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Corporate Accounting: Still Evolving After All These Years

by Chris Edwards

Politicians were quick to blame recent accounting scandals on failures in the free-market system. But financial markets are far from free, and the government deserves a share of the blame for the scandals. For example, the distortionary tax code causes corporations to amass too much debt, which leaves them vulnerable to downturns. Also, the tax code encourages workers to hold their retirement savings in employer-sponsored plans, a source of contention in the Enron meltdown.

However, the accounting industry can learn lessons from the demise of Arthur Andersen and the various corporate financial shenanigans of 2002. Like any market institution, accounting does not work with perfection, however that might be defined. Instead, the industry has continually evolved to correct mistakes and meet new demands since the first specialized firms arose in London in the mid-1800s.

To get some context for recent scandals, I revisited two books on the history of Price Waterhouse (PW) that had been buried in my basement.[1] Accounting may strike some folks as boring, but the industry's development was integral to the rise of modern industry. Firms such as PW arose partly in response to government-created "rents" and partly from purely market demands, or spontaneous order.

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In Britain, the rents began with the enactment of new rules for bankruptcy in 1831. The law required independent specialists to liquidate a bankrupt firm's assets and to sort out creditor claims. Accounting firms prospered because Victorian England had high levels of insolvent businesses, which in turn reflected the high levels of entrepreneurial activity at the time. Bankruptcy work would be the profession's bread and butter for the next few decades.

Accountants also garnered rents by limiting entry into their profession, much as the lawyers had done. Initially, accountancy had open entry and was viewed as a second-tier occupation compared to the monopolized professions. Accountants lobbied the government for entry barriers, and they were successful with rules that created qualifying exams and other controls after 1880.

Additional rents were delivered to the industry with the expansion of income and death taxes. England introduced its first regular income tax in the 1840s, but it was low and simple enough that taxpayers did not need expert advice for compliance and avoidance.[2] But financing the Boer War, and adoption of redistributionist policies at the turn of the century, resulted in higher and more complex taxes and the rapid growth in tax accountancy.

Clearly, the industry benefited substantially from government action. But there was also a large element of spontaneous

order in the industry's growth, particularly in auditing. The size of business enterprises increased immensely in the 1800s with the coming of the railroads and other large-scale industries. These industries needed more sophisticated double-entry bookkeeping techniques to properly account for expensive long-lived assets. Depreciation accounting was needed to measure net income over the life of investments such as railroad tracks. Independent accountants became the innovating specialists who showed companies how to use new-fangled bookkeeping techniques. In addition, the large scale of the new joint-stock companies required huge sums of money from a broad base of investors. Investors needed someone to vouch for the accuracy of the accounts of companies they invested in. They depended on firms such as Price Waterhouse, founded in 1849, to detect fraud and provide trustworthy information.

British laws in 1856 and 1862 liberalized the rules for joint-stock companies and allowed them to operate with limited liability. Limited liability had been outlawed back in 1720 in the wake of the South Sea bubble scandal. The new rules spurred a rapid increase in the number of companies established in Britain and created a framework for continued economic growth because the scale of industry was getting too large for the old partnership rules to handle. Accountants were in high demand to run the numbers on all the new companies.

Indeed, fraud was a serious problem in company promotion in the early years after the new rules were put in place. As a consequence, companies that wanted to project an image of probity were eager to hire the new accounting firms to examine their books. As one history of PW notes, "scant accounting regulations sent investors in search of professional advice. They began to hire practicing accountants to assist them in their investigations and to put pressure on directors to behave responsibly."[3]

Commitment to Integrity

PW's history reveals that a strong commitment to honesty and integrity helped spur the industry's growth. That was also my impression in four years working at PW in the 1990s. It was generally understood that it would be foolish to risk the firm's hard-won reputation for the sake of a single client. Arthur Andersen's recent behavior seems to have been a mutation into unethical decision-making that the industry should evolve away from. Indeed that is happening. As Andersen has crashed, the good employees have gone to work for the remaining Big Four, which, one hopes, have better control systems in place.

While investor demand for accurate and unbiased information spurred the initial growth in auditing, the government eventually got involved as well. An 1844 law had mandated that firms receive independent financial audits. That mandate was repealed in 1856, but then re-imposed in 1900. Nonetheless, there was a generally laissez-faire auditing environment in Britain until 1948.[4] Financial accounting was thought to be within the sphere of private contract between shareholders and companies.[5] Firms voluntarily signaled their soundness through reports by independent auditors and by assigning respected leaders or titled persons to their boards. From 1857, shareholders also had the protection of accounting fraud's being established as a criminal offense.[6] Also, stock exchanges usually required listed companies to disclose substantial amounts of information. In the United States, a generally laissez-faire approach to financial reporting lasted until the Securities Exchange Act of 1934.

In both countries there were demands for more government rules whenever a speculative bubble burst. But bubbles occurred both before and after heavy financial accounting regulation was in place. We have just seen the high-tech bubble of the 1990s burst despite more than 60 years of regulation in this country. Speculative manias seem to have more to do with new technologies, and less to do with insufficient accounting regulation. Railroad- and telegraph-investment mania hit in the mid-1800s, and the market boom of the 1920s was fueled by surging

innovation in automobiles, radios, and electricity.[7] Since it is natural for investors to get excited about new technologies, huge stock run-ups might be just the way that markets work. There should be consequences for firms that issue false figures, but broad market declines do not call for greater top-down accounting regulation.

Instead, perhaps we need more bottom-up innovation in financial accounting. In this country decades of regulation have locked in one-size-fits-all "generally accepted accounting principles" (GAAP). But GAAP rules may not be right for every industry. Many high-tech firms today issue additional "pro forma" statements because they think that GAAP figures distort their true financial picture.[8]

It is time to deregulate accounting and to promote diversity in standards. Different stock exchanges could develop different listing categories with alternate accounting standards. The accounting industry started out 150 years ago by competing through reputation and innovation. If we loosen the regulatory shackles, accountants would be freed up to discover better ways to inform investors about the worth of tomorrow's leading-edge companies. □

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1. Edgar Jones, *True and Fair: A History of Price Waterhouse* (London: Hamish Hamilton, 1995), and David Grayson Allen and Kathleen McDermott, *Accounting For Success* (Boston: Harvard Business School Press, 1993). Price Waterhouse is now PricewaterhouseCoopers.
2. Jones, p. 99.
3. Ibid., p. 49.
4. Ibid.
5. Robert G. Day, "UK Accounting Regulation: An Historical Perspective," School of Finance & Law Working Paper no. 20, Bournemouth University, 2000.
6. Ibid.
7. Chris Edwards, "Entrepreneurs Creating the New Economy," Joint Economic Committee, U.S. Congress, November 2000.
8. T.J. Rodgers, "Corporate Accounting: Congress and FASB Ignore Business Realities," Cato Institute Policy Brief no. 77, October 25, 2002.