Sarbanes-Oxley Act of 2002

Will it Be Effective in Preventing Another Enron Scandal?

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Abstract

The Sarbanes-Oxley Act of 2002 (SOX) was introduced to Congress as a result of the deceit and fraud taking place at Enron in December of 2001. The three factors that led to the scandal were Enron's weak internal control, misleading off-balance sheet entities, and conflicting interests between Enron's employees and their chief auditor, Arthur Andersen. The provisions of SOX were established, in part, to strengthen internal control, require proper disclosure for special purpose entities, and eliminate conflicts of interests between a firm and its auditors. The purpose of this paper is to measure the effectiveness of these implementations to prevent fraud from occurring in the future.

Introduction

The Sarbanes-Oxley Act of 2002 (SOX) was introduced to Congress as a result of the deceit and fraud taking place at Enron in December of 2001. The bankruptcy of Enron in 2001, with its $62 billion in assets, was the largest in U.S. history, to that point (McLean & Elkind, 2002). It resulted in over four thousand employees losing their jobs, retirement savings, and medical benefits. The average severance pay awarded was $4,500 (McLean & Elkind). In addition, Arthur Andersen, then one of the world's leading international accounting firms, essentially ceased to exist in June of 2002, after being found guilty of obstruction of justice in an Enron-related case. After the scandal that was taking place at Enron and its auditing firm Arthur Andersen was unraveled, it became apparent that legislation was necessary to prevent this from occurring in the future.

As a result, SOX was established mainly as a direct response to the accounting irregularities and fraud that took place at Enron and its auditing firm Arthur Andersen. President Bush signed the Sarbanes-Oxley Act of 2002 into law July 30, 2002, describing it as incorporating the “most far-reaching reforms of American business practices since the Great depression” (Hays, 2003, p.1). Many have questioned whether SOX puts into place the necessary provisions to prevent a fraud like the one that took place at Enron from occurring again.

Enron’s weak internal control, abuse of off-balance sheet entities, and the conflicting interests with its external auditors at Arthur Andersen led to the largest accounting scandal in United States history. Sarbanes-Oxley certainly confronts these issues, but does it solve them? Is more regulation the answer to the fraud that took place at Enron? The purpose of this paper is to look at three factors that led to the collapse of Enron and determine whether or not Sarbanes-

Oxley's measures will be effective in preventing these from leading to another Enron-like scandal from occurring in the future.

The Enron Scandal

Enron's Business and Rapid Growth

Enron was formed in May of 1985, when InterNorth, who owned the largest, most extensive gas-pipeline network in the country, merged with Houston Natural Gas (Jackson, 2006). Kenneth Lay became CEO of this merger that took the name of Enron. Enron's plan was to be basically a gas bank (Jackson, 2006). Gas producers could contract to make deposits of gas with Enron for future years at previously agreed prices (Jackson). In addition, the gas users could contract in advance to make withdrawals (or purchases) of gas from Enron, at specified prices for future years. Enron was able to make "a percentage on the spread in the same way that a bank borrows from lenders at a low interest rate and lends to borrowers at a higher interest rate" (Jackson, 2006, p. 139).

In 1987 this idea took off and Jeffrey Skilling was placed in charge of carrying out the operations. A trading floor was established, and Skilling's division "Enron Finance" began selling financial instruments (Jackson, 2006, p. 139). This division of Enron began selling commodities and eventually, when the Enron Online division was opened, they sold over 800 different commodities. This business, which Enron pioneered, was usually described in "vague, grandiose terms like the financialization of energy--but also, more simply, as buying and selling gas and electricity" (McLean, 2001, p. 2). Enron used a practice known as "mark-to-market" to account for these transactions. Mark-to-market accounting is the practice used by financial-service companies to revalue assets on the balance sheet that respond to the increased market value and reports the difference as profit on the income statement (Jackson). Skilling persuaded the Securities and Exchange Commission (SEC) to allow Enron to use mark-to-market accounting on the grounds that they were trading energy futures (Jackson). The abuse occurred when Enron began recognizing profits on gas futures that were intending to be sold 20 to 30 years later, a price that seemed impossible to estimate (Jackson). Jackson added that Enron could estimate “any amount it wanted for the price it would have to pay for future gas deliveries” (p. 140). Enron recorded these highly unreliable profits on its income statement and it drove their share price up at a high rate.

In the year 2000, Enron represented the “pinnacle of corporate success” (Jackson, 2006). By the year 2000 it was a well diversified firm with business dealings ranging from energy production, distribution, and broadband trading. In 1990, 90% of Enron’s revenues came from the closely regulated gas-pipeline business (Jackson). However, ten years later, Enron had completely changed the face of its business. By 2000, “95% of its revenues and more than 80% of its operating profits came from wholesale energy operations and services” (McLean, 2001, p. 1). Bethany McLean, a reporter for Fortune Magazine reported in 2001 that “while tech stocks were bombing at the box office last year, fans couldn't get enough of Enron, whose shares returned 89%” (McLean, p. 1).

By almost every measure the company turned in a virtuoso performance: earnings increased 25%, and revenues more than doubled, to over $100 billion (McLean, 2001). Famous Goldman Sachs analyst David Fleischer wrote that, “Enron has built unique and, in our view, extraordinary franchises in several business units in very large markets” (McLean, p. 1). Enron appeared to be growing at an insurmountable rate and was expected to continue to produce massive earnings growth for its shareholders.

Enron Exposed

Shortly after the high earnings were reported, however, concerns began to mount as to whether Enron's share price was too high (McLean, 2001). By the end of August 2001 Enron was facing several serious operational challenges: namely logistical difficulties in running a new broadband communications trading unit, constructing the Dabhol Power project, and also the criticism it was facing for the alleged role it had played in the power crisis of California (McLean & Elkind, 2002). In fact, David Fleischer, an analyst at Goldman Sachs, confronted Kenneth Lay and told him that "there is an appearance that you are hiding something" (McLean & Elkind). Kenneth Lay was furious over the accusation, and shortly after this, Enron's stock began to fall. This immediately prompted the SEC announcing that it would begin an investigation into the declining stock price.

On October 17, 2001, Enron announced that its third-quarter results were negative due to one-time charges of over $1 billion. On October 22, 2001, the share price of Enron fell from 26.05 to $20.65, down $5.40 in one day, following the SEC's announcement that it was investigating several suspicious deals struck by Enron, pronouncing them as "some of the most opaque transactions with insiders ever seen" (Norris, 2001, p. 1). In November of 2001, Enron announced that it would consolidate its financial statements, retroactive back to 1997. This retroactive consolidation resulted in "a massive reduction in Enron's reported net income and a massive increase in reported debt" (Wilson & Campbell, 2003). On November 19, 2001, Enron disclosed to the public further evidence of its critical state of affairs. The company announced that it was facing debt repayment obligations in the range of $9 billion by the end of 2002. Such debts were "vastly in excess of Enron's available cash" (Oppel & Norris, 2001, p. 1)

Enron Goes Bankrupt

Enron's European operations filed for bankruptcy on November 30, 2001, and it sought Chapter 11 protection in the U.S. two days later on December 2 (Moritsugu, 2002). At the time, Enron was the largest bankruptcy in U.S. history, and it cost 4,000 employees their jobs (Moritsugu). The day that Enron filed for bankruptcy, Enron's employees were told to pack up their belongings and were given 30 minutes to vacate the building (McLean & Elkind, 2002). To make matters worse, as the Enron scandal continued to unfold, it became clear that top Enron executives had continued to make millions of dollars by cashing in their stock options, even as they were leading their company toward ruin (Moritsugu). For example, Enron Chairman Kenneth Lay realized $123.4 million from exercising stock options in 2000. Mr. Lay was not alone in doing so, as a number of other top executives also exercised their stock options. By contrast, most ordinary shareholders ended up losing the bulk of their Enron investments and thousands of Enron workers lost their jobs and much of their retirement savings.

Factors Leading to Enron’s Collapse

Introduction

Although there were many factors and influences that led to the collapse of Enron, the three strongest factors that led to the collapse were Enron’s weak internal control, their deceptive treatment of special purpose entities, and the conflicting interests that were present between them and their chief external auditor, Arthur Andersen. Each of these factors will be analyzed in detail below.

Weak Internal Control

Enron’s internal control system was the first factor leading to the company’s collapse. After the scandal unfolded, it became clear that Enron’s internal control system was vulnerable for a number of reasons. First, Arthur Andersen performed some of Enron's internal audit work (Locatelli, 2002). Arthur Andersen was the company's external auditor at the time which is a clear breach in auditing policy, because of the extreme amount of differences between an internal and an external audit (Locatelli). Enron also turned over to Arthur Andersen some responsibility for its internal bookkeeping, "blurring a fundamental division of responsibilities that companies employ to assure the honesty and completeness of their financial figures" (Stevens & Schwartz, 2006, p. 1).

Enron's board "waived the company's conflict of interest policy to allow its CFO to invest in the corporation's special purpose entities, then failed to follow up to ensure the mandated compensating controls were being adhered to" (Locatelli, 2002, p. 2). This shows just how weak Enron's internal control system was. For controls to be effective, "senior managers must consider the design of an effective control structure to be a central part of their jobs" (Locatelli, p. 2). Enron's managers failed to "identify the major risks facing their operating areas and develop control practices and procedures for employees to follow" (Locatelli, p. 2).

At Enron, the board of directors appears to have been either unwilling or unable to fulfill its responsibilities. Although it is possible that Enron's board members did not understand the necessity of strong internal controls, it is far more likely that they understood the need but did not possess the knowledge or skills to implement an effective control system (Hays, 2003).

Enron's Abuse of Off-Balance Sheet Entities

Introduction. Enron had massive amounts of debt on their books, but they were able to keep it off their balance sheet and from affecting their inflated share price. They accomplished this through their use of an accounting structure known officially as an "off-balance sheet entity"

(OBSE). OBSEs became a way for Enron to hide massive amounts of debt by keeping these transactions off the company's balance sheet.

Enron's use of OBSEs. Off-balance-sheet financing arrangements often involve the creation of an entity in the form of a joint venture, limited-liability company, partnership, or other unconsolidated entity (Jackson, 2006). OBSEs created for a specific purpose, often referred to as "special or limited purpose entities, are contractually limited to narrow activities that facilitate a company's transfer of or access to assets" (Chandra, Etredge, & Stone, 2006, p. 4). Enron's OBSEs were known as special purpose entities (SPEs).

There are definite, legal business reasons for sponsoring OBSEs: "increasing financial flexibility, decreasing the cost of borrowing, reducing taxes, increasing profitability, and improving financial statement ratios" (Chandra et al., 2006, p. 4). SPEs are perfectly legal and may borrow cash and incur debt in their own name, and under certain conditions, this debt need not be added to the company's debt on the company's consolidated balance sheet. In other words a SPE's debt does not need to be "consolidated with the company's debt and, of course, its assets are also not consolidated into the company's balance sheet" (Jackson, 2006, p. 162).

Another key advantage to the sponsoring company for having a SPE is that the company's share of the SPE's earnings is accounted for in the company's income statement, and the company can also record profits on its transactions with the SPE (Jackson, 2006). This means that a SPE's earnings can appear on a company's income statement without its debt appearing on the balance sheet. There were two pre-Enron requirements that had to be met in order for Enron to report its SPEs in this fashion:

1. An owner independent of the company must make a substantive equity investment of at least 3% of the SPE's assets, and that 3% must remain at risk throughout the transaction.
2. The independent owner must exercise control of the SPE (Jackson, p. 163).

Both of these conditions were set forth in 1991. By meeting both of these conditions, Enron was permitted to record gains and losses on all transactions with the SPE and not include the assets and liabilities of their SPEs on Enron's consolidated balance sheet even though the companies were closely related (Jackson).

Enron already had a substantial debt load. Funding the new investments by issuing additional debt was unattractive because cash flows in the early years would be insufficient to pay for the debt; this would place pressure on Enron's credit ratings (McLean & Elkind, 2002). Maintaining Enron's credit ratings at investment grade was vital to continuing its business of trading energy commodities (McLean & Elkind). Alternatively, funding the investments by issuing additional equity was also unattractive because the earnings in the early years would be insufficient to avoid dilution of Enron's earnings per share figure. This is why Enron turned its focus to SPEs. Enron used the SPEs as an effective way to manage the company's compiling debt from profit-draining energy projects (such as the Dabhol power project in India). Enron set up thousands of these SPEs which did not qualify as true subsidiaries and therefore did not need to be consolidated (Deakin & Konzelmann, 2004). Enron's SPEs were being used to keep their debt and massive investments that had been poured into some of their not-as-profitable expenditures off their balance sheet. Because of the literal interpretation that Enron took in following the accounting regulations that were in place, Enron was able to avoid reporting them on their consolidated balance sheet.

Problems meeting the requirements. Did Enron meet the two requirements that were set forth in 1991? Enron's auditing firm Arthur Andersen would say yes, in fact they helped Enron manage them at times (Jackson, 2006). However, problems arose with Enron's SPEs because often the person who was managing the SPE was not remaining at arms' length with Enron. For example, many Enron investors were putting up the 3 percent of equity capital that needed to be put up independently. Jackson wrote that many times, the capital that should have been provided by an independent outsider was being "indirectly provided or guaranteed by Enron" (Jackson, p. 163).

Enron's use of SPEs was hidden under a large amount of complex transactions, making it difficult for its auditor, Arthur Andersen, to sort through (Deakin & Konzelmann, 2004). Further, Arthur Andersen advised Enron to use SPEs as a way to eliminate the debt off the company's balance sheet and was ignoring the "fairness principle of GAAP" (Cunningham & Harris, 2006). For example, investments must be reported under the equity method if a company owns 20% or more (Cunnigham & Harris). Companies began owning only 19.9% of companies to avoid reporting them in this fashion (Cunningham & Harris). In the same way, Arthur Andersen failed to insist that Enron consolidate these SPEs on Enron's balance sheet as they should have been under the fairness principle (Cunningham & Harris). In internal communications during 2000, Andersen partners had characterized Enron as a "maximum risk" client (Deakin & Konzelmann, p. 6). Its managers were said to be "very sophisticated and enter into numerous complex transactions and are often aggressive in structuring transactions to deal with derived financial reporting objectives" (Deakin & Konzelmann, p. 6). One Andersen lawyer commented that it was "ridiculous to characterize Enron's accounting practices as mainstream" (Deakin & Konzelmann, p. 6).

Enron's Conflicts of Interests

Introduction. The last factor leading to the fall of Enron involves the presence of Enron's many conflicting interests. Conflicts of interests were one of the downfalls for Enron. Enron had two major conflicting interests: those with its SPEs and those with its chief external auditor, Arthur Andersen.

Conflicting interests between Enron and their SPEs. Michael Kopper, a senior employee in the finance section of the company, ran many of the SPEs through a series of limited partnerships and companies which he controlled; in the beginning, his involvement was not even disclosed to the board (Deakin & Konzelmann, 2004). Fastow, a senior manager, also ran some of the SPEs and was "prominently involved in several of the entities, as were a number of more junior Enron employees in accounting and finance positions" (Deakin & Konzelmann, p. 6). Fastow's involvement in the SPE dealings was not disclosed to the board until a meeting which took place in 1999, but the board approved of Fastow and Kopper's participation, following a recommendation to this effect from the then CEO and Chairman, Kenneth Lay "who most likely deceived the board into thinking these were regular, mainstream transactions" (Deakin & Konzelmann, p. 5).

Fastow and Kopper were "self-dealing, in other words acting on both sides of the deal"; this is a breach of the fiduciary duty of loyalty which a director or senior employee owes to the company (Deakin & Konzelmann, 2004, p. 7). How could Fastow or Kopper be considered independent, when they were making decisions for Enron in order to help SPEs that they were controlling?

In some instances, these fiduciary duty laws can, in effect, be waived (Deakin et al., 2004). For example, in the context of a company such as Enron, "approval by the board will almost certainly suffice" (Deakin & Konzelmann, p. 5). Obviously a company of Enron's size cannot be required to gain approval from all of its shareholders, and the SEC does not require this. Fastow's involvement was disclosed to shareholders in Enron's annual report for 2000 after the transactions were undertaken, but well before the company's difficulties began. Although, his involvement was disclosed, it was written in very complicated language and hidden under a string of confusing transactions that would not be understood by the average investor or shareholder. His role in SPEs was a breach of Enron's own code of ethics. The board waived it on Lay's advice, "demonstrating that the code was not legally binding" (Deakin & Konzelmann, p. 5).

Congress is convinced that the board was either misled, or simply not informed, about Kopper's role in one particular SPE named "Chewco" (McLean & Elkind, 2002). This also indicates that the board was not informed of the large sums which Fastow, Kopper, and others received for managing the SPEs which they set up. Fastow received $30 million in return for his part in this (Deakin & Konzelmann, 2004). Finally in October of 2001 when the deals were falling apart, the board asked and learned about the extent of Fastow's involvement with the SPEs. The board immediately suspended him. Why the board made "no earlier inquiry on the matter is a difficult question" (Deakin & Konzelmann, p. 6).

Conflicting interests between Enron and Arthur Andersen. Besides the dealings with its SPEs, Enron did not maintain arms' length with its chief external auditor, Arthur Andersen (Deakin & Konzelmann, 2004). Boyd suggests that a "substantial contribution to the Enron collapse came from the failings of Enron's audit firm, which was itself affected by a general build-up of tensions related to conflicts of interest" (2004). There seems to be little evidence favoring that Arthur Andersen was independent from Enron.

Arthur Levitt, one of the profession's leading critics, and former head of the SEC claims that "conflicts of interest inevitably occur when a company pays an accounting firm consulting fees that far outweigh the audit fee" (Boyd, 2004). Arthur Andersen was receiving a large amount of revenue for consulting services while they were performing their audit. The firm received fees for both of these services, and it engaged in regular exchanges of employees with Enron (Deakin & Konzelmann, 2004). Arthur Andersen was also involved in the SPE's transactions. The firm earned substantial fees, tens of millions of dollars, from organizing these transactions which were to prove most costly to Enron and its stakeholders. The fact that Enron

> …paid Arthur Andersen slightly more in non-audit fees ($27 million a year) than it did in audit fees ($25 million a year) strike many as strong evidence that Andersen could not have been independent. The fear of losing such large consulting fees, they say, may have caused Andersen to be less skeptical when faced with evidence of financial shenanigans by Enron management. The fact that Andersen's consulting services included internal audit services strikes a particularly sour chord. (Locatelli, 2002, p. 1)

Conclusion of Enron's Collapse

The three factors mentioned in detail above contributed to the largest accounting scandal in United States history. Enron's lack of internal control, complex and hidden off-balance sheet activity, and conflicting interests with its auditors and SPEs led to the company's massive downfall. The next section will look at Congress's response: the legislative measures of Sarbanes-Oxley and determine whether or not this piece of legislation will be effective in preventing future Enrons from occurring in the future.

The Sarbanes-Oxley Act of 2002

Introduction and Purpose

The responses of lawmakers to the collapse of Enron were “immediate and far-reaching” (Buckberg, Foster, Miller, & Werner, 2003, p. 8). In an effort to “deter future fraud and increase the accountability” of corporate executives and boards, Congress passed the Sarbanes-Oxley Act in July of 2002 (Buckberg et al., p. 12). The Sarbanes-Oxley Act of 2002 was primarily formed as a direct response to the fraud that was occurring at Enron and its external auditing firm, Arthur Andersen. It was established as a result of strong lobbying by the accounting profession in order to prevent Enron-like fraud from occurring again.

Many believed that this was the answer needed to prevent accounting fraud to the extent that took place at Enron (Wegman, 2007). The following article titles summarize the support for Sarbanes-Oxley: “Promoting Public Trust,” “Sarbanes-Oxley: A Bridge to Excellence,” “Private Companies Embrace Sarbanes-Oxley,” and “Sox: Not So Bad After All”. The focus is on regulation: “restoring investor confidence, improving business controls and processes and supporting ethical practices” (Wegman).

Opposition to the Act

The Sarbanes-Oxley Act 2002, however, has not been accepted by everyone. The following titles and headlines display the opposition towards it: “Sarbanes-Oxley Is a Curse for Small-Cap Companies,” “Sarbanes-Oxley to Create Litigation Nightmare,” “The Sarbox Conspiracy,” and “Dump This Destructive Deadweight” (Wegman, 2007). Former Vice President Dick Cheney said in an interview with business television station CNBC, "I think you can make a case that Sarbanes-Oxley went too far" (CMP TechWeb, 2006, p. 4). Sarbanes-Oxley has been called a reaction “to the media outcry and the anguished moans of the many that had lost jobs, pensions and savings" (Hamilton, 2006, p. 1). The US Congress rushed to pass "an ill-considered and hasty piece of legislation" (Hamilton, p. 2).

Is the act going to make any difference in preventing future fraud? Many believe that the act is simply too much added regulation. They believe that it "adds unnecessary costs and diverts management's attention away from its primary missions of competitiveness, innovation, and profitability" (Agami, 2006, p.14). Even Stephen Cooper, Enron's interim chief executive, said at a bankruptcy seminar for lawyers that "if an unscrupulous company wants to game the system, Sarbanes-Oxley won't be a hindrance" (Hays, 2003, p. 2). The Sarbanes-Oxley Act

> …seeks to prevent future Enrons, an objective it is doomed to fail as it does not, and cannot, address the underlying problems. The fundamental causes of corporate failure are more complex. Accounting, or, more accurately, the misuse of accounting, was not the main problem. Rather the uncontrolled pursuits of flawed strategies, coupled with greed on the part of many, were the real reasons for the downfall (Hamilton, 2006, p. 6).

Even Kenneth Lay, former CEO of Enron, told reporters that Sarbanes-Oxley would not have prevented them from what they did.

The effectiveness of Sarbanes-Oxley has certainly been called into question. There are supporters on both sides of the debate. The purpose of the next section is to look at Sarbanes-Oxley's statements on the factors leading to Enron's collapse: internal control, off-balance sheet entities, and conflict of interests, in order to determine whether Sarbanes-Oxley will be effective in preventing an "Enron-like" fraud from occurring in the future.

Sarbanes-Oxley's Strengthening of Internal Control

Introduction. The internal control requirements of Sarbanes-Oxley are quite extensive. Section 404, which specifically deals with internal control, has received quite a bit of criticism and opposition to its demanding requirements. Auditing standards are defined as a “process designed to provide reasonable assurance” in the following areas: reliability of financial reporting, effectiveness and efficiency of operations, and lastly compliance with all laws and regulations. Sarbanes-Oxley speaks mainly on three new areas of internal control: management’s assessment of internal control, a code of ethics for senior financial managers, and new audit committee provisions. The purpose of this section was to strengthen internal control after watching Enron’s internal control lead to the collapse of the company. Many have claimed that the added cost weight of the internal control requirements do not add enough value to small companies.

Management’s assessment of internal control. The act requires that in each annual report of a company, it must contain (1) “a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting” (Securities and Exchange Commission [SEC], 2003, para. 3).

Management must also disclose “any material weakness and will be unable to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in such control” (SEC, 2003, para. 4). Section 404 also requires the company's internal auditor to attest to, and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with the Public Company Accounting Oversight Board (PCAOB).

Code of ethics for senior financial managers. Sarbanes-Oxley requires that companies disclose a code of ethics containing the standards that are to be followed by senior financial managers. Senior financial managers are defined as the "CFO, controller, or principal accounting officer" (Sarbanes-Oxley Act of 2002). The requirements of the code of ethics are that they promote the following:

> …(1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and (3) compliance with applicable governmental rules and regulations. (Sarbanes-Oxley Act of 2002, para. 42)

The requiring of a code of ethics is designed to strengthen investor's confidence in financial reporting and nothing else. A code of ethics would not have prevented Enron from doing anything they did, because of the cohesion between Enron's CEO and CFO. A code of ethics needs to have measures in it for the enforcement of its principles. A code of ethics will not ensure that the CFO or controller is going to behave ethically. "A code of ethics can function effectively only to the extent that management desires" (Tipgos, 2002, p. 2). "Enron underscored this when its board voted twice to suspend its code of ethics to allow the setting up of the partnerships that led to its demise" (Tipgos, p. 1).

New audit committee standards. An audit committee is to be established "by and amongst the board of directors in order to oversee the accounting and financial reporting processes of the issuer" (Sarbanes-Oxley Act of 2002, para. 12). All public accounting firms that performs an audit must report to the audit committee these three things:

> (1) all critical accounting policies and practices to be used; (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such

alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and (3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences. (Sarbanes-Oxley Act of 2002, para. 194)

All members of the audit committee must be independent and not have any conflicting interests. A member of an audit committee of a company may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee ‘‘(i) accept any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof” (Sarbanes-Oxley Act of 2002, para. 195).

Also, it is required that an audit committee must have at least one “financial expert” (Sarbanes-Oxley Act of 2002). This is to be someone that has an in-depth understanding of financial accounting standards (Sarbanes-Oxley Act of 2002). This person must be a public accountant, auditor, or controller. Although these requirements will be time consuming and costly, it is believed that they will help bring management and its auditors on the same page as well as create transparent financial disclosure for all stakeholders of the company.

Sarbanes-Oxley on Off-Balance Sheet Entities

Introduction. Kopper and other Enron employees used “complex structures, straw men, hidden payments, and secret loans to create the appearance that certain entities that Kopper and others at Enron funded and controlled were independent of Enron” (SEC, 2003, p. 1). This allowed Enron to move its interests in these entities off its balance sheet when, in fact, those interests should have been consolidated into Enron's financial statements (SEC).

As a result, Enron's financial statements did not properly reflect Enron's interest in these entities, thereby enabling Enron to engage in “various transactions with these entities that were designed to improve its apparent financial results” (SEC, 2003, p. 1). Kopper and other Enron executives “exploited the fiction that these entities were independent of Enron to misappropriate millions of dollars representing undisclosed fees and other illegal profits” (SEC, p. 1). In response to these actions, Sarbanes-Oxley requires new disclosure for off-balance sheet entities. It states that no later than 180 days after the enactment of the Sarbanes-Oxley Act of 2002 that

> …the Commission shall issue final rules providing that each annual and quarterly financial report required to be filed with the Commission shall disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses. (Sarbanes-Oxley Act of 2002, para. 34)

Study Required. A study was required one year after the implementation of the new disclosure rules for off-balance sheet entities. The study was to state

> …(A) the extent of off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities; and (B) whether generally accepted accounting rules result in financial statements of issuers reflecting the economics of such off-balance sheet transactions to investors in a transparent fashion. (Sarbanes-Oxley Act of 2002, para. 36)

The purpose was to conduct a study of filings by issuers and issue a report that addresses two primary questions: “(1) the extent of off-balance sheet arrangements, including the use of special purpose entities and (2) whether current financial statements of issuers transparently reflect the economics of off-balance sheet arrangements" (Sarbanes-Oxley Act of 2002). The report included several key initiatives in order to prevent abuse in reporting off-balance sheet entities.

The first one is that transactions motivated by accounting and reporting figures should be discouraged, whereas ones for economic purposes encouraged (SEC, 2003). Also, communication is to be the focus of financial reporting (SEC). If shareholders and investors cannot understand the technical language, then the company must put it in better terms, otherwise the purpose of disclosure is useless (SEC). Enron did not follow either of these principles. First, they were using SPEs for the sole purpose of accounting profits and manipulation, not feasible economic purposes. Second, they were disclosing their SPEs using technical language and confusing transactions in order to not be discovered.

Conclusion. Enron used off-balance sheet entities to manipulate its earnings and hide its debt. Sarbanes-Oxley should be effective in preventing this type of abuse by requiring more disclosure for off-balance sheet entities. It seems as if this measure by Congress will be effective in at least preventing the use of SPEs to hide debt and manipulate earnings. Requiring that OBSEs be included on a company's consolidated balance sheet, if they are being used solely for accounting purposes, will go a long way in creating financial reporting transparency to a company's stakeholders.

Sarbanes-Oxley on Conflict of Interests

Introduction. Lastly, eliminating conflicts of interests is also a major focus of the Sarbanes-Oxley Act (Locatelli, 2002). Auditor independence has clearly been impaired when "outside auditors are hired and paid by the company they are charged with auditing" (Locatelli). This certainly was the case with Enron. Generally, it is the person most involved in the company's financial records, the CFO, who has the primary responsibility for hiring and retaining the outside auditor (Locatelli).

The Sarbanes-Oxley Act requires that an audit committee be "directly responsible for appointing, determining compensation, and overseeing the work of the outside auditors" (Locatelli, 2002). Revsine (2001) puts it this way, “One benefit of the Enron scandal is that it convinced Congress and the general public that drastic improvements are needed to ensure auditor independence” (p. 4). Three specific topics that the Sarbanes-Oxley Act of 2002 discusses are: conflicting duties of a firm’s employees and auditors, auditor partner rotation, and distinguishing between audit and non-audit services.

Conflicting duties. Section 206 of Sarbanes-Oxley deals specifically with conflicting duties of an audit firm’s employees (Kulzick, 2004). It states that it is unlawful

> …for a registered public accounting firm to perform for an issuer any audit service required by this title, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit. (Sarbanes-Oxley Act of 2002, para. 14)

Auditor rotation. Sarbanes-Oxley also put an auditor rotation system into place. The act states that it is illegal for a registered public accounting firm

> … to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer. (Sarbanes-Oxley Act of 2002, para. 15)

This provision is designed to prevent the cohesion of fraud that seemed to take place between Enron and Arthur Andersen. In other words, every five years, the audit partner responsible for reviewing the audit must be someone different. This will prevent on-going fraud from occurring for more than a few years. Fraud will be less likely to occur because it will take much more cohesion amongst many different people in order for it to go unseen.

Distinguishing services. The Sarbanes-Oxley Act of 2002 makes it clear that external auditors distinguish between auditing services and non-auditing services in order to prevent any conflict of interest among the auditors (American Institute of Certified Public Accountants [AICPA], 2002). The act states that it is

> … unlawful for a registered public accounting firm that performs for any issuer any audit required by this title or the rules of the Commission under this title to provide to that issuer, contemporaneously with the audit, any non-audit service, including—(1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board determines, by regulation, is impermissible. (Sarbanes-Oxley Act of 2002, para. 16)

In order to override this, a firm must receive permission from the audit committee of the issuer in advance to providing non-audit services. The audit committee must pre-approve any audit and non-audit service. This is to act as a checks and balance system on an external auditing firm and its relationship with a company to prevent fraud from occurring. Also, if a firm is offering both audit and non-audit services to a company, this must be periodically disclosed to investors in the company's reports. This is to keep investors informed of a company's actions with its auditors.

Conclusion. The question is: Will these legislative measures prevent future conflicts of interest? Boyd believes that this measure will to "some extents prevent conflicts of interest arising from the transfers of employees at the highest levels, although it does not bar the transfer of audit team members into intermediate or transitory positions within audit clients" (2004). He goes on to say that,

> …the fact that the ban is just for one-year seems to be insufficient—the financial rewards may be such that an employee subject to the transfer ban may be willing to step out of the ring for one year. A one-year ban is also far too short a time for the audit team's work practices to have changed sufficiently so as to render a former audit team member's knowledge of these practices obsolete (Boyd, 2004, p.1).

Enron's external auditing firm was being paid highly for consulting services and therefore their auditing services were partially fraudulent (Sentar, 2002). A check and balance system is needed that will prevent one auditor from looking after his own interests (Stephens & Schwartz, 2006). Sarbanes-Oxley aims

> …to strengthen the model by insisting, among other things, on stronger guarantees of independence for non-executive directors. Whatever else their failings may have been, Enron's non-executive directors were as well qualified as almost any group of outsiders could have been to judge the regulatory and business risks which arose from the company's operations. That they failed to do so is testimony to the complexity of the monitoring task. (Deakin & Konzelmann, 2004, p. 6)

Integrity has no need of rules, but the complexity, pressures and aggressiveness of business today make it "impossible to rely on old-world judgments of good character" (Nelson, 2002, p. 22). "We have to build strong control cultures within companies to curb the excesses of human nature" (Nelson, p. 22). Nelson believes this is the mindset of Sarbanes-Oxley's internal control requirements: "to curb the excesses of human nature" (p. 23).

Questioning Sarbanes-Oxley Effectiveness

Although Sarbanes-Oxley strengthens internal control, requires a more transparent disclosure of off-balance sheet entities, and increases oversight and regulation on public auditors, it does not necessarily guarantee the prevention of a future Enron-like scandal. Sarbanes-Oxley did not address the issue of mark-to-market accounting. Mark-to-market accounting allowed Enron to estimate future market values of its 800 different commodity contracts and record the profits as current earnings. McLean & Elkind believe that this type of logic implies that "General Motors should book all the future profits of a new model automobile at the moment the car is designed, long before a single vehicle rolls off the assembly line" (2004, p. 39-40). Sarbanes-Oxley fails to address this large factor that led to Enron's inflated profits and share price.

Conclusion

It can be reasoned that the provisions in Sarbanes-Oxley will reasonably satisfy the three areas that allowed Enron to get away with the fraud that they did and enable them to deceive their stakeholders for so long. However, Sarbanes-Oxley is only one piece of legislation; many believe that it was only intended to ensure investor confidence in financial reporting figures. Legislation and regulation cannot eliminate fraud completely (Hays, 2003). The factors discussed in this paper contributed largely to Enron's collapse and were the areas which Sarbanes-Oxley increased regulation and created new standards in; however, Sarbanes-Oxley fails to address many other factors that also played a role in Enron's downfall such as mark-to-market accounting.

Since 2002, Oversight Systems Inc. has been doing a study as to whether Sarbanes-Oxley has been efficient in eliminating corporate fraud. They stated in their report, that although Sarbanes-Oxley has reduced the risk, there will never be a way to eliminate it (*Business Wire*, 2005). Sarbanes-Oxley's put standards and regulations into place that are meant to strengthen internal control, enhance disclosure for off-balance sheet entities, and reduce conflicts of interests between a firm and its auditing staff. Through these provisions it will be reasonably effective at preventing another "Enron tragedy" from occurring in the future.

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