Competition as a Discovery Procedure in the Practice of Accounting[*]

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1. Introduction

Even though they developed separately as two distinct disciplines, there is a complex relationship between accounting and economics. For example: 1) accounting is a means that makes economic calculation possible; it provides the managers, the investors and lenders (current and potential), and the public in general with information that aids them in assessing the profitability and the appropriate use of resources of a business. Although mainly historical, accounting information allows them to form an expectation of future performance and hence it is useful for making economic decisions; 2) economics theorizes on the same elements which accounting endeavors to measure; 3) the market for financial reporting, i.e. for the financial statements and other information disclosed periodically by companies, which is one of the products of an accounting system, is a market like that of any other good or service and it is therefore subject to the same economic analysis. Given this complex relationship, there are several paths an economic work on accounting could take.

This author will approach his study first by acknowledging that accounting is an evolving institution, one of spontaneous formation that has not yet reached, and probably will never reach, its final form. Although its form and practice has been subjected to regulation by different governments and governmental agencies for centuries, in particular the market for financial reports of public companies, that fact does not change its spontaneous character. The author will also argue that competition is underutilized as a discovery procedure in accounting in general and in the preparation of financial reports in particular. As a consequence of government intervention, better and less expensive ways of serving the consumers of financial reports have not yet been discovered under the current system.

As an economist and practicing accountant, this author could be tempted to try to prescribe the form and substance of the financial reports. Although admittedly economics could inform a lot about this, and the author does not deny the importance of those investigations for the marketplace of ideas, one of the main conclusions of this essay is that one of the tasks of competition is precisely to discover the characteristics of the goods and services that best serve the consumers and hence, to discover the substance and form of the financial reports that best aid the users for their particular ends.

After this introduction, in the second part of this essay, the author will summarize the conceptions that Friedrich A. Hayek developed and that are relevant for his analysis. In the

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[*] Dedicated to the memory of Juan Carlos Cachanosky and Giancarlo Ibargüen, whose works on the substance (Cachanosky, 1999) and practice (Ayala & Ibargüen, 2006) of accounting furthered the interest of the author in this research program. The interest was also sparked by Professor Jesus Huerta de Soto's remarks on Fair Value Accounting (Huerta de Soto, 2009, pp. xxii-xxv).

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third part, an elaboration of accounting as a language is provided. In the fourth part, a brief summary of the history of accounting, since the spontaneous emergence of the double entry bookkeeping system in medieval Europe until our times, will be presented, along with the origin and alleged justifications of government intervention in accounting. In the fifth part, the author will enumerate some of the problems presented by such intervention. In the sixth part, to conclude this essay, a general prediction of a free market in accounting services will be presented.

Financial reporting is a subset of accounting. Usually the same system fulfills several ends such as filling tax statements (tax accounting), tracking and allocation of cost elements to different products or services (cost accounting) and the preparation of financial reports for external users such as current and potential lenders and investors (financial accounting). In this work, the arguments are addressed in general to accounting and in particular to financial reporting. When names such as financial reporting, financial reports, financial accounting, external reporting and others similar are not explicitly mentioned, the arguments should be understood as applying to accounting in general.

2. Theoretical framework

Hayek first elaborates on the difference between rules and commands in *The Constitution of Liberty* (1960, pp. 149-51). Rules are those conventions that are abstract, general, oftentimes unarticulated, that guide or inform actions of individuals but that do not impose them specific actions, so people are free to use their knowledge, that do not aim at specific ends, and are negative in the sense that they only indicate what the actors must refrain from doing, mainly to assure others a free sphere of action. In contrast, a command is a concrete order, given by an identifiable issuer to a specific person or group, which aims at particular ends that the issuer finds valuable, and can take a positive or negative form (i.e. it can tell the actors what they must do besides telling them what they must not do). This distinction is important because spontaneous orders rest only on rules and not on commands (Hayek, 1973, pp. 43-46). As a matter of fact, commands can only disrupt the smooth functioning of the spontaneous order (Hayek, 1976, p. 128-29).

There is certain knowledge in society that is not concentrated but dispersed among all the people. It is the knowledge of particular circumstances of time and place (Hayek, 1948, p. 80). Being aware of this type of knowledge is very important as being able to use it allows people to make discoveries hitherto unknown, which are brought about by the process of competition among free individuals (Hayek, 2002, p. 9).

Hayek's conception of competition is different from that of mainstream economists. In "The Meaning of Competition" (Hayek, 1948, pp. 92-106), the Austrian Economist says that the "perfect competition model" has nothing to do with actual competition. In it, all the traits of competition are absent and it is useless and even dangerous for basing public policy on it. Its focus is the long term equilibrium in which, if ever reached, competition would cease to exist. In it, the relevant data or knowledge is assumed as given. Since one of its assumption is that a homogeneous commodity is provided and bought by a large number of sellers and buyers, who have no perceptible influence on the price, basing policies on its conclusions calls for compulsory standardization, demand for orderly competition, fair return of capital, destruction of excess capacity, etcetera.

In contrast, real competition is a dynamic process by which the data of the different participants are progressively adjusted. The lowest costs, the tastes of the consumers, the characteristics of goods and services to be demanded are also facts to be discovered through competition. Trial and error are the means to discover better ways to serve the consumers. Real competition is in a large measure a competition for reputation or goodwill. It spreads information among the people regarding who can serve them best. According to Hayek, the benchmark against which to measure the results of competition in the market should not be an unrealizable state of affairs but what would happen if competition is prevented from operating, for example, through licensing (Ibid. p. 100). According to him, not only would things not be produced by those who know how to produce them more efficiently but the things actually produced would be different from those that would have been chosen by the consumers, had they had the choice.

In his 1968 lecture under the title “Competition as a Discovery Procedure” (2002, pp. 9-23), Hayek elaborates more on actual competition and derives other important insights. Competition is a procedure for discovering facts which would remain unknown or unused if the procedure did not exist. Two important conclusions are that: 1) competition is important because its outcomes are unpredictable and different from what anyone could consciously strive for and 2) the validity of competition can never be empirically verified or, in other words, the particular outcomes cannot be confirmed; it can only be verified that those societies making use of it discover relevant circumstances to a greater extent. In that investigation Hayek introduces the terms *cosmos* and *taxis,* to distinguish spontaneous orders from made, planned orders, respectively, notions that he would develop further later in his career (1973, pp. 35-54). The cost of competition is considerable but it is not fair to judge the market “from the top down,” by comparing it with an ideal standard; that should rather be done “from the bottom up,” by comparing it with what we could obtain by other means, in particular, by comparison with what would be produced if competition were prevented.

According to Hayek, an order is a situation in which multiple elements are related so that it is possible to form correct expectations regarding the whole by knowing only a part of it (1973, p. 36). Hayek makes the distinction of two types of systems (or structures, or patterns) that usually go by the same name, namely, order (1973, pp. 35-54). He goes back to the Greek language to find new terms to distinguish between a made and designed order, or taxis, in the one hand and a spontaneous and undesigned order, or cosmos, in the other. It is habitual for people to think of an order as something designed and aiming to a particular end or set of ends. But in society and in nature another type of orders exists, like that of the market or an anthill.

The particular characteristics of spontaneous orders are that they are not the product of a thinking mind, they rest on the members following general rules, there is no single supreme authority, they allow each individual member to decide based on their particular knowledge of the circumstances and the rules, order is formed endogenously, they consist of abstract relationships between its members, they are not visible and they need to be grasped by the intellect and reflection, they can reach high complexity because they are not limited by what one single mind or group of minds can survey, they do not have a particular purpose but they are serviceable in the pursuit of multiple ends by its individual members.

Spontaneous orders evolve as the circumstances and the rules on which they are based evolve. This is why it is possible to influence the general character of one order by changing the rules. Not all the rules are conductive to an overall order.

While the rules on which a spontaneous order rests may also be of spontaneous origin, this needs not always be the case. It is possible to conceive a spontaneous order resting on rules deliberately made. The spontaneous character of the order is conceptually different from the spontaneous origin of the rules on which it is oftentimes based.

Groups of men will always join organizations to achieve particular ends, but these organizations also are part of an extended spontaneous order. In contrast to a spontaneous order, an organization is based on a designed hierarchical structure, rests on a relation of command and obedience and in a subsidiary manner on rules of organization, there is a single supreme authority who determines what each individual must do, it is relatively less complex (to allow one mind or group of minds to still survey it) and it serves a purpose. Corporations, private entities, nonprofit organizations and the government are examples of organizations.

The rules that made the growth of society possible were initially not designed, but people that adopted them were able to survive and preserve them and transmit them. That is how society came to be such a complex order, because it was not constrained by a single mind as, in the primitive tribes, the organization of the small group was constrained by the mind of the chief. This is why to say that modern society needs to be planned because it is "too complex" is paradoxical. The fact is that the extended order can be preserved only by enforcing and improving the rules conductive to the formation of spontaneous order. It is impossible to improve or correct the functioning of society by interference through direct commands. Social balance would be destroyed if some actions were determined by another agency on the basis of different knowledge and in the service of different ends.

The market order, along with money, "law, language, and morals" (Hayek, 1978, pp. 37-38) is a kind of spontaneous order, one with special attributes that are worth examining (Hayek, 1976, pp. 107-32). Its merit is to increase everyone's chance of having a greater command over various goods, and ultimately to satisfy more of their particular ends than what they would be able to secure by other means. Despite its merit, the price of the market order is the constant disappointment of some expectations.

Hayek uses the word *catallaxy* (derived from the Greek word *katalattein,* which remarkably means to exchange or to trade, but also to accept into the community and to turn an enemy into a friend) to distinguish the market order from an economy. An economy is that of an organization and as such it is designed upon a single scale of ends for which to aim. Catallaxy has no single order of ends. It was made possible when people substituted common ends by abstract rules, like those needed for trading

The extended order or Great Society is held together mainly by economic relations. Although this situation is often derided, it can hardly be denied, especially in the case of a complex society such as ours. These economic (means-connected) relations are what makes it possible to reconcile different ends. All ends are non-economic in nature, but the channels provided by the market make possible for everybody to attain their own ends. Policy should be oriented not to the attainment of particular ends, but to secure the overall order that allows the members of society the best chance to achieve their unknown particular ends. According to Hayek, the economists are entitled to insist that the degree of conduciveness to the market order be the standard against which all particular institutions are judged.

The correspondence of expectations comes at the price of frustrating some plans. But this process of adaptation operates as a negative feedback, in which the differences between expected and actual results tend to result in the reduction of said differences in the future, which will bring about an increased correspondence of expectations.

People should bear the cost of their decisions so they have the incentive to anticipate impeding changes as accurately as possible.

Interference in the market order through specific commands would be inconsistent with the overall order. It is an act that would disrupt it. It creates privilege: it secures benefits at the expense of others. The formation of the spontaneous order requires limiting coercion to the enforcement of rules of just conduct, were rules are uniform and applicable to all.

3. Accounting as a language

Accounting has been often referred to as “the language of business” (Davidson, 2008). This is much more than just a metaphor. Indeed, it is a systematic compilation of rules that guide the collection, classification, summarization, and presentation of the economic effects for an entity of transactions and other events. But accounting is much more than the rules that could fit into a manual; it also involves unarticulated rules but, furthermore, it involves the actions of gathering, recording, retrieving, preparing, and interpreting that information, a process that is performed by actual people and that confirms the order with every instance. Accounting is a true spontaneous order. In that, it is similar to any living language, for example, the English language. As English, it emerged spontaneously several centuries ago, it has changed, and it will keep changing.

Accounting is a spontaneous order in itself. Though closely related to, it is conceptually distinct from, the market order or catallaxy. In the next section a brief outline of the history of accounting and government intervention with its form and practice will be presented.

4. History of accounting

The double entry accounting system emerged spontaneously during the late Middle Ages. It evolved along with Western civilization during the Renaissance in the city-states of northern Italy: Pisa, Genoa, Florence and Venice (Gleeson-White, 2011). Those cities became trading centers due to their strategic position. The passing from the Feudal society to the more individualistic society is closely associated with the growth of commerce and it is therefore no surprise that along with commerce, a more sophisticated form of bookkeeping had evolved. Here is Hayek's own account of that period:

> "The gradual transformation of a rigidly organised hierarchic system into one where men could at least attempt to shape their own life, where man gained the opportunity of knowing and choosing between different forms of life, is closely associated with the growth of commerce. From the commercial cities of Northern Italy the new view of life spread with commerce to the west and north, through France and the south-west of Germany to the Low Countries and the British Isles, taking firm root wherever there was no despotic political power to stifle it." (1944, pp. 14-15)

This system of bookkeeping allowed medieval merchants to know not only what they had but also to calculate their profits and losses to know how well their business was doing.

The man responsible for the first systematic codification of the method was Luca Bartolomeo de Pacioli (c. 1447-1517), a Franciscan friar who in 1494 published a slender 27-page bookkeeping treatise, *Particularis de computis et scripturis* (Pacioli, 1999), originally as part of his mathematical encyclopedia *Summa de arithmetica, geometria, proportione et proportionalità*. Thanks to the printing press, it was very influential in making the Venetian method standard across Europe. This method has survived until our days. The way in which the books are kept has changed thanks to technological innovations, and the current criteria for recognizing and valuing elements and transactions are different from what they were at that time, but double-entry bookkeeping is an essential trait of modern accounting.

Pacioli is oftentimes called "the father of accounting." This epithet has made some think that he "invented" the method. That long widespread view can be exemplified by the following famous quote from the German poet Johann Wolfgang Goethe, who in 1795 made his character Werner say:

> "What advantages does the merchant derive from Bookkeeping by double-entry? It is amongst the finest inventions of the human mind." (Goethe, 1867).

In reality, the double entry system was not an invention; it had arisen spontaneously and it had been in use for two centuries before the publication of Pacioli's treatise (Gleson-White, 2011). It was the result of the contributions of thousands of people whose identities are unknown, so its invention cannot be attributed to anyone in particular.

As the double entry system spread, it proved to be very adaptable to other circumstances, not just those of the merchants, being used by multitude of businesses and other entities. From the late eighteenth century to the close of the nineteenth, the joint stock company rose above the others and bookkeeping transformed into accountancy, as the focus switched from recording exchanges to managing and controlling businesses (Gleeson-White, 2011). This was also the birth of capitalism. When new methods of mass production were discovered, books using double entry aided the managers in tracking and measuring the cost elements such as raw materials and labor in the manufacturing processes of various products. This is the branch of accounting known as cost accounting.

Another important change was the way the new industries needed to be funded. The railways, for instance, required enormous amounts of capital that no single individual or small group of acquaintances had at that time. This resulted in the emergence of the joint-stock company and financial accounting. Financial accounting rose to allow external owners and creditors to monitor the stewardship of corporate assets by management (King, 2006). With the split of the ownership from the management of a business, a new problem gained importance: the risk that managers behaved in a manner contrary to the interests of the owners or stockholders; what nowadays is called the principal-agent problem (Fama & Jensen, 1983). It was this risk, which materialized in actual cases of fraud, that put pressure on the British government to regulate industry in order to protect the public on the new stock markets (Gleeson-White, 2011).

The British parliament issued the Joint Stock Companies Act of 1844, which established conditions to form a company and required public disclosure of financial information (Gleeson-White, 2011). Companies had to pay dividends from profit and not capital, they had to be publicly registered, to present a “full and fair” balance sheet at annual shareholders’ meetings, and audit their accounts by people external to management (Ibid.).

Subsequently, in 1862 the presence of accountants was required at every phase of a public company: its formation, during its life, and at its liquidation (Gleeson-White, 2011). Thus, the demand for accountants increased exponentially. This was the first time they acquired the importance they nowadays have, as an unintended consequence of government regulation. Compulsory auditing made accountants ubiquitous and raised their professional status (Ibid.).

In the 1870s a group of accountants formed a charter with restricted membership to allegedly distinguish themselves from charlatans. Some years later, several British accounting groups were incorporated into the Institute of Chartered Accountants in England and Wales (ICAEW), by royal charter, with the endorsement of the Queen. Other countries imitated the example and there were professional bodies all around Europe. It is now time to turn to the United States of America, which was to displace Great Britain in its importance as the main financial market and which was to lead the regulation of the practice of accounting.

In 1862 the Bureau of Internal Revenue was established. The Revenue Act of 1894 established a flat 2 percent tax on corporate profits. This new regulation influenced accounting in establishing bright-line rules due to the high politicization of the process (King, 2006).

After the Crisis of 1929, the Securities and Exchange Commission (SEC) was founded in the United States, in order to prevent future cracks. The SEC was established by the Securities and Exchange Act of 1933, and the Securities and Exchange Act of 1934 established the requirement of filing periodic financial information and granted the SEC authority to prescribe financial accounting principles and specify the form and content of financial statements filed with the SEC (King, 2006).

Uniform financial accounting standards were conceived as a means to reduce diversity in practice which would allegedly lead to much misunderstanding by the investing public (King, 2006).

The history of the setting of the financial accounting standards in the U.S. is a very long a complex one. The issuance of what is called Generally Accepted Accounting Principles (GAAP) is performed today mainly by the Financial Accounting Standards Board (FASB). The SEC officially recognized the FASB through the issuance of Accounting Series Release 150 in December, 1973 (King, 1973). In their standard setting process the FASB can hold public hearing, solicit written comments, and release Exposure Drafts with the proposed accounting treatment. Interested parties then submit their comments (Ibid.).

Independent auditors formed in 1887 the American Association of Public Accountants, which is now called the American Institute of Certified Public Accountants (AICPA) (King, 2007), equivalent to the ICAEW in Great Britain. The AICPA lobbied for state certification, required certain minimum college education and established a uniform certification exam (Ibid.).

Public accountants successfully reduced the scope of the assurance (and of their responsibility) given in an audit report in order to cope with litigation risk. The auditor's report has changed from a *certificate*, to a *report* to an *opinion* (King, 2006).

After Enron's bankruptcy in 2001, the US Government's reaction was to further increase the regulation on the activities performed by all public companies by issuing the Sarbanes-Oxley Act (SOA) and creating the Public Company Accounting Oversight Board (PCAOB). It was now required that the Chief Financial Officer (CFO) of each company signed a statement on the effectiveness of the Company's internal control and that the external auditors issued a report on this management's statement, besides their previously required report on the fair presentation of its financial statements (SEC, 1934, Sec. 13, p. 120 and *ff*.).. The auditors also became subject to many regulations on the quality controls of their procedures and were now going to be overseen by the PCAOB (Sarbanes-Oxley Act, 2002, Sec. 404).

5. Problems of government intervention with accounting

The problems of government regulation with accounting and financial reporting are numerous. It is possible to make reference here only to a few of them. In general, it hinders competition as a discovery procedure to find better and less costly ways to satisfy the needs of the public. The following are some examples:

1) By endorsing a single set of accounting standards, it stifles experimentation with the content, periodicity, nature of the information, and other characteristics of the financial reports. New knowledge is never created and more relevant information is not provided to the users of the financial statements. Managers are presumably the ones who have more direct particular information of the business, information that is lost because it is different from what is required by the standards.
2) The prominent place accountants have nowadays is largely the effect of regulation. This makes the accounting process very expensive, and cheaper alternatives are never discovered.
3) By preventing competition through certification of external auditors, an entrenched monopoly is created, which results in lack on innovation and the refusal to assume more responsibility over the financial statements. Competition over the degree of responsibility, for example, is prevented from ever happening. The process of acquiring goodwill and reputation is hindered because people tend to focus on the certification rather than on the personal qualifications of the professional.
4) By issuing standards from the top down, especially with bright-line prescriptions, the moral hazard of all the participants in the financial reporting process in increased as the incentives are shifted to complying only with the minimum required by the standards.
5) By making the standard setting process depend on the members of the standard issuing committee, it makes the order thus created depend on a few minds and does not take into account the knowledge that is widely dispersed in society.
6) The current standards setting process, by letting particular interest groups participate in it through their comments, is subject to political pressure, which goes against the role of policy, which should focus on issuing general rules and disregard the particular consequences for specific people or groups.

6. Free market in accounting services

It is impossible to anticipate in detail what the spontaneous order of accounting would look like without government intervention. If it were possible, there would be no point in advocating for competition, because it is the task of competition precisely to discover those details. However, it is possible to anticipate the general pattern. For instance, all the problems enumerated in the previous point would be resolved.

The risk of fraudulent financial reporting by the managerial groups of public companies is admittedly one of the greatest challenges for freedom in the accounting practice. However, it is a blunder to maintain that government regulation is the best solution among the alternatives for this problem, or even a solution at all. Competition has not been completely eliminated from the market of financial reporting and it has allowed for the emergence of some mechanisms to prevent fraudulent behavior, like the way the market punishes managers who engage in fraud, or the market for mergers and acquisitions, especially the fear of a hostile takeover.

It is for sure, however, that additional free market mechanisms would arise without the government intervention which has hitherto prevented their appearance.

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