The Events Leading Up to the Sarbanes-Oxley Act

Eric Arnold

ACCT 301
Table of Contents

<table>
<thead>
<tr>
<th>Topic/Subtopic</th>
<th>Page #</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Summary</td>
<td>1</td>
</tr>
<tr>
<td>Introduction</td>
<td>2</td>
</tr>
<tr>
<td>The Enron Scandal:</td>
<td></td>
</tr>
<tr>
<td>First Signs of Trouble for Enron</td>
<td>2-3</td>
</tr>
<tr>
<td>More Signs of Trouble for Enron</td>
<td>3</td>
</tr>
<tr>
<td>Employees’ Knowledge of Fraud</td>
<td>3-4</td>
</tr>
<tr>
<td>The WorldCom Scandal</td>
<td>4</td>
</tr>
<tr>
<td>The Arthur Andersen Scandal</td>
<td></td>
</tr>
<tr>
<td>Details of Crime</td>
<td>5</td>
</tr>
<tr>
<td>Working Atmosphere at Arthur</td>
<td>5-6</td>
</tr>
<tr>
<td>Rules and Objectives of the Sarbanes-Oxley Act</td>
<td>6-7</td>
</tr>
<tr>
<td>Conclusion</td>
<td>7</td>
</tr>
<tr>
<td>References</td>
<td>8-14</td>
</tr>
</tbody>
</table>
Executive Summary

In the early 2000’s, scandals at once respected companies such as Enron, WorldCom, and Arthur Andersen led to a question of credibility in the accounting profession. Companies such as Enron and WorldCom used accounting methods that made their earnings amounts appear greater than what they really were, and eventually these companies were caught for committing fraud. Arthur Andersen faced a felony conviction for having knowledge that Enron was acting with unethical behavior on their accounting practices, but not doing anything to stop Enron from doing this. To ensure investor confidence and regain credibility in the accounting profession, Congress passed the Sarbanes-Oxley Act in 2002.

While most business analysts in the early 2000’s considered companies such as Enron and WorldCom to be excellent investments, there were a few business analysts who were not convinced. Even former employees at these companies were convinced that their companies were promising investments. Enron and WorldCom deceived their investors by making them think these companies were excellent investments, when they were not in reality. This was a part of the working atmosphere at companies such as Enron, WorldCom, and Arthur Andersen, where profits were more important than integrity. The Sarbanes-Oxley Act was intended to stop scandals as severe as the ones at Enron and WorldCom from ever happening again. The Sarbanes-Oxley Act created requirements such as: companies having to report their implementation of internal controls and companies having external auditors approve their usage of internal controls.
The Events Leading Up to the Sarbanes-Oxley Act

In the early 2000’s, the accounting profession faced its biggest criticism for a lack of credibility and investor confidence because of the failures of once respected companies. In order for the accounting profession to regain credibility and ensure investor confidence, Congress passed the Sarbanes-Oxley Act in 2002. Companies such as Enron, WorldCom, and Arthur Andersen went from being some of the most respected companies in the United States to being the headlines for some of the biggest scandals in the history of accounting. The Sarbanes-Oxley Act have contains plenty of goals and rules in order to ensure that credibility in the accounting profession is no longer questioned. The accounting scandals at Enron, WorldCom, and Arthur Andersen in late 1990’s and early 2000’s were the major events that forced Congress to pass the Sarbanes-Oxley Act.

The Enron Scandal

First Signs of Trouble for Enron. While most people in the year 2000 felt Enron was one of the best investments of a company, there were those few people such as Mark Roberts who were not convinced about Enron being a great investment. Roberts, who operated a company called Off Wall Street, found “indications that Enron may be utilizing certain types of transactions and accounting techniques to manage and boost earnings” and not generating “enough cash flow” (Swartz and Watkins, 2003, 258). When a company does not generate a sufficient amount of cash flow, that company’s earnings amount should come out as a negative number, but that was never the case with Enron’s earnings amounts. Enron was essentially lying to their investors into thinking they were producing earnings, when in reality, they were losing money. Roberts’ findings proved that there were “smoke signals” that Enron was involved in
fraud.

**More Signs of Trouble for Enron.** Not only did Roberts suspect fraud taking place at Enron, but even an employee at Enron suspected fraud happening at Enron. This person was Sherron Watkins, who was a former vice president for Enron. One concern Watkins found with Enron’s financial information was in 2001, related to Enron’s usage of SPEs. Watkins says in Loren Fox’s (2003) book *Enron: The Rise and Fall* that the “SPEs owed Enron hundreds of millions of dollars due to their hedges on Enron investments, but they had no ability to pay and LJM had no requirement to put more money into the Raptors” (Fox, 2003, 248). SPEs were a company that managed Enron’s stocks and had some ownership interests in Enron. Enron used these SPEs to essentially make their profits appear greater than what they really were and to avoid having any debt appear on the company’s income statement. As Galit Ailon said in his (2012) article *The Discursive Management of Financial Risk Scandals: The Case of Wall Street Journal Commentaries on LTCM and Enron*: “the company hid losses and shuffled debts through complex financial procedures” (Ailon, 2012, 256). Enron performing these acts was considered fraud because Enron was presenting false information on their income statements to their shareholders. Enron was able to deceive many people prior to December of 2001, but not able to deceive people such as Roberts and Watkins.

**Employees’ Knowledge of Fraud.** Many people at Enron, from senior executives to middle-level workers, were aware that the company was committing fraud. Lynn Brewer’s belief in her (2007) article *Is There a Little Bit of Enron in All of Us?* is that “in all likelihood, two-thirds” of employees at Enron knew about the company committing fraud. One of these employees, named Sherron Watkins, was aware of this and wanted to put this to a stop. Dick
Carozza said in a *Fraud Magazine* (2007) interview of Watkins that she “sent seven pages of memos to [former Enron CEO Ken Lay] and memos to other top executives” (Carozza, 2007). These memos mentioned her opinions of how the company should no longer keep its fraud a secret to the American public. Lay and other senior executives decided to ignore Watkins’ recommendations. This goes to show that Enron was not concerned about integrity, but instead, profits.

**The WorldCom Scandal**

WorldCom was another company in the early 2000’s who filed for bankruptcy because of Congress catching them commit fraud on their annual reports. The thing WorldCom did wrong was create fake accounts and misplace expenses, in order for the company to be able to record positive earnings on their annual reports. In Susan Pulliam and Deborah Solomon’s (2002) *Wall Street Journal* article called *How Three Unlikely Sleuths Exposed Fraud at WorldCom*, it revealed that a couple of WorldCom employees were aware of “misallocated expenses and phony accounting entries” (Pulliam and Solomon, 2002). Gary Giroux mentioned in his (2008) article *What Went Wrong? Accounting Fraud and Lessons from the Recent Scandals* that WorldCom “recorded improper expenses of $3.8 billion” (Giroux, 2008, 1206). Other employees felt some of WorldCom’s accounting practices were “faulty”, but none of them had courage to say anything to the company’s senior executives. This was a part of the working culture at that company, where employees were intimidated about speaking the truth and the company was only concerned that their employees were making the company profitable. Companies that committed fraud faced strict penalties, but companies that allowed the committed fraud to happen faced strict penalties as well.
The Arthur Andersen Scandal

Details of Crime. Arthur Andersen was a company that was responsible for allowing accounting fraud to happen during the late 1990’s and early 2000’s. Arthur Andersen served as Enron’s external auditing company when Enron filed for bankruptcy for committing fraud. Flynn McRoberts mentioned in his (2002) *Chicago Tribune* article titled *The Fall of Andersen* that they committed a “felony conviction for obstructing a federal investigation into Enron Corp.” (McRoberts, 2002). John Gledhill, author of the (2003) article *Old Economy, New Economy; Old Corruption, New Corruption* said they “knowingly, intentionally, and corruptly” allowed Enron to commit fraud (Gledhill, 2003, 130). Enron was such an intimidating company that they made sure Arthur Andersen never reported any of Enron’s committed frauds. That reason as well as Arthur Andersen valuing profits over morals was why Arthur Andersen allowed Enron to commit fraud. This meant that Arthur Andersen was aware that Enron was committing fraud, and they did nothing about it.

Working Atmosphere at Arthur. Former Arthur Andersen employees would agree that the former accounting firm had the chance to stop Enron from committing fraud, but the company just simply allowed the fraud to happen anyways. One former Arthur Andersen employee, Barbara Ley Toffler, believed Arthur Andersen’s main goal was make their clients happy, regardless of the circumstance. Arthur Andersen was good at making Enron happy, but they were good to a fault. For example, she mentions in her and Jennifer Reingold’s (2003) book *Final Accounting: Ambition, Greed, and the Fall of Arthur Andersen* that a couple of workers “discovered that another Enron Special Purpose Entity, called Merlin, was not actually independent and that Enron was reimbursing investors in the partnership for losses” (Reingold
The senior partners at Enron basically ignored these claims in order to keep Arthur Andersen from facing any trouble. Arthur Andersen decided to keep Enron as one of their clients, even though they were aware that Enron was committing fraud. In the end, Arthur Andersen decided that generating revenue was more important than making morally sound decisions.

**Rules and Objectives of the Sarbanes-Oxley Act**

With the frauds and bankruptcies of Enron in 2001, WorldCom in 2002, and plenty of other companies in 2001 and 2002, the United States government needed to react. Referring to Cris Shore’s (2003) article *Corruption Scandals in America and Europe*, former U.S. Treasury Secretary Paul O’Neill reacted to Enron and WorldCom’s scandals by promising “stringent legislation to tighten up accounting rules” (Shore, 2003, 147). In order to “tighten up accounting rules”, Congress passed the Sarbanes-Oxley Act in July of 2002. According to Cindy Burrows, writer of the (2008) article *So, What About SOX? Market Response to Government Regulation*, this act was “intended to restore both shareholder and global confidence in American financial markets” (Burrows, 2008, 9). Companies such as Enron and WorldCom made their annual report information look better than what it was in reality, which fooled many of their investors. The Sarbanes-Oxley Act made requirements of how companies present their financial information, in hopes that scandals such as Enron’s and WorldCom’s do not happen again. One requirement is that companies have to mention in their annual reports how they use their internal controls effectively. After that, companies have to have external auditors confirm that the company uses their internal controls effectively. With the Sarbanes-Oxley Act, companies are
BEFORE THE SARBANES-OXLEY ACT

no longer able to manipulate their investors the way companies such as Enron and WorldCom
did in the late 1990’s and early 2000’s.

**Conclusion**

The scandals at Enron, WorldCom, and Arthur Andersen made the accounting profession realize
that their credibility needed to be improved in the early 2000’s. Without the passing of the
Sarbanes-Oxley Act, there would be many more cases of companies providing false information
to their investors. Imagine the perception of the accounting profession if the Sarbanes-Oxley Act
was never passed by Congress.

Ailon’s article goes into great detail over various companies’ risk-management techniques as well as how some companies inadequately use their risk-management techniques. Enron and LTCM are notable companies that Ailon mentions to originally have excellent risk-management skills. Though eventually, risk taking proved to be inadequate for both companies when they were both caught for providing false and misleading financial information to their shareholders.

Ailon’s article will be useful in the paragraph that talks about more signs of trouble for Enron. The article mentions how Enron hid losses and debts in order to make their annual reports look impressive to shareholders.


Brewer discusses in her article the number of Enron employees, including herself, that were aware of the company’s fraudulent behavior before the rest of the world found out about it. She feels that most of the employees, including herself, considered the company to be operated
“unethically.” In her opinion, denial was a huge reason why Enron continued use “unethical” behavior until they had to file for bankruptcy.

Brewer’s article will be referenced in the paragraph about Enron employees’ having knowledge about the fraud the company was committing. Her approximation of how many employees were aware of Enron committing fraud will be useful information to include in the paper.


Burrows’ article discusses the Enron scandal being a significant reason for Congress passing the Sarbanes-Oxley Act of 2002 in hopes of reestablishing shareholder confidence. Burrows talks about the various goals the Sarbanes-Oxley Act has in order to make sure there is never a situation such as the one with Enron that happens again. The article also mentions requirements the Sarbanes-Oxley Act must enforce such as every company having an external auditor who looks to see if a company is performing their internal controls efficiently.

Burrows’ article will be useful for paper in the paragraph that goes into the details of the Sarbanes-Oxley Act. The paper will use Burrows’ article as a reference to explain the intention of the Sarbanes-Oxley Act being passed as well as what the Sarbanes-Oxley Act enforces.


Carozza interviews former vice president of Enron, Sherron Watkins, and asks her numerous questions regarding the Enron scandal. Watkins points to greed and a lack of good moral decision making as the key reasons for Enron’s fall from power. During the interview, Watkins emphasizes the importance of the CEO of any company having good moral ethics in order for that company to have sustained success.

The Carozza interview goes into detail about how Watkins sent seven pages of memos to the former CEO of Enron. This information will be useful for the paper when talking about how Watkins and top executives were aware of fraud taking place at Enron, yet nothing was done to stop the fraud.


This book by Fox discusses how Enron went from being an innovative company to becoming one of the biggest financial collapses in United States history. In the late 1990’s, Enron was one of the most powerful and respected companies in the United States. Enron became greedy by misrepresenting some of their financial information that their investors look at, which led to Enron’s fall from power.

Fox’s book discusses the former Enron CFO’s usage of SPEs to make the company’s profit appear greater than what they really were. This is useful information that can explain how the usage of SPEs were an early sign that Enron would eventually get caught for fraud.


Giroux believes that fraud in the field of accounting can sometimes be inevitable during financial recessions. Companies that perform at high-risk, tend to be the companies most vulnerable to performing illegal accounting acts. Giroux also feels that a common cause for companies’ involvement in fraud is that the major executives of these companies believe they will not get caught.

Giroux pointing out that WorldCom recorded improper expenses of nearly $4 billion will be a useful reference for the paper. This reference will be used in the paragraph that goes into detail about the WorldCom scandal.


Gledhill’s article mentions some differences between Enron’s accounting fraud and WorldCom’s accounting fraud. The major difference according to Gledhill was that WorldCom’s accounting fraud was basic and easier to detect, while Enron’s accounting fraud was complicated and not as obvious. Gledhill finds it surprising that it took Congress such a long time to find out about Enron and WorldCom’s unethical behavior.

Gledhill points out that Arthur Andersen convicted a felony for knowingly allowing Enron to commit fraud. This information will be useful in the paragraph that discusses the details of Arthur Andersen’s crime.


McRoberts’ newspaper article gives a major reason for the collapse of Arthur Andersen in that he believes the accounting firm valued money over honesty. Workers at Arthur Andersen who were uncomfortable with dishonesty usually did not stay as a worker there. For example, a worker in 1969 kept counting the number of bricks in inventory to be less than the company’s count, which angered the former CEO, even though the worker was being truthful and the CEO was not being truthful.

McRoberts’ newspaper article will be useful in the paper when discussing the facts of what Arthur Andersen did to commit a crime. The newspaper article points out that Arthur Andersen received a felony for obstruction of justice, which is information that will be referenced in the paper.


Pulliam and Solomon’s newspaper article shares the story of how WorldCom was caught for fraud. Two employees noticed peculiar expense entries WorldCom had made that they could not find anywhere in their documents and noticed that WorldCom had created fake accounts. They counted a total of almost $4 billion in strange expenses and fake accounts, which led Congress to find out that WorldCom had committed fraud.

This newspaper article will contribute to paragraph in the paper about WorldCom committing fraud. The article explains WorldCom’s use of fake accounts and misplaced expenses, which is information that will be useful in the paper.


In this first-person narrative by Toffler, she shares her experience of working at Arthur Andersen and her opinions of what led to the fall of this once respected accounting firm. According to Toffler, Arthur Andersen made it a priority to "keep the client happy" no matter the circumstance. The use of this motto led to the accounting firm being responsible for allowing Enron to provide false information to their shareholders.

Reingold and Toffler mention how some employees at Arthur Andersen were aware of Enron committing fraud before Congress found out about it. This will be useful for the paper to show evidence how pressure from Enron, greed, and valuing profits over morals led to Arthur Andersen letting Enron get away with committing fraud.


Shore’s article looks at some of the biggest financial scandals in the United States and compares them to some of the biggest financial scandals in Europe. Shore compares the Enron scandal to the scandal of a European company called EU. The article points out that EU’s financial scandal was more significant because they had scandals in which transactions were not traceable, compared to Enron’s financial scandal.

Shore uses a quote from former U.S. Treasury Secretary Paul O’Neill where he said accounting rules need to be much tighter. This article will be a useful reference during the paragraph that talks about the rules and objectives of the Sarbanes-Oxley Act.

In this book based on former Enron vice president, Sherron Watkins, and her experience working at Enron, Swartz reveals the process from Enron being one of the most powerful companies in the United States to becoming a bankrupt company. One day, while working at Enron, Watkins found financial information of the company that suggested that the company had provided misleading information on their financial reports to their investors. Watkins emailed Ken Lay, the company’s then CEO, soon after to make him aware of her findings, which led to Watkins being considered by many a “whistle-blower.”

This book talks about how Enron used certain accounting methods to boost their earnings amounts on their annual reports. This is information that will be referenced in the paragraph discussing the first signs of trouble for Enron.