

In the Midst of Corporate Fraud:  
History, Legislative Responses and the Impact of Sarbanes-Oxley

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## **In the Midst of Corporate Fraud: History, Legislative Responses and the Impact of Sarbanes-Oxley**

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The early years of the 21<sup>st</sup> century marked a significant turning point for the accounting profession as its credibility shattered under the collapse of numerous financial institutions. Investors and the public became more and more skeptical as to the reliability of financial documents and the stability of other major corporations that had not yet fallen as an increasing number of accounting scandals were revealed. In what is referred to as the Corporate Scandal Sheet, Forbes provides a list of 22 companies whose accounting improprieties resulted in huge investor loss and negative media attention. The list provides information pertaining to the allegations, investigating agencies involved, and the date in which each of the frauds were made public. The firms listed include: Xerox, WorldCom, Tyco, Reliant Energy, Qwest Communications International, Peregrine Systems, Nicor Energy LLC, Mirant, Merck, Kmart, Homestore.com, Halliburton, Global Crossing, Enron, El Paso, Dynegy, Duke Energy, CMS Energy, Bristol-Myers Squibb, Arthur Andersen, AOL Time Warner and Adelphia Communications (Patsuris, 1). Collectively, these companies represented huge flaws in financial legislations and numerous failures in the enforcement of regulations. Of those companies listed above, the three that probably received the most attention were WorldCom, Enron, and Arthur Andersen. The fraudulent activities of these three companies were very influential in both the development and passage of the Sarbanes-Oxley Act of 2002 that has significantly impacted public accounting firms and their audit clients.

## ***WorldCom: A Company's Rise to Power and Subsequent Downfall***

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### ***Early History***

WorldCom's history began in 1983 when Murray Waldon, William Rector, Bill Fields and investor Bernard Ebbers founded LDDS, also referred to as Long-Distance Discount Service. The Hattiesburg, Mississippi based company was designed to take advantage of misfortunes that had taken place at AT&T by signing leases for the use of local Bell System Wide-Area Telecommunications Services (WATS). The idea was for LDDS to purchase "line time" through the signing of leases, and then turn around and sell the time to local businesses. As long as the expenses to lease the WATs remained stable, LDDS could afford to sell "line time" at discounted prices as its number of customers increased (MCI, 7). Unfortunately for LDDS, however, the costs to lease the lines increased and the company began to face recurring losses.

Unable to effectively counter the increasing costs, the owners of LDDS made Bernard Ebbers president and CEO of LDDS in 1985. With a focus on customer service, Ebbers led LDDS in selling its services in customized bundles to smaller businesses that were being ignored by the larger telecommunications companies. By following such an approach, and by acquiring other long-distance providers, LDDS was able to raise annual revenues to \$95 million after three years and extend its coverage to nine other states including Missouri, Tennessee, Arkansas, Indiana, Kansas, Kentucky, Texas, Alabama, and Florida. Then in 1989, LDDS became LDDS Communications, Inc. through the acquisition of Advantage Companies Inc. which enabled LDDS to become a publicly traded company. Through further acquisitions, LDDS was able to reach 27 states by the end of 1991.

Although the LDDS network was present in 27 different states, up through 1991, many of the calls provided by LDDS either began or ended within LDDS's network, but not both (MCI, 8). Important acquisitions in 1992 and 1993, however, reduced the occurrence of such situations. In 1992 LDDS merged with Advanced Telecommunications Corp. (ATC) which increased revenues by 30 percent. Then in 1993, LDDS merged with Metromedia Communications Corporation (MCC) and Resurgens Communications Group, Inc. in a \$1.2 billion "three way stock and cash transaction" which not only eased rumors about a possible hostile takeover, but also helped to make LDDS "the fourth largest long distance provider in the United States behind AT&T, MCI, and Sprint" (MCI, 8/WorldCom Co., 1). Under the name LDDS Communications, Inc. the newly merged long distance telephone providers provided services in every state except for Hawaii and Alaska. Also during this time, LDDS's headquarters were moved to Jackson, Mississippi and Ebbers's title of CEO was transferred over to LDDS Communications, Inc.

### ***Going Global***

As the leaders of LDDS Communications, Inc. watched their company grow within the United States, they also hoped to extend their reach into other countries. Two important acquisitions near the end of 1994 and beginning of 1995 helped them reach their goal. In December of 1994, LDDS Communications, Inc. acquired IDB Communications Group, Inc. after negotiating a \$900 million stock deal (MCI, 9). The acquisition of IDB allowed LDDS to gain "gateways to 65 countries, voice and data networks, undersea cables, and international earth stations and satellites (MCI, 9)." In early 1995, LDDS purchased Williams Telecommunications Group Inc., a division of a pipeline company known as the Williams Companies. The purchase from Williams Companies was a turning point in LDDS's history as it gave LDDS access and control of a fiber

optic cable network that was 11,000 miles long (MCI, 9). LDDS was now in control of one of the largest U.S. networks.

Aspiring for the company to be viewed as being successful abroad as well as in the United States, LDDS's leaders renamed the company WorldCom. The goal for global success, however, was soon joined by another of WorldCom's ambitious objectives when the Telecommunications Act of 1996 was passed by Congress. The Telecommunications Act of 1996 removed barriers that had been set up to prohibit long distance providers and local providers from joining forces (MCI, 9). A few months after the act was passed, WorldCom acquired MFS Communications Company, Inc. and MFS's subsidiary UUNET Technologies, Inc. MFS was a provider of local telecommunication services and UUNET was the first and largest Internet service provider in the world (MCI, 9). Then in 1997 and 1998 WorldCom merged with CompuServe Corp, Brooks Fiber Properties Inc. and MCI Communications Corp. After merging with MCI, WorldCom, "boasted of 22 million customers, 25 percent of the long distance market in the United States, some 933,000 miles of fiber for long distance service, local network facilities in 100 U.S. markets, 508,000 fiber miles for local service, and an international presence in more than 200 countries (MCI, 9)."

Such achievements, however, still did not satisfy WorldCom's ambitious streak. For in 1999, WorldCom and Sprint arranged a \$129 billion deal to merge the two companies which had become the second and third largest long distance service providers within the United States (Beltran, 2). The agreement, however, was withdrawn by both WorldCom and Sprint before representatives of the companies met with a European Union regulatory committee. The

withdrawal of the plan to merge was in response to the filing of an antitrust lawsuit by the United States Department of Justice in late June of 2000. Antitrust regulators in both the United States and in Europe feared that if WorldCom and Sprint merged, the newly formed joint venture would create a monopoly. The company that had started out leasing local Bell-system WATS networks to purchase “line time” to be resold at a discount to small businesses was now feared to be on a path of becoming a monopoly.

### ***Questionable Reporting***

Although WorldCom had not become a monopoly, its high status meant that if improprieties were to significantly weaken the foundations of the company, its pillars had a long way to fall and the potential for thousands of investors, creditors and consumers to be harmed in its collapse would be likely. Indeed one of the first indications of reporting problems came on March 11 of 2002 when the SEC informally inquired about certain accounting practices and questionable loans (WorldCom Company, 1). Further indications of problems came in the following few weeks as WorldCom began laying off thousands of employees which was a telltale sign that the company was trying to rapidly reduce short-term expenses. In addition, credit rating agencies, such as Standard & Poor’s and Moody’s Investors Service cut WorldCom’s ratings. Then on April 30, CEO Bernard Ebbers resigned and John Sidgmore, a former WorldCom chairman, became the new CEO. Throughout May WorldCom’s credit and debt ratings were cut to junk status and on May 13, the company was eliminated from Standard & Poor’s S&P 500 Index (WorldCom Company, 2). The company also continued taking steps to reduce its workforce and placed a lot of strain on various lines of credit. Then on Tuesday, June 25, SEC suspicions pertaining to accounting improprieties were confirmed.

***Scandal!***

In an article written for Forbes, Dan Ackman stated the following: “Still Tuesday it managed to shock the world with-of all things-an accounting scandal (Ackman, 1).” On June 25, WorldCom publicly announced that Scott Sullivan, WorldCom’s former CFO, had been fired and that expenses for 2001 and early 2002 had been understated by \$3.8 billion. In addition WorldCom announced its plans to reduce its workforce by about 20 percent (WorldCom Company, 2). As investors reacted, the value of WorldCom shares that had previously been traded on the Nasdaq at \$64 per share in June of 1999 fell to \$0.20 per share (Ackman, 2). Then on June 26, the value of the shares fell even further to \$0.09 before the market opened and Nasdaq halted further trading (Ackman, 2/WorldCom Company, 2). Also on June 26, former President George W. Bush ordered an official investigation of WorldCom’s accounting practices and financial situation (WorldCom Company, 2).

On July 1, WorldCom publicly announced that the accounting scandal may have dated back to 1999 and three weeks later on July 21 WorldCom officially filed for what became the largest U.S. bankruptcy to date. A couple of weeks later WorldCom’s reputation was further degraded as company representatives announced a \$3.3 billion increase in estimated misstatements for 2001 and early 2002. Unfortunately for WorldCom the estimations were not finished because on November 6 of 2002 the SEC announced that WorldCom was guilty of more than \$9 billion in fraudulent misstatements and activities (WorldCom Company, 3).

### ***Fraudulent Practices***

WorldCom's \$9 billion plus fraud has been considered to have been much more simplistic to commit as compared to the frauds committed by other companies listed on Forbes's Corporate Scandal Sheet. For example, in her article "WorldCom: A Simple Recipe for Cooking the Books," Rebekah A. Sheely, Ph.D., CPA states: "While Enron is perhaps the most complicated fraud in the recent string of business failures, WorldCom was the most simple to perpetrate (Sheely 1)." For the most part, WorldCom's model for fraud included improperly classifying operating expenses as capital expenditures and inappropriately issuing personal loans to corporate executives.

With regard to the misclassification of operating expenses, one could gain a basic understanding of the fraud by knowing the basic definitions and differences between operating expenses and capital expenditures and the general effects that they have on net income (Sheely 1). As such, operating expense accounts such as Utilities Expense and Machine Maintenance Expense are referred to as temporary or nominal accounts because their balances are not carried from one reporting period to the next. Rather, the account balances are closed at the end of each reporting period into an Income Summary account, which in turn is closed into a capital account. Capital expenditures, on the other hand, are costs of improvements to and/or additions to a fixed asset that are capitalized (Warren, G-2). The capitalized costs add value to the related fixed asset and the corresponding expenses are allocated over the useful life of the asset (Warren, G-2). In other words, while operating expenses are recognized in the short term, the expenses relating to capitalized assets are recognized mostly in the long term with only relatively small portions contributing to current year end expenses. Therefore, if members

of upper management wanted their company to appear more profitable and show higher net income, they might try to hide current expenses by reclassifying them as capital expenditures and as a result would also make their balance sheet appear to be more appealing. Another motivation for management to manipulate the recognition of expenses might be to reduce income volatility. Regardless of management objectives, however, earnings quality would be reduced through the misclassification of capital expenditures.

As WorldCom's competitive advantage dwindled away, the company increasingly relied on taking expenses and reclassifying them as capital expenditures. For example, \$500 million in computer expenses were capitalized to be shown in asset accounts (Sheely, 2). Also, at Scott Sullivan's bidding, David Myers, WorldCom's former controller and senior vice president, often capitalized expenses relating to "line costs," which refer to expenses associated with leasing "line time" from other companies to complete calls (Sheely, 2).

As mentioned earlier, WorldCom's misconduct also included the inappropriate issuance of loans to corporate executives. With regard to issuing personal loans to corporate executives, approximately "27 percent of major publicly traded companies had loans outstanding for executive officers in 2000," including WorldCom (Moberg, 5). Obviously, the issuance of personal loans to executive officers by their respective companies was not uncommon, but the question of whether such loans were ethical remained.

In the case of WorldCom, approximately \$366 million in personal loans were granted to Bernard Ebbers by the company (Beltran, 2). The high dollar amount, however, was not the only problem pertaining to the disreputable loans. Prior to issuance, Ebbers had a tendency to

purchase common stock using shares that he already had as collateral, which meant that if the value of the common shares declined, more collateral would be required to satisfy margin calls (Moberg, 4-5). In addition, Ebbers often used common stock to secure commercial bank loans to finance a number of other businesses that were owned by Ebbers (Pandey, 118). The other businesses included “hotels, real estate ventures, a Canadian cattle ranch, timberlands, a rice farm, a luxury yacht building company, an operating marina, a lumber mill, a country club, a trucking company, and a minor league hockey club” (Pandey, 118). The loans used to finance such businesses were also subject to potential margin calls.

Under instructions from WorldCom’s Board of Directors, Ebbers accepted personal loans with low interest rates from the company to cover the additional collateral needed when the stock price of WorldCom’s shares plummeted because the Board did not want investors to question WorldCom’s health if it were publicized that the CEO was selling large amounts of common stock (Moberg, 4-5). Not only was the Board attempting to conceal major financial problems from investors, but the directors were also issuing loans with rates “considerably below those available to “average” borrowers and also below the company’s marginal rate of return” (Moberg, 5). According to an article published in late 2004, the average interest rate on Ebbers’s personal loans was only 2.15% (Pandey, 117). To conceal its faltering financial status, WorldCom’s fraud included the issuance of questionable loans in addition to the reclassification of operating expenses as capital expenditures.

### ***A Culture of Individualism***

In a management case study published in Vikalpa's Journal for Decision Makers, Professors Satish Pandey and Pramod Verma described WorldCom's corporate culture as being "an 'individualistic culture,' where loyalty to people was appreciated and rewarded more than the loyalty to the company" (Pandey, 117). The study indicated that WorldCom's top-down management approach was so ingrained into the corporate culture that regular employees found it nearly impossible to effectively communicate concerns about financial reporting, company policies, and questionable behavior exhibited by corporate officers (Pandey, 117). Former WorldCom controller David Myers's treatment of Steve Brabbs was cited as an example.

Steve Brabbs was the Vice President of International Finance and Control in WorldCom's London division. On numerous occasions, Steve Brabbs expressed concerns regarding questionable accounting practices. For example, in 2000 he discovered and questioned what appeared to be an understatement of \$33.6 million in line costs. Rather than responding to Steve Brabbs's concerns with investigations and direct communications with Arthur Andersen staff, corporate officials such as David Myers and Mark Willson ordered Brabbs to keep quiet (Pandey, 117). David Myers told Brabbs that he had no business questioning Arthur Andersen staff, while Mark Willson, informed Brabbs that "he was not following the correct protocol in dealing with issues raised with Andersen's British representatives and that 'asset writedowns and other accounting determinations would be made by Andersen officials in the United States'" (Pandey, 117). Although Steve Brabbs stood up on numerous occasions to express his concerns, his inquiries were typically ignored or met with severe criticism. No policies and

procedures had been established to allow concerned employees to effectively communicate their concerns about financial reporting and corporate operations.

Another example of WorldCom's corrupt culture was demonstrated through Scott Sullivan's attempts to squelch additional concerns among managers. Sullivan "instructed David Myers and Buford Yates, the Director of General Accounting, to handle any resistance from other managers" that related to the misclassification of "line costs" as capital expenditures (Pandey, 118). Sullivan also instructed Myers to "restrict the scope" of an operational audit being performed by WorldCom's internal audit team (Pandey, 118). The audit was being led by WorldCom's Vice President of Internal Audits, Cynthia Cooper. Although Cooper was told to limit her testing of capital expenditures and was even told to delay the audit, Cooper and her team ignored Sullivan and Myers's orders. As demonstrated in the examples above, there were officials who were aware of financial problems, but the attainment of such knowledge was often followed with attempts to cover up fraudulent misstatements.

### ***Roles of the auditors***

Although the WorldCom scandal had resulted in the largest bankruptcy filing in U.S. history, it is important to note that it was internal auditors rather than the external auditors who detected and reported the fraud. Arthur Anderson LLP was the public accounting firm responsible for performing WorldCom's external audits, but the accounting firm failed to detect and uncover WorldCom's fraudulent activities. According to a U.S. District Court, Anderson auditors would have discovered numerous material misstatements if the firm had conducted an examination of how WorldCom recorded line costs (Sheely, 3).

Shown below in Exhibit 1.1 is a copy of Arthur Andersen's 2002 audit report of WorldCom.

### Figure 1.1

To the Shareholders of WorldCom, Inc.:

We have audited the accompanying consolidated balance sheets of WorldCom, Inc. (a Georgia corporation) and subsidiaries as of December 31, 2000 and 2001, and the related consolidated statements of operations, shareholders' investment and cash flows for each of the years in the three-year period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those **standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.** An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

**In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of WorldCom, Inc. and subsidiaries as of December 31, 2000 and 2001,** and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.

As discussed in Note 1 to the consolidated financial statements, effective January 1, 2000, the Company changed its method of accounting for certain activations and installation fee revenues and expenses.

ARTHUR ANDERSEN LLP

Jackson, Mississippi  
March 7, 2002

<http://www.uic.edu/classes/actg/actg516rtr/Readings-M/Worldcom-10K-01.txt>

As stated in the second paragraph of the auditor's report, "standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (Whittington, 42)." In addition, "An audit includes examining, on

a test basis, evidence supporting the amounts and disclosures in the financial statements (Whittington, 42).” Arthur Anderson failed to follow protocol by omitting certain relevant examinations from their audit plan. Members of the internal audit team, however, were much more diligent. Cynthia Cooper, Gene Morse, and Glyn Smith, all members of WorldCom’s internal audit team, played key roles in detecting the fraud, and upon discovering the fraud, they immediately briefed the head of the audit committee (Sheely, 2-4).

Interestingly, Arthur Andersen had not only failed to discover the fraud, but also failed to respond to concerns expressed by WorldCom’s internal audit team. After hearing that former CFO Sullivan had questionably taken control of \$400 million in hedge funds from a senior manager, Cynthia Cooper had notified Andersen auditors who failed to investigate the matter (Moberg, 7). Cynthia Cooper then addressed WorldCom’s audit committee and she, Morse, and Smith continued to look for evidence of fraudulent activity. After discovering \$2 billion of operating expenses that had been reclassified as capital expenditures without authorization, Cynthia Cooper and Glyn Smith spoke with Max Bobbit, head of the audit committee who in turn addressed WorldCom’s new auditors KPMG and the remainder of the audit committee (Moberg, 7). WorldCom’s audit committee responded quickly and publicly announced its first estimate of the misstatements and fired Scott Sullivan. In addition to firing Sullivan and asking KPMG to perform a comprehensive audit for 2001 and 2002, WorldCom’s board of directors also contacted the SEC and the company’s lead bank lenders to inform them of the situation (Pandey, 113). WorldCom’s audit committee also appointed William R. McLucas to lead an independent investigation of WorldCom’s practices and financial situation. William R. McLucas

was from the law firm Wilmer, Cutler & Pickering and had formerly served as the Chief of the Enforcement Division of the Securities and Exchange Commission (Pandey, 113).

### ***Reorganization and emergence from Chapter 11 Bankruptcy***

On April 15, 2003, approximately 9 months after filing for bankruptcy in the southern district of New York, WorldCom introduced the first draft of its reorganization plan in which the company would be renamed MCI. After 5 months of revisions and subjection to approval processes of other long-distance providers such as Verizon, a judge overseeing the WorldCom case in U.S. Bankruptcy Court authorized the release of the reorganization plan to creditors for approval on September 12, 2003 (WorldCom Company, 4-5). After making additional revisions to address creditor objections to the reorganization plan, WorldCom representatives presented the final draft of the reorganization plan which was approved by U.S. Bankruptcy Judge Arthur J. Gonzalez on October 31, 2003 (WorldCom Company, 5). Almost six months later, on April 20, 2004, WorldCom emerged from bankruptcy as MCI Incorporated. Then on February 14 of the next year, Verizon Communications Inc. made public its plan to purchase MCI for \$6.75 billion (WorldCom Company, 6).

Although WorldCom eventually emerged from Chapter 11 bankruptcy in April of 2004 after being reorganized and renamed MCI, the company's reputation was still severely damaged and the lawsuits were not finished. Even Verizon's purchase of MCI Inc., could not erase from investors' memories the scandal that had helped to shatter the credibility of the accounting profession. The name WorldCom continues to be used as an example of how accepting accounting improprieties does not pay in the long term.

### ***Additional Aftermath***

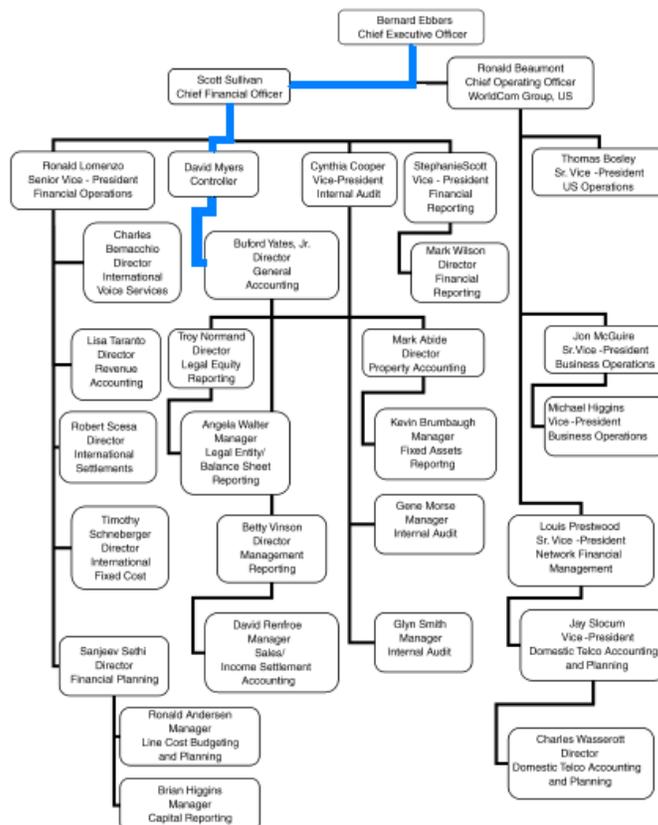
Numerous arrests were made in conjunction with fines levied against WorldCom. On August 1, 2002, Scott Sullivan (former CFO) and David Myers (former Controller) were arrested for falsification of documents filed with the SEC and for securities fraud. A couple of months after his arrest, David Myers plead guilty to the falsification of the documents, the securities fraud, and also to three counts of conspiracy. Buford Yates Jr. (former accounting director) met a similar fate after being charged with two counts of securities fraud and conspiracy.

With regard to Scott Sullivan, even after his arrest he still would not initially admit to his involvement in the WorldCom scandal. For example, on April 22, 2003 he pleaded not guilty to securities and bank fraud (WorldCom Company, 5-6). The prosecution, however, was not impressed and added participation in thirteen types of accounting fraud to their initial accusations in December of 2003. Only when a prison sentence seemed inevitable did Sullivan admit to his participation in the securities fraud, falsification of documents, and bank fraud. He was sentenced to five years in prison.

Sullivan's five years in prison, however, were minimal as compared to the prison sentence given to former CEO Bernard Ebbers. Ebbers initially plead not guilty on September 3, 2003 after being accused of violating Oklahoma fraud and securities statutes (WorldCom Company, 4-6). On March 15, 2005, however, Ebber's like Sullivan was found guilty of engaging in securities fraud, falsification of filed documents, and conspiracy (WorldCom, Company, 6). Ebbers was sentenced to 25 years in prison.

### ***A Culture of Individualism Revisited***

Although Sullivan, Ebbers, Myers and Yates were not the only individuals who played active roles in covering up fraudulent activities, it is interesting to review the relationships between these individuals in WorldCom’s organizational structure. The diagram shown below is a partial organizational chart showing the relationship between officers in key positions immediately before the WorldCom scandal became public. As shown in blue, a chain of direct relationships was present amongst Ebbers, Sullivan, Myers and Yates. The links among these officers further emphasizes the “individualistic culture” that was present at WorldCom. While a top-down approach is not in and of itself a poor strategy, the absence of an effective program that allows lower level managers and employees from expressing concerns may help lead to the downfall of a company. [Diagram retrieved from (Pandey, 124)].



## ***Enron: Creative Innovation Followed by Creative Accounting***

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### ***Deregulation and a Brief History***

Enron came into existence on May 3, 1985 through the merger of Houston Natural Gas and InterNorth. Commonly referred to as a “child of deregulation,” Enron chose to find ways to take advantage of deregulation (Fox, 11). The energy industry had been highly regulated and prices were generally set by governmental bodies rather than through market forces. With regard to the gas industry, gas producers typically found and pumped gas while gas pipelines purchased the gas directly from producers at prices set by governmental authorities (Fox, 10-13). Local gas utilities would then purchase the gas from the pipeline companies. The prices paid by the local utilities were also typically set by governmental authorities. Such regulation, however, often resulted in shortages since producers did not have many incentives to continually explore for and extract additional gas due to limited potential for profit growth (Fox, 10-13). As a result, the energy sectors underwent a series of deregulations to encourage increased production through the potential for increased profits.

During early attempts to increase gas production, governmental authorities allowed gas producers and pipeline companies to engage in “take-or-pay” contracts in which pipeline companies “would agree to purchase at least a set minimum amount of gas in the future from gas producers” (Fox, 10-11). On the date of settlement, the pipeline companies could accept the gas or refuse to transport it and pay for the gas with an additional penalty (Fox, 10-11). Such efforts resulted in temporary reliefs from insufficient levels of production, but after a few years, economic hardships led to a surplus of gas and thus lower market prices.

For pipeline companies just entering the market, the lower prices were welcomed, but for those companies subject to higher purchase prices under “take-or-pay” contracts, the lower market prices resulted in huge losses (Fox 10-11). To ease the effects of fluctuating market prices, the Natural Gas Clearinghouse was developed in 1984 after a “spot-and-hub” market was approved by regulators (Fox, 10-11). The spot-and-hub system allowed both gas producers and pipeline companies to sell gas directly to wholesalers. The wholesalers in turn would sell the gas to local utilities in monthly supplies.

Following the formation of the Natural Gas Clearinghouse was the enactment of Order 436.

Issued by the Federal Energy Regulatory Commission (FERC), Order 436

“encouraged pipeline companies to voluntarily make their lines available to all gas utilities, which meant that local utilities could buy gas from the producers and then pay the pipeline just for transporting the gas. It meant pipeline companies had to separate their businesses of gas transportation and gas sales.” (Fox, 13)

As a result, certain gas pipeline companies, such as Enron, often became more like traders of financial contracts and were increasingly affected by fluctuating gas prices.

Enron quickly became the second largest pipeline network in the United States with both intrastate and interstate lines. The company also participated in numerous mergers and acquisitions that often left the company with large amounts of debt. By the end of 1985, Enron had reached a debt to capital ratio of 75.6%, which meant that the company was severely overleveraged (Fox, 16-18).

### ***Common Practices***

Under the direction of Enron's former COO and Vice President, Jeffrey Skilling, the company engaged in a series of transactions that followed a similar pattern for expansion. The February 1, 2002 Report of the Special Investigative Committee (aka. the Powers Report) offers a brief overview of the typical approach Enron used to enter new markets and to expand operations.

In the Powers Report the following was stated:

“During the late 1990s, Enron grew rapidly and moved into areas it believed fit its basic business plan: buy or develop an asset, such as a pipeline or power plant, and then expand it by building a wholesale or retail business around the asset. During the period from 1996 to 1998, we are told, approximately 60% of Enron's earnings were generated from businesses in which Enron was not engaged ten years earlier, and some 30% to 40% were generated from businesses in which Enron was not engaged five years earlier.” (Powers, 36)

The approach followed by Skilling was to focus on “asset-light” (intangible) assets rather than tangible “hard assets”, but even Skilling believed that “hard assets” had a purpose within Enron's corporate strategies (Fox, 50). In his book titled *Enron: The Rise and Fall*, Loren Fox described the relationship between hard and light assets at Enron with the following:

“Despite the increasing reliance on intellectual assets, hard assets had their place. Even Skilling favored investing in those hard assets that seemed like good strategic opportunities. The idea was to get a physical presence in a business to learn the ins and outs of that market, then build trading and finance businesses around that.” (Fox, 88).

With increasing frequency, Enron made large capital investments in physical assets to enter an industry and then would sell those assets or neglect them while focusing on developing a market in which to trade financial contracts that related to the products produced within the industry. By the time Enron filed for bankruptcy on December 2, 2001 with \$62 billion in assets, the company had engaged in the trading of numerous commodities. The list of items traded was extensive, and included, but was not limited to, trades involving natural gas, renewable

energy, estimations of weather patterns, electricity, and paper (Fox, 136-138). Before the company's collapse, Enron was often trading commodities worth \$1 billion every day (Fox, 185). Also, as Enron became increasingly more involved in trade, Skilling hired numerous traders and a number of employees who had formerly worked in banks and other financial institutions. Among the hires was Andrew Fastow who in 1998 became Enron's CFO.

In addition, by 2000, the company had become the 7<sup>th</sup> largest publicly traded corporation within the United States with over 20,000 employees spread across forty different countries. Over the history of the company, however, the stock price ranged from \$90.56 to \$0.26.

### ***Aggressive Use of Mark-to-Market Accounting***

Mark-to-market accounting involves the adjustment of an asset to its fair market value while recognizing relevant gains and losses on the value of the asset. As Enron's stock prices rose to \$90.56 a share, public confidence skyrocketed, but as Enron's competitive advantage slowly diminished, reporting decisions within the organization became increasingly questionable and unethical. From the beginning, Enron's use of mark-to market accounting presented challenges in deriving estimates. Since the assets and liabilities needed to be adjusted to their fair market values and unrealized holding gains or losses had to be recognized in the statements at the end of each reporting period, estimations had to be used (Thomas, 2-3). Unfortunately, with the volatility of the energy industries, estimations were largely left up to the energy companies' own discretion (Thomas, 2-3). In deriving the market value, Enron often had to estimate "probable gas production, transportation capacity, future gas demand (which in turn involved forecasting economic growth and the growth of gas-consuming facilities such as power plants

and refineries), and U.S. interest rates” (Fox, 40-41). In addition, Enron’s aggressive use of mark-to-market accounting often encouraged short-term thinking because even contracts that would extend far into the future were only considered to generate profits in the year in which they were arranged (Fox, 42). An Enron executive described the situation as follows: “You put yourself in a position where you had to kill to eat” (Fox, 42). Since long-term contracts only offered benefits in the short-term, Enron’s survival increasingly relied on the number of new contracts it could negotiate in the short-term (Fox, 42).

### ***An Issue of Consolidation: SPEs***

In addition to the problems related to FMV estimations, Enron failed to properly disclose related party transactions in its notes to the financial statements. Many of the related party transactions involved the use of Special Purpose Entities (SPEs). An SPE “refers to an off-balance-sheet arrangement for companies engaged in securitization” (Soroosh, 1). As summarized from FASB Interpretation 46R, SPE related transactions

“originally served a legitimate business purpose: to isolate financial risk and provide less-expensive financing. In theory, because SPEs do not engage in business transactions other than the ones for which they are created, and their activities are backed by their sponsors, they are able to raise funds at lower interest rates than those available to their sponsors” (Soroosh, 1).

For an off-balance-sheet arrangement to qualify as an SPE, two general characteristics of the arrangement were required to be present. In the Powers Report, the two general characteristics were described as follows:

“First, an independent owner or owners of the SPE must make a substantive capital investment in the SPE, and that investment must have substantive risks and rewards of ownership during the entire term of the transaction. Where there is only a nominal outside capital investment, or where the initial investment is withdrawn early, then the SPE should be consolidated. The SEC staff has taken the position that 3% of total capital is the minimum acceptable

investment for the substantive residual capital, but that the appropriate level for any particular SPE depends on various facts and circumstances. Distributions reducing the equity below the minimum require the independent owner to make an additional investment. Investments are not at risk if supported by a letter of credit or other form of guaranty on the initial investment or a guaranteed return.” (Powers, 39)

“Second, the independent owner must exercise control over the SPE to avoid consolidation. This is a subjective standard. Control is not determined solely by reference to majority ownership or day-to-day operation of the venture, but instead depends on the relative rights of investors.” (Powers, 39)

SPEs were supposed to be consolidated in instances in which they failed to meet the above requirements, but in the case of Enron, numerous SPEs that were supposed to be consolidated were left off of Enron’s books.

The excessive use of SPEs at Enron presented a number of problems. Enron held interest in thousands of SPEs, many of which should have been consolidated into the financial statements due to the nature of the level of control Enron had over them and the failure to obtain a minimum 3% capital investment from an independent external investor (Thomas, 3-4). Among other things, Enron began to hide its increasing debt within the SPEs and shifted outdated and failing fixed assets to the SPEs to recognize a profit on the sales and avoid reporting any associated losses on the income statements (Thomas, 3-4). Some of the relationships between Enron executives and the SPEs also presented situations in which the SPEs should have been consolidated. For example, Fastow received higher pay from the SPEs that he was in charge of than for being Enron’s CFO (Thomas, 3-4). In addition, Fastow was considered to have almost complete control over the management of some of the SPEs.

### Questionable Disclosures

Investors and creditors began to question unclear disclosures, but were met with hostility by upper levels of Enron's management. Prior to the December 2<sup>nd</sup> filing for bankruptcy, Sherron Watkins, a vice-president at Enron, had sent a memo to Lay addressing the lack of related party disclosures and suggesting that a series of misstatements and misappropriations were putting Enron at extreme risk. A copy of the letter sent by Sherron Watkins is presented in Figure 1.2.

**Figure 1.2**

Dear Mr. Lay,

Has Enron become a risky place to work? For those of us who didn't get rich over the last few years, can we afford to stay?

Skilling's abrupt departure will raise suspicions of accounting improprieties and valuation issues. Enron has been very aggressive in its accounting-most notably the Raptor transactions and the Condor vehicle. We do have valuation issues with our international assets and possibly some of our EES MTM positions.

The spotlight will be on us, the market just can't accept that Skilling is leaving his dream job. I think that the valuation issues can be fixed and reported with other goodwill write-downs to occur in 2002. How do we fix the Raptor and Condor deals? They unwind in 2002 and 2003, we will have to pony up Enron stock and that won't go unnoticed.

To the layman on the street, it will look like we recognized funds flow of \$800 mm from merchant asset sales in 1999 by selling to a vehicle (Condor) that we capitalized with a promise of Enron stock in later years. Is that really funds flow or is it cash from equity issuance?

We have recognized over \$550 million of fair value gains on stocks via our swaps with Raptor, much of that stock has declined significantly-Avici by 98%, from \$178 mm to \$5 mm, The New Power Co by 70%, from \$20/share to \$6/share. The value in the swaps won't be there for Raptor, so once again Enron will issue stock to offset these losses. Raptor is an LJM entity. It sure looks to the layman on the street that we are hiding losses in a related company and will compensate that company with Enron stock in the future.

I am incredibly nervous that we will implode in a wave of accounting scandals. My 8 years of Enron work history will be worth nothing on my resume, the business world will consider the past successes as nothing but an elaborate accounting hoax. Skilling is resigning now for 'personal reasons' but I think he wasn't having fun, looked down the road and knew this stuff was unfixable and would rather abandon ship now than resign in shame in 2 years.

Is there a way our accounting guru's can unwind these deals now? I have thought and thought about how to do this, but I keep bumping into one big problem-we booked the Condor and Raptor deals in 1999 and 2000, we enjoyed a wonderfully high stock price, many executives sold stock, we then try and reverse or this the deals in 2001 and it's a big like robbing the bank in one year and trying to pay back it back 2 years later. Nice try, but investors were hurt, they bought at \$70 and \$80/share looking for \$120/share and now they're at \$38 or worse. We are under too much scrutiny and there are probably one or two disgruntled 'redeployed' employees who know enough about the 'funny' accounting to get us in trouble.

What do we do? I know this question cannot be addressed in the all employee meeting, but can you give some assurances that you and Causey will sit down and take a good hard objective look at what is going to happen to Condor and Raptor in 2002 and 2003?

Retrieved from [Fox, Loren. *Enron: The Rise and Fall*. Hoboken: John Wiley & Sons, Inc. Hoboken (2003).]

Enron's former CEO Lay had passed the message on to Arthur Andersen, but both he and the accounting firm failed to take immediate action to properly resolve the issues, and to make matters worse, Arthur Andersen began to suddenly enforce a document retention policy that would result in the destruction of truckloads of Enron related documents after learning about preliminary investigations of the Securities and Exchange Commission.

### ***A Culture of Extreme Competition***

Similar to WorldCom, Enron's corporate culture encouraged individualism. Initially, new hires were instructed to follow Enron's standards of RICE-respect, integrity, communication and excellence, but such standards were quickly forgotten as employees were increasingly exposed to extreme levels of competition. Employees were evaluated two times a year on a scale of one to five by the PRC, also known as the Performance Review Committee. Although the initial purpose of the reviews had been to help both the employees and the company grow, the reviews, referred to as 360-degree reviews, became largely based on profits (Thomas, 1-2). Employees engaged in contracts that generated significant profits scored close to one, while employees that generated lower profits scored closer to five and were usually fired shortly thereafter (Thomas, 1-2). As a result, the PRC system was commonly referred to as the 'rank-and-yank system'. Employees in management positions who scored low were usually fired upon the conclusion of the review process. Lower level employees, on the other hand were put on probation and each given a one shot chance to improve their scores for the next PRC review. During their probation, "employees had to spend about an hour each day documenting their daily activities and how they helped Enron" (Fox, 84).

As competition within the organization increased, short term profits and goals increasingly overshadowed long-term plans and the values expressed by RICE slowly dwindled away from Enron's atmosphere (Thomas, 1-2). Employees became paranoid and began to sabotage the work of fellow associates. An example of such sabotage may be seen in the following reported description of some of the activities that took place on the trading floor: "Occasionally, when one trader got up to go to the bathroom, another trader would go over to his computer screen and either steal his trade or change his position on a trade" (Fox, 84). Not only was such behavior allowed, it was indirectly encouraged by a lack of ethics policies.

Extreme competition was also encouraged by basing an employee's bonuses partially off of the success of the departmental unit in which the employee was stationed. Employees were frequently moved from one department to another and thus, "little institutional memory" remained within the departments (Fox, 89). Short term planning took precedence over long-term planning since employees knew that they would not remain in one department for long (Fox, 89-90). If profits were deferred for more than a few months, an employee that helped generate such profits would likely not receive any of the monetary benefits. Therefore, employees increasingly focused on employing mark-to-market accounting and other strategies that allowed them to book profits immediately (Fox, 89).

***“Arthur Andersen LLP v. United States”***

Enron’s stock price rapidly declined as more and more accounting improprieties were uncovered, leaders at both Enron and Arthur Andersen frequently encouraged employees to adhere to Arthur Andersen’s document retention policy. The increased enforcement of the policy resulted in the shredding of truckloads full of documents pertaining to past audits of Enron during the latter part of 2001. The legality of the shredding was questioned in the Southern District Court of Texas where a jury found Arthur Andersen guilty of violating Section 1512 (b)(2)(A) and (B) of Title 18 of the United States Code, which addresses witness tampering. The Fifth Circuit Court of Appeals affirmed the verdict in 2004 after which Arthur Andersen appealed to the United States Supreme Court. The justices of the Supreme Court granted certiorari and the case *Arthur Andersen LLP, v. United States* was argued on April 27, 2005. [A *writ of Certiorari* is a “formal notice from the United States Supreme Court that it will accept a case for review” (Beatty, G3)]. The Supreme Court’s decision was rendered on May 31, 2005 and the opinion reversing and remanding the case back to the Fifth Circuit Court of Appeals was written by Chief Justice Rehnquist.

In the Opinion of the Court, the Supreme Court Justices stated that they “hold that the jury instructions failed to convey properly the elements of a “corrup[t] persuas[ion]” conviction under §1512(b), and therefore reverse (*Arthur*, 1).” The justices also stated that they initially granted certiorari “because of a split of authority regarding the meaning of §1512(b) (*Arthur*, 2).” 18 U.S.C. §1512(b)(2)(A) and (B) reads

Whoever knowingly uses intimidation or physical force, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to...cause or induce any person to...withhold

testimony, or withhold a record, document, or other object, from an official proceeding [or] alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding...shall be fined under this title or imprisoned not more than ten years, or both. (Arthur, 2)

To allow for a better understanding of the opinion, however, the justices state that their focus is on “what it means to “knowingly...corruptly persuade[e]” another person “with intent to...cause” that person to “withhold” documents from, or “alter” documents for use in, an “official proceeding” (Arthur, 2).”

In determining the meaning of SS1512, the Supreme Court found two main faults with the instructions provided to the jury in the Southern District Court of Texas, and therefore, the justices also found oversights in the judgment rendered by the Fifth Circuit Court of Appeals. First, the jury was not informed of the necessity to find Arthur Andersen guilty of mens rea. [In criminal law, mens rea refers to a “guilty state of mind” (Beatty, G12)]. Secondly, the requirement for a “nexus” between the shredding of documents and specific legal proceedings was ignored. With regard to the first fault, the Supreme Court found that “Section 1512(b) punishes not just “corruptly persuad[ing]” another, but “knowingly...corruptly persuad[ing]” another (Arthur, 3).” The jury had been instructed that it could issue a verdict of guilty even if it believed that the “petitioner honestly and sincerely believed that its conduct was lawful (Arthur, 3).” In addition, the jury was instructed to find petitioner guilty “if it found petitioner intended to “subvert, undermine, or impede” governmental fact-finding by suggesting to its employees that they enforce the document retention policy (Arthur, 3).” As discussed in the Opinion of the Court, impeding fact-finding by having a document retention policy is not by itself considered to be a criminal act under SS1512; nor is persuading others to comply with the

policy. For example, the justices refer to suspects invoking their 5<sup>th</sup> Amendment Rights against self-incrimination after being persuaded by family members to refrain from openly discussing their case with law enforcement officials. The suspects intended to impede a guilty verdict by withholding information, but they were exercising a constitutional right. In addition, if finding a petitioner guilty is dependent on first finding the petitioner guilty of mens rea, then instructions stating that a petitioner may be found guilty even if the “petitioner honestly and sincerely believed that its conduct was lawful” would be in stark contrast to the meaning of “knowingly...corruptly persuading.”

With regard to the “nexus” requirement, the Supreme Court also found the instructions to the jury inept. The jury was told that it did not have to find any link between petitioner’s attempts to “persuade,” the shredding of documents, and “official proceedings.” In the Opinion of the Court, Chief Justice Rehnquist states that “A “knowingly...corrup[t] persuade[r]” cannot be someone who persuades others to shred documents under a document retention policy when he does not have in contemplation any particular official proceeding in which those documents might be material (Arthur, 3).” The shredding may indeed have been related to Arthur Andersen’s awareness of the SEC investigations, and thus a nexus may have been present, but the jury was not told that the link had to be sufficiently proven in the courtroom before a verdict of guilty could be issued.

### ***Guilty or Not Guilty?***

Although the Supreme Court reversed the judgment and remanded the case, the Arthur Andersen case was never retried in the Fifth Circuit Court of Appeals. By the time the Supreme Court issued its opinion, there was not an Arthur Andersen left to be represented in yet another trial. As such, a final verdict of guilty or not guilty pertaining to the shredding of documents was never issued in a U.S. Court, but rather by the general public as people questioned the credibility of the accounting profession. The Supreme Court's duty had not been to determine whether or not Arthur Andersen was guilty of violating, 18 U.S.C. SS1512. The duty of the court was to determine whether or not the instructions provided to those who had previously issued a verdict had been sufficient and free of material misstatements.

### ***Sarbanes-Oxley: Legislative Reforms and the Impacts on Accounting Firms and Audit Clients***

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In response to the substantial number of accounting scandals that occurred from late 2000 through early 2002, Congress enacted Public Law 107-204 on July 30, 2002. More commonly referred to as the Sarbanes-Oxley Act of 2002, the stated purpose of the Act is as follows: "An Act: To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes (SOX 745)." The "securities laws" mentioned in the purpose of the Act refer to the Securities Exchange Act of 1934. Although the Sarbanes-Oxley Act amends certain parts of the Securities Exchange Act of 1934 to offer additional protection to investors through enhanced disclosures and procedural requirements, it should be noted that in no way does the Sarbanes-Oxley Act "impair or limit" the powers of the Securities and Exchange Commission (SEC) previously granted under the Securities

Exchange Act of 1934 (SOX 750). In addition, violations of the Sarbanes-Oxley Act will be treated in a manner equivalent to the way in which violations of the Securities and Exchange Act of 1934 are handled (SOX 749).

The Sarbanes-Oxley Act contains eleven titles in addition to a short title, table of contents, a section containing definitions, and a section pertaining to commission rules and enforcement.

The eleven titles include the following:

Title I: Public Company Accounting Oversight Board

Title II: Auditor Independence

Title III: Corporate Responsibility

Title IV: Enhanced Financial Disclosures

Title V: Analyst Conflicts of Interest

Title VI: Commission Resources and Authority

Title VII: Studies and Reports

Title VIII: Corporate and Criminal Fraud Accountability

Title IX: White-Collar Crime Penalty Enhancements

Title X: Corporate Tax Returns

Title XI: Corporate Fraud and Accountability.

***Public Company Accounting Oversight Board: Board Composition, Terms of Service and Duties***

According to Title 1, the Public Company Accounting Oversight Board (PCAOB) is established to “oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports” for publicly traded companies (SOX 750). The PCAOB is a non-governmental, non-profit that is subject to SEC oversight as if it was a “registered securities association” that is subject to the Securities

Exchange Act of 1934 (SOX 750; 765). In addition, once established, the PCAOB may only be “dissolved by an Act of Congress” (SOX 750).

The composition of the PCAOB includes five members, one of whom serves as chairman of the Board. A maximum of two members may be or have been CPAs, and the member serving as the chairman may not be a CPA that has practiced within the last five years. While serving on the Board, members are not allowed to be employed by another professional or business organization as such a relationship could impair the independence or focus of the Board members who are appointed to fulfill full-time positions. Board members may serve for a maximum of only two terms. A full term runs for five years, but any member may be removed or censured by the SEC prior to completion of a term for failure to adhere to rules and regulations established under the Securities and Exchange Act of 1934 and the Sarbanes-Oxley Act of 2002. For purposes of efficiency and consistency, board positions are subject to rotating expirations of service terms.

The general duties of the Public Company Accounting Oversight Board include the following:

- Register public accounting firms that issue audit reports for publicly traded companies
- Set forth rules pertaining to “auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports”
- Perform inspections of registrants
- “Conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon, registered public accounting firms and associated persons of such firms”

- Perform duties not presently established that the Board and SEC find necessary to adhere to and pursue the purposes and goals of the Act subsequent to enactment
- Enforce registrant compliance to regulations
- Develop a budget and plans for management of operations and Board members. (750-751)

Although the above list provides a brief overview of the responsibilities delegated to the PCAOB, it is important to remember that one of the main functions of the Board is to enforce compliance in a profession that was previously self-regulated. Subsequent to the enactment of the Sarbanes-Oxley Act, readers may find that many of the duties listed above may seem to be commonplace and that common sense should have suggested the necessity for the establishment of such regulations decades ago. Unfortunately for many investors, accounting firms, and other stakeholders, however, the passage of the Sarbanes-Oxley Act was too late. Prior to the onslaught of accounting scandals made public in the early 21<sup>st</sup> century the accounting profession appeared to be self-sufficient with regard to establishing and enforcing regulations. The effectiveness of the self-regulation was only questioned after significant damage was already done.

### ***Registration of Public Accounting Firms***

If an accounting firm is to prepare audit reports for a publicly traded company, registration with the PCAOB is mandatory. To register with the PCAOB, registrants must provide the Board with information pertaining to quality control procedures, ongoing criminal and civil investigations relevant to audits conducted by the accounting firm, and the revenues earned through the performance of services offered to publicly traded companies. (SOX 753-754). In addition, a

registrant must provide the Board with the accounting firm's state license number, a list with the names and license/certification numbers of accountants employed by the firm who are engaged in audit activities, and a list of clients that issue publicly traded stock. Registrants must also file forms of consent pertaining to agreed upon cooperation and compliance with regard to producing documents and testifying as requested by the Board (SOX 754).

### ***PCAOB Evaluations of Registrants***

As established under the Sarbanes-Oxley Act, the PCAOB must inspect registered firms with more than 100 issuers at least annually. With regard to registered firms with 100 or less than 100 issuers, the PCAOB must perform inspections at least once every three years. Upon completion of the inspections, the Board must send a written report with the findings of the investigations to the SEC and relevant state regulatory bodies. The SEC will make available a modified version of the report to the public that omits certain confidential information. In instances in which the Board finds problems associated with the quality control standards established by an accounting firm, the public accounting firm will have 12 months to amend the standards before the public version of the PCAOB report is published. If the issues are resolved within the twelve month time period, the sections of the report pertaining to weaknesses in quality control will be omitted from the publicized version of the report. (SOX 759)

### ***General Additions to Auditing Standards***

The Sarbanes-Oxley Act has also affected accounting firms of publicly traded companies through the enactment of additional auditing standards. Under the Act, registered accounting firms must adhere to new rules regarding the retention of audit work papers, partner reviews,

and the auditing of internal controls. With regard to audit work papers, registered accounting firms must retain all work papers supporting their conclusions reached in an audit report for a minimum of seven years (SOX 755). The objective for such a requirement is to provide a trail to follow of the audit process and procedures used in a situation in which the conclusions reached in an audit report are questioned. For example, if a class action lawsuit was brought against an accounting firm by a group of investors from a publicly traded client company, a court of law would want to see the evidence that the accounting firm used in reaching its conclusions. If such evidence were not made available, the court would largely have to rely on verbal claims from both parties which could make arriving at an accurate and reasonable ruling much more difficult and very time consuming.

With regard to partner reviews, an audit report must be reviewed and approved by at least two partners. In addition, one of the partners may not be a lead auditor for the client. The goal is to improve the accuracy of audit reports issued by reducing marginal errors and occurrences of conflicts of interest.

New regulations pertaining to the testing of internal controls has significantly impacted the audits of publicly traded companies. Internal controls refer to:

“systematic measures (such as reviews, checks and balances, methods and procedures instituted by an organization to (1) conduct its business in an orderly and efficient manner, (2) safeguard its assets and resources, (3) deter and detect errors, fraud, and theft, (4) ensure accuracy and completeness of its accounting data, (5) produce reliable and timely financial and management information, and (6) ensure adherence to its policies and plans.” (*Internal Control*)

Because the effectiveness of a company’s internal controls significantly impacts the operations of the firm and the accuracy and reporting of financial information, Congress believed that an

evaluation of such controls was necessary if auditors were to understand and gain a true understanding of the representativeness of a company's financial position, statements and disclosures. The Sarbanes-Oxley Act requires registered accounting firms to provide the SEC and investors with a report on internal control testing performed that includes a description of the scope of testing, an explanation of findings, evaluations of the effectiveness of the controls, identification of material weaknesses, and a report of noncompliance issues. (SOX 755-756)

Figure 1.2 shows a standard example of the paragraph on internal controls that should be added to a registered firm's audit report. Although the paragraph may have to be modified to address the issues involved in a particular audit, Figure 1.2 provides a general outline of the items that should be included.

### Figure 1.3

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of XYZ Company's internal control over financial reporting as of December 31, 20X1, based on Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated Month XX, 20X2, expressed unqualified opinions.

Whittington, Ray and Kurt Pany. (47)

Interestingly, the Treadway Commission mentioned above in Figure 1.2 was organized prior to the publicized onslaught of accounting scandals of the early 21<sup>st</sup> century. In 1987, the Treadway Commission (National Commission on Fraudulent Financial Reporting) issued a report that included recommendations regarding internal controls that eventually led to the development of the Internal Control-Integrated Framework, which is also mentioned in the above paragraph (Whittington, 8-9). A mandatory report on internal controls to be included in

the audit report, however, was not required on a large scale until the passage of the Sarbanes-Oxley Act. For example, by referring back to Figure 1.1, one may see that a paragraph pertaining to internal control is absent from Arthur Andersen's 2002 audit report on WorldCom. Although separate or combined reports on the audit of internal controls and financial statements/positions are allowed, the fourth paragraph in Figure 1.2 has become a required reporting standard (Whittington, 46-47).

### ***PCAOB Funding***

To meet the financial needs of the Board subsequent to enactment, funds are collected from registered public accounting firms in the form of registration fees and annual fees. Monetary penalties collected by the Board are placed in a scholarship fund to sponsor undergraduate and graduate students pursuing accounting degrees through accredited programs (SOX 770).

### ***Prohibition of Non-audit Services, Partner Rotation and Conflicts of Interest***

Also affecting registered accounting firms are new standards relating to auditor independence. Prior to enactment of the Sarbanes-Oxley Act, a public accounting firm could offer a client both audit and non-audit services. In some instances, a public accounting firm would receive a higher percentage of its revenues from a client for non-audit services than for those relating to an audit. Questions pertaining to the auditor's independence arose as investors and regulatory agencies considered the potential for conflicts of interest. External auditors were supposed to be independent and offer investors and regulatory agencies with assurance as to the accuracy and representativeness of the firm's financial position and published financial statements. If an accounting firm earned higher revenues for non-audit services than for attestation services,

would the firm be willing to risk losing revenues for non-audit services by issuing a less than unqualified audit opinion (e.g. a qualified opinion, adverse opinion, or disclaimer of opinion)?

Congress believed that a conflict of interest could arise and in response prohibited the overlapping of certain audit and non-audit services. Activities generally prohibited for public accounting firms providing audit services to an issuer include the following:

- Bookkeeping/Preparation of Financial Statements
- Accounting Information Systems Design/Implementation
- Appraisal/Valuation Services
- Actuarial Services
- Internal Auditing
- Management/Human Resource Work
- Investment Banking/Brokerage Services
- Legal Services/Professional Services Not Relevant to the Audit (SOX 771-772)

If approved by the issuer's audit committee, certain non-audit services not listed above, such as tax preparation, may be allowed unless deemed inappropriate by the PCAOB (SOX 772).

Further, the Sarbanes-Oxley act allows a de minimus exception with regard to certain non-audit services offered during the course of an audit that were not planned for during the preliminary planning for the audit. Generally, if the aggregate amount of non-audit revenues earned from a client is 5% or less as compared to the total revenues earned by the accounting firm on a particular engagement, the non-audit services may be allowed as long as the services are properly disclosed and approved by the audit committee (SOX 772).

To further promote auditor independence, the Sarbanes-Oxley Act has put five-consecutive year limitations in place that require mandatory rotations of lead auditors at least every five

years. Without such a limitation in place, increased risk is present that a lead auditor could get too comfortable with his clients in which case his or her independence could be impaired.

Under Section 206 of the Sarbanes-Oxley Act, it is stated that:

“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 proceeding the date of the initiation of the audit,” the registered firm may not perform the audit. (SOX 774-775)

The excerpt from the Act shown above may serve as an illustration of the position Congress has taken on the potential for conflicts of interest. If an officer in a key position within the issuing company had previously been involved in the audit of the issuing company, the negative impacts that could result from conflicts of interest could be severe. The former auditor would be familiar with the audit procedures and planning processes of the audit firm and would also know what types of tests would likely be used. Thus, the officer would be in a position to considerably hinder the accuracy and efficiency of an external audit. In addition, the engagement team may have previously worked with the former auditor and may have a close relationship to the individual that could further impair the independency status of the audit.

### ***Investigative and Disciplinary Actions of the PCAOB***

The Public Company Accounting Oversight Board is authorized to investigate any registered public accounting firm and/or any individual associated with a firm suspected to be in violation of the Sarbanes-Oxley Act, auditing standards established under the Securities Exchange Act of 1934, rules of the PCAOB, and other relevant professional standards (SOX 759). During its investigation, the PCAOB may require firms or individuals to testify, produce work papers and

other documents relevant to the investigation, as well as request subpoenas for the testimonies and documents of clients (SOX 760). Noncooperation may lead to the suspension or ending of a relationship between a registered public accounting firm and an individual associated with the firm, suspension or revocation of a firm's registration with the PCAOB, and the imposition of various sanctions (SOX 760).

A decision to impose a sanction must be accompanied by a statement with allegations, a listing of violations, and an explanation of the conclusions reached in deciding to impose a sanction. Further, the firm or individual charged with violations must be informed of the ongoing proceedings and given an opportunity to organize a defense. Generally the hearings are not public in cases where the defense requests a hearing. (SOX 761-762)

Information pertaining to imposed sanctions must be conveyed to the SEC, state regulatory bodies, both domestic and foreign licensing boards associated with the parties involved, and to the public after stays have been resolved (SOX 764). ["In the legal context, a stay is a court order preventing further action until a future event occurs, or the order is lifted."(*Stay*, 1)] The report should include the names of associated parties, and the reasons behind and explanations of the sanctions. The sanctions are reviewed by the SEC which may "enhance, modify, cancel, reduce, or require the remission of a sanction" with due cause (SOX 767).

### ***Corporate Responsibility: Audit Committees and the Certification of Audit Reports***

The Sarbanes-Oxley Act places a lot of emphasis on the formation and responsibilities of audit committees. Trading of a public company's stock will be prohibited if the company's audit committee fails to adhere to the standards set forth under Title III of the Sarbanes-Oxley Act.

Under SEC. 301 subsection (2), the basic responsibilities of a public company's audit committee are assigned as follows:

“The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.” (SOX 776)

As indicated above, the audit committee serves as a mediator between the accounting firm performing the audit and the issuers of stock. Since the members of the audit committee only receive compensation for services performed as members of the board of directors and audit committee, the members of the audit committee should be independent and less likely to corruptly influence the proceedings of an audit. To further promote the representativeness of the audit report, the audit committee is also responsible for designing systems to receive complaints from employees and officers of the publicly traded company which may relate to concerns about accounting processes, internal controls, or auditing issues (SOX 776). In addition, the audit committee may seek external advisors, such as lawyers, for additional information pertaining to questionable procedures.

To deter CEOs and CFOs from engaging in fraudulent activities and to encourage them to more actively monitor the operations and financial conditions of their companies, rules have been set forth in the Sarbanes-Oxley Act to increase corporate officer liability by making it mandatory for CEOs and CFOs to confirm the accuracy of the financial reports. CEOs and CFOs must certify in all annual and quarterly reports that he/she has reviewed the audit report, and that to his/her knowledge no material misstatements are present and that the financial statements and

accompanying information “presents fairly in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report (SOX 777).”

In addition, the officers must certify that internal controls have been evaluated for effectiveness and that he/she has reported any material changes and weaknesses in internal controls and any fraud involving management to the audit committee and auditors (SOX 777).

The liabilities of certain CEOs and CFOs are further increased in that restatements of financial reports could result in the relinquishment of bonuses. In general, CEOs and CFOs must surrender any bonuses received in the 12 months after an initial public offering or initial filing prior to restatement if the restatement is due to violations of the Sarbanes-Oxley Act or the Securities Exchange Act of 1934 (SOX 778)

An interesting correlation may be observed through a comparison of the language used in the opinion paragraph of the standard auditor’s report and the language used in SEC. 302. (a)(3) of the Sarbanes-Oxley Act. See Figure 1.3. In the auditor’s report, the auditors must express an opinion as to whether or not the financial statements “present fairly, in all material respects, the financial position of Company A...and the results of their operations” (Whittington, 47). Similarly, CEOs and CFOs must certify that “the financial statements, and other financial information,...fairly present in all material respects the financial condition and results of operations” (SOX 777).

**Figure 1.4**

“In our opinion, **the financial statements** referred to above **present fairly, in all material respects, the financial position** of WorldCom, Inc. and subsidiaries as of December 31, 2000 and 2001, **and the results of their operations** and their cash flows for each of the years in the three-year period ended December 31, 2001, in conformity with accounting principles generally accepted in the United States.”

Whittington, Ray and Kurt Pany. (47)

SEC. 302. (a) (3) “based on such officer’s knowledge, **the financial statements, and other financial information** included in the report, **fairly present in all material respects the financial condition and results of operations** of the issuer as of, and for, the periods presented in the report;”

Sarbanes-Oxley Act (SOX 777)

As indicated in the paragraphs above, the authors of the Sarbanes-Oxley Act considered corporate responsibility to be of significant importance. Title IX of the Sarbanes-Oxley Act, which may be referred to as the “White-Collar Crime Penalty Enhancement Act of 2002,” further emphasizes Congress’ concerns about the accuracy of financial reporting (SOX 804). Under Title IX Sec. 906 of the Sarbanes-Oxley Act, the United States Code (Title 18, Chapter 63) is amended through the addition of “SS1350 Failure of Corporate Officers to Certify Financial Reports” (SOX 806). Under subsection (c) of SS1350, criminal violators of the certification requirements are subject to the following:

“Whoever (1) certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$1,000,000 or imprisoned not more than 10 years, or both; or (2) willfully certifies any statement as set forth in subsections (a) and (b) of this section knowing that the periodic report accompanying the statement does not comport with all the requirements set forth in this section shall be fined not more than \$5,000,000, or imprisoned not more than 20 years, or both.” (SOX 806)

The addition of SS1350 makes clear the severity of monetary penalties and jail sentences that may be enacted upon corporate executives considering to falsify or omit certifications. The purpose of specifying the penalties is to ensure that corporate executives know with certainty their responsibilities and to prevent violators from claiming ignorance of potential consequences in a court of law.

### ***Whistleblower Compensation***

To encourage employees to report accounting improprieties taking place within their firms, Congress added SS1514A to the United States Code (Title 18, Chapter 73). SS1514A provides standards for addressing employee claims of retaliation for informing the PCAOB of fraudulent and negligent activities. If an employee is found to have suffered from retaliation, the Sarbanes-Oxley Act states that the employee “shall be entitled to all relief necessary to make the employee whole” (SOX 803). If applicable, the employee will receive back pay with accrued interest, compensation for litigation costs, attorney fees, etc., and will be rehired or transferred to the position held prior to the retaliation or to a position of an equivalent position (SOX 804). As illustrated in the WorldCom case, employee reporting of misstatements and fraudulent practices can be instrumental in uncovering accounting scandals. If Cynthia Cooper, Gene Morse, and Glyn Smith had not had the courage to stand up against corrupt executives, many more stakeholders could have been negatively impacted by the WorldCom’s fraud. The situation could have become increasingly worse. Knowing that some employees might be more hesitant to defy orders and report fraudulent activities, Congress has taken steps to encourage more hesitant employees to come forward through the addition of SS1514A.

### ***General Regulations Pertaining to Financial Disclosures***

Past treatment of material corrections, off-balance sheet financing, and internal controls has led to the development of new and enhanced disclosure requirements under the Sarbanes-Oxley Act. First, all material corrections must be disclosed with no exceptions. Since all material corrections must be disclosed, corporations that discover fraudulent activities through internal audits and reviews will not face strict penalties if they are caught attempting to cover up the fraud by failing to disclose material adjustments after making error corrections. In addition, firms may not claim that disclosures are unnecessary if the errors were corrected. With regard to off-balance sheet financing, all significant off-balance sheet financial relationships must be disclosed. As stated under Title IV, Sec. 401(j) of the Act,

“Each annual and quarterly financial report required to be filed with the SEC 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 (SOX, 786).”

The requirements relating to off-balance sheet financing address some of the issues related to the use of special purpose entities (SPEs). For example, Enron used numerous SPEs to gain favorable financing positions to fund many of the company's operations. While the use of an SPE as a form of off balance sheet financing can in some circumstances be a legal and effective means of financing a transaction, improper use of an SPE can be devastating to a corporation's long term health and stability. When an SPE is not independent and the corporation essentially controls the entity, failure to disclose the relationship and to consolidate the entity into the corporation's financial statements often leads to significant misrepresentations of the

corporation's actual financial position. As mentioned earlier, the purpose of the Sarbanes-Oxley Act is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes (SOX 745)." If a corporation were not required to disclose significant off-balance sheet affiliations, investors would be vulnerable. In the case of Enron, many investors were unaware of the risks involved with investing in Enron stock. If those investors had additional information to base their decisions on, the fall of Enron may not have caused such severe damage.

### ***Appropriateness of Personal Loans to Corporate Executives***

As mentioned previously, approximately "27 percent of major publicly traded companies had loans outstanding for executive officers in 2000" (Moberg, 5). The issuance of personal loans to WorldCom's former CEO Bernard Ebbers illustrates the negative impact that such loans could have on investors and the need for regulations pertaining to the issuance of personal loans. Under Section 402 of the Sarbanes-Oxley Act it is currently illegal for publicly traded companies to directly or indirectly establish lines of credit to executive officers and directors (SOX 787). Although the Act prohibits corporations from offering corporate executives lines of credit for personal reasons, regulators did recognize that the sudden onset of the new rules pertaining to personal loans could place significant hardships on corporate executives and directors who had active lines of credit that were established prior to the passage of the Act (SOX 787). As such, lines of credit established prior to the issuance of the Sarbanes-Oxley Act were given exemption status and considered legal unless materially modified or renewed. In addition, personal loans may still be issued if the organization offering the line of credit is considered to be a "consumer credit business" that offers credit arrangements as a part of its "ordinary course of business"

(SOX 787). Loans of this type, however, are governed by strict regulations when issued to officers of the issuing company.

The Sarbanes-Oxley Act states that the “ordinary course of business” loans must be “of a type that is generally made available by such issuer to the public, and made by such issuer on market terms, or terms that are no more favorable than those offered by the issuer to the general public for such extensions of credit” (SOX 787). If the Sarbanes-Oxley Act had been issued prior to the issuance of personal loans to Bernard Ebbers, any attempts to subsequently issue loans would have been declared illegal. The loans would have not only failed the ordinary course of business test, but would also have failed to meet exemption status since the arrangements were much more favorable than market terms. Ebbers was only expected to pay interest at a rate of 2.15% when the rates for personal loans at commercial banks was much higher (*Consumer*, 1). For example, the interest rate for a 24-month personal loan at a commercial bank was approximately 13.30% in May of 2001 (*Consumer*, 1).

### ***Standards for Audit Workpapers***

The Sarbanes-Oxley Act places significant emphasis on the integrity and availability of audit workpapers. Standards have been put in place that require all audit and review workpapers to be retained for a minimum of five years subsequent to the completion of an audit or review (SOX 800). Further, those who are aware of the standards and consciously destroy audit documents prior to the five year requirement may be fined and/or sentenced to a maximum of ten years in prison (SOX 800). Although the potential for spending ten years in prison should be enough to deter most individuals from destroying documents prematurely, additional measures

have been put in place in an attempt to deter corrupt individuals who are not at all disconcerted with the idea of shredding documents relevant to a criminal investigation.

Under Title VIII of the Sarbanes-Oxley Act, which may be referred to as “the Corporate and Criminal Fraud Accountability Act of 2002,” the following is statement is added to the United States Code (Title 18, Chapter 73):

“Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.” (SOX 800)

In addition, under Sec. 1102 “Tampering with a Record of Otherwise Impeding an Official Proceeding,” the Sarbanes-Oxley Act amends section 1512 of the United States Code by adding the following statement:

“Whoever corruptly (1) alters, destroys, mutilates, or conceals a record, document, or other object, or attempts to do so, with the intent to impair the object’s integrity or availability for use in an official proceeding; or (2) otherwise obstructs, influences, or impedes any official proceeding, or attempts to do so, shall be fined under this title or imprisoned not more than 20 years, or both.” (SOX 807)

Upon reading the two excerpts shown above, it might at first appear that the two sections are almost identical and indeed some of the language is the same. An important distinction, however, may be observed in at the beginning of each section. The first excerpt begins with “whoever *knowingly*,” while the second excerpt begins with “whoever *corruptly*.”

In May of 2002, prior to the passage of the Sarbanes-Oxley Act, Arthur Andersen was convicted in the United States District Court for the Southern District of Texas for “obstructing justice

under SS1512(b)(2)(A)&(B)” (United, 10). Prior to the passage of the Sarbanes-Oxley Act the focus of SS1512 as it pertains to destroying documents included the following:

“Whoever knowingly uses intimidations, threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to...cause or induce any person to (A)...withhold a record, document, or other object, from an official proceeding; [or] (B) alter, destroy, mutilate, or conceal an object with intent to impair the object’s integrity or availability for use in an official proceeding...shall be fined under this title or imprisoned not more than ten years, or both.” (United, 10)

As mentioned earlier in the section titled “Arthur Andersen LLP v. United States,” the Supreme Court spent considerable time discussing the difference between “corruptly persuading” and “knowingly...corruptly persuading”. [See previous discussion pertaining to “Arthur Andersen LLP v. United States”]. Although the Supreme Court rendered its decision after the passage of the Sarbanes-Oxley Act, the portion of SS1512 was the version that appeared in the Fifth Circuit Court of Appeals case, which was used in reference to the law reviewed by the Texas Court. The amended version of SS1512 may in the future assist courts in convicting accountants and executives for the destruction of audit work papers since the requirements for conviction are slightly simplified. Title VIII emphasizes *knowingly* while Title XI emphasizes *corruptly*.

### ***Effects Across the Organization***

When considering the implications of the Sarbanes-Oxley Act it is important to remember that the effects of the Act are not limited to auditors and executive officers (Zachry, 5). In an article published in a 2010 issue of the *New Accountant*, Professor Benny R. Zachry presented a study titled *The Organizational Implications of Sarbanes-Oxley: Eight Years Later*. According to Zachry, departments and people that have been greatly affected by the passage of the Sarbanes-Oxley Act include, “top executives, human resource departments, those overseeing

company travel and stewardship of company assets, and information technology departments (Zachry, 32). Zachry argues that “bottom line: it is now necessary that all members of an organization have an understanding of the Sarbanes-Oxley Act and how to comply and maintain control for proper implementation of the Act” (Zachry, 32).

As discussed previously, the Sarbanes-Oxley Act now makes it a requirement for CEOs and CFOs to certify the accuracy of the financial reports issued by a corporation by reviewing and signing all 10Qs and 10Ks. In addition, members at the executive level must issue a report evaluating the effectiveness of established internal controls. Zachry argues that because of such requirements, executive officers must educate themselves as to the requirements of the Sarbanes-Oxley Act itself and new accounting standards that have been derived since the Act’s issuance in 2002.

With regard to human resource departments, Zachry cited evidence pertaining to an increase in the establishment of ethics hotlines and the implementation of new whistleblower policies. He also noted that many policies have been revised to make adherence to the new standards easier since human resource expenses such as employee benefits, workers’ compensation, taxes and pension plans represent significant expenses in most corporations (Zachry, 32-34). Other expenses that require additional attention include those relating to travel expenses of corporate executives and the utilization of corporate assets for personal reasons. Zachry discusses how the use of business credit cards must be actively documented and that assets used for personal reasons must be described in documents that are provided to companies’ stockholders (Zachry, 32-34).

Although the Sarbanes-Oxley Act does not specifically discuss technology and software, the strict rules governing internal controls require that the technology and accounting information systems used by publicly traded companies be designed and monitored in ways to ensure compliance to the Sarbanes-Oxley Act (Zachry, 32-34). Measures must be taken to ensure the preservation of the accuracy and integrity of financial reports and transactions. Although many of the regulations presented in the Sarbanes-Oxley Act directly affect accounting firms, auditors, and corporate executives, the implications often extend far beyond such groups. As a business entity, a publicly traded company as a whole must absorb the increased compliance costs and ensure that all members of the organization are up to date on relevant standards.

### ***Proposals for the Rotation of Audit Firms***

On August 16, 2011 the PCAOB released a concept statement titled *Concept Release on Auditor Independence and Audit Firm Rotation: Notice of Roundtable*. The stated purpose of the release was “to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced” (Concept, 1). Within the release the PCAOB presented “mandatory audit firm rotation” as a possible means to enhance investor protection and stated that a roundtable meeting would be held in March 2012 to hear public responses and concerns (Concept, 1). The concept release in August of 2011 was the first time the PCAOB issued a release on the topic of auditor rotation, but the idea of mandatory rotation was not a new concept to regulators. Proposals for rotation were considered unnecessary by an independent commission, the SEC and the General Accounting Office in 1978, 1994, and in 2003 respectively (Chasan, 1).

The Chairman of the PCAOB, James Doty stated the following: “The reason to consider auditor term limits is that they may reduce the pressure auditors face to develop and protect long-term client relationships to the detriment of investors and our capital markets” (Cain, 1). The Chairman of the SEC, Arthur Levitt had a similar response and suggested that “blocking auditor rotation ‘would be a further erosion of investor protection’” (Rapoport, 1). Other supporters of rotation argue that new auditors will review financial statements and notes to the financial statements in more detail and with a new perspective (Cain, 2).

Negative consequences could result, however due to the high costs associated with obtaining new auditors. Also, many of the larger accounting firms are experts in particular industries, which may present challenges for large corporations to find replacement accounting firms with the same level of expertise in their respective areas of business. Similarly, problems could arise for smaller corporations as the new auditors learn about the company’s history and operations (Rapoport, 1). Valuable time and resources would be spent by corporations reintroducing themselves every few years (Cain, 2).

The PCAOB is considering comments made by those advocating auditor rotation and those opposing the passage of such a requirement. The ultimate decision, however, likely will not be up to the PCAOB. On March 28, 2012 a draft bill to prohibit regulators such as the PCAOB from issuing mandatory auditor rotation standards was presented to a subcommittee of the House of Representatives (Rapoport, 1). Also, even if the House were to reject the draft bill, the PCAOB would still have to have new standards on auditor rotation approved by the SEC prior to implementation. Although the SEC supported the concept of auditor rotation in 1994, new business and political environments may impact the overall position taken by the SEC.

An interesting position was also taken by the Chamber of Commerce and other industry organizations, as well as numerous businesses (Chasam, 1). The collective group chose to attack to potential effectiveness of mandatory audit rotation rather than the general idea that the PCAOB may be overstepping its boundaries. The group stated the following:

“It appears that the PCAOB is concerned with auditor independence, a laudable goal. However, the current features of independence rules: partner rotation, limits on revenue sources from an audit client, job freeze periods, personal holdings etc, appear to be working based upon the PCAOB’s statements on improved audit quality and lack of factual evidence to the contrary.” (Chasam, 1)

Although the opponents of mandatory audit rotation appear to be gaining the upper hand, auditor rotation remains to be a potential option in the future. Should the standards established under the Sarbanes-Oxley Act prove to be insufficient in future business environments, audit firm rotation may become a viable option to address the shortcomings.

### ***Conclusion***

The credibility of the accounting profession was shattered in the early 21<sup>st</sup> century as numerous accounting scandals were made public. The bankruptcy of companies such as WorldCom and Enron and the devastation that was brought upon investors revealed huge flaws in financial legislation and numerous failures in the enforcement of regulations. The passage of the Sarbanes-Oxley Act is of historic significance as it has transformed a previously self regulated profession into a profession that is subject to substantial regulation and oversight. Through its impacts on both accounting firms and their clients, the Sarbanes-Oxley Act has significantly improved financial reporting and disclosure requirements. One of the underlying reasons for the failures of past standards and the potential for failure of the Sarbanes-Oxley Act, however, remains the same. Rapidly changing business environments require constant analysis and

testing of the effectiveness of standards. Without such considerations, previously effective standards may become outdated and subsequent failures may result. Therefore the future reporting of inefficiencies by regulators, auditors, and clients will be of significant importance.

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