The Enron Scandal That Prompted the Sarbanes-Oxley Act

The Sarbanes-Oxley Act is a federal law that enacted a comprehensive reform of business financial practices. The 2002 Sarbanes-Oxley Act aims at publicly held corporations, their internal financial controls, and their financial reporting audit procedures as performed by external auditing firms.

The act was passed in response to a number of corporate accounting scandals that occurred in the 2000–2002 period. This act, put into place in response to widespread fraud at Enron and other companies, set new standards for public accounting firms, corporate management, and corporate boards of directors.

Enron and the Need for Internal Financial Controls

A large scandal involving the public company Enron showed the American public and its representatives in Congress that new compliance standards for public accounting and auditing were sorely needed. Enron was one of the biggest and, it was thought, one of the most financially sound companies in the U.S.

Enron, located in Houston, Texas, was considered one of a new breed of American companies that participated in a variety of ventures related to energy. It bought and sold gas and oil futures, built oil refineries and power plants, and became one of the world's largest pulp and paper, gas, electricity, and communications companies before it filed for bankruptcy in 2001.

Several years before Enron's bankruptcy, the government had deregulated the oil and gas industry to allow more competition, but deregulation also made it easier for companies to act fraudulently. Enron, among other companies, took advantage of this situation.

The various misdeeds and crimes that Enron's officers and employees committed were extensive and ongoing. Particularly damaging misrepresentations produced inflated earnings reports for shareholders, many of whom eventually suffered devastating losses when the company failed. Many other instances of dishonesty and fraud also occurred, including embezzlement of corporate funds by Enron executives and illegal manipulations of the energy market.

The Sarbanes-Oxley Act

In order to cut down on the incidence of corporate fraud, U.S. Senator Paul Sarbanes and U.S. Representative Michael Oxley drafted legislation known as the Sarbanes-Oxley Act (SOX). The intent of SOX was to protect investors by improving the accuracy and reliability of corporate disclosures in financial statements and other documents by:

In response to what was widely seen as collusion between Enron and public accounting firm Arthur Andersen & Co. concerning Enron's fraudulent behavior, SOX also changed the way corporate boards deal with their financial auditors.

All companies, in accordance with SOX, must now provide a year-end report regarding the internal controls they have in place and the effectiveness of those internal controls.

Although the Sarbanes-Oxley Act of 2002 is generally credited with having reduced corporate fraud and increasing investor protections, it also has its critics. Some analysts have negative views about the degree to which Congress has weakened the act over time by withholding funding necessary to put these reforms into motion and by passing bills that effectively counter the intent of the act. Other critics have opposed the act because it increases corporate costs and reduces corporate competitiveness.

Sox Today: Opposing Viewpoints

The results of the SOX legislation continue to receive mixed reviews, although a 2017 study published by the American Accounting Association (AAA) provides evidence that the requirements SOX set for financial reporting and public audits have, in fact, served as an extremely effective warning process in detecting corporate fraud.

The AAA report discusses a link that has been established between companies with weak internal financial controls and the incidence of undisclosed fraud. From a sample of roughly 3,500 public companies studied over a three-year period, about 1,500 had material financial weaknesses.

During the three years studied, over 8 percent of those companies were involved in legal actions as a result of fraud. The report also states that even in the absence of fraud, companies with weak internal financial controls consistently underperformed the market.

Critics still focus on the cost burden that corporations must bear to implement and maintain the processes for SOX compliance; Tom Farley, the former head of the NYSE Group, which includes the New York Stock Exchange, has been one vocal critic. Farley claims that, among other things, the costs have led to fewer companies going public, and he continues to urge lawmakers to change the law’s provisions.

Public accounting firm Ernst & Young, conversely, has highlighted the benefits of SOX compliance—including increased investor confidence and a decrease in the severity of companies’ financial restatements—as reasons to keep the existing laws in place.