Fraudulent Reporting in Nigeria: Management Liability for Corporate Financial Statements as an Antidote.

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Abstract

Financial statements are prepared by the management of an enterprise and released to the various stakeholders who rely on them to assess the type of dealings they could have with the company. An accurate assessment of an enterprise could only be carried out if the financial statements are accurate. Recent events, particularly the sudden collapse of enterprises with very healthy financial statements, have indicated that most inaccuracies in financial statements could be a result of their deliberate action or inaction. This paper therefore examines the issues involved in making management liable for corporate financial statements from the perspectives of both the management and the users of financial statements. It concluded that there was need to make management liable for corporate financial statements but within certain defined restrictions defined by statute. The paper recommends that apart from the Chief Executive Officer and the Chief Finance Officer, other Board members should be liable. In addition, the paper recommends that management liability for corporate financial statements should be applicable to all companies in Nigeria irrespective of size or quotation status.

KEYWORDS: Management, liability. Financial statements, criminal liability, civil liability

1.0 INTRODUCTION
1.1 Background information

Financial statements are prepared by the management of a company for the usage of various stakeholders. These financial statements indicate the state of the financial well-being of the company. They are usually the window into a company’s financial affairs available to the average investor, and sometimes the only information available to banks and other institutional investors. Consequently, potential investors and other stakeholders rely on these financial statements to assess the type of dealing they could have with the company. An accurate assessment of a company could only be carried out if the financial statements are accurate. Recent events, particularly the sudden collapse of companies with very healthy financial statements, have showed that most financial statements are not prepared in line with generally accepted accounting principles (GAAP) and accounting standards. In the past and up till now in most jurisdictions, when a company fails or when it is realized that published financial statements are not accurate, it is usually the auditors who are blamed. However, in the recent past, there has been an increasing realization that since management has the primary responsibility for the preparation and presentation of financial statements, most inaccuracies in financial statements could be as a result of their deliberate action or inaction. This paper therefore examines the issues involved in making management liable for corporate financial statements from the perspectives of both the management and the users of financial statements. It concluded that there was need to make management liable for corporate financial statements but within certain defined restrictions defined by statute. The paper recommends that apart from the Chief Executive Officer and the Chief Finance Officer, other Board members should be liable. In addition, the paper recommends that management liability for corporate financial statements should be applicable to all companies in Nigeria irrespective of size or quotation status.

1.2 Statement of the problem

Nigeria is one of Africa’s most important capital markets. And like in most African countries, it has been plagued with bad corporate governance. One of the manifestations of the bad corporate governance is fraudulent financial reporting. There has been various responses to the problem through the enactment of various corporate governance codes such as the Code of Corporate Governance in Nigeria 2003, the Code of Corporate Governance for Nigerian Banks post consolidation 2006, the Code of Conduct for Shareholders’ Associations in Nigeria is one of Africa’s most important capital markets. And like in most African countries, it has been plagued with bad corporate governance. One of the manifestations of the bad corporate governance is fraudulent financial reporting. There has been various responses to the problem through the enactment of various corporate governance codes such as the Code of Corporate Governance in Nigeria 2003, the Code of Corporate Governance for Nigerian Banks post consolidation 2006, the Code of Conduct for Shareholders’ Associations in...
1.3 Statement of the research objectives

Flowing directly from the research questions above, the basic objectives of the paper are (i) To determine whether there is a relationship between management liability for financial statements and the quality of financial statements; (ii) To determine the appropriate mean(s) of ensuring management liability for financial statements; (iii) To examine the associated liability of the company and the external auditor.

1.4 Scope and delimitation.

The study is limited to aspects of overall corporate governance including internal control over financial reporting, fraudulent financial reporting and the civil and criminal liabilities of directors, the chief executive officer, the chief finance officer, the auditor and the company. The paper, however, did not extend to the shareholders. The study extends its focus beyond publicly owned companies to include private companies as well.

1.5 Disposition

This study begins with an introductory section which describes the background to the agitation for a stricter regime of sanctions for fraudulent financial reporting by corporate officers in Nigeria. It thereafter states the research questions, the research objectives and the scope and delimitation. Section 2 deals with the methodology adopted for the study. Section 3 reviews the existing literature while Section 4 is on analysis and discussion. The paper ends with the conclusion and recommendations in section 5.

2.0 METHODOLOGY

The choice of Methods depends primarily on the subject and the purpose of a study (Merriam, 1994). This study is qualitative in nature and therefore no quantitative tool is used to analyze the data. It is conducted on the basis of literature survey and secondary information. Various journals, newspapers and magazine articles are referred to in writing the paper.

3.0 LITERATURE REVIEW

This section discusses the relevant issues relating to management liability for corporate financial statements in Nigeria. It starts by examining the concept and meaning of fraudulent financial reporting. After that it looks at
the current state of financial reporting in Nigeria. Subsequently, the literature review examines the current state of management liability for financial statements in Nigeria and internationally, effects of management liability for financial statement and penalties, sanctions and legal liabilities.

3.1 The concept of fraudulent financial reporting

Sometimes, fraudulent financial reporting is simply referred to as financial statement fraud. In both cases there are various definitions, but we shall examine only a few. According to the American Institute of Certified Public Accounts (AICPA, 1987), fraudulent financial reporting is intentional or reckless conduct, whether act or omission that results in materially misleading financial statements. According to the Commission, it entails gross and deliberate distortion of corporate records such as inventory court tags, or falsified transactions such as fictitious sales or orders. According to the AICPA, fraudulent financial reporting may also entails the misapplication of accounting principles. According to Cooper (2005), financial statement fraud involves a deliberate inclusion of misleading accounts or disclosures in financial statements aimed at deceiving financial statement users. Cooper (2005) listed some instances of financial statement fraud to include: (i) alteration, manipulation or falsification of financial records; (ii) deliberate omissions and misrepresentation of event or transaction amounts; (iii) intentional misapplication of accounting principles, procedures and policies; and (iv) deliberate omission of disclosures or rendering of inadequate disclosures. Cooper (2005) however excludes internal frauds or other types of dishonest conduct.

For the purpose of this study, it is important to note that fraudulent financial reporting differs from other causes of materially misleading financial statements such as other unintentional errors. It is also very critical to differentiate between earnings management and earnings manipulation. In other words, we differentiate between within-GAAP earnings management and non-GAAP earnings management. Non-GAAP earnings management is regarded as fraudulent while the within-GAAP earnings management is not.

3.2 Current state of financial reporting in Nigeria.

Financial reporting in Nigeria is governed mainly by two principal statutes-the Companies and Allied Matters Act (CAMA) 2004 and The Investment and Securities Act (ISA) 2007. Financial statements and audit are generally covered in Part XI of CAMA, while annual returns are covered in part XII. In general CAMA did not deal with the issue of fraudulent financial reporting. The ISA establish the Securities and Exchange Commission of Nigeria (SEC) as the principal regulatory authority for the Nigerian capital market. Financial reporting by publicly quoted is covered under part VIII of ISA. The provisions of ISA were obviously influenced to some extent by the provisions of the Sarbanes Oxley Act of 2002 (SOX) in the US. Section 60 (2) of the Act requires the Chief Executive Officer (CEO) and the Chief Accounting Officer (CFO) to certify annual or periodic reports filed with the SEC. The Act requires the two officers to certify to among other things to the effect that: (a) They have reviewed the reports; (b) the report does not contain any untrue statement of a material fact or any misleading statement; (c) the report fairly and materially represents the financial condition and results of operations of the company; (d) they are responsible for establishing and maintaining internal controls and that such controls are adequate and functional in all material respects. While the provisions of Section 60 of ISA are similar to the provisions of the SOX of the US, the penalty clauses are definitely not. Section 65 (1) provides to the effect that a public company who contravenes section 60,61,63 and 64 is liable to a penalty not less than #1,000,000 By today’s exchange rate of #160 to $1, this is equivalent to about $7,000. The CEO and CFO are also personally liable to pay these amounts if found guilty. It is instructive to note that these are administrative fines and not indictable offences. Moreover, there is no stated liability to third parties who relied on misleading or fraudulent reports.

The foregoing is the background in which publicly quoted companies operate in Nigeria. The Nigerian landscape has been plagued with poor corporate governance and the attendant fraudulent financial reporting. The case of Cadbury Nigeria Plc. is a good example.

3.3 Current position on management liability for corporate financial statements in Nigeria and internationally

In almost all jurisdictions, the directors are responsible for the preparation of financial statements. For instance in Nigeria, Section 334 (1) of the Company and Allied Matters Act 1990 make it a duty of the directors to prepare financial statements for each accounting year. The directors are however, not required to certify the accuracy of the financial statements either individually or collectively. It is only by section 343 (1), that two directors are required to sign on behalf of the board of the company, the balance sheet and a copy of which is laid in general meeting or delivered to the Corporate Affairs Commission. The obvious essence of this is to attest to the authenticity of the document and not to attest to its accuracy. After the preparation of financial statements by the Directors, auditors are required to carry out a statutory audit of the financial statements to ascertain whether they give a true and fair view of the underlying transactions. According to Shore (2000), although financial statements are prepared by management, assurance of these assertions for the users of the information is given by the auditors. As a consequence of this role, the accounting profession has faced litigations mainly due
to corporate failures. It is alleged that it is audit failures that give the way for the non-detection of failure signs in failed companies. But with more and more failures and corporate scandals, attention has shifted partially from the auditor to the preparers of the financial statements, namely the Directors/management.

The first major action towards making management liable for financial statements is the Sarbanes Oxley (SOX) Act of 2002 in the U.S. The SOX followed the Enron disaster and the disclosure by WorldCom that its financial statements had been overstated. (Geiger & Taylor III, 2004). Section 32 require the chief executive officer (CEO) and the chief financial officer (CFO) or officers or persons performing similar functions to certify in among other things in each annual or quarterly report filed with the SEC: (i) that the signing officer has reviewed the report. (ii) that the report does not contain any materially untrue statement or has omitted to state a material fact that would render the statement misleading (iii) that the financial statement/information is a fair representation of the state of affairs of the company. The second part of the certification requires in section 404 the CEO/CFO’s assessment of internal control over financial reporting in the form of an internal control report filed along each annual report. It also includes a requirement that external auditors include an report on management’s assessment of the internal controls. The last part of the certification requirement for CEO/CFO is in section 906. The section requires that each of the periodic report containing financial statements filed with the SEC shall be accompanied with a written statement by the CEO/CFO that the information contained in the periodic report fairly presents, in all material respects the financial condition and results of operations of the company. In particular, Section 906 (c) imposes criminal penalties for any CEO/CFO who certifies financial statements knowing that such periodic report accompanying statements do not comply with the requirement of the Act.

Following the U.S. certification requirements for CEO/CFOs, other jurisdictions have been exploring the possibilities of making management liable for corporate financial statements. Canada was the first country to adopt the certification provisions of the U.S Sarbanes-Oxley Act. Starting from 2004, CEOs and CFOs of Canadian public companies are now required to certify that the financial statements and associated information they filed with the regulatory authorities are free from material errors and misleading (Canadian Performance Reporting Board, 2004). The CEO and CFO are also required to certify that the interim and annual filings are true in all material respects and do not contain misleading statements. According to the Canadian Performance Reporting Board (CPR Board) (2004), two fundamental principles are central to the regulations and to the functioning of the capital market that can serve as a guide to CEOs and CFOs in the certification process. The first principle which is transparency refers to the degree to which the information contained in the filings being certified enables a reader to reliably assess and interpret the financial condition, results of operations and cash flows of the company. The certification by the CEO and CFO is the mechanism to achieve the transparency. The second principle is accountability which refers to the public acknowledgement by the CEO and CFO of their responsibility for the completeness, accuracy, timeliness and reliability of the information contained in the filings being certified.

The Canadian Securities Administrators (CSA) Multilateral instruments that detailed the certification requirement did not specify the penalties that may be applied to those found to have provided a false certification. However, companies policy 52 – 109 CP of Canada does note that such an action would be subject to quasi-criminal, administrative and civil proceedings under existing applicable laws (CPRB, 2004). In addition to the penalties and sanctions contained in Corporate and Securities statutes, other penalties that could apply to CEOs and CFOs signing false certificates may be found in several new processes of legislation (CPRB, 2004).

The foregoing is a review of the two jurisdictions namely the U.S.A and Canada that have enacted laws that require CEO and CFO certification of corporate financial statements. The obvious objectives of the certification requirements are to make management represented by the CEO and the CFO to be liable for frauds or error in financial statements presented to the public by their company. We shall now proceed to examine the internal processes that the CEO and CFO may have to go through to ensure that what he certifies is accurate, drawing from theory and practice. After this we examine the effect that certification may have on the morale and productivity of the management and staff of company.

### 3.4 Effects of management liability/ certification

According to Prentice (2007), SOX404 has produced benefits in many ways. One of such benefits include the revival of the capital markets in the US. According to him, when SOX was passed, there was a very low level of investors’ confidence in the capital markets in the US which caused a drop in average trading volume to 54%. According to Alvarado (2006), SOX helped achieved a significant restoration of investor confidence in the stock market which has facilitated a quick recovery by the market. According to Goldstein (2006), corporations that are complaining about SOX are also making record profits that were far higher than what they were in 2002. SOX has also contributed resulted in improving corporate governance (Prentice, 2007). A study of 2,500 international companies performed by Governance Metrics International found that SOX reforms resulted to a significant improvement in the corporate governance performance of U.S. companies compared with their foreign counterparts (Healey & Steel, 2005). Also according to Prentice (2007), SOX
has improved the liquidity of firms in the US. Jain, Kim and Rezaee (2006) finds that SOX improved the liquidity of American capital markets. According to them the regulatory actions of SOX is very successful in restoring market participants’ confidence in corporate governance, financial reporting, and assurance functions. SOX has contributed significantly in improving financial reporting (Prentice, 2007). According to Prentice, SOX 404 is effective. The academic research has also provides important support for the conclusions that the accounting reforms of SOX has been successful and that it is victory for investors. (Leech, 2005, Henry, 2007).

The foregoing studies and many others indicate that the implementation of the SOX is providing investors in U.S. markets with very reliable financial statements than ever before. There is overwhelming evidence that SOX 404 has contributed to the revival of U.S. capital markets, reformed corporate governance, and improve financial reporting accuracy, fraud detection and market liquidity. Thus, it can be concluded that there is a positive relationship between management liability for corporate financial statements and financial reporting quality.

3.3.5. Penalties, sanctions and legal liability

Legal liabilities fall into two broad categories - criminal and civil liabilities. Criminal penalties in the Sarbanes – Oxley Act of 2002 are very severe. According to the Act, whoever certifies any financial statement knowing that the periodic report accompanying the statement does not conform with the requirements shall be fined not more than $1,000,000 or imprisonment not more than 10 years or both, and whoever willfully certifies not more than $5,000,000 and or up to 20 years imprisonment. Apart from the severity of the penalties imposed, certification changes the legal status quo. Prior to certification requirements in the U.S., CEOs/CFOs of companies sign financial statements on behalf of the company and do not give personal endorsement. The criminal liabilities for inaccurate certification are direct and straight forward. The CEOs and CFOs are criminally liable for negligence and fraud in the preparation of financial statements. A statute has fixed the CEO and CFO with the duty to prepare accurate financial statements. There is not much case law on director or officer liabilities to third parties. What most cases deal with is the liabilities of the auditor to third parties. However, CEOs and CFOs can be placed on the same pedestal as far as the third parties are concerned as they both have contractual relationships with the company. Thus, case law on auditor liability to third parties can be extended to directors/officers of the company at least for purposes of analysis. So the basic questions are: Should the CEO and CFO be liable to third parties for a breach of duty to prepare accurate financial statement? If so, to whom, on what basis and why?. The issue of the liability of the auditor (or any other officer of the company) to third parties is far from being settled. We shall briefly outline the history and case law relating to auditor (director) liability to third parties. As we have stated earlier, we are using the case law on the auditors’ liabilities as a proxy for that of the CEO and CFO.

The controversy surrounding auditor (or officer) liability has become complicated because the plaintiffs are normally third parties that have relied upon the certified financial statements rather than the contracted clients of the auditor (or officer). These plaintiffs generally consist of borrowers and creditors that use the certified information to make a decision regarding extending to the company short or long term credit. Other possible plaintiffs are investors that rely upon the information to make investment decisions (Buffington, 1997). Historically, restrictive liability made it difficult for third parties to recover damages from auditors/officers due to negligent certification.

There are three doctrinal views on third party liability: the privity or Ultramares rule; the foreseeability standard, and the restatement of tort. The privity rule was first developed in the English case of Winter bottom v Wright in 1842. The court found in favour of the defendant stating there was no privity of contract between the plaintiff and defendant, therefore no duty flowed to the plaintiff, and no liability existed (Gomez, 2003). In 1931, the courts applied the privity rule to accounting negligence in the Ultramares Corp v Touche case. Touche prepared a balance sheet for Fred Stern and Company upon their request. The balance sheet reflected that Stern had a large net worth when in reality the company was insolvent. A lender, Ultramares Corp because of the favorable balance sheet figure extended credit to Stern. Stern later filed for bankruptcy and as a result Ultramares sued Touche for negligence. The court ruled in favour of Touche, finding that there was a negligence on the part of the accountants but a lack of contractual privity between Ultramares and Touche (Gomez, 2003). Later in 1985, the privity rule was reversed in the case of Credit Alliance v Arthur Anderson & Co. The court developed the following three part legal test in determining accountants liability to third parties. (i) The accountant must have known that his or her work was to be used for a particular purpose, (ii) A known party or parties were intended to be able to rely on the accountants work product, (iii) Some conduct must have linked the accountants to the relying party (Pancins, et al (2001). The court redefined the principles expressed in Ultramares (Gomez, 2003).

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Some jurisdictions have codified the liabilities for third parties by accountants for certification of financial statements. The New Jersey Statute for accountants’ liability to third parties for negligence states to the effect that accountant shall not be liable for damages for negligence arising from the rendering of professional accounting service unless (a) the accountant knew at the time of the engagement, was specifically identified to the accountant in connection with a specified transaction made; (b) the accountant knew that the claimant intended to rely upon the professional accounting service in respect of that specified transaction (c) the accountant directly expressed to the claimant by words or conduct, the accountants understanding of the claimant’s intended reliance on the service.

The foreseeability rule has only been followed in a few cases (Shore, 2001). In the case of Rosenbum v Adler in 1983, after relying on the audited financial statements of the Corporation, and Completing a Corporate acquisition transaction, the plaintiff discovered that the financial statement were fraudulent and the stock was of no value. The court determined that in order to protect the public, accountants should have a duty to foreseeable users. The court, however, further concluded that this principle only applied if the audited statements are received directly from the business entity.

Under the restatement rule the accountant owes a duty to the clients as well as the individuals or limited groups that the accountant is aware will benefit from the information (AICPA, 2003). This known user doctrine is also sometimes referred to as the “intended beneficiary” approach. The restatement Approach provides for liability for accountant/officer to third parties without the requirement of privity only when the accountant provides financial statements or other financial reports such as audit reports for the intended benefit of a known person or class of persons to be justifiably relied upon as guidance for a specific transaction or type of transaction identified to the accountant (Grubbs et al, 2007). According to Gomez (2003), the restatement rule is more generous than the privity rule but narrower than the foreseeability approach. The difference of between the standards is the extent of the relationship required.

The conclusion from the foregoing is that the issue of auditor or management liability to third parties is far from being settled by the courts.

4.0. DISCUSSION
A financial statement is supposed to show a company’s true financial position at any given time. It enables investors to take informed decisions on their investments. But over time, management, either through fraud or negligence has manipulated the content of financial statements to achieve their own objectives. In the past and up to the present in some jurisdiction including Nigeria, auditors have been blamed for the inaccuracies in corporate financial statements. But the world is becoming wiser and it is being increasingly realized that auditors alone cannot solve the problem of inaccurate corporate financial statements. This is why attention is being justifiably shifted to management. Management has control over the preparation of financial statements within the company, and is better placed to monitor the process for the preparation of financial statements. The naked implication of the present system is that management may deliberately device ingenious and carefully laid schemes of fraud in preparing financial statements and thereafter call in the auditor who is expected to detect those frauds/schemes. This is tantamount to the game played by primary school children called “puppy” whereby one of the pupils has his or her eyes tied with a piece of cloth and then asked to catch the other person who is rigging a bell and trying to avoid the blind folded person. The certification requirements introduced by the Sarbanee Oxley Act of 2002 in the U.S is novel and quite commendable. Management (particularly the CEO and the CFO) must have primary responsibility for the content of financial statements. However, in making management responsible and liable for financial statements, care must be taken to ensure that working for a corporation is not rendered absolutely unattractive through heavy liabilities. Thus, there has to be a proper balance between management liability for corporate financial statements and the need to protect management from liability traps.

From the experience of the U.S. and Canada that have enacted legislations making management liable for corporate Financial Statements, it is obvious that there is a positive relationship between the quality of corporate financial statements and their certification by management. After the introduction of the certification regimes, CEOs/CFOs started implementing measures that would guarantee sound financial reporting systems. Sub certification ensured that subordinates down the organization ladder contribute to ensuring quality financial reporting systems. Apart from ensuring high quality financial statements, a well designed sub-certification process would produce opportunity for the management (CEO and CFO particularly) to engage in a meaningful manner, the business unit leaders in the financial reporting process which helps them to understand the importance of risk management and effective control. In the end, it will help them run their business units more effectively. However, where certification by management is implemented, there will be need by most companies to address some important behavioral and cultural issues when implementing sub-certification. Management
must evaluate the effect that sub-certification could have on morale, corporate culture, and the practical ability of delegating responsibility appropriately within the officer group.

The highpoints of management liability for corporate financial statements is the penalty for default or contravention. In the U.S. and Canada, the penalties imposed are considered excessive given that inaccurate financial statements may have been the result of genuine error which the officers are unable to prove. There is no doubt, however, that Criminal liability must be attached to the certification exercise. The various enactments in the U.S. and Canada did not explicitly elaborate on the civil liability status of management. However since the statutes impose a duty of care, there are bound to be civil claims by third parties who rely on the financial statements. As analyzed in the paper, there are no settled and conclusive rules for determining liability of officers of a company to third parties. This means that CEOs/Directors are going to be faced with a multitude of suits. Thus with a little negligence or simple error, they may be exposed to liability in ‘an indeterminate amount, for an indeterminate time to an indeterminate class’. Determination of liability has been left to the various courts through case law. This has not yielded the desired results. It may therefore be necessary at this point in time to streamline the situation by statute. In this case, the statute would identify the class that can make claims against the officers, the time limit for making the claims and the methods of determining the amount of claims.

One feature of the jurisdictions (US and Canada) currently implementing certification regimes is that it is assumed that only the CEOs/CFOs are the key determinants of the content of Corporate financial statements. But then, there are other board members who may have overbearing influences on the CEO and CFO. This category of officers should be bought into the Certification Universe, albeit in a lesser form.

Another issue that was highlighted in the paper is the fact that certifications in the US and Canada is only required of publicly quoted companies. This scope may be adequate in those jurisdictions. However, in a country like Nigeria where virtually everything is fraud compliant, it will be counter productive to exclude any corporation. The worst culprits in financial statements fraud in Nigeria are the private small and medium scale enterprises. In most of these companies, different financial statements could be prepared for different purposes. If we must do business at all, there must be complete accountability and truthfulness at all levels irrespective of the size.

5.0. CONCLUSION AND RECOMMENDATIONS

The purpose of having management particularly the CEO and CFO liable for corporate financial statements is to enhance investors’ confidence through improving the transparency of disclosure and holding key executives/management accountable for the accuracy and completeness of financial reporting and related controls. A well designed management liability regime, particularly through certification, can provide significant additional benefit of more meaningfully involving senior operating executives from outside the finance process. For these benefits to fully crystallize there has to be good quality management leadership.

To ensure quality financial statements and credibility in financial information given by corporations therefore, the following recommendations are made for application in Nigeria and other developing nations(i) A statute or law should be made mandating management to certify corporate financial statements; (ii) Criminal sanctions should be imposed on management who certify inaccurate financial statements; (iii) Management should be liable to third parties who rely on their certified financial statements. However, the scope and limitation of third party liabilities should be fixed by a statute; (iv) management liability for corporate financial statements should be applicable to all companies in Nigeria whether big or small, quoted or unquoted (v) CEO and CFOs should be liable in the main for corporate financial statements both criminally and for third parties civil liabilities. However, the dragnet should be extended to other directors found to have contributed to the inaccuracies in financial statements.

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