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Research paper

Spectacular Transformation to Spectacular Failure: Enron and the Us Regulatory Changes

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Abstract

Enron was the blossoming company known around the world for its "spectacular transformation from domestic pipeline business to fully integrated global energy company" (Seitts, 2016). America's new shining star soon fell in the year of 2002. Enron was providing false information to stakeholders and investors making the company seem much more profitable than it truly was. The country had been fighting financial schemes since its creation. Laws were already put in place to deter fraud and prevent mass destruction in the stock market. These laws did not cover every aspect of the business world, so the government had to create a new act that would specifically lay out criteria for all layers of publicly traded companies. The Sarbanes-Oxley act was passed in 2002 and the act targeted not only internal decision makers but also external information holders such as auditors and banks. The SOX act was not perfect and did not solve all of the problems in the financial market but did lay out additional guidelines and penalties when it came to fraudulent misrepresentation.

1. Introduction

The year of 2002 brought a lot of change to the US financial market. Mass losses of jobs and money brought the world's attention upon the United States' largest companies. "The state of corporate financial reporting and auditing had reached a crisis point, threatening public confidence in the integrity of the U.S. financial markets and causing substantial losses for investors and thousands of lost jobs" (Franzel, 2014). A great example of these massive financial scams was a company named Enron which was a thriving company in the energy market. "Enron was the wonder child of the new economy and everybody believed in its success" (Aßlünder, 2005). One of the greatest reasons for belief in its success was that "Enron increased its market capitalization from about US $3.5 billion in 1990 to around US $35 billion in 1999" (Seijts, 2016). This kind of leap in market capitalization is unheard of and far out reaches any other company of its time. To get these amazing numbers, Enron was doing "off balance sheet financing…specifically to help the company meet its financial objectives" (Seijts, 2016). "Enron's first priority now became keeping the stock price up" and not actually providing the services the business was created for (Aßlünder, 2005). "We don't break rules…we get around rules" seemed to be the moto for the company (Seijts, 2016). The company's and executive's attitude as a whole created a breeding ground for fraud and greed.

The "Enron system enforced the temptation of self-enrichment and the greed for extraordinary payment" (Aßlünder, 2005) Many of the executives had tens of millions of dollars in stock and simply cashed out before the fall. "Numerous documents examined by the subcommittee clearly demonstrate that the financial institutions that partnered with Enron knew of the company's intention" (Aßlünder, 2005). "In some cases, the financial intuitions helped design the transactions specifically so that Enron could cook its books" (Aßlünder, 2005). "In monetary terms [the Enron scandal is] the largest dollar level of fraud, accounting manipulations and unethical behavior in corporate history and certainly the most economic scandals and failures since the 1920s" (Rockness, 2015). Enron was not the only company that went down due to fraudulent financial misrepresentation. Sunbeam, Waste Management, Global Crossing, Xerox, WorldCom/MCI, HealthSouth, Tyco, Adelphia Communications Cable, Parmalat, Ahold NV, Cendant, ImClone Systems Inc and many more were also greatly impacted by fraud within their companies.

Enron got away with its wrongdoing for so long due to a complex web of lies that spanned every aspect of the financial market. Banks and investors played a big role in Enron's ability to fool the public into seeing the best of the company. "Enron was ranked higher by investment banks, and its better performance with the credit raters allowed favourable conditions for refinancing; finally, the better conditions for refinancing strengthened analysts' confidence in Enron stock" (Aßlünder, 2005). The actions that Enron and investment banks took were legal if they were used in the correct manner. Instead, the company strategically and fraudulently made its assets look much bigger than they truly were. Successively, Enron invested an increasing number of assets in certain finance arrangements without any relation to real business transactions just to keep its financial situation looking good (Aßlünder, 2005). With the help of the banks, the company manipulated its balance sheet by listing the assets that it acquired through outstanding debt obligations as liabilities. Enron would not have been able to pull off such transactions without the help of two major banks, Chase and Citigroup. "Both companies helped to establish Enron's system of prepaid-forward-contracts using their own offshore companies especially designed for Enron" (Aßlünder, 2005). Overall, investment banks helped Enron borrow money through other companies to hide the loans that were taken out to acquire the big-time assets.

Another group that had big impacts on the ability of Enron to do these off the book financing was accounting and consulting firms. A specific firm that was involved in the fraud was Arthur Anderson.

Arthur Anderson was not only Enron's auditor but also its consultant. Additionally, it began to serve as the internal auditor for Enron as well. By playing all these roles, external auditor, internal auditor and consultant, Arthur Anderson ended up reviewing its own work thus failing to create checks and balances in the accounting department. "Andersen assisted Enron by creating a lot of 'creative accounting' tools and helping to establish numerous "special purpose entities" (Aßlünder, 2005). "With the help of Andersen, Enron successfully excluded about 50% of its assets selling them to numerous fictitious firms till its collapse" (Aßlünder, 2005). When selling off assets, Enron was able to appear to have growing earnings during the time of the collapse. "Andersen had ample knowledge that all these accounting gimmicks were designed only to manipulate Enron's financial situation; nevertheless, Andersen assisted Enron in numerous transactions" (Aßlünder, 2005). "Andersen, who should have been monitoring and supervising the financial activities and corporate behavior of Enron on behalf of the public, had become a part of the 'Enron system'" (Aßlünder, 2005). The consulting firms should have been a check to the Enron system but instead, they were helping with the fraud and reaping the benefits.

The government supervising agencies also played a part in the Enron scandal. In 2005, President George W. Bush signed the Energy Policy Act passed by Congress that created new rules for energy companies and a regulation committee known as the Federal Energy Regulation Commission or the FERC. "The law required utility providers to open up their power transmission systems and pipelines for other energy companies and allowed wholesale energy trading" (Aßlünder, 2005). This law was supposed to open up the energy market allowing energy companies to provide customers in different states their energy through the pipelines of other companies. Enron took advantage of this act by reducing its production of energy, in some ways outsourcing, by buying and selling energy contractually. "The FERC knew about the potential for large energy providers to manipulate energy prices" (Aßlünder, 2005). The government said that it needed more time to investigate leading to Enron's continuous reign over the energy market.

The trading back and forth between energy companies across the United States caused energy prices to skyrocket. Not only were prices a problem but also there became congestion within the pipelines. This crisis effected the state of California the worst. "…Enron bought energy in California and sold it to the surrounding states. Enron simultaneously scheduled power transmissions at the ISO (independent system operator that regulated electricity transmission in California), but never [actually] intended to transmit energy" (Aßlünder, 2005). In the aftermath of this energy crisis, Enron decided to step up and try to change the laws dealing with the energy market. Enron pushed for deregulation of the energy market by going straight to President George W. Bush's administration. In a memo addressed to the Vice President [Enron's CEO] demanded: "The Administration should reject any attempt to re-regulate wholesale power markets by adopting price caps or returning to archaic methods of determining the cost-base of wholesale power. Price caps, even if imposed on a temporary basis, will be detrimental to power markets and will discourage private investment by significantly raising political risk" (Aßlünder, 2005). Enron truly had not only had major influences in the economy but consequently had major influences in the government. The president wanted to keep the economy on the rise, so he would not dare to intervene in the Enron dominated energy market. "To hinder Enron from applying for new strategies in order to successfully invest in new market ideas would have meant destroying the confidence of consumers and shareholders in the potential of the whole New Economy" (Aßlünder, 2005).

Although the government seemed to be on the business' side, many attempts had been made by the government to stop fraud in the financial market before scandals like Enron emerged. Owens-Glass (Federal Reserve) Act of 1913 was one of the very first attempts by the federal government to prevent fraud. The focus of this act was "banking failures due to inadequate or fraudulent reserves" (Cernușca, 2011). The Owens-Glass act created the Federal Reserve System for increased supervision of banks and other financial institutions and also created additional rules for banks including routine maintenance, reserves, and reporting requirements (Cernușca, 2011). As the U.S. economy changed in the 1920s and early 1930s, new legislation was needed. Many banks had conflicts of interest and cases of fraud. The Glass- Stegall Act of 1933 prohibited banks from persisting in both commercial and investment banking. This act was "intended to keep banks from selling securities to pay off loans made by the bank to failing company[ies] or countr[ies]" (Cernușca, 2011). Additionally, the US Securities and Exchange Act of 1933 was passed in response to the new economy. The ethical focus of this act was to "prohibit deceit, misrepresentations, and other fraud in sale of securities" (Cernușca, 2011). Now banks were required to disclosure important financial information through registering securities (Cernușca, 2011). The result of the US Securities and Exchange Act of 1933 was criminalizing the sale of securities in fraudulent methods. The act was extremely successful for its use but did not cover all topics that needed to be addressed.

As a result, the US Securities and Exchange Act of 1934 was passed. This act was created to focus on new techniques of fraud such as insider trading and manipulation of both markets and financial reports. The Securities and Exchange Act of 1934 "established CPA as the independent outside auditor of published financial statements. It also provided for civil actions by the SEC and private investors for fraud, insider trading, and market manipulation" (Cernușca, 2011). In the following years, the government faced increased abuse of investment companies such as mutual funds and investments in stocks. The Investment Company Act of 1940 established the requirements of "periodic disclosure of structure, operations, financial condition, and investment policies. [It also] established fiduciary responsibilities of investment company's directors and trustees" (Cernușca, 2011). The Investment Company Act resulted in registration of mutual funds and disclosures of transactions between major management companies.

As foreign trading increased, the government needed to establish regulation on foreign exchange of not only goods but also money and investments. The Foreign Corrupt Practices Act was a pioneer act in regulation of foreign business. The Act's purpose revolved around the bribery of foreign government. It "required companies to design and maintain internal control systems and detailed records which accurately and fairly reflect financial activities" (Cernușca, 2011). FIDCA improvement act was the "first instance [an act spoke] of separate management assertion with respect to internal control and auditor attestation of management's assertion" (Cernușca, 2011) This act required reports of internal controls to evaluate compliance with federal regulations. This requirement was put into place in hopes of reducing fraud and conflicts of interest with top executives and board members. The last major act that was passed before the collapse of Enron was the Private Securities Litigation Reform Act. This act had great similarities to what would become the SOX Act. The major requirement the act put in place was the reporting of wrongdoing. "Outside auditor must report evidence of serious financial wrongdoing to board of directors and then to SEC if the board does not take appropriate action" (Cernușca, 2011). It also required these reports to be very specific to allow for a more direct investigation.

2. Sarbanes-Oxley

Sarbanes- Oxley Act, better known as the SOX Act was passed in 2002 in response to scandals like Enron. Previous legislation had

provided a platform, but did not specifically target every area in the accounting cycle. "Sarbanes is very inclusive and prescribes expected behaviors, ethical responsibilities, and certifications that carry heavy penalties if violate[d]" (Cernușca, 2011). The legislature made sure that the act covered every aspect in detail of the financial market. "The overall goal of this act is to protect investors by improving the accuracy and reliability of corporate disclosures, and much of the law seeks to further this goal by imposing strict rules for audits and auditors of publicly traded companies, by preventing insider trading and deals, by requiring companies to adopt strict internal controls, and by increasing the penalties for white-collar crimes relating to investor fraud"(Guerin, 2016). Because of the immense amount of information in this act, the act was subdivided into 11 titles that each target a specific goal to create a more trustworthy financial system.

2.1 Title I: Public Company Accounting Oversight Board

The sections within Title I establish the Pubic Company Accounting Oversight Board (PCAOB) and explain the board's importance and power when it comes to inspecting books. "The PCAOB has been directed to register public accounting firms, establish auditing standards, inspect registered public accounting firms, and lead investigations as well as disciplinary proceedings" (Anand, 2007). The board is also the central taskforce in the oversight of accounting firms that provide auditing services. The core values of the Public Company Accounting Oversight Board include "public interest and stewardship; excellence, integrity and fairness; and teamwork and diversity" (King, 2014). Some people believe that this title is one of the most important since it develops an oversight board for accounting firms.

2.2 Title Ii: Auditor Independence

The sections with Title II provide regulatory rules for auditors. The major idea of this title is to "establish clear guidelines prohibiting auditors from providing extra services to companies…includ[ing] bookkeeping, appraisal, actuarial, broker, and legal services, among many others" (Anand, 2007). This title gives an immense number of specifics when it comes to auditing companies. "Under the scope of SOX [companies] are obligated to rotate their audit partners every five years" to eliminate personal relationships being formed between the auditor and the company employees (Kecskés, 2015). Also, auditors are required to wait a year before getting an executive position at a company that was previously a client.

2.3 Title Iii: Corporate Responsibility

Title III contains many requirements for companies and chief executive officers. It ensures that only "accurate financial records are distributed to the public" (Anand, 2007). It also requires "companies [to] establish independent special audit committee[s]" (Anand, 2007). The last big component of this title is that it creates "limits regarding bonuses and stock trades for executive members" (Anand, 2007). Executive officers now "bear significant financial responsibility for the accuracy of the reports, as they have to reimburse the issuer for any bonus or other incentive-based or equity-based compensation and for any profits realized from the sale of securities of the issuer" (Kecskés, 2015). Unlike years prior, executives have to step up to the plate and be responsible for the financial statements.

2.4 Title Iv: Enhanced Financial Disclosures

The sections within this title create further requirements to promote disclosure of all financial information in the most accurate manner. "It requires that all material financial transactions be reported to eliminate misrepresentation" (Anand, 2007). It also mandates that "all annual and quarterly reports shall include all off-balance sheet transactions and relations with unconsolidated entities that materially affect the financial conditions of the issuer" (Kecskés, 2015). This title also addresses the problems of personal loans to executives and requires disclosure of share trades within the corporation.

2.5 Title V: Analyst Conflicts Of Interest

This title only has one section in it which solely speaks about conflicts of interest in auditing. This sections purpose is to "eliminate conflicts of interest that could produce biased reports by limiting the involvement that investment bankers can have with analysts" (Anand, 2007). To ensure accurate and fair analysis of securities, separation is critical in referred to the analysis of securities and investment banking division of each broker firm. This title was put in place as a safeguard against analysts influencing performance during the time period of initial public offering to increase the profits of the investment banks. Everything dealing with analyst must be reported from holding stock in the company to receiving compensation such as bonuses for productive numbers.

2.6 Title Vi: Commission Resources And Authority

Title VI speaks in great deal about the Securities and Exchange Commission (SEC). "It expands the powers of the SEC and gives it the ability to hire more manpower to oversee auditors and audit firms" (Anand, 2007). SEC is now "obliged to set forth rules of conflict of interest in order to provide an objective and realistic view for the investors" (Kecskés, 2015). The Securities and Exchange Commission is also given the authority to fire brokers, advisors, and dealers under specific conditions.

2.7 Title Vii: Studies And Reports

Title VII gives the government the power to conduct research and collect information on companies to guide how effective Sarbanes Oxley Act is and what improvements need to be made. "These reports assess public accounting firms, credit ranking agencies, and investment banks in their influence on public markets and relevant issues, including fraud" (Anand, 2007). This title sets up research to understand if business suffered due to limited completion and to identify possible problems such as an increase in prices and decrease in quality. Research is also done to make sure firms, agencies and banks are not participating in illegal acts that could result in damage to investors and the financial market as a whole.

2.8 Title Viii: Corporate and Criminal Fraud Accountability

This section of this act expands the criminalization of fraud and falsifying documents. Title VIII not only steepens the penalties but also expands the statute of limitation for fraud. "The penalties under Title VIII are for individuals who knowingly falsify or destroy financial records, as well as for auditors who fail to maintain their records for the five-year minimum" (Anand, 2007). Any documents that are altered, hidden or destroyed will result in prosecution that can be punished by hefty fines and time in prison. This title also sets up protections for whistleblowers and retaliation in the workplace. "Employees who complain of, or provide information about, actions they believe to be shareholder fraud are protected from discrimination and retaliation" (Guerin, 2016). By providing protection, people within the company may come forward at the first sign of fraud to prevent a scandal on a big scale.

2.9 Title Ix: White-Collar Crime Penalty Enhancements

Title IX increases accountability for white collar crimes by raising the criminal penalties. This title also speaks about "the legal penalties for executives who do not certify the accuracy of the

company's financial reports or who certify reports that do not meet SOX compliance standards" (Anand, 2007). Another key aspect of this title is that it states that attempting to commit a white-collar crime will be held at the same level as the actual crime itself, it does not matter whether or not the attempt was successful. The goal of this title is to increase penalties for crimes to outweigh the financial gains resulting in less fraudulent acts in the financial market.

2.10 Title X: Corporate Tax Returns

This title simply mandates that federal income tax returns are to be signed by the CEO thus increasing the executive's responsibility for accuracy of income statements (Anand, 2007). These statements are often very long and complex which requires that the CEO have knowledge of each department or sometimes means that the reports are looked over by a third party to insure accuracy. This creates another check in the system to verify that financial information is not only accurate but disclosed in full.

2.11 Title Xi: Corporate Fraud and Accountability

The sections within Title XI were created to expand the powers of the SEC when it comes to fraud. These powers include "payment freezes, as well as increasing penalties for violations of the Securities Exchange Act" (Anand, 2007). The Securities and Exchange Commission is allowed to freeze transactions that they find unusual that deal with large amounts of money. Within this section, it is established that former convictions of fraud disqualify a person from sitting in any executive position. Also, this section identifies fraud and document tampering as crime and gives each their own specific penalty.

3. Reaction to The Sarbanes Oxley Act

Following the signing of the SOX act, many companies ran into various problems. There was an overwhelming confusion on what exactly they were required to do. "In some cases, companies implemented processes and procedures that were more involved or cumbersome than required due to conflicting interpretations and aggressive enforcement by regulatory agencies" (Moran, 2013). "Even companies with a strong corporate governance environment found themselves unsure of what to communicate to regulators and how much to change" (Moran, 2013). "Companies had to develop permanent systems and processes to ensure ongoing compliance" (Moran, 2013). Another downside to the Act is the resources that it requires. The act is mandatory, so all publicly traded companies have to be in compliance. Companies lose productivity by allocating employees to making sure the company is in compliance instead of doing their usual tasks or in some cases creating new positions just to stay in compliance. "Some smaller companies listing costs were as much as $500,000 to comply" (Cernușca, 2011). Critics also bring up the time wasted by the regulations. Some believe that this act just stalls companies from completing tasks. Critics claim that it results in an unnecessary stalling in the course of audit. Other professionals believed that the SOX act was nothing new. "According to critical professional viewpoints, it only reorganizes the previous rules on investor protection, corporate governance and accounting" (Kecskés, 2015).

But there are also many positives that have come out of the passage of the SOX act. "Companies have benefited from the changes driven by SOX- from an improved approach to internal control, to an increased public confidence in financial statements- but active debate remains about whether these benefits have been worth the costs" (Moran, 2013). "The propensity to manage analyst earnings expectations to meet or beat their earnings forecasts…has significantly decreased in the Post-SOX period" (Bartov, 2009). This may seem like a small improvement to some, but it has had a huge impact on the business world. By taking away the overwhelming pressure to make the financials something that they are not has created an environment where off the books transactions do not have to take place. Another positive is that "accrual-based earning management [had] increased over time before the passage of SOX and decreased significantly thereafter" (Bartov, 2009). The impacts of the Sarbanes-Oxley act have shown through financial statements. The impacts need to continue as the economy changes.

As the financial market changes regulation needs to adapt quickly to changing circumstances, and that auditors must effectively fulfill their responsibilities at all times" (Franzel, 2014). The government has also stepped up to the plate and made changes and amendments to the act as they see fit. A "huge amount of effort has been expended by the board to create this network of rules to improve the quality of auditing and protect the stockholders of public corporations" (King, 2014). "In its first 11 years, the PCAOB has adopted 16 auditing standards that have been approved by the Securities Exchange Commission" (King, 2014). The continued work being done to improve the financial markets will continue to show in years to come. "SOX has had a major impact over the past 10 years, and it'll continue to affect the way publicly traded companies do business for years to come. While all companies have felt the burdens of increased audit costs, newly created roles within the organization, and additional work to maintain compliance, the most effective companies found ways to incorporate the intent of SOX reforms into the way that they do business, making their compliance efforts more efficient and improving management and oversight of their enterprise" (Moran, 2013).

4. Future Legislation

The Sarbanes-Oxley Act has recently been threatened by not only the American public but also the United States government. President Donald Trump signed an executive order on February 3, 2017, "urging regulatory agencies to review recent regulation… and ensure that the rules align with a list of 'core principles' that include fostering economic growth and enabling American companies to be competitive with foreign firms" (McCafferty, 2017). "The fight over the rule has been simmering for years, but…President Trump's anti-regulatory push has given it renewed intensity" (Rapoport, 2017). "Business groups want to soften a Sarbanes-Oxley rule that requires companies to have auditors weigh in on their "internal controls" – the policies and procedures intended to prevent errors or fraud on their financial statements" (Rapoport, 2017). Why is the business world asking for the change exactly? They "feel that dialing back on some of those provisions would help spur economic activity and create jobs" (Rapoport, 2017). "The number of U.S. companies going private (so-called 'going dark') has increased dramatically since the enactment of Sarbanes-Oxley" (Lanois, 2017). The numbers show the astonishing truth. The "total number of listed companies fell from 8,000 to 4,00 from 1996 to 2012" (Lanois, 2017). Many of these companies have cited Sarbanes-Oxley's compliance costs as their reason for abandoning the public market. The business professions in the current marketplace feel that the "problem with the SOX 404 is that it applied a solution for the misdeeds of a few very large companies to nearly all public companies, putting a disproportionate burden on them" (McCafferty, 2017). This is burden can include increased expenses and also increased training of specialized individuals to make sure that the companies are in compliance with all of the Sarbanes Oxley Act requirements.

The government has been working alongside President Donald Trump trying to find a solution to this problem. "The House Financial Services Committee passed a version of the CHOICE act…last year" (McCafferty, 2017). The CHOICE act had 7 key principles. Four of these principles directly related to financial institutions and fraud prevention Legislators agreed with the public in that "both Wall Street and Washington must be held accountable"

for their actions (Financial CHOICE Act). They also felt that "simplicity must replace complexity, because complexity can be gamed by the well-connected and abused by the Washington powerful" (Financial CHOICE Act) The basic principle that "economic growth must be revitalized through competitive, transparent, and innovative capital markets" was also reinstated in the CHOICE act (Financial CHOICE Act). Just like the Sarbanes Oxley act, the CHOICE act brought light again to the financial market that "consumers must be vigorously protected from fraud and deception as well as the loss of economic liberty" (Financial CHOICE Act). The CHOICE Act "contained a provision that would relax SOX 404 requirements" (McCafferty, 2017). "While a provision of the JOBS Act, signed into law by President Barack Obama in 2012, gives some public companies as many as five years to comply with 404, the CHOICE Act could make it easier for companies to receive that exemption and may include a longer time frame" (McCafferty, 2017). The CHOICE Act could also provide "newly public companies with a longer exemption period before they must meet the requirements of SOX 404" (McCafferty, 1). These changes would help small businesses that are struggling with the confusion and price of compliance.

5. Conclusion

No matter what legislation is passed, laws cannot change the morals of some business professionals. "We are still witnessing corporate misconduct and failure, as well as unethical actions in hedge funds, the stock exchanges, and mutual funds" (Rockness, 2005). Andy Fastow, the former CFO of Enron, said himself "I do not believe that the solution to this issue will appear through some miraculous piece of legislation. It's going to occur through slow, cultural change" (Seijts, 2016). Students are now being taught a "fundamentally different decision-making process with a fundamentally different vocabulary, so they develop a different view of the world" (Seijts, 2016). Andy Fastow admitted that "crossing the line typically results from operating in the grey are, where things are allowed, even if they may not be advisable" (Seijts, 2016). His advice for the up and coming business professional is to "stop worrying about personal liability and start worrying about shareholders and other stakeholders by looking at the real risks and dealing with them, instead of looking the other way and being happy not knowing what is really going on" (Seijts, 2016). Most business professionals feel a "strong conviction that we will never be "done" and cannot ever declare victory and become complacent when it comes to ensuring high-quality financial reporting and auditing to protect investors and the public interest" (Franzel, 2014).

Looking back to the early 2000's, the financial markets have become a friendlier place for investors to feel safe and protected when it comes to the information that they are provided. We have seen improvements within the financial market that makes investors more comfortable and trusting to the system. The work is not done and will never be done. As the US economy and financial markets change, the government alongside the business world will need to make improvements for investors and the country's economy as a whole. The goal of Sarbanes Oxley act was to create a change in the financial markets. The change might not have been as big and life changing as expected but it sparked a much-needed conversation about the powerhouse of the financial market and how we are able to regulate this power. The hope is that one day, not only laws change but also morals change to better our economy and our country as a whole.

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