Auditors and the Permissive Society: 
Market Failure, Globalisation and 
Financial Regulation in the US

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The case of Enron, and the long list of corporate collapses that followed in its wake, have uncovered a corporate America beset by deception, false accounting and bankruptcy. This paper is concerned with the limits to detecting corporate fraud through auditing. In particular, it attempts to explain these limits in terms of the historical development of the accounting profession, the legal context in which it operates, and the uneven nature of ‘corporate colonisation’ in US government and financial regulation. A key question here is whether the internationalisation of the world’s capital markets, so often the cause of disabling financial disasters, helps us to make sense of this regulatory failure. The basic conclusion of the analysis is that it does not. On the contrary, the evidence presented here demonstrates that this crisis is rooted in a regulatory structure that was forged long before the present liberalisation of the world’s capital markets.

Key Words: Financial regulation; fraud; Enron; globalisation; auditing

Introduction

On 2 December 2001, Enron, the Houston-based energy trading company, filed for bankruptcy protection. The nature and scale of Enron’s bankruptcy was, at the time, unprecedented. Enron had come into existence in 1985 as the product of a merger between two gas-pipeline companies. Massive debts initially held back growth in the new company, but a decision to transform the business into a financial institution in the late 1980s provided a substantial lift to the company’s earnings, which was soon reflected in an extraordinary rise in the price of its shares (Fox, 2002; Bratton, 2002). Between January 1991 and January 1993, Enron’s stock rose 75 per cent and, by the end of 1993, it had risen above $50 a share for the first time (Fox, 2002:47). By August 2000, when the stock reached a high of $90.75, the company was the seventh largest in the US by market capitalisation (Staff to the Senate Committee on Governmental Affairs, 2002:72). Not only, however, had Enron become one of the US’s leading corporations, it had also developed a reputation ‘as America’s corporate shock troop’ for urging ‘radical reliance on market discipline’ and the dismantling the New Deal regulatory legacy (Bratton, 2002:7,17; Business Week, December 2001). The combined effect of the rapid growth of the company and its success in driving back the boundaries of federal and state regulation led Fortune Magazine to rank Enron as the country’s most innovative for six years, and probably explains why the company’s CEO, Jeff Skilling, was voted the second-best chief executive in the US in August 2001. Despite these plaudits, however, Enron’s status as a symbol of the confidence of US corporations in the late 20th century was brief. By the end of September 2001, the company’s shares were quoted at just $25. Exactly a month later they were trading at $13.90 and, by the end of the next month, on 30th November they were quoted at 26 cents (Bratton, 2002:41–2). Two days later the company filed for bankruptcy protection.
Not only was the loss of shareholder equity immense—in excess of $60 billion (Fox, 2002:264)—but with assets of $62 billion Enron was also the largest company to declare bankruptcy protection in US history (Staff to the Senate Committee on Governmental Affairs, 2002:71; Ribstein, 2002). Over the months that followed, the full extent of the company’s attempts to manage its earnings—still the best explanation for both the spectacular rise and the sharp decline in its fortunes (Bratton, 2002:22–54)—became apparent. Put simply, from 1997 Enron had fraudulently managed its reported accounts to make it look as though the company had more revenue and earnings, less debt and greater operating cash flow (Powers et al, 2002; Bratton, 2002). The sums involved in some of the accounting schemes were, like the decline in the company’s share price and its bankruptcy huge. For example, Enron’s attempts to disguise loans as commodity trades accounted for an estimated $7–8 billion, in what allegedly were improperly recorded liabilities and cash flow. Likewise, when Enron restated its earnings for the period 1997 to 2001, to bring a number of hitherto concealed subsidiaries back on to the company’s consolidated accounts, the effect was to reduce reported net income by $586 million (or 20 per cent of its earnings for the period) and to increase reported debt by a massive $2.6 billion (Fox, 2002:275–7). However, although the sums involved in Enron’s false accounting were vast, the loss of shareholder equity breath-taking and the company’s bankruptcy unprecedented, Enron was not, in the event, exceptional (Ribstein, 2002:8).

On the contrary, five of the largest bankruptcies in US history (including Enron) occurred in 2002 (The Guardian, 19 December 2002). Moreover, large frauds at other large companies were discovered soon after, as was the need for several major companies to restate their accounts. These included the telecommunications companies Global Crossing, Qwest Communications and Worldcom (which quickly surpassed Enron as the largest bankruptcy in US history), as well as Tyco International, Adelphia, Dynergy, Rite-Aid and Xerox. More interestingly, perhaps, Enron’s fall had been immediately preceded by a host of other cases, such as Sunbeam, Cendant and Waste Management, all of which had involved massive frauds and accounting restatements. The simple fact was that corporate America had been laid waste by deception, false accounting and bankruptcy. This fact (and the fact that in many cases these frauds were not so deeply embedded within the corporations concerned or so complex that the deceptions could not have been uncovered long before they actually emerged) imposed some important constraints on the political debate that followed. Put simply, it became very difficult for those unsympathetic towards reform to argue that the regulatory failure involved was an isolated fault in an otherwise reliable system. This was especially true given that in most cases the institutions with formal responsibility for regulating the capital markets either did not discover the frauds or did not report them to the Securities and Exchange Commission (SEC), the lead regulatory body in the US (Ribstein, 2002). Not only, in short, did the watchdogs not bark, but their collective silence suggested systemic failure (Healy and Palepu, 2002; Bratton, 2002:59–62; Staff to the Senate Committee on Governmental Affairs, 2002:2). The key question, of course, is why.

The following analysis aims to address this question as part of a wider discussion which asks whether the internationalisation of the world’s capital markets (and the attendant massive expansion in the movement of capital), so often the cause of disabling financial disasters (Beller et al, 2000), helps us to make sense of this regulatory failure. The basic conclusion of the analysis is that, in many important respects, it does not. More specifically, while there is some, quite persuasive, evidence to suggest that liberalisation of capital flows is deeply implicated in the emergence of what a former chair of the SEC once described as the ‘numbers game’ (and, therefore, by implication in many of the recent cases of accounting fraud), it does not really help us to understand why there was such a complete failure in the SEC’s ability to anticipate and prevent such a large number of huge corporate frauds (Doug, 1997; Levitt, 1998). Instead, this paper contends that to understand most of the recent examples of regulatory failure we need to focus, in the first instance, on the structure of the current system of financial regulation in the US (which was forged long