Fall 2017

The Fall of Enron and the Creation of the Sarbanes-Oxley Act of 2002

Megan Connell
connellm2@student.lasalle.edu

The Fall of Enron and the Creation of the Sarbanes-Oxley Act of 2002

By: Megan Connell
With assistance from: Dr. Bruce Leauby
November 20, 2017

Table of Contents

Abstract:

The goal of this research paper is to analyze accounting fraud and its characteristics, explore the collapse of Enron and what happened because of it, and how the relationship between an auditor and its client has changed because of the creation of the Sarbanes-Oxley Act of 2002. Learning about some of the positives and negatives of SOX will help the progression of the research into how the passing of SOX has changed over 15 years later. After discussing these topics, a personal opinion on the fall of Enron, if one group is more at fault than another, and how regulation plays a role in auditing and the business world will conclude the paper.

1. What is Fraud?

To understand how a major fraud case was able to occur, a solid foundation defining fraud and its characteristics needs to be established. The Association of Certified Fraud Examiners defines fraud as, “any crime for gain that uses deception as its principal modus operandus” (ACFE, 2017). Although initially broad, fraud can be dissected further into internal fraud, external fraud, and fraud against individuals. Internal fraud, which will be the focus of this research paper, is also called occupational fraud. It involves an employee who uses their job for personal gain or use through deliberate misappropriation of an employer’s resources or assets. External fraud occurs outside of a company or a business. A vendor may attempt to rip-off a buyer by increasing prices unfairly, threatening an employee, or bill a buyer for goods or services that were not provided. Similarly, a customer could commit external fraud by returning stolen goods for money or using false account information and bad checks. The ACFE concludes external fraud’s definition by including these other forms of fraud: “hacking, theft of proprietary information, tax fraud, bankruptcy fraud, insurance fraud, healthcare fraud, and loan fraud” (ACFE, 2017). The final form of fraud listed by the ACFE is fraud against individuals. This includes any type of identity theft, Ponzi-schemes, and phishing schemes.

In an annual study completed by the ACFE called the Report to the Nations on Occupational Fraud and Abuse, domestic and international statistics regarding fraud are examined and reviewed (Report to the Nations, 2016). This report uses information from almost 2,500 occupational fraud cases that were investigated between January 2014 and October 2015 in 114 different countries throughout the world. Some interesting facts from this report follow:

- The median loss suffered by small organizations (those with fewer than 100 employees) was the same as that incurred by the largest organizations (those with more than 10,000 employees). However, this type of loss is likely to have a much greater impact on smaller organizations.
- The perpetrator’s level of authority was strongly correlated with the size of the fraud. The median loss in a scheme committed by an owner/executive was $703,000. This was more than four times higher than the median loss caused by managers ($173,000) and nearly 11 times higher than the loss caused by employees ($65,000).
- More occupational frauds originated in the accounting department (16.6%) than in any other business unit. Of the frauds we analyzed, more than three-fourths were committed by individuals working in seven key departments: accounting, operations, sales, executive/upper management, customer service, purchasing, and finance
- The most prominent organizational weakness that contributed to the frauds in our study was a lack of internal controls, which was cited in 29.3% of cases, followed by an override of existing internal controls, which contributed to just over 20% of cases.
- Fraud perpetrators tended to display behavioral warning signs when they were engaged in their crimes. The most common red flags were living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general “wheeler-dealer” attitude involving

> unscrupulous behavior, and recent divorce or family problems. At least one of these red flags was exhibited during the fraud in 78.9% of cases.

There are many different types of occupational fraud; however, by looking more closely at employee fraud and embezzlement, examples provided later in the paper will be better understood. Employee fraud is the use of fraudulent means to take money or other property from an employer and consists of three phases: the fraudulent act, the conversion of the money or property to the fraudster's use, and the cover up. Embezzlement involves employees' or nonemployees' wrongfully taking money entrusted in their care, custody, and control, often accompanied by false accounting entries and other forms of lying and cover up (Louwers et al, p. 222). With so many ways an individual or a group of individuals can commit fraud, figuring out what motivates a fraudster will facilitate this understanding.

1.1 The Fraud Triangle

Originally developed by American penologist, sociologist, and criminologist Donald Cressey, the fraud triangle models the factors that cause someone to commit occupational fraud. These three factors are defined in Cressey's book *Other People's Money,* "Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property" (Cressey, p. 30). More simply, there needs to be a motivation, an opportunity, and a rationalization of the illegal activity. By having these three factors, fraud is highly likely to occur.

This motivation can stem from an economic motive, such as an actual or perceived need for money, a psychotic motive, such as a criminal who steals for the sake of stealing, an egocentric motive, such as someone who commits fraud for personal prestige, or an ideological motive, such as a someone who believes they are morally superior and are justified in making others victims. An opportunity to commit fraud mainly stems from weak internal controls, or the controls within a company or business that serve as a checks and balances. Rationalization can occur in many ways. One will make an argument to make the action seem as though it is in line with their moral and ethical behavior. Examples of frequent rationalization include: I need it more than the other person; I'm borrowing the money and will pay it back; everybody does it; the company is big and will never miss it; nobody will get hurt; I am underpaid, so this is due compensation; I need to maintain a lifestyle and image (Louwers et al, p. 228). Knowing the factors that go into the fraud triangle is not the only way to detect fraud. Red flags and characteristics of fraudsters allows us to create a profile for a prime suspect.

1.2 Who Commits Fraud

When unsure if there is a fraud being committed, an employer may take a step back and take a look at his or her employees to note any red flags. Common red flags of fraudsters include: sleeplessness, drinking too much, taking drugs, easily becoming irritable, unable to relax, easily gets defensive, can't look people in the eye, sweat excessively, goes to confession, finds excuses and scapegoats for mistakes, works standing up, works alone, or frequently works late. Characteristics of fraudsters can be defined by: has a post-high school education, is likely to be married, is a member of a religious organization, is in the age range of teenager to over 60, is socially conforming, has been employed from one to 20 years, does not have an arrest record, and is usually acting alone (Louwers et al, p. 224).

Unfortunately, these descriptions of the typical fraudster do not alienate one specific type of person, as most people in the work force can be described by most or all of these characteristics. In a lot of fraud cases, people will say that they never expected the fraudster to commit the crime and that they cannot believe it. Because of this ambiguity, other red flags which increase the probability of fraud include management characteristics, industry condition, and operating characteristics.

1.3 Risk Factors Related to Fraudulent Financial Reporting

Aside from the fraud triangle and common characteristics of fraudsters, multiple factors increase the risk of fraud within an organization. Management's characteristics strongly influence how a company can be portrayed. Examples of management risk factors include: a motivation to engage in fraudulent reporting, decisions are dominated by an individual or a small group, lack of importance on internal control, aggressive attitude toward financial reporting, too much emphasis on earnings projections, frequent disputes between managers and auditors, a history of violations, a high turnover of senior management, and nonfinancial management participates excessively in the selection of accounting principles or determination of estimates. Another area which can create fraud risk are industry conditions. Rapid changes within the industry, new requirements are passed which impair profitability, strong competition, and a declining industry are all influences that could impact a company. Lastly, the way a company operates can create a more fraud-prone environment. Weak internal controls, inexperienced accounting personnel, significant transactions that are difficult to audit, and a pressure to obtain capital are all characteristics within an organization which increase the risk of fraud. Although there are many ways that fraud can occur, preventing fraud before it happens or detecting fraud before it has a material impact is possible (Louwers et al, p. 228).

1.4 How Can Fraud be Prevented?

A good way to prevent fraud from occurring in the first place is to have a strong and ethical tone at the top. A control environment which emulates following laws and procedures will have that same trickle-down effect and will most likely create a less fraudulent atmosphere. Another way to prevent fraud is to provide counseling services for employees. Life outside of work can become a huge stressor for employees, so having an outlet for them to safely talk about what's going on allows an employee to feel less stressed and continue to do their job or receive additional help if necessary. Having an anonymous hotline provides a way for employees to inquire or inform an ethics officer or another controls employee about an event or transaction that they are unsure about. Some people do not want to feel like they are telling on someone, especially if that someone is your superior, so having an anonymous hotline eliminates the possibility of feeling awkward or embarrassed (Louwers et al, p. 228).

Internal controls and employee monitoring are huge fraud prevention methods. Having easily accessible company-wide procedures and rules allows employees to understand exactly what they are supposed to do no matter what the situation is. Being able to monitor employees is also another important method for preventing fraud: common red flags can inform a controls officer whether an employee seems to be acting fishy. Other ways which internal control activities can detect fraud include: segregation of duties and responsibilities for transaction authorization, record keeping, custody of or access to assets, and reconciliation of actual assets to the accounting records. Finally, having a checks and balances within the company creates an attitude of accountability. Required background checks prior to hiring decreases the probability of hiring someone who had issues with inappropriate or unethical behavior. A code of conduct, a list of ways to properly act within the company in order to follow the correct procedures, is another common way of reinforcing the importance of being accountable for your actions and having integrity with your work.

1.5 How Can Fraud be Detected?

There are many ways fraud can be prevented; however, if prevention was unsuccessful, there are other ways that fraud can be detected. Within a company, there is normally a group of accountants who are internal auditors. Internal auditors must be independent and objective of a company's procedures. They provide assurance and consulting activities which adds value and improves an organization's operations. In order for a company to accomplish its goals, internal auditors must audit business systems within the company to ensure that the company is on track to complete its financial goals while following its code of conduct and business practices (Louwers et al, p. 681). Internal auditors have many roles including: ensuring reliability and integrity or information, safeguard assets, ensure compliance with policies and regulations, achieve organizational objectives and goals, improve operational economy and efficiency, identify business risk, and help prevent and detect fraud.

Internal auditors have four main principles of the Institute of Internal Auditors Code of Ethics: integrity, objectivity, confidentiality, and competency (Institute of Internal Auditors, 2017). Integrity establishes trust that is the basis for reliance on their judgement. Objectivity needs to be maintained in gathering, evaluating, and communicating information to adequately balance the assessment of all the relevant circumstances while remaining uninfluenced by self-interest or by others. Confidentiality is respecting the value and ownership of information. Competency is applying the knowledge, skills, and experience needed in performance of internal audit services. Finally, internal auditors must be in regular communication with external auditors to coordinate audit activities.

External auditors are Certified Public Accountants, or CPAs, who work in accounting firms and do an annual audit of the company at hand. To become a CPA, a student must complete 150 credit hours along with passing the CPA exam, which is divided into four parts. Those four parts are Auditing & Attestation (AUD), Financial Accounting & Reporting (FAR), Regulation (REG), and Business Environment & Concepts (BEC). After passing all four parts, accountants are then officially CPAs and can work on audits as well as filing tax returns for individuals. They work closely with the internal auditors and share the goal of accurately and fairly portraying that company. External auditors need to maintain a healthy amount of professional skepticism, or a questioning mindset towards representations made by management and evidential matter gathered. Sufficient evidence must always be gathered because inquiry alone is never enough.

With annual audits come audit opinions. External auditors are required to issue an opinion based on the evidence gathered and analyzed. The four types of opinions are: unqualified, financial statements are in conformity of Generally Accepted Accounting Principles (GAAP); qualified, except for limited items, financial statement is in conformity with GAAP; adverse, financial statements are not in conformity with GAAP; disclaimer, auditors do not express an opinion.

Major public accounting companies typically performed external audits for most organizations. The opinion they did or did not give regarding the accuracy and fairness of an organization's financial statements allowed shareholders to decide how they wanted to invest in that company. However, these opinions were not always true, accurate, or fair because of many factors, including fraud.

2. The Enron Scandal

Enron, Corp. was a company with unbelievable growth and profits. With strong, persuasive, and money-hungry executives leading the way, Enron evidently fell because of financial statement fraud. At its best, Enron was trading at $90.75 per share. By the time they declared bankruptcy at the end of 2001, shares were worth $0.67 each (Investopedia: Enron Scandal Summary, 2017). Enron's collapse impacted the lives of countless employees and changed the way financial statements were presented forever. How Enron employees were able to pull this off still amazes people today. However, with off-the-books transactions and "aggressive" accounting, Enron fooled almost everyone into thinking that they were the best company to come along. Knowing what kind of company Enron was is the first step to understanding its ultimate demise.

2.1 What Was Enron

Enron Corporation was an energy company that resulted from a combination of two companies. Initially, Enron was just a gas provider. "Enron was founded in 1985 by Kenneth Lay in the merger of two natural-gas-transmission companies, Houston Natural Gas Corporation and InterNorth, Inc.; the merged company, HNG InterNorth, was renamed Enron in 1986. After the U.S. Congress adopted a series of laws to deregulate the sale of natural gas in the early 1990s, the company lost its exclusive right to operate its pipelines (Britannica, 2016). Enron acted as an intermediary between natural-gas producers and their customers, and by 1994 Enron began trading electricity. With strong leadership from executives like Kenneth Lay, Jeffrey Skilling, and Andrew Fastow, Enron was named *Fortune's* "America's Most Innovative Company" from 1996 to 2001 (Investopedia: Enron Scandal Summary, 2017).

2.2 Who Were the Key People Involved

The executive board of Enron Corporation was led by experienced leaders. First in line is founder Kenneth Lay. Information about Lay and his career at Enron follows: "Kenneth Lee Lay was born on April 15, 1942, in Tyrone, Missouri, and received both his bachelor and master degrees in economics from the University of Missouri. With the military draft at its highest level, Lay applied for Navy officer's candidate school and was accepted. He served in the U.S. Navy from 1968 to 1971 as an economist. In 1970, after earning a Ph.D. in economics at the University of Houston, Lay worked as an energy deputy undersecretary for the United States Department of

Interior until 1974. He then went to work for Exxon Corporation's predecessor, Humble Oil & Refining. In 1974, Kenneth Lay joined the Florida Gas Company, eventually serving as president of its successor company, Continental Resources Company. In 1981, he left Continental to join Transco Energy Company in Houston, Texas. Three years later, Lay joined Houston Natural Gas Co. as chairman and CEO. The company merged with InterNorth in 1985, and was later renamed Enron Corp. In 1986, Kenneth Lay was appointed chairman and chief executive officer of Enron" (Biography: Lay, 2016).

Jeffrey Skilling was appointed just below Lay. Working in the energy industry for the length of his career, Skilling's short biography follows: "Business executive Jeffrey Keith Skilling was born on November 25, 1953, in Pittsburgh, Pennsylvania. The second of four children, Jeffrey Skilling received his B.S. in applied science from Southern Methodist University in 1975 and his M.B.A. from Harvard in 1979. Upon graduation, he worked for McKinsey & Company in their energy and chemical consulting practices. In 1990, Skilling was hired away from McKinsey by Kenneth Lay to work at Enron Corporation. Skilling was named chairman and chief executive officer of Enron Finance Corporation and became the chairman of Enron Gas Services Company in 1991. In 1997, he was promoted to president and chief operating officer. In that capacity, Skilling pushed an aggressive investment strategy, helping make Enron the biggest wholesaler of gas and electricity, with $27 billion traded in a quarter. He was named CEO of Enron, replacing Lay, in 2001" (Biography: Skilling, 2014).

Andrew Fastow worked closely with Skilling and Lay. Former CFO of Enron, some more background on Fastow: "With a B.A., Chinese and economics, Tufts University, 1983; M.B.A., Northwestern University, 1986, Fastow Started his career at the Continental Bank in Chicago and moved to Enron in 1990. Named CFO in March 1998. Fastow reportedly came up with the innovative financing scheme that moved debts and assets off the books and into the Enron-related partnerships that the CFO had for his family, his neighborhood and even Star Wars characters. The company forced Fastow to resign on Oct. 24, 2001" (Forbes, 2002).

The large accounting firm Arthur Andersen was Enron's financial advisory and consulting for the length of its existence. Arthur Andersen was one of the "Big Eight" accounting firms which also included Arthur Young, Deloitte Haskins and Sells, Ernst and Whinney, Peat Marwick Mitchell, Price Waterhouse, Touche Ross, and Coopers and Lybrand. Arthur Andersen took care of Enron's tax work, auditing, and consulting and was led through by Richard Causey. A short biography about Causey follows: "Richard A. Causey was executive vice president and chief accounting officer of Enron. Previously, Mr. Causey was a managing director of Enron Capital & Trade Resources (ECT) with responsibility for the development of ECT's core retail energy products. Other areas of responsibility at ECT included accounting and risk management operations, as well as the leadership of treasury activities (capital markets, portfolio management and transaction evaluation). Mr. Causey was also a member of Enron's Management Committee. Before joining Enron, Mr. Causey was a senior manager with Arthur Anderson & Co. in Houston where he specialized in the natural gas industry. While at Arthur Anderson, he had primary responsibility for the Enron engagement as well as other natural gas pipeline and marketing clients" (APFN, 2002).

2.3 The Collapse of Enron

Enron had a humble beginning with a reported loss of $14 million in its first year in 1986 (Thibodeau and Freier, p. 178). However, with a strong stake in the energy business and involvement in three major stages of the supply chain of natural gas: production, transmission, and distribution, Enron began a series of cost-cutting actions, such as layoffs and selling assets to reduce debt. As previously mentioned, Enron was formed in the middle of huge regulation changes in the industry. With deregulation in process, the government hoped to create more transparent access to energy from energy companies. Enron began to adapt to this new industry policies in their own way.

This allowed Enron to engage in more risky business deals with gas companies. For example, "in 1988, Enron signed a 15-year contract with Brooklyn Union to supply gas to a plant being built in New York. Because Brooklyn Union was not connected to Enron's pipeline system, Enron needed to contract with another pipeline company to transport the gas to Brooklyn Union. Enron was therefore assuming added risks related to the transportation of the gas. The long-term nature of the contract was also risky because prices could rise to a level that would make the contract unprofitable" (Thibodeau and Freier, p. 178).

Enron recorded profits of the difference between the prices of how much they bought the gas for and how much they sold it for. However, it was becoming difficult to get more long-term contracts signed by gas producers. To help reduce this issue, Enron began giving these producers cash up front as opposed to payment over the life of the contracts. After completing these deals, Enron would then allow those negotiated contracts to be traded. This method of trading gas contracts would quickly become the outline which Enron would model each market it was involved in. Enron's new strategy proved to be an easy way to have very little assets on the books and to achieve its goal of, "achieving the advantages of a presence in the physical market without the disadvantages of huge fixed capital expenditures" (Thibodeau and Freier, p. 179). By slowly eliminating its ownership of gas pipelines, Enron was able to expand in other places. Enron looked internationally to start more projects. In 1993, Enron established the Enron International division with facilities in Europe, Africa, the Middle East, India, China, and Central and South America, which did not adhere to the same strategies that were following in the U.S. Another area which facilities grew into was the broadband network, which is the use of fiber optics to transmit audio and video.

As Enron continued to expand and change its business model, it began to change its accounting procedures. One example of a change is the establishment of multiple special purpose entity. A special purpose entity is, "an entity – partnership, corporation, trust, or joint venture – created for a limited purpose, with limited activities and a limited life. A company forms an SPE so outside investors are assured that they will only be exposed to only the risk of the SPE and its particular purpose, such as building a gas pipeline, and not the risks associated with the entire company. In addition, SPE also protects the investment of outside investors by giving them control over its activities" (Thibodeau and Freier, p. 180).

Special purpose entities also allowed companies to separately report assets and liabilities of the SPE and the main corporation, and it could record gains and losses from transactions of the SPE. Two conditions had to be met in order for this recognition to take place: “an owner independent of the company had to own a ‘substantive’ equity interest (at least 3 percent of the SPE’s assets, and that 3 percent remain at risk through the transaction), and the independent owner had to exercise control of the SPE” (Thibodeau and Freier, p. 180). This regulation was specifically controversial because most consolidation rules required a standard of 50 percent indirect or direct ownership in order to record any gains or losses. Therefore, this deregulated standard made it easier for companies to use SPEs for fraudulent purposes, such as hiding debt by keeping it off of the organization’s balance sheet and putting it on the SPEs balance sheet.

Enron quickly took advantage of this new standard with the formation of an SPE with the California Public Employees Retirement System (CalPERS) in 1993. The $500 million 50-50 partnership was named Joint Energy Development Investments Limited (JEDI) allowed Enron not to consolidate the partnership with Enron’s own financial statements because they did not have over 50 percent ownership. “In 1997, Enron offered to buy out CalPERS’s interest in JEDI. To maintain as an unconsolidated entity, Enron needed to identify a new limited partner” (Thibodeau and Freier, p. 180). Chief Financial Officer Andrew Fastow decided to create a new SPE called Chewco Investments. Chewco would have a majority of its equity investments come from third-party investors. However, Chewco was unable to obtain outside equity, so it had a new structure. A $250 million unsecured loan from Barclays Bank (guaranteed by Enron), a $132 million advance from JEDI to Chewco through a revolving credit agreement, and $11.5 million (approximately 3 percent) in equity from Chewco’s general and limited partners made up Chewco’s capital structure.

Chewco’s general partner was Michael Kopper, an Enron employee who reported directly to Fastow. The explanation of the limited partner of Chewco was a bit more complicated. An entity called Big River Funding, LLC, was the limited partner for Chewco; however, they only had one member which was an entity called Little River Funding LLC. “Kopper had invested $115,000 in Big River and $10,000 in Little River but transferred these investments to William Dodson. As such, Kopper technically had no interest in Chewco’s limited partner. The remaining $11.4 million was provided by Barclays Bank in the form of equity loans to Big River and Little River” (Thibodeau and Freier, p. 181). Essentially, a majority of the funding for this SPE deal was from Barclays Bank. Because of this complicated transaction, Enron’s auditor Arthur Andersen required that Enron provide all documentation regarding the Chewco transaction.

Andersen received little documentation from Enron regarding the Chewco transaction. Among what they did receive included confirmation regarding the loan agreement from a Chewco representative. Andersen then requested that Enron provide documents related to the structure and formation of Chewco. However, Enron told Andersen, “that it did not have these documents and could not obtain them because Chewco was a third party with its own legal counsel and ownership independent of Enron” (Thibodeau and Freier, p. 182). When Andersen reviewed these documents, they decided that Chewco should have been consolidated with Enron’s financial statements because there was not enough outside equity. Therefore, a retroactive consolidation of Chewco caused a decrease in Enron’s net income: $28 million out of $105 million total in 1997, $133 million out of $703 million total in 1998, $153 million out of $893 million total in 1999, and $91 million out of $979 million total in 2000 (Thibodeau and Freier, p. 182).

As Enron continued to change their structure with SPEs, they also lobbied the SEC regarding the use of mark-to-market (MTM) accounting. Wanting to use this method for its trading business, MTM, "allowed the present value, rather than the actual value which was used in its original natural gas business, of a stream of future inflows and expenses under a contract to be recognized as revenues and expenses, respectively, once the contract was signed" (Thibodeau and Freier, p. 183). The SEC's chief accounting Walter Sheutz allowed Enron to use this method in the first quarter of its fiscal year ended December 31, 1992. He emphasized that this method was only to be used in Enron's natural gas trading business. In response to the SEC, Enron's CFO at the time, Jack Tompkin, wrote back, "Enron has changed its method of accounting for its energy related, price-risk management activities effective January 1, 1991… the cumulative effect of initial adoption of mark-to-market accounting, as well as the impact on the 1991 earnings is not material" (Thibodeau and Freier, p. 183).

The first contract which Enron used MTM accounting with was an agreement for Enron to supply Sithe Energies with 195 million cubic feet of gas per day for 20 years for a plant that Sithe Energies was planning to build in New York. The value of this gas was estimated at $3.5 to $4 billion. Before MTM, Enron would have recorded the actual costs and actual revenues. However, using MTM meant that once Enron and Sithe Energies signed this contract, Enron could book the present value of both the expenses and revenues. Any change in value was recognized as an additional income or as a loss. The SEC had only allowed Enron to use this method for one area of their business: natural gas for contracts. Enron decided it would use this method for all areas of their business. Two instances illustrate their use of MTM accounting: "Enron signed a 15-year $1.3 billion deal to supply electricity to Eli Lilly. Enron calculated the present value of the contract at more than $500 million and recognized this amount as revenue… Enron signed a 20-year agreement with Blockbuster Video in July 2000 to introduce entertainment on demand. Enron set up pilot projects in Portland, Seattle, and Salt Lake City to store the entertainment and distribute it over its broadband network. Based on these pilot projects, Enron recognized estimated profits of more than $110 million for the Blockbuster deal" (Thibodeau and Freier, p. 184).

In order to account for these transactions, Enron had Arthur Andersen as their external auditor. However, Andersen had also been performing Enron's internal audit function since 1993. Enron was very dependent on Andersen and had fees for auditing, business consulting, and tax work for $48.6 million in 1999, $58 million in 2000, and over $50 million in 2001. It is safe to say that Enron was one of Andersen's largest clients. The SEC tried to step in to reform the industry practice of an audit firm also providing consulting and tax services. Enron's Chair and CEO Kenneth Lay sent a letter to SEC Chair Arthur Levitt saying, "While the agreement Enron has with its independent auditors displaces a significant portion of the activities previously performed by internal resources, it is structures to ensure that Enron management maintains appropriate audit plan design, results assessment, and overall monitoring and oversight responsibilities… Enron has found its 'integrated audit' arrangement to be more efficient and cost effective than the more traditional roles of separate internal and external auditing functions" (Thibodeau and Freier, p. 185).

Andersen employees relied on their ability to sell other services to their clients to receive individual compensation. This meant that non-audit services provided to Enron had a huge impact on the salary for the lead Andersen partner. David Duncan, the lead Andersen partner, and Richard Causey, Enron's Chief Accounting Officer, developed a very strong relationship and worked together a lot. Causey, having previously worked at Andersen after moving to Enron in 1991, had continuously hired Andersen accountants, some having made their way to executive positions. Even with an office in Houston, Andersen insisted on having an entire floor in Enron's building in Texas. Duncan enjoyed this close relationship with his client because of his ability to serve his client better. Some Andersen accountants recalled how they felt while working at the Enron building: "We basically do the same types of things… we're trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron; Being here full-time, year-round day-to-day gives us a chance to chase the deals with them and participate in the deal making process" (Thibodeau and Freier, p. 186). Andersen and Enron had a very close relationship and often went on company trips together to go skiing, had parties at work, and played fantasy football on each other's computers.

Enron continued their method of creating SPEs, and in 1999, Enron's CFO Fastow spoke to Duncan about a plan to create another SPE called LJM to finance a vehicle used to access capital or increase leverage without adding debt to a firm's balance sheet. Duncan was unable to come to a conclusion after reviewing the necessary documents, and he asked for the advice from a professional standards group (PSG). Benjamin Neuhasen represented the PSG and emphasized his disapproval in an email to Duncan on May 28, 1999, "Setting aside accounting, (the) idea of a venture equity managed by CFO is terrible from a business point of view… Conflicts of interest galore. Why would any director in his or her right mind ever approve such a scheme?" (Thibodeau and Freier, p. 186). The PSG continued to disagree with this method of accounting, but Duncan reported to Fastow that Andersen would approve of the creation of the new SPE based on a few conditions: receiving the approval from Enron's CEO and its board of directors.

Carl Bass became the new representative of the PSG in December 1999 and he agreed with Neuhasen's opinion. Bass wrote to his boss John Stewart, "This is a big item and the team apparently does not want to go back to the client on this. I think at a minimum the Practice Director needs to be made aware of this history and our opposition to the accounting" (Thibodeau and Freier, p. 187**).** Even after this email was sent, Bass's opposition remained ignored by Duncan. Later in 2000, Bass went to Duncan again for some advice on how to account for some Enron SPEs. Enron wished to lump together the financial results from each of the four entities in the SPE called Raptors, but Bass disagreed. However, when Bass repeated his opposition to Duncan, Duncan continued to ignore Bass and decided that Andersen would, "accept the client's position with some modifications" (Thibodeau and Freier, p. 187). In early 2001, an annual risk assessment meeting was held by Andersen in order to determine whether or not to keep Enron as a client. After some partners voiced their concerns regarding, "how much debt Enron was not putting on its balance sheet, Fastow's conflict of interest, and the lack of disclosure in the company's financial footnotes," Duncan reiterated that there were no issues (Thibodeau and Freier, p. 187).

Interestingly, Bass was removed from the Enron account in March 2001. In an email to his boss, Bass wrote, "'Apparently, part of the process issue stems from the client (Enron) knowing all that goes on within our walls on our discussions with respect to their issues… we should not be communicating with the client that so and so said this and I could not get this past so and so in the PSG… I have also noted that on this engagement that the question is usually couched along the lines 'will the PSG support this?' When a call starts out that way, it is my experience that the partner is struggling with the question and what the client wants to do'" (Thibodeau and Freier, p. 188). Just after this email, Bass's boss reached out to a senior partner and complained about Bass's removal. The reasoning for Bass's removal seemed uncanny: Duncan later called and explained that Enron executives Richard Causey and John Echols really pushed for Bass's removal.

2.4 The Effect

Just before Bass was removed from the Enron account, Enron went under a huge executive change in February 2001. Kenneth Lay announced his retirement and appointed Jeffrey Skilling as CEO. Skilling readily took the reins: "In February Skilling held the company's annual conference with analysts, bragging that the stock (then valued around $80) should be trading at around $126 per share" (Journal of Accountancy, 2002). Shortly after Skilling assumed the CEO position, Enron called off a deal it had with Blockbuster. By the time March came around, Enron stock had fallen to the mid-$60s (Journal of Accountancy, 2002). As if things were no getting bad enough, Enron the spring and summer brought more news of Enron's shortcomings because of poor performances in risky deals. This evidently led to a cash shortage, which signaled to senior management that things were not looking good. Eventually, "Senior management, which had been voting with its feet since August 2000, selling Enron stock in the bull market, continued to exit, collectively hundreds of millions of dollars richer for the experience" (Journal of Accountancy, 2002). Two major turning points for Enron occurred in August: after being appointed CEO just 6 months prior, Skilling resigned from the position for "personal reasons," and an Enron employee brought to the attention of a Vice President the danger that Enron was in. "In an internal memorandum to Lay, a company vice-president, Sherron Watkins, described her reservations about the lack of disclosure of the substance of the related party transactions with the SPEs run by Fastow. She concluded the memo by stating her fear that the company might "implode under a series of accounting scandals." Lay notified the company's attorneys, Vinson & Elkins, as well as the audit partner at Enron's auditing firm, Arthur Andersen LLP, so the matter could be investigated further" (Journal of Accountancy, 2002). A few months later, Enron underwent many changes which were huge red flags.

Within one week in October 2001, Enron was truly at the end of its course. On October 16, Enron announcing its first quarterly loss because of poorly performing business which caused a $1 billion charge. On this same day, Enron, "disclosed the reversal of the $1.2 billion entry to assets and equities it had made as a result of dealings with these arrangements. It was this disclosure that got the SEC's attention" (Journal of Accountancy, 2002). Just one day later, Enron announced that it would be changing its employee's 401(k) plans, therefore making it impossible for employees to sell their Enron stock because of locking the investments for 30 day periods. This event caught the attention of investors and solidified suspicions of Enron's true status. To top off such a big week for Enron, the company announced that the Securities and Exchange Commission (SEC) was investigating transactions between the company and the partnerships owned by Fastow, who was fired just 2 days earlier. Shortly after, "On November 8

Enron announced a restatement of its financial statements back to 1997 to reflect consolidation of the SPEs it had omitted, as well as to book Andersen's recommended adjustments from those years, which the company had previously 'deemed immaterial.' This restatement resulted in another $591 million in losses over the four years as well as an additional $628 million in liabilities as of the end of 2000. The equity markets immediately reacted to the restatement, driving the stock price to less than $10 a share" (Journal of Accountancy, 2002). With a pending merger with competitor Dynergy scheduled for November 9, Enron continuously sunk in value, causing Dynergy to rescind its offer because of Enron's lack of balance sheet disclosures. With a final push burying Enron, the company filed for Chapter 11 bankruptcy on December 2, 2001. Chapter 11 bankruptcy can be defined by: "generally filed by corporations that require time to restructure their debts, and it gives the debtor a fresh start, subject to the debtor's fulfillment of his obligations under the plan of reorganization" (Investopedia: Chapter 11, 2017).

The SEC quickly responded to Enron's collapse; however, it was characterized as too little, too late. On December 11, SEC chairman Harvey Pitt gave his opinion in a piece in the Wall Street Journal stating, "the current outdated reporting and financial disclosure system the financial 'perfect storm…' under the current quarterly and annual reporting system, information is often stale on arrival and mandated financial disclosures are often 'arcane and impenetrable'" (Journal of Accountancy, 2002). In an effort to reassure investors and to restore confidence in financial reporting, Pitt called for a response from CEOs of large and regional accounting firms to work together to achieve the following goals (Journal of Accountancy, 2002):

- A system of "current" disclosures, supplementing and updating quarterly and annual information with disclosure of material information on a real-time basis.
- Public company disclosure of significant current "trend" and "evaluative" data in addition to historical information.
- Identification of "most critical accounting principles" by all public companies in their annual reports.
- More timely and responsive accounting standard setting on the part of the private sector.
- An environment of cooperation between the SEC and registrants that encourages public companies and their auditors to seek advice on disclosure issues in advance.
- An effective and transparent system of self-regulation for the accounting profession, subject to SEC's rigorous, but nonduplicative, oversight.
- More proactive oversight by audit committees who understand financial accounting principles as well as how they are applied.

Arthur Andersen was also taking a lot of heat from the SEC because of its involvement in Enron's downfall. When there was word that the SEC was looking into investigating Enron and its financial statements, Andersen partners and Enron executives decided that the best way to deal with the issue was to shred thousands of documents and emails pertaining to the financial reporting and accounting methods of Enron and Andersen. In a Wall Street Journal article from January 16, 2002, reports recounted the description given by Andersen:

> "Andersen said in its statement: 'The effort [to destroy documents] was initiated following an urgent meeting the lead partner called on Oct. 23 to organize the expedited effort to dispose of Enron-related documents. This meeting occurred shortly after the lead partner learned that Enron had received a request for information from the [Securities and Exchange Commission] about its financial accounting and reporting. This effort was

> undertaken without any consultation with others in the firm and at a time when the engagement team should have had serious questions about their actions. Nothing in an Oct. 12 e-mail, almost two weeks earlier, or so far as we know, other conversations around that time, authorized this activity.' The firm added that the document destruction 'appears to have ended shortly after the lead partner's assistant sent an e-mail to other secretaries on Nov. 9 -- the day after Andersen received a subpoena from the SEC -- telling them to 'stop the shredding.'' By that time, huge volumes of e-mails and written documents had been destroyed. Andersen said, 'These activities were on such a scale and of such a nature as to remove any doubt that Andersen's policies and reasonable good judgment were violated'" (Brown et al, 2002).

From beginning and growing into one of the nation's largest accounting firms, Andersen began to battle more and more civil suits prior to the Enron scandal. However, after pleading guilty to being involved in shredding and falsifying of Enron's financial statements, Andersen voluntarily ceased operations in August 2002. Because Andersen was responsible for the audits of over 2,000 public companies, its collapse would wreak havoc on the rest of the major accounting firms, known as the Big Five, which consisted of Pricewaterhouse Coopers, Deloitte, KPMG, and Ernst & Young (ABC News, 2002).

3. The Response from the Accounting World

The Enron scandal not only impacted the lives of ex-employees from both Enron and Andersen, but also forced a change within the accounting world and how financial reporting is now conducted by public accounting firms. This, along with other major corporate frauds which were committed by organizations such as WorldCom and Tyco, prompted the creation of the Sarbanes-Oxley Act of 2002 by Senator Paul Sarbanes and Representative Michael Oxley in order to cut down the occurrence of corporate fraud.

3.1 What is the Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was created as a response to the increase in corporate fraud that was being committing in the 1990s and early 2000s. This act that was passed by Congress aims as protecting investor's and their money by:

- "closing loopholes in recent accounting practices
- strengthening corporate governance rules
- increasing accountability and disclosure requirements of corporations, especially corporate executives, and corporation's public accountants
- increasing requirements for corporate transparency in reporting to shareholders and descriptions of financial transactions
- strengthening whistle-blower protections and compliance monitoring
- increasing penalties for corporate and executive malfeasance
- authorizes the creation of the Public Company Accounting Oversight board to further monitor corporate behavior, especially in the area of accounting" (Peavler, 2017).

Another important change which SOX implemented was a yearly report on internal controls within the company in an effort to reduce collusion between the company and the auditors.

Finally, SOX also addresses requirements for information technology (IT) regarding electronic records. SOX does not have set business practices for IT but instead, “defines which company records need to be stored on file and for how long. It does not specify how a business should store its records, only that the IT department is responsible for storing them, according to standards outlined in the SOX Act” (Investopedia: Sarbanes-Oxley Act of 2002, 2015).

There are two key provisions within SOX that deal with security regulations and financial reporting. The first, SOX Section 302 titled Corporate Responsibility for Financial Reports, deals with senior management certifying the validity of the financial statements of that company. In summary from the SEC website documentation of SOX, Section 302 requires that the executive officers of the company or organization certify that the signing officer has reviewed the report, has read the report and understood that there is not any, “untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading,” and that the report fairly represents the company (SEC: Sarbanes Oxley Act of 2002, 2002). In addition, Section 302 also outlines the responsibilities of the signing officers by stating that they are responsible for maintaining and implementing internal controls, have created effective internal controls to detect any material information within that reporting period, have properly evaluated those internal controls, have reported on the effectiveness of those internal controls based on their evaluation, and have reported on a significant changes within the company’s internal controls or any changes that would impact the company’s internal controls including any report of deficiencies and material weaknesses (SEC: Sarbanes Oxley Act of 2002, 2002). The second, SOX Section 404 titled Management Assessment of Internal Controls, addresses the necessity of internal controls within a company along with a report evaluating the effectiveness in the annual report. In summary, a company must have internal controls and must report on those internal controls. The report must address the responsibilities of management to maintain the proper internal controls structure and procedures for financial reporting, supply an assessment of those internal controls and how effective they were for that reporting period, and the public accounting firm that is auditing that company must also report on the company’s internal controls and its effectiveness (SEC: Sarbanes Oxley Act of 2002, 2002).

These two sections are important to stopping fraud in other major ways. Firstly, SOX created a new level auditing regulators: the PCAOB, or the Public Company Accounting Oversight Board. The PCAOB is, “a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The PCAOB also oversees the audits of brokers and dealers, including compliance reports filed pursuant to federal securities laws, to promote investor protection” (PCAOB, 2017). The PCAOB’s main job is to make sure that the firms that are auditing a company are not also doing consulting business as well. This allows the auditing firm to remain independent and therefore increase compliance with the standards defined in SOX. Another way that sections 302 and 404 limit fraudulent behavior is through the standard of having an independent auditor review and report on the company’s internal controls. By having the internal auditing department working with the external auditors, compliance is increased. Finally, SOX provides protection for whistleblowers. In the Enron scandal, it is hard to believe that no one wanted to or tried to stop the fraud from occurring. If they had security from the possibility of being fired or ostracized, things may have turned out differently. SOX protects, “employees that report fraud and testify in court against their employers. Companies are not allowed to change the terms and conditions of their employment. They can't reprimand, fire or blacklist the employee” (Peavler, 2017).

3.2 The Positives of Sarbanes-Oxley

Because of the large implementations that occurred from SOX, the corporate world changed a lot. What once was an environment with little internal checks and balances is now a setting which emphasizes fact checking, accuracy, and transparency. Investors have access to so much more financial information regarding the companies and organizations that they invest in. However, because of the requirement of internal controls, independent external auditors, and protection of employees and whistleblowers, there has been some backlash from the implementation of SOX.

One major provision from the adoption of SOX in the corporate world is the role that auditors play in a company. Independence between the auditor and the company being audited is regarded as most important and therefore leads to restrictions for the auditor. An auditor is not allowed to provide a client with consulting and non-audit work simultaneously: “Bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible” (Bumgardner, 2010). Another regulation which increases auditor independence is the SEC requiring that the lead audit partners for a company switch every five years so that the possibility of fraud is decreased.

A group which gained more power from the passing of SOX is the audit committee. An audit committee is, “an operating committee of a company's board of directors that is in charge of overseeing financial reporting and disclosure. All U.S. publicly-traded companies must maintain a qualified audit committee in order to be listed on a stock exchange. Committee members must be made up of independent outside directors, including a minimum of one person who qualifies as a financial expert” (Investopedia: Audit Committee, 2010). The audit committee has new duties including, “pre-approve numerous audit and non-audit services, although in many instances they may do so by putting in place policies and procedures to be followed rather than actually reviewing each decision. Auditors must communicate to the audit committee all ‘critical accounting policies’ and any discussions of ‘material accounting alternatives’ that may affect how results are reported” (Bumgardner, 2010).

CEOs and directors have a larger responsibility to not only the company, but also to its investors. Requiring that executives certify the accuracy of financial reports creates a larger punishment for those CEOs who do not do so. For example, if an executive knowingly certifies false reports, they are subject to up to 10 years in prison, and up to 20 years if an executive willfully certifies false reports (Bumgardner, 2010). Basically, SOX makes it more difficult for those executives who had committed securities law violations previously to be in that position at another company.

The increased cost that companies are facing can be attributed to the increased time and effort required to meet the SOX regulations. Although this may seem like auditors are doing this just for more money, “investors should welcome the increased scrutiny of financial statements. Anything that puts the auditor into a more inquisitive, independent mode will increase investor confidence in the capital markets” (Ciesielski and Weirich, 2006).

Additionally, a past PCAOB board member, Steven Harris, discussed the reasons why SOX should not be repealed. Among reasons previously stated, Harris emphasized one major positive, “It restored investor confidence. The Sarbanes-Oxley Act was not just a response to Enron despite the failures its collapse exposed. As the Los Angeles Times reported January 26, 2002, less than two months after Enron filed for bankruptcy: ‘There was a total failure by everyone, a complete breakdown in the system, in all the checks and balances. It was a failure by Wall Street analysts who just went along for the ride, and by the auditors who were collecting so much money they couldn't walk away from it, and by government agencies who are supposed to monitor those companies…’ In July 2002 alone, the Dow dropped over 15 percent. And between the time the House passed its bill in April and the Senate acted in July, the Dow declined almost 23 percent, or over 2,000 points. If nothing else, the Sarbanes-Oxley Act stopped cold the stock market hemorrhage at the time” (Harris, 2012).

With some opponents of SOX stating that the increased regulations would increase companies leaving the U.S economy, proponents have a different perspective. A contributor to a LexisNexis website reflects, “The Act’s critics also have contended that the Act would ‘increase the marginal cost of being a U.S.-registered public company more than the benefits of the status,’ which in turn, it was predicted, would lead to more companies going private or going dark, fewer companies going public, and loss of listings to exchanges outside of the U.S. However, the authors found that the research to date showed that ‘while smaller, less liquid and more fraud-prone firms did indeed exit U.S. stock markets after SOX,’ the evidence that SOX reduced the number of IPOs is ‘weak at best, and is offset by evidence that IPO pricing improved.’ The firms that have gone private or gone dark typically are very small, with market capitalizations generally under $30 million, and in fact going private trends in the U.K. ‘were similar to those in the U.S. after SOX’” (LaCroix, 2014). The author goes on to discuss the general criticism of upper management being opposed to changing their ways in order to adopt the regulations SOX outline: “The authors also found that the results of various surveys about SOX stand in interesting contrast to the frequent criticisms of the Act. The authors found after a review of various surveys of corporate officials and investors that ‘contrary to the vehement criticisms of SOX,’ the views of SOX among those most affected by its provisions ‘has been far more nuanced, even receptive,’ producing among other things a higher level of confidence in companies’ financial reporting” (LaCroix, 2014).

Although the initial cost of structuring a company for SOX compliance may be more costly than expected, public accounting firms which audit those companies have come up with way that make it simpler to ensure those regulations are being met. For example, the Big Four accounting firm PricewaterhouseCoopers has outlined what they describe the “five attributes of SOX excellence: Improved quality – of the overall program and Internal Controls over Financial reporting, in line with most recent regulatory expectations; Reduced level of effort – by balancing cost through conscious decisions around strategy, structure, people, processes and technology; Enhanced reliability – increasing the use of management's work by the independent auditor from enhanced competence and objectivity of testing; Increased alignment – of organizational governance, risk and compliance efforts; Talent redeployment – from compliance activities to more strategic business priorities" (PwC, 2017). By applying this method to their clients and their financial statements, PwC aims at making the transition, or continuously applying SOX regulations smooth for each of their clients.

3.3 The Negatives of Sarbanes-Oxley

There are many critics of SOX and how it has changed the corporate world. A contributor to the website *MarketWatch* explains why he believes it should be exterminated in an article from 2007: "I tell people that Sarbanes-Oxley should be called by its real name, 'The public accountant and auditor's protection act of 2002…' Well the fallout from MCI and Enron and other companies showed that the auditors were apparently not doing their jobs well enough to prevent the mishaps. Sarbanes-Oxley keeps them from getting in trouble by mostly taking them out of the loop they are supposed to monitor" (Dvorak, 2007).

The biggest negative with the passing of SOX in 2002 is in the increased cost which companies must pay to receive accounting services from firms. Recounted from a CPA Journal Article, some initial cost changes within the first few years SOX which were being implemented are explained below:

- "Between 2001 and 2004, total audit and audit-related fees increased 103% for 496 of the S&P 500 companies. The fees increased 41% in 2004 alone. (Throughout this article, only 496 of the S&P 500 companies' audit fees were examined. Four entities—Fannie Mae, Freddie Mac, Interpublic, and News Corporation—were excluded due to a lack of available 2004 information.)
- Fees for tax services that auditors provided to their clients increased 28% over the same timeframe; however, total tax-related fees have decreased each year since 2002. All other fees, which formerly included fees for financial reporting systems and design engagements (now prohibited), dropped from about $2.3 billion in 2001 to about $100 million in 2004. Audit fee increases made up the difference.
- Smaller companies in the S&P 500 had the bigger percentage change in audit fees. Audit fees as a percent of revenues have increased, but not to a great degree. For the 50 companies demonstrating the biggest effect, the median increase in the ratio was only 17% between 2001 and 2004.
- Expressed as an after-tax per-share amount, audit fees were $0.03 or less per share for 93% of the firms in the S&P 500. The average 2004 audit fee for S&P 500 companies has more than doubled since 2001. Over the same timeframe, audit fees have increased to 82% of auditors' total fees (41% in 2001). Clearly, auditing firms are doing more auditing work than before" (Ciesielski and Weirich, 2006).

More recent information regarding how audit fees have changed over time provide us with a better understanding of how SOX has changed the corporate world after 10 years of being implemented. With economical events, such as the recovery from the 2008 recession, along with business mergers and acquisitions, SOX has had to undergo some alterations and additions in order to move along with the changing business world. Nevertheless, a similar complaint regarding how SOX has changed corporations nation-wide remains the same: increased cost. The Journal of Accountancy explains how these numbers have increased, “More than one-third (38%) of companies reported that SOX compliance costs rose year-over-year in 2012, while just one in 10 said these costs decreased. But companies said on average that the costs for SOX compliance are not extraordinarily high relative to the objective of quality financial reporting through improved internal controls” (Tysiac, 2013). In order to meet these compliance regulations, companies are altering the way that they conduct their processes so that they can increase effectiveness and eventually drive down costs.

A contributor to *Forbes* also aired his opinion in an article from 2008. He explains that SOX is unnecessary, harmful, and inadequate, “Unnecessary--because the stock exchanges had already implemented most of the SOX changes in the rules of corporate governance in their new listing standards, the Securities and Exchange Commission (SEC) had full authority to approve and enforce accounting standards, the requirement that CEOs certify the financial statements of their firms and the rules for corporate disclosure…Harmful--because SOX substantially increases the risks of serving as a corporate officer or director, the premiums for directors and officers liability insurance and the incentives, primarily for foreign and small firms, not to list their stock on an American exchange. The ban on loans to corporate officers eliminates one of the more efficient instruments of executive compensation. And SOX may also reduce the incentive of corporate executives and directors to seek legal advice…Inadequate--because SOX failed to identify and correct the major problems of accounting, auditing, taxation and corporate governance that have invited corporate malfeasance and increased the probability of bankruptcy” (Niskanen, 2008). Later in the article, the author states that Congress should at least clarify the criminal penalties underlined in SOX as well as getting rid of the PCAOB and, “amending SOX to shift the authority to select, monitor and compensate the independent public auditors from the audit committee of the corporate board to the stock exchange on which the corporation is listed” (Niskanen, 2008).

Another critic of SOX discusses the inconveniences faced by the international business world. A contributor to *The CLS Blue Sky Blog* states in a piece written in February 2017, “As a result, multinational groups listed on U.S. stock exchanges find themselves in an unenviable position: On one hand, they are required to set up specific whistleblowing procedures in their establishments located outside the United States, but, on the other hand, they also need to comply with local legislation and be sensitive to cultural differences that may exist. This is no easy feat, as there are potential conflicts between Sarbanes-Oxley and foreign law (such as EU data protection and privacy legislation)” (Lanois, 2017). Because of the increased regulations for public companies, many companies opted to moving to the private sector in order to avoid rules outlined in SOX. In fact, “In 2003 and 2004, over 300 U.S. companies deregistered their common stock for reasons other than a merger, acquisition, liquidation, registration withdrawal, or going-private transaction. Large foreign issuers, such as Porsche of Germany and Daiwa and Fuji Photo Film of Japan, have cited Sarbanes-Oxley’s compliance costs as their reason for abandoning plans to list on U.S. exchanges” (Lanois, 2017).

A final critic of SOX can be found referencing reformations suggested by President Barak Obama from 2011. Two contributors to a law forum voiced their opinions on the 15-year anniversary of SOX being passed, “The concept of reducing regulatory barriers created by SOX is buried in President Barack Obama's Council on Jobs and Competitiveness 2011 Interim Report: 'Regulations aimed at protecting the public from the misrepresentations of a small number of large companies have unintentionally placed significant burdens on the large number of smaller companies'" (Ingles and Gonzalez, 2017). The pair elaborates the business environment for companies wanting to expand and grow has been anything but favorable because of regulations outlined in SOX. With another reference to the 2011 Interim Report, there is one direct proposal to amend SOX: "Amend Sarbanes-Oxley (SOX) to allow shareholders of public companies with market valuations below $1 billion to opt out of at least Section 404 compliance, if not to all of the requirements, of Sarbanes-Oxley; or, alternatively, exempt new companies from SOX compliance for five years after they go public" (Ingles and Gonzalez, 2017). Congress has begun to explore revisions to SOX with one major push in an act called the Financial Choice Act. Provisions within the Financial Choice Act directly aim at SOX Section 404 requirements: "The current SOX regulations exempt public companies with a market capitalization of less than $75 million from SOX 404. The current version of the Choice Act has raised that threshold anywhere from $250 million to $500 million" (Ingles and Gonzalez, 2017).

In conclusion, most critics agree that SOX has overstepped its boundaries and has imposed regulations that are no longer necessary. In a current economic environment with the U.S experiencing a decrease in big businesses establishing themselves on U.S soil, opponents argue that altering the regulations outlined in SOX to better-suit the present business world. However, looking at the positives which SOX brings, such as increased investor confidence and another layer of check and balances within financial reporting, arguing against it becomes more difficult.

4. My Opinion

After reviewing and understanding the basics of fraud, how the Enron scandal unfolded, how the accounting world reacted to this scandal, and the positives and negatives of the Sarbanes-Oxley Act of 2002, a few things can be observed. With the opportunity for an employee to commit fraud being so common from examples such as poor upper management, an aggressive financial reporting attitude in a company, or unreliable and ineffective controls, deregulation within the business world only fueled a fraudulent company from committing crimes.

A question I would like to explore is who's fault really was it: Enron's or Arthur Andersen's? Analyzing the downfall of Enron because of its faulty structure and sleazy upper management would initially lead to one concluding that it is solely Enron's fault for its collapse. As a public company with thousands of investors, Enron had a duty to its employees, its shareholders, and to the business world to accurately depict its financial standings. Once its demise became public knowledge and the SEC became involved in an investigation, all trust was lost. Even if someone came forward with information about Enron and its financial reporting fraud, there were little to no protection for whistleblowers, and in an international company with large amount of pressure felt by everyone, one can only imagine the damage that could have been done if someone did step forward. This threatening and bullying atmosphere which encompassed Enron forced everyone to be on board, even if everyone did not agree. On the other hand, Arthur Andersen also had a duty to Enron and to the public.

As a public accounting company that completes audits for public companies, Andersen had its own duties to uphold. As stated previously, auditors provide reasonable assurance that a company's financial statements accurately and fairly represent the company. Because Andersen was so involved with Enron, there was barely any independence maintained which caused collusion among the two corporations. This collusion, along with Enron being one of Andersen's biggest clients, created pressure to "make the numbers right" and to go with what the Enron employees were doing instead of questioning their practices with professional skepticism. Andersen's kiss of death was when the firm decided to handle the SEC investigation by shredding and deleting thousands of Enron documents and electronic documents. Although they thought that they were getting themselves out of a hole, they were only burying themselves deeper.

Ultimately, I believe that Andersen is more responsible for the downfall of Enron than Enron is. Although Enron failed its duties by committing fraud years, lying to investors and to the public, and a toxic work environment that only awarded sleazy behavior, Arthur Andersen completely disregarded its duties as an auditor. If Andersen had done its job as an auditor and had refused to give an opinion (disclaimer) on Enron's financial statements because of insufficient evidence and false information, Enron would have been the only company to fall instead of both Enron and Andersen. Because of the actions of both Enron and Andersen, a dramatic increase in regulations for both public companies financial reporting and for public accounting firms.

In the early 2000s, SOX had to be created. The increase in financial statement fraud and the lack of action from auditors gave a reason for the formation of Sarbanes-Oxley and the PCAOB. Now, over 15 years after those frauds were committed, the business world has changed so much. Although there is some opposition towards the PCAOB, I believe it should remain as a checks and balances for auditors and public companies. The PCAOB has successfully grown and adapted with the economy to guide companies towards transparency and honesty. However, I do agree with some of the support towards repealing SOX.

Because so many public companies have now either gone private or have established their grounds in another country in order to avoid the regulations SOX imposes, I believe that business men and women are completely discouraged to establish themselves as an American company. Corporations are not only avoiding establishment in the U.S because of SOX, but also because of the decreased tax rates in most other countries. Bringing some of those big corporations back to America may be happening soon. President Trump recently proposed reducing the corporate tax rate from 35% to 20%. This dramatic cut will definitely entice current and future business owners to establish themselves in America; however, the audit fees associated with being a public company are not decreasing anytime soon. Therefore, I think the money that would not be spent in taxes would just be spent in audit fees for public companies moving to America, and those companies moving back to the U.S. may not be saving any money.

In conclusion, going through a detailed description of what fraud is, how Enron fell, how Arthur Andersen was involved, why Sarbanes-Oxley was created, and how it has impacted the business world has allowed me to better understand the relationship between companies and their auditors. For now, I believe that SOX has been beneficial in creating more regulations and the PCAOB for an emphasis on transparency in financial reporting. In a speech made in September 2013 by Andrew Ceresney, Co-Director of the Division of Enforcement, he discusses the decrease in the number of fraud cases and financial statements being restated per year: "in FY2012, we opened 124 financial fraud/issuer disclosure investigations compared to 304 in FY2006 and 228 in FY2007. As for accounting fraud cases, we saw a reduction here as well: we filed 79 financial fraud/issuer disclosure actions in FY2012 compared to 219 in FY2007…Another trend we have seen over the last few years is a reduction in restatements. So for example, across all public companies, restatements fell from a peak of 1,771 in 2006 to 768 in 2012" (Ceresney, 2013). Although the cost of being audited is high, receiving an unqualified opinion from an audit firm provides investors with a confidence to continue to believe in that company. It also provides the employees in the company to have pride for working at a company that meets or exceeds those standards set by the SEC and the PCAOB. Public accounting firms are working longer and harder in order to increase the efficiency in their work to drive down their cost, but this will take time. Sarbanes-Oxley should not be repealed anytime soon; however, Congress should continue to observe where the business world is moving to in order to properly adapt and change with it.

Bibliography:

ABC News. “Arthur Andersen Indicted in Enron Case.” *ABC News*, ABC News Network, 14 Mar. 2002, abcnews.go.com/Business/story?id=87293.

“About the PCAOB // .” *About the PCAOB*, 2017, pcaobus.org/About.

ACFE. “Report to the Nations on Occupational Fraud and Abuse.” *Report to the Nations on Occupational Fraud and Abuse*, 2016, s3-us-west-2.amazonaws.com/acfepublic/2016-report-to-the-nations.pdf.

ACFE. “What Is Fraud?” *Association of Certified Fraud Examiners - Fraud 101*, 2017, www.acfe.com/fraud-101.aspx.

“Andrew Fastow.” *Forbes*, Forbes Magazine, 6 June 2013, www.forbes.com/2002/03/19/afastow.html.

APFN. “ENRON'S Richard A. Causey.” *ENRON'S Richard A. Causey*, 2002, www.apfn.org/enron/causey.htm.

Brown, Ken, et al. “Andersen Fires Partner It Says Led Shredding of Documents.” *The Wall Street Journal*, Dow Jones & Company, 16 Jan. 2002, www.wsj.com/articles/SB1011096414335724680?mg=prod%2Faccounts-wsj.

Bumgardner, Larry. “Reforming Corporate America - How Does the Sarbanes-Oxley Act Impact American Business?” *Graziadio Business Review | Graziadio School of Business and Management | Pepperdine University*, 29 Oct. 2017, gbr.pepperdine.edu/2010/08/reforming-corporate-america/.

Ceresney, Andrew. “Financial Reporting and Accounting Fraud.” *SEC Emblem*, 19 Sept. 2013, www.sec.gov/news/speech/spch091913ac.

Ciesielski, Jack T, and Thomas R Weirich. “Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act.” *Ups and Downs of Audit Fees Since the Sarbanes-Oxley Act*, The CPA Journal, Oct. 2006, archives.cpajournal.com/2006/1006/essentials/p28.htm.

Donald R. Cressey, Other People's Money (Montclair: Patterson Smith, 1973) p. 30.

Dvorak, John C. “Repeal Sarbanes-Oxley.” *MarketWatch*, 16 July 2007, www.marketwatch.com/story/its-time-to-repeal-sarbanes-oxley.

Harris, Steven B. “Remarks on The Sarbanes-Oxley Act of 2002: Ten Years Later // .” *Remarks on The Sarbanes-Oxley Act of 2002: Ten Years Later*, 24 Sept. 2012, pcaobus.org/News/Speech/Pages/09242012_NYU.aspx.

Ingles, Adam, and Frank Gonzalez. "15 Years Of SOX: It Is Time To Revisit The Burdens - Law360." *Law360 - The Newswire for Business Lawyers*, 1 Aug. 2017, www.law360.com/articles/949352/15-years-of-sox-it-is-time-to-revisit-the-burdens.

Institute of Internal Auditors. "Code of Ethics." *The Institute of Internal Auditors North America*, 2017, na.theiia.org/standards-guidance/mandatory-guidance/Pages/Code-of-Ethics.aspx.

Investopedia. "Audit Committee." *Investopedia*, 14 Nov. 2010, www.investopedia.com/terms/a/audit-committee.asp.

Investopedia. "Enron Scandal: The Fall of a Wall Street Darling." *Investopedia*, 23 Oct. 2017, www.investopedia.com/updates/enron-scandal-summary/.

Investopedia. "Sarbanes-Oxley Act Of 2002 - SOX." *Investopedia*, 13 Jan. 2015, www.investopedia.com/terms/s/sarbanesoxleyact.asp.

"Jeffrey Skilling." *Biography.com*, A&E Networks Television, 9 Sept. 2014, www.biography.com/people/jeffrey-skilling-235386.

"Kenneth Lay." *Biography.com*, A&E Networks Television, 19 May 2016, www.biography.com/people/kenneth-lay-234611.

LaCroix, Kevin M. "Looking at the Costs and Benefits of SOX." *Looking at the Costs and Benefits of SOX*, 24 Mar. 2014, www.lexisnexis.com/legalnewsroom/corporate/b/blog/archive/2014/03/24/looking-at-the-costs-and-benefits-of-sox.aspx.

Lanois, Paul. "The Legacy of the Sarbanes-Oxley Act, 15 Years On." *CLS Blue Sky Blog*, 9 Feb. 2017, clsbluesky.law.columbia.edu/2017/02/09/the-legacy-of-the-sarbanes-oxley-act-15-years-on/.

Louwers, Timothy J, et al. *Auditing & Assurance Services*. 6e ed., McGraw-Hill Education, 2015.

Niskanen, William A. "Repeal Sarbanes-Oxley--Lock, Stock And Barrel." *Forbes*, Forbes Magazine, 19 June 2013, www.forbes.com/2008/12/16/sarbanes-oxley-reform-oped-cx_wn_1217niskanen.html.

Peavler, Rosemary. "Enron, the Sarbanes-Oxley Act and Corporate Fraud." *The Balance*, 1 July 2017, www.thebalance.com/sarbanes-oxley-act-and-the-enron-scandal-393497.

PricewaterhouseCoopers. "Sarbanes-Oxley (SOX) Compliance Solutions: Helping You Implement and Sustain Cost-Effective Compliance." *PwC*, 2017, www.pwc.com/us/en/risk-assurance/internal-audit/sarbanes-oxley-compliance.html.

SEC. “Sarbanes Oxley Act of 2002.” *Sarbanes Oxley Act of 2002*, 30 July 2002, www.sec.gov/about/laws/soa2002.pdf .

“The Rise and Fall of Enron.” *Journal of Accountancy*, 1 Apr. 2002, www.journalofaccountancy.com/issues/2002/apr/theriseandfallofenron.html.

Tysiac, Ken. “SOX Compliance Costs Rise for Many Companies, Report Finds.” *Journal of Accountancy*, 15 May 2013, www.journalofaccountancy.com/news/2013/may/20137990.html.