# Optimism Has No Place in Accounting

By Charles T. Munger April 4, 2002

The fiasco at Enron had two causes: (1) perverted "financial engineering" that portrayed failure as progress and (2) generally accepted accounting principles that practically invited delusion and fraud.

The faults of those who misled now get much attention and create demands for greater criminal penalties. But the faults of generally accepted accounting principles are more important, because changing accounting rules, and the way they are adopted, has a greater potential for preventing Enron-type disasters.

Fools and knaves, like those at Enron, will always be with us and will be particularly active where big money can be made -- for instance, in reporting ever-higher earnings.

Therefore, accounting rules must make it very difficult for fools and knaves to fake profits and net assets. Every retailer knows that his "shrink rate" from stealing depends on his maintaining a system that makes it hard for anyone to get away with theft. Similarly, sound accounting must make it difficult for corporations to get away with presenting failure as success.

A rule-making system that instead makes misuse of numbers easy operates like a retailing system without cash registers. Troubles are sure to come in each instance, no matter what the criminal penalties, because neither system insists on the margin of safety demanded by, say, engineering, which seeks to prevent damage from inevitable human foibles. For instance, engineering, reacting to many avoidable deaths in surgery, created anesthesia machines that do not permit operators to reduce oxygen delivery to zero. Wise accounting rules must display similar shrewdness in preventing undesirable accounting.

The way to get maximum safety from accounting rules is to force a pessimistic outlook. In the long term, huge public benefits are to be gained, with almost no public dangers, from pessimistic accounting, while optimistic accounting is a public menace.

Seldom has this been better demonstrated than in the case of Enron, where optimistic accounting of its derivatives trading resulted in a "front-ending" of too much dubious and uncollected revenue into earnings. In the first part of this charade, generally accepted accounting principles allowed "marked to market" valuations, based on defective information about market prices and inadequate allowance for the risks of clearing trades. Later, hundreds of turgid pages of accounting rules were used to justify determining earnings on a "mark to model" basis, in which "model" prices were calculated by the very traders subject to audit while they were paid bonuses based on reported profits.

The system of generally accepted accounting principles is defective because the desires of accounting firms and the wishes of their clients make it so. Moreover, because significant parts of the system are rotten to the core, the trouble will not be limited to firms that engaged in derivatives trading or hired the accounting firm Arthur Andersen. Huge vested interests love misleading accounting. And the Securities and Exchange Commission, even under a would-be reformer like Arthur Levitt, can't bring about much reform because it is deterred by politicians serving the vested interests.



To so state the problem suggests a solution: placing the control of accounting much farther away than it now is from the influence of accounting firms, corporations and politicians.

Thus, our model for accounting rule-making should be, first, some new control body similar to but even more independent than the Federal Reserve System. Second, the SEC must be required to enforce the standards established by the new rule-setters.

These rule-makers should be at least as expert, determined and virtuous as Paul Volcker was when he tamed inflation. They should also be less removable than the head of the Fed. After all, folly often is not appraised as such by those who profit from it, and eliminating it will be painful for some.

Some people think that, to correct accounting, we merely need some new committee or some increase in power for the SEC. But these ideas have failed, time after time, because they are equivalent to trying to influence an elephant with a peashooter. We need a stronger remedy.

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