



THE ACCOUNTING AFTER THE 2000S FINANCIAL SCANDALS CASE OF ENRON AND WORLDCOM

REDDA Khadidja*

Djillali Bounaama University - Khemis Miliana (Ain Defla) - k.redda@univ-dbkm.dz

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SUMMARY:

The purpose of this paper is to highlight the implications of the financial scandals of Enron and WorldCom for the accounting. In other words, and using a descriptive analytical methodology, we will present a short explanation about how the aforementioned companies succeeded in deceiving Wall Street for such a long time by presenting themselves as a very successful companies. After that, we conclude the article by citing the new rules introduced by the International Accounting Standards Board, in order to limit the manipulation that have taken place in that period.

KEY WORDS: financial scandals, accounting, new rules, Sox act.

JEL CLASSIFICATION : M4, M40, M41, M42, M49.

INTRODUCTION:

The last two decades saw a number of financial scandals that are classed among the worst accounting scandals in history. Billions of dollars were lost, companies were destroyed and a lot of peoples' lives were ruined as a result of these financial disasters .

In this context, we will look at two among the ten biggest accounting scandals in the early 2000s and their impact on the accounting, which are Enron and WorldCom.

These scandals were chosen above the other companies' failures because of the huge impact that they had on the accounting as a profession and a discipline. Even if this remains true, it should be noted that Enron (2001) is the granddaddy of them all and If WorldCom tipped the political scales toward the different changes that we will set later, it was only because it was preceded by Enron.

In this article, we will try to provide answers to the following question: **What major changes occurred as a result of the accounting scandals of Enron and WorldCom?**

In ordrer to answer the question above, we will try to subdivide it to **sub-questions** as the fllowing:

- What do we mean by financial scandals? And what manipulations had happened inside Enron and WorldCom?
- What are the main rules that have taken place after Enron and WorldCom's financial scandals?

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As **hypotheses**, which will serve as provisional answers for the previous questions, we say:

- By financial scandals, we refer to different manipulations used by companies to hide their true values. And this what did both of Enron and WorldCom.
- At the period of post Enron and Worldcom's financial scandals, some of new rules have taken place such as the SOX act.

We cite these questions as well as these hypotheses in order to identify the following **objectives**:

- Explain the meaning of the financial scandals' terme;
- Briefly explain the manipulations used by Enron and WorldCom to hide their true value;
- Highlight the main rules put in place by the IASB to deal with the problems encountered in accounting after the financial scandals of Enron and WorldCom.

In order to reach the previous objectives, we set the plan below:

First of all, we will define the word scandal, then we will present a short historical overview of Enron and WorldCom's financial scandals and finally, we will try to offer an explanation of their impacts on accounting.

➤ **PREVIOUS STUDIES:**

The purpose of this study is to identify the major changes that have occurred on the accounting after the fall of the two geants Enron and WorldCom. To note, studies on this subject are numerous, but each one deals with the subject from a different angle.

Previous literature shows that three lines of research could be distinguished. While the first stream of research focuses on the presentation of the manipulations used by the afermentioned companies to deceive people and than representing themselves as profitables companies. The second investigates the principals rules that have affected the accounting in that period, and the third one focuses on the Sox act as the most important change that had taken place after the financial scandals of Enron and WorldCom.

Within the framework of this research, the major focus of this study is centered around examining the main manipulations used by Enron and WorldCom in order to confuse public opinion. In other words, in this article, we are looking at how the previous companies manage to present themselves profitable when their actions were not worth more than one dollar. This on the one hand.

On the other hand, we will try to determine the most relevant changes that have affected the accounting as a profession, especially in the period following the announcement of the fall of Enron and WorldCom.

Noteworthy, Anthony Abdalnor Pishay in his Project "the fall of Enron and its implications on the accounting profession" Presented to the Faculty of California State University, San Bernardino (June 2003), aimed to develop significant implications for the accounting profession based on an in-depth analysis of the fall of energy giant Enron Corporation. His paper includes details about how the company managed to deceive Wall Street for such an extended period of time and. The scope of his study also covers the unfolding of certain details about the accounting scandal

surrounding the company and which led to its eventual bankruptcy. Anthony had specifically highlights Enron above other companies' failures because of the huge impact this company had on the existing self-regulatory financial reporting system.

As for Jeffrey Unerman & Brendan O'Dwyer, (Journal of Critical Perspectives on Accounting, 2004) in their article titled: "Enron, WorldCom, Andersen et al.: a challenge to modernity". Have used the lens of Anthony Giddens' theories regarding the mechanisms which sustain late-modernist societies [The Consequences of Modernity, Polity Press, Cambridge, 1990; Modernity and Self-Identity, Polity Press, Cambridge, 1991] to analyse the 2001 and 2002 accounting and audit failures at Enron, WorldCom and Andersen. Assessments of risk and trust play a central role in Giddens' model, and their paper traces an escalating withdrawal of trust in systems of audit and accounting, and related increased perceptions of risk in corporate investment instruments. It also analyses regulatory responses aimed at sustaining or regaining public trust, and argues that failure to sustain such trust risks compromising the continued momentum of late modernity and the interests of people who benefit from institutions of late modernity.

Similarly, Andrew Holt and Timothy Eccles "Accounting practice in the postEnron era: The implications for financial statements in the property industry" used the Enron case and similar financial events to highlight the accounting issues arising from recent corporate failures, and to examine the implications for the future. These include whether it could happen outside the USA, what lessons are being learned and the implications for those involved in real estate and property management. The case argued there is that all financial statements are simply artificially constructed realities attempting to describe the (financial) well being of a company within a framework of prescribed rules determined by socio-economic debates. The perceived laxness of US accounting regulations compared with UK and International Accounting Standards (IAS) adds weight to the calls for adoption of universal standards within the USA, since Europe claims with some qualification that 'it could not happen here'.

Moreover, in the article titled "The role of a crisis in reshaping the role of accounting" published in the J. Account. Public Policy, the author, Alnoor Bhimani thinks that prior to 2001, international accounting standards (IAS) were insufficiently attractive to gain the support of US regulators. And the potential role of IAS in the US gained prominence during a period of extreme financial reporting instability in 2001–2002. According to Alnoor, emerging opinion increasingly upheld principles-based rather than rulesbased accounting standards in the face of the financial reporting crisis. But to promote any active shift in the US position, an institutionally legitimate infrastructure for the international accounting standards setter had to be created. As this was taking shape, the globalisation of business activities grew with inter-organizational linkages and cross-national financial inter-dependencies and flows becoming increasingly complex. Given the extensively uncertain, uneven and constantly evolving nature of global business changes, the aptness of applying judgment in assessing financial performance and position rather than relying on the application of predefined rules continued to achieve wider acceptance. The argument is made in the paper that international financial reporting standards are today seen to fulfil a global risk-mitigating role founded on a logic that had to first gain political and institutional legitimacy and that had to be viewed as being responsive to perceived market imperatives.

1. DEFINITION OF FINANCIAL SCANDALS:

Before defining the term financial scandals, which is one of the main concepts, used in this paper, it is helpful to introduce a brief distinction between financial failures and financial scandals . With “financial failures”, we refer to a company’s financial situation that falls short of what people expect of it. Many financial failures have only limited impact and are dealt with as routine occurrences. On the other hand, “financial scandals” are those financial failures that, despite the general inevitability of such failures, occasion surprise and indignation in society at large, prompting the question: ‘how could this happen?’. We offer no exact predictions as to when failures become scandals, but assume that ‘scandals’ can be expected when the failure is large, when it is associated with immoral behaviour or negligence of duty by those responsible, rather than with unintentional error, and when adverse consequences are suffered by many stakeholders (Camfferman & L. Wielhouwer, 2019).

According to Steven Toms, a financial scandal has typically three components:

- First, it is an event or situation (the context in terms of time and place) involving the employment of financial resources ,
- Second, there is questionable ethical behaviour (judged against social norms of accepted behavior),
- And third, there is wide public knowledge (the significance of its consequences).

For the purposes of the present analysis, therefore, a financial scandal is defined as: A situation or event that has occurred as a result of financial resources being employed in a morally questionable manner where there are serious consequences for third parties, which are widely known.

According to this definition, financial scandals may involve accounting and financial market manipulation, multiple types of fraud, and accentuate the possibility of corporate bankruptcy (Toms, 2019).

2. CAUSES OF ACCOUNTING SCANDALS:

After having defined the financial scandals, let's move on to their main causes, and here down Some of them (<https://www.educba.com/accounting-scandals/>, 2020):

- Excessive greed for generating quick money,
- Lack of transparency in financial reporting,
- Poor quality of management information (such as inaccurate and irrelevant information),
- Very lavish performance linked bonus programme,
- Non independence of the internal audit team,
- Low moral grounds established by company’s leadership/ senior management (such as corrupt behavior),
- The extremely convoluted organizational structure,
- Lack of proper control on financial reporting/ accounting,
- An individual feeling that they are above the system,

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- Complacency on the part of the managers.

3. HISTORICAL OVERVIEW OF ENRON AND WORLDCOM'S FINANCIAL SCANDALS:

3.1. ENRON SCANDAL (2001):

Enron Corporation was an energy, commodities, and services company based out of Houston, Texas, United States of America. Its success seemed to define a new kind of company for the new millennium. And it had assigned for both internal and external auditing one of the big fives around the world: Arthur Andersen.

➤ WHAT LED ENRON TO ITS BANKRUPTCY?

In summary, Enron's fraud included both complex financial maneuvering (by hiding its debt via "special purpose entities") and simple fabrication of numbers (by its valuation of a failed venture with Blockbuster).

More precisely, the energy trader's unfathomable accounts had obscured huge debts stashed off its balance sheet (Farrell, Tue 21 Jul 2015)

In other words, the company had been using accounting loopholes to hide billions of dollars of bad debt, while simultaneously inflating the company's earnings and Retained Earnings. The Retained Earnings formula represents all accumulated net income netted by all dividends paid to shareholders. Retained Earnings are part of equity on the balance sheet and represent the portion of the business's profits that are not distributed as dividends to shareholders but instead are reserved for reinvestment (<https://corporatefinanceinstitute.com/resources/knowledge/other/top-accounting-scandals/>, 2020).

The fiasco led to the dissolution of Arthur Andersen and the bankruptcy of Enron wiping out \$74 billion of shareholder funds, jobs of thousands (20 000) of employees (Byrnes, Accounting in Crisis: reform is urgent, 2002), also the Enron's share price collapsed from around \$90 to under \$1 within a year (<https://corporatefinanceinstitute.com/resources/knowledge/other/top-accounting-scandals/>, 2020).

3.2. WORLDCOM SCANDAL (2002):

WorldCom was a telecommunications American company based out of Ashburn, Virginia. It too, did like Enron, and had assigned for both internal and external auditing: Arthur Andersen's auditing company.

➤ WHAT LED WORLDCOM TO ITS BANKRUPTCY?

In 2002, just a year after the Enron scandal, it was discovered that WorldCom had inflated its assets, making it by far one of the largest accounting scandals ever.

In a first amended complaint for securities fraud brought before the US District Court SDNY on 5th November, 2002, the SEC outlined how WorldCom overstated the income reported in its financial statements by approximately \$9bn. Revenue-related expenses were inappropriately accounted for as capital expenditure (ie capitalised on the balance sheet). As a result, earnings were massively misreported in the profit and loss account (Plender & Estates, 2002).

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The scandal resulted in over 30,000 job losses and over \$180 billion in losses by investors (institute, 2020).

4. POST-ENRON AND WORLDCOM ACCOUNTING RULES:

The recent corporate scandals revealed two kinds of problems with our accounting system. One was that companies (and sometimes their auditors) ignored the rules. The other was that the rules themselves are so complex that even when they are followed to the letter, investors may not get a clear picture of a firm's financial condition (Jickling, 2004).

So, before talking about the new accounting rules that have emerged after the aforementioned scandals, it is wise to talk about the main changes that have taken place within the accounting harmonization' international entities.

As of February 2001, the IASC: International Accounting Standard Committee, the international entity responsible for the disclosure of IAS: International Accounting Standards was restructured, and subsequently became IASCF: International Accounting Standards Committee Foundation, which created in its turn the IASB: International Accounting Standards Board, body now responsible for developing international accounting standards called IFRS: International Accounting Reporting Standards.

This on the one hand, on the other hand, a new law has been put in place, it is the SOX act which took its name from the respective names of the two Senators Paul Sarbanes and Michael G. Oxley on its initiative, was passed by the US Congress in July 2002.

This law, also called Public Company Accounting Reform and Investor Protection Act of 2002 or more simply SOX or Sarbox

SOX was engineered to set rules for compliance. The stringent new rules were put in place "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes" (Byrnes, Accounting in Crisis: reform is urgent, 2002).

Moving now to the impact of the financial scandals of Enron and WorldCom on the accounting which was so important.

4.1. RULES APPLIED ON THE TOPIC OF ACCOUNTING FOR LEASES:

Though leases are similar to loans, companies have long been permitted to exclude most leases from their balance sheets. As a result, investors looking at a company's financial statements may have struggled to calculate its true financial obligations .

Section 401c of the Sarbanes-Oxley Act required the US Securities and Exchange Commission SEC to conduct a study on 'off-balance sheet transactions, including assets, liabilities, leases, losses, and the use of special purpose entities' (Healy, P.M., Palepu, & K.G, 2003).

In its report published three years later, the Commission recommended that the Financial Accounting Standards Board FASB should add a project to its agenda to revise the leasing Accounting and Business Research 507 standard, preferably in cooperation with the International Accounting Standards Board IASB (Commission, 2005).

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In other words, these scandals had led The FASB, to take other steps to prevent companies from using special off-balance-sheet entities to obscure how much they really owe. Therefore, it has issued a final rule that changes how companies account for most of their leases.

The two boards FASB and IASB did succeed in issuing new and converged leasing standard IAS 17 (which was subsequently replaced by IFRS 16 in 2019).

The new rule requires that the most common type of lease be included on a company's balance sheet, potentially giving investors a more accurate picture of a company's health.

Bringing all the leases onto the balance sheet is expected to have benefits for investors. The rule further standardizes how leases are presented in financial statements and perhaps subjects them to deeper scrutiny by auditors. The rule could make it easier for investors to compare the strength of several companies in one sector.

Under the new rule, companies must bring their "operating leases" onto their balance sheets. Operating leases give a company the right to use an asset, like a retail location in a mall, over time. Companies owe far more through operating leases than they do through capital leases, which are already accounted for on companies' balance sheets. Capital leases typically allow companies to gain ownership of the asset at the end of the lease. Leases of less than 12 months will not have to be included on the balance sheet.

The new leasing rule will not affect earnings. The way lease payments are reflected in the income statement will not change (Eavis, 2016).

4.2. RULES APPLIED ON THE TOPIC OF ACCOUNTING FOR CONSOLIDATION:

By June 2002, the IASB recognized the need to take up the topic of consolidation of special purpose entities SPEs (K & Zeff, 2015). In 2008, the IASB succeeded in publishing IAS 27: Consolidated and individual financial statements ,

In 2011, and always around the topic of consolidation, the IASB succeeded in publishing a package of standards, IFRS 10: Consolidated financial statements, IFRS 11: Joint arrangements, IFRS 12: Disclosure of interests held in other entities .

On May 12, 2011, the IASB published a new version of IAS 27 (IAS 27 - 2011) entitled "Separate financial statements" following the publication of IFRS 10 "Consolidated financial statements". The rules relating to individual financial statements remain unchanged. The other sections of IAS 27 (relating to consolidated financial statements) are thus replaced by IFRS 10. When the entity applies IAS 27 (2011) early, it must indicate this and at the same time apply IFRS 10, IFRS 11, IFRS 12, and IAS 28 (2011): Joint arrangements (Focusifrs, 2021).

As regards IFRS, starting in January 2013, IFRS 10 will substitute for IAS 27 and SIC 12, introducing new rules for the consolidation of SPEs, while the requirements for asset recognition included in IAS 39: Financial instruments: recognition and measurement, remain unchanged (Fabrizio, Fabrizi, & Parbonetti, 2015).

CONCLUSION :

The purpose of this article was to look in detail into the impact of the 2000s financial scandals, specially those of Enron and WorldCom, on the accounting. Therefor we set the following question: What major changes occurred as a result of the accounting scandals of Enron and WorldCom ?

By trying to answer the question above, we conclude some results:

- The disclosure of Enron and WorldCom's massive manipulation of their financial reportings and the fall of one of the nation's most prominent and respected CPA firm, Arthur Andersen, was the most significant event to affect the accounting's profession in the 2000s .
- According to experts, Part of the problem (that led to the financial scandals) was the financial reporting model itself: the proper treatment of many issues is not clear, such as off-balance sheet activity. Clearly, part of the problem was some inherited weaknesses in disciplinary and monitoring processes for the profession. That's why, many procedures have been implemented, such as the new rule of treatment of leases and consolidation.
- In addition to what we have advanced, other changes occurred such as the SOX act.
- The Sarbanes-Oxley Act of 2002 is certainly part of the solution, but the main question is did the Sarbanes-Oxley Act succeed really to combat the accounting fraud ?
- According to an opinion article written in 2012 by Michael Peregrine, a partner at the law firm, McDermott Will & Emery, Sarbanes-Oxley has not failed at all, but rather, has made a huge corporate difference. It has reformed corporate responsibility and fiduciary duties to the company and shareholders. After the implementation of the act, corporate governance and expectations increased for executives and officers of companies. This, in turn, made the shareholders and general public more aware of corporate responsibility, which resulted in more attentiveness being paid to operations and controls of companies. Although this opinion does not directly mention the occurrence of accounting fraud, it clearly states that SOX has achieved an important aspect of corporate governance and responsibility, and improved from where it once was (Peregrine, 2016).

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