and internal control violations in their companies. The fifth section examines subsequent legislative and private sector internal control initiatives, and then considers how continuing corporate resistance to internal control regulation might undermine the investor protection provisions of SOX (2002). The final section explores the study's broader implications for research on accounting regulation.

2. A theory of corporate resistance to internal control reform

2.1. Self-interest, power, and dominance

Stronger internal control creates new opportunities for corporate inquiry and problem solving, but it also exposes executives to more scrutiny. When agents believe that legislation will harm their interests, they will attempt to render the legislation largely symbolic (ineffective) or block the legislation altogether (cf. Bealing et al., 1996, p. 321; Bush, 1987, pp. 1093-1095; Meyer & Rowan, 1977, pp. 356-358; Waller, 1987, p. 324). Indeed, we later document that corporate executives and the accounting industry weakened internal control regulations and promoted a largely ineffective program of industry self-regulation.

The egalitarian ideals of a deliberative democracy are based on the premise that diverse institutions (e.g., economic, educational, military, kinship, political, and religious) have a voice in shaping social policy. Such ideals are undermined if one institution dominates the others. Dugger (1980, 1989a) argued that economic institutions (primarily corporations) dominate the noneconomic institutions in our society, and prevent the noneconomic institutions from effectively pursuing their objectives. Later we document that dominant corporate values (e.g., profit-seeking; executive power and autonomy; freedom from internal and external scrutiny) eclipsed the government and kinship values of stakeholder protection and social justice, and ultimately limited the development of internal control practices.

Dominant values acquire their power in part because they are taken for granted rather than closely scrutinized (cf. Carruthers, 1995, p. 315). The habitual patterns of thinking and behavior that accompany dominant corporate values do not require a conspiracy to exert their influence:

[T]he habits of thought of most political officials are those learned in performing, or in preparing to perform, corporate roles. These political officials are *not corrupt*. They are *not conspirators*. They do not have to be. They simply follow the motives, goals, and ideals they have learned, and in doing so they also use the means they have learned (Dugger, 1980, p. 900).

Corporate executives, lobbyists, policy makers, and even those who are exploited by the dominant institutional players share similar patterns of thinking and behavior, whether consciously or unconsciously (Veblen, 1899).

2.2. Processes of institutional change

Radical institutionalists have used Veblen's (1918) four processes of institutional change (subordination, contamination, emulation, and mystification) to explain corporate hegemony's emergence and control of technological change (Dugger, 1980, pp. 901-903; 1989a, pp. 39-47). Through *subordination*, an institution becomes an instrumental means for another institution's ends. For example, government institutions are subordinated to corporations when legislation that is supposed to protect investors instead is designed instead to shield executives from regulatory, legal, or public scrutiny. Through *contamination*, the objectives that are appropriate for one institution spread to other institutions. For example, an overriding concern to run government like a business (e.g., "efficiently") may outweigh concerns about social justice, fairness, or investor protection. Likewise, a concern about achieving high profit and economic growth might be used to justify a curtailment of legal and ethical codes of conduct. *Emulation* is the process whereby an institution becomes the source of status or prestige. Through emulation, an exploited population strives to become like its exploiters (Veblen, 1899) and unknowingly acts against its self-interest. A dominant ideology achieves its power not through overt coercion but by getting people to believe that by submitting to its power they act freely and advance their own interests. Finally, *mystification* involves the manipulation or distortion of valued symbols to garner support for someone else's values. For example, valued corporate symbols include executive autonomy, risk-taking, and individual ownership of the fruits of one's labor. Later we document that an argument for curtailing the FCPA's accounting and internal control provisions in the early 1980s was that an excessive fear of litigation led executives to overinvest in internal controls and avoid taking reasonable risks. Thus, it was argued that weaker accounting and internal control regulations were necessary to promote economic growth. Subsequent events showed that weak internal control in fact enriched many executives at the expense of investors, employees, and taxpayers.

2.3. Strategic responses to perceived threats from institutional processes

The above four processes provide a general account of the emergence and maintenance of corporate hegemony. The particular constellations of processes and ideologies that influence social change will vary depending on the particular historical circumstances and issues involved. Oliver's (1991, pp. 152-159) typology of strategic responses to institutional pressures describes in more detail how agents will attempt to shape specific social outcomes. The five strategies (in increasing order of active resistance) are *acquiesce*, *compromise*, *avoid*, *defy*, and *manipulate*. Participants in the internal control debates employed some of these strategies in varying degrees.

The *acquiesce* strategy includes such tactics as following taken-for-granted norms, imitating other institutional and organizational models (cf. the institutional isomorphism of DiMaggio and Powell, 1983), and complying with applicable laws and regulations. These relatively passive strategies characterize the behavior of agents in settings where the applicable norms have already been established and are no longer subject to critical scrutiny. For example, acquiescence typically describes the behavior of regulatees after the enactment of new regulation -- unless the regulatees think they can overturn the regulation.

The more active *compromise* strategy attempts to balance the expectations of multiple constituents (e.g., the profit-seeking objective of corporations versus the stakeholder

protection objective of investors) by appeasing, accommodating, or negotiating with key players. For example, we document that at a critical turning point in internal control regulation in 1981, the SEC withdrew its proposal to regulate internal control reporting and instead permitted ongoing industry self-regulation.

The *avoid* strategy includes tactics that disguise an organization's nonconformity with norms of expected behavior, in order to shield the organization from scrutiny. Mandatory internal control reports would have increased the visibility of public companies' ineffective internal controls, and thereby would have increased executives' and directors' exposure to legal liability. In the internal control arena, one avoidance tactic involved the active promotion of industry self-regulation as effective when in fact it was mainly symbolic. Such tactics delayed the onset of government-mandated internal control regulation.

Opponents of government-mandated internal control regulation also employed more aggressive strategies. The *defy* strategy includes tactics such as the dismissal of cherished norms and values as unimportant; active opposition to proposed or newly enacted rules and regulations; and ad hominem attacks on the proponents of unpopular legislative or regulatory initiatives. For example, we document that the Reagan 1980 SEC transition team sought to slash funding for the SEC and further weaken the FCPA's already weak accounting and internal control requirements. Finally, the *manipulate* strategy includes tactics such as co-opting influential lawmakers and "assisting" members of Congress by redrafting sensitive parts of the FCPA's internal control provisions.

Oliver's (1991) typology and the Veblen (1891) and Dugger (1980, 1989a) macro-level description of institutional change do not predict the specific strategies and tactics people will employ in a particular setting. They instead provide a general framework for our institutional and historical analysis of corporate resistance to internal control regulation.

3.0 Research methods

Our sources consist of the legislative history of the FCPA (1977); the Commission on Auditors' Responsibilities (1978); FCPA auditing standards pertaining to internal control; SEC internal control proposals and policy statements (1978-1988); the FCPA Amendments (1988) and legislative history (1981-1988); the Federal Deposit Insurance Corporation Improvement Act (1991); GAO reports (1981, 1989, 1996); the Sarbanes-Oxley Act (2002) and related SEC (2003) internal control regulations; and media articles. All of these sources are publicly available. In some cases we use extensive quotes to provide examples of the available data.

The primary groups of social actors we examined were the American Bar Association (ABA, an industry group for attorneys), AICPA, Financial Executives International (FEI, a vocal lobbying group led by Chief Financial Officers and corporate controllers), members of U.S. Congress, and the SEC. The U.S. Congress bears the ultimate responsibility for writing the federal securities laws. The SEC administers the federal securities laws and regulates the securities exchanges, CPAs, and other parties involved with selling securities. The SEC is overseen by Congress and must maintain its legitimacy with Congress and the Executive Branch in order to receive adequate funding. Throughout most of its history, the SEC has delegated accounting and auditing standard setting to private sector entities such as the FASB

and AICPA. Throughout most of the legislative history of management's internal control responsibilities, the AICPA and FEI advocated voluntary private-sector internal control regulation.

Institutional theory guided a latent content analysis of the symbolism and power-interest relations in the archival materials. To enhance the reliability of the conclusions, both researchers interpreted the same material until agreement was reached about its meaning. In addition, longitudinal archival materials provided converging evidence for conclusions reached about earlier materials.

4.0 Corporate resistance to internal control: FCPA (1977)

The FCPA (1977) required SEC registrants to devise and maintain a reasonable system of internal controls and reasonably detailed accounting records (see Table 1, Panel A). The Act's objective was to provide reasonable assurance that company transactions are executed in accordance with management's authorization, financial statements are fairly stated, and accountability is maintained for assets (15 U.S.C. § 78m(b)(2)).⁷ Despite these requirements, the U.S. financial markets subsequently experienced junk bond and insider trading scandals in the early 1980s, a costly savings and loan crisis in the late 1980s, and even costlier accounting scandals in the late 1990s and early 2000s.

This section examines the legislative history of FCPA (1977) to better understand why the Act's requirements failed to (1) provide reasonable assurance that executives would be informed about the internal control weaknesses at their companies, and (2) prevent violators from falsely denying that they knew or should have known about the accounting and internal control violations in their companies. We begin with the debate over anti-bribery regulations because that debate substantially influenced the FCPA's accounting and internal control provisions.

4.1 Resistance to anti-bribery legislation

During the investigation of the Watergate political scandal, the special prosecutor uncovered several corporate political slush funds that had not been recorded in corporations' books and records. The SEC (1976) subsequently discovered that many more large U.S. corporations had used secret slush funds to pay illegal foreign bribes. The Senate Foreign Relations Subcommittee on Multinational Corporations later determined that over 200 corporations had made questionable foreign payments totaling hundreds of millions of dollars, with Lockheed paying at least \$25 million since 1970 and Exxon paying \$56 million over a 12-year period (U.S. Congress, 1976a, p. 2). These revelations prompted a national debate over anti-bribery laws. Congress could vote to do nothing, merely require corporations to disclose their bribes, or outlaw bribery altogether.

The proposed anti-bribery laws initially faced stiff opposition. A survey in 1975 indicated that almost half of business executives in the U.S. saw nothing wrong with paying foreign bribes in order to attract or retain contracts (SEC, 1976, p. 44). The Pentagon and

⁷ Although the accounting requirements emphasize assets, Congress also intended it to cover liabilities and equities (U.S. Congress, 1977a, p. 16, fn 3). The FCPA adopted its objectives almost verbatim from the description of management's responsibilities in Statement on Auditing Standards No. 1 (AICPA, 1972, AU §110).

other government agencies feared that anti-bribery laws would adversely affect foreign trade and harm U.S. companies' ability to compete. Some executives tried to persuade members of Congress that anti-bribery laws would adversely affect U.S. exports, balance of payments, and employment (see Sorenson, 1976, p. 727).

These attempts to subordinate anti-bribery legislation to commercial interests ultimately failed. It was relatively easy for Congress and some business leaders to refute the corporate-interest and national-interest justifications for foreign bribery. First, New York Rep. John Murphy, serving as Chairman of the Subcommittee on Consumer Protection and Finance, voiced his concern that "Payments by Lockheed alone may well have advanced the Communist cause in Italy" and that the bribery scandals lend "substantial credence to the suspicions by extremists that U.S. businesses operating in their country have a corrupting influence on their political systems" (U.S. Congress, 1976a, p. 2). Murphy and other members of Congress backed their foreign policy concerns with evidence. For example, the Lockheed scandal caused former Japanese Prime Minister Tanaka to be indicted on charges that he accepted \$1.7 million, and Prince Bernhardt of the Netherlands had to resign from his official position due to allegations that he received \$1 million in pay-offs from Lockheed.

Second, California Rep. John Moss explicitly contrasted the functions of government versus corporations when he stated that "Surely the public expects more than to have foreign policy made in the board rooms of United Brands or Lockheed" (U.S. Congress, 1976a, p. 152). New York Rep. Stephen Solarz attacked the assertion that laws prohibiting foreign bribes would harm U.S. companies' ability to compete, and he argued that foreign policy should have priority over corporate interests:

Thus what is at stake is much more than the traditional interests of corporations which are competing for a share of foreign markets. What is in fact at stake is the foreign policy and national interest of the United States. It is clearly in our interest to put a stop to these pernicious practices. Leaving aside the question whether bribery is necessary to win contracts – and there is much evidence that it is not – there is much more involved than a few dollars. We simply cannot permit activity which so damages U.S. foreign policy (U.S. Congress, 1976a, p. 141).

Third, New York attorney Theodore Sorenson, a well-known critic of foreign bribery practices, testified against the corporate claims that foreign bribery served the national interest and that companies making those payments deserved the contracts they were awarded:

Those companies too inefficient to compete in terms of price, quality or service, or too lazy to engage in honest salesmanship, or too intent upon unloading upon a recipient government a marginal weapons system it cannot afford or does not need or will not be able to operate, are not the companies upon which our balance of payments should depend (U.S. Congress, 1976a, p. 116; see also Sorenson, 1976).

Fourth, Rep. Murphy noted that in most cases the firms paying the bribes competed with other U.S. firms (U.S. Congress, 1976a, p. 2). This fact alone motivated some executives to become strong advocates for the proposed anti-bribery laws. Finally, Idaho Senator Frank Church dismissed the notion that the questionable payments were just a normal way of doing

business abroad, noting that some corporations went to great lengths to conceal the payments via “double bookkeeping, off-the-books accounts, Swiss bank accounts, dummy or shell corporations set up in Switzerland or Lichtenstein, numerous agents or intermediaries whose existence is often kept secret, code names and code books” (U.S. Congress, 1976a, p. 2).

Congress decided that something must be done to curb bribery and considered two approaches (U.S. Congress, 1976a, p. 32). One approach would have mandated public disclosure of bribes, with criminal penalties imposed only for failure to disclose. The other approach would have criminalized bribery.

Proponents of the disclosure approach argued that criminalized bribery would be extremely difficult to enforce and would do little to deter payoffs. For example, J. T. Smith II, General Counsel of the Department of Commerce, cited a Senate report asserting that the availability of witnesses and evidence “would probably be so limited as to preclude proof beyond a reasonable doubt” (U.S. Congress, 1976a, p. 33). Smith then partisanly concluded, “We urge that Congress not act in haste to adopt an essentially rhetorical, token solution in lieu of the more meaningful proposals put forth by President Ford” (U.S. Congress, 1976a, p. 34). President Ford’s Proposed Foreign Payments Disclosure Act is noteworthy for its false predictions:

The disclosure-plus-criminalization scheme would, by its very ambition, be ineffective. The existence of U.S. criminal penalties for certain questionable payments would deter their disclosure and thus the positive value of the disclosure provisions would be reduced....The Task force concluded...that the criminalization approach would represent little more than a policy assertion, for the enforcement of such a law would be very difficult if not impossible (U.S. Congress, 1976a, pp. 49-50).

Similarly, Richard Darman, Department of Commerce Assistant Secretary for Policy, accepted the opinions of “an overwhelming majority of responsible legal scholars, law enforcement officials, and serious analysts of this issue” that a law prohibiting bribery would be essentially unenforceable, and concluded that such a law would be only symbolic:

It cannot be said to be for reasons of practicable moral leadership, for this would be potentially hypocritical. The answer must depend upon either a conception of the value of unenforceable law as a force for change, through the power of declaratory policy alone; or it must depend upon a conception of the value of unenforceable law as a stabilizing force, through the periodic purgatorial effects of ritualistic collective expressions of outrage (U.S. Congress, 1976a, p. 82).

In opposition to the disclosure-only approach, attorney Sorenson testified that he knew of “no crime which can be deterred by disclosure alone” (U.S. Congress, 1976a, p. 117).⁸

⁸ In addition, the SEC had earlier encountered resistance to mandatory disclosure when it maintained that shareholders had a right to know if their company’s profits depended on bribery and the magnanimity of foreign officials. Eventually, many U.S. corporations voluntarily disclosed the amount and nature of these payments when requested, but in several cases the SEC had to seek injunctive relief in order to obtain public disclosure and cessation of the questionable or illegal activities.

After receiving extensive testimony on both approaches, the Subcommittee on Consumer Protection and Finance reached a consensus that foreign bribery “should be outlawed rather than legalized through disclosure”, and it agreed that the criminalization approach would be “the most effective deterrent, the least burdensome on business, and no more difficult to enforce than disclosure” (U.S. Congress, 1977b, p. 3). The FCPA eventually prohibited foreign bribery by issuers and other domestic entities (15 U.S.C. §78dd-1(a), 2(a)), and it established substantial penalties for violations (15 U.S.C. §78ff(a), (c)).

4.2 Corporate resistance to defining “adequate” internal control

In May 1976, the SEC recommended that Congress also should enact legislation to tighten internal accounting controls (SEC, 1976). The rationale was that more effective internal control practices would enable companies to better prevent and detect bribes on a timely basis. In support, Texas Rep. Bob Eckhardt argued that keeping reasonably good records would make it more difficult to commit fraud, and that adequate documentation would be “a tool for enforcement” (U.S. Congress, 1976a, p. 175). Assistant Attorney General Patricia M. Wald gave similar testimony:

By its very nature the bribery of public officials is covert and generally involves consensual parties who go to great lengths to conceal the transaction. ...[The proposed rules] governing corporate record keeping, if promulgated, should further thwart attempts by issuers to conceal such payments and will presumably result in many fertile investigative leads (U.S. Congress, 1977b, pp. 9-10).

The SEC had concluded that the accounting profession had “defined the objectives of a system of accounting control”, and was “satisfied that the specifications of the objectives of a system of internal accounting controls found in the accounting literature can be readily understood by issuers and accountants” (SEC, 1976, p. 59). Different versions of the proposed FCPA internal control provisions would have required corporations to establish and maintain “adequate” internal control systems.

Corporate executives and other affected groups employed various tactics to weaken the proposed internal control requirements. Thomas Holton, Chairman of the AICPA’s Committee on SEC Regulations, led the attack by testifying that the phrase “adequate system of internal accounting controls” was too vague given the state of accountants’ knowledge. Holton’s hairsplitting can be interpreted as an example of denial or avoidance in Oliver’s (1991) typology:

There are no definitive standards against which to judge what is or is not an adequate system, and there are widely varying opinions among accountants, both accounting officers of companies and independent auditors, about what would constitute an “adequate” system. The term “adequate” as applied to systems of internal accounting control has not been defined (U.S. Congress, 1976a, p. 158).

Holton did not entertain the possibility that the concept of “adequate internal control” might in the near future be better defined and incorporated into public law. Despite denying that he

knew what “adequate internal control” meant, Holton had no trouble denying that adequate internal accounting controls were lacking in the foreign bribery cases:

There is no indication that it was the lack of adequate systems of internal accounting controls of these companies that resulted in the abuses and prevented their detection and disclosure. Instead, the abuses usually involved circumvention of internal accounting controls (U.S. Congress, 1976a, p. 158).

The AICPA assisted Congress in redrafting the proposed legislation. Eventually, the word “adequate” was deleted from the FCPA’s internal control provisions.

4.3 Resistance to criminalizing failure to establish reasonably effective controls

Executives and their representatives feared that the proposed internal control provisions would make minor mistakes legally actionable. Holton gave the following testimony:

[A]s presently drafted, H.R. 15481 appears broad enough to permit a court to hold that a negligent mistake in a book or record or a negligently made misstatement is a criminal violation. Therefore, to put it as simply as we can, an honest mistake might land you in jail (U.S. Congress, 1976a, p. 159).

When asked for specific instances under the securities laws where the courts had applied criminal sanctions in cases of honest mistakes, Holton replied that there were no known cases, but then he asserted that without explicitly requiring prosecutors to establish management’s intent to deceive, the proposed bill would create a precedent.⁹

To make the bill more agreeable to accountants and executives, the AICPA opposed criminalizing management’s failure to devise and maintain effective controls. The AICPA argued that the requirement that management “devise and maintain an adequate system of internal accounting controls to provide reasonable assurances ...” should be replaced with “It shall be unlawful for any director, officer or other employee of an issuer...*deliberately to engage* in any act, practice, or course of conduct *for the purpose of avoiding or circumventing* internal accounting controls established by such issuer to provide reasonable assurances...” (U.S. Congress, 1976a, p. 165, emphasis added).

The AICPA’s preferred language recognized that evidence of corporate wrongdoing does not by itself establish that internal controls were inadequate or that management had necessarily failed to meet its internal control responsibilities. Along these lines, Holton, again testifying on behalf of the AICPA, emphasized that no system of internal controls can provide absolute assurance:

⁹ Holton (U.S. Congress, 1976a, p. 163) argued that some support for his concerns could be based on *U.S. v. Natelli* (1975), a criminal case in which the appeals court, upon affirming a lower court’s conviction, conceded that “It is hard to probe the intent of a defendant. Circumstantial evidence, particularly with proof of motive, where available, is often sufficient to convince a reasonable man of criminal intent beyond a reasonable doubt. When we deal with a defendant who is a professional accountant, it is even harder, at times, to distinguish between simple errors of judgment and errors made with sufficient criminal intent to support a conviction, especially when there is no financial gain to the accountant other than his legitimate fee” (*US v. Natelli*, 1975, p. 318).

We believe it is critically important to additionally recognize that illegal or improper corporate activities can and will occur regardless of the strength of internal accounting controls, because no system has yet been devised that can withstand collusive behavior or circumvention by corporate officials (U.S. Congress, 1976a, p. 158).

The ABA repeated the same mantra:

It must be borne in mind that there is no such system that could prevent all attempts at circumvention even if it could withstand a cost-versus-benefit analysis. It seems to us that a far better approach would be to deal with attempts at circumvention of an internal system of accounting controls (U.S. Congress, 1976a, p. 210).

Most members of Congress agreed with Holton and the AICPA. The Committee on Banking, Housing, and Urban Affairs of the U.S. Senate believed that the “knowingly” liability standard was appropriate because of the danger that inadvertent misstatements or minor unintended discrepancies might otherwise be deemed actionable. Similar to the AICPA proposal, Congress intended to shield management from criminal liability for internal control violations except in cases where management knowingly failed to implement a system of internal accounting controls.

Nevertheless, some members of Congress intended to restrict management’s “head-in-the-sand”, “deliberate ignorance”, and “willful blindness” defenses:

The committee does not, however, intend that the use of the terming [sic] “knowingly” will provide a defense for those who shield themselves from the facts... The knowledge required is that the person be aware that he is or may be making a false statement or causing corporate records to be falsified through a conscious undertaking *or due to his conscious disregard for the truth* (U.S. Congress, 1977a, p. 9, emphasis added).

Under this “conscious disregard for the truth” liability standard, a prosecutor would have been able to establish the element of knowledge by proving that the defendant deliberately closed his eyes to problems that otherwise would have been brought to his attention. But the Congressional Committee on Banking, Housing, and Urban Affairs dug in its heels when it explicitly stated that it did not intend to affirm, expand, or overrule the knowledge-and-intent-to-deceive liability standard under *Ernst & Ernst v. Hochfelder* (1975, 425 U.S. 185).¹⁰ But executives still could be subject to civil proceedings if they failed to establish reasonably effective controls.

4.4 Resistance to helping management become aware of control deficiencies

¹⁰ *Ernst & Ernst v. Hochfelder* (1975) is a landmark U.S. Supreme Court case establishing that knowledge and intent to deceive (scienter) is required to establish criminal liability under Rule 10b(5) of the Securities and Exchange Act of 1934. Simple or ordinary negligence is not sufficient to convict someone of a 10b(5) violation. Months earlier, the Metcalf Report recommended that Congress should pass legislation to overturn the *Ernst & Ernst v. Hochfelder* (1976) “scienter” standard (see U.S. Congress, 1976b, p. 21).

Evidence that could inform management that their companies' internal controls are inadequate also could expose management to criminal liability if they failed to remedy the deficiencies. Two proposals could have provided executives and auditors with timely information about internal control weaknesses, but both proposals were defeated: (1) prohibitions against lying to auditors about financial accounting and internal control, and (2) mandatory auditor reports on the effectiveness of internal controls.

Prohibition against lying to auditors. The Senate passed a bill on September 15, 1976 that would have made it unlawful for any person to mislead an accountant with a materially false or misleading statement, or by knowingly omitting to state any material fact necessary to make statements to an accountant not misleading (U.S. Congress, 1976a, p. 6). The AICPA and ABA testified that it would be counterproductive to prohibit clients from making materially false or misleading statements to external auditors, without also specifying an appropriately high standard of proof for criminal responsibility. Representatives of these organizations argued that without a sufficiently high standard of proof, a prohibition against lying to auditors would have a "chilling effect on communications between outside auditors and management, not to mention persons outside of management or the company" (U.S. Congress, 1976a, p. 26). Holton, again speaking on behalf of the AICPA, gave the following testimony:

[I]t seems obvious that lawyers would advise their clients to discontinue or at least strictly curtail the normal practice of obtaining criticisms – that is, suggestions for improvement – from internal auditors, outside consultants, independent auditors, and others (U.S. Congress, 1976a, p. 159).

Clearly, if this bill is passed in its present form, lawyers would advise corporate officials not to pursue conversations with an auditor without a lawyer monitoring what was being said... Bankers, customers, suppliers, and other third persons will be advised by their lawyers to simply refuse to respond to audit inquiries in the light of increased legal exposure (U.S. Congress, 1976a, p. 160).

Constructive criticism of those with real insight into the intricacies of internal controls would neither be solicited nor welcomed in such a legalistic approach (U.S. Congress, 1976a, p. 163).

When questioned, Holton conceded that he lacked sufficient evidence to support the AICPA's stated concerns:

Mr. Opper: Do you really believe that bankers, customers, and suppliers and others who have nothing to hide will refuse to respond to auditors' questions on the basis of their increased exposure? Don't you think that the value of their relationship with the issuer and the reputation of the marketplace would really obviate such a reaction?

Mr. Holton: I think those relationships would have an effect to not get completely to the extremes, but, based on conversations with admittedly limited numbers of financial executives and others, but particularly with

lawyers, lawyers have said that that would be the advice of many lawyers (U.S. Congress, 1976a, p. 172).

Regarding the standard of proof, the following exchange between Rep. Murphy and SEC Chairman Rodderick Hills clarifies the intent of the proposed prohibition against lying to auditors:

Murphy: Is it inherent in this provision that the person making the misstatement [to an auditor] must have actual knowledge that such misstatement is materially false or misleading? (p. 30)

Hills: If one knows or should reasonably have known, that he is causing someone else to be misled, he would have violated the bill, as I understand it (U.S. Congress, 1976a, p. 31).

But as noted in Section 4.3, the Senate committee did not intend the inclusion or deletion of the word “knowingly” to “affirm, expand, or overrule the decision of the Supreme Court in *Ernst & Ernst v. Hochfelder*” (U.S. Congress, 1977c, p. 2). The committee also noted that the SEC was considering similar prohibitions against lying to auditors, and thus the legislation did not need that provision. A subsequent House amendment deleted a provision that would have prohibited clients from lying to their auditors, and the Senate concurred. The FCPA (1977) did not include a prohibition against lying to auditors.

Mandatory auditor reports on internal control. Notably, the FCPA’s failure to require auditor reports on internal control was not a mere oversight. California Rep. Moss introduced two amendments. One amendment would have required the board of directors to review and approve the corporation’s internal accounting controls and code of conduct. The other amendment would have required the independent accountant to attest that management’s internal controls are adequate to safeguard shareholders’ assets (U.S. Congress, 1976a, p. 154). Robert Sack, a partner in Touche, Ross & Company, envisioned “an evaluation to determine whether or not there’s a significant problem for the investor.” But Walter Hanson, a senior partner of Peat, Marwick, Mitchell & Company declared that “public reporting on internal controls is meaningless” (Cole, 1976). The AICPA and some Big 8 public accounting firms wanted to restrict the distribution of auditor reports on internal control to corporate managers and directors, and opposed their distribution to external parties (Koshetz, 1977). Both Moss amendments failed, and Congress unanimously passed the FCPA in 1977.

4.5 Summary of FCPA

The FCPA did not fundamentally change how companies would be governed. While it imposed some accounting and internal control responsibilities on management, it did not require mandatory management and auditor reports on internal control, and it did not criminalize management’s failure to establish and maintain reasonably effective controls. Although the FCPA did little to curb executives’ head-in-the-sand attitude toward internal control, AICPA spokesman Holton concluded his Congressional testimony with much optimism about industry self-regulation:

[A] significant expansion is underway as to the responsibilities and functions of independent audit committees and outside directors. Increasingly included in these responsibilities are matters relating to establishment, monitoring, and enforcement of corporate policy statements, as well as matters relating to systems of internal accounting control (U.S. Congress, 1976a, p. 161).

Georgia Rep. William Stuckey, Jr., who presided over the hearings, then thanked Mr. Holton and said “I am pleased to see that the private sector of this country is very well represented by you and the American Institute of Certified Public Accountants this morning” (U.S. Congress, 1976a, p. 162).

5. Corporate Resistance to Internal Control Regulation: 1979-2003

Sometimes it takes a crisis to convince the world that the status quo has to change (Arthur Levitt, 2002, p. 143).

5.1 The Commission on Auditors’ Responsibilities (1978)

In 1974, the AICPA responded to disclosures of corporate wrongdoing by establishing the Commission on Auditors’ Responsibilities (hereafter, “Cohen Commission” or “Commission”). The Commission’s goal was to address the gap between what the public expects auditors to do and what auditors should reasonably expect to accomplish. The Commission met monthly beginning in November 1974, issued its Report of Tentative Conclusions in March 1977, and completed its final report in 1978. During this time, a lengthy report titled “The Accounting Establishment” (also known as “The Metcalf Report”, U.S. Congress, 1976b) sharply criticized “the extraordinary manner in which the SEC has insisted upon delegating its public authority and responsibilities on accounting matters to private groups with obvious self-interests in the resolution of such matters” and “the alarming lack of independence and lack of dedication to public protection shown by the large accounting firms” (p. v). The Metcalf Report concluded that extensive government regulation of the accounting profession was necessary (U.S. Congress, 1976b, pp. 20-24).

High-ranking partners at the Big Eight firms responded to the threat of substantially increased government regulation by asserting that the report lacked substance, its conclusions were unwarranted (Sloane, 1978), and its recommendations would hinder rather than improve financial reporting (Andrews, 1977a). The AICPA also formed a political action committee and polled its members to find those who might have influence with Senators or Congressmen. While some AICPA members viewed these tactics as unprofessional, Wallace Olson, the AICPA President, said that “it would be folly for us not to make our views known” (Andrews, 1977b).

Amidst the AICPA’s defense of private-sector internal control regulation, and in contrast to AICPA spokesman Holton’s 1976 Congressional testimony, the Cohen Commission recognized that “Users of financial information have a legitimate interest in the condition of the controls and management’s response to the suggestions of the auditor for corrections of weaknesses” (Commission on Auditors’ Responsibilities, 1978, p. 62). The Commission accordingly recommended that senior management issue a report acknowledging its internal control responsibilities:

The report by management should present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of control systems and a description of the company's response to material weaknesses identified by the independent auditor. It should describe the work of the company's audit committee and its internal auditors (Commission on Auditors' Responsibilities, 1978, pp. 76-77).

The Commission further recommended that the independent auditor render an opinion as to whether management's internal control representations are fairly stated, and if not, the nature of the discrepancies (Commission on Auditors' Responsibilities, 1978, p. 78).

The Cohen Commission's internal control reporting recommendations presumed an adequate and generally agreed upon framework for evaluating internal control. Again, this contradicts Holton's previous Congressional testimony that a definite internal control framework did not exist for evaluating internal controls (U.S. Congress, 1976a, p. 158).¹¹ Notwithstanding the Commission's advocacy of internal control reporting, the Commission notably did not recommend government-mandated reporting. Instead, the Commission concluded that its recommendations should be implemented through ongoing private sector and SEC initiatives:

The Commission is gratified to note that the AICPA has already adopted some of the recommendations made in the *Report of Tentative Conclusions* and that it has appointed several committees to study many of the other recommendations. The Commission is also pleased to note the citation of some of its recommendations in recent proposals by the Securities and Exchange Commission, as well as a general endorsement of the *Report of Tentative Conclusions* by the Senate Subcommittee on Reports, Accounting, and Management. However, in addition to such official actions, *the Commission believes that many of the recommendations can be implemented through voluntary action principally by independent auditors and corporate managements and directors acting together to improve financial reporting* (Commission on Auditors' Responsibilities, 1978, p. xi, emphasis added).

The Financial Executives Institute (FEI), a long-time vocal advocate of voluntary private-sector initiatives, endorsed the Cohen Commission's recommendations for a voluntary

¹¹ The Cohen Commission's independence of the AICPA may explain the discrepancy between its internal control recommendations and earlier AICPA testimony. Regarding independence, the Cohen Commission stated that "The board of directors of the American Institute of Certified Public Accountants established the Commission as 'an independent study group.' While the term *independent* was never defined for the Commission, it was taken to mean that the members of the Commission and its staff would have full freedom and responsibility to determine the scope of its study, the issues to be examined, and the manner in which they would be examined; that the members of the Commission and its staff would be free of outside influences and restrictions and would not be considered to represent particular constituencies; that the Commission would be provided with adequate resources; and that the Commission's report would be widely disseminated, regardless of its conclusions. All of those conditions have been met, and the Commission believes that its work and conclusions are independent" (p. xv). In addition, the report stated that "During its three years of operation, the Commission made two interim reports to the Council of the AICPA... Other than those reports, no formal or informal contacts were maintained between the Commission and the AICPA besides those related to resource arrangements" (Commission on Auditors' Responsibilities, 1978, p. xvi).

management report on internal control, and in June 1978 it issued suggested guidelines for preparing such a report. A special advisory committee of the AICPA also considered the Cohen Commission's recommendations and issued a report of its tentative conclusions and recommendations (AICPA, 1978). Altogether, the FEI and AICPA endorsements gave at least the appearance that the private sector was taking sufficient steps to improve corporate governance and control.

5.2 SEC (1979) proposal to require internal control reports

Despite strong accounting industry pressure to leave the development of management and auditor reports to the private sector, the SEC proposed a rule that would have required (1) management to issue a statement on internal accounting control in annual reports, and (2) the independent public accountant to report on management's internal control assertions (SEC, 1979). The proposed mandatory reports had three noteworthy characteristics. First, their scope would have been limited to management's accounting and internal control responsibilities under the FCPA. Unlike the more inclusive Cohen Commission recommendations, management's report would not have included a statement about audit committee effectiveness and the role of internal audit.

Second, management's opinion would have covered control conditions that existed throughout the reporting period, instead of as a specific point in time only. This "whole period" scope would have required management to disclose internal control weaknesses that existed at any time during the reporting period, even if the weaknesses were corrected before the end of that period.

Third, the auditor's report on internal control would have significantly expanded the independent public accountant's responsibilities. The SEC's proposal would have required auditors to conduct comprehensive internal control evaluations to verify management's internal control assertions. In contrast, Statement on Auditing Standards No. 1 (and subsequent AICPA internal control standards) required auditors to study and evaluate a client's internal controls only to the extent necessary to plan the scope of an examination of the financial statements.

The SEC's rationale for its 1979 proposal was that the widely acknowledged limitations of internal control should not excuse management from discharging its internal control responsibilities. For example, the proposed ongoing internal control review and monitoring would have enabled management to determine whether the internal controls were functioning as intended. Any ongoing material weaknesses that were not identified on a timely basis due to inadequate monitoring and review procedures, or any identified material weaknesses that were not subsequently corrected, would have precluded an unqualified management opinion (SEC, 1979, p. 26706).

In essence, the 1979 proposal sought to ensure that management establishes, documents, reviews, and monitors a reasonably effective system of internal control. The dual management and auditor reports arguably would have made it more likely that management and the public would be informed of internal control problems on a more timely basis. The SEC threatened to develop internal control testing and reporting procedures on its own if the accounting profession did not make sufficient progress.

5.3 SEC (1980) withdrawal of proposal to require internal control reports

The SEC (1979) proposal provoked stiff industry opposition. Of the more than 950 individuals and organizations who submitted comment letters, most were substantially opposed (SEC, 1980, p. 40138). The commentators offered mixed and inconsistent reasons for opposing the proposed rule. More than 500 commentators stated that the proposed internal control reports were essentially a statement of compliance with the FCPA's internal control requirements, and thus argued that the reports would not provide meaningful additional disclosure. More than 200 commentators asserted that the proposed rules violated Congress' intent because the FCPA did not require such reports (SEC, 1980, p. 40138). The SEC summarized the opposing views:

Many of these commentators...suggested that the rule proposals were apparently intended not to provide useful information to shareholders, but rather to establish useful existence of violations of the FCPA for enforcement purposes and to influence corporate conduct; questioned whether the proposals violated Constitutional protections against self-incrimination; and contended that they were beyond the Commission's statutory authority (SEC, 1980, p. 40138).

Some commentators who generally supported a required management report on internal control thought that the report should be limited to conditions existing as of a specific point in time. These commentators "questioned the disclosure value of weaknesses in internal accounting control which had been corrected, maintaining that disclosure of corrected weaknesses would be confusing and possibly misleading" (SEC, 1980, p. 40142). Almost all commentators who gave specific comments believed that the costs to implement the required auditor's report on internal controls would far exceed the possible benefits (SEC, 1980, p. 40144), especially given the AICPA's existing initiatives (e.g., AICPA, 1980). Finally, approximately 100 commentators suggested that a more comprehensive management report (as recommended by the Cohen Commission, FEI, and AICPA) would provide more useful information than the more limited report on internal accounting control under the proposed 1979 rules.

The SEC withdrew its proposal, having based its concession in part on "a determination that private-sector initiatives for public reporting on internal accounting control had been significant and should be allowed to continue" (SEC, 1980, p. 40134). In deferring to the private sector, the SEC acknowledged that 65 companies among those submitting comments indicated that they had voluntarily included a management report in the annual reports. The SEC also cited an FEI review of 410 annual reports documenting that 106 companies included a management statement, with 100 of these 106 statements discussing management's responsibility for internal control (SEC, 1980, pp. 40137-40138). The SEC stated that "the trend towards such reports is continuing" (SEC, 1980, p. 40138, fn 36), it sought to "encourage further voluntary initiatives and permit public companies a maximum of flexibility in experimenting with various approaches to public reporting on internal accounting control" (SEC, 1980, p. 40134), and it urged similar experimentation with auditor reports on management's internal control statements (SEC, 1980, p. 40134). To support management's assertion that internal controls provide reasonable assurance, the SEC suggested that management should provide "appropriate and persuasive documentation not only of the system of internal accounting control, but also of management's ongoing review and evaluation of it" (SEC, 1980, p. 40140).

Finally, the SEC warned that it “will evaluate on an ongoing basis the progress that has been made in reports filed in 1980 through 1982 and will consider whether it is necessary or desirable to require statements of management on internal accounting control and to propose more comprehensive management reports” (SEC, 1980, p. 40139). The SEC repeated these threats several times (pp. 40134, 40143, 40144, and 40145), but ultimately it did not enforce them (see Briloff, 1999, p. 277). The SEC’s interaction with its adversaries was ritualistic and ceremonial. As Bealing (1994, p. 557) observed in a different context, the SEC would continue being funded and the accounting profession would gain if they were perceived as ‘improving’. Subsequent events revealed, however, that the voluntary private-sector initiatives were largely ineffective.

5.4 SEC (1981) placates executives’ worries about criminal prosecution

A December 1980 report submitted by the SEC transition team of the incoming President Ronald Reagan contended that the SEC’s aggressive enforcement policies hindered capital formation and unnecessarily harassed executives. To alleviate these alleged burdens, the Reagan team sought to reduce the SEC’s budget by 37% during 1981-1983, reduce the Washington, D.C. enforcement division staff from 200 people to 50 people, and eliminate the FCPA’s criminal penalties (Reagan SEC Transition Team, 1981, pp. 1-2, 20). The transition team also recommended that Reagan appoint a new SEC Chairman so that the current SEC Chairman Harold Williams would resign on March 1, 1981 (Reagan SEC Transition Team, 1981, p. 18). The transition team sought to restrict the SEC’s alleged aggressive enforcement activities, but it then argued that its proposed funding and staffing changes would not adversely affect the SEC’s enforcement capabilities.¹² Altogether, the transition team projected a savings of \$107.5 million during 1981-1983, and it predicted that its proposed legal and structural changes would eliminate “unnecessary regulatory impediments to capital formation” (Reagan SEC Transition Team, 1981, p. 20).

Soon thereafter, SEC Chairman Williams appeased the business community and sought to comply with Congressional and Presidential expectations about the SEC’s future enforcement and regulatory actions. In a January 1981 address to the SEC Developments Conference of the AICPA, Williams conceded that in seeking technical compliance with the Act, “business resources may have been diverted from more productive uses to overly-burdensome compliance systems” (SEC, 1981, p. 2). Williams sought to allay the audience’s litigation fears:

1. Newly enacted standards may be subject to unforeseen interpretations and compliance difficulties.
2. Technical and insignificant errors in corporate records or weaknesses in internal controls could expose executives to SEC enforcement or criminal liability.
3. The broadly stated nature of the accounting provisions without concrete details exposes corporate executives to allegations of noncompliance (SEC, 1981, p. 2).

¹² For evidence on the relation between SEC funding and enforcement, see Bealing (1994).

Williams reassured his audience by repeating key SEC interpretations of the FCPA's accounting requirements:

Inadvertent recordkeeping mistakes, and falsifications for which the company's management was not aware and reasonably should not have known, would not give rise to SEC enforcement proceedings.

The [FCPA] does not mandate any particular kind of internal control system. The only test is whether the system as a whole "reasonably" meets the act's objectives. The issuer need not select the best or most effective control measures (SEC, 1981, p. 3).

The following comment in particular reinforced how the FCPA's anti-bribery focus overshadowed its accounting and internal control objectives:

[T]he Commission has not sought out violations of the accounting provisions for their own sake; indeed, we have not chosen to bring a single case under these provisions that did not also involve other violations of law (SEC, 1981, p. 3).

While placating the business community, Williams did not say much about how its future actions would protect investors. However, Williams did reaffirm the FCPA's accounting and internal control objectives:

A failure to correct a known falsification – or a falsification that reasonably should be known – or any attempt to cover-up a falsification – is, of course, prohibited...[O]ccasional failings... will happen in the most ideally managed company. But, an adequate system of internal controls means that, when such breaches do arise, they will be isolated rather than systemic, and they will be subject to a reasonable likelihood of being uncovered in a timely manner and then remedied promptly (SEC, 1981, p. 8).

5.5 1988 FCPA amendments seek to weaken the FCPA's accounting and control provisions

SEC Chairman Williams' attempt in early 1981 to placate the business community's litigation concerns apparently was not sufficient. A March 4, 1981 report by the U.S. General Accounting Office recommended that Congress amend the FCPA to repeal the criminal penalties associated with accounting violations, and to "establish criminal penalties [only] for the knowing and willful falsification of corporate books and records" (US GAO, 1981, p.33).¹³ The GAO also urged the SEC and Attorney General to take certain actions to address the business community's concern that without an appropriate materiality standard, the FCPA was vague, ambiguous, unclear, and unreasonable (US GAO, 1981, pp. 19-30).

The GAO based its recommendations on a survey of 250 Fortune 1000 companies, 55% of whom indicated they believed the cost of compliance with the Act's accounting provisions exceeded the benefits, and more than 30% of whom asserted that the anti-bribery

¹³ Under the FCPA, a person who knowingly violated its accounting provisions would be subject to the criminal penalties imposed under the 1934 Securities Exchange Act (fines of up to \$10,000 and imprisonment for up to 5 years).

provisions caused U.S. companies to lose foreign business (US GAO, 1981, pp. 13-14). Some survey respondents indicated that the absence of a generally accepted definition of “reasonableness” led them to incur unnecessary compliance costs (US GAO, 1981, p. 32). The majority of respondents reported that they made moderate or extensive changes in such areas as internal control documentation and testing, internal audit, and the use of audit committees (US GAO, 1981, pp. 9-12), but the GAO did not evaluate whether these industry-led developments were in fact effective.

The GAO’s critique of the FCPA’s antibribery provisions played a prominent role during the May 1981 Congressional hearings to amend the FCPA’s accounting, internal control, and criminal provisions. In addition, U.S. Trade Representative William Brock recommended that “any successful reform bill should alleviate the major uncertainty that businessmen are faced with under the FCPA liability, based on having reason to know that a foreign agent was planning to engage in a questionable payment” (U.S. Congress, 1981a, p. 237).¹⁴ According to Brock, executives should be held criminally liable for anti-bribery violations only in cases where they had actual knowledge and intent that bribes were made. However, Brock and Reagan administration officials also sought to remove rather than merely clarify the Act’s accounting and bookkeeping provisions. These FCPA reform proposals privileged corporate profits at the expense of ethical business practices. Indeed, as former SEC Commissioner Roberta Karmel put it, with the weak economy “there’s less readiness to criticize business practices which are conducted in order to improve the economic profitability of a corporation” (Noble, 1982, p. D1).

Moreover, Sen. John Chafee proposed a bill that would have eliminated the FCPA provision prohibiting payments while “having reason to know” that the payment might be used to bribe foreign official. SEC Chairman Williams was concerned that the Chafee provision would allow management to use a deliberate ignorance approach and foster a culture where management says “I’m not going to direct, I’m not going to authorize, and don’t tell me” (Hamilton, 1981, p. D7). Williams also was concerned that eliminating the “having reason to know” language would make it extremely difficult for prosecutors to establish that the company actually directed or authorized the bribe.

In September 1981, a report by the Senate Banking, Housing and Urban Affairs Committee asserted that because of the lack of clarity in the FCPA accounting and control provisions, “the direct and indirect costs of compliance with the FCPA and the lost opportunities of U.S. businesses have been excessive, and there is a compelling need to re-examine and refine the provisions of the Act in order to reduce or eliminate unnecessary compliance costs, without undermining the basic purposes of the FCPA” (U.S. Congress, 1981b, p. 3). Support for the reform effort was bipartisan, and attorney Sorenson, a strong advocate of the FCPA (1977) accounting and control provisions, concluded that “The vague and sweeping language of the present law has to my personal knowledge caused some wholly honorable entrepreneurs to stop doing business abroad and caused others to erect distorted and inefficient business structures as a shield against any unintended liability” (U.S. Congress,

¹⁴ Brock and other administration officials also testified that the FCPA damaged American sales abroad (U.S. Congress, 1981a, pp. 235-252). Under intense questioning and in the face of evidence showing that US foreign trade had in fact doubled in the two years after the FCPA legislation was passed, Brock and other witnesses conceded that the Department of State’s survey methods were biased and that its conclusions were based solely on executives’ opinions and perceptions (U.S. Congress, 1981a, pp. 253-274).

1981b, p. 4). The Senate report then documented alleged examples of lost trade and increased costs that were allegedly caused by the FCPA (U.S. Congress, 1981b, pp. 6-10).

The proposed bill would have precluded “the possibility of an enforcement action based solely on the fact that records are inaccurate” (U.S. Congress, 1981b, p. 14). The proposed bill also sought to give managers considerable latitude for determining the appropriate cost-benefit tradeoffs regarding “reasonable assurances” in internal accounting controls (U.S. Congress, 1981b, pp. 10-11, 15-16). The inherent subjectivity of the cost-benefit test would have bolstered executive autonomy. Finally, the bill sought to explicitly limit criminal liability for accounting to “knowing” and intentional violations (p. 14).

In their deliberations over the proposed FCPA amendments, the Congressional conference committee clarified that accounting and internal control penalties should not be imposed for technical infractions or inadvertent conduct:

[C]riminal penalties shall not be imposed for failing to comply with the FCPA’s books and records or accounting control provisions. This provision is meant to ensure that criminal penalties would be imposed where acts of commission or omission in keeping books or records or administering accounting controls have the purpose of falsifying books, records, or accounts, or of circumventing the accounting controls set forth in the Act. This would include the deliberate falsification of books and records and other conduct calculated to evade the internal accounting controls requirement” (FCPA, 1988, pp. 916-917).

Regarding these clarifications, Wisconsin Sen. William Proxmire observed that “At first blush some of the changes appear to be reasonable” (U.S. Congress, 1981b, p. 26), but he was concerned that “the strained and incorrect interpretation of the term ‘knowingly’” would “encourage slipshod accounting controls and recordkeeping and encourage circumvention of such controls by companies”, allowing managers “to put their head in the executive sand and claim they did not know” (p. 27).

The enacted 1988 FCPA amendments clarified that a person would be held criminally liable for accounting or internal control violations only if the violations were committed “knowingly” (see Table 1, Panel B). Without auditor reports on internal control and other checks and balances, the “knowingly” standard arguably made it easier for management to adopt a head-in-the-sand approach to internal control, despite some Congressional members’ professed intentions. As noted in Treadway (1987, p. 76), the 1988 amendments were motivated by some executives’ view that “potential private liability under the current court system [had] become excessive.” A concern for investor welfare did not figure prominently in this debate.

5.6 SEC (1988) proposal for a mandatory internal control report

Like the FCPA of 1977, the 1988 FCPA amendments did not mandate management and auditor reports on internal control. Following the Treadway (1987) recommendation to require management and auditor reports on internal control, the SEC (1988) again issued proposed rules to require registrants to include a report of management’s responsibilities in Forms 10-K and annual reports to security holders. In contrast to the SEC’s 1979 proposal, the management report would have included a statement describing how management

responded to any significant problems identified by its internal auditors and independent accountants. In addition, the independent accountant would have been required to read management's disclosures, determine whether the disclosures included a material misstatement of fact, and take certain actions if necessary to achieve appropriate disclosure. But as with its previous attempts, the SEC did not implement these proposals.

5.7 FDICIA (1991) requires insured depository institutions to issue internal control reports

I would like to have a crusade today, and I would like to lead that crusade with your help. And it would be one to take Government off the backs of the great people of this country, and turn you loose again to do those things that I know you can do so well, because you did them and made this country great.
(California Governor Ronald Reagan's closing remarks during the October 28, 1980 Carter-Reagan Presidential debate.)

The U.S. savings and loan crisis represented the largest U.S. financial crisis since the Great Depression (Curry and Shibut, 2000, p. 33). From 1986 to 1995, more than 1,000 banks and thrifts failed, with total assets exceeding \$500 billion. As of December 31, 1999, the estimated total loss was \$153 billion, of which taxpayers paid approximately \$124 billion (Curry & Shibut, 2000, pp. 30-33). The savings and loan crisis has been widely attributed to deregulation, lax accounting rules, managerial incompetence, and poor internal controls at the savings and loan institutions.¹⁵ A U.S. General Accounting Office report documented that pervasive internal control weaknesses contributed to the bank failures:

Of the internal control weaknesses federal regulators identified, those which contributed most significantly to the 184 bank failures were inadequate or imprudent loan policies and procedures (79 percent), inadequate supervision by the bank's board of directors (49 percent), weak loan administration (42 percent), and poor loan documentation and inadequate credit analysis (41 percent). Other internal weaknesses regulators cited related to an overreliance on volatile funding sources (32 percent), the presence of a dominant figure (31 percent), and a failure to establish adequate loan loss allowances (29 percent) (US GAO, 1989, p. 3).

To remedy these failures, the GAO recommended management and auditor reports on internal control (U.S. GAO, 1989, pp. 47-50).

This time, Congress recognized the need for early identification of weak internal controls over financial reporting and safeguarding of assets. Section 36 of the Federal Deposit Insurance Incorporation Improvement Act of 1991 (FDICIA) required the chief executive officer and chief accounting or financial officer of each insured depository institution to (1) sign a report stating management's responsibilities in preparing financial statements,

¹⁵ State and federal deregulation of U.S. depository institutions allowed savings and loan institutions (thrifts) to enter new but riskier markets. The Garn-St. Germain Act of 1982 allowed thrifts to issue credit cards, make non-residential real estate and commercial loans, and perform other activities previously allowed only to commercial banks. This Act and other state and federal deregulation allowed thrifts to enter new and riskier markets with reduced capital requirements and reduced oversight. Many thrifts failed soon after the real estate markets collapsed in the 1980s.

establishing and maintaining adequate controls for financial reporting, and complying with the applicable laws and regulations governing such institutions, and (2) assess annually the effectiveness of such internal controls and the institution's compliance with the laws and regulations (see Table 2). In addition, the FDICIA required the institution's independent accountant to attest to management's assertions contained in the report, and it required an independent audit committee. FIDICIA (1991) thus mandated the management and auditor reports on internal control that both the Cohen Commission and SEC had recommended during 1978 to 1988. Importantly, however, the new rules applied only to insured depository institutions.

5.8 Failed attempts to have all SEC registrants issue internal control reports

The AICPA's Public Oversight Board (POB) recommended that *all* SEC registrants be required to state publicly whether their internal controls over financial reporting were effective and to have independent auditors publicly opine on management's assertions (POB, 1993, pp. 52-54). The POB explained its reasoning as follows:

The Board believes that requiring auditors to assess management's reports on the quality of internal control systems will benefit the public. First, the auditing profession's evaluation of internal control systems will lead to improvements in those systems. Second, as long as companies' boards and top management demand conformity with those systems, the improved systems will make management fraud and manipulation of financial reporting more difficult (POB, 1993, p. 53).

In contrast, SEC Chief Accountant Walter Schuetze doubted that such requirements would reduce fraudulent financial reporting and litigation against auditors, and said he would reserve his judgment until he saw or heard more evidence or argument (Schuetze, 1993, pp. 41-42). A few years later, the U.S. GAO (1996, Chapter 3) endorsed the recommendations to make management and auditor reports on internal control mandatory for all public companies. The U.S. GAO also noted that the SEC "has not been convinced of the merits of reporting on internal controls" and yet "SEC support is critical to further progress on this important issue, as is the linkage of fraud detection and internal controls" (US GAO, 1996, p. 75). The SEC did not endorse GAO's internal control reporting recommendations. Investors would need to finance the costliest accounting scandals in U.S. history before Congress would pass legislation to mandate management and auditor internal reports for all public companies.

5.9 Failed accounting industry self-regulation

Although the Metcalf Report (U.S. Congress, 1976b) criticized the accounting profession's self-regulation failures, self-regulation continued to dominate the arena of corporate internal control. More than a quarter of a century later, amidst the scandals at Enron, WorldCom, and a rising number of other companies, the U.S. GAO harshly criticized the failures of accounting self-regulation:

The issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not

well coordinated, involves certain conflicts of interest, lacks effective communication, has a funding mechanism that is dependent upon voluntary contributions from the accounting profession, and has a discipline system that is largely perceived as being ineffective...Simply stated, the current self-regulatory system is broken and oversight of the self-regulatory system by the Securities and Exchange Commission (SEC) has not been effective in addressing these issues to adequately protect the public interest (U.S. GAO, 2002, p. 657).

Similarly, Shaun O'Malley, Chairman of the POB Panel on Audit Effectiveness, testified that "The Panel found that the current system of governance lacks sufficient public representation, suffers from divergent views among its members as to the profession's priorities, implements a disciplinary system that is slow and ineffective, lacks efficient communication among its various entities and with the SEC, and lacks unified leadership and oversight" (POB, 2002; published in U.S. Congress, 2002, p. 683). The Panel issued its recommendations in August 2000, but as of March 2002 they still had not been adopted by the accounting profession.

Despite the by then well-documented critiques of self-regulation, the FEI continued to advocate voluntary, private-sector initiatives in the internal control arena. On the surface, the FEI's internal control recommendations (U.S. Congress, 2002, Vol. 2, pp. 1155-1162) appear constructive, but they are primarily of the voluntary, moral exhortation variety and offer no specific compliance and enforcement mechanisms. Among other things, the FEI recommended that "All financial executives should adhere to a specialized code of ethical conduct" and that steps be taken to improve auditor independence, the financial reporting system, and audit committees. Notably, the FEI prefaced its observations and recommendations with the policy statement that "FEI supports a clear and coordinated look at all areas of possible improvement", but its recommendations did not mention the possibility of management and auditor reports on internal control.

5.10 Sarbanes-Oxley Act of 2002 and related SEC rules

Repeated violations of the financial fraud and insider trading provisions of the U.S. Securities Acts of 1933 and 1934 led some accounting historians to conclude that the investor protection Acts were largely symbolic (e.g., see Merino & Mayer, 2001; Merino & Neimark, 1982). The accounting scandals of the late 1990s and early 2000s indicate that the SEC and the U.S. Department of Justice had not adequately enforced the existing securities laws, and that the corporate governance and internal control regulations needed improvement. SOX (2002) now mandates the corporate governance and internal control practices that had previously been recommended by certain members of Congress, the SEC, the GAO, and certain AICPA committees from 1976 onward. Section 404 of SOX (2002) requires all public companies to issue management and independent accountant reports on the effectiveness of internal control SEC (2003) and Public Company Accounting Oversight Board (2004) regulations implement SOX Section 404.

Section 404 -- along with prohibitions against lying to auditors (Section 802), executive disgorgement of ill-gotten gains (Section 304), financial statement certifications by senior executives (Section 302), and a required code of ethics for senior financial officers (Section 406) -- arguably reduce opportunities for accounting fraud. The extensive documentation, testing, and public reporting requirements of Section 404 also should make it easier for prosecutors to establish that violators knew or should have known about accounting and internal control failures at their companies. But it is not yet clear whether SOX will in fact make it easier to prosecute violators. For example, the SEC's ability to enforce the U.S. securities laws depends on the continued adequacy of its funding, which in turn depends on relations of power, interest, and political sentiment in Washington (Bealing et al., 1996).

Radical institutional theory asserts that progressive institutional change requires a fundamental change in the problematic institution's value structure (cf. Bush, 1987, p. 1078; Dugger, 1989b, pp. ix-x; Waller, 1987, p. 39). Will the corporate values of efficiency, profit, power, and autonomy that defeated earlier internal control proposals eventually erode SOX's impact? Before and soon after the enactment of SOX, some members of the business community complained that it was hastily [sic] conceived and that its governance and internal control provisions would yield too few benefits to justify their cost. As David Landsittel (1991, p. 12), a former partner of Arthur Andersen & Co. and former Chairman of the AICPA's Auditing Standards Board observed more than a decade earlier in the aftermath of the U.S. savings and loan crisis, "Those who dismiss such auditor activity as only adding unnecessary costs to large segments of American business...miss the fundamental significance of recognizing and identifying the increased business risk that exists in poorly controlled enterprises."

6. Concluding remarks

The internal control policy debates in the U.S. during the 1976-2002 period involved a conflict between private-sector and state-mandated regulation. Our historical and institutional analysis describes how relations of power and interest prolonged the era of ineffective industry self-regulation in the internal control arena. The agents who blocked or weakened government regulation of internal control during this period included the ABA, AICPA, FEI, the 1980 Reagan SEC transition team, U.S. trade representatives, and certain members of Congress. Concerns about corporate profit, efficiency, and executive autonomy eclipsed the government's investor protection objectives. During the nearly three decades of internal control regulation before SOX (2002), executives and their representatives defeated each of several proposals to mandate internal control reports. Arguably, mandatory management and auditor reports on internal control would have given executives timely information about internal control weaknesses at their companies, and would have increased the likelihood that such weaknesses would be remedied. But such reports also would have exposed those executives to increased internal, regulatory, and legal scrutiny.

Industry self-regulation and the absence of mandatory internal control reporting helped to bring about systemic and costly governance and internal control failures during the 1980s-early 2000s. The financial cost to improve corporate governance and control before SOX (2002) would have paled in contrast to the economic devastation wrought by the savings and loan debacle in the 1980s and the recent corporate scandals. The investors, taxpayers, and families who were economically injured by these scandals did not have sufficient interest or opportunity to participate in the internal control policy debates from 1976 onward.

Of course, the management and auditor internal control reports that are now mandated by SOX (2002) and implemented via SEC (2003) and PCAOB (2004) are not a panacea to prevent corporate corruption. Ultimately, the effectiveness of these new internal control regulations will depend on the quality of independent accountants' examinations, the SEC's financial and political willingness and ability to enforce the securities laws. It also depends on whether other significant gaps exist in corporate governance and accountability. For example, some lucrative executive compensation schemes continue to fail to establish a reasonable link between pay and performance, contrary to the publicly professed intent of those schemes. For another example, the business judgment rule, whereby the courts generally abstain from second-guessing the substantive decisions of boards (see *Smith v. Van Gorkom*, 1985; Stout, 2002), has traditionally shielded most directors from personal liability.

Recent legislative and regulatory developments now suggest that the rules of the investor protection game no longer overwhelmingly give directors, officers, and professional advisers the benefit of the doubt. But some cracks in the promised investor protection armor already are visible. For example, some unhappy executives have bitterly complained that SOX Section 404 was hastily conceived, costs too much, adds too little value, and prevents management from taking reasonable risks. The FEI, U.S. Department of Commerce, and the conservative business media actively encourage these complaints. Such complaints are reminiscent of the myopic attacks on the FCPA's accounting and internal control requirements during the 1980s, and the critics who allege that SOX (2002) was too hastily conceived fail to recognize that the rationale for management and auditor reports on internal control was thoroughly debated for at least 25 years before Enron, WorldCom, and other corporate disasters. Some critics now contend that investors and society at large would be better served if some SOX governance and internal control provisions were scaled back:

Congress can correct its overreach by simply making Section 404 mandates on internal controls voluntary, while keeping the rest of Sarbanes-Oxley intact. Firms can determine the appropriate level of controls by management discretion or by shareholder vote, with full disclosure to the SEC and in annual reports. Such a scaled back Sarbanes-Oxley II would let shareholders and managers have more say than government in deciding how corporate resources are best spent. A solution along these lines would help keep us competitive in world markets, while it would restore balance at home and reaffirm the primacy of free market initiatives and innovation (Scott S. Powell, Visiting Fellow, Hoover Institution, 2005).

Future research could examine the strategies and tactics that powerful individuals in influential institutions employ to undermine or rescind SOX-related regulations. Strategies of avoidance, defiance, and manipulation might include deliberate underfunding of the SEC and public derision of its enforcement activities, undermining of the SEC's jurisdictional authority, and the calculated use of rhetorical devices to subordinate investor protection to corporate profit and efficiency. To better understand the accounting profession's role in regulating advanced capitalism, future research also could document and analyze the accounting industry's previous resistance to other reforms, such as auditor independence reforms and proposals for an auditing oversight board independent of the AICPA. Just as with the accounting profession's opposition to mandatory internal control reporting, the profession's other policies and their related adverse consequences were not the result of mere

mistakes, oversight, or differences of professional opinion. Rather, they were made possible by the conscious, deliberate, and repeated actions of interested and influential parties.

Appendix

The following statements are direct quotes from WorldCom, Inc.'s June 9, 2003 8-K.

B. WorldCom's Culture

[A] culture emanating from corporate headquarters...emphasized making the numbers above all else; kept financial information hidden from those who needed to know; blindly trusted senior officers even in the face of evidence that they were acting improperly; discouraged dissent; and left few, if any, outlets through which employees believed they could safely raise their objections (p. 18).

When efforts were made to establish a corporate Code of Conduct, Ebbers reportedly described it as a "colossal waste of time" (p. 19).

[The investigators] came across e-mails and a voicemail in which senior management directed employees not to discuss in e-mail or writing certain items that had raised concerns. Access to the Company's computerized accounting system, particularly the accounts where senior officials made corporate adjustments, was restricted to a handful of people and kept from others who needed access (p. 20).

There was also a systemic attitude conveyed from the top down that employees should not question their superiors, but simply do what they were told. Employees told us that personnel were discouraged from challenging anyone above them in the corporate hierarchy, and senior officers and managers made it clear that their actions should not be questioned. Staff accountants in the General Accounting group frequently and without question entered large, round-dollar journal entries—in the tens, and often hundreds, of millions of dollars—after the close of a quarter, without being provided *any* supporting documentation whatsoever (p. 21).

When financial personnel did raise questions about accounting discrepancies, senior management often stymied those inquiries through intimidation and belittling e-mails (p.22).

D. Why WorldCom's Auditors Did Not Discover the Fraud

Based on the materials available to us, the blame for Andersen's failure to detect the fraud appears to lie with personnel both at Andersen and at WorldCom. There were apparent flaws in Andersen's audit approach, which limited the likelihood it would detect the accounting irregularities. Moreover, Andersen appears to have missed several opportunities that might have led to the discovery of management's misuse of accruals, the capitalization of line costs, and the improper recognition of revenue items. For their part, certain WorldCom personnel maintained inappropriately tight control over information that Andersen needed, altered documents with the apparent purpose of concealing from Andersen items that might have raised questions, and were not forthcoming in other respects. Andersen, knowing in some instances that it was receiving less than full cooperation on critical aspects of its work, failed to bring this to the attention of WorldCom's Audit Committee. Andersen employed an approach to its audit that it itself characterized as different from the "traditional audit

approach.” It focused heavily on identifying risks and assessing whether the Company had adequate controls in place to mitigate those risks, rather than emphasizing the traditional substantive testing of information maintained in accounting records and financial statements. This approach is not unique to Andersen, and it was disclosed to the Audit Committee. But a consequence of this approach was that if Andersen failed to identify a significant risk, or relied on Company controls without adequately determining that they were worthy of reliance, there would be insufficient testing to make detection of fraud likely (pp. 25-26).

Andersen does not appear to have performed adequate testing to justify reliance on WorldCom’s controls. We found hundreds of huge, round-dollar journal entries made by the staff of the General Accounting group without proper support; examples include unsupported journal entries of \$334,000,000 and \$560,000,000 on July 21, 2000, and July 17, 2001, respectively. We also found accrual reversals were made with little or no support. And where we did find documentary support it was frequently disorganized and maintained haphazardly. These deficiencies made reliance on controls impossible. We do not understand how they escaped Andersen’s notice (p. 26).

The WorldCom personnel who dealt most often with Andersen controlled Andersen’s access to information in several respects. They denied Andersen’s requests to speak with some employees. They “struck” Andersen’s requests for detailed information, supporting documentation, or material that they felt was overly burdensome. WorldCom personnel also repeatedly rejected Andersen’s requests for access to the computerized General Ledger through which Internal Audit and others discovered the capitalization of line costs. And they fostered an attitude in which questions from Andersen were to be parried, rather than answered openly. Of course, it was Andersen’s responsibility to overcome those obstacles to perform an appropriate audit, and to inform the Audit Committee of the difficulties it faced, but it did not do so. Moreover, certain members of WorldCom’s management altered significant documents before providing them to Andersen, with the apparent purpose of hampering Andersen’s ability to identify problems at the Company (pp. 27-28).

E. WorldCom’s Governance

WorldCom’s collapse reflected not only a financial fraud but also a major failure of corporate governance. The Board of Directors, though apparently unaware of the fraud, played far too small a role in the life, direction and culture of the Company. Although the Board, at least in form, appeared to satisfy many checklists of the time, it did not exhibit the energy, judgment, leadership or courage that WorldCom needed (p. 29).

The outside Directors had virtually no interaction with Company operational or financial employees other than during the presentations they heard at meetings. While in this respect the Directors were far from unique among directors of large corporations, this lack of contact meant that they had little sense of the culture within the Company, or awareness of issues other than those brought to them by a few senior managers. They were not themselves visible to employees, and there were no systems in place that could have encouraged employees to contact them with concerns about either the accounting entries or operational matters. In

short, the Board was removed and detached from the operations of WorldCom to the extent that its members had little sense of what was really going on within the Company (p. 31).

Ebbers was autocratic in his dealings with the Board, and the Board permitted it. With limited exceptions, the members of the Board were reluctant to challenge Ebbers even when they disagreed with him. They, like most observers, were impressed with the Company's growth and Ebbers' reputation, although they were in some cases mystified or perplexed by his style. This was Ebbers' company. Several members of the Board were sophisticated, yet the members of the Board were deferential to Ebbers and passive in their oversight until April 2002. The deference of the Compensation Committee and the Board to Ebbers is illustrated by their decisions beginning in September 2000 to authorize corporate loans and guaranties that grew to over \$400 million, so that Ebbers could avoid selling WorldCom stock to meet his personal financial obligations (p. 32).

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Table 1, Panel A. The Accounting Control Provisions of the Foreign Corrupt Practices Act of 1977 (Source: 15 USCS §78m(b)(2)(2004)).

(2) Every issuer which has a class of securities registered pursuant to section 12 of this title [15 USCS §78I] and every issuer which is required to file reports pursuant to section 15(d) of this title [15 USCS §78o(d)] shall--

(A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that--

(i) transactions are executed in accordance with management's general or specific authorization;

(ii) transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Table 1, Panel B. Criminal Provisions in the 1988 Amendments to the Foreign Corrupt Practices Act of 1977 (Source: 15 USCS §78m(4-5)(1988)).

(4) No criminal liability shall be imposed for failing to comply with the requirements of paragraph (2) of the subsection except as provided in paragraph (5) of this subsection.

(5) No person shall knowingly circumvent or knowingly fail to implement a system of internal accounting controls or knowingly falsify any book, record, or account described in paragraph (2) [of Table 1, Panel A].

Table 2. Financial reporting and internal control provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (Source: Public Law 102-242, 102d Congress).

SEC. 36. EARLY IDENTIFICATION OF NEEDED IMPROVEMENTS IN FINANCIAL MANAGEMENT.

(b) **MANAGEMENT RESPONSIBILITY FOR FINANCIAL STATEMENTS AND INTERNAL CONTROLS** – Each insured depository institution shall prepare...

(2) a report signed by the chief executive officer and the chief accounting or financial officer of the institution which contains –

(A) a statement of the management’s responsibilities for –

(i) preparing financial statements

(ii) establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(iii) complying with the laws and regulations relating to safety and soundness which are designated by the Corporation or the appropriate Federal banking agency; and

(B) an assessment, as of the end of the institution’s most recent fiscal year, of –

(i) the effectiveness of such internal control structure and procedures; and

(ii) the institution’s compliance with the laws and regulations relating to safety and soundness which are designated by the Corporation and the appropriate Federal banking agency.
