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IS OUR ACCOUNTING SYSTEM FLAWED?

It may be insensitive to capital destruction

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The accounting principle, the Law of Liabilities, asserts that a firm must carry its liabilities in the balance sheet at its value upon maturity, or at liquidation value, *whichever is higher*. This Law is universally ignored by present accounting standards, which threatens the economy with massive deflation through the destruction of capital, in view of the persistent fall of interest rates for the past 25 years, as it keeps increasing the liquidation value of debt.

The Book-Keeper's Dilemma

One of the plays of George Bernard Shaw branded "unpleasant" by the playwright himself is entitled *The Doctor's Dilemma*. The protagonist is a physician who comes into conflict with the Oath of Hippocrates (fl. 460-377 B.C.) He has developed a new treatment for a fatal disease, but the number of volunteers for the test-run exceeds the number of beds in his clinic. Unwittingly, the doctor finds himself in the role of playing God as he decides who shall live and who shall die.

By the same token Shaw could have written another "most unpleasant" play entitled *The Book-Keeper's Dilemma*. The protagonist, a chartered accountant, finds himself in conflict with the letter and spirit of book-keeping set out by Luca Pacioli (fl. 1450-1509). As a result of compromising the high standards of the accounting profession, the book-keeper becomes the destroyer of Western Civilization.

Finest Product of the Human Brain

Luca Pacioli taught mathematics at all the well-known universities of Quattrocento Italy including that of Perugia, Napoli, Milan, Florence, Rome, and Venice. In 1494 he published his *Summa Arithmetica*, Tractatus 11 of which is a textbook on book-keeping. The author shows that the assets and liabilities of a firm do balance out at all times, provided that we introduce a new item in the liability column that has been variously called by subsequent authors "net worth", "goodwill", and "capital". This innovation makes it easy to check the ledger for accuracy by finding that, at the close of every business day, assets minus liabilities is equal to zero. If not, there must be a mistake in the calculation.

But what Pacioli discovered was something far more significant than a method of finding errors in the arithmetic. It was the invention of what we today call double-entry book-

keeping, and what Göthe called "the finest product of the human brain" (*Wilhelm Meister's Apprenticeship.)*

Why was this discovery so important in the history of Western Civilization? Because, for the first time ever, it was now possible to calculate and monitor shareholder equity with precision. This is indispensable in starting and running a joint-stock company. Without it new shareholders could not get aboard, and old ones could not disembark safely. There would be no stock markets. The national economy would be a conglomeration of cottage industries, unable to undertake any large-scale project such as the construction of a transcontinental railroad, or the launching of an intercontinental shipping line.

The invention of the balance sheet did to the art of management what the invention of the compass did to the art of navigation. Seafarers no longer had to rely on clear skies in order to keep the right direction. The compass made it possible to sail under cloudy skies with equal confidence. Likewise, managers no longer have to depend on risk-free opportunities to keep their enterprise profitable. The balance sheet tells them which risks they may take and which ones they must avoid. It is no exaggeration to say that the present industrial might of Western Civilization rests upon the corner-stone of double-entry book-keeping. Oriental (Chinese) and Middle-Eastern (Arab) civilizations would have outstripped ours if they had chanced upon the discovery of the balance sheet first. By the same token, the continuing leadership of the West depends on keeping accounting standards high and isolated from political influences.

Barbarous Relic or Accounting Tool?

There is cause for concern in this regard. For the past 75 years the West has been fed the propaganda line, attributed to John Maynard Keynes, that the gold standard is a "barbarous relic", ripe to be discarded. The unpleasant truth, one that propagandists have 'forgotten' to consider, is that the gold standard is merely a proxy for sound accounting and, yes, for sound moral principles. It is an early warning system to indicate erosion of capital. It was not the gold standard *per se* that politicians and adventurers wanted to overthrow. They wanted to get rid of certain accounting and moral principles, especially as they apply to banking, that had become an intolerable fetter upon their ambition for aggrandizement and perpetuation of power. Historically, accounting and moral principles had been singled out for discard before the gold standard was given the *coup de grâce.*

The attack on accounting standards and on the gold standard was heralded by the establishment in 1913 of the Federal Reserve System (the Fed) in the United States, the chief engine of monetizing government debt. Just how the monetization of government bonds has led to a hitherto unprecedented, even unthinkable, corruption of accounting standards — this is a question that has never been addressed by impartial scholarship before.

Bonds and the Wealth of the Nation

In order to see the connection we must recall that any durable change of interest rates has a direct and immediate effect on the value of financial assets. Rising interest rates make the value of bonds fall, and falling rates make it rise. As a result of this inverse relationship the Wealth of the Nation flows and ebbs together with the variation of the rate of interest. Benefits and penalties are distributed capriciously and indiscriminately, without regard to merit.

This was hardly disturbing under the gold standard, as the rate of interest was remarkably stable and the corresponding changes in the Wealth of the Nation were negligible. A lasting increase in the rate of interest could only occur in the wake of a national disaster such as an earthquake, flood, or war. In all these cases a higher rate of interest was beneficial.

It had the effect of spreading the loss of wealth due to the destruction of property more widely, easing the burden on individuals. Those segments of society that were lucky enough to escape physical destruction had to share in the loss through the increased cost of servicing capital due to higher interest rates. Everyone was prompted to work and save harder in order that the damage might be repaired quickly and expeditiously. As the rate of interest gradually returned to its lower level, the Wealth of the Nation expanded. Once again, everybody shared equally, as the lower interest rate benefited all, through the reduction in the cost of servicing capital.

It is not widely recognized that the chief eminence of the gold standard is not to be found in stabilizing the price structure (which is neither desirable nor possible). It is to be found in stabilizing the interest-rate structure. By ruling out capricious and disturbing swings, the Wealth of the Nation is maximized.

The gold standard ruled supreme before World War I. It was put into jeopardy when general mobilization was ordered in 1914 by the manner in which belligerent governments set out to finance the war effort. Governments wanted to perpetuate the myth that the war was popular and there was no opposition to the senseless bloodshed and destruction of property that could have been avoided through better diplomacy. The option of financing the war through taxes was ruled out as it might make the war unpopular. The war was to be financed through credits. In more details, war bonds were sold in unprecedented amounts, subsequently monetized by the banking system. Naturally, these bonds could not possibly be sold without a substantial advance in the rate of interest. Accordingly, the Wealth of Nations shrank even before a single shot was fired or a single bomb dropped.

Under the gold standard bondholders are protected against a permanent rise in the rate of interest (which in the absence of protection would decimate bond values) by the provision of a sinking fund. In case of a fall in the value of the bond the sinking fund manager would enter the bond market and would keep buying the bond until it was once more quoted at par value. Every self-respecting firm issuing bonds would offer sinking-fund protection.

Even though governments did not offer it, it was understood and, in the case of Scandinavian governments explicitly stated, that the entire bonded debt of the government would be refinanced at the higher rate, should a permanent rise in the rate of interest occur. Bondholders who have put their faith in the government would not be allowed to suffer losses. The banks, guardians of the people's money, could regard government bonds as their most trusted earning asset. They were solid like the rock of Gibraltar. Such faith, at least in Scandinavian government obligations, was justified. The risk of a collapse in their value was removed. Governments, at least those in Scandinavia, occupied the moral high ground. The money they borrowed belonged, in part, to widows and orphans. They took to heart the admonition and did not want to bring upon themselves the Biblical curse pronounced on tormentors of widows and orphans.

Law of Assets

However, there was a problem with war bonds issued by belligerent governments. They were quickly monetized by the banking system making the refinancing of bonded debt impossible. This created a dilemma for the accounting profession. According to an old book-keeping rule going back to Luca Pacioli that we shall refer to here as the Law of Assets, *an asset must be carried in the balance sheet at acquisition value, or at market value,* ***whichever is lower***. In a rising interest-rate environment the value of bonds and fixed-income obligations are falling, and this fall must be faithfully recorded in the balance sheet of the bondholder.

There are excellent reasons for this Law. In the first place it is designed to prevent credit abuse by the banks and other lending institutions. In the absence of this Law banks

would overstate their assets that could be an invitation to credit abuses to the detriment of shareholders and depositors. If the abuse went on for a considerable period of time, then it could lead to the downfall of the bank. In an extreme case, when all banks disregarded the Law of Assets, the banking system could be operating on the strength of phantom capital, and the collapse of the national economy might be the ultimate result. For non-banking firms the danger of overstating asset values also exists, and can serve as an invitation to reckless financial adventures. Even if we assume that upright managers would always resist the temptation and stay away from dubious adventures, in the absence of the Law of Assets the balance sheet would be an unreliable compass to guide the firm through turbulence, materially increasing the chance of making an error. Managerial errors could compound and the result could again be bankruptcy.

Economists of a statist persuasion would argue that an exception to the Law of Assets could be safely made in case of government bonds. The government's credit, like Caesar's wife, is above suspicion. The government will never go bankrupt. Its ability to retire debt at maturity cannot be doubted. As a guarantee these economists point to the government's power to tax. However, the problem is not with paying the nominal value of the bond at maturity, but with the purchasing power of the proceeds. Currency depreciation is a more subtle and, hence, more treacherous form of default. Governments, however powerful, cannot create something out of nothing any more than individuals can. They cannot give to Peter unless they have taken it from Paul first. Nor is the taxing power of governments absolute. Financial annals abound in cases where taxpayers have revolted against high or unreasonable taxes, sometimes overthrowing the government in the process. If the taxing power of governments had been absolute, then they could have financed World War I out of taxes. Bondholders would have suffered no loss of purchasing power as a result of debt-monetization, at least on the victors' side.

It is true that governments as a rule do not go bankrupt, but this could be a disadvantage. Putting a value on bonds higher than what they would fetch in the market is a fool's paradise. Governments could use methods, fair or foul, to stave off ill effects of their own profligacy. Awakening could be postponed, but it would be made that much ruder.

A strict application of the Law of Assets would have made most banks and financial institutions in the belligerent countries insolvent. The dilemma facing the accounting profession was this. If book-keepers insisted that the Law be enforced, they would be called "unpatriotic", and be made a scapegoat held responsible for the weakening financial system. Demagogues would charge that the accountants were undermining the war effort. On the other hand, if they allowed banks to carry government bonds in the asset column at acquisition rather than at the lower market value, then they would compromise the time-tested standards of accounting and expose the firm, and ultimately the national economy, to all the dangers that follows from this, not to mention the fact that they would also draw the credibility of the accounting profession into question.

Illiquid or Insolvent?

The story of how the accounting profession solved the dilemma has never been told. It may be a safe assumption that the dilemma was solved for it by the belligerent governments in prohibiting the public disclosure of the banks' true financial condition. In the meantime a new accounting code was created, far more lenient in adjudicating insolvency. The Law of Assets was thrown to the winds, and was replaced with a more relaxed one allowing the banks to carry government bonds at face value, regardless of true market value, as if they were a cash item. A new term was introduced to describe the financial condition of a bank with a hole in the balance sheet punctured by government bonds. Such a bank was henceforth considered

"illiquid", but still solvent. Never mind that the practice of allowing the illiquid bank to keep its door open is a dangerous course to follow. It has far-reaching consequences, including the threat to the very foundations of Western Civilization. The scandals involving Enron and Bear-Sterns may be only the beginning of the unraveling of the financial system. It is clear that the recent "sub-prime crisis" is a delayed effect of the unwarranted relaxation of accounting standards back in 1914.

While I cannot prove that a secret gag-rule was imposed on the accounting profession, I am at a loss to find an explanation why an open debate of the wisdom of changing time-honored accounting principles has never taken place. Apparently there were no defections from the rank and file of the accountants denouncing the new regimen as unethical and dangerous. The underhanded changes in accounting practice have opened the primrose path to self-destruction.

The dominant role of the West in the world was due to the moral high ground staked out by the giants of the Renaissance, among them Luca Pacioli. As this high ground was gradually given up, and the commanding post was moved to shifting quicksand, rock-solid principles gave way to opportunistic guidelines. Western Civilization has been losing its claim to leadership in the world. It comes as no surprise that this leadership is now facing its most serious challenge ever.

The chickens came home to roost as early as 1921 when panic swept through the U.S. government bond market. Financial annals fail to deal with this crisis (exception: B. M. Anderson's Financial and Economic History of the United States, 1914-1946, posthumously published in 1949, see reference at the end). Nor was it given the coverage it deserved in the financial press. Information was confined to banking circles. An historic opportunity was missed to mend the ways of the world gone astray in 1914. It was the last chance to avert the Great Depression, already in the making.

Law of Liabilities

Purely by using a symmetry argument we may formulate another fundamental principle of accounting: the Law of Liabilities. It asserts that *a liability must be carried in the balance sheet at its value at maturity, or at liquidation value,* ***whichever is higher***. Since liquidation would have to take place at the current rate of interest, in a falling interest-rate environment the liabilities of all firms are rising. This spells a great danger to the national economy, one that has been completely disregarded by the economists' profession, as it also has by the accountants' profession.

Economists have failed to raise their voice against the folly of allowing the interest-rate structure to fluctuate for reasons of political expediency, implicit in the application of both Keynesian and Friedmanite nostrums. It is possible that the reason for this failure was the fatal blind spot that economists appear to have in regard to the danger of overestimating national income in a falling interest-rate environment.

The proposition that a firm must report liabilities at a value higher than that due at maturity whenever the rate of interest falls is, of course, controversial. Let us review the reasons for this crucial requirement. If the firm is to be liquidated, then all liabilities become due at once. Sound accounting principles demand that sufficient capital be maintained at all times to make liquidation without losses possible. If the rate of interest were to fall, then, clearly, earlier liabilities had been incurred at a rate higher than necessary. For example, if an investment had been financed through a bond issue or fixed-rate loan, then better terms could have been secured by postponing it. A managerial error in timing the investment had been made. This is a world of crime and punishment where even the slightest error brings with it a penalty in its train. Marking the liability in the balance sheet to market is penalty for poor

timing. If the investment had been financed out of internal resources, penalty is still justified. Alternative uses for the resource would have generated better financial results.

Even if we assume that the investment was absolutely essential at the time it was made, and we absolve management of all responsibility in this regard, the case for an increase in liability still stands. After all has been said and done, there is a loss that must not be swept under the rug. If the balance sheet is to reflect the true financial position, then the loss ought to be realized. Any other course of action would create a fool's paradise. To see this clearly, consider losses due to an accidental fire destroying physical capital uncovered by insurance. The loss must be realized as it is absolutely necessary that the balance sheet reflect the changed financial picture caused by the fire. That's just what the balance sheet is for. The proper way to go about it is a three-step adjustment as follows:

(1) Create an entry in the asset column called "fund to cover fire loss".
(2) Create an equivalent entry in the liability column.
(3) Amortize the liability through a stream of payments out of future income.

It is clear that if the accountant failed to do this, then he would falsify future income statements. As a result phantom profits would be paid out and losses would be reported as profits. Not only would this weaken the financial condition of the firm, but it would also render the balance sheet meaningless, which may compound the error further.

Exactly the same holds if the loss was due not to accidental fire but to a fall in the rate of interest. The way to realize the loss is analogous. A new entry in the asset column must be created under the heading "fund to cover overpayment in servicing capital, due to a fall in the interest rate", against an equivalent entry in the liability column, to be amortized through a stream of payments out of future income. *This is not an exercise in pedantry*. It is the only proper way to realize a loss that has been incurred as a result of the inescapable increase in the cost of servicing productive capital already deployed, in the wake of a fall in the rate of interest. Ignoring that loss would by no means erase it. It may well compound it.

Historic Failure to Recognize the Law of Liabilities

I anticipate a torrent of criticism asserting that there is no such a thing as the Law of Liabilities in accounting theory or practice. I submit that I have no formal training in accounting, or in the theory and history of accounting. Nor do I recall having seen the Law of Liabilities in any of the textbooks on book-keeping that I have perused (although I have seen the Law of Assets in older textbooks that have long since been discarded by professors of accounting as obsolete). But I shall argue that either Law follows the spirit if not the letter of Luca Pacioli. Affirming one Law while denying the other makes no sense. Every argument that supports one necessarily supports the other. The Law of Liabilities is a mirror image of the Law of Assets, arising out of the perfect logical symmetry between assets and liabilities.

Ignoring either Law is a serious breach of sound accounting principles, possibly with grave consequences. For example, if the rate of interest keeps falling for an extended period of time, as it has in Japan for over fifteen years, then the present (in my opinion, deeply flawed) accounting rules will allow losses to be reported as profits. Wholesale capital consumption/destruction may be the result, which the country may not realize until it is too late. Banks and producing firms would operate on the strength of phantom capital, and would ultimately collapse. This could bring the national economy to its knees, spelling deflation, depression, or worse (as it seems to be occurring in Japan right now). This depression appears to be metastasizing across the Pacific to the United States through the yen-carry trade, foolishly encouraged by both central banks concerned.

Even if the fact were established that the Law of Liabilities has never been spelled out in any accounting code going back all the way to Luca Pacioli, we should still not jump to the conclusion that there is no justification for it. A convincing argument can be made explaining why the Law of Liabilities has escaped the notice of upright and knowledgeable accountants in the past with the consequence that it has never been codified. Since time immemorial the powers-that-be have shown a persistent bias favoring debtors against creditors, as demonstrated by their desire to suppress the rate of interest by hook or crook. However, this effort has remained counter-productive before the advent of central bank open market operations in the 1920's championed by the Fed. Indeed, the usuriously high rates charged on loans in pre-capitalistic times were not due to an alleged greed of the usurers. They were due to the usury laws themselves. Charging and paying interest had been outlawed, but the result was not zero interest on loans as the authors of the usury laws had foolishly anticipated. On the contrary, the result was rates higher than what the free market would have charged, representing compensation for risks involved in doing an extra-legal business transaction. For these and other reasons the problem, traditionally, was not falling but rising rates. In such an environment the Law of Liabilities remains inoperative and is easily overlooked. It is hard to discover a law that has been inoperative through all previous history.

The situation changed drastically when the Federal Reserve started its illegal open market operations. (The practice was later legalized through retroactive legislation.) Speculators were happy to jump on the bandwagon of risk-free profits. They could easily preempt the Fed by purchasing the bonds beforehand. After the Fed has bought its quota, speculators dumped the bonds and pocketed the profits. The net result was a falling interest rate structure.

In fact, the opportunity for risk-free profits from bond speculation due to the introduction of open market operations was a major cause of the Great Depression. Yet to this day textbooks on economics hail open market operations as a refined tool in the hands of monetary authorities "to keep the economy on an even keel". Only one other mistake economists have made surpasses this one in enormity. Textbooks blame the Great Depression on the "contractionist bias" of the gold standard.

This is just the opposite of the truth. The Great Depression was largely caused by the governments sabotaging the gold standard in preparation for its overthrow, as I shall now show. The persistent fall of interest rates in the 1930's has never been properly explained. What happened was that the only competition for government bonds, gold, has been knocked out through confiscation and other measures of intimidation. Freed from competition, the value of government bonds started to rise, making interest rates fall, causing prices to fall, too. The Great Depression was self-inflicted. Governments in their zeal removed the gold standard, the policeman cordoning off the black hole of zero interest to prevent interest rates from falling in. Speculators were quick to understand that this also meant the removal of a ceiling on bond prices. For the first time ever, there was an opportunity to bid bond prices sky-high. Speculators abandoned the high-risk commodity markets in droves and flocked to the bond market to reap risk-free profits made available by the regime of open market operations. You cannot understand the Great Depression without understanding how speculators reacted to the removal of competition for government bonds. Only by searching for the consequences of the forcible removal of gold from the system can the unprecedented fall in interest rates and the Great Depression be explained.

Threat of a New Depression

Superficial thinking may suggest that if the rise of interest rates is bad, then their fall is good for the economy. Not so. A falling rate is even more damaging than a rising one. I am aware

that my thesis is highly counter-intuitive. I have been challenged by many other economists who deny the validity of my contention. They argue that if the present value of future income is lower when discounted at a higher rate, then it must be higher when discounted at a lower rate of interest. We may admit that this statement is true. However, obviously, the firm has to be around to collect the higher income. Many of them won't be, as they succumb to capital squeeze caused by falling rates. My critics hold that falling rates are always beneficial to business and it is preposterous to suggest that they aggravate deflation. These critics confuse a *falling* structure of interest rates with a *low* structure. While the latter is beneficial, the former is lethal to producers. When interest rates are falling, the low rates of today will look like high rates tomorrow. A prolonged fall creates a permanently high interest-rate environment. This paradox explains the reluctance of the mind to admit that falling rates spell deflation and, in an acute case, depression.

Falling rates mean that businesses have been financed at rates far too high. This fact ought to be registered as a loss in the balance sheet, and be compensated for by an injection of new capital. If businesses choose to ignore the loss, and they merrily go on paying out phantom profits in the form of dividends and executive compensation, then they will further weaken capital structure. When they finally plunge into bankruptcy, they wonder what has hit them. They don't understand that they have failed to augment their capital in the face of falling interest rates. Their downfall is due to insufficient capital. In a falling interest rate environment all producers are affected by the elusive process of capital destruction. This was true in the 1930's; it is still true today. Incidentally, this also explains why American producers have been going out of business in droves since the mid-1980's, resulting in the export of the best-paying industrial jobs to Asian countries such as China and India where labor costs were lower.

The U.S. government may be unconcerned about the fact that the liquidation value of its debt is escalating by several orders of magnitude due to falling interest rates. After all, the Fed has the printing presses to create dollars with which any liability can be liquidated, however large. American producers are not so fortunate. They have to produce more and sell more if they don't want to sink deeper in debt. But selling more may not be possible in a falling interest-rate environment, except at fire-sale prices. What this shows is that *the cause of deflation is not falling prices: it is falling interest rates.* As they fall, a vicious circle is set in motion. Bond speculators take advantage of the opportunity created by the central bank's open market operations. They forestall central bank buying of government bonds. The resulting fall in interest rates bankrupt productive enterprise that could not extricate itself from the clutches of debt contracted earlier at higher rates. The debt becomes ever more onerous as its liquidation value escalates past the ability to carry it. The squeeze on capital causes wholesale bankruptcies among the producers.

What central bankers never consider is that, while they have the power to put unlimited amounts of irredeemable currency into circulation, they have no power to make it flow in the "approved" direction. Money, like water, refuses to flow uphill. In a deflation it will not flow to the commodity market to bid up commodity prices as central bankers have hoped. Rather, it will flow downhill, to the bond market, where the fun is bidding up bond prices. As the central bank has made bond speculation risk free, the bond market will act as a gigantic vacuum cleaner sucking up dollars from every nook and cranny of the economy. A sense of scarcity of money will become pervasive.

In feeding ever more irredeemable currency to the markets the central bank cuts the figure of a cat chasing his own tail. More fiat money pushes interest rates lower; falling interest rates squeeze producers more. They cut prices in desperation, and cry out for the creation of still more fiat money, completing the vicious circle. The interest rate structure and

the price level are linked. Subject to leads and lags, they keep moving together in the same direction.

The Fed through its open market operations generates a deflationary spiral that may ultimately bankrupt the entire producing sector. Like the Sorcerer's Apprentice, the Fed can start the march to the black hole of zero interest, but hasn't got a clue how to stop it when the pull of the black hole becomes irresistible. At that point the deflationary spiral gets out of control.

Stop the March to the Black Hole of Zero Interest!

Restoring sound accounting standards is imperative if we want to avoid the pending disaster. We must stop turning a blind eye to the deleterious effect of a falling interest rate environment on capital deployed in support of production. Open market operations of the Fed, the chief cause of deflation as demonstrated by the pull of the black hole of zero interest, must be outlawed.

Only the gold standard can effectively cordon off the black hole of zero interest. By opening the Mint to gold, the U.S. government must restore the gold standard.

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