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ETHICS IN ACCOUNTING: THE CONSEQUENCES OF THE ENRON SCANDAL

ETICA ÎN CONTABILITATE: CONSECINȚE PRIVIND SCANDALUL ENRON

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Abstract: *The article discusses the Enron scandal and its immediate consequences as well as the new legislation issued as a result of several fraud scandals: Sarbanes-Oxley Act.*
Enron Corp. is known as one of the largest scandals in U.S. history. As a result of the investigations and after a long trial, Enron's former chief executive, Jeffrey Skilling was sentenced to 24 years in jail.

Key terms: *Enron, Sarbanes-Oxley Act, effects, ethics, compliance, costs*

INTRODUCTION

Enron, "a provider of products and services related to natural gas, electricity and communications to wholesale and retail costumers" (Chary, 112) represented one of the largest fraud scandals in history. As a result of the fraud investigations, the company was forced to file for bankruptcy in December 2001.

Up to end of 2000, no one pointed fingers at Enron. For 2000, the corporation reported $101 billion revenue and the auditors gave a clean report. But, at this stage, Enron announced its intention that during the third quarter of 2001, it would book a loss of $1.01 billion and, at the same time, reducing shareholders' funds by $1.2 billion as a result of correcting accounting errors in the past.

After a long trial, Andrew Fastow, the former Enron finance executive has been sentenced to six years in prison. Fastow pleaded guilty for fraud and money laundering in 2004 and also became the chief whiteness in the trial against Jeffrey Skilling and Ken Lay. His testimony helped convict Lay (who died in July 2006 after a heart-attack) and Skilling,

who was sentenced to 24 years in jail. In May 2006, the latter was found guilty on 19 counts of conspiracy, fraud and inside trading over Enron scandal. Skilling was found to have orchestrated a series of deals and financial scheme which later lead to loses as they hide debts from investors. Michael Kopper, former executive at Enron, was sentenced to 37 months in jail. Kopper pleaded guilty in 2002 to wire fraud and money laundering and his testimony helped convict Fastow. Michael Koenig, another former executive, served 18 months in jail as he helped present false accounts to investors.

After the Enron scandal, one of the debates was conducted around the ethical behaviour of executives. Although there are a number of factors that influence ethical behaviour, none were powerful enough to change the ethical behaviour. As stated by Weeks & Nantel, the only factor that could change the ethical behaviour is a properly devised distributed, promoted and enforced code of ethics, updated on a regular basis, which can act as a catalyst in an organisation to comply to ethical standards (Weeks & Nantel, 1992).

Enron did have a Code of Ethics, a nearly 65 pages document which probably made employees think that the company they are working for is a pure and clean organisation. The Code begins with a letter from Enron's founder, Kenneth Lay, who assures employees he conducts business "in accordance with all applicable laws and in a moral and honest manner" (apud Michael Miller). Also, the Code states: "We know Enron enjoys a reputation for fairness and honesty that is respected. Enron's reputation finally depends on its people, you and me." (apud Michael Miller). The Code is based on several values, such as respect, integrity and communication. Sadly, Enron's executives didn't comply to any of the Code's requirements.

The Enron scandal led to huge losses to company creditors, investors and employees but the reasons why the scandal took place had little effect on other parties (Sosnoff, 2002).

The initial government response to the Enron bankruptcy was to impose new regulations that would give employees more flexibility to sell the company's stock in their 401(k) retirement plans. The new regulation would allow employees to sell any company stock contributed to 401(k) after 3 years.

Enron followed a rule that allows a company to prevent employees to sell company stock, including 401(k), before the age of 50 (Stevenson & Labaton, 2002). Obviously, this was a very questionable practice when a company chooses to preserve its stock value at the expense of its employees. At one point, the Enron employees had 60% of their 401(k) in Enron stock, causing them to lose more than $1 billion, as the share price fell from more than $90 in August 2000 to less than $1 when the company declared bankruptcy.

Clearly, after the Enron scandal, investor sentiment was not expressed as public outrage but it affected the valuation of public firms and the US stock market and hence creating a need to improve investor confidence in US financial markets.

The revelation of "unethical" accounting policies by Enron and other firms (such as WorldCom) and the continuous weakness of the stock market, have determined political and public support for free-market policies. It has already led to increased regulations of accounting and auditing authorized by the Sarbanes-Oxley Act and an increase in criticism of privatisation.

The most significant changes brought on by the Sarbanes-Oxley Act include (*Joseph T. Wells, 334*):

- The creation of the Public Company Accounting Oversight Board;
- Requirements for senior financial officers to certify SEC filings;
- New standards for auditor committee independence and for auditor independence;
- Enhanced financial disclosure requirements;
- New protection for those who disclose frauds;
- Enhanced penalties for white-collar crime.

According to Gifford, SOX is a result of public demand to "do something" about a problem of concern regarding American corporations (2004). However, the major potential problem of the Act is that senior corporate managers may be held liable for the illegal actions of their subordinates that these managers did not direct or even know about.

An FD Morgen-Walke survey showed that 40% of portfolio managers and investors said that SOX reforms are insufficient to enhance accountability, while 56% say they are unconvinced that a public accountability board will be more effective than the old system. However,

more than 53% believe that Enron-like scandals are not just work of a "few bad apples", as the Bush administration indicated. But the investors see the SOX as a step in the right direction. Two out of three investors said that CEO/CFO certifications enforced and the penalties imposed would improve the accuracy of financial reporting (Smart Pros, 2002).

Sarbanes-Oxley Act compliance is mandatory; therefore resources must be allocated to its implementation. As a result, the diversion of funds from other potentially profitable endeavours may result in improper investment which can further result in loss of value or innovation to companies. Furthermore, companies lose productivity with the necessity of allocating employees to compliance instead of their usual profitable activity. Also, some of the resources required to implement the Act cannot be included in rate of investment (ROI) calculations, hence in meeting ROI targets, the Act may fall short of acceptable levels.

As a result of SOX, as found by a Wharton School study, delisting of public companies tripled in 2003 from 2002 ((Leuz, et, al., 2004). The study found that most companies de-listed their shares in an attempt to avoid high costs of complying with the Act, mostly because some smaller companies listing costs were as much as $500,000 to comply.

Controversial or not, SOX "has often been described as the most important corporate reform legislation in the United States since the Securities and Exchange Act of 1934" (Business Law Online).

In recent years, researchers have begun to examine the market reaction to the passage of the Sarbanes-Oxley Act. Li, Pincus, and Rego (2004) find significantly positive stock returns associated with SOX's final provisions, while Rezaee and Jain (2003) show a positive stock price reaction on several days before the passage of SOX.

Several studies showed that customers believe it's important for a business to seek out ways to employ good governance and that companies have a more positive image if they are doing something to make the world a better place. (Ptacek & Salazar, 1997; Weeks & Nantel, 1992). However, the public's scepticism towards the actual results remains high.

Obviously, no system of controls can prevent all misconduct, but a company can demonstrate that it has satisfied its obligation to implement good procedures and hence has a better chance to receive leniency.

A survey by Oversight Systems Inc. (2004) asked what impact SOX compliance had on shareholders value. 37% of respondents say SOX

increase shareholder value as investors know they operate as an ethical business, while 25% of those questioned report that SOX boosts shareholder value by building overall confidence in the market. But the survey also showed the negative impact of SOX on the stock value. 33% of respondents say that SOX compliance created costs that suppress the stock prices, while 14% say that SOX decreased their ability to pay out dividends as compliance costs are draining their earnings.

A 2003 study by AMR Research found out that as much as 85% of public companies are planning changes in their IT systems in order to support compliances to SOX To analyze the effect on SOX on shares, Gompers, Ishii and Metrick (2003) construct a governance index to capture the extent of shareholders' protection in a corporation using some of the governance rules. The researchers show that the relationship between shareholders and executives is defined by the rules of corporate governance.

John, Litov, and Yeung (2004), in a research, show that an increase in investor protection reduces executives' inclination to bypass risky projects that could bring value to the company. This suggests that SOX should lead to an increase in risk-taking by companies with weak shareholder rights.

SOX applied to all companies in the United States. Of all the provisions, only two apply to nonprofits. However, these two provisions quickly sparked debates whether nonprofits should adhere to certain provisions of the Act. The provisions that apply to nonprofits refer to the Independent Audit Committee, auditor responsibilities, certified financial statements, "whistleblower" protection, document destruction policy, disclosure and insider transactions and conflicts of interest.

Although the debate regarding SOX compliance and effects have been mostly about United States companies, little focus has been placed on effects of SOX compliance on the global trade. The Act requires companies involved in international trade to establish control for import-export operations and global supply chain. The processes must be published in annual and quarterly reports to investors. Furthermore, companies have to report their efforts to "identify, assess and respond to risk such as terrorist attacks" (Field, 2004). Wrongful declarations and errors in valuation of import-export operations will face legal action under the new Act as well as under the Customs and Border Protection, the Department of Commerce and

the Food and Drug Administration and other agencies. According to SOX, companies involved in international trade have to disclose all off-balance sheet transactions, obligations and arrangements. Failure to comply, results in delisting the company by the SEC or barring of international trade.

CONCLUSIONS

It's hard to believe that anything good would come out after a scandal such as Enron. However, even with the loss of million of jobs and thousands of dollars, the lessons to be learned from Enron might be a valuable by-product of the entire scandal. As a result of the scandal, the Sarbanes-Oxley Act forced companies to better control their accounting policies and make financial information more reliable. The scandal brought attention to the financial statement fraud by executives and, as a result, good governance has become a priority for most companies, while the focus on ethics in financial reporting has increased investors confidence in some companies.

The Sarbanes-Oxley Act has obviously had an impact on the managerial structure and government regulations of the public company. The Act attempts to regulate what would normally be personal ethical decisions in a corporate world where ethics are not really of any interest anymore. SOX is an excellent step towards regulating corporate governance and is comparable to the legislation implemented in Europe.

Sarbanes Oxley Act has both positive and negative effects. The Act has a predominating positive effect of increased investor confidence in the US financial market but also creates costs that result in lowered productivity of public companies and dilution of the dominant US financial services market.

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