The Enron failure: Should Accounting be blamed?

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The recent collapse of Enron, which has exposed the lacunae in accounting practices followed by many US companies, has come as a shock to many. Here was a company, which had successfully transformed itself from an old economy outfit into a new economy star focused totally on trading. Its lean operations and its pioneering efforts in restructuring energy markets in a deregulated area received praise from analysts and management experts including Gary Hamel. Enron itself had adopted an attitude, bordering on arrogance towards the big energy giants with smoke stack operations.

Today, many of Enron's accounting malpractices are being examined under the microscope. People are raising fundamental questions about the US Gaap (Generally Accepted Accounted Principles), long considered the ultimate standard in corporate disclosure and reporting practices. So, does this mean that the US Gaap has outlived its utility? Before we go further, we need to understand that the function of Accounting is to portray the financial health of a business as accurately as possible. This it does in the form of summarised statements that provide important numbers along with brief explanatory notes wherever required. By their very nature, accounting statements, which summarise the financial position of a business, cannot disclose all details.

Accounting standards have evolved over time to protect the interests of investors. They emphasise fundamental principles such as conservatism to ensure that investors are not presented a rosy picture when the business is not doing well. But ways of manipulating books of accounts can always be found. For example, the dividing line, at times, between finished goods inventory and sales can be very thin. Once goods are loaded on trucks and leave the factory premises, the sale and profits can be booked. So, it is not an uncommon practice to scramble to complete shipments towards the end of a quarter. Goods may remain with the dealer, but the company can book the sales. Similarly, the quality of assets on the balance sheet is more a matter of judgement than conformity with any accounting standard. Let us say a company incurs heavy expenditure in an advertising campaign associated with the launch of a new product. Since the benefits will come over a period of time, it makes sense to amortise the expenditure. But the period of amortisation is a matter of judgement and involves basic assumptions like the life of the product. When it comes to complicated derivative instruments, the job of the accountant becomes even more difficult. The valuation of such instruments even if disclosed in the balance sheet, can go haywire if there are unexpected market movements. This is exactly what happened in the case of the well known hedge find, Long Term Capital Management (LTCM). Even though LTCM was regularly marking to market its various instruments, the unexpected movements in interest rates following the Russian currency crisis in August 1998 led to huge losses. Only a bail out coordinated by the Federal Reserve could save the fund.

Currently, analysts are creating panic by questioning the accounting practices of many healthy companies across the board. Instead, efforts should be made to create a more ethical climate where managers in their enthusiasm to achieve quarterly financial targets do not resort to various kinds of window dressing. Indeed, a more long term orientation towards the measurement of financial performance is desirable. Fortune (February 18, 2002) has explained how a sharp focus on shareholders has led to unintended consequences: "The single biggest reason behind the recent spate of God-awful accounting has got to be the rise of the cult of the shareholder. Simply put, over time, so much focus has been placed on levitating companies' stock prices that many executives will do almost anything-legal or otherwise – to make it happen."

We must also appreciate that more stringent accounting standards may not necessarily be the solution to the problem. According to Warren Buffett, the famous investor, (Fortune, February 18, 2002), "Today is significantly different from the 1950s. Back then there was less disclosure, but the disclosure you had was accurate. It's not like today, where too often otherwise high-grade companies start with a number of quarterly earnings and work backward. Situational ethics has reared its ugly head."

Indeed, the earnings guidance game played by US companies has been taken too far. Companies make earning forecasts and beat them by exactly a penny. Till recently, Cisco was doing this quarter after quarter. To beat projected earnings, companies have used various dubious practices including borrowing from next quarter's sales and indiscriminate customer financing. Enron even created special purpose entities to which it transferred its debts to make its balance sheet look clean.

In short, accounting standards should not be held responsible for all bankruptcies and failures. Accounting standards provide checks and balances. They encourage caution wherever possible. But beyond a point, accountants are helpless. Clever managers will always find ways to inflate profits or hide losses. It is unrealistic to expect accountants to have complete understanding of the business. Good accountants do ask questions and check the assumptions made by line managers. But to expect them to identify all the loopholes and malpractices prevailing in the system is unrealistic. The collapse of Enron no doubt offers useful lessons in accounting and auditing. But it is wrong to put all the blame on the accounting profession. What is needed is a new ethical climate that encourages decisions aimed at improving the long-term health of the company rather than the next quarter's earnings.