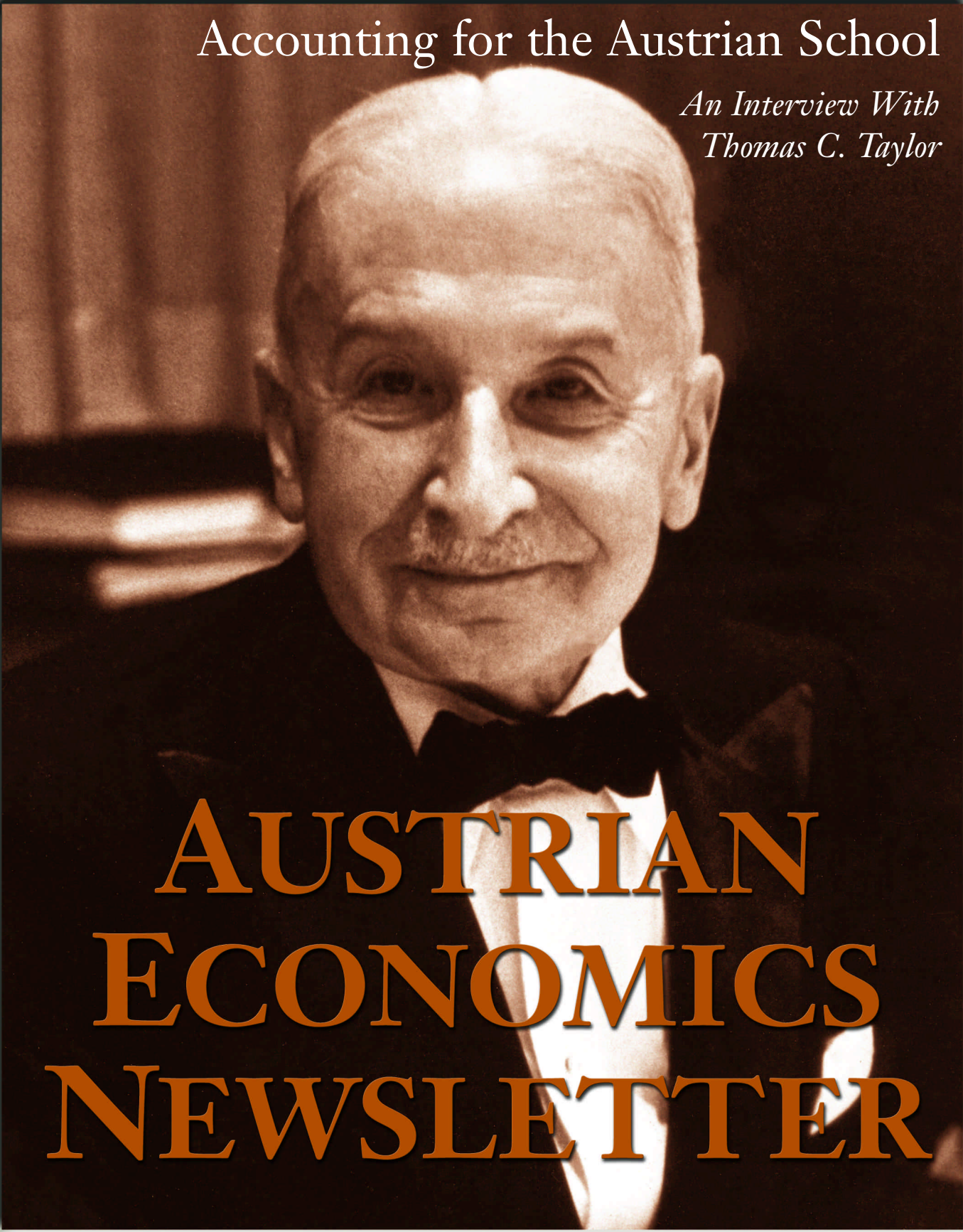


Accounting for the Austrian School

*An Interview With
Thomas C. Taylor*

A sepia-toned portrait of Thomas C. Taylor, an elderly man with a mustache, wearing a tuxedo and a bow tie. He is looking directly at the camera with a slight smile. The background is dark and out of focus.

AUSTRIAN ECONOMICS NEWSLETTER

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Front cover: Ludwig von Mises

THE AUSTRIAN ECONOMICS NEWSLETTER

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An Interview with Thomas C. Taylor

ACCOUNTING FOR THE AUSTRIAN SCHOOL

AEN: The so-called corporate scandals of 2002 have brought the accounting profession unusual degrees of attention.

TAYLOR: The accounting profession is usually considered dull and lifeless, populated by guys with green-eyed shades who are just looking at the facts. Now suddenly, we are seen as cowboys who really make things happen. We are said to be the ones covering up for billions in scams. Accountants and crooked corporate executives are being blamed for bringing down the Nasdaq. Most people had thought that the job of accounting amounted to nothing more than adding up the numbers. Now it turns out that there is a lot of discretion, and this does indeed confuse people.

We have an outstanding accounting program here at Wake Forest, and many people have wondered out loud how these scandals are going to affect our program. All these concerns are really misguided, however. Accounting and auditing are an inherent feature of a market economy, which is to say, anything that looks and behaves like an economy. We aren't going anywhere, though these events are going to have an impact on the profession, whether through a tightening in standards or new government regulations or, no doubt, both.

AEN: What are the biggest confusions you run into?

TAYLOR: Many people think that accounting is a very simple job, that it works pretty much like a checkbook in which you report income and expenses. In fact, there is a huge range of challenging intellectual issues at stake. The stock-option question is a good example. When companies award executives options on buying stock in a company, that is a form of compensation. Generally companies do not record that as an expense in determining their profit or loss. But the argument is that if we do not record the cost, profits come to be distorted and inflated.



THOMAS C. TAYLOR

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He is the author of *An Introduction to Austrian Economics*, published first in 1980 and remaining in print since, as well as articles in many scholarly journals, including *Management Accounting*, *The CPA Journal*, and *The Quarterly Journal of Austrian Economics*. He may be contacted at taylorlort@wfu.edu.

But how do you put a measure on an option? If I give you the option to buy a stock at \$10 over the next 30 years, and you can exercise that anytime, let's say the current price is \$40. Of course it would be worth it to buy. But usually the option price reflects the current market price. If the price rises, great. But

WITH TOO MANY RULES, THE METHOD OF ACCOUNTING BECOMES SIMILAR TO THAT OF TAX PREPARATION: THE GOAL IS TO FIND WAYS AROUND THE RULES.

what happens if the market price falls? The option won't be taken. To book this expense ahead of time may imply a belief that the price is

going up, which is not written in stone, as we know.

Had it been required to book this, the rule would have come out of the Financial Accounting Standards Board, the FASB. It is a private sector group. The SEC does have the legal authority to dictate accounting standards adopted by the FASB, but fortunately it has not been a heavy-handed regulator. In the mid-90s, the FASB favored expensing these options because they had begun to work as proxies for CEO salary (which had been capped by Congress), but it faced opposition from industry and some members of Congress. So companies could have continued to treat the matter as they see fit, being required only to disclose in footnotes the estimated effect on earnings and earning per share of stock options granted during the period.

AEN: These are areas where experience and expertise are crucial.

TAYLOR: Both count. A part of experience is with real markets too. Accounting standards are subject to market pressure. In the boom times, liberal standards were on top. In the bust, people become very conservative. The market works but these days everyone is clamoring for government to intervene. The options question is one of many issues that could be treated by heavy-handed regulation that will dictate accounting standards and short circuit the market process. This step could make accounting more expensive and the quality of accounting worse.

AEN: Why worse?

TAYLOR: Because it will exacerbate what is already an extremely rule-oriented mindset in public accounting. So long as there are extensive rules, accountants will have less, not more, inclination to scrutinize the books carefully and make judgments about the economic substance of business transactions. With too many rules, the method of accounting becomes similar to that of tax preparation: the goal is to find ways around the rules. That is fine with regard to tax preparation. But that should not be the purpose of accounting.

Accounting is a service that would exist whether or not the rules existed. Its goal should be to reveal, not conceal. But to do this, we need to get away from rules and go back to sound principles. Professional judgment should be the hallmark of accounting. How would you like for your physician to make critical determinations about your health by only adhering to rules printed in a manual published by the AMA?

AEN: What is an example of a principle that has been forgotten?

TAYLOR: The classic principle is full disclosure. It says that the company should disclose anything that is likely to be of potential use or relevance to the user of the financial statements issued by the company. Now, remember that Enron did not disclose much of its debt because it pertained to so-called off-balance-sheet debt tied to certain outside entities, "special purpose entities."

Do you know how they justified this treatment? They followed a

An Introduction to Austrian Economics

Thomas C. Taylor

rule that said if you can get outside investors to put up only 3 percent of equity in the partnerships, the debt qualifies for not being disclosed in the company's balance sheet. Technically here the CFOs did not break the law; they followed the rules. But they were not following the long-established principle of full disclosure, which I was teaching over 40 years ago.

This will get worse under more government intervention. Accountants will become more rule-bound and less judgmental, or, shall we say, less professional. The public oversight board now being created by Congress amounts to a further politicization of the accounting profession. The SEC would have authority but, so far as I can see, the new board will be completely unaccountable. There is a real danger here that over time it will trump the massive accounting edifice that has involved over a century of work. This edifice is

quite strong and impressive, and continues to respond to changes in the market. It would be a huge mistake if it is dismissed or taken for granted, as if we need to start from scratch or ground zero in setting auditing and accounting standards.

AEN: It would seem that accounting needs to take account of ever more financial innovations as well.

TAYLOR: Yes. Consider the whole area of derivatives. These are financial instruments whose market values are derived from or tied to the value of some other security or underlying asset. This is a relatively new accounting issue, where you have, say, cocoa beans underlying some other asset whose value in the financial statement is derived from the value of an option on cocoa beans. How do you impute value based on underlying hedging?

I mention this to point out that accountants are always trying to grapple with new issues, and they must do so as they come up. We cannot wait for a government oversight board, which won't understand the issue anyway. It is interesting to note here that the official published rule for accounting for derivatives is over 600 pages long! Incidentally, stock options are a form of derivatives since they derive their value from the perceived value of the company's stock.

The whole problem of companies without a sign of profitability is an issue here. For a long time, Amazon.com didn't have any sign that it could make a profit. Prices were

and are based on long-run forecasts reflecting a belief in the strength of technology or the management team or whatever. We cannot capture everything everyone needs to know in accounting, though we try to do our best. The

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practical problems of measurement are huge. The only way to sort them out is through trial and error, and competition, in the marketplace.

AEN: These complications suggest that the corporate scandals are not clean cases of fraud.

TAYLOR: Many may well be based on mistakes, not intentional deception. Yet it is being magnified to the point that it is seen as a collapse in ethics. You do wonder

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what was going on at Arthur Andersen, which seems to have adopted lax auditing procedures, and apparently some Andersen individuals were in on the deception at

Enron. And at Worldcom, it is hard to understand how the misclassification of \$3.8 billion, which inflated reported earnings by that amount, was not caught by Andersen.

(Parenthetically, in my judgment it was a tragedy to completely destroy the firm for the malfeasance of perhaps 50 individuals regarding the Enron fraud.)

Yet it is useful to consider cases like Enron and Worldcom where strategic market arrangements were recognized as promising new approaches to their industries. As often happens in competitive markets, these strategies failed—the unexpected and dramatic fall in natural gas prices was the death knell for Enron. If these expectations had turned out to be correct, might there have been no scandals? This is a hard question to answer.

AEN: This is not to say that fraud does not exist.

TAYLOR: The outright theft of corporate property appears to have been involved in these cases. But we libertarians never promised a market made up of pure saints. Our comfort lies in the self-correcting quality of the market process. At the same time, “accounting scandals” tend to turn up during recession. Investors are much more cautious and less forgiving as regards corporate bookkeeping. When stock prices are rising, few seem to care.

But when the prospect of heavy losses appears, everyone suddenly becomes more exacting and in the

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“Current Developments in Cost Accounting and the Dynamics of Economic Calculation,” *Quarterly Journal of Austrian Economics* 3, no. 2 (Summer 2000): 3–19.

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“A Comment on Smith’s ‘One Type of Security,’” *Abacus* (December 1976): 166, 167.

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“Next: The Negative Income Tax,” *Louisiana Certified Public Accountant* (Fall 1968): 27–35.

hunt for scapegoats. On the other hand, there is no denying that when business is down, the unscrupulous are more motivated to distort the numbers. Management and accountants certainly can create some interesting scenarios. But we must remember that the fraudulent behavior of individuals participating in the market is not a feature of capitalism.

In accounting classes, we do study cases of real criminal fraud. One case that was very prominent years ago involved a life insurance company that was claiming sales of insurance policies to individuals that as it turned out were deceased or totally fictitious! Now, here is a case of fraud, plain and simple. Many of the cases in the public eye today are not of this type.

AEN: How significant is it that these scandals tend to grow up around recessions?

TAYLOR: Part of it is that people are angry about losing money and, as I said, looking for a scapegoat. They thought they were rich and now they are not. They figure that someone took the money and someone must pay them back. We saw this in the Great Depression, when business was demonized and accountants were trashed. In fact, there have been only a few high-profile cases of accounting controversy in this recession out of the hundreds and thousands of company stocks that have taken huge hits. But the political class likes to seize on these and direct attention toward them.

People have tended to think that the purpose of the stock market is

to assure people of a constantly growing portfolio. The nice ride up during the 90s made things seem so easy and automatic. In fact, of course, capital markets cannot assure this. The market has not mistreated people; it is people who have misunderstood the purposes of the market, which is not to make everyone rich but rather to provide opportunities for resources to find their most valuable uses.

AEN: And it is an error-ridden process.

TAYLOR: If only because the future is unknown. In light of the recession, for example, many companies have had to restate their projected earnings, generally referred to as “pro forma” earnings, based on new forecasts, so you end up with many accounting restatements. These restatements are often cast by the press as admissions of guilt when they are nothing other than adaptive behavior in light of new market realities.

Recessions introduce new uncertainties. The thing to be explained is the cluster of accounting errors. The explanation of this is very similar to the cluster of errors that characterizes the market generally. But let’s not confuse restatements of previous forecast earnings with major audit failures involving erroneous financial statements purporting to reflect the actual results of past operating periods. The latter situations should be minimal and can be explained only by either auditor negligence or fraud involving upper management and possibly the auditors, too.

I was struck that not once during the bubble did I note anyone demanding that corporations justify their numbers. So long as people are making money, it doesn’t

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seem to matter. What’s more, the management always wants a company to look as good as possible in the eyes of investors, and so management will often push auditors to paint a pretty picture, with nice upward trend lines, arguing for favorable leanings within acceptable

accounting guidelines. I recall once when I was doing an audit that the CFO actually wrote on the chalkboard the earnings-per-share that he expected us to find acceptable.

This is not fraud. It is just aggressive market behavior. CEOs and

causes people to look more carefully at business conditions, with an eye toward allocating resources more carefully.

AEN: What about accounting and audits under normal business conditions? Are there other dimensions of it that are not generally understood?

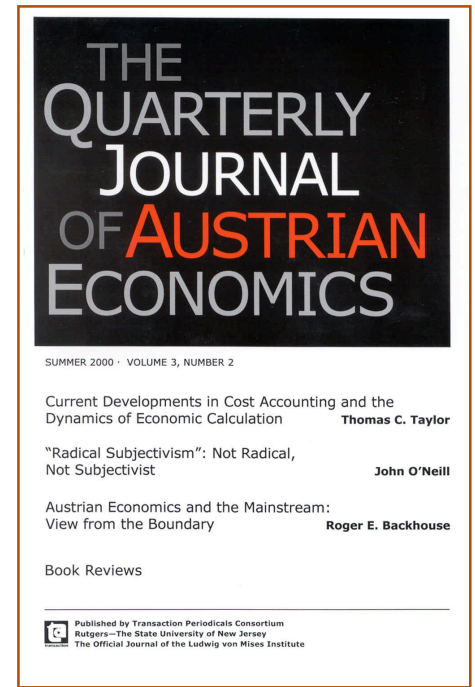
TAYLOR: People need to realize that it is not easy to find everything in audits. For any mid-size company and up, they are done on a sample basis. Otherwise, they would be absurdly expensive and time consuming. Mistakes will be made. There are many details that cannot be known. There can be errors and disagreements. It is not as simple as it is made out to be, such that a CFO or CEO can sign a statement that says: "These accounting statements are true."

If we take this line of thinking far enough, we begin to get very confused about the nature of accounting itself. We begin to think of it as a police power of the state rather than something intrinsic to the market process itself. Accountants shouldn't wear badges. They are providing a service that is indispensable to the market. Most concerned people do not wish to see the market hampered with a lack of trust. On the other hand, the bear market shows that the best means to restore trust is to allow the market to sort out the standards of trustworthiness.

The institution of accounting is a central element in the crucial pillar of monetary calculation in Austrian economic theory. As Mises argued, the ability to calculate profits and

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CFOs can get away with this for a period of time, but the market works to keep them honest. In a sense, we could say that this is one beneficial aspect of a recession. It



losses, both retrospectively and prospectively, is the very essence of what constitutes economic behavior. Without that ability, the economy collapses into chaos because investors and entrepreneurs are just groping in the darkness. This is the essential point of his devastating socialist calculation critique. Even under attempts at socialism in the real world, places like the Soviet Union had access to competitive market prices from outside the socialist domain. Thus theirs was never a purely socialist endeavor albeit a doomed experiment given its central planning basis.

Stock markets and money markets will be in sync with the results generated by the capital markets. This is an important linkage. The companies that do well attract more resources. If you break that linkage between stock markets and capital markets, you mislead people, which is what both credit expansion does

and what bad accounting does. The market will not tolerate this kind of static for long. This is why I am not losing sleep over this, except to the extent that government gets involved.

AEN: The drive to federalize accounting standards predates the current recession.

TAYLOR: It goes way back, even to the Great Depression. One change that emerged out of that is mandatory audits for public companies. Well, what effect has this had? It has given investors a false sense of security based on the idea that paternal government is taking care of us. It also diminished competition for auditing firms. Neither has been a good thing for conservative auditing standards.

Even so, the private sector has been the dominant influence in accounting. Certainly the SEC has had strong influence. But the bottom line is that all the talent and expertise in the private sector are the source of sound accounting standards and auditing procedures. The popular demand these days is that the SEC tighten its surveillance with increased resources and that the new oversight board needs significant enforcement power.

Actually, what we need is less government intervention and a more competitive marketplace in which investors come to understand that investors themselves are the final authority in judging the soundness of a company's books. We need to let firms provide audits to whom they would like, however they would like, and whenever they would like. The market can sort

out the best companies and standards. While much of the existing edifice would no doubt survive, at least there would be the opportunity for a great diversity of approaches.

This is not an invitation for rampant fraud any more than is the freely competitive process of delivering laptop or handheld computers. The realm of effective accounting is distinct from the realm of cheaters. This is fundamentally no different from all other dimensions of social life. No one can deny that under capitalism, or any other form of social organization, opportunities to cheat and deceive exist. The record, of course, reveals the system where the greatest opportunities arise.

AEN: What about the problem of accounting compatibility and comparability? Aren't uniform standards needed?

TAYLOR: If that is the case, and I generally agree that this is true, the market will generate uniform standards. A company that is being audited by a firm that specializes in eccentric standards will come under suspicion. There is probably a natural tendency in a market economy for firms to adopt uniform standards of accounting, if that is indeed what the market requires. But it could be that an auditing firm may specialize in departing from those standards in order to provide a better product. It must be free to do this if we want the best quality product.

Forces in the market have already shown serious response to the current situation. For example, the

New York Stock Exchange is instituting new filing requirements regarding the independence of board members and their audit and compensation committees. Standard and Poor's, the important

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credit ratings company, has developed its own concept of "core earnings" for the purpose of analyzing the earnings performance of thousands of public corporations. These are market responses without governmental mandates!

In part because of federal involvement, we tend to think of audits as a perfectly uniform product. But, in fact, there are many different qualities available at different prices that generate different results. It

tendency to just satisfy that law rather than the market.

In any case, the degree of uniformity out there right now is exaggerated. Even under Generally Accepting Accounting Principles or GAAP, there is so much diversity in accounting. Analysts now have to tinker with numbers all the time to make comparisons between two similar sized companies in the same industry. There is no way to know *a priori* how much uniformity will be demanded.

AEN: Again, underscoring the need for a market to provide a constant check.

TAYLOR: There is no way to know in advance of market competition to what extent audits are needed, what kinds of accounting standards should prevail, and the conditions under which they should take place. The current hysteria is based in large part on confusion. No institution in society has a greater incentive to bring about honesty in accounting than the market itself. Certainly the government has no great record in honest accounting. We cannot expect it to manage private-sector accounting.

AEN: Finally, congratulations on your book *An Introduction to Austrian Economics*, which has been in print continually for 22 years.

TAYLOR: Thank you. I am extremely pleased about that. And I am grateful that the Mises Institute has deemed it worthy of publication and use for all these years. ■■■ **AEN**

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should be up to the market process to determine how much in the way of resources companies should put into audits and accounting. Now, with federal oversight, there is a

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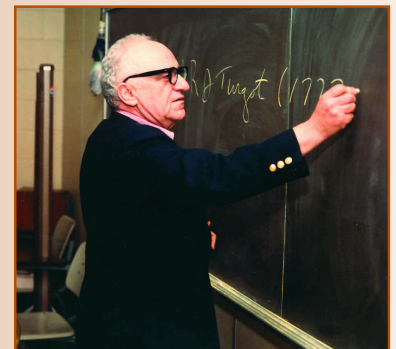
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About the *Austrian Economics Newsletter*

The *Austrian Economics Newsletter* began publishing in the fall of 1977, under the auspices of the Center for Libertarian Studies, which was then located in New York City. The writers and editors were part of a small but growing contingent of graduate students in economics who had been influenced by Ludwig von Mises's New York seminar and the writings and personal example of Mises's students Murray N. Rothbard and Israel M. Kirzner, as well as Ludwig Lachmann. Their goal was to reinvigorate Austrian theory in a new generation as a means of combating mainstream trends in economic thought.

But for the Nobel Prize given to F.A. Hayek in 1974, academia then considered Austrian economics to be a closed chapter in the history of thought, supplanted by Keynesianism and the neo-classical synthesis. The purpose of the *AEN* was to provide a forum for Austrian students and serve as a communication tool for the new movement. Among its most effective offerings was the interview, which provided students an inside look into the thinking, drawn out in an informal setting, of the best Austrian theorists.

At the request of the Center for Libertarian Studies, the Mises Institute assumed responsibility for the publication in 1984 and nurtured it to become the most closely read periodical in the world pertaining exclusively to the Austrian School. Two years later, Murray N. Rothbard founded the *Review of Austrian Economics* (later succeeded by the *Quarterly Journal of Austrian Economics*) to provide an outlet for scholarly articles, thereby relieving the *AEN* of this responsibility. The *AEN* began to emphasize reviews, topical pieces, and, most of all, the extended interview as an effective means of highlighting the newest contributions of Austrians to the literature. Today, interview subjects are now chosen from a variety of disciplines to reflect the full influence of the Austrian tradition.

Over the years, the *AEN* has interviewed a variety of scholars, including the following:

William L. Anderson	Randall G. Holcombe	George Reisman
Dominick T. Armentano	Hans-Hermann Hoppe	Shawn Ritenour
Walter Block	Jeffrey M. Herbener	Murray N. Rothbard
James Buchanan	Jesús Huerta de Soto	Joseph T. Salerno
Peter Calcagno	Israel M. Kirzner	Pascal Salin
Paul Cantor	Peter G. Klein	Hans F. Sennholz
Gregory Dempster	George Koether	G.L.S. Shackle
Thomas J. DiLorenzo	Alexander Kouryaev	Frank Shostak
Gene Epstein	Ludwig M. Lachmann	Karl Socher
Roger W. Garrison	Fritz Machlup	Thomas C. Taylor
James Grant	Yuri N. Maltsev	Mark Thornton
Bettina Bien Greaves	Roberta Modugno	Richard K. Vedder
Gottfried von Haberler	Hiroyuki Okon	Christopher Westley
Henry Hazlitt	Michael Prowse	Leland B. Yeager

Complete archives of these interviews are available at <http://www.mises.org/journals.asp>.

With the expansion and redesign of the *AEN* that began with Volume 21, the *AEN* has sought to put on display the energy, creativity, and productivity of today's Austrian thinkers, who work in many fields to bring the insights of the tradition to bear on new issues of the day. It is a sign of the health and vigor of the Austrian movement that the list of thinkers slated for interview in the future grows ever longer.

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