Recap of ENRON and SOX

Enron was founded in 1985, and at its peak in 2000, it was one of America’s largest energy companies. By 2001 Enron was taking on massive liabilities and incurring massive losses. To keep its stock price up and hide the losses form the public, it used highly questionable offshore transactions and creative bookkeeping methods.

Arthur Andersen was one of the five largest accounting firms in the United States at the time. It had a reputation for high standards and quality. Arthur Andersen oversaw, audited, and signed off on Enron’s financials and accounts.

By December 2001, Enron declared bankruptcy.

By August 2002, Arthur Andersen (Enron’s Auditor) had closed its doors.

# Sarbanes-Oxley (SOX) Act of 2002

## **What Is the Sarbanes-Oxley (SOX) Act of 2002?**

The Sarbanes-Oxley Act of 2002 is a law the U.S. Congress passed on July 30 of that year to help protect investors from fraudulent financial reporting by corporations. Also known as the SOX Act of 2002 and the Corporate Responsibility Act of 2002, it mandated strict reforms to existing securities regulations and imposed tough new penalties on lawbreakers.

The Sarbanes-Oxley Act of 2002 came in response to financial scandals in the early 2000s involving publicly traded companies such as Enron Corporation, Tyco International plc, and WorldCom. The high-profile frauds shook investor confidence in the trustworthiness of corporate financial statements and led many to demand an overhaul of decades-old regulatory standards.

#### Sarbanes-Oxley Act Of 2002 – SOX

## **Understanding the Sarbanes-Oxley (SOX) Act**

The rules and enforcement policies outlined in the Sarbanes-Oxley Act of 2002 amended or supplemented existing laws dealing with security regulation. The new law set out reforms and additions in four principal areas:

1. Corporate responsibility
2. Increased criminal punishment
3. Accounting regulation
4. New protections

## **Major Provisions of the Sarbanes-Oxley (SOX) Act of 2002**

The Sarbanes-Oxley Act of 2002 is a complex and lengthy piece of legislation. Three of its key provisions are commonly referred to by their section numbers: Section 302, Section 404, and Section 802.

 Because of the Sarbanes-Oxley Act of 2002, corporate officers who knowingly certify false financial statements can go to prison.

**Section 302 of the SOX Act of 2002**mandates that senior corporate officers personally certify in writing that the company's [financial statements](https://www.investopedia.com/terms/f/financial-statements.asp) "comply with SEC disclosure requirements and fairly present in all material aspects the operations and financial condition of the issuer." Officers who sign off on financial statements that they know to be inaccurate are subject to criminal penalties, including prison terms.

**Section 404 of the SOX Act of 2002** requires that management and auditors establish [internal controls](https://www.investopedia.com/terms/i/internalcontrols.asp) and reporting methods to ensure the adequacy of those controls. Some critics of the law have complained that the requirements in Section 404 can have a negative impact on publicly traded companies because it's often expensive to establish and maintain the necessary internal controls.

**INFO 6008 Summer 2023 Assignment 1 due SUNDAY May 21, 2023:**

Please read the following three articles (all are from “The Economist”).

For purposes of this assignment – you will use your understanding of Lecture 1 (recording and slides) as well as the three articles below.

**The question you need to answer is:**

**Do you think SOX actually works in today’s world?**

**You CAN ONLY cite from these three articles for your reasoning.** Take your time when you read these articles. Please note, there is no right or wrong answer – how you reason is how you will be marked.

I would like a title page with:

* your name
* course #
* Assignment #
* date

The assignment itself should not be more than 1 page (1.5 spaced – Font: Calibri). Marks will be deducted for poor grammar, sentence structure and spelling. This assignment is worth 5 marks.

**Article 1:**

Sarbanes-Oxley - Five years under the thumb

Corporate America is learning how to live with the tough regulations introduced after the collapse of Enron

[**Briefing**](https://www.economist.com/briefing/)[Jul 26th, 2007 edition](https://www.economist.com/printedition/2007-07-28)

Jul 26th, 2007

NEW YORK

FOR the leaders of corporate America, it has been five long years. The Sarbanes-Oxley Act, widely known as SOX, was signed into law on July 30th, 2002 by George Bush, who called its tough new rules the “most far-reaching reforms of American business practices since Franklin Roosevelt was president”. The hope was to restore public confidence in American business, which had been badly shaken by huge corporate scandals, such as those which led to the bankruptcies of Enron and WorldCom.

The act created a new regulator for the accounting industry: The Public Company Accounting Oversight Board. To address some obvious conflicts of interest, auditors were prohibited from doing a variety of non-audit work for clients. Firms had to establish independent audit committees, company loans to executives were banned, top executives had to certify accounts and whistleblowers were given more job protection if they reported any suspicions of fraud.

In the act's now notorious section 404, managers were made responsible for maintaining an “adequate internal-control structure and procedures for financial reporting”. Companies' auditors were required to “attest” to the bosses' assessment of these controls and disclose any “material weaknesses”. Failure to comply could result in tough new criminal penalties.

Controversial from the start, SOX came to be despised by many businessmen in America (and beyond, where it has touched big foreign firms). Even its authors have reservations, conceding that its hasty passage into law meant it was badly drafted in parts. “Frankly, I would have written it differently,” Michael Oxley, one of the former congressmen who drafted the act said in March. He added that the same was true of his co-author, Paul Sarbanes. “But it was not normal times.”

The charges levelled against SOX are numerous and serious. Top of the list is the price of compliance. It soon became clear that the costs of implementing SOX's provisions, particularly section 404, far exceeded the modest sums initially predicted. The act is now widely regarded as a licence for audit firms to print money—ironic in that it was these fee-driven firms that, arguably, encouraged the lax accounting that led to the legislation.

Beyond its immediate price-tag, SOX stands accused of undermining America's entrepreneurial spirit. Barely a year after it became law, William Donaldson, then chairman of the Securities Exchange Commission (SEC), wondered if by unleashing “batteries of lawyers across the country” the legislation would lead to a “loss of risk-taking zeal” due to a “huge preoccupation with the dangers and risks of making the slightest mistake”. Others argue that the act has backfired. Rather than restore confidence in public companies, they claim, it has weakened America's stock markets, by driving domestic firms into the arms of private-equity buyers and prompting foreign firms to list their shares elsewhere.

## Number crunching

How plausible are these accusations? An army of academics has weighed in on the great SOX debate. But their analyses are hindered by two difficulties. First, SOX was one of a number of post-Enron initiatives, ranging from tougher listing requirements for firms to longer jail sentences for errant executives. Untangling the effects of SOX from these other changes is hard. Nor is it easy to work out how investors and businessmen—who were trying to come to terms with the bursting of the late 1990s stock market bubble—might have reacted to the corporate scandals without SOX.

Some academics have concluded that the costs of SOX far outweigh the gains. A much-debated 2005 study by Ivy Zhang, then of the William E. Simon Graduate School of Business Administration, estimated that the law's costs exceeded any benefits by a mind-boggling $1.4 trillion. That controversial figure was derived from an econometric estimate of “the loss in total market value around the most significant legislative events”—in other words it assumes that, after taking account of other news, any drop in share prices as the new rules were enacted was thanks to SOX.

In a more recent study, Leonce Bargeron, Kenneth Lehn and Chad Zutter, of the University of Pittsburgh, argue that SOX has “had a chilling effect on risk-taking” by publicly traded American companies. Using a sample of British companies as a benchmark, the study found that American firms have significantly reduced their investment in R&D and overall capital spending, while increasing their holdings of cash. Collectively, they concluded, this reveals a “statistically significant reduction in risk-taking after the adoption of SOX”.

The academics found a second measure to support their conclusions. The standard deviation of share returns—a measure of risk—also fell for the American firms relative to their British counterparts. On the other hand, the study also reported that the riskiness of American companies post-SOX was higher than in the mid-1990s before the stock market bubble got really out of hand. And the ratio of R&D and total capital spending to assets—and thus, presumably, the appetite for risk—was considerably higher in America than in Britain before and after SOX.

Messrs. Bargeron, Lehn and Zutter also looked at 9,258 initial public offerings in America and Britain between 1990 and 2006. They found that post-SOX, the probability of listing shares in Britain rose sharply. This seems to support the view that SOX has weakened America's stock markets, by driving domestic firms into the arms of private-equity buyers and causing foreign firms to list elsewhere. Others, however, dispute that claim. The past year has seen several official inquiries into the competitiveness of American financial markets, supported by the treasury secretary and the mayor of New York, among others. None pinned much blame on SOX, pointing instead to a range of problems including America's addiction to litigation.

Kate Litvak, of Texas Law School, used a different technique to gauge SOX's effect on America's capital markets. In a recent paper she examined its impact on the shares of firms listed both in America and abroad. Shares of cross-listed firms tend to trade at a premium to shares of similar firms that are not. Cross-listed firms seem to gain extra credibility by subjecting themselves to tough foreign corporate-governance requirements, as in America. Ms. Litvak found that the cross-listing premium declined after SOX, suggesting that investors believed that the costs of the legislation would, on average, exceed the benefits for cross-listed firms.

In a study published last year by the University of Southern California, Ehud Kamar, Pinar Karaca-Mandic and Eric Talley investigated whether SOX had driven firms out of the public markets. Using a sample of 8,266 acquisitions by private-equity firms in 76 countries between 2000 and 2004, they found that after SOX was passed, it became relatively more likely for small public firms in America to be sold to private-equity buyers than similar small firms elsewhere. But there was no change in the relative likelihood of larger American-listed firms going private. This seems to support the view that SOX is particularly burdensome for smaller companies.

Not all academics are anti-SOX. Luigi Zingales, of the University of Chicago, argues that it was a public-relations triumph, quickly restoring confidence. “The fact it was there, it was strong, it was done quickly, was very important,” he says. This, he notes, was in contrast with his native Italy, which took “two years and lots of bickering” to get a new law after an Enronesque scandal at Parmalat.

Making the audit committee independent and giving it, not the boss, the responsibility for hiring the auditor, was also a big step forward, says Mr. Zingales. It may have contributed to the improved performance of auditors which Mr. Zingales, Alexander Dyck and Adair Morse report in their paper “Who Blows the Whistle on Corporate Fraud?”. The three economists examined 230 alleged corporate frauds in America during 1996-2004. They found that, pre-SOX, only one-third of big corporate frauds were uncovered by those with a responsibility to find them, such as auditors, industry regulators or the SEC. Employees were more likely than anyone to report corporate wrongdoing. After SOX, however, the proportion of serious frauds discovered by those professionally responsible for doing so rose to 50%. In particular, there was a “stunning increase in the role of auditors (a four-fold increase in the relative frequency of detections) and of the SEC (a doubling of their importance, albeit from a very low level)”.

## Sharpening up

Alas, the economists admit they “cannot determine” what part of the post-Enron reforms has led auditors to sharpen their scrutiny of companies. Could it have been the severing of their consulting businesses from their auditing clients? Or was it the salutary effect of the demise of Arthur Andersen, or the required increase in professional scepticism now demanded from section 404? In other words, they do not know whether this is “a permanent change or a temporary reaction to an event that made the risk of bad auditing salient”.

The professionals may have a sharper eye, but successful whistleblowing by employees fell after SOX, from 20.7% to 15.6% of cases. This, argue the three economists, “suggests SOX's modest incentives are not very effective”. They seem to have brought a surge in frivolous accusations by disgruntled and fired employees rather than tips about serious fraud. Far better, say the three economists, to replicate the financial incentives for whistleblowing used in America's health-care system, which have led to a higher rate of fraud detection but scant increase in frivolous accusations.

Another good sign is that the costs of complying with SOX are coming down. According to the latest annual study of compliance by Financial Executives International, a club for chief financial officers, even the hated section 404 is costing less. The group's poll of 200 companies with average revenues of $6.8 billion found that the typical cost of section 404 compliance was $2.9m in 2006, 23% lower than in 2005. Internal staff time also fell, by 10%. Adapting to section 404 involved high start-up costs, but now “efficiency gains are being realised”, says Michael Cangemi, the group's chief executive.

Better still, under pressure from the SEC, the Public Company Accounting Oversight Board has changed its guidance on how to implement section 404. Until now, auditors have been encouraged to be zealous with internal controls, replicating much or all of the work of a firm's internal auditors, and testing the robustness of internal controls against every imaginable risk. The new audit standard, which was approved by the SEC this week, allows a more pragmatic, common-sense approach. Some estimates suggest that compliance fees could fall by as much as half.

Yet, as seems to be the way with SOX, not everyone welcomes this reform. Stephen Bainbridge, the author of “The Complete Guide to Sarbanes-Oxley”, argues that “nothing the SEC has done or plans to do will change the existing incentive-structure for officers and directors. The firm's top management will still have plenty of incentives to spend shareholder money on protecting themselves from SOX liability.”

Others are more sanguine and see SOX as part of the inevitable swings in America's regulation of business. In a study, Mark Roe of Harvard Law School argues that scandals such as the fall of Enron are the result of two “core instabilities” in America's system of corporate governance: the separation of the ownership and control of big firms, and weaknesses arising from America's decentralised system of regulation. These two instabilities have combined to create some sort of “fundamental large-firm problem” in each decade since the second world war.

If history is any guide to the outcome of reforms such as SOX, America will “solve the current issues—or more plausibly, reduce them to manageable proportions—but then sometime later, somewhere else, another piece of the corporate apparatus will fail,” argues Mr. Roe. “We'll patch it up, we'll move on, we'll muddle through. That's what will happen this time, and that's what will happen next time.”

**Article 2 a and b:**

# Bloodbath The reckoning at Theranos (a)

A Silicon Valley darling is accused of misleading investors.

A picture containing text, person, outdoor, male

Description automatically generated

[**Business**](https://www.economist.com/business/)[Mar 17th 2018 edition](https://www.economist.com/printedition/2018-03-17)

“THE Next Steve Jobs” is how Inc., an American business magazine, described Elizabeth Holmes when her photograph appeared on its cover in 2015. They may share an affinity for black turtlenecks but the reputations of Ms Holmes and Apple’s celebrated late boss could not be more different. On March 14th Ms Holmes was accused of fraud by America’s Securities and Exchange Commission (SEC). She has agreed to pay a $500,000 fine, not serve as an officer of a public company for ten years and turn over much of her stake in Theranos, the startup she founded (she has neither admitted nor denied wrongdoing).

Only a few years ago Ms Holmes, who is 34 years old, was touted as the world’s youngest self-made female billionaire, a shatterer of Silicon Valley’s reinforced-glass ceiling. She graced magazine covers and speechified about Theranos, which was trying to upend diagnostic testing by using pinprick amounts of blood rather than vials. At its height Theranos claimed a private-market valuation of around $9bn and raised more than $700m from investors—until a critical article by the Wall Street Journal in 2015 prompted media and regulatory scrutiny.

It now turns out that Ms Holmes’s claims were deceptive, according to the SEC. She allegedly exaggerated her startup’s capabilities. Theranos only reliably performed a dozen of the 200 tests it offered with its own technology. It also lied about its portfolio of clients. For example, investors were told that its technology had been used by the American military on the battlefield, when it had only been used in studies; and that it was poised to be rolled out by a grocery chain even when the deal had collapsed. The financial figures were apparently concocted, too. Ms Holmes told one investor that Theranos had $108m in revenue in 2014; the real figure was $100,000.

The Theranos saga is not over. Ms Holmes’s business partner, Ramesh “Sunny” Balwani, whom the SEC has also charged with fraud, is contesting the charges. A criminal investigation into Theranos is believed to be ongoing.

Ms Holmes wooed investors while sharing few details about how exactly her technology worked. Today they are being more inquisitive and cautious, especially in health care. The SEC is eyeing Silicon Valley’s firms more closely for foul play, too, for example by asking to see how venture-capital firms mark their investments and how startups value their private shares. The time when plucky wannabe tech titans could do no wrong is gone. Ms Holmes has certainly left a mark on Silicon Valley—and not a mere pinprick.

# Blood will have blood A jury finds Elizabeth Holmes guilty of fraud

# Theranos’s founder captured the imagination of investors, political bigwigs and Hollywood alike

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Jan 8th 2022

NEW YORK

ON JANUARY 3RD, after seven days of deliberation, a 12-member jury in Silicon Valley found Elizabeth Holmes, the entrepreneur behind a blood-testing startup, guilty of four counts of fraudulently deceiving investors. Each count carries a prison term of up to 20 years; no date has been set for her sentencing. She was acquitted of four charges of deceiving patients and doctors; on three others the jury were deadlocked. The verdict, against which Ms Holmes’s lawyers are expected to appeal, marks the collapse of a career that beguiled the media, politicians and investors.

After dropping out of Stanford University in 2003 at the age of 19, Ms Holmes founded Theranos to develop a radical advance in blood-testing technology that she hoped would allow hundreds of tests to be performed using a single tiny drop of blood rather than a full vial. The tantalising vision promised to make health care more effective and efficient.

Unfortunately, Ms Holmes could not bring it to fruition. In voting to convict on four counts, the jury concluded that, aware of her company’s failures, Ms Holmes intentionally lied about its prospects and capabilities, and so crossed the fine line from promotion to deliberate fraud—a step she explicitly denied in her own testimony.

In many ways Theranos differed little from many hot startups. It raised more than $1bn, reached an extravagant theoretical valuation (in its case $9bn) [before crashing without ever going public](https://www.economist.com/business/2016/07/16/red-alert) and disintegrating into a vast graveyard of unfeasible ideas. Typically, executives behind such ventures are quickly forgotten. But Ms Holmes’s path differed at least in part because even though her company’s products failed, her presence and broader story proved unusually compelling.

In building Theranos, Ms Holmes assembled a remarkable collection of acolytes. Her board was filled with several former secretaries of state and defence. Joe Biden, while vice-president, called Theranos “the laboratory of the future” and Ms Holmes “an inspiration”. The company’s [shocking failure](https://www.economist.com/books-and-arts/2018/06/02/the-rise-and-fall-of-elizabeth-holmes-silicon-valleys-startup-queen) suggested her famous followers had fed merely on hype. The fashion press was besotted by Ms Holmes’s [ability to present herself](https://www.economist.com/business/2021/12/11/the-shortcuts-to-theranos). The Steve Jobs-inspired black turtlenecks she wore at work were seen as reflecting authority. The open-necked shirts and blouses she donned during the trial were a sign of appealing vulnerability, augmented by the nappy bag she carried to court, which signalled to the jury the costs of a potential prison term to a young mother and her infant child (who was born in July). Reporters and other onlookers waited for hours to nab a seat in the packed courtroom.

Ms Holmes’s defence followed two distinct lines. The most obvious hinged on naivety. She may have been wrong about Theranos’s prospects, the argument went, but that is not a crime. Startup investors are supposed to be a sophisticated lot, willing to wager based on deep insights in the hope of a big return, while understanding that long shots can fail. The prosecutors’ counterargument rested primarily on the presentations which Ms Holmes made to investors. These appeared to exaggerate potential sales and trumpet non-existent endorsements from the armed forces and big pharmaceutical companies. The single substantive request made by the jurors during their deliberation was to rehear a presentation that had been recorded, suggesting they were parsing what precisely she had been telling her backers.

Ms Holmes’s second line of argument, the so-called Svengali defence, was particularly appealing to Hollywood, but its impact on the jury was unclear. She claimed at the trial to have been sexually and emotionally abused and manipulated by Ramesh “Sunny” Balwani, her ex-partner and Theranos’s former chief operating officer. As such, her lawyers posited, she could not be held responsible for her actions.

Mr Balwani has strongly denied all allegations. His own trial for fraud charges will begin next month, ensuring the Theranos saga will not end soon. And even after the last gavel is pounded, there will be more to come. In the lead-up to the verdict Hulu, a cable network, released photos from an upcoming mini-series on Ms Holmes’s story, starring Amanda Seyfried. Ms Holmes may end up going to prison, but she will not be going away. ■

**Article 3:**



Auditors aren’t so bad -Box ticked

The rich world is not suffering an outbreak of accounting fraud - [**Business**](https://www.economist.com/business/)[Sept 8th, 2016 edition](https://www.economist.com/printedition/2016-09-10) NEW YORK

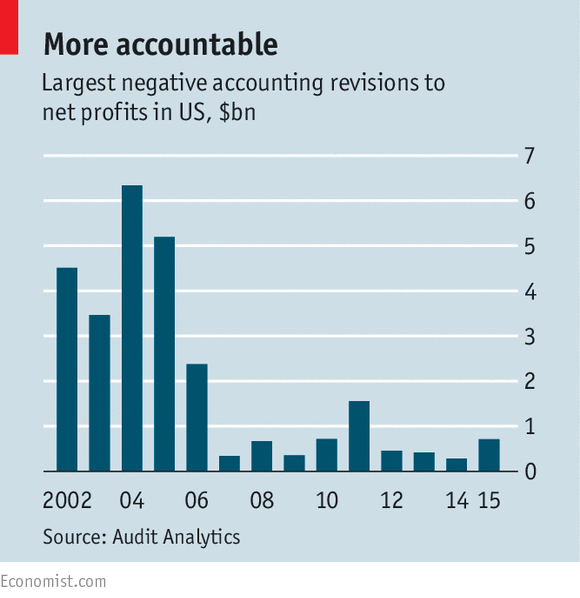
IF YOU peer into the world of accounting in any given month, it is easy to get the impression that an epidemic of skulduggery and incompetence has broken out. Consider the month of August. A whistleblower at Monsanto, an American seeds firm, received a reward from the Securities and Exchange Commission, after spotting that the firm was misreporting its earnings for Roundup, a weed killer. T. Rowe Price, an asset manager, launched a lawsuit against Valeant, a drugs firm which it accuses of fraud and misleading accounting.

The list goes on. PricewaterhouseCoopers, one of the Big Four accounting firms, settled a case involving Colonial BancGroup, a lender it audited which went bust after suffering fraud. The boss of Monte dei Paschi di Siena, an Italian bank, said that he was under investigation as part of a probe into false accounting. Shares in Orbital ATK, an American defence firm, tanked after it said it had made accounting mistakes, and an internet firm called ComScore replaced its top brass amid problems with its numbers.

The obvious conclusion is that the accounting industry has failed to clean itself up since 2001-03, when Enron and WorldCom, among others, blew up in spectacular style because of book-cooking. Those two American firms were worth a combined $250 billion at their peak, and their collapse also brought down their auditing firm, Arthur Andersen.

In fact, the opposite is true: accounting scandals have become less of a problem. With over 10,000 listed firms in Europe, America and Canada, bad apples are inevitable. But the impact of recent blow-ups has been far lighter than at the turn of the century. WorldCom overstated its profits by a colossal $7 billion. Enron puffed up its shareholders’ equity by $1 billion. Parmalat, an Italian food firm that folded in 2003, had a $15 billion hole in its accounts.

Today’s scandals are smaller. When companies admit to fraud or mistakes, their books are restated, making comparisons straightforward. Valeant’s restatement, announced in February, was a modest $58m, while Monsanto’s was $48m. Tesco, a British supermarket that confessed in 2014 to an accounting scandal, exaggerated its profits by about $350m. One important measure, which is the scale of the single largest restatement by an individual firm in America in any given year, has shown a marked decline in the size of the corrections, points out Don Whalen of Audit Analytics, a data provider and research firm (see chart).



In the dark days of 2000-01, investors worried that no firm in America could be entirely trusted. If you look at the sum of losses across the economy due to accounting fraud now, the number is low. The figure in 2015 was $2.7 billion, or 0.3% of total corporate profits, suggesting there is no systemic problem.

There are plausible reasons why auditing and book-keeping might have improved so much. Sarbanes-Oxley, a corporate-governance law passed in America in 2002, has bite: it requires chief executives and chief financial officers personally to certify accounts. The spread of a common international accounting rule book in Europe has raised standards. The grisly collapse of Arthur Andersen may have led the other big accounting firms to behave better. During the financial crisis, auditors, along with regulators, pushed big banks to write down the value of subprime securities to realistic prices, often to squeals of protest from bosses and politicians.

There is still no room for complacency. It is quite possible that huge undiscovered frauds are taking place. The incentive structure of the accounting industry remains suspect: accounting firms are paid fees to audit their customers, but they often earn more by selling various advisory services to them. The rise of opaque private markets for trading the shares of private firms—including Silicon Valley “unicorns”—seems ripe for fraud.

And in many big emerging economies, including China and India, the state of accounting rules and of the auditing business is still murky. In Japan, an accounting scandal at Toshiba, a conglomerate, which led to a restatement worth $1.9 billion last year, dented faith in accounting and in the local affiliate of EY, another Big Four audit firm. Yet to argue that there is a crisis in the quality of financial information that investors get about Western firms is to be guilty of a misleading overstatement.