

# False profits

Throughout history, nations that rose on the back of good accounting practice have fallen just as spectacularly, as a recent book illustrates

**A**ccounting is all very well, but it is easy to forget that it exists for rather more than technical expertise and efforts at precision. The important part of accounting is accountability – to take the results and hold somebody to account as a result. The purpose, as Sir David Tweedie (see page 42) used to say when he was chairman of the International Accounting Standards Board, is ‘to keep capitalism honest’.

But accountability is even more powerful than that. It is the means whereby a society, a nation, a state or a political construct stays in business. Without accountability at their heart, they founder. And the examples roll down through history to prove this point.

A recent book by Jacob Soll, professor of history and accounting at the University of Southern California, documents all this amid a rollicking narrative. Here’s a taste: ‘Over and over again, good accounting practices have produced the levels of trust necessary to found stable governments and vital capitalist societies, and poor accounting and its attendant lack of accountability have led to financial chaos, economic crimes, civil unrest, and worse. All this is every bit as true in our own day of multi-trillion-dollar debts and massive financial scandals as it was in the Florence of the Medici, Holland’s Golden Age, the heyday of the British Empire, and, of course, 1929 on Wall Street.’

The consequences of a disconnect between accounting and accountability are grave. Soll

writes: ‘Capitalism and government, it seems, have flourished without massive crises only during distinct and even limited periods of time when financial accountability functions. People have known how to do good accounting for nearly a millennium, but many financial institutions and regimes have just chosen not to do it. Those societies that have succeeded are not only those rich in accounting and commercial culture but also the ones that have worked to build a sound moral and cultural framework to manage the fact that humans

## The balance of account books, he argued, represented the moral equilibrium of God

have a regular habit of ignoring, falsifying and failing in accounting.’

Soll shows that you can find a failure to understand this point echoing down the years in the same way as it has resounded over the last few decades. Back in the late 1500s, financial institutions under King Philip II of Spain failed to share information, reforms were not implemented and, although Philip had ‘realised that one can fire one’s accountant, but the problems do not go away’, it all went to hell in a handcart. The great Spanish Armada, the failed invasion of England, was a financial disaster as well as a naval one.



### Technology further hinders accountability

‘Considering that there have been centuries of struggles over financial accountability,’ writes Jacob Soll in *The Reckoning*, ‘our own recent inability to effectively audit and hold companies and governments accountable seems incomprehensible. And yet, our predicament follows a historical pattern: no sooner is any accounting reform made than we find a way to resist it. Indeed, the rise of technology has made the task of accountability even more daunting, as regulators and even auditors come up against labyrinthine big numbers and financial logarithms, high-speed trading, and complex financial products such as bundled mortgages.’



### Accountants perceived ‘inexpert’ after Enron

‘From the Renaissance to the 19th century,’ writes Soll, ‘great artists and philosophers painted and discussed accountants and their complex role in society. But great artists don’t paint accountants any more. It is not surprising. In the wake of fiascos like Enron, accountants have come to be perceived not only as boring but also as venal and inept. Few political and financial commentators discuss accountants or accounting. Due to their dour image and the indecipherable aspects of their profession, accountants have become separated from everyday culture.’



In the great Medici days of Florence in the 15th century, the dynasty ‘showed the power of good finance but fell prey to the temptations to ignore accounting’. As Soll puts it: ‘The great masters of the Medici bank used accounting to create a financial machine that allowed them to dominate their age, both culturally and politically, like no family before them. Yet one generation later, they had almost lost it all, not simply by bad accounting, but because they no longer considered accounting as an essential branch of knowledge for themselves and their heirs.’

#### COUNTDOWN TO REVOLUTION

The Sun King of France, Louis XIV, put his confidence in finance minister Jean-Baptiste Colbert, who provided pocket account books. And, writes Soll: ‘For the first time...accounting and traditional learning were used together to manage a large government.’ But then Colbert fell ill and died, the financial information dried up or was suppressed, and by Louis XIV’s death in 1715 the country ‘was bankrupt, with no effective accounting system’. The long countdown to the French Revolution had begun. And so it goes on. Dominican friar Luca Pacioli, for years more famed for being a friend and mathematical mentor to Leonardo da Vinci, published the first manual of double-entry bookkeeping in 1494. The balance of account books, he argued, represented the moral equilibrium of God. ‘If transactions were kept

This sketch of Raymond Auguste Quinsac Monvoisin’s most famous work, *Le 9 Thermidor*, illustrates the arrest of Maximilien Robespierre, one of the crucial events of the French Revolution. While the reign of Louis XIV had seen the introduction of an effective accounting system, this had vanished by his death, eventually leading the country into the bankruptcy that paved the way for revolution.

faithfully,’ says Soll, ‘that would not only help merchants but also put them in good stead with God, for they would be “trustworthy” and “upright”.’ It opened the skills up to the world. And yet the lessons learned down the centuries continually fall out of favour and are ignored, landing the world in financial chaos, disaster and ruin once more. Charles Dickens, in his novel *Little Dorrit*, put the bare bones into fiction. Soll writes: ‘For Dickens the wilfully opaque accounting and management of the Victorian Treasury pointlessly ruined honest men like Dorrit and opened the doors for swindlers like Sadleir, whom Dickens immortalised as Mr Merdle.’

On a personal note I enjoyed the huge coincidence that I was in New York at the time of the arrest of the mass-swindler Bernard Madoff – the same week as a TV dramatisation of *Little Dorrit* back in Britain had reached the point where Merdle realised the game was up with his swindling and committed suicide. For me, it simply reinforced the case that when it comes to accountability and scandal the same problems come round time and time again, with no lessons learned or remembered.

And this, essentially, is Soll’s message: knowledge is eroded, and the same mistakes are made. Josiah Wedgwood, the china magnate and giant of the Industrial Revolution, was the grandfather of Charles Darwin, who made plain the logic of evolution. Both were orderly men who believed in the order imposed



by accounting. Wedgwood taught it to his sons and daughters; Darwin kept detailed account books for all his activities.

#### CULTURE OF ACCOUNTABILITY

In conversation, Soll stresses the need for a culture of accountability. He feels we had it and then forgot it. And that is why we are prey to so many financial disasters. 'It was a key element of European culture, and we have lost it,' he told me. His reading of history tells him that if you don't have a population that is literate in accounting, then it cannot judge what is right and wrong within the

Campaigners at a property in Oakland, California, which is threatened with mortgage foreclosure. Jacob Soll suggests that if the public had had a better general knowledge of accounting they would not have taken out unaffordable home loans.

of double-entry 'then they wouldn't have taken all those home loans out'.

And he is scathing about the error-strewn nature of public accountability. When ratings agency S&P downgraded US Treasury debt for the first time in 70 years there was, famously, a US\$2 trillion error in the calculations. 'That would not have cut the mustard in the 18th century,' Soll pointed out to me.

What we learn from this immensely lively chronicle is that we are living, globally, in a new dark age when it comes to accountability and understanding. Soll cites the International Accounting Standards Board as describing government accounting as being in a stage of 'primitive anarchy'.

As with the financial crisis, much of this is so because the public is disengaged from accountability and the knowledge and understanding that would empower such accountability. It would be hard to disagree with one of Soll's conclusions: 'If there is any historical lesson to be learned here, it is that those societies that managed to harness accounting as part of their general cultures flourished.'

Robert Bruce, accountancy commentator and journalist

*The Reckoning: Financial Accountability and the Making and Breaking of Nations*, by Jacob Soll, is published by Allen Lane.

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economy, both domestic and across the world. 'People used to write everything down from Renaissance times until the 1950s and then we let go of it.'

The great debate about how to restore trust in business, which we have seen burgeon since the financial crisis, is tied up with all this. Without society understanding how accountability works, then business will not be understood and, as a result, will be mistrusted. Soll told me: 'Everyone needs to learn double-entry.' Had people in general possessed a knowledge