2003

The fall of Enron and its implications on the accounting profession

Anthony Abdalnor Pishay

THE FALL OF ENRON AND ITS IMPLICATIONS

ON THE ACCOUNTING PROFESSION

A Project

Presented to the

Faculty of

California State University,

San Bernardino

In Partial Fulfillment

of the Requirements for the Degree

Master of Business Administration

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June 2003

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ABSTRACT

The main purpose of this paper is to develop significant implications for the accounting profession based on an in-depth analysis of the fall of energy giant Enron Corporation. The paper includes details about how the company managed to deceive Wall Street for such an extended period of time and, then, present itself as a very successful profitable company. The scope of the paper also covers the unfolding of certain details about the accounting scandal surrounding the company and which led to its eventual bankruptcy. The paper also includes details about the self-regulated accounting profession and the changes that affected the profession as a result of the Enron accounting scandal. This paper specifically highlights Enron above other companies' failures because of the huge impact this company had on the existing self-regulatory financial reporting system.

The paper concludes with recommendations and insights based on the author's analysis of Enron's demise. The paper contains information about the Sarbanes-Oxley Act and its impact on the accounting profession; included also is a survey about the Act and a discussion about the results of the survey. Appendix A of this paper includes the 10-questions survey.

This paper is very valuable to all accountants, especially those practicing in public accounting or those working for publicly-traded companies. It is informational and instructional; it contains valuable educational information that can be taught in ethical, managerial, and accounting classes.

ACKNOWLEDGMENTS

No book like this could be written without the help of many people. First and foremost, I would like to thank my wife, Mary, for being there, and, for her encouragement and support.

My thanks also go to my daughter, Marian, and my son, Mark, for leaving me alone when isolation was required.

Finally, I am sincerely grateful for the help of my instructors, Dr. Otto Chang and Dr. Sue Greenfeld, who have not only taught me, but have shared with me many of their innovative and up-to-date information and ideas.

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CHAPTER ONE

INTRODUCTION

The Story of Enron

In 1985, after federal deregulation of natural gas pipelines, Enron was born from the merger of Houston Natural Gas and InterNorth, a Nebraska pipeline company (Thomas, 2002). In the process of the merger, Enron incurred large debts and, because of deregulation, the company lost its exclusive rights to its pipeline. In order to survive, the company created a "gas bank" in which Enron would buy gas from a network of suppliers and sell it to a network of consumers, contractually guaranteeing both the supply and the price as well as promising to deliver so many cubic feet of gas to a particular utility or business on a particular day at market price, charging fees for the transactions and assuming the associated risks (Thomas, 2002).

With the deregulation of electrical power markets and under the direction of former Chairman Kenneth L. Lay, Enron expanded into being an energy broker trading electricity and other commodities (O'Harrow, 2002). Enron became a giant middleman that worked like a hybrid of traditional exchanges. Rather than simply bringing buyers and sellers together, Enron entered into the contract with the seller and then signed a different contract with the buyer, making money on the difference between the selling price and the buying price. Enron also kept its books closed, making it the only party that knew both prices (O'Harrow, 2002).

Over time, Enron began to design increasingly varied and complex contracts. Customers could insure themselves against all sorts of risks, such as a rise or fall in interest rates, a change in the weather, or a customer's inability to pay. Pretty soon the volume of such financial contracts far exceeded the volume of contracts to actually deliver commodities (O'Harrow, 2002). As its services became more complex and its stock soared, Enron created a group of partnerships that allowed managers to shift debt off the books. In 2003, as the losses from various partnerships started piling up, some partnerships' losses would have to be paid for out of Enron stock or cash, bringing the debts back home (O'Harrow, 2002).

Enron executives and its accounting firm, Arthur Andersen, had warnings of problems nearly a year before Enron announced on October 16, 2001 a $638 million loss for the third quarter of 2001. In Nov. 8, 2001, the company announced that it had overstated earnings over the past four years by $586 million and that it was responsible for up to $3 billion in obligations to various partnerships (O'Harrow, 2002). On November 28, 2001 a $23 billion merger offer from rival Dynegy Corporation was dropped after lenders downgraded Enron's debt to junk-bond status. Wall Street reduced the value of stockholders' equity by $1.2 billion. In November 30 Enron stock closed at an astonishing 26 cents share (Thomas, 2002).

Dozens of lawsuits have been filed against the company by an array of pension funds. Dozens more are directed at former Chairman Kenneth L. Lay, former CEO Jeffrey Skilling, and former Chief Financial Officer Andrew Fastow. The suits could take years to resolve. U.S. District Judge Lee Rosenthal in Houston says she will consider freezing Enron officers' and directors' financial assets. On December 2, 2001 Enron filed for bankruptcy protection. With $62.8 billions in assets, it became the largest bankruptcy case in U.S. history at that time (American Institute of Certified Public Accountants [AICPA], 2002a) [On July 21, 2002 WorldCom filed for bankruptcy listing some $107 billion in assets and $41 billion in debt, on a consolidated basis as of March 31, 2002] (WPNI, 2002b).

The day Enron filed for bankruptcy its stock closed at 72 cents, down from more than $75 less than a year earlier. Many employees lost their life savings and tens of thousands of investors lost billions. In early October 2002, former Chief Financial Officer Andrew Fastow was charged with securities, wire, and mail fraud as well as money laundering and conspiring to inflate Enron's profit (WPNI, 2002a). Fastow was also responsible for creating thousands of special purpose entities (SPEs); these SPEs were used by Enron to hide losses and to improve the company's credit rating. The following section of the paper will go into detail to explain SPEs and how did Enron use them.

CHAPTER TWO

BACKGROUND

Special Purpose Entities

In order to satisfy credit rating agencies, Enron had to make sure the company's leverage ratios were within acceptable ranges. Consequently, Andrew Fastow became heavily involved in lobbying the ratings agencies to raise Enron's credit rating, using different ways to lower the company's debt ratio. Reducing hard assets while earning increasing paper profits served to increase Enron's return on assets (ROA = Estimated Annual Earnings / Total Assets) and reduce its debt-to-total-assets ratio (Total Liabilities/Total Assets), making the company more attractive to credit rating agencies and investors. Enron also used "special purpose entities" (SPEs) to access capital and hedge risk. By using SPEs, such as limited partnerships with outside parties, a company is permitted to increase leverage and ROA without having to report debt on its balance sheet (Thomas, 2002).

How Special Purpose Entities Work

The company contributes hard assets and related debt to an SPE in exchange for an interest. The SPE then borrows large sums of money from a financial institution to purchase assets or conduct other business without the debt or assets showing up on the company's financial statements. The company can also sell leveraged assets to the SPE and book a profit. To avoid classification of the SPE as a subsidiary (i.e., thereby forcing the entity to include the SPE's financial position and results of operations in its financial statements), Financial Accounting Standards Board (FASB) guidelines require that only 3% of the SPE be owned by an outside investor (Thomas, 2002).

How Enron used Special Purpose Entities

Enron took the use of SPEs to new heights of complexity and sophistication. The company used SPEs to "park" troubled assets that were falling in value, such as certain overseas energy facilities, the broadband operation, or stock in companies that had been spun off to the public. Transferring these assets to SPEs meant their losses would be kept off Enron's books. To compensate partnership investors for downside risk, Enron promised issuance of additional shares of its stock. As the value of the assets in these partnerships fell, Enron began to incur larger and larger obligations to issue its own stock later down the road.

Enron conducted business through thousands of SPEs. The two most controversial of them were LJM Cayman LP and LJM2 Co-Investment LP, run by Fastow himself (Thomas, 2002). From 1999 through July 2001, these entities paid Fastow more than $30 million in management fees, far more than his Enron salary; supposedly he had the approval of the top management and Enron's board of directors. In turn, the LJM partnerships invested in another group of SPEs, known as the Raptor vehicles, which were designed in part to evade an Enron investment in a bankrupt broadband company, Rhythm NetConnections (Thomas, 2002).

As part of the capitalization of the Raptor entities, Enron issued common stock in exchange for a note receivable of $1.2 billion. Enron increased notes receivable and shareholders' equity to reflect this transaction, which violates consolidations rules as included in generally accepted accounting principles [GAAP] (Thomas, 2002). Enron failed to consolidate the LJM and Raptor SPEs into its financial statements when subsequent information revealed they should have been consolidated.

Enron used SPEs, and other very complex improper accounting transactions in order to keep the stock price as high as possible. However, the company's auditing firm, Arthur Andersen, is also responsible for failing to uncover the accounting fraud committed by the company. The following section of the paper will cover details about the involvement of Arthur Andersen with the accounting scandal that surrounded Enron.

Arthur Andersen LLP

Arthur Andersen, one of the nation's largest accounting firms, was responsible for auditing the financial statements of Enron. Enron was the firm's second-largest client. Andersen, which had the job not only of Enron's external but also internal audits for the years in question, kept a whole floor of auditors assigned at Enron year-round (Thomas, 2002). Andersen was also responsible for some of Enron's internal bookkeeping. Many of Enron's internal accountants, controllers, and Chief Financial Officers (CFOs) were former employees of Arthur Andersen. The job of Arthur Andersen was to make sure investors could rely on Enron's financial statements, but Andersen was also a major business partner of Enron's, soliciting and selling millions in consulting services to Enron.

The collapse of Enron has raised awareness about possible conflicts of interest among accounting firms that perform both audits and which also provide consultation services for their clients. The stock markets require listed corporations to be audited by independent accountants. Critics argue that a firm performing both functions is not truly independent since well-paid consulting work can influence auditors to pander to their clients.

When the Securities and Exchange Commission (SEC) began its investigation of Enron, Andersen was accused and later found guilty of obstructing justice by destroying incriminating Enron-related documents. As a result, Andersen was no longer able to perform any audit work and was forced to close down its operations in the U.S. effective August 31, 2002 following its conviction in June 2002 on obstruction of justice charges related to the Enron bankruptcy (Goff, 2002).

The History of Self-Regulations

For the past sixty years, the accounting profession's system of self-regulations has helped create the most respected financial market in the world. Self-regulation by the accounting profession started just after the Securities and Exchange Commission (SEC) was established by the Securities Act of 1933 and the Securities Exchange

Act of 1934. Congress passed the two new laws in response to huge sums of money lost by investors in the stock market Crash of 1929 and throughout the Great Depression (AICPA, 2002b). The SEC was given statutory authority to set accounting standards and oversight over the activities of auditors; however, the role of establishing auditing standards was left to the accounting profession.

Accounting Standards

The SEC had always trusted the private sector in establishing and improving accounting principles and reporting standards. During the period from 1938 to 1959, the American Institute of Certified Public Accountants (AICPA) issued fifty-one authoritative announcements that became the basis for Generally Accepted Accounting Principles (GAAP). In 1959, the Accounting principles Board (APB), a part-time body, replaced the Committee on Accounting Procedures (CAP). During the fourteen-year period from 1959 to 1972, the APB issued thirty-one new standards (AICPA, 2002b).In 1972, a full-time independent body was created outside the AICPA to take on the primary responsibility of setting up new accounting standards and was called the Financial Accounting Standards Board (FASB). The FASB operates under the sponsorship of the

Financial Accounting Foundation (FAF), which consists of sixteen trustees, twelve of whom are elected by representatives of FAF's sponsoring organizations, including the AICPA and the American Accounting Association. The FAF itself appoints the other four members, and also appoints the members of the FASB and its advisory council. The method used in appointing the members is designed in such a way as to ensure that the standard-setting body is independent and kept within the private sector (AICPA, 2002b).

Auditing Standards

The American Institute of Accountants, the predecessor organization of the AICPA, appointed a standing committee on auditing procedures in 1939; the committee issued the first auditing standards (AICPA, 2002b).

Then, in 1941, the committee issued a series of statements as guidelines for independent auditors and, during 1951, the committee consolidated the first twenty-four of these pronouncements. In 1972, the committee confined all previous rules into a single presentation, as well as changed the name of the committee to the Auditing Standards Executive Committee, and became the AICPA's senior technical committee charged with interpreting Generally Accepted Auditing Standards (GAAS).

In 1978, the Auditing Standards Board (ASB) replaced the Auditing Standards Executive Committee. The ASB has 15 members, is an entity within the AICPA, and is responsible for setting the rules for how the auditor can determine whether the information reported in the financial statements is reasonable and whether it conforms to GAAP. The ASB is a senior technical committee within the AICPA, and, therefore, has the authority to make public statements without clearance from the AICPA Council or the Board of Directors (AICPA, 2002b).

Peer Review

Peer Review is one of the techniques used by the self-regulated profession to enhance audit quality; it was first introduced as a requirement by the AICPA in 1977. With the establishment of the division for Certified Public Accountant (CPA) firms, firms that chose to join the division agreed to follow certain standards including peer review every three years.

In 1989, these requirements were made mandatory as part of a package of across-the-board changes to the profession's self-regulatory structure enacted by the

AICPA. The AICPA's bylaws were changed so that all members who audit publicly-held companies would be required to work for a firm that belongs to the AICPA's SEC Practice Section (SECPS).

Securities and Exchange Commission Practice Section

The SEC Practice Section (SECPS) was created by the AICPA in 1977 as a self-regulatory group whose objective is to improve the practice of CPA firms. The AICPA bylaws require that all members who engage in the practice of public accounting with a firm auditing one or more SEC clients, as defined by AICPA Council, are required to join the Section (AICPA, 2002c).

One of the requirements of SECPS membership is a review every three years by another accounting firm of similar size. The intention of the SECPS peer review program is to assure the public that a firm performing auditing and accounting services for SEC registrants has an effective quality control system that provides reasonable assurance that its auditors and accountants are complying with both generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS).

The Section currently has approximately 1200 member firms, which either audit registrants that file financial statements with the SEC or have joined the Section voluntarily (AICPA, 2002c).

Public Oversight Board

In 1977, the Public Oversight Board (POB) was created as an independent private sector body charged with overseeing and reporting on the programs of the SEC Practice Section (SECPS). The POB was independent from both the profession and the regulatory process. It elected its own board members, hired its own staff, and developed its own budget. The POB was responsible for reviewing all firms with 30 or more SEC audit clients as well as performing a sampling of about one of every five reviews of firms with less than 30 SEC clients (AICPA, 2002b).

The POB was the cornerstone of the self-regulatory system that oversees the accounting profession in the United States. The main purpose of the POB was to help give surety to regulators, investors, and the public that audited financial statements of public corporations can be relied upon to provide an accurate picture of the financial health of those companies. The SEC at random inspected a sample of peer review files. The POB used to issue an annual report that makes public all of the POB's important actions from the previous year.

After the fall of Enron and as a result of statements by the Chairman of the SEC, Harvey Pitt, concerning proposed changes in the accounting profession's system of self-regulation, the members of the Public Oversight Board announced their intention to terminate the Board's existence no later than March 31, 2002 (Public Oversight Board, 2002). The termination date was extended to May 1, 2002, at which time the POB passed a resolution terminating the POB effective immediately. At that time, the POB members also indicated their preparedness to individually, or collectively, offer their advice or other assistance in establishing an effective oversight mechanism in the private sector for the accounting profession that audits public companies. This section concludes the history of self-regulation for the accounting profession in general; the following section will also have information about the history of the accounting profession, but will focus on specific issues related to auditors independence, quality control, and corporate governance.

Rotation of Auditors and Concurring Review

Other SECPS membership requirements include rotation of audit partners and concurring review by a fellow partner. The rules state that if any audit partner within a firm that has five or more SEC clients and ten or more partners has been in charge of an SEC audit engagement for a period of seven consecutive years, a new audit partner must be assigned (AICPA, 2002b). The audit report and financial statements of publicly-held companies are also subject to a concurring review by a partner other than the audit partner-in-charge of the engagement.

Quality Control Inquiry Committee

In 1979, the Quality Control Inquiry Committee (QCIC) was established to investigate alleged audit deficiencies of a firm's quality control systems and to provide reasonable assurance that firms were complying with professional standards by identifying corrective actions when appropriate (AICPA, 2002b).

Other SECPS membership requirements mandate that each member firm of the SECPS must report to the QCIC any litigation or proceedings by a regulatory agency that alleges deficiencies in the conduct of an audit of a current, or former, SEC registrant client. All such reports must be made within 30 days. QCIC investigations are normally completed within 5-6 months of the matter being reported.

Professional Ethics Division

The AICPA also maintains a professional ethics division, responsible for maintaining, interpreting, and enforcing the AICPA Code of Professional Conduct and when, appropriate, suggesting changes to the Code. The Division investigates any allegation of wrongdoing by members made by the public, federal or state regulatory bodies, other AICPA members, or the QCIC. The division also initiates investigations if it becomes aware of allegations of wrongdoing through media reports, federal or state regulatory action (AICPA, 2002b).

Corporate Governance

The fall of Enron highlighted the failure of corporate governance in the United States and underscored the need for fast and decisive action to require more accountability at publicly-held companies. Internal auditors, the board of directors, senior management, and external auditors are the foundation on which effective corporate governance must be built. In order to achieve a consistent and effective governance process, all four of these groups must be in place and be working together. These four groups provide an effective system of checks and balances that melds internal understanding of the business with independent external assessment.

During the Enron fiasco, fingers pointed to the system used to select/nominate corporate Directors as full of conflicts of interests. The practice in most corporations in America is that management selects Director-candidates and help them to be "elected." The system does not give the shareholders the opportunity to nominate truly independent Director-candidates and assure that the names of those candidates will appear on the Company's ballot along with those nominated by the management.

While dependent on management for their longevity, directors still have a fiduciary duty to all shareholders to monitor management's actions. It is an obvious conflict of interest. Additional conflict of interests are caused by the existence of a director clique, such as friends, colleagues or partners elected for the same board together, creating the potential for conflicts of interest and violating what is supposed to be an independent watchdog in Corporate America. Historically, the SEC has seldom brought disciplinary actions against outside corporate directors in cases involving accounting irregularities (Committee of Concerned Shareholders, 2002).

Due to the many hurdles placed in front of directors-candidates who are not selected by management, institutional investors' occupied with their own interest and the SEC's reluctance to prosecute lapses of proper conduct by Directors, Directors had no real concern about their personal accountability to shareholders.

CHAPTER THREE

PROBLEMS

The collapse of Enron and its aftermath has shaken investors' faith in the U.S. capital markets. The bankruptcy of Enron has put unprecedented focus on the accounting profession and its role in the self-regulatory system. The external accounting profession (especially, the auditing function) and the internal auditing professions have come under severe public and governmental scrutiny due to a perceived lack of independence and the failure to protect the public's interest.

Many investors began to exercise a fair amount of diligence and became more skeptical to companies whose bookkeeping seemed confusing. It is a public knowledge that a range of companies, such as America on Line (AOL), Tyco, and WorldCom, has become subjected to increasing scrutiny.

In the wake of Arthur Andersen's involvement with the Enron scandal, the accounting profession faced a major credibility crisis. The Enron drama represented the systemic failure of the fundamentals in the accounting profession. The Enron fiasco also served as a wake-up call for the accounting profession to work closely with the SEC to produce a better regulatory system for auditors of all publicly-traded companies.

Problems and Recommendations

Problem # 1 - Impaired Independence

Although the seven-year rotation rule did specify how long public accounting firms could head auditing for a particular company, the SEC never made such a rule mandatory. This oversight became very clear in the case of Enron and Arthur Andersen. When Arthur Andersen engaged in providing non-audit services to Enron, long-term personal relationships were established between Enron and its "independent" auditor. Enron paid Arthur Andersen $27 million in 2000 for non-audit consulting services (Katz, 2001), including fees for "business process and risk management consulting." With this kind of money, the CPA firm was preoccupied with the desire to preserve lucrative contracts with Enron.

Independence is greatly being impaired by conflicts of interest when a public accounting firm offers internal auditing, external auditing, and consulting services to the same client. This was the case with Arthur Andersen, which served Enron as both the auditor (internal and external) and the non-audit financial consultant.

The issue of impaired independence raised a debate in the accounting profession regarding the need for limitations on non-audit services, defining non-audit services, and new standards for independence. The tradition that was followed in conducting external audits was that audit firms should rotate audit engagement partners every seven years in order to remove the risk of over-familiarity with the client. However, the engagement partner may remain in a management position relationship with respect to the client, which mitigates the effect of the partner rotation.

Proposed Solutions and Recommendations by Different Parties. As a result of the Enron's debacle, recommendations were made by the SEC to require mandatory rotation of audit firms every seven years. Such rotation would provide a number of important benefits.

First, a new audit firm would bring new skepticism and a fresh perspective that a long-term auditor may lack. Second, auditors tend to rely excessively on prior years' working papers, including prior tests of the client's internal control structure, particularly if fees are a concern. Also, long-time auditors may come to believe that they understand the totality of the client's issues, and may look at those issues in the next audit as normal rather than staying open to other possibilities. Finally, an auditor may place less emphasis on retaining a client relationship, even at the cost of a compromised audit, if he/she knows that the engagement will end after several years.

Other recommendations call for banning audit firms from offering internal audit and certain technology consulting services to organizations for which they also provide external audit services, or prohibit public accounting firms from offering both internal and external auditing services for any new clients.

Because not all non-audit services may impair independence, some recommendations made by the Institute of Internal Auditors (IIA) called for the need for a set of guidelines to assess non-audit services and provide auditors and directors with a basis for evaluating the degree or risk of impairment of independence caused by non-audit services.

The relativity of fees for non-audit services to the audit fee, materiality of the transaction to the financial statements, the extent of review and approval required to contract the non-audit service, and the oversight of the service are some of the factors to consider in the assessment. Guidelines will begin by specifying the non-audit services that simply are not appropriate for the external auditor to provide under any circumstances. Also a list of non-audit services that may impair the auditor's independence should be developed and maintained current as marketplace conditions change over time.

The concept of "acting as management or an employee of an audit client" seems straightforward, but unambiguous guidance is needed in this area. While it is almost universally agreed that the auditor should not take on management functions, criteria are needed for determining when management functions have been assumed. While action is necessary with regard to non-audit services, a total ban of all extended services is not required. In general, extended services can be divided into two categories:

- Non-audit services that by their very nature should not be rendered by the organization's external auditor;
- Non-audit services that may enhance the control environment or provide special support to client organizations. They generally do not impair independence.

Services in the second category should be permitted so long as (1) the total amount of their associated fees are not sufficient to bring the independence of the external auditor into question and (2) so long as there are no other managerial or operating considerations that hinder independence.

While many non-audit services raise potential independence issues, there are others for which the independent accountant may be well positioned to provide valuable non-audit services. The first step in achieving a solution is to obtain an understanding of what types of non-audit services are to be prohibited and what services are appropriate—as long as the aggregate fees are not excessive. For example, providing an audit client with consulting services in the area of Human Resources, in most cases, this type of services does not affect the auditor's independence with the client. However, advising an audit client with respect to the design of a management organization structure constitutes a management function that would impair independence.

Evaluation of the Proposed Solutions and Recommendations. Audit firm rotation has significant costs such as:

- Increase in audit failures. According to the Public Oversight Board (POB), Commission on Auditor Responsibilities, and National Commission on Fraudulent Financial Reporting found that audit failures are three times more likely in the first two years of an audit (AICPA, 2003a).

- Increased start-up costs. Changing auditors results in more frequent start-up costs, both for the auditor and the company.
- Increased difficulties in timely reporting. Mandatory rotation makes timely reporting more difficult because audit firms need to meet a very short "learning curve" to perform a rigorous audit.
- Loss of "institutional knowledge." Over successive audits, audit firms increase institutional knowledge, such as their knowledge of the client's accounting and internal control systems and familiarity within the industry in which the client operates. These benefits would be greatly diminished by mandatory rotation.

Despite all the costs mentioned above related to rotation of auditors, the benefits to shareholders, lenders, and the investing public from requiring rotation of auditors are by far much higher in value than the additional cost that may be entailed in connection with a new auditor becoming familiar with the client. In fact, the AICPA's SEC Practice Section has required lead audit partner rotation for decades.

Existing SEC Practice Section membership requirements provide that a member firm must assign a new audit partner to be in charge of each SEC engagement that has had another audit partner-in-charge for a period of seven consecutive years, and prohibit said incumbent partner from returning to in-charge status on the engagement for a minimum of two years. The Practice Section requirements were adopted after thorough consideration of the effects of the requirements on SEC clients and their audit firms (AICPA, 2003a).

The SEC should hold the Public Company Accounting Oversight Board responsible for devising clear criteria specifying the types of extended services that are allowable and not allowable. Then, the SEC should adopt and enforce very strict rules prohibiting audit firms from offering internal audit and certain consulting services that may impair their independence with organizations for which they also provide external audit services.

It may not be feasible or appropriate for the accounting firm to cease all non-audit engagements (that are not already restricted) immediately. The audit client may need time to find a new provider of those services, allow the accounting firms to complete work in progress, and arrange for a smooth transition from one provider to another.

The effectiveness of all of the above-proposed recommendations will be greatly impacted by how serious and how successful is the SEC in implementing and enforcing the new rules. The SEC is under tremendous pressure to implement and enforce new rules related to auditor independence and other rules related to lack of discipline and quality control for audit firms, which will be discussed in detail in the following section of the paper.

Problem # 2 - Lack of Discipline and Quality Control

The self-regulatory financial reporting system was lacking sufficient disciplinary process and quality monitoring for publicly-traded companies in the area of auditing. The SEC was not authorized with disciplinary power to oversee erroneous, unlawful, or unethical auditing practices. Publicly-traded companies were not required to submit reports on assessment of internal controls and risk management processes within organizations. When such information is not mandatory to be monitored, it allows problems like the ones in Enron to grow without being noticed until they snowball into disasters. By the same token, due to lack of regularity, the program of firm-to-firm triennial peer review for auditors of publicly-traded companies does not allow quality monitoring. A few neglected red flags can grow out of hand before we realize it.

Proposed Solutions and Recommendations by Different Parties. On January 2002, the SEC made a proposal to restructure the accounting profession's quality monitoring and disciplinary processes and strengthen public and investor confidence in auditing and financial reporting (AICPA, 2002d). The recommendations called for the accounting profession to produce a better regulatory system for auditors of publicly traded companies.

The SEC envisioned a new body with two primary responsibilities, discipline and quality control. Here are some components of the proposed system: The system should be subject to a new body that is dominated by public membership. The SEC should decide whether conduct should be pursued as violations of law (in which case the SEC would handle it), or pursued as violations of ethical and/or competence standards (in which case they would be handled by the private sector regulatory body). The body would also consider complaints regarding public company auditors that come from sources other than the SEC (AICPA, 2002d).The body should be empowered to perform investigations, bring disciplinary proceedings, publicize results, and restrict individuals and firms from auditing public companies. It would also have the ability to impose fines. These disciplinary proceedings should proceed expeditiously and disciplinary actions should be subject to SEC oversight.

In addition, there should also be a reform of the current peer review process for SEC registrant that re-engineers firm-on-firm review. The new process should replace the current triennial firm-on-firm peer review for auditors of publicly traded companies with more frequent monitoring of audit quality designed to produce better audits in the future. There should also be a permanent quality control staff composed of knowledgeable people unaffiliated with any accounting firms. The staff should be deployed and overseen by the new publicly dominated body and its staff (AICPA, 2002d).

Evaluation of the Proposed Solutions and Recommendations. In order to bolster public and investor confidence in auditing and financial reporting, there is a great need to restructure the accounting profession's quality monitoring and disciplinary process. The accounting profession has to resolve its vulnerabilities and weaknesses. However, on the positive side, the accounting profession has actually shown great willingness to work with the SEC to produce a better regulatory system for auditors of publicly-traded companies, especially after the Enron's collapse (AICPA, 2002d).

The new system would have to be tough, no-nonsense, fully transparent, and subject to independent leadership and governance. In addition, there must be regular monitoring of the ways in which auditing firms perform their responsibilities; it is time for a new public regulatory body responsible for monitoring the quality review and discipline in the accounting profession. In fact, the AICPA expressed a great support for the creation of a new public regulatory organization to undertake professional discipline and quality review in the accounting profession. The AICPA described the idea of the new regulatory organization for auditors of the financial statements of public companies as a radical change in the accounting profession's landscape (AICPA, 2002e). The AICPA commented that the proposed changes would go a long way toward increasing confidence in the capital market, the financial reporting system, and the accounting profession (AICPA, 2002e).

In 2002, the Sarbanes-Oxley Act (Public Law 107-204) created a five-member Public Company Accounting Oversight Board (PCAOB); the next section of this paper will include information about the new board.

CHAPTER FOUR

NEW LAWS AND REGULATIONS AFFECTING THE ACCOUNTING PROFESSION

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. The Act, which applies in general to publicly-held companies and their audit firms, dramatically affects the accounting profession and impacts not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly-traded company.

The Sarbanes-Oxley Act of 2002 is a major reform package mandating the most far-reaching changes Congress has imposed on the business world since FDR's New Deal (Miller & Pashkoff, 2002). It seeks to prevent future scandals and restore investor confidence by, among other things, creating a public-company-accounting-oversight board, revising auditor independence rules, revising corporate governance standards, and significantly increasing the criminal penalties for violations of securities laws.

The Public-Company-Accounting-Oversight Board

Accounting firms that audit public companies must register with the Board (registered firm). The new board's operations are subject to direct and substantial SEC oversight. The board will issue standards or adopt standards set by other groups or organizations to be used by audit firms as guidelines in auditing public companies. These standards include: auditing and related attestation, quality control, ethics, independence, and "other standards necessary to protect the public interest." The Board has the authority to set and enforce audit and quality control standards for public company audits (AICPA, 2002f).

The board will have the authority to regularly inspect registered accounting firms' operations and will investigate potential violations of securities laws, standards, competency, and conduct. Sanctions may be imposed for non-cooperation, violations, or failure to supervise a partner or employee in a registered accounting firm. These include revocation or suspension of an accounting firm's registration, prohibition from auditing public companies, and imposition of civil penalties. During investigations, the Board can require testimony or document production from the registered accounting firm, or request information from relevant persons outside the firm. Investigations can be referred to the SEC, or with the SEC's approval, to the Department of Justice, state attorneys general or state boards of accountancy under certain circumstances (AICPA, 2002f).

The board will also have an international authority. Foreign accounting firms that "prepare or furnish" audits report involving U.S. registrants will be subject to the authority of the Board. Additionally, if a registered U.S. accounting firm relies on the opinion of a foreign accounting firm, the foreign firm's audit work papers must be supplied upon request to the Board or the Commission.

Comments on the Effectiveness of the Board

The creation of the board and making all its operations subject to direct and substantial SEC oversight represents a change in the self-regulatory accounting profession, a change from public oversight to public participation. It changes the way the accounting profession has been regulated, shifting it from a system of self-regulation and peer-review to one of independent review by a body with investigative and disciplinary powers.

The author believes that the creation of this board is an important step forward to restructure the accounting profession and resolve its vulnerabilities and weaknesses. However, the board needs to be independent, yet, knowledgeable enough to have the desired impact. The board should have the right combination of backgrounds, ranging from individuals knowledgeable in the areas of law to those in accounting to those experts in the industry.

The author also believes that one of the most important functions of the board is to make sure that the audit committee has real independence and not influenced by management. In fact, in the Sarbanes-Oxley Act, Congress requires that auditors be hired and supervised by company audit committee, not by management (Miller & Pashkoff, 2002). Roderick M. Hills, a former SEC chairman, highlighted the importance of an independent audit committee alleging that in many companies, audit committees are still too influenced by management when they make such decisions (Reddy, 2003).

New Rules for Auditor Independence and Corporate Governance

The Sarbanes-Oxley Act changed the relationship between accounting firms and their publicly-held audit clients. Under the new law, auditors will report to and be overseen by a company's audit committee, not management. Audit committees must preapprove all services (i.e., both audit and non-audit services not specifically prohibited) provided by its auditor. An auditor must report new Information to the audit Committee. This information includes: critical accounting policies and practices to be used, alternative treatments of financial information within GAAP that have been discussed with management, accounting disagreements between the auditor and management, and other relevant communications between the auditor and management (AICPA, 2002f).

The Act statutorily prohibits auditors from offering certain non-audit services to audit clients. These services include: bookkeeping, information systems 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 by rule to be impermissible. Other non-audit services not banned are allowed if preapproved by the audit committee.

The Act requires that the lead audit partner and audit review partner must be rotated every five years on public company engagements. Also under the Act, an accounting firm will not be able to provide audit services to a public company if one of that company's top officials (i.e. CEO, Controller, CFO, Chief Accounting Officer, etc.) was employed by the firm and worked on the company's audit during the previous year (AICPA, 2002f).

Comments on the Effectiveness of the New Rules for Auditor Independence and Corporate Governance

The Sarbanes-Oxley Act prohibits all registered public accounting firms from providing audit clients, contemporaneously with the audit, certain nonaudit services including internal audit outsourcing, and expert services. The author believes that these scope-of-services restrictions go way beyond existing SEC independence regulations and they should help improve auditor independence. In addition, all other services including tax services are permissible only if preapproved by the audit committee, and in order to hold the audit committee accountable for all these approvals, the law requires that such approvals must be disclosed in the company's periodic reports to the SEC.

The new law did improve the auditor independence by restricting auditors from offering certain non-audit services to audit clients and thus ending a major conflict of interest problem when a public accounting firm offers internal audit, external audit, and consulting services to the same client. The law also established new rules for rotation of auditors and thereby removed the risk of over-familiarity with the client, and new rules related to employment of auditors by the audit client requiring mandatory cooling-off period of one year before an auditor can take a position at the audit client, improving another area of impaired independence (Securities and Exchange Commission, 2003).

The Act also provides for significant corporate governance reforms regarding audit committees and their relationship to the auditor, making the audit committee responsible for the appointment, compensation and oversight of the company's auditor (Miller & Pashkoff, 2002).

The author believes that this will fundamentally change the auditor/client relationship. Further, the auditor reports directly to the audit committee, not to management, and that should reinforce the position that the auditor's duties are to the shareholders, rather than management.

Increasing the Criminal Penalties for Violations of Securities Laws

The new law creates tough penalties for those who destroy records, commit securities fraud, and fail to report fraud. It is now a felony with penalties of up to ten years to willfully fail to maintain "all audit or review workpapers" for at least five years (AICPA, 2002f). The SEC will establish a rule covering the retention of audit records and the Board of Accountancy in each state will issue standards that compel auditors to keep other documentation for seven years.

Under the new law, it is a felony with penalties of up to 20 years to destroy documents in a federal or bankruptcy investigation, criminal penalties for securities fraud have been increased to 25 years, and the statute of limitations for the discovery of fraud is extended to two years from the date of discovery and five years from the time the fraud was committed (AICPA, 2002f). It was previously one year from discovery and three years from the time the fraud was committed.

Other provisions protect corporate whistleblowers, ban personal loans to executives, and prohibit insider trading during blackout periods (AICPA, 2002f). This provision will protect employees from becoming victims of management. For example in the case of Enron, the company encouraged employees to invest in the company's stock and matched their 401(K) contributions with company stock, but the company imposed a blackout period and froze the plan in late October 2001, barring employee sales before the stock's final plunge. During that blackout period, many executives were able to sell substantial amount of their holdings of the company's stock (O'Harrow, 2002).

Comment on the Effectiveness of the New Rules Increasing the Criminal Penalties for Violations of Securities Laws

The Act creates a number of new crimes, including a new federal offense called "securities fraud." This makes it a crime to knowingly "defraud any person in connection with any security" of a public company or to obtain money or property "in connection with any purchase or sale of any security" of a public company "by means of false or fraudulent pretenses, presentations, or promises" (Softrax Corporation, e-mail, February 20, 2003).

Although the new securities fraud crime is similar in a number of respects with previous laws on securities fraud, it is both broader and the prison term is much longer. It carries a maximum of 25 years rather than five or ten. The maximum limits on prison terms and fines for individuals and companies (fines only) have been sharply increased. Other new crimes cover attempts to commit fraud, destruction of documents/tampering with evidence in anticipation of a governmental investigation, false certification of quarterly/annual reports and retaliation against whistle-blower (Softrax Corporation, e-mail, February 20, 2003).

The author believes that by substantially increasing existing criminal penalties and creating new criminal penalties for violation of the securities laws and misconduct relating to fraudulent representations in the marketplace, the Act is actually sending a strong message to CEOs, CFOs, and other individuals responsible for the company's financial information to think twice before certifying the company's financial statements, issuing a disclosure or making any presentation, and making sure they are communicating accurate information or they will face serious consequences.

The increased criminal penalties should help and support the new rules relating to corporate governance by holding top management and the board of directors responsible for their acts. The Act also defines new crimes, with heavier penalties for destruction of documents and tampering with evidence, which came as a response to the destruction of documents committed by Arthur Andersen in anticipation of a governmental investigation related to the collapse of Enron.

Survey about the Sarbanes-Oxley Act

Appendix A of this paper includes a survey about the Sarbanes-Oxley Act. The survey consists of ten questions covering the Act and its impact on the accounting profession. The survey was sent to ten CPAs practicing in public accounting, or in the industry, with only four responses received. While these responses are very limited, in the author's opinion, they represent only a small sub-sample of issues related to the Sarbanes-Oxley Act. To illustrate, one issue concerns section 408 of the Act, which requires the SEC to conduct "regular and systematic" reviews of every public company at least once every three years. Therefore, the requirements are not realistic for one good reason. The SEC does not, and probably will never, have the adequate staff and financial means to do so because there are currently about 9,000 listed companies, and a large number of them are multi-nationals with very complex structures and financial transactions. Another issue involving the Act's effectiveness is dealing with the inherited problems of the corporate governance. The author learned that there is a need for improvements to the Act in order for it to be more beneficial. For instance, there should be rules requiring public companies to disclose any change in auditors. The author believes that new laws are needed to prevent public companies from dismissing the auditing firm and bringing in a new one simply because they do not like the auditors position on a certain matter. Anytime a company wants to change auditors they should disclose to the public the reasons for the change. Without this, we will continue to see various cases of audit firms giving into client requests in order to keep a profitable client.

A similar survey was done using a much larger sample. That survey was conducted by Robert Half Management Resources, the world's premier provider of senior-level accounting and finance professionals and covered the same subject, but focused more on new corporate governance standards mandated by the Act. The survey included responses from 1,400 chief financial officers (CFOs) from a stratified random sample of U.S. private companies with more than 20 employees. Fifty-eight percent of CFOs said they are implementing new practices in response to these regulations. The steps that they reported taking include changing their firms' accounting procedures as well as enhancing their organizations' internal audit function. CFOs were asked, "In light of new corporate governance standards, what steps has your company taken or plan to take to ensure greater control of the accounting processes?" Among the 58 percent who cited a specific action, their responses were:

- Review or change current accounting procedures 44%
- Create or expand internal audit function 36%
- Hire an independent firm for consulting work 23%
- Restructure executive compensation plans 8%
- Some other steps 2%.

Although the Sarbanes-Oxley Act is directed toward public companies, privately-held and non-profit organizations are also scrutinizing financial processes in the wake of various corporate scandals. The author believes that all companies, publicly-traded, privately-held, or non-profit, should have a system of internal checks and balance that integrates core business functions within a strong corporate governance framework. In particular, publicly-traded companies should have a fully resourced, independent internal audit function that is professionally staffed. The author also recommends the adoption of a uniform set of corporate governance principles for publicly-held companies, and encourages a mandate for public disclosure related to compliance with these principles.

CHAPTER FIVE

CONCLUSIONS

What was the most significant event to affect the profession in the past fifty years? It was the disclosure of Enron's massive manipulation of its financial reporting and the fall of one of the nation's most prominent and respected CPA firm, Arthur Andersen. The impact was felt at the highest levels of government as legislators engaged in a large number of debates and accusations. Lawmakers investigated not only disclosure practices at Enron, but for all public companies, concerning SPEs, related party transactions and use of "market-to-market" accounting.

Unquestionably, the Enron implosion has wreaked more havoc on the accounting profession than any other case in U.S. history. Critics in the media, Congress, and elsewhere called into question, not only the adequacy of U.S. disclosure practices, but also the integrity of the independent audit process. As a result, President George W. Bush signed the Sarbanes-Oxley Act into law in July 2002. The Act, which applies in general to publicly-held companies and their audit firms, dramatically affects the entire accounting profession.

To Recap all Previous Sections

What Went Wrong

For executives of Enron and for Arthur and Andersen, part of the problem was simple greed or ignorance. Part of the problem was the pressure of a market in which the difference of a penny or two in earnings per share could lead to the difference of a billion or two in market capitalization. Part of the problem was a failure of some auditors to step up to their own responsibility, and part of it is the financial reporting model itself: the proper treatment of many issues is not clear, such as off-balance sheet activity. Financial statements are not written in plain English and disclosure is periodic. Clearly, part of the problem was some inherited weaknesses in disciplinary and monitoring processes for the profession, and part of it is the threat of auditor dependency on fees from major clients.

The Impact

Beside its dramatic impact on the accounting profession, the collapse of Enron also had major impact on the company's employees, banks, investors, politicians, and of course on Arthur and Andersen. Thousands of Enron employees, many with similar skills, were left unemployed. Thousands of employees and retirees have lost almost all the value in their retirement accounts invested in the company's stock.

One of Enron's biggest lenders, J.P. Morgan Chase, announced losses of $456 million as of January 2002 related to Enron's demise. Citigroup recorded $228 million as of January 2002 in Enron-related losses (O'Harrow, 2002). But bank and regulators said the overall impact would be minimal because no one bank is over invested in Enron.

Enron's stock lost nearly all its value, dropping from almost $34 a share on October 16, 2001 to 26 cents a share on November 30, 2001. Billions of dollars in stock value were erased. The stock was delisted from the New York Stock Exchange on January 15, 2002. Several prominent politicians from both parties returned Enron contribution money to the company or contributed it to charity. Others have been asked about their relationships with Enron. Arthur Andersen was found guilty and was convicted in June 2002 on obstructing justice for destroying Enron-related documents. As a result, Andersen was no longer able to perform any audit work and in August 2002 was forced to close down its operations in the U.S. (Goff, 2002).

What more Should be done to Restore Public Confidence in the Capital Market and in the Accounting Profession?

The AICAP is leading an effort to reduce the incidence of financial fraud, which requires a team effort among auditors, corporate management, and financial professionals. The AICPA is working with corporate America in designing antifraud programs and controls to be implemented by corporations and that CPAs can test and report on. The AICPA sponsored a new antifraud summit for financial market executives and for corporate America; the summit identified new antifraud initiatives and ways to collaborate on implementing them.

The AICPA is establishing an Institute for Fraud Studies in collaboration with the University of Texas at Austin and Association of Certified Fraud Examiners. This new organization will sponsor or conduct research in the areas of fraud prevention and detection. The goal is to deliver vital information to business and government on how to reduce the adverse impact of fraud and to help investors protect themselves.

To further establish a culture of ethical behaviors, the AICPA is asking all its members to commit more time to fraud detection in their continuing education. The institute is also working with academic institutions, university accounting programs and college textbook publishes to incorporate information about fraud prevention and detection in the appropriate education materials (Castellano, 2002). Additionally, the AICPA is urging the stock exchange to mandate antifraud training for all members of management, boards of directors and audit committees (Castellano, 2002).There is a need for an improved reporting model that provide investors with timely disclosure of better quality information such as off-balance-sheet activity, liquidity, non-financial performance indicators and unreported intangibles. Currently the AICPA is working with the Financial Accounting Standards Board (FASB) to move toward this kind of financial reporting model (Castellano, 2002).

In an effort to promote strong corporate governance, the AICPA is working with the Auditing Standards Board (ASB) to revise existing internal control and reporting standards, one of the goals for the new standards is to inform the public when the auditor communicates internal control weaknesses to the audit committee of a public company.

The Sarbanes-Oxley Act of 2002 is certainly part of the solution. It ushers in a new era of corporate accountability and public participation in certain areas of the accounting profession, but it will take more than legislation to increase investor confidence in the capital markets and in the audit function.

In summary, the author believes that the value of this project is that it offers an in-depth study and analysis of the problems that led to the collapse of Enron. This paper is unique and different from any other literature the author read.

The other papers covered only one angle of the problem with Enron or with the accounting profession, but this paper did an integration of all angles covering all issues whether it is related to accounting, auditing, ethics or corporate governance. Then this project provided analysis and evaluation of all problems with pros and cons for each proposed solution. The paper also covered the Sarbanes-Oxley Act, and how this Act attempts to tackle those problems. In this matter, the paper is the most conclusive report the author has seen covering the fall of Enron and the implications of that collapse on the accounting profession.

This project could be very valuable to college students who major in accounting or finance. It could be taught in some accounting classes. It could be also read by accounting and audit professionals, especially those practicing in public accounting or working for publicly traded companies, and finally the report can be useful to other people who are interested to know what happened in the Enron case, such as investors, Enron's employees, financial advisors, and the interested public in general.

APPENDIX A

SURVEY ABOUT THE

SARBANES-OXLEY ACT

SURVEY ABOUT THE SARBANES-OXLEY ACT

This survey consists of 10 questions about the Sarbanes-Oxley and its impact on the accounting profession. The survey was sent to 10 CPAs practicing in public accounting or in the industry; unfortunately only 4 responses were received. However, Robert Half Management Resources, the world's premier provider of senior-level accounting and finance professionals conducted also a survey covering the same subject, but focusing more on new corporate governance standards mandated by the Act, the survey included response from 1,400 chief financial officers (CFOs) from a stratified random sample of U.S. private companies with more than 20 employees. 58 percent of CFOs said they are implementing new practices in response to these regulations. Steps they reported taking include changing their firms' accounting procedures and enhancing their organizations' internal audit function. CFOs were asked, "In light of new corporate governance standards, what steps has your company taken or does it plan to take to ensure greater control of accounting processes?" Among the 58 percent who cited a specific action, their responses* were:

Review or change current accounting procedures 44%

Create or expand internal audit function 36%

Hire an independent firm for consulting work 23%

Restructure executive compensation plans 8%

Some other steps 2%.

The following three pages will include the 10 questions survey developed by the author and sent to 10 CPAs followed by the four response received.

A survey about the Sarbanes-Oxley Act

1. Does the accounting profession participate enough in the process of current accounting reform?
   ☐ Yes ☐ No

2. In my opinion, the Sarbanes-Oxley Act......
   ☐ Does not go far enough ☐ Is fine
   ☐ Goes too far

   If your answer is "does not go far enough" or "goes too far", please explain why?

3. Do you think the current accounting standards need improvement?
   ☐ Yes ☐ No

   If yes, in what directions?

4. How do you evaluate the new and increased penalties imposed by the Sarbanes-Oxley Act?
   ☐ Good enough ☐ Too harsh
   ☐ Not tough enough

   If your answer is "too harsh" or "not tough enough", please explain why.

5. Do you think the auditor independence rules introduced by the Act are sufficient to resolve current problems related to impaired independence?
   ☐ They are sufficient ☐ Not sufficient
   ☐ There is a need for new rules

   If your answer is "not sufficient" or "need new rules", please explain why.

6. Section 408 of the Sarbanes-Oxley Act requires the SEC to conduct "regular and systematic" reviews of every public company at least once every three years.
   ☐ The requirements are realistic
   ☐ The requirements are not realistic

   If your answer is "nor realistic", please explain why.

7. The Act requires that CEOs and CFOs must certify that the internal control system they have established provides them with all material information they need on a timely basis.

- ☐ The requirements are appropriate
- ☐ The requirements are not appropriate

If your answer is "not appropriate", explain why.

8. Before the passing of the Sarbanes-Oxley Act the self-regulated accounting profession was lacking discipline and quality control, in your judgment, did the Act provided the solution to correct these weaknesses?

☐ Yes ☐ No

If your answer is "no", please explain why.

9. Do you think the Sarbanes-Oxley Act will have any significant impact on nonprofit organization?

☐ Yes ☐ No

If your answer is "yes", please explain in what way.

10. Evaluate whether the Sarbanes-Oxley Act was effective in dealing with the inherited problems of the corporate governance.

- ☐ The Act is very effective
- ☐ The Act is somewhat effective
- ☐ The Act is not effective at all

If your answer is "not effective", please explain what is needed to be done.

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