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HOW THE ENRON CORPORATE ACCOUNTING FRAUD LED TO THE FAILURE OF THE CORPORATE GOVERNANCE MECHANISM

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ABSTRACT

Houston's natural gas firm and inter-north incorporation merged to establish the Enron Corporation. It flourished quickly after the merger and was recognized as the most inventive corporation. It did, however, stoop to unethical accounting tactics. It was involved in the formation of special purpose entities, which were used to disguise the Enron Corporation's mounting debt, ultimately leading to the company's implosion and demise.

There have been a slew of books written about Enron's fall, all attempting to explain why things went wrong. As we have seen, the United States and the United Kingdom have had a significant reaction to Enron's downfall, and corporate governance has been thrust into the spotlight. This occurs as a result of Enron's corporate governance system's flaws. Enron's long-term consequences are likely to be a cleaner, more ethical corporate climate around the world. Furthermore, to avoid future Enron's, corporate governance standards of practice must be updated on a regular basis, and corporate governance checks and balances must be reviewed on a regular basis.

As a result, the purpose of this article is to examine the obstacles that transition countries confront as they shift from a politically oriented partnership to a rule-based relationship. It also examines the importance of corporate governance as a key factor in the extraordinary shift of transition countries to market economies.

Thus, the researcher finishes the paper by elaborating on the Sarbanes – Oxley Act and what impact it had made on the accounting profession since its inception as well as providing recommendations and insights of the Enron Scandal.

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INTRODUCTION

Initially the Enron Corporation was considered to be a big name in the corporate world. But its success was short lived, as it plummeted down and had declared bankruptcy. This not only stunned the Wall Street, but also made many employees bankrupt. The Corporation had accumulated a lot of debt, which it concealed by the means of special economic organizations as well as special – purpose vehicles. On 2nd December 2001, Enron had recorded its highest market price of $90.75, but as the scandal was revealed the market price of Enron plummeted to a record low of $0.26.

The scandal started as Enron entered the Video rental industry. The Corporation than collaborated with a blockbuster as a way to enter the Video on Demand market. After entering the market, Enron overvalued the earnings of the VOD industry as a way of showing its growth. Though, the corporation was in charge of $350 billion worth of deals, after the dot- com bubble had burst, the success was short – lived. It failed to recoup its money, even after launching various broadband initiatives. Not only did Enron gain significant exposure, but after the market capitalization saw a downfall, the investors had lost a lot of money.[2]

The downfall of the Corporation can be seen from the year 2000. The then CEO Jeffrey Skilling had hidden any of the financial losses that Enron had suffered from either the trading business or the broadband initiative, by implementing accounting concepts such as mark – to – market accounting. The corporation still cumulated its assets. Future profits were also being reported. The loss was not going to be reported since the actual profit was less than the stated earnings. Another way through which the corporation was able to conceal its losses were by transferring its assets to a covert organization.

What added to the controversy was that even though the subsidiaries of the corporation lost a lot of money from the investors, the chief financial officer of Enron, Andrew Fastow was able to depict that the corporation was still in good financial state.

Many Enron executives were indicted and sentenced to prison on a variety of offences. In 2006, both Skilling and Lay were found guilty of multiple conspiracy and fraud offences. Skilling was sentenced to more than 24 years in prison but only served 12. Lay, who faced a term of more

[2] Rishabh Nigam, Enron Scandal, https://www.wallstreetmojo.com/enron-scandal/ (Last Visited Sept. 19, 2021)

than 45 years in prison, died before his punishment could be carried out. Fastow also pled guilty. Though he had been sentenced for a term of 6 years in prison, he was later released in 2011.

The accounting firm Arthur Andersen was heavily questioned and was declared to be in obstruction of justice by the US Department of Justice. The firm's clients had gone to their competitors in order to assure the highest accounting standards to their financial assets. This was later followed by the entire team of employees that worked with Arthur Andersen. This later resulted in the layoff of more than a thousand workers. The firm on 15th June 2002 was thus found guilty of tampering with evidence and resulted in its license to practice public accounting being revoked. The lawyers representing Arthur Andersen then later moved to the US Supreme Court, after three years to reverse the decision of obstructing justice with the contention that it was an incorrect jury order. But by that time, the firm had only 200 staff left to manage its lawsuits.[3]

The shareholders had filed a plethora of lawsuits against both Enron as well as Arthur Andersen. But these law suits turned out be a waste of time and money since the investors ultimately lost money and the employees were able to recover only a small portion of their 401(k)s, while only the small lawsuits being successful in their case.

Following the crisis, a slew of new laws and legislation aimed at improving the accuracy of financial reporting for publicly traded corporations was enacted. The Sarbanes-Oxley Act of 2002, the most important of these laws, set hefty penalties for deleting, changing, or fabricating financial documents. The statute also made it illegal for auditing firms to perform concurrent consulting work for the same customers.

Thus, to summarize as to what could be the causes to the Enron corporate accounting fraud:

- The creation of a special purpose vehicle for concealing financial losses and a pile of financial debt.
- Mark-to-market accounting as an accounting concept is an excellent method to value securities, but such a concept becomes a disaster when applied to the actual business.
- Lapse of corporate governance in Enron Corporation.

[3] Peter Bondarenko, Enron Scandal, https://www.britannica.com/event/Enron-scandal/ (Last Visited Sept 22, 2021)

HOW DID THE CORPORATE GOVERNANCE MECHANISM FAIL IN THE ENRON SCANDAL

A set of rules or procedures by which a firm is governed is known as corporate governance. It guarantees that the corporation operates in the way it is expected to operate in order to accomplish the desired results. It holds organizations responsible to all stakeholders, such as directors, shareholders, employees, and customers. Governance is defined as the act of governing a business entity by the term itself. Because a corporation's entity is distinct from its officers, corporate governance is an essential subject to research. Corporate governance is critical in protecting the rights of thousands of shareholders who own the company but aren't involved in the day-to-day operations. Corporate governance has always been a part of the Indian corporate sector, but the failure of Satyam Computer Services Limited's corporate governance has raised worries about corporate governance in India.

Corporate fraud and governance failures have been more common in the previous decade, which is why we need good corporate governance in the country. To administer a corporation, India gives necessary norms and legislation that are matched with international needs.[4]

The Indian corporate governance system is quite like international standards. It is divided under the following legislations:

1) Independent Directors, Board Constitution, General Meetings, Board Meetings, Board Processes, Related Party Transactions, Audit Committees, and other topics are covered under the Companies Acts of 2013.
2) The SEBI (Securities and Exchange Board of India) Recommendations protect investors by requiring businesses to follow the best practices outlined in the guidelines.
3) The ICAI (Institute of Chartered Accountants of India) is an independent authority that has the power to issue regulations regarding accounting standards practiced in India. Section 129 of the Companies Act, 2013 has backed the ICAI and has made financial statement disclosure mandatory.
4) The ICSI (Institute of Company Secretaries of India) publishes secretarial guidelines on topics such as "Meetings of the Board of Directors," "General Meetings," and other topics. The Companies Act of 2013 authorizes this autonomous organization to establish rules that every company must follow to avoid being penalized under the Companies Act.

[4] Bharat Rajvanshi, Corporate Governance in India, https://blog.ipleaders.in/corporate-governance-india/ (Last Visited Sept. 18th, 2021)

Due to such developments in the corporate world, corporate governance has been termed as the most commonly used phrase in today's business vocabulary. The downfall of the Enron Corporation in 2001 has become a leading case in the world regarding business failures. It also makes us learn about how well corporate governance can help eradicate such business failures.

The Corporate Governance mechanism that was established in America turned out to be a failure after the occurrence of the Enron Corporate Accounting Fraud. The interest of the shareholders is safeguarded by the practice of supervising the management of the company, which is done by the board of directors. But in 1999, the board of directors of Enron allowed Andrew Fastow who was the then chief financial officer of the corporation to create private partnership as a way of conducting business with the other companies and thus disregarding the guidelines of the conflict of interest of the shareholders. These private partnerships were seen to include debts that were hidden, which could have affected the recorded profits by Enron drastically. Thus, Enron's downfall gives rise to the issue as to what authority does the board of directors have in regard to opposing unethical practices that are performed by the company's managers.

Enron's bankruptcy has resulted in a slew of corporate governance issues. Enron's management suffered from the problem of giving unlimited power to the CEO of the Corporation. Even though the Corporation was declared bankrupt, instances of unethical practices continued to take place by the company's management. Thus, it can be stated that Enron's corporate governance was shady in all the aspects. Thus, after the downfall the board of directors is constituted of people who were morally bankrupt, who are not afraid of indulging in any kind of unethical practice. Therefore, we can say that the above said are the reason as to why the corporate governance mechanism of the Enron corporation fail.[5]

Therefore, the systems of checks and balanced in corporate governance cannot cure the morally wrong practices but can only work to the extent of finding it in the company's management. Furthermore, it can be said that there is a tendency in human behavior which is still unable to differentiate between what is good, bad, and horrible for them. An American civil and criminal lawyer, Sheldon Zenner has made a series of comments on the Enron trial which have further helped in understanding the situation of the Scandal.

As a result, corporate governance refers to the collection of rule-based legal, policy, and accountability systems that control the relationship between the investor (a company's

[5] Rezart Dibra, Corporate Governance Failure: The Case of Enron and Parmalat, European Scientific Journal June 2016 edition vol.12, No.16, https://core.ac.uk/download/pdf/236418354.pdf (Last Visited Sept 19th 2021)

stockholder) and the investee (management). Following the early 2000s U.S. company scandals such as Enron, corporate governance has received a lot of attention.

The reason as to why Enron was able to undertake such shady activities for so long primarily through deceptive accounting practices. Administrators freely cooked the books of the companies and entered into numerous hedging agreements. On the other hand, despite the fact that there were numerous spheres of fraudulent activity within these two companies' internal workings, the boards of directors and auditing firms of the companies are liable to a large extent for these incidents, due to extreme failures in mitigating their responsibilities responsibly.[6] In light of this, it's critical to examine the failures of Enron's boards of directors and auditing firms in order to determine how much they contributed to the disasters and how such occurrences might be avoided in the future.

WHAT CHANGES HAVE BEEN MADE TO THE LEGAL FRAMEWORK POST THE ENRON SCANDAL

The Enron case of 2001 showed the deficiency that the American notion of Corporate Governance. But new regulations had to be introduced so that further no such corporate accounting frauds occur in the future. The landmark regulation implemented to prohibit such scandals further was the Sarbanes – Oxley Act, 2002. The institutions that were affected by this act were both the publicly held corporations as well as audit firms. This act has major influence on large accounting firms, as well as including every Certified Public Accountant, irrespective of whether he is an auditor or a publicly traded company.

The Sarbanes-Oxley Act of 2002 is a major reform package that mandates some of the most significant reforms to the business world since FDR's New Deal. The aim of this act was to prohibit any kind of similar scenario to occur in the future as well as implement a public accounting supervisory body, amendment with regard to the independence of auditors, modify the standards set for corporate governance and escalate the criminal penalties for any violation

[6] Kanchan Yadav, Enron, and Satyam Frauds: A Comparative Study Based on Corporate Governance, INDIAN LEGAL SOLUTION INTERNATIONAL JOURNAL OF LAW AND MANAGEMENT, https://ilsijlm.indianlegalsolution.com/enron-and-satyam-frauds-a-comparative-study-based-on-corporate-governance-kanchan-yadav/ (Last Visited Sept. 19th, 2021)

of the security law in order to safeguard the trust of the investors.[7]

The act can further be explained by the changes it aims to introduce:

The Public-Company-Accounting- Oversight Board

As per the law registration with the board is mandatory for all accounting firms that audit public corporations. The new board's function was under the direct oversight of the SEC. While auditing public corporations the guidelines that are going to be used are the ones that are established other parties or organizations and later either issued or adopted by the board. The norms as set by the act include auditing attestation, quality control, ethics, independence, and other various necessities to safeguard the public interest.

With the inception of the new Act, the board will be granted powers of inspecting the accounting firms that are registered, in addition will be able to investigate any matter with regards to violation of the security laws, competency or situations of unethical behavior. A sanction can be imposed in the situation of non – corporation, violations, or there is failure in supervision of an employee or partner of a registered accounting firm. The sanction can be in the form of a suspension of the registration of the accounting firm made to the board as well as prohibiting the firm to further auditing of the public businesses and civil penalties that would be imposed. The board will also carry international authority which means that the board will have a say in matters where foreign accounting firms either submit or audit a company with US registration.

New Rules for Auditor Independence and Corporate Governance

The Act has changed the way in which accounting firms have done business with their audit clients. As per the new law an Audit Committee will be set up in the company which will oversee the Auditors. The services that are provided by the auditor must gain pre – approval from such audit committee. Any new information that comes by the auditor must be communicated to the audit committee of the company by him. This information could contain essential accounting rules and procedures to be implemented, other procedures of financial data that comes within the GAAP has been examined by the management of the company as well as

[7] Anthony Abdalnor Pishay, The fall of Enron and its implications on the accounting profession, https://scholarworks.lib.csusb.edu/cgi/viewcontent.cgi?article=3381&context=etd-project (Last Visited Sept. 23rd , 2021

any other essential information that needs to be made between the auditor and the management.

This act puts a restriction on auditors for providing any non – audit services to their audit clients. Bookkeeping, information system design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer, and investment banking services, legal or expert services unrelated to audit services, and other services the board determines to be impermissible by rule are among these services. Other non-audit services that are not prohibited are permitted provided they have been pre-approved by the audit committee.

The new law mandated that the lead audit partner as well as audit review partner must rotate every 5 years in scenarios of public business. The new law also states that if one of the public company's top official used to work for the accounting firm and has worked during the company's audit in past years, then that accounting firm will not oversee the audit of that particular public company.[8]

Increasing the Criminal Penalties for Violations of Securities Laws

The new law has imposed strict penalties for individual who have either tampered or eradicated data, were involved in a securities fraud or do not corporate with regard to the disclosure of a securities fraud. The punishment for not keeping "all audit or review work papers" for a period of at least 5 years is up to 10 years of imprisonment. Rules regarding the retention of audit records would be adopted by the SEC, where each state's Board of Accountancy would require the company's auditors to retain their documents for at least 7 years as per the rule issued by them.

In the situation of a federal or bankruptcy investigation the act of destroying papers has been made a felony, as well as 25 years has been made the penalty for any securities fraud committed. The limitation period has been increased from one year to two years from the date of when the fraud was discovered, secondly, the limitation period is also increased from three years to five years from the time of commission of the fraud.

Various other clauses of the new act put restriction on the practice of insider trading during the blackout period as well as corporate whistleblowers as well as bar executives from carrying out

[8] Same as 6

their personal loans. These provisions also safeguard the employees by not making them the victims of frauds done by the company's management. An example can be given with respect to the Enron scandal where the corporation had asked the employees to invest in the company's stock at the same value as their 401(k), but later in October 2001 the company announced a blackout period, where it froze the employee plan thus, preventing profits to the employees before the stock plummeted down. But this cannot be said for the company's management as many top officials of the corporation were able to sell their stock during the blackout period and not worrying about the price fall.[9]

CONCLUSION

The organizational system by which a corporation represents and serves the interests of its investors is known as corporate governance. It includes everything from a company's board of directors to executive compensation plans and bankruptcy legislation. The system of checks and balances that underpins corporate governance must work properly. As a result, Enron emphasize the importance of non-executive directors, audit, and disclosure, as well as managerial ethics. Top management's immoral behavior cannot be prevented by corporate governance systems. They can, at the at least, be used to detect such behavior by top management before it is too late. There is no remedy for a rotting fruit. Nonetheless, before the virus spreads and affects the entire barrel, the rotting apple can be removed. As a result, an examination of the Enron case reveals how dissimilar the US and corporate governance systems are. Furthermore, they are susceptible to exploitation and corporate governance flaws of a similar sort. This is exactly what good company governance entails.

Sarbanes-Oxley Act that was introduced in 2002 can be termed as a solution to the problem of these corporate accounting scandals. Though it aims to increase the public participation in the accounting business but gaining the confidence of investors with respect to the capital market as well as audit function would require more than just a new law.

The establishment of the board and the imposition of direct and considerable SEC scrutiny on all its operations marks a shift in the self-regulatory accounting profession, from public oversight to public involvement. The Act establishes a variety of new offences, including a new federal criminal known as "security fraud." This makes it illegal to knowingly "defraud any

[9] Same as 6

person in connection with any security" issued by a public company, or to obtain money or property "in connection with any purchase or sale of any security" issued by a public company "by means of false or fraudulent pretenses, presentations, or promises."[10]

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[10] Section 802 and Section 803 of the Sarbanes – Oxley Act, 2002