FINANCIAL TIMES BUSINESS LIFE - Business books / Published: September 10 2006

Accounting for capitalism after Enron

By Barney Jopson

Enron is the scandal that keeps on burning. It is nearly five years since the energy trader’s bankruptcy destroyed thousands of jobs and billions of dollars of wealth. Yet its searing effects are as clear as ever.

Jeffrey Skilling, Enron’s former chief executive, is awaiting a prison sentence that could run to several decades after his conviction for fraud and conspiracy. Kenneth Lay, the group’s former chairman and a fellow convict, escaped a prison sentence after a fatal heart attack in July. And a team of extradited British bankers – the NatWest Three – await their own trial in Texas next year on Enron-related fraud charges.

Outside the courts, however, the company’s meltdown has perhaps had the most profound impact on accountancy. Its implications continue to unfold, and are charted for lay readers by Nicolas Véron, Matthieu Autret and Alfred Galichon.

In the first phase of the post-Enron era, public interest in accounting surged as people discovered how its abuse could play a central role in corporate scandals. The authors write: “Once the accuracy of financial information can no longer be taken for granted, the entire economic and financial system runs the risk of paralysis.”

By 2003, the second phase of the post-Enron era had begun with a realisation that mitigating the risk of future scandals was not a matter of correcting obvious regulatory faults. The authors, who wrote the original in French, show how the characteristics of today’s financial reporting system make the idea of quick fixes to restore damaged trust implausible.

For readers who are affected by accounting but know little about it, technical points are illustrated via the rather corny tale of Smoke & Mirrors, Inc., a fictional company that gives the book its title. There is also a whirlwind historical tour that links the creation of public accounting standards and the requirement to use an external auditor to the October 1929 stock market crash.

The next landmark event was the collapse of Enron, the repercussions of which are evident in three issues explored by the authors.

The first is that accounts, contrary to popular perceptions, are never objective. They depend on judgments. Accounting standards are not neutral tools but “a set of conventions with the inevitable whiff of the arbitrary”. Both US and international accounting standards – the two predominant systems – are often the “negotiated” out. Both US and international accounting standards – the two predominant systems – are often the “negotiated” outcome of lobbying by groups with competing interests in the result, namely companies, investors, banks, regulators and the tax authorities. The authors say that because standards can change corporate behaviour, they have served as instruments of economic policy. Witness the once rampant popularity of stock options in the US, encouraged by the fact that they did not have to be treated as an expense.

A second vexing issue dashing hopes of watertight financial reporting is the existence of just four large international audit firms: PwC, KPMG, Deloitte and Ernst & Young. Andersen, the firms’ former counterpart, disintegrated after an Enron-related indictment, and left the verification of the accounts of the world’s biggest companies in the hands of a highly concentrated oligopoly. There is no suggestion that the firms are colluding or abusing their position. But the structure of the market has led to concern that they are now “too few to fail”, protected from the consequences of mistakes because no one wants to face the repercussions of penalising them severely.

It is a problem with no simple solution, and questions in a third area – the geography of regulation –are equally intractable. Globalisation has created tensions between those who want the regulation of accounting and accountants to be standardised, and those who argue that competition between different systems is healthier.

In the absence of any consensus, the US is becoming the world’s regulator by default, mainly through the Sarbanes-Oxley act. Many Europeans are appalled. But the region’s ability to act as a counterweight is hindered by the fragmentation of regulation within the European Union, which hampers efforts to detect and deter accounting fraud.

Disappointingly, the authors are coy about desirable solutions to this or any of the other big issues they address. Their neutral voice makes the book an excellent primer on the political economy of accountancy, but it also means it lacks punch. Only in a final prophetic passage on Smoke & Mirrors, Inc., supposed to be written in May 2016, do the authors stick their necks out.

Companies are publishing financial statements every two weeks. There are 15 international audit firms. And a single European securities regulator has been created “following an unprecedented series of interrelated accounting scandals in the UK, Poland, Malta and Luxembourg”.

Stranger things have happened. Enron was one of them.

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