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Table of Abbreviations

Ashmore Energy International Ltd	AEI
Bank of Credit and Commerce International	BCCI
Houston Natural Gas	HNG
New York Stock Exchange	NYSE
Northern Natural Gas	NHG
Public Company Accounting Oversight Board	PCAOB
Securities and Exchange Commission Decisions and Reports	SEC

CHAPTER ONE: INTRODUCTION

Overview of the Enron Scandal

One of the most shocking revelations of the early 21st century was at the end of 2001 and showed that the financial condition of one of the US's and the world's most stellar companies (in terms of performance) was actually being sustained by creatively planned, systemic and institutionalized accounting fraud.[1] This essentially meant that the near-perfect and near-ideal financial image that the corporation portrayed to investors and the rest of the world was actually not a true reflection of its true financial condition. Instead, the reported financial condition was based on fraudulent and falsified information and data. This creatively planned, systematic, and institutionalized accounting fraud has ever since come to be known globally as the Enron scandal and has over time become a popular and near-perfect example of willful corporate corruption and fraud. As a result of the Enron scandal, the accounting and general corporate governance activities of other US firms were brought into question and scrutiny by way of different investigations.[2]

The greater business world was affected by the Enron scandal in that it directly or indirectly contributed to the collapse or dissolution of other companies.[3] A notable example in this regard is the dissolution of Arthur Andersen, an accounting firm that had for many years been the main auditor of Enron. Few other corporate governance scandals in the 21st century have had far-reaching legal, legislative, and policy implications in the US) and the UK than the Enron scandal. In fact, with the notable exception of the corporate malpractices that triggered the global financial crisis of 2008,[4] the Enron scandal could be regarded in many aspects as the most notorious corporate governance scandal of modern times. This is because the scandal not only caused the collapse of one of the US's and the world's largest corporations but also caused an industry-wide panic across the world regarding corporate governance. Among other concerns, the scandal raised serious fundamental questions about corporate governance practices in the US

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[1] Yuhao Li, 'The case analysis of the scandal of Enron.' *International Journal of business and management* 5, no. 10 (2010): 37.
[2] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013).
[3] Jamel Azibi, Hubert Tondeur, and Mohamed Tahar Rajhi, 'Auditor choice and institutional investor characteristics after the Enron scandal in the French context' [2010] Crises et nouvelles problématiques de la Valeur 1.
[4] Jamel Azibi, Hubert Tondeur, and Mohamed Tahar Rajhi, 'Auditor choice and institutional investor characteristics after the Enron scandal in the French context' [2010] Crises et nouvelles problématiques de la Valeur 2.

and the UK and especially as it pertained to large corporations that had until then been considered to be too big to fail.[5]

Before examining the nature of the scandal and its implications for corporate governance law across the US and the UK, it is important to provide a brief historical background of Enron and its commercial activities. This background could prove useful in understanding the internal and external factors that may have contributed to one of the world's largest corporate governance scandals of all time. It could also help understand and justify the need for the legislative changes that came in the wake of the Enron scandal.

Historical Background of Enron

The Enron Corporation was an energy, commodities and services company that was established in Houston, Texas, in 1985 following the merging of two companies namely Houston Natural Gas and InterNorth. Before filing for bankruptcy, the corporation had an estimated 29,000 employees and was among the leading producers of and distributors of electricity and natural gas in the US and other parts of the world. It was also engaged in other businesses such as the manufacture and distribution of pulp and paper as well as communications. In 2000, the total claimed revenues of the corporation were close to $101 billion.[6] It is highly likely that these reported financial figures were not accurate. Still, the financial reports released by the company in the last few years prior to the discovery of the accounting fraud made the company one of the most attractive and good-performing in the US and across the world.[7] In fact, for six consecutive years from 1996 to 2001 (just before the unearthing of the accounting fraud), Enron was named by *Fortune* as America's most innovative company. During the year 2000, the corporation also made an appearance in *Fortune*'s list of "100 Best Companies to Work for in America."[8] Looking back at the accounting fraud, it is indeed true that the company was the most innovative except that the actual innovation was not the kind that *Fortune* usually looks out for. Instead,

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[5] Stephen J. Conroy and Tisha LN Emerson, 'Changing ethical attitudes: The case of the Enron and ImClone scandals' (2006) 87 Social Science Quarterly 397.
[6] Nancy Rapoport, Jeffrey D. Van Niel, and Bala G. Dharan, *Enron and other corporate fiascos: The corporate scandal reader* (Foundation Press, 2009) 3.
[7] Tobias Pavel and Mylene Encontro, 'The Enron scandal' [2012] Chalmers University of Technology Financial Risk 5.
[8] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, 'The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 279.

Enron's innovation was actually in terms of being able to meticulously, creatively, and systematically plan and execute some of the world's most far-reaching accounting fraud ever.

Partly as a result of the discovery of the accounting fraud and partly because of waning investor confidence, Enron was forced to file for bankruptcy on December 3. This was done in the Southern District of New York; and Weil, Gotshal & Manges became the corporation's bankruptcy counsel. The corporation's bankruptcy was to last until November 2004 after which its name was changed to Enron Creditors Recovery Corp.[9] This new cooperation's main priority was to reorganize and liquidate some of the assets and operations that Enron had prior to its filing for bankruptcy. The last of the remaining assets of Enron (namely sold Prisma Energy International Inc.) was sold on September 7, 2006, to AEI (which was known back then as Ashmore Energy International Ltd).[10]

At the time of its collapse, Enron's downfall was the biggest corporate bankruptcy in US history. The Enron scandal led to its shareholders losing 74 billion USD and its employees losing billions in pension benefits. Most importantly, the collapse had far-reaching impacts on corporate governance laws throughout the world and demanded immediate amendments in European and US corporate governance legislation in order to prevent more corporate frauds from taking place.[11]

Aim and Objectives

The aim of this thesis is to dig deeper into the Enron scandal with a view to discovering how it influenced – directly or otherwise – changes in corporate legislation in the US, UK, and EU in its aftermath and especially in the wake of the collapse of Enron. The objective of the thesis is to determine the potency and effectiveness of the laws enacted in response to the Enron scandal in terms of preventing similar scandals.

[9] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, 'The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 279.
[10] Stephen J. Conroy and Tisha LN Emerson, 'Changing ethical attitudes: The case of the Enron and ImClone scandals' (2006) 87 Social Science Quarterly 395.
[11] Nancy Rapoport, Jeffrey D. Van Niel, and Bala G. Dharan, *Enron and other corporate fiascos: The corporate scandal reader* (Foundation Press, 2009) 4.

Research Questions

To achieve the aforementioned objective, the thesis focuses on answering the following research questions:

Main Research Question

How did the Enron Scandal influence legislative changes to US, UK, and European Union (EU) corporate laws?

Supplementary Research Questions

1. What were the EU and US legislative responses to the Enron scandal?
2. How were the US, EU, and UK corporate laws amended to prevent scandals similar to the Enron scandal?
3. To what extent have the post-Enron corporate governance legislation changes managed to achieve their stated or intended purposes of preventing accounting fraud and overall corporate governance problems?

Overview of Methodology

This thesis relied on archival data collected from different sources. The data were collected using secondary (desk) research which entailed collecting data from existing documents. These documents were obtained by searching relevant online and offline databases for appropriate documents. The documents collected included periodicals, journal articles, books, legislation, legal commentaries, and legal reports. Therefore, both secondary and primary documents were used. Several other documents pertaining to the Enron scandal and the Sarbanes–Oxley Act were searched and synthesized to generate as much information on the subject matter as possible. Similar documents on the UK Corporate Governance Code were searched, obtained, and then synthesized. The documents were synthesized using thematic analysis where the relevant themes were identified and linked to the research questions.

Thesis Structure

Apart from this first chapter, the thesis is divided into four other chapters. The second chapter (Chapter Two) explores and discusses the Enron scandal and its legal implications. The third chapter (Chapter Three) discusses how the US Congress responded to the Enron scandal with the Sarbanes–Oxley Act and how this legislation has fared in terms of achieving the intended purpose. The fourth chapter discusses the process of reforming company law and securities regulation in the UK and the EU. In the fifth chapter, relevant conclusions are drawn.

CHAPTER TWO: THE ENRON SCANDAL

How the Enron Scandal Unfolded

From the outset, it is worth distinguishing between the Enron scandal and the bankruptcy of the Enron Corporation.[12] The two are distinct from each other with the Enron scandal having led to, among other effects, the bankruptcy of the Enron Corporation. The other notable effect of the Enron scandal – and one which subsequent legislative reforms sought to address – was the *de facto* dissolution one of the largest accountancy and audit partnerships across the world, Arthur Andersen. Although the Enron scandal may have been successfully concealed for a significant period of time prior, it was made public in October 2001 and involved the deliberate misreporting of financial information and other forms of accounting fraud designed to keep Enron's share price high. Specifically, the creatively planned accounting fraud saw the Enron's senior-level managers working in cahoots with other external and internal players use unethical practices to misrepresent earnings and manipulate the balance sheet to indicate favorable performance and boost the company's stock price.[13]

However, the discovery of the scandal and the negative media publication that followed pushed the company to file for bankruptcy under Chapter 11 of the US Bankruptcy Code. At the time, towards the end of 2001, Enron became not just the biggest audit failure but also – and more importantly so – the largest bankruptcy reorganization in the history of the US (in terms of asset base). However, Enron was to be overtaken in the latter aspect by WorldCom only a year later. The Enron scandal is believed to have had its roots in the management practices developed by the firm several years after the merger whereby executives managed to conceal debt worth billions of dollars occasioned by failed projects and deals. This was in turn made possible through the use of poor financial reporting, special purposes entities, and loopholes in accounting. The company's chief financial officer together with other high-ranking executives was able to mislead both the audit committees and the board of directors regarding the

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[12] Tobias Pavel and Mylene Encontro, 'The Enron scandal' [2012] Chalmers University of Technology Financial Risk 2.
[13] Yuhao Li, 'The case analysis of the scandal of Enron.' *International Journal of business and management* 5, no. 10 (2010): 37.

company's extremely high-risk accounting practices. In addition to this, the company's external auditor, Arthur Andersen, compelled to overlook the problems issues.[14]

Enron's problems peaked when a $40 billion lawsuit was filed by its shareholders following a dramatic and sudden drop in the share price of the company from a mid-2000 high of US$90.75 a share to a November 2001 low of less than $1 a share. As investigations by the SEC began, attempts by Dynegy (a Houston-based rival of Enron) to acquire Enron failed; and this led to the filing of bankruptcy at which time the corporation's total assets were worth approximately $63.4 billion.[15] It is no wonder that at that time it was the largest corporate bankruptcy.

The Enron scandal itself could be said to have largely manifested in the form of misleading financial accounts.[16] These accounts were purposely but carefully falsified in order to cover up the actual financial condition of the corporation and in doing so make it possible for investors to continue investing their money in it. In fact, when the scandal was uncovered, the corporation was still considered to be among the most good-performing companies in the US with various indices ranking it highly or even among the topmost. Indeed the corporation did not disappoint when it came to public relations stunts. Apart from the fact that it was presenting false accounting information to the public and investors in order to boost its share price, Enron was also maintaining good physical appearances at its offices with its employees and front offices being some of the most admired across the US.[17]

Even in the aspect of corporate governance, the company was managed to portray itself as the best.[18] It portrayed itself on paper as having a model board of directors that consisted mainly of outsiders with a significant share of the company's stock as well as a highly talented audit committee. This in part explains why the company managed to rank so highly in key indices throughout the years and right up to the time its accounting fraud was discovered. For

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[14] Gary M. Cunningham and Jean E. Harris, 'Enron and Arthur Andersen: The case of the crooked E and the fallen A' (2006) 3 Global Perspectives on Accounting Education 7.
[15] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 14.
[16] Gary M. Cunningham and Jean E. Harris, 'Enron and Arthur Andersen: The case of the crooked E and the fallen A' (2006) 3 Global Perspectives on Accounting Education 3.
[17] Tobias Pavel and Mylene Encontro, 'The Enron scandal' [2012] Chalmers University of Technology Financial Risk 2.
[18] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 17.

instance, Enron was in the year 200 included among *Chief Executive*'s best boards.[19] This illustrates the extent to which the company must have gone to conceal its accounting fraud by making itself the most attractive company on the face of it. Unfortunately, it managed to deceive virtually everyone – and for a long period of time. Not even the company's extremely complex network of intermediaries and corporate governance model could prevent the company from being attractive to virtually all categories of people including investors, the media, analysts, members of the general public, and even regulators.[20]

Rather than be viewed with suspicion, the company was praised and regarded as a model American corporation. As a result, Enron was able to attract large amounts of capital most of which was used to fund its questionable, complex and hard-to-understand business model as well as conceal its true performance using a wide array of financing and accounting maneuvers. Similarly, it managed to hype its stock to unprecedentedly high and unsustainable levels. Yet management was committed to maintaining that high stock price as it was by far the leading source of revenue for the company.[21]

In order to keep the share price high and keep attracting capital, the management and employees of the company devised another strategy that was based on compensation and bonuses especially for the executives. Like most other companies, Enron operated a performance and compensation management system that was no different from that of most other US corporations: that of retaining and rewarding the most valuable employees. However, Enron's compensation system was also mostly about rewarding its senior-most executives based on the company's performance.[22] As such, it led to a dysfunctional corporate culture that was obsessed with immediate earnings in order to increase bonuses. As long as employees met their targets, they would be guaranteed of their bonuses. This provided the incentive for employees to do all they could to achieve targets most of which were unrealistic. It soon became common practice and the norm for employees to attempt to start different deals with any regard to either the profits

[19] Tobias Pavel and Mylene Encontro, 'The Enron scandal' [2012] Chalmers University of Technology Financial Risk 2.
[20] Yuhao Li, 'The case analysis of the scandal of Enron.' *International Journal of business and management* 5, no. 10 (2010): 37.
[21] Tobias Pavel and Mylene Encontro, 'The Enron scandal' [2012] Chalmers University of Technology Financial Risk 4.
[22] L Cernușca, 'Ethics in accounting: the consequences of the Enron scandal' (2011) 13 Agricultural Management/Lucrari Stiintifice Seria I, Management Agricol 3.

or cash flow of the company. For these employees, the only thing that seemed to matter was being able to get the best possible rating when their performance review came up.[23]

To compound an already dire financial and accounting situation, the results of accounting would be recorded as soon as possible to ensure that they kept up with the share price. For those involved in making these deals possible and the executives of the company, such practices served only one single purpose namely earning them large bonuses in cash and stock options. In this regard, stock options were not really considered to be a form of compensation; and the company preferred paying its employees using these options to make its balance sheet look more attractive. It became the norm rather than the exception at Enron for executive compensation to be in the form of stock options. In fact, the corporation placed a lot of emphasis on stock price and as such always ensured that as many employees as possible were compensated using stock options.[24] While this was a common practice among other US companies, it is likely that Enron had no money with which to compensate employees and stock options became their preference. This is why the stock price had to be kept as high as possible. Moreover, the policy of compensating using stock options helped the management of the company to create expectations that there would be rapid growth in the stock price. This also gave the appearance of reported earnings necessary to meet the expectations of Wall Street.

Looking back to these final two years before the company filed for bankruptcy, one cannot help but marvel at how it managed to carefully conceal its dubious activities and how everyone seemed convinced. This is even more disturbing when one considers the fact that in the days leading to the discovery of the scandal, many people (including analysts and industry regulators) had been concerned about the complex financial reporting model adopted by the company.[25] However, they were apparently not able to suspect anything beyond that.

The Enron scandal may have begun as a result of the desire for by its senior executives to make money quickly and/or maintain its newly-found wealth derived from the new business ventures it had entered in the 1990s. By 1998, the company had operations in different sectors of

[23] L Cernușca, 'Ethics in accounting: the consequences of the Enron scandal' (2011) 13 Agricultural Management/Lucrari Stiintifice Seria I, Management Agricol 5.
[24] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 15.
[25] Nancy Rapoport, Jeffrey D. Van Niel, and Bala G. Dharan, *Enron and other corporate fiascos: The corporate scandal reader* (Foundation Press, 2009) 5.

the economy that included energy, data management, and water. It also began operating more like an investment bank and/or a hedge fund when it realized that it could make huge profits from the margins of the different products that it used to trade. By that time, its share price was so high that most of the company's revenues were generated through sales of shares. The company's marketing of power was also a major source of revenue. These two played a particularly important role in making Enron wealthy.[26] Having become so wealthy, the problem that Enron must have faced was staying wealthy. This could, in turn, explain why it chose to do all it could to keep its share price high. After all, the higher the share price the more money the company made through the sale of those shares.

These issues must have forced the company to begin altering financial accounts to portray the company's financial condition as extremely good even though the finances were not that good. Over time, the initially limited misrepresentations of financial statements and reports metamorphosed into a major accounting cover-up when the company's debts began piling up and its revenues plummeted. By the year 1999, it is believed that most of the company's recorded profits and assets were either totally fraudulent or were highly inflated. Many others were found to be non-existent. In one notable case of outright fraud in financial recording, the company in 1999 made a promise that it would repay an investment by Merrill Lynch with interest as a way of depicting a profit on its accounts.[27] The company developed the habit of putting its many (and increasing) losses and debts into entities that were allegedly formed offshore but that were usually never included in its financial statements.[28] In the same way, Enron's other arcane and highly sophisticated financial transactions involving its related companies were usually utilized as tools to remove from Enron's financial records entities deemed to be unprofitable.[29]

The coming to light of Enron's accounting scandals had the most devastating effect on the company. Back then, it was revealed that Enron had been engaging in irregular accounting procedures that dated back to the 1990s and that bordered on outright fraud. These irregular accounting procedures were also determined to have also involved Arthur Andersen, Enron's auditor. In the course of the scandal, the share price of the company fell from a high of US

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[26] Nancy Rapoport, Jeffrey D. Van Niel, and Bala G. Dharan, *Enron and other corporate fiascos: The corporate scandal reader* (Foundation Press, 2009) 4.
[27] Nancy Rapoport, Jeffrey D. Van Niel, and Bala G. Dharan, *Enron and other corporate fiascos: The corporate scandal reader* (Foundation Press, 2009) 3.
[28] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013) 8.
[29] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013) 7.

$90.56 during the summer of 2000 to less than one dollar in just over a year. Since the company had been regarded as a blue-chip stock investment, the scandal and the company's subsequent collapse was in many aspects unprecedented in the financial sector of the world.[30]

The final blow for the company came when revelations were made that virtually all of its revenues and profits were derived from dealings involving special-purpose entities. These were essentially limited partnerships that were under the control of Enron. This had the implication that most – if not all – of the losses and debts incurred by the company did not get reported in the company's financial statements as it ought to have been the case. Of Enron's many affiliated companies, the only one that was consistently profitable and that had been consistently earning honest income was the Northern Natural Gas (NNG) Company founded way back in the early 1930s. Owing to the scandal and associated financial challenges, NNG had to be sold. Attempts to rescue Enron from collapsing proved unsuccessful especially after Dynegy, a smaller but similar company that had shown great interest in buying Enron, discovered that the expected restatement of earnings could reveal even serious financial problems for Enron. Clearly, no one wants to buy a company whose true financial condition remains mysterious.

Enron's failure could be attributed to systematic manipulation of disclosure such that what was reported to the public did not reflect the true financial position of the corporation. Instead, the company's financial position was tailored and made to look more favorable than it actually was in order to attract new investors and retain existing ones. The managers of Enron reasoned that as long as the share price remained favorable, the company would not lose investors. Keeping the share price favorable meant altering the balance sheet and misreporting the company's financial position.[31] More specifically, Enron's share price was attached with overly attractive incentives; and this sort of compelled both the auditors and top managers of the company to manipulate accounting information with the aim of keeping the company's stock as high as possible.[32]

Owing to regulatory flaws and gaps, it was possible for the company to conceal its malpractices for a fairly long period of time. More specifically, the disclosure regime for publicly

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[30] L Cernușca, 'Ethics in accounting: the consequences of the Enron scandal' (2011) 13 Agricultural Management/Lucrari Stiintifice Seria I, Management Agricol 3.
[31] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 14.
[32] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013).

traded financial companies was weak; and this allowed unscrupulous managers to collude with auditors to manipulate financial information. This was especially made manifest following the onset of a series of corporate scandals and frauds that occurred between 2000 and 2002. Virtually of these scandals had one aspect in common namely the manipulation of information and operations conducted in secret.[33] This could be the basis for arguing that the Sarbanes–Oxley Act could only be deemed to have been effective so far if it addressed the issues of conflict of interest. This is especially so because auditors played a major role in the Enron scandal in particular. Capitalizing on loopholes in the law that left them unregulated and that made it possible for them to provide other commercial services (such as consultancy) to the same clients they audited, audit firms had the motive to help Enron conceal its true financial position.

Usually, auditors have the final word on a firm's true financial position. If auditors collude with firms, it becomes easier for the firm's financial statements to be manipulated. In the case of Enron, the complicity of auditors was largely motivated by the desire to ensure that the company did not go bankrupt as this would result in losses of not only audit business but also consultancy business. Therefore, it was in the best interests of both Enron and its auditors for Enron to remain operational in spite of its weak financial position. Manipulation of financial statements became the only way of achieving this.[34] In this regard, strengthening the law or introducing new laws to address the issue of conflict of interest especially between firms and their auditors was necessary. Moreover, auditors needed to not just be regulated but regulated more closely to ensure that their activities were strictly in conformity with what they were licensed to do.

Yet one cannot blame auditors in general for the problems that befell Enron. Actually, it can be argued that Enron's accounting fraud was more as a result of the diminished importance of auditors (as perceived by corporations) rather than the willful collusion between auditors and their clients (corporations). The diminished attractiveness of auditors could, in turn, be attributed to changing market trends especially in the 1990s which led to significant and unprecedented

[33] L Cernușca, 'Ethics in accounting: the consequences of the Enron scandal' (2011) 13 Agricultural Management/Lucrari Stiintifice Seria I, Management Agricol 3.
[34] Jamel Azibi, Hubert Tondeur, and Mohamed Tahar Rajhi, 'Auditor choice and institutional investor characteristics after the Enron scandal in the French context' [2010] Crises et nouvelles problématiques de la Valeur 4.

growth in the capital markets.[35] This growth had the effect of significantly altering the traditional function of gatekeepers in general and auditors in particular.[36] While in the past it was important – even necessary – for corporations to have a certified audit in order for them to attract capital as this enhanced their reputations, this changed in the 1990s as reputation was no longer a prerequisite for accessing or attracting low-cost capital. This meant that the only issue that mattered to corporations in terms of attracting capital was their financial performance. As long as a corporation performed well it could attract capital regardless of whether its audit was certified or not.[37]

Subsequently, corporations become overly focused on the sale of services and not their credibility. Issues of audit credibility or having certified audits came to be largely considered as merely being part of the formalities as opposed to being a critical requirement. Accounting and audit firms also followed this new approach, and before long they become less concerned about their reputations even as they become preoccupied with the financial motive. Therefore, they became increasingly inclined to accepting risky accounting policies as long there were guarantees of good financial returns.[38] This no doubt explains how Enron's long-time auditor ended up conspiring with the company's executives to engage in accounting fraud. The financial incentives for Enron were more than the auditor could resist. After all, the popular view back then was that if everyone else was doing something then there was nothing wrong with it. For the accounting fraternity, reputation had become just a formal aspect as opposed to the most critical issue as used to be the case before the 1990s.

Therefore, addressing the issues pertaining to audit independence was necessary. Moreover, there was a need for legislation to curb the practice of not taking audits seriously. Corporations needed to be made to understand that without a certified audit they would not be able to access important capital from investors. This could be achieved, for instance, by making such audits mandatory just as financial reports are mandatory. In fact, audited financial statements or other statements of account needed to be audited and then verified or authenticated

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[35] Jamel Azibi, Hubert Tondeur, and Mohamed Tahar Rajhi, 'Auditor choice and institutional investor characteristics after the Enron scandal in the French context' [2010] Crises et nouvelles problématiques de la Valeur 1.
[36] Stephen J. Conroy and Tisha LN Emerson, 'Changing ethical attitudes: The case of the Enron and ImClone scandals' (2006) 87 Social Science Quarterly 395.
[37] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013).
[38] L Cernușca, 'Ethics in accounting: the consequences of the Enron scandal' (2011) 13 Agricultural Management/Lucrari Stiintifice Seria I, Management Agricol 3.

by not just the auditor but also the corporations' executives and chief financial officers. Without credible audits, there was reason to believe that similar – if not the same – audit problems would recur after some time.

Causes of the Enron Scandal

Overall, the Enron scandal, as well as the subsequent filing for bankruptcy, could be attributed to various specific factors that included the deregulation of the post-1970s era in the energy sector. It is evident that the decision to deregulate the oil and gas sector was well-meaning as its intention was to foster competition and hopefully also reduce prices and enhance innovation owing to increased competition. However, companies must have taken advantage of the deregulation of the all-important oil and gas sector to act with more secrecy and even engage in fraudulent corporate behavior. Enron exemplifies the latter. It is largely because of the lack of proper oversight and close monitoring practices that Enron's executives were able to manipulate the company's financial reports and statements to make them look favorable to investors and therefore push up the share price.[39] This is a fact that cannot be denied because had the financial sector been as closely regulated as it has been prior to the aforementioned deregulation, it would have been at least difficult for the company's executives to deceive virtually everyone – including the Securities and Exchange Commission (SEC). Specifically, it takes close regulation of the financial sector to prevent collusion between auditors and the executives of the companies they audit.

In the case of Enron, the fabrication of financial statements was only made possible because the auditor was in on the plot.[40] Even though the auditor argued that he was compelled to overlook the glaring discrepancies between Enron's costs and revenues, the fact remains to be that he facilitated the entire misreporting. Moreover, there was a clear conflict of interest in that the auditor offered other non-audit services to Enron.[41] It is only through proper and closer financial regulation that such malpractices can be prevented or at the very least kept at a minimum. At this point, it is not even prudent to talk about ethical causes. Clearly, there was no

[39] Stephen J. Conroy and Tisha LN Emerson, 'Changing ethical attitudes: The case of the Enron and ImClone scandals' (2006) 87 Social Science Quarterly 397.
[40] Alexandre Di Miceli da Silveira, 'The Enron scandal a decade later: Lessons learned' (2013).
[41] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, 'The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 280.

regard for ethics among Enron's senior executives. Otherwise, they would have chosen to act ethically in spite of the legal loopholes available to them and which they could exploit.

Role of Organizational Culture in the Corporate Malpractices

Several issues of importance are worth noting with regard to the Enron scandal. As has been noted, Enron was formed as a result of a merger between Houston Natural Gas (HNG) and InterNorth – two relatively small companies. The two issues are of significance in this regard especially in terms of corporate governance laws. The first one is the fact that Enron was formed from a merger while the second is that the merger involved two relatively small companies. Even though mergers are generally popular in the US and Europe and among the commonest approaches that firms use to consolidate their market shares and increase their capital base, mergers can prove disastrous to an economy unless they are examined critically before they are permitted to proceed.[42] This does not mean that all mergers result in – or have the potential of resulting in – major corporate and accounting scandals similar to that of Enron. However, mergers have the effect of bringing together two or more companies with markedly different organizational structures and cultures.

Organizational culture is particularly important when it comes to issues of corporate governance because every company's operations (including how its accounting and financial reporting practices) are influenced to a large extent by its corporate culture. When two firms with different corporate cultures merge, there the resultant corporation adopts the corporate culture of one of the two merging entities or there is a mixing of corporate cultures. Regardless of the approach adopted, the ultimate effect is that a new corporate culture emerges and is heavily dependent on the cultures of one or two of the merging entities. If by any chance one or more of the merging entities had poor corporate governance culture, this is most likely to be passed over to the new entity.

Even though there is no proof that Houston Natural Gas and/or InterNorth had a history of manipulating its financial information or misreporting it, there is a high likelihood that this was the case. The implication is that corporations that emerge from mergers may need to be particularly subjected to intense scrutiny to ensure that they do not engage in corporate governance malpractices designed to deceive members of the public and investors. This is

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[42] Shane Premeaux, 'The link between management behavior and ethical philosophy in the wake of the Enron convictions' (2009) 85 Journal of Business Ethics 13.

especially so if such firms are public corporations whose managers are always under immense pressure from shareholders to perform excellently and maintain a favorable share price. Such pressure was the major motivation for Enron's managers' decision to misreport financial information. They wanted to ensure that the share price remained attractive so that investors would not take away their investments from the company.[43]

The second important issue pertains to the size of the merging firms. A mistake that has often been committed by regulators is the tendency to assume that only mergers involving large firms pose a threat to the industry or sector. Moreover, they tend to assume that the most likely threat to the sector or industry is in terms of lessening the competition. As a result, mergers between large firms tend to be subjected to intense scrutiny by regulators before they are allowed to proceed. Even then, the scrutiny mainly focuses on ensuring that the resultant corporation does not significantly lessen the competition. This has the implication that hardly ever, if at all, are merging entities scrutinized to ascertain how prudent their corporate governance is. While corporations can still engage in corporate malpractices long after they have merged, closer scrutiny – if undertaken early enough before the merger is allowed to proceed – could significantly reduce the inclination to misreport or alter financial and accounting information. It ought not to matter whether the merging entities are small or big because all firms have the potential of engaging in financial misreporting.

These arguments are made here because even though the Sarbanes–Oxley Act has helped limit the risk of corporations engaging in corporate malpractices, it is largely a reactionary measure that may not successfully prevent or discourage corporate governance malpractices for firms that have been engaging in the practice for many years already. As was noted, the corporate culture of a merged entity is usually the sum total of the corporate cultures of the individual entities. Therefore, it is highly unlikely that firms that have traditionally been manipulating their financial and accounting information to boost share prices or to achieve some other goals will be effectively deterred by the Sarbanes–Oxley Act.

[43] Stephen J. Conroy and Tisha LN Emerson, 'Changing ethical attitudes: The case of the Enron and ImClone scandals' (2006) 87 Social Science Quarterly 395.

CHAPTER THREE: THE RAPID RESPONSE OF THE US CONGRESS

Background to the Sarbanes–Oxley Act

The Enron scandal and the company's subsequent collapse shocked not just shareholders but also regulators at the federal and state levels of the US government. Until then, the US financial system had thrived on the basis of being efficient, effective, and transparent. Even more significant is that it had prided itself on being the world's most deregulated yet successful financial markets in the world.[44] The Enron scandal had the effect of changing all this and forcing federal – not even state – regulators to act with speed to avoid similar scandals. The fact that the response was at the federal level and not the state level underscores the importance with which the matter was regarded in the US; and the overwhelming support that the subsequent corporate governance legislations received indicated the shared concerns among all Americans. Never in the 21st century had any legislation received so much bipartisan support in both the House and the Senate since the enactment of the US Patriot Act (in response to the September 9 terrorist attacks). During the voting, the desire for the Sarbanes–Oxley Act to be implemented was made evident in that the result was 99-0 in the Senate (and 423-3 in the House (with a few abstentions).[45]

In the wake of the Enron scandal and especially following the collapse of Enron, the US Congress enacted the Sarbanes–Oxley Act of 2002 on July 30, 2002. Also known as the US Senate as the Public Company Accounting Reform and Investor Protection Act and in the House as the Corporate and Auditing Accountability, Responsibility, and Transparency Act, this federal law specifically either set new requirements or significantly expanded existing ones for all US public accounting firms, management, and public company boards.[46] However, certain provisions of the law also extend and apply to the non-public (privately held) companies. This is especially as the law pertains to acts such as willfully destroying evidence with the goal of impeding federal investigations.

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[44] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 137.
[45] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, 'The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 280.
[46] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 17.

In this regard, the Sarbanes–Oxley Act provides in part that:

> Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States or any case filed under title 11, or in relation to or contemplation of any such matter or case, shall be fined under this title, imprisoned not more than 20 years, or both.[47]

The Sarbanes–Oxley Act of 2002 has eleven sections and could be said to have been specifically enacted as part of the federal government's reaction to not just the Enron scandal but several other corporate accounting scandals that rocked the country between 2000 and 2002. Even though the collapse of Enron and WorldCom was the major trigger of the legislative response from the US federal government, other accounting and corporate scandals played added impetus to the enactment of the legislation and included those involving or pertaining to Peregrine Systems, Adelphia, and Tyco International. Taken together, these five accounting and corporate scandals cost investors billions of dollars occasioned by the collapse of the share prices of the concerned companies. Moreover, the costs came about as a result of significant losses in public confidence in the securities markets of the US. The Sarbanes–Oxley Act contains specific provisions on the responsibilities of the board of directors of a public corporation and introduces criminal penalties for different forms of misconduct. It also specifically demands that regulations defining public corporations' compliance with the law be created by the Securities and Exchange Commission.[48]

Certification of Financial Information

One of the most notable causes of the collapse of Enron in particular was the fact that there was no accountability for the reporting of financial information. As a result, financial information was misreported without anyone discovering it for a long time. Therefore, the Sarbanes–Oxley Act partly requires that a public corporation's top managers have to individually offer certification for financial information while making the penalties for misinformation and fraudulent financial activities mere severe. Boards of directors of corporations also have

[47] Section 802(a) of the Sarbanes–Oxley Act, 18 U.S.C. § 1519.
[48] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 16.

increased oversight roles while external auditors have increased independence. These legislative changes were designed to ensure that the financial statements that public corporations reports are accurate as they can be verified at different levels. Moreover, managers can be individually held to account for false or inaccurate reporting of financial information of a public company. The reasoning was that as long as there is increased and proper oversight over the reporting of financial information, the motivation to misreport or cover up certain information with a view to boosting a public company's share price would be reduced.[49]

Independence of boards of directors or management is also without a doubt important in enhancing good accounting and information reporting practices. This is because the more independent auditors are the less likely they are to collude with managers in misreporting of falsifying accounting information. Since all public corporations' financial information is only released to the public after being audited, auditors play one of the most important roles in corporate accounting practices. Elimination of conflict of interest by enhancing the independence of auditors is therefore important.[50]

Setting up the Public Company Accounting Oversight Board

One of the most notable changes introduced by the Sarbanes–Oxley Act was to set up the Public Company Accounting Oversight Board (PCAOB). With the mandate of developing standards for preparing audit reports, the board would also help restrict public accounting firms from offering non-audit services when auditing.[51] This is no doubt an important legal reform given the fact that Enron's ability to successfully alter and falsify financial reports was made possible by the support it received from its auditor. The auditor had every right – legal and ethical – to refuse to be part of the scam. However, he must have bowed to pressure and chosen to cooperate because he was possibly threatened with the loss of lucrative business. Indeed the auditor was found to have been providing other services to Enron in addition to auditing services

[49] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 139.
[50] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 17.
[51] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 14.

all at the same time as it was offering financial services. Even if this was not against any law at theta me, it was definitely unethical given the evident conflict of interest.[52]

Even more significant is the fact that it was a major regulatory loophole for audit companies to be allowed to provide other services to the same firms they are auditing and during the same period of the audit. Even if there is was no pressure to engage in malpractices, these audit firms would be more than willing to cooperate in aiding malpractices just so as to protect their business interests. The auditor for Enron was without a doubt not prepared and not ready to lose lucrative business with Enron by reporting the accounting fraud and the falsification of financial statements at Enron. The critical issue in this regard is conflict of interest, and it is important that the Sarbanes–Oxley Act establishes a board charged with, among other duties, the responsibility of ensuring that pubic accounting companies are restricted from the provision of non-auditing services – at least for the duration of the audit.

Having noted that, it is worth adding that the Sarbanes–Oxley Act falls short in this regard because even if non-audit services are provided when not auditing, there is still the chance that in future the concerned firm may change auditors and choose the one that used to provide it with non-auditing services in the past. Therefore, the Act would have been more effective in addressing issues of conflict of interest by making it absolutely illegal for public accounting companies to offer other non-audit services. This way, there would be no concerns – both in the present and the future – about companies forming extra business relations with their auditors. If not, the Act should have made it mandatory for public accounting firms to never offer non-audit services to clients they have ever audited or will ever audit. This would have been an even better approach because it would have allowed these public accounting companies to still provide non-audit services but as long as they are not provided to clients they intend to audit in the future or have ever audited. In its current form, the Act only reduces the motivation of these firms to engage in conflicting businesses but does not do enough to deter them.

Auditor Independence and Related Issues

The Sarbanes–Oxley Act made important changes to the conduct of auditors and their clients. In the past, a company had the legal right to retain the same lead auditor for as long as it

[52] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, ‘The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 281.

wanted.[53] Clearly, the longer two parties work together the more likely it is that friendships would develop. Therefore, the practice of retaining the same lead auditor for a very long time – even for life – was misplaced. The Act changes this by requiring that lead auditors have to be changed at least once every five years.[54] This is commendable in that it eliminates the risk of auditors covering up for their clients owing to friendship relationships established as a result of a long period of time working together or for each other.

As is noted elsewhere, requiring that auditors be independent may not achieve much if the same lead auditor is retained for as long as the corporation wants. While there could be clear benefits associated with retaining the same auditor for a long period of time (such as better continuity and conversance with the corporate culture and accounting model of the corporation), it also poses major risks. The longer an auditor works for a given client the greater the likelihood that familiarity begins to develop and with it the greater the risk that the auditor's independence would get compromised.

It is also commendable that the Sarbanes–Oxley Act mandated the Board to come up with appropriate standards when it comes to preparing audit reports. One of the major contributors to the Enron scandal and by extension the collapse of Enron was the fact that the firm adopted extremely complex financial reporting standards. In fact, so complex were the financial reports of the firm that even analysts and external experts could not understand them. The implication was that only the senior executives of the company and the company's auditor knew exactly where Enron made money and lost money. That this was happening in the financial sector of one of the most developed countries in the world and in the 21st century is quite a major indictment for the US financial regulations.

It is true that the regulation of the financial sector has its shortcomings notable among them of which is making the financial industry uncompetitive relative to the financial markets of other countries with deregulated financial sectors.[55] However, deregulation ought not to look like abdication. The fact that Enron was making money in ways that not even experts could understand can only point to a financial market that was so deregulated to the point of being left

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[53] Karen K. Nelson, Richard A. Price, and Brian R. Rountree, 'The market reaction to Arthur Andersen's role in the Enron scandal: Loss of reputation or confounding effects? (2008) 46 Journal of Accounting and Economics 279.
[54] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 139.
[55] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 139.

to its own devices. In essence, there was near-abdication. Every company, especially if it is a public one – has to be able to provide not just regular but also accurate financial statements that can be backed up by evidence and that analysts and the firm's executives can easily understand. It is at best bizarre for analysts not to be able to understand how and where a company listed among the top 10 Fortune 500 companies makes its money.

Yet Enron managed to conceal its true financial position through a combination of classified reports and use of a complex financial reporting system that made it impossible for even experts to understand its source of revenue. This is one of the negative aspects of deregulation of the financial sector: it becomes at best difficult to understand the actual sources of firms' revenue and whether or not the revenue being reported can be backed up by actual assets. In essence, it encourages both positive and negative innovation with the latter capable of triggering financial crises that result in the collapse of important companies. With the Public Company Accounting Oversight Board in place, it should become easier for such accounting malpractice and falsified audit reports to be identified early enough and addressed.

The other important legal provision introduced by the Sarbanes–Oxley Act is the requirement that members of the audit committee of public companies be independent. Independence is important in this regard as it also touches on the critical issue of conflict of interest.[56] This importance lies in the fact it would still be possible for members of the audit committee to take part in covering up the true financial position of a company even if the external auditor is not conflicted in the matter. In essence, merely ensuring that there is no conflict of interest on the part of the external auditor may not help avert a scandal similar to that of Enron unless the concerned company's audit committee is independent enough not to be unduly influenced by the company's management. As a result of the fact that members of Enron's audit committee lacked adequate independence from the company but were closely linked to it in different ways, they were either willing co-conspirators or were easily pressured into the cover-up of the true financial position of the company.

To make the situation worse, even those members of the audit committee who would have chosen not to be part of the cover-up would have done little to change the situation because none of them seemed to be knowledgeable enough to understand the extremely complex

[56] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 137.

financial reports the company made available to them. In this regard, making the board of auditors more independent may have been a good thing but definitely not the absolute best. The Sarbanes–Oxley ought to have gone a step further and expressly required that all (not just one or a few) members of the audit committee of any public company have at least the required threshold level of accounting and related skills and expertise necessary for them to understand even the most complex audit and financial statements. It is true that even if members of the audit committee were highly skilled and with the requisite expertise in accounting, they could not help prevent an accounting fraud similar to that of Enron if they are not independent enough.

In this regard, it is true that the issue of independence needed to be prioritized over that of knowledge, skills, and competencies. However, better results are achieved where members of the audit board are both independent and highly knowledgeable and skilled in matters of accounting. Even though the Sarbanes–Oxley Act did not expressly address the issue of competences of audit board members, it is commendable the New York Stock Exchange (NYSE) proposed that every member of the audit committee of public companies should have financial literacy with at least one of them being required to have relevant accounting or related expertise in financial management. The proposals also recommended that all audit boards must have the majority of its members being independent directors who have to comply with the strictest (broad) definition of the term "independent directors."[57] When all these proposals made by the SEC and those expressly provided for by the Sarbanes–Oxley Act are considered, it can be argued that the Sarbanes–Oxley Act has managed to address the key issues of the independence of board of directors as well as the independence and educational qualifications of members of the audit board.

Executive Responsibilities and Bonuses

One final but no less important legal change introduced by the Sarbanes–Oxley Act pertained to the executive responsibilities and bonuses. In this regard, the Act requires all public company executives to sign off on all financial reports as well as relinquish some forms of executive bonuses in the event of financial restatements.[58] These two issues are important

[57] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 196.
[58] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 195.

because they played a key role in the Enron scandal. The issue of signing off on financial reports is of particular importance given the fact that it helps to hold these executives to account in the event of misreporting or falsification of financial statements. Before the enactment of the Act, senior company executives did not have to sign off on financial reports. Instead, this was a responsibility that was left to the chairperson of the audit board and the auditor. As a result, it was possible for the senior executives to disown the reports if need be or to not closely examine them to verify their authenticity. This requirement effectively makes it mandatory for executives to countercheck all the financial reports of a company prior to being published. This, in turn, prevents the release to the public of inaccurate or falsified information. In the event the executives fail to notice or flag false information, they would be personally held liable for a criminal offense of taking part in a cover-up or in the falsification of financial information.

Executives' bonuses also played a key role in the Enron scandal with the senior executives being too obsessed with paying themselves large bonuses to accept any company results that would take away these bonuses. In essence, the huge bonuses were a key motivation in the executives' falsification of financial reports and statements since these bonuses were pegged on the company's continued good performance. For many years, Enron's executives focused on ensuring that the company's financial records were good enough to justify the award of huge bonuses. For them, it really mattered little how the company actually performed. The only thing that seemed to matter was ensuring that the company results released to the public were favorable enough to justify their paying themselves huge bonuses.[59] Therefore, all they had to do was come up with new and creative ways of falsifying the company's financial reports to reflect improved earnings each new financial year.

Some clarification is important in this regard: the Sarbanes–Oxley Act does not prohibit public company executives (especially chief executive officers and chief financial officers) from taking bonuses and other financial incentives entirely. Instead, it only focuses on those bonuses and financial incentives that are pegged on the financial performance of the company. Enron was in the habit of awarding huge bonuses and other financial incentives to senior-level managers as a way of boosting performance.[60] While that is perfectly fine, the problem was that these

[59] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 195.
[60] IV Coates and C John, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 95.

payments were only made if and when the company posted good results. Therefore, executives were constantly under immense pressure to deliver good results so that they could maintain their bonuses. Moreover, these bonuses and incentives were just not morally right because they would be awarded on company results that would later be restated. Even if this had not been illegal back then, it was definitely unethical in that in the end, the bonuses had to be awarded without but the results upon which they were based were never really guaranteed.

Talking of financial restatements, it could be argued that this is arguably one of the areas where the Sarbanes–Oxley Act has been most effective if available statistics are anything to go by. Compared to the period of time before the Act was enacted, there has been a significant and steady reduction in financial restatements especially beginning in 2005. Today, there is a comparatively lower number of class-action lawsuits in the area of (or pertaining to) securities. Such lawsuits may have declined by as much as 60% since the enactment of the Act. In addition, there has been a general improvement in the quality of audits since the enactment of the Act.[61] The importance of audit quality needs no emphasis because the better the audit quality the less likely that a company can misreport financial reports.

In arguing that audit quality has significantly improved, it is appreciated that there is a lot more than needs to be done in the area of audit especially given the major role that poor audit quality played in the Enron scandal. However, the successes so far achieved are also worth pointing out and celebrating. After all, the purpose of the Act, as identified in its preamble, is to "protect investors by improving the accuracy and reliability of corporate disclosures."[62] In addition, one of the members of the two committees of the Senate and the House investigated the Enron scandal is quoted as saying that the Sarbanes–Oxley Act could be said to be "a mirror image of Enron: the company's perceived corporate governance failings are matched virtually point for point in the principal provisions of the Act."[63] This statement reflects a general feeling among members of the two committees that the Sarbanes–Oxley Act had adequate provisions capable of addressing at least the most glaring legal and regulatory loopholes in previous laws that had been utilized by Enron to deceive the public and shareholders. While members of the

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[61] Weili Ge and Sarah McVay, 'The disclosure of material weaknesses in internal control after the Sarbanes-Oxley Act' (2005) 19 Accounting Horizons 137.
[62] See Preamble to the Sarbanes–Oxley Act of 2002.
[63] Deakin, Simon; Suzanne J. Konzelmann (September 2003). *"Learning from Enron"* *(PDF)*. ESRC Centre for Business Research. *University of Cambridge* (Working Paper No 274): 1.

investigating committees tend to be overly inclined to support reports of their findings even if these reports have flaws, in the case of the recommendations made in the report it can be argued that indeed the subsequent Act was equally matched with the Enron scandal.

The two committees, namely the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs, had between December 2001 and April 2002, taken on the task of investigating not just the Enron scandal but also other related accounting and investor protection issues. These hearings by the two committees – in addition to the various corporate scandals the came in the immediate wake of the Enron scandal – directly led to the ultimate enactment and passage of the Sarbanes–Oxley Act just within three months of the cessation of the hearings.[64] This shows that Congress was serious and greatly disturbed about the corporate scandals affecting the country during that short period of fewer than three years (between 2000 and early 2002). By all standards, the rate at which the corporate scandals were being uncovered and the associated collapse of most of the affected companies was unprecedented in the history of the US – at least since the deregulation of the country's financial sector in the 1970s.

Therefore, when one takes into consideration the stated purpose of the Sarbanes–Oxley Act, one can be justified in arguing that the Act has managed to achieve that to a large extent. Similar sentiments regarding the expected future success of the Act have been expressed by one of the sponsors of the original Bill, Senator Sarbanes.[65] According to him, the expectation was that the Act would become part and parcel of the way commercial activities in the country were conducted by helping set up relevant standards of which law is not part and not separate. He expected that the law would become the basis of every aspect of the business world; and that the result of that would be the realization of more ethical behavior and higher standards of corporate governance that would provide benefits to all people. These higher standards have largely been entrenched in US corporate governance; and especially as they pertain to the area of internal controls.[66]

[64] Ivy Xiying Zhang, 'Economic consequences of the Sarbanes–Oxley Act of 2002' (2007) 44 Journal of accounting and economics 74.
[65] IV Coates and C John, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 93.
[66] IV Coates and C John, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 91.

The Issue of Internal Controls

It is important to critically examine the issue of internal controls and their relationship with the Act. This is owing to the fact that this issue has been – and continues to be – one of the most controversial. If anything, all the opposition raised against the Sarbanes–Oxley Act revolved around the issue of assessment of internal control. The controversy is partly because of the fact that implementing Section 404 of the Act – the one that deals with internal controls – has been determined to be the most expensive. This is in turn because the documentation and testing of valuable financial manuals, as well as other automated controls, need a lot of effort on the part of public firms.[67] More specifically, the Act's requirement that public companies have an internal controls system especially with regard to financial reporting is also important and one that has gone a long way in eliminating corrupt dealings in such companies.

The Sarbanes–Oxley Act specifically requires that it is the responsibility of management to "establish, assess and report on the issuer's system of internal controls over financial reporting."[68] In the same way, auditors are required to provide reports concerning the level of effectiveness of the system of internal controls. Specifically, managers of public companies are required to submit what is known as an internal control report to be part of every Annual Exchange report. [69] Significantly, this report has to "contain an assessment, as of the end of the most recent fiscal year of the Company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting" and make it clear "the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting."[70]

The fact that the provisions pertaining to internal controls have since proven to be the most costly and by extension most controversial is somewhat surprising in the sense that the Sarbanes–Oxley Act was not necessarily the first to recommend such controls. Instead, the Act was just building on what previous legislation had started. Specifically, the precedent with regard to internal controls was established in two other legislations namely the Federal Deposit Insurance Corporation Act (1991) and the Foreign Corrupt Practices Act (1977). Perhaps the

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[67] IV Coates and C John, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 91.
[68] 15 USC § 7262.
[69] 15 USC § 7262.
[70] 15 USC. § 7262(a).

reason why the internal controls become controversial is that they were fully enforced unlike in the past when the regulations were not as vigorously enforced.

Even though it may be practically possible for auditors to actually report on the effectiveness of companies' internal controls, there is the concern that the auditors may not be objective enough to provide an accurate assessment or appraisal of the internal control systems. This is a problem that has been common with credit rating agencies which, though supposedly independent, were sometimes found to be providing biased credit ratings especially for firms with which they had interests. Given that it is almost impossible for working relations between auditors and their clients to be totally devoid of friendship, it may prove hard for auditors to be fully objective when doing their work.

Because of vested interests not just present and past but also future, auditors may not be able to accurately and objectively appraise the effectiveness of a company's internal controls system. Still, the provisions of the Sarbanes–Oxley Act are an important starting point in ensuring that public companies have effective internal control systems capable of making financial reporting better and enhancing the confidence of investors in financial reports. The fact that Enron's financial reports were both extremely complex and not trusted by the company's investors had the effect of quickly pushing down the share price of Enron. Through better internal controls made possible by the Act, these two challenges have been addressed to a large extent.

Another issue of internal control pertains to the issuance of loans to directors and officers of the company. In this regard, one of the most important provisions of the Sarbanes–Oxley Act was to significantly restrict the issuance of loans to directors and officers of public companies.[71] This provision must have specifically sought to address the issue of conflict of interest when it comes to internal controls. There is no doubt that an officer or director of a public company who has benefitted from the company's loans will be extremely unwilling to do anything that could reveal the dire financial status of the company. Instead, such directors and/or officers will be inclined to cover up so that they do not run the risk of being required to repay their loans immediately. On the contrary, public company directors and officers who have no loans from the company can have stronger motivation to question the company's financial prudence and

[71] IV Coates and C John, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 91.

possibly even report any malpractices suspected or identified. The latter is possible because the officers and auditors would not be conflicted in any way. Therefore, the Act makes an important provision in this regard as it reduces conflict of interest within public companies.

Effectiveness of the Sarbanes–Oxley Act

As was noted before, the specific provisions dealing with or pertaining to internal controls have been among the most controversial. Most of those who oppose the Sarbanes–Oxley Act, in particular, argue that the internal controls are too many and have the effect of reducing the efficiency of the financial markets.[72] There is no question about the regulatory effect introduced by the Act. In fact, after many years of deregulation of the financial sector, the Act effectively introduced regulations by specifically establishing the Public Company Accounting Oversight Board. It means that for the first time in many years, the operations of the sector are subject to scrutiny and no player can unilaterally act without the approval of the board or without adhering to the strict regulatory standards set by the board.

Specifically, it is true that the costs to firms of having to comply not just with the Sarbanes–Oxley Act as a whole but with section 404, in particular, have been significant. However, independent surveys have indicated that the costs of compliance have been on a downward trend since 2004. This means that even though compliance costs were high when the Sarbanes–Oxley Act was first introduced, they began to decline after about two years. This is to be expected given in any situation where a sector moves from deregulation to regulation. Usually, firms have to channel what used to be earnings or revenue towards financing the costs of complying with the new regulations and especially those pertaining to Section 404 of the Act. Companies also have the tendency to want to exaggerate their costs occasioned by a newly introduced regulatory regime and especially if they are opposed to the legal regime. As such, it is only normal to expect that there would be resistance from public sector firms to the Sarbanes–Oxley Act and especially to Section 404 provisions.

The opposition to the Sarbanes–Oxley Act in this regard can, therefore, be said to be more to do with trying to avoid extra compliance costs rather than they are about the provisions being misplaced or unrealistic. Everyone attempts to scuttle the operationalization of something

[72] Ivy Xiying Zhang, 'Economic consequences of the Sarbanes–Oxley Act of 2002' (2007) 44 Journal of accounting and economics 77.

they know or think is likely to increase their costs even when they are not opposed to it in principle. In this regard, there is no real valid reason given by the public companies regarding their opposition to the Act. All they seem to be concerned about is the fact that it eats into their revenues. This has in turn been the basis for the prevalent view that the Sarbanes–Oxley Act has made the public sector companies in the US to become less competitive compared to their European counterparts. The reality is that it is much better for the firms to experience reduced competitiveness in the short-term than to report increased competitiveness that is most likely not based on true and accurate financial reports.

In essence, it is better for there to be mechanisms that guarantee the public and investors that whatever level of competitiveness forms register are genuine and not falsified than to have high levels of competitiveness that is based on forged financial reports and that do not foster trust and confidence among members of the public and investors. Competitiveness is good and should be sought; but this ought not to be achieved at the great experience of accounting prudence and fidelity.

Moreover, it is also true that major European countries have also implemented – or are in the process of implementing – provisions similar to – and inspired by – those in Act.[73] As is discussed in Chapter Four, France, and Germany – two of Europe's largest economies – have implemented their own set of regulations derived from the Act. This means that there is no real basis for the contention that European firms have a competitive advantage over US firms as a result of the implementation of the Sarbanes–Oxley Act as a whole and Section 404 of the Act in particular. It is also possible that if there has indeed been any loss of competitiveness on the part of US firms relative to their European counterparts then it could be because these firms are no longer able to engage in financial misreporting and the falsification of accounting statements.

As has just been noted, any losses in earnings occasioned by reduced competitiveness of US firms could be said to have been more than compensated by the substantial increase in investor confidence owing to the increased reliability of financial statements and the immense success achieved in terms of preventing fraud. It really means so little for firms to purport to be successful financially or to be better than their competitors in other countries when in fact there are lingering concerns and questions over the authenticity of those firms' financial statements.

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[73] Gerald J. Lobo and Jian Zhou, 'Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? Initial evidence.' (2006) 20 Accounting horizons 57.

Public and investor confidence could be said to be a much better and more valuable asset to any firm than the highest profits the firm has ever recorded.

This is because if members of the public and investors lose confidence in a firm's accounting practices, it really does not matter how high the firm's share price is or how much revenue the firm has generated over the years. It also does not matter how big (in terms of asset base) the firm is. The moment public and investor confidence in a firm's financial reports gets lost or starts waning, it is usually only a matter of time before the firm comes tumbling down and with it all its assets and other perceived valuables. On the other hand, a firm with modest earning and whose share price is average compared to the market average stands a better chance of achieving even exponential growth if the public and investors have confidence in its financial statements. The gist of the argument is that it is much better for firms to practice prudent financial and accounting standards and remain modest or even small in terms of revenue earned than to falsify financial statements to maintain an abnormally high share price as Enron did.

Restoration of investor confidence especially in the US markets is definitely something that can be directly attributed to the Sarbanes–Oxley Act. However, there is something else about investor confidence that many analysts seem to overlook. This is the fact that investor confidence was not necessarily restored just in the medium-term and the long-term but also in the short-term. This is an important point that deserves to be critically analyzed. Just like the urgent intervention (in the form of government bailouts) in the global financial crisis helped prevent several large US companies from collapsing and restored investor confidence in the markets, the Sarbanes–Oxley Act helped restore investors' confidence as soon as it was implemented. This is especially so given the fact that contrary to what the false view that the Sarbanes–Oxley Act was a knee-jerk response to Enron's scandal and collapse, the Act was actually a response to failures by several other companies in the US. In fact, it can be argued that there was a total breakdown in the entire financial regulatory system in the country and no one could be exempted from blame.

For instance, all checks and balances were missing or were not being implemented by the relevant agencies. On their part, Wall Street analysts could be said to have just gone along with whatever was being reported by public companies with caring to question the credibility of the financial statements provided. Even more important is that auditors had developed the habit of simply collecting money from companies without necessarily caring whether or not the audited accounts were a reflection of the actual financial health of those companies. Then there were the government agencies that undoubtedly failed the most in that while it was their responsibility to monitor companies they were not monitoring at all or as it was required of them. Therefore, the Sarbanes–Oxley Act responded to the myriad of problems affecting the entire US financial services sector and not just one company named Enron. It just happened that Enron's collapse exposed far more and deeper failures in reporting and financial accounting problems.

In fact, the two committees were already in the process of developing relevant legislative responses to the systemic failures when several other big US corporations started collapsing in quick succession. These included WorldCom, Adelphia, and Tyco. The reason why the committees needed legislative changes was the fact that investors were losing confidence in the US financial markets and it would not be long before the entire sector collapse – unless something was done urgently. Therefore, the Sarbanes–Oxley Act was designed to restore confidence among investors. Given the fact that the series of collapses of big US corporations ended almost as soon as the Sarbanes–Oxley Act was signed into law and implemented, there is justification to argue that the Act helped restore investor confidence. In the absence of the Sarbanes–Oxley Act – or any other legislative changes for that matter, there is reason to believe that there might have been a massive flight of investors from the US financial markets to other markets in Europe and especially in the UK.

Actually, a lot of research on the effectiveness of the Sarbanes–Oxley Act has centered on gauging the extent to which the investors shifted from the US market to other markets (especially to the London Stock Exchange). As would be expected, different findings have been reached mostly depending on the scope of the study and the type of firms investigated. At least a significant number of these studies have shown that not many large companies moved away from the US financial market; and that those that moved out were mostly smaller firms.[74] This finding could be explained in terms of the added financial costs associated with complying with the requirements of the Act and especially Section 404. Unlike large firms that could easily finance such increased operational (compliance) costs, owing to their larger capital base, smaller firms could struggle with managing these new costs.

[74] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 199.

Therefore, it can be argued that smaller firms may have been more negatively affected by the Sarbanes–Oxley Act than bigger firms; but then these effects had nothing to do with investor confidence. Instead, the reason why smaller firms; listing on US financial markets such as NASDAQ may have declined is due to concerns about mounting costs of compliance. This was expected given that the higher governance costs introduced by the Sarbanes–Oxley Act were as a result of screening of smaller firms which tended to generally have weaker corporate governance attributes.

Still, there is evidence that the Sarbanes–Oxley Act may have actually displaced business from the US to the UK – albeit to a limited extent. It really matters little whatever the displaced firms are small or large; the one thing that ultimately matters is that the Act has made it comparatively more costly for firms to invest in the US relative to jurisdictions without similar legislation or with similar legislations that are not as forcefully enforced as the Act. The reality is that the UK has its versions of the Act but they are not as forcefully enforced as it is done in the US. Therefore, it may be argued that if indeed investor confidence was restored then firms – small or gig – would not be leaving the US market and investing elsewhere.[75] One of the most accurate measures of investor confidence is investors' movement from across similar markets. As long as there is evidence of heightened movement of investors from one market to another, then investors could be said to have lost confidence in the market they are leaving.

Having argued that way, it is important to add that the ultimate goal of the Sarbanes–Oxley Act was not to enhance investor confidence in the US financial markets but rather to "protect investors by improving the accuracy and reliability of corporate disclosures."[76] This means that investors choosing to invest in the US are the ones whom the Sarbanes–Oxley Act sought to protect. As investors may choose where to invest as this is their right. However, it is the responsibility of the federal government – especially Congress – to ensure that those investing in the US are protected by ensuring that corporate financial disclosures are reliable and accurate. This protection has no doubt been achieved by the Act as it is now less likely for corporations to misreport or falsify financial statements to their advantage and to the detriment of investors.

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[75] Gerald J. Lobo and Jian Zhou, 'Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? Initial evidence.' (2006) 20 Accounting horizons 60.
[76] See Preamble to the Sarbanes–Oxley Act of 2002.

Even if the Sarbanes–Oxley Act may have increased the costs of doing businesses for small firms and possibly discouraged others from investing in the USD financial markets, this flaw could be said to have been addressed by the SEC when on September 15, 2010, it released the final rule 33–9142.[77] The rules expressly exempt registrants that, as defined by Rule 12b-2 of the Securities and Exchange Act of 1934, are neither accelerated nor large accelerated filers from the provisions of Section 404(b) of the Sarbanes–Oxley Act pertaining to audit requirements and internal control. According to the SEC, the purpose of the new rules was to ensure that they were in conformity to Section 404(c) of the Sarbanes-Oxley Act of 2002 as added by Section 989G of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 404(c) of the Sarbanes-Oxley Act of 2002 expressly states that "Section 404(b) of the Sarbanes-Oxley Act shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934." These amendments to the rules and forms of the SEC are definitely important in minimizing the negative effects on firms brought about as a result of the implementation of Section 404 of the Act.

On the issue of disclosures in periodic reports as provided for in Section 401 of the Act, it can be argued that the Sarbanes–Oxley Act may not have achieved its intended purpose – at last not fully. This is owing to the fact that during the global financial crisis, it emerged that some companies were still able to become exceedingly innovative with their finances and investment vehicles that it was not exactly clear how they were making their money. Lehman Brothers is a notable example in this regard. The company was found to have been engaging in practices that were similar to those of Enron prior to the global financial crisis. Some of the activities of the company were directly responsible for triggering the global financial crisis as well as the collapse of the company itself and many others not just in the US but across the world.

One of the reasons Enron had collapsed was that it has mastered the art of using off-balance-sheet instruments to cover up its true financial position. Specifically, Enron would move most of its assets and debts off the balance sheet and in doing so make itself appear more financially stable than it really was. For instance, it had the habit of registering canceled projects

[77] See SEC Release Nos. 33-9142; 34-62914.

as assets even though these were debts.[78] At first, only a limited amount of such debts were recorded as assets but much later it became the norm to record canceled projects or tenders assets regardless of their actual value. These "assets" were then moved off the balance sheet in order to avoid detection but were known to only a few employees and senior company executives. In the same way, Lehman Brothers were found to have used off-balance instruments known as "Repo 105" as a way of moving a large number of its assets off its balance sheet and in doing so made itself look more financially healthy even though it was on the verge of being brought down by debt. The ultimate goal of Lehman Brothers – just like that of Enron – was to make itself look financially attractive to investors and possibly maintain a favorable share price.[79]

If the Sarbanes–Oxley Act had indeed managed to address the issue in the first place, the same would not have occurred within a period of just five years. Specifically, the Sarbanes–Oxley Act requires that companies disclose all off-balance sheet items. Even though it was not exactly clear whether Lehman Brothers had not disclosed all its off-balance sheet items of if it disclosed them but regulators never saw anything wrong with them. Regardless, it is evident that the Act had not achieved the objective of ensuring that off-balance sheet items were disclosed with a view to determining both the extent of the use of these off-balance sheet instruments and whether available principles of accounting addressed these sufficiently.

It is highly likely that the SEC did not do enough to monitor and regulate Lehman Brothers' use of off-balance sheet instruments, an oversight that significantly contributed to the collapse of the company and the global financial crisis. If the Sarbanes–Oxley Act had to be effective in addressing problems related to off-balance sheet instruments and their use, perhaps it ought to have also made it mandatory for the SEC to also be watched over or regulated by another entity. Indeed in the wake of the global financial crisis of 2007/2008, the SEC was found to have failed in its regulatory role by allowing companies to develop exceedingly risky financial products for sale to investors. That this happened in spite of the clear provisions of the Act points to failures in the Act. Actually, it can be argued that the Act places many oversights and regulatory responsibilities on the SEC, something that may compromise enforcement capacity.

[78] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 197.
[79] Haidan Li, Morton Pincus, and Sonja Olhoft Rego, 'Market reaction to events surrounding the Sarbanes-Oxley Act of 2002 and earnings management' (2008) 51 The Journal of Law and Economics 111.

Another shortcoming of the Sarbanes–Oxley Act – and one that could be blamed on Congress – is that it has been ineffective owing to its failure to protect itself from the negative effects of other laws. Towards this end, both the House and the Senate have over the years (after the enactment of the Act) passed other legislations that have weakened the Sarbanes–Oxley Act. Otherwise, Congress has failed to authorize resources necessary for the implementation of the Act in its entirety or as required. The latter issue is of particular importance given the fact that any law is only as effective as it is enforced to the letter. Without proper implementation, even the most effective law becomes as good as nonexistent. Unfortunately, Congress has from time to time blocked or failed to pass bills that could have helped channel resources to the implementation of the Act. It has also passed bills that appear designed to deafest the very intent of the Act. Strong lobbying by some corporations against some provisions of the Sarbanes–Oxley Act (especially Section 404 on internal controls) could be part of the reasons why other bills are being passed that go against the intent of the Act.

Another concern raised with regard to the Sarbanes–Oxley Act is its tendency to hinder or discourage advance warnings regarding possible impending accounting problems. A common practice by firms in general and listed public companies, in particular, is to issue certain warnings in advance before releasing their quarterly or yearly financial results. These earnings serve the purpose of preparing investors for the actual news that a firm had made a loss or has recorded a poor performance than expected.[80] Other than profit warnings, listed firms can issue advance warnings on possible accounting problems. Truth be told, every firm experiences accounting problems once in a while, and it is best for all stakeholders if any such accounting problems are not only detected in advance but also communicated to investors. Among other benefits, such early warnings help show that a company takes its corporate governance seriously and that it is transparent and ethical. On the contrary, failure to issue such a warning could lead to loss of trust in the company and the possibility of the firm being suspected of engaging in accounting fraud or some other kind of cover-up.[81]

It is therefore important that the Sarbanes–Oxley Act enhances companies' ability to not just provide reports but also ensure that those reports provide advance warning of the likelihood

[80] Haidan Li, Morton Pincus, and Sonja Olhoft Rego, 'Market reaction to events surrounding the Sarbanes-Oxley Act of 2002 and earnings management' (2008) 51 The Journal of Law and Economics 115.
[81] Kate Litvak, 'The effect of the Sarbanes-Oxley Act on non-US companies cross-listed in the US' (2007) 13 Journal of corporate Finance 195.

of impending accounting problems. For some reason, the Act seems to have lowered firms' incentive to issue such warnings. This is in spite of the fact that the Sarbanes–Oxley has increased the number of reports that firms have to release or make public annually. Instead, only a small number of the reports released under the provisions of Section 404 of the Sarbanes–Oxley Act seem to offer some kind of early warning regarding the likelihood of impending accounting problems. This has in turn been attributed to the likelihood that the firms' reporting incentives that include the need for raising additional external capital, larger firm size and decreased external auditor objectivity – is most likely preventing firms from reporting internal control weaknesses early enough. The ultimate effect of this is that on its own – without the support of complementary legislations – the Sarbanes–Oxley Act may not be able to fully achieve its stated purposes especially with regard to internal controls.

CHAPTER FOUR: REFORMING COMPANY LAW AND SECURITIES REGULATION IN THE UK AND THE EU

Corporate Governance Legislation of the EU

The EU brings together at least 28 different countries each of which has its own unique legal system and especially corporate governance rules and legislation. As such, it has not been possible to have EU-wide legislation to address specific issues with regard to corporate governance. Instead, the approach taken at the EU level has been to come up with guidelines or rules that represent best practices and encourage – not require or demand – member states to adopt them and incorporate them in domestic law. As a result of changes in corporate governance practices in the last two decades, even EU guidelines have been changing to address emerging issues, challenges, and limitations.[82] In response, the EU has been issuing Directives from time to time requiring member states to comply with or consider certain changes as appropriate. The main focus of these EU directives has been ensuring that member states have in place corporate governance regulations that enhance the competitiveness of companies while protecting the rights of shareholders and employees. Balancing between these competing interests has been the ultimate goal of EU corporate governance legislation.

At the same time, the legislation seeks to ensure that there is accountability on the part of companies especially in the area of accounting. However, the major challenge for EU policymakers has often been coming up with legislative or legal reforms that enhance accountability without undermining the checks and balances that have been put in place. Moreover, it has remained a major challenge to these policymakers how far they ought to go – or can go – in order to harmonize corporate governance in Europe. This has mostly resulted in a legal system whereby the EU only comes up with draft recommendations or guidelines and leaves it for individual member states to decide which ones to adopt. Once adopted at the national level, companies also have the same prerogative to decide whether or not to comply with these guidelines which represent global best practices with regard to corporate governance.

[82] Financial Reporting Council, 'The UK approach to corporate governance' [2006] Financial Reporting Council.

As currently constituted, corporate governance within the EU can be said to be defined by or founded on two important action plans both of which were published by the European Commission (EC). These are the EU Action Plan of 2003 and the EU Action Plan of 2012. Of the two, the former is the most important as it was enacted just about the same time as the Sarbanes-Oxley Act. The EU Action Plan of 2003 sets out four main pillars pertaining to corporate governance. These are with regard to (1) modernizing the board of directors, (2) improving corporate disclosures; (3) Strengthening the rights of shareholders; and (4) overseeing the initiatives of corporate governance in member states. On the modernization of boards of directors, the most important issues addressed include separation between executive and non-executive directors, the independence of directors, the remuneration of directors, and collective responsibility. On the issue of disclosure, listed companies are required to provide an exhaustive comprehensive statement on corporate governance that covers important elements of these firms' corporate governance structures. This statement has to be accompanied by annual reports. Regarding the issue of strengthening shareholder rights, the requirement is for all shareholders within the EU to have equal rights.

Given that the UK is still a member state of the EU, it is important to use its corporate laws to better illustrate and understand the EU approach to corporate governance. The UK is particularly a good example in this regard because it is a Common Law jurisdiction similar to that of the US. Therefore, it is a lot easier to make comparisons between UK company law and US corporate governance law. UK company law is mostly based on – or inspired by – EU-level corporate governance guidelines.

Corporate Law of the UK

The Code: Origin and Key Provisions

The UK is one of the few countries in the developed world that did not take any reactive legislative measures in direct response to the Enron scandal in particular. Instead, it strengthened its Financial Conduct Authority Act which could be said to be the UK equivalent of the Sarbanes-Oxley Act.[83] Still, UK corporate law as is currently constituted could be said to have been enacted in response to corporate governance scandals similar to that of Enron. Known as the corporate governance code and formerly as the Combined Code, this set of laws on corporate

[83] S Grundmann, *European Company Law* (Intersentia 2006) 55

governance is part of UK Company Law and is designed to enhance good corporate governance practices among companies listed on the London Stock Exchange. The Financial Reporting Council oversees the Code whose importance derives from the Financial Services and Markets Act 2000.[84]

According to the Financial Services and Markets Act, all public companies have to expressly declare how they are complying with the Code as well as provide explanations of where they have failed to comply with the code. The same disclosure is not required of private companies;[85] and this makes UK corporate law slightly different from US corporate law and especially the Sarbanes–Oxley Act. Even though the Sarbanes-Oxley Act does not really apply to private companies as it does to public ones, some of its provisions extend to private entities. Moreover, UK corporate law could be said to largely use a principles-based approach in that it offers general guidelines with regard to industry best practices. This was opposed to the Sarbanes-Oxley Act which is based on rules and which adopts a rigid definition of the exact legal provisions that corporations have to fully adhere to.[86]

The UK Corporate Code brings together and refines different codes and reports on good corporate governance practices. The Cadbury Report of 1992 is especially an important source of the Code because it was prepared in response to a series of corporate governance scandals in the early 1990s. Specifically, the report was the product of investigations into the collapse of Polly Peck, a key British company that went under after several years of fraudulent financial reporting similar to that of Enron. Soon after, the Robert Maxwell and BCCI scandals followed; and this expanded the mandate of the committees that later developed the report to cover corporate governance issues as a whole.[87] In this regard, it can be argued that the UK did not take any immediate legislative measures in response to the Enron scandal because it had already taken such measures about nine years earlier.

Among the most critical recommendations of the Cadbury Report that were later made part of the Code included separation between the positions of chairperson and chief executive officer of public companies and ensuring that boards needed to have a minimum of three non-

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[84] Financial Reporting Council, 'The UK approach to corporate governance' [2006] Financial Reporting Council.
[85] A Dignam, 'A Principled Approach to Self-regulation? The Report of the Hampel Committee on Corporate Governance' [1998] Company Lawyer 140
[86] S Grundmann, *European Company Law* (Intersentia 2006) 53
[87] David Walker, 'A review of corporate governance in UK banks and other financial industry' entities (2009).

executive directors (with two of them being required to have no personal or financial ties to the company's executives). The other recommendation was that every board needed to have an audit committee made up of non-executive directors.[88]

Like in the US were the Sarbanes-Oxley Act generated a lot of controversy, the recommendations of the Cadbury Report generated a lot of controversy in the beginning. However, the report also emphasized that the recommendations could not be universally applied as each public company was unique in its own respect.[89] Even though the principles were made part of the Listing Rules of the London Stock Exchange in 1994, companies needed not to comply with them as long as they explained to the London Stock Exchange why not they could not comply.[90] Recommendations pertaining to executive pay were later incorporated following views collected by another committee. The second committee's findings were contained in the Greenbury Report of 1995. Its key recommendations included requiring boards to have remuneration committees and directors being required to have long-term pay that is pegged on performance.[91]

In 1998, a third report – known as the Hampel Report – came up with more suggestions. These included consolidating all the provisions of the first two reports to come up with one consolidated code known as the Combined Code. Moreover, it recommended that chairpersons of boards ought to function or at least be regarded as the leaders of the non-executive directors; and that all forms of remuneration – including pensions – needed to be disclosed. Finally, it recommended that all institutional investors needed to be open to the possibility of voting the shares they held at every meeting (as long as the voting was not compulsory). This third report also adopted the view that the UK would not follow the Germany or EU model regarding corporate governance. Over the subsequent years, new reports were generated by different committees in response to emerging corporate governance scandals and other corporate issues especially those involving public companies. In the end, the final Code contained provisions that were proposed in response to the Enron scandal.[92]

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[88] David Walker, 'A review of corporate governance in UK banks and other financial industry' entities (2009).
[89] V Finch, 'Board Performance and Cadbury on Corporate Governance' [1992] Journal of Business Law 581.
[90] E McGaughey, 'Votes at Work in Britain: Shareholder Monopolisation and the 'Single Channel'' (2017) 46 Industrial Law Journal 446.
[91] Financial Reporting Council, 'The UK corporate governance code' [2012] London, September.
[92] E McGaughey, 'Votes at Work in Britain: Shareholder Monopolisation and the 'Single Channel'' (2017) 46 Industrial Law Journal 444.

The current Corporate Governance Code contains five major sections. The first section (Section A) pertains to leadership and requires that companies be headed by an effective board that is responsible – in a collective manner – for the company's long-term success. Moreover, it requires that clear divisions be created between the board's responsibilities and those of the chief executive officer when it comes to running the company and running of the board. The leadership of the board is vested in the chairman while the chief executive officer is responsible for the running of the business of the company.[93]

The most important provision of Section B is that directors ought to be appointed in a transparent, formal, and rigorous manner.[94] This is important because it ensures that the directors of every company are people who have the requisite skills and can effectively discharge their responsibilities. It could also help prevent the hiring of directors who may be conflicted or who are closely related – personally or otherwise – to the company's executives. In this regard, Section B emphasizes the need for both the board and its committees to have the requisite level of independence and possess the relevant skills and core competencies. Knowledge of the company's operations is also given priority.[95] The issue of independence of boards is important in this regard as it mirrors the provisions of the Sarbanes–Oxley Act. Independence of members of the board and its different committees – especially the audit committee – is paramount as it limits the tendencies by board members to collude with management in defrauding investors.

Section C pertains to accountability and is without any doubt one of the most important. The provisions of this section reflect those on internal controls in the Sarbanes–Oxley Act. More specifically, Section C requires the board to avail understandable and balanced assessments of the prospects and position of the company. This includes making a determination of the extent and nature of risks the company can take in order to achieve its business objectives. Most importantly, it provides that boards have to be responsible for the maintenance of internal control and risk management systems that are sound.[96] Like the provisions in Section 404 of the Sarbanes–Oxley Act, these provisions are intended to ensure that there are adequate internal

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[93] Sridhar Arcot, Valentina Bruno, and Antoine Faure-Grimaud, 'Corporate governance in the UK: Is the comply or explain approach working?' (2010) 30 International Review of Law and Economics 193.
[94] A Dignam, 'A Principled Approach to Self-regulation? The Report of the Hampel Committee on Corporate Governance' [1998] Company Lawyer 140.
[95] Erik Berglöf and Anete Pajuste, 'What do firms disclose and why? Enforcing corporate governance and transparency in Central and Eastern Europe' (2005) 21 Oxford Review of Economic Policy 178.
[96] Luca Enriques and Paolo Volpin 'Corporate governance reforms in continental Europe' (2007) 21 Journal of Economic Perspectives 117.

controls to ensure that the true and accurate condition of the company is known to all inventors. Such internal controls enhance transparency in reporting and reduce the risk of fraudulent accounting practices.

Section D of the Code deals with remuneration and emphasizes the need for such remuneration to be not just sufficient but also capable of attracting, motivating, and retaining directors of the requisite quality. In essence, the company needs to be able to pay its directors enough compensation to motivate them and ensure they do not leave. Otherwise, the pay should be able to attract new managers capable of ruling the company successfully.[97] This was one area where Enron greatly failed by offering extremely high compensation that was clearly unsustainable. At one time, it is known that it paid its executives and employees more than double the compensation paid by its competitors. Usually, such unrealistic bonuses and compensations are designed to cover up for something sinister. In the case of Enron, the unusually high compensation was designed to purposely prevent employees from having to worry about costs and instead focus on being innovative and keeping the company’s share price high. Section D of the Code makes it clear that public companies must have a clear, transparent, and formal policy on executives’ compensation as well as for fixing remuneration packages for each director.[98] Most importantly, it requires that directors be barred from taking part in the decision-making involving or pertaining to their own remuneration.[99]

Effectiveness of the Code

These provisions have had the effect of ensuring that there is no conflict of interest among directors and/or executives of companies when it comes to remuneration. This was evidenced by the Enron scandal where Enron’s executives not only determined their own remuneration but also paid themselves far more than was necessary for them to be retained at the company. As was noted before, remuneration at Enron may have been structured in such a way that it properly linked rewards to both individual and corporate performance. However, there were no formal procedures for the development of policies on executive pay. Instead,

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[97] Luca Enriques and Paolo Volpin, ‘Corporate governance reforms in continental Europe’ (2007) 21 Journal of Economic Perspectives 117.
[98] S Arcot and V Bruno, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance' (2007).
[99] Sridhar Arcot, Valentina Bruno, and Antoine Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ (2010) 30 International Review of Law and Economics 193.

compensation was based on the performance of the company's share price such that as long as the share price remained high executive compensation also remained high.[100]

Enron's directors must have also taken part in deciding their own remuneration, an oversight that definitely contributed to an increased appetite for corporate success to sustain the high levels of remuneration. Finally, even though pay was linked to the performance at both the individual and cooperate levels, this performance was measured in the short-term; and this often overlooked the fact that there would be financial restatements later on. In fact, this was done deliberately in order to ensure that executive compensation was preserved regardless of the final results of the company.[101] Therefore, it suffices to argue that in the long-term there was no link between executive compensation and performance of the organization –or even of individuals.

Compliance with the Code in the UK has been varied given the fact that the Code is not legally binding but only a set of guidelines. As noted before, these guidelines are meant to be applied only by those firms which find it beneficial for them to be applied. Those firms that think – or know –that the guidelines are not appropriate for them may choose not to comply with them subject to giving an explanation. Clearly, a company cannot lack an explanation for not complying with a legal requirement or guideline. Therefore, it ought not to come as a surprise that the Code has achieved a fairly low level of compliance compared to compliance with the Sarbanes–Oxley Act. At approximately 33% compliance,[102] this is far lower than in the US. However, this level of compliance could be considered moderate or even high given the fact that these are guidelines that are not mandatory. Had they been mandatory, every company would have complied or chosen to move elsewhere where regulations are not strictly enforced or nonexistent. The non-compliant companies may still be uncertain about the guidelines' benefits relative to their costs.

It is also worth adding that the transparency standards among UK corporations are comparatively higher than their US counterparts.[103] This could explain why the Code consists of guidelines and not legally binding provisions. It means that UK corporations are less likely to

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[100] Pamela L. Cox, Barry Friedman, and Ann Edwards, 'Enron: The smartest guys in the room—Using the Enron film to examine student attitudes towards business ethics' [2009] Journal of Behavioral and Applied Management 14.
[101] Ibid.
[102] See PIRC, Review of the impact of the Combined Code (2007); S Arcot and V Bruno, 'One Size Does Not Fit All, After All: Evidence from Corporate Governance' (2007).
[103] Mairi Maclean, Charles Harvey, and Jon Press, *Business Elites and Corporate Governance in France and the UK* (Palgrave Macmillan, London, 2006) 2.

engage in fraudulent activities than their US counterparts; and this explains the differences in the manner in which issues of corporate governance are approached in the two Common Law jurisdictions. In the UK, the emphasis is on the view that no single law or recommendation can apply equally and with the same effects to all corporations owing to their uniqueness.[104] In the US, the opposite view that one law can fix the corporate governance problems of all corporations seems to have prevailed. This illustrates a different approach to the same issue but mostly with the same results. Like in the US where several corporations failed in the wake of the enactment of the Sarbanes–Oxley Act, at least major corporate failure occurred in the UK at the same time. Both Lehman Brothers and Northern Rock failed during the global financial crisis and long after both countries had come up with their respective laws concerning corporate governance. Under such circumstances, one cannot help but wonder whether the Code and the Sarbanes–Oxley Act have achieved the goal of enhancing good corporate governance practices among public companies.

Another important and related question pertaining to the compliance with the Code is the apparent tension between the desire (even need) to achieve consistency and that of maintaining flexibility. This is an issue of importance because it is evident that the UK is attempting to achieve both at the same time. A decision needs to be made once and for all on which between consistency and flexibility is more important for the country in terms of helping deal with issues of corporate fraud and especially misrepresentation of financial statements. In this regard, the approach taken by the US ought to be commended because at least it has yielded the desired results. Today, there is near-consensus that the Sarbanes–Oxley Act has, among other achievements, managed to significantly improve corporate governance practices especially in the area of internal controls for both accounting firms and public companies.

The reason this much success was achieved is that Congress made the decision to adopt one approach regardless of how controversial or costly it would be. Subsequently, Congress chose to go with achieving consistency so that all US public companies would comply with the Act. Many complained and some even moved out. However, there is near-total compliance now; and those that have complied are more than happy and grateful that they did. The few that failed to comply are in the process of doing so and are being facilitated by the SEC to do so. Among

[104] Sridhar Arcot, Valentina Bruno, and Antoine Faure-Grimaud, ‘Corporate governance in the UK: Is the comply or explain approach working?’ (2010) 30 International Review of Law and Economics 193.

other issues, this shows that the ultimate object of the Sarbanes-Oxley Act was not to punish the innocent firms alongside the guilty by increasing costs of compliance (as has been argued by some analysts opposed to the Act). However, the object was to ensure that every player is brought on board and made to comply in spite of the high cost.

The UK has chosen to use both approaches; and to be fair, there is no evidence that this is working as planned or expected. Fewer corporate governance scandals may have been reported in the UK than in the US since 2002 when the Sarbanes–Oxley Act came into effect. However, the difference has more to do with the differences in national and corporate cultures of the two countries than the effectiveness of their laws. In the UK, levels of transparency are generally higher than in the US. Therefore, company executives, directors, and board of directors are less likely to engage in accounting fraud whether or not there are laws against such fraud. In the US, lower levels of transparency tend to not just encourage but also sustain and conceal accounting fraud. Therefore, corporations in the US are better prevented from engaging in accounting fraud through the use of the law than through the use of optional best practices or guidelines.

In fact, there is reason to believe that had the Code been implemented in the US as it has been in the US, more corporate governance scandals would have been uncovered in the wake of the code's implementation. On the other hand, the UK may have opposed the implementation of a law similar to the Sarbanes-Oxley Act as corporations would regard it as an attempt to take away their freedom. This is because UK corporations have a long history of – and are therefore used to – ethical business practices that discourage accounting fraud.[105] This explains why the most that could be done in response to scandals similar to that of Enron is to come up not with a binding legal framework or legislation but a set of guidelines for companies to follow if they so wish. The prevalent view in the US seems to be that flexibility is by far more important than consistency. The good thing about the UK is that no corporation seems eager to exploit regulatory or legal loopholes to engage in accounting fraud and other malpractices.

Still, there is need for action especially in light of the fact that globalization has significantly altered national and corporate cultures. With a growing number of US firms now moving to London and British firms investing in the US, the common assumption that British companies are more ethical and will not engage in governance malpractices may no longer hold

[105] Ruth V. Aguilera, 'Corporate governance and director accountability: An institutional comparative perspective' (2005) 16 British Journal of Management S39; S Arcot and V Bruno, 'In Letter but not in spirit: An Analysis of Corporate Governance in the UK' (2006).

true. Therefore, the UK may need to seriously consider seeking to achieve some consistency rather than flexibility in its approach to corporate governance issues. It is better for companies to experience some restrictions now but prevent a catastrophic financial crisis likely to be triggered when companies engage in accounting fraud or when there are massive corporate failures as happened in the early 1990s. So far, the Code has wavered between the two extreme ends namely practices that have been tested and tried over time and aversion to solutions that could be described as “one size fits all.” It is best if it chose one approach and stuck to it in order to maximize compliance.

There is little doubt, if any at all, that the Code contains important guidelines for corporations that can help them prevent accounting fraud. These guidelines have also been tested and tried and proven to be successful. However, it is one thing for a country to have effective strategies and a whole different issue altogether for the strategies to be put to good use. As it is, the Code is only good on paper as long as it is not applied equally and consistently across the industry. In fact, it is a worrying trend for some companies to apply all the guidelines and others not to apply even a single one. Even though different companies have different corporate cultures and as such need varying degrees of compliance with the Code, the benefits associated with consistency cannot be overlooked. Among other benefits, consistency makes it easier for regulatory agencies to monitor compliance with the regulations. Without effective monitoring, the regulations may only be partially applied or not applied at all; and this could lead to more corporate governance problems. Moreover, companies always tend to look for the easiest and less costly way out of problems. Therefore, they are prone to overlooking or circumventing available legal and regulatory provisions to achieve their financial goals. Therefore, they are more likely to comply with regulations if they are compelled to comply than if they are given the option to decide whether or not to comply.

Once again, it all comes down to their perceived or real relative costs of complying versus not complying. In the event that not complying is determined to be more beneficial to companies than complying (especially in terms of the costs saved as a result), these companies are effectively on their own and can easily engage in malpractices. In the case of the Code, the onus is on companies to decide what to do; and this may have far-reaching implications for the entire financial sector. Specifically, the firms that find non-compliance to be working for them may or may not be punished by investors depending on whether or not investors support the view.

Different investors will adopt different positions on such a matter with some preferring that their companies do not comply with the guidelines and others preferring that their firms comply. This, in turn, depends on the financial metrics of each individual firm. The goal of shareholders is to maximize their returns on investments by ensuring that the company’s share price is as high as possible. This could mean that they will support compliance or non-compliance depending on which one of them has the greatest chance of increasing the company’s share price. If firms decide that they will not comply and their shareholders think otherwise, it is likely that such a love would prove counterproductive as investors would punish the company through a mass exodus of those investors. On the other hand, if firms decide not to comply and get the approval of their shareholders then nothing much may come out of it that negatively affects the firm. The implication is that it is largely the responsibility of the shareholders to decide whether or not to punish companies for compliance or non-compliance.

Unfortunately, there are times when by the time shareholders act a lot of damage has already been done to the company. The market (shareholders) can without a doubt bring about accountability to companies. However, this is only to a limited extent. On the other hand, the law definitely brings accountability to the market albeit with some increased costs to some companies relative to others. The UK ought to decide once and for all whether it will wait for the market to hold firms accountable or if it will use the law. Currently, it is still somewhere in between with the law being applied in some instances and market forces being left to do the monitoring in other instances. There is no saying for certain which approach is better than the other especially given the different national and corporate cultures UK forms have relative to their US counterparts.

CHAPTER FIVE: CONCLUSIONS

The Enron scandal may have taken place nearly two decades ago but its effects are still being felt in the form of legislative changes enacted to address the problems it uncovered. From the US to the EU, the overarching goal has been to ensure that no similar scandal occurs by closing and tightening the legislative and regulatory loopholes on which Enron capitalized. As a result, there are in place some of the most comprehensive legislations corporate and company laws ever enacted in the modern history of the corporate world. While they are different, they have more or less the same goal. Yet the most important thing is not to have laws in place but preventing corporate governance malpractices and problems similar to those uncovered by the Enron scandal. It is possible for one country or legal jurisdiction to have enough laws to address issues of corporate governance but never achieve much in terms of tangible positive outcomes. Another country may have fewer laws but its corporations could be more ethical and therefore less prone to engaging in governance malpractices. Therefore, the most important aspect is to a system that works regardless of whether it is centralized regulation or self-regulation.

Still, investigation of the legislative responses of the UK and the US to the Enron scandal and similar scandals is important given the fact that the Enron scandal was not the first such scandal and may not be the last depending on the effectiveness of the laws enacted in the aftermath of the scandal. In this regard, the main focus is on the Sarbanes–Oxley Act of 2002[106] in the US and the similar legislation in the UK. It is also worth noting at this point that within approximately seven years after the Enron scandal was uncovered, US financial sector firms were once again engaged in financial malpractices that triggered the global financial crisis. Among the offenses committed by these firms were improper accounting practices that were strikingly similar to those committed by Enron.

Taking these contextual issues into consideration, there is every reason to question the effectiveness of the corporate law regimes of the US in particular in sustainably addressing the issue of corporate accounting disclosure. If the Sarbanes–Oxley Act of 2002 had been well-thought-out in the first place, it should have prevented American corporations from engaging in malpractices that threatened not just themselves but also others with which they did business. In arguing so, it is appreciated that the scandals that triggered the global financial crisis may not have been of an accounting or reporting nature. However, it is a fact that both the Enron scandal

[106] Public Law 107–204, Approved July 30, 2002, 116 Stat. 745.

and the malpractices of other corporations in the lead-up to the global financial crisis constitute corporate governance challenges which the Sarbanes–Oxley Act of 2002, in particular, was designed to address. This is why it was important to critically analyze the Sarbanes–Oxley Act of 2002 and related corporate governance laws as only such could help answer the many questions about corporate prudence in the US and the UK.

Other than the leading to the enactment of the Sarbanes–Oxley Act of 2002 and the reforming of the rules of both NASDAQ and the New York Stock Exchange, the Enron scandal also added impetus to corporate law reform in the UK. In particular, the UK's company laws have been reformed by, among other issues, addressing three main areas of conflict that were identified as contributing the most to corporate scandals. These involved executive directors or management of companies, companies' non-executive directors, and companies' auditors. Often, it is the collusion among these three that leads to scandals, and reducing the likelihood of such collusion was deemed critical in preventing corporate scandals like Enron.

Towards this end, it may be concluded that the Sarbanes-Oxley Act has achieved a lot in terms of dealing with corporate governance problems. Specifically, the Act has addressed internal control issues and ensured that corporations are made more accountable for their actions and inactions. In doing so, investors are better protected than used to be the case. It has also eliminated issues of conflict of interest to a large extent. In the UK and the EU, the same gains have largely been reached. However, the one notable problem that remains in the UK is that the Corporate Governance Code seems to be tittering between seeking to achieve consistence and maintaining flexibility. This is because the Code consists of legal guidelines that are optional to corporations as opposed to legally binding laws. While the code has a lot of flexibility in that corporations can elect to comply or not to comply with it, there is no consistency. This has the implication that the responsibility to hold corporations to account still lies with the investors.

Leaving the market to hold corporations to account has its merits and demerits. However, it is a risky approach in the 21st century because it can easily cause disaster. In the wake of globalization where corporations are unlimited in terms of where to invest, there are no guarantees that the good, largely ethical corporate culture that has been predominant in the UK or among UK corporations will remain forever or will be taken up by non-UK corporations listing on the London Stock Exchange. On the contrary, these foreign firms are likely to bring their corporate cultures with them; and this may negatively affect corporate governance practices in the UK.

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Abstract

Der Enron-Skandal und der darauf folgende Zusammenbruch von Enron im Jahr 2001 waren in der Finanzwelt beispiellos. Während andere Unternehmensskandale in den Vereinigten Staaten (USA) und in Europa (insbesondere in Großbritannien) vor dem Enron-Skandal aufgedeckt wurden, war der Enron-Skandal weitaus systematischer, sorgfältiger geplant, und hatte schwerwiegende Auswirkungen auf die Unternehmensführung in den USA und auf der ganzen Welt. Der Skandal konzentriert sich auf die Tatsache, dass die Finanzlage der Enron Corporation durch kreativ geplanten, systematischen und institutionalisierten Rechnungslegungsbetrug gestützt wird. Als Anfang der 2000er Jahre Ermittlungen zum Enron-Skandal und zu ähnlichen Fragen der Unternehmensführung bei anderen Unternehmen begannen, veranlasste das Enron, einen Insolvenzantrag gemäß Kapitel 11 des US-amerikanischen Insolvenzgesetzes zu stellen. Die Einreichung eines solchen Insolvenzantrags wurde zum Teil durch die Aufdeckung von Rechnungslegungsbetrug und zum Teil durch das nachlassende Vertrauen der Anleger in das Unternehmen ausgelöst. Zum Zeitpunkt der Insolvenzanmeldung im Dezember 2001 war Enron das größte Versagen der Wirtschaftsprüfer und die größte Insolvenz - Umstrukturierung in der Geschichte der USA. In beiden Hinsichten sollte er später von WorldCom und Lehman Brothers überholt werden.

Diese These untersucht Änderungen in der Unternehmensführungsgesetzgebung in Europa und den USA infolge des Enron-Skandals. Das Ziel war, tiefer in den Enron-Skandal einzutauchen, um seine Auswirkungen auf Änderungen des Gesellschaftsrechts in den USA, Großbritannien und der EU zu entdecken, und insbesondere eine Bilanz aus dem Skandal als Folge der Auflösung von Enron zu ziehen. Ziel der Studie ist es, die Wirksamkeit von Gesetzen zu bestimmen, die als Reaktion auf den Enron-Skandal erlassen wurden, zwecks Verhinderung solcher Skandale. Um diese Ziele zu erreichen, musste die These die übergeordnete Frage beantworten: Wie hat sich der Enron-Skandal auf Gesetzesänderungen im Gesellschaftsrecht der USA, Großbritanniens und der EU ausgewirkt? Drei weitere Fragen wurden beantwortet: (1) Wie haben die EU- und US-Gesetzgebung auf den Enron-Skandal reagiert?; (2) Wie wurden die Unternehmensgesetze der USA, der EU und des Vereinigten Königreichs geändert, um ähnliche Skandale wie der Enron-Skandal zu verhindern?; und (3) Inwieweit konnten seit dem Enron-Skandal Änderungen in der Unternehmensführungsgesetzgebung vorgenommen werden, um die

erklärten oder beabsichtigten Ziele der Verhinderung von Rechnungslegungsbetrug und die allgemeinen Probleme der Unternehmensführung zu erreichen?

Es wurde festgestellt, dass die USA auf den Skandal und den Zusammenbruch von Enron reagieren, indem sie eines der umfassendsten Unternehmensgesetze verabschieden - das Sarbanes – Oxley Gesetz von 2002. Das Gesetz schafft es, die meisten vom Enron-Skandal aufgedeckten Fragen der Unternehmensführung zu regeln. Hierzu zählen Themen wie unzureichende interne Kontrolle, Interessenkonflikte, Vergütung von Führungskräften und die Verwendung von Aktienoptionen als Form der Vergütung von Mitarbeitern. Das Vereinigte Königreich hat seinerseits nicht direkt und unmittelbar auf den Enron-Skandal reagiert, im Vergleich mit anderen EU-Ländern wie Deutschland und Frankreich. Der Grund dafür war, dass das Vereinigte Königreich bereits etwa ein Jahrzehnt zuvor, als mehrere seiner eigenen Unternehmen zusammengebrochen waren, ähnliche Legislativempfehlungen abgegeben hatte. Das Vereinigte Königreich hat es jedoch geschafft, seine Unternehmensführungsgesetzgebung zu modernisieren und zu verbessern, um neue Themen zu berücksichtigen, die vom Enron-Skandal aufgedeckt wurden. Sowohl der britische Kodex als auch das britische Gesetz haben sich bei der Bewältigung von Fragen der Unternehmensführung als weitgehend wirksam erwiesen, obwohl immer noch Umsetzungsprobleme bestehen.

The Enron scandal and the subsequent collapse of the Enron Corporation in 2001 were unprecedented in the financial world. While other corporate scandals had been uncovered in the United States of America (US) and Europe (especially the United Kingdom (UK)) prior to the Enron scandal, the Enron scandal was by far more systematic, carefully planned and with far-reaching implications for corporate governance practice in the US and across the world. The scandal centered on the fact that the financial condition of the Enron Corporation was being sustained by creatively planned, systemic and institutionalized accounting fraud. When investigations were launched into the Enron scandal and similar corporate governance problems affecting other corporations in the early 2000s, they led to Enron filing for bankruptcy under Chapter 11 of the US Bankruptcy Code. This filing for bankruptcy was partly driven by the discovery of the accounting fraud and partly because of waning investor confidence in the company. At the time of filing for bankruptcy in December 2001, Enron was the biggest audit failure and the largest bankruptcy reorganization in the history of the US. It was to be overtaken later in both respects by WorldCom and Lehman Brothers.

This thesis explored the changes in corporate governance law in Europe and the US in the wake of the Enron scandal. Its aim was to dig deeper into the Enron scandal with a view to discovering how it influenced changes in corporate legislation in the US, UK, and EU in its aftermath and especially in the wake of the collapse of Enron. The objective of the study is to determine the effectiveness of the laws enacted in response to the Enron scandal in terms of preventing similar scandals. To achieve these objectives, the thesis had to answer the overarching question: How did the Enron Scandal influence legislative changes to US, UK, and European Union (EU) corporate laws? Three supplementary questions were also answered: (1) What were the EU and US legislative responses to the Enron scandal?; (2) How were the US, EU, and UK corporate laws amended to prevent scandals similar to the Enron scandal?; and (3) To what extent have the post-Enron corporate governance legislation changes managed to achieve their stated or intended purposes of preventing accounting fraud and overall corporate governance problems?

It was found the US responded to the Enron scandal and collapse by enacting one of the most comprehensive corporate laws ever – the Sarbanes–Oxley Act of 2002. The Act has managed to address most of the corporate governance problems uncovered by the Enron scandal.

These include those problems pertaining to weak internal controls, conflict of interest, executive compensation and the use of stock options as a form of employee compensation. On its part, the UK did not directly and immediately respond to the Enron scandal as did several other countries in the European Union (EU) such as Germany and France. This was because the UK had already come up with similar legislative recommendations about a decade earlier when several of its own corporations had collapsed. Still, the UK was able to modernize and improve its Corporate Governance Code to address new problems uncovered by the Enron scandal. Both the UK Code and the Act have been largely effective in addressing corporate governance problems even though implementation challenges remain.