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International Accounting: P. Pacioli's Law: Wrong Accounting Results in Wrong Behavior

Ula K. Motekat

accounts of the Symphony are not included with Institute holdings because operating control of the orchestra is under a separate Board of Trustees.

The accounts of the Institute are maintained in accordance with the principles of fund accounting to ensure observance of limitations and restrictions placed on use of resources. Funds are classified according to activities or specified objectives, with indication of any restriction on the use of such funds or the revenues they may generate.

Deeds of gift for endowment funds often specify restrictions that the principal be invested in perpetuity, and that the income be either unrestricted and for general purpose, or restricted for specific use as indicated by the donor. Restrictions of either principal or income are observed in the financial accounting, with full disclosure of resources and distributions for each of the funds.

In 1944 a consolidated investment pool was established for the various funds under Institute supervision, with each fund receiving participating units based on the market value of the securities, or cash equivalent, invested in the pool. Additional investments receive additional pool units based on market value at the time of addition. Revenue from investments is recognized when earned, and allocated to participating investors on the basis of pool units owned.

Ownership of the Taft Museum places an immensely valuable art collection in the trust of the Cincinnati Institute of Fine Arts. The museum building and building improvements are not depreciated in the accounts, as the asset is an historical landmark. The land and building are recorded at values established by an independent appraisal in 1932.

Art objects are not included as assets in the balance sheet of the Institute in conformity with practices at similar institutions. The art collection of the Taft Museum must be perpetually maintained and preserved unimpaired in conformity with the terms of the original gift instrument. It is the intent of the Institute to preserve the Taft Museum building and art collection in perpetuity.

International Accounting

P. Pacioli's Law:

Wrong Accounting Results in Wrong Behavior

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Department Editor's Note: We are pleased to print below the acceptance speech given by Prudence Pacioli, an indirect descendant of the famous 15th century monk, when she was presented with the Accountant of the Year Award by the Professional League of Accountants in Generally Unprofitable Enterprises (PLAGUE) in an unidentified Eastern capital. Ms. Pacioli's speech is especially suitable for this issue, since all accounting in socialist countries is governmental accounting due to government ownership of all enterprises.

Dear Colleagues: Thank you very much for electing me PLAGUE Accountant of the Year for 1980. Last year was a really gratifying year for our organization, because more and more enterprises became unprofitable, resulting in a tremendous increase in our membership and making our slogan "PLAGUE in every business" very popular.

For the topic of my acceptance speech I chose Pacioli's Law which I discovered recently. Pacioli's Law, as formulated by me, states that "the wrong accounting results in the wrong behavior." The opposite is, however, *not* necessarily true. Correct accounting does not always, or even frequently, result in correct behavior due to the interference of Murphy's Law (If anything can go wrong, it will.[1]) or Pudder's Law (Anything that begins well, ends badly. Anything that begins badly ends worse.[2])

The Collection of Evidence

I discovered Pacioli's Law the way any scientist discovers the laws that govern the operation of our universe. I observed various business phenomena and then looked for the guiding principle which shaped and explained these events.

The first piece of evidence I collected, quite accidentally, when I received delivery of a dishwasher from the Drab Department Store in early 1980. I had signed the customer order list in 1978 and paid the full price for it, as requested, in July 1979.

In anticipation of the arrival of the dishwasher I had collected an assortment of dishes, mostly my own, which I promptly deposited neatly inside the machine as soon as it was properly hooked up. When I switched the dishwasher on, it emitted what I thought were noises appropriate to the mechanical cleaning of china (which were rather similar to the noises made by men when they are asked to do the dishes). When the commotion inside the machine died down, I opened it and discovered that most of the dishes had been broken into small, but very clean pieces. My initial reaction was annoyance until I realized that the dishwasher had, indeed, eliminated the chore of washing dishes for me, not only for that day but for however long it will take me to replace these dishes (or the friends who loaned me theirs).

The repair person I hired (for hard currency sent me by my aunt Millie O. Nare) discovered that the machine was short a number of screws, nails, and brackets. I obtained these missing parts (through an ad in the *Daily Intelligence* in exchange for a bathroom sink, two light bulbs, and three gloves, but no partridge in a pear tree) from a person who works in a people-owned enterprise that manufactures dishwashers. As soon as the missing ingredients were deposited inside the dishwasher, it worked perfectly on pots and pans. Since I have not yet been able to replace the dishes (or the friends), I don't know whether it will also work perfectly on china.

The next two pieces of evidence came to me almost simultaneously and, again, accidentally. (After all, this is not the sort of thing one looks for deliberately.) I was standing in line last fall in the Drab Department Store to pick up the TV set I had ordered and paid for in 1977, when I overheard a conversation about a washing machine. A woman behind me in the line told her friend that, when she turned her new washing machine on for the first time, it tore her clothes to shreds. However, she added, the machine did it so successfully that it was impossible to tell whether the pieces were clean or still dirty. The shredding action was caused, in her opinion, by a combination of the rough edges on the agitator and the absence of some screws which would have kept the agitator firmly anchored in its place instead of permitting it to agitate all over the inside of the machine. I filed this information away in my mind, not knowing that I had acquired another piece of evidence.

When I received my TV set, it was packed in a box. Due to Ettore's Observation (The other line moves faster.[3]) my line of people waiting to pick up their sets was by now quite long. I was therefore not allowed to open the box and look at my set in the store. Consequently it wasn't until I got home that I discovered that my TV set lacked a picture tube. After several months of advertising in the *Weekly Intelligence* (intelligence had, by now, become so rare that there was only enough for a weekly, not a daily, issue) I finally succeeded in locating a repair person with a spare picture tube which she installed in my set (in exchange for an ERA pin, two Lily Tomlin records, and an electronic pocket calculator).

Since I was unable to watch TV without a picture tube, I used these video-less evenings to read accounting books and to ponder the problem of the defective appliances. I rejected from the first the idea of a correlation between the faulty construction and our latest thirteen-year plan of socialist economic development. I also rejected the thought that the defects were simply another instance of Flap's Law of the Perversity of Inanimate Objects (Any inanimate object, regardless of its composition or configuration, may be expected to perform at any time in a totally unexpected manner for reasons that are either totally obscure or completely mysterious.[4]) The TV set had, in fact, behaved in the manner expected of a set without a picture tube.

I had almost concluded that these appliances illustrated Murphy's Law (see above), when I realized that the Drab Department Store had an abundance of children's clothes and absolutely no clothes, male or female, calculated to fit anybody above age seven. Since Murphy's Law could not explain the absence of adult clothing, I began to look seriously for another explanation. And here my reading of current accounting books lead me to the discovery of Pacioli's Law.

The Economic Function of the Accounting System

In our socialist economy accounting is used as an instrument to manage and plan the activities of people-owned enterprises. The accounting system must, therefore, fulfill two functions: (1) it must record and control the production process as prescribed by the government's economic plan for the enterprise, and (2) it must teach managers and workers not only to protect and increase the nation's property, but also to think in cost-benefit terms. These are the economic and behavioral functions, respectively, of a socialist accounting system.[5]

The government's plan for an enterprise, as we all know, determines what is to be manufactured and in what quantities, provides technical blueprints for all items produced, and describes the production process. Since the prices for all goods and services are set by the proper governmental authorities, the cost of producing every item is determined in advance. The results of operations in financial terms are, therefore, also determined in advance as is the division of the planned net income between the government and the enterprise.

The accounting system fits into the economic plan because it is designed to record and monitor the manufacturing process and to determine and display any negative or positive deviations from the plan. In this manner it fulfills its economic function.

To use an example let us assume that a factory's plan calls for the production of 100 TV sets during a period. From the technical blueprint for the TV set it is determined that for this production the factory needs, among other parts, 100 picture tubes, 100 cabinets, 400 legs for the cabinets, 100 channel selector knobs, 100 volume control knobs, and similar components. The accounting system is then designed to record the purchase of the parts necessary for the production of 100 TV sets, and the cost accounting system monitors the costs as the parts make their way through the production process and become TV sets. Assuming that everything goes according to the plan, the factory will produce the 100 TV sets at the predetermined cost and realize the planned net income. In this case the accounting system will have fulfilled its economic function.

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The Behavioral Function of the Accounting System

The behavioral function of the accounting system is tied to both the net income and the production goal. In order to serve as a strong motivating force, planned net income is generally divided evenly between the government and the enterprise, whereas deviations from planned net income are allocated disproportionately to the enterprise. In other words, if actual net income is less than planned net income, the enterprise gets less than 50 percent; and if actual net income is more than planned net income, the enterprise gets more than 50 percent.

The production goal reinforces net income as a motivator, since production virtually always results in sales due to the temporary shortages we have experienced in consumer goods for the last thirty-five years. Not only are the workers interested in fulfilling the economic plan, they are also strongly motivated to exceed the plan because, in addition to the larger share of net income, they get many rewards for excess production, such as free Saturdays, citations for meritorious service, and—in extraordinary cases—even medals.

Free Saturdays provide time for searching for repair parts for defective appliances the worker may have at home, while citations and medals can be very advantageously displayed atop, or strung across the screen of, a non-functioning TV set. In the event a worker receives a particularly coveted medal it can be beautifully enshrined within the gleaming interior of an inoperative refrigerator, providing that the little inside light is in good working order.

Because each worker wants to proudly display a chest full of medals at the annual factory picnic (financed by the enterprise's share of planned net income), most people-owned enterprises exceed their planned production. Unfortunately, this can often be accomplished only at the price of quality.

To illustrate the point, let us return to our example of the manufacturer of TV sets. If this factory wants to increase its production above 100 TV sets per period, it must either obtain more parts or produce more TV sets with the available parts. For two reasons the second alternative is usually chosen: (1) it is generally impossible to get more parts, and (2) net income is increased more if sales are increased without a corresponding increase in production costs. The results are TV sets without a picture tube, like mine, TV sets stuck on one channel because the channel selector is missing, TV sets which must be propped up against a wall because they have only three legs, and similar aberrations from the ideal. Thus everyone has something to talk about while standing together in line to pick up some long-awaited new appliance.

The same motivating force of the accounting system works in the factory producing dishwashers. Here the screws, nails, and brackets sufficient for 1,000 dishwashers may be stretched over 1,050 dishwashers, resulting in 1,050 dish breakers, rather than 1,000 dishwashers.

The abundance of children's clothing and the shortage of adult clothing can also be explained by the behavioral function of the accounting system. By manufacturing smaller sizes, a factory can naturally produce more clothing. Because the retail price of clothes is set by the authorized government department and is usually not related to the amount of material used in a garment,[6] children's clothes are generally more profitable than adult clothes. The clothing manufacturer is therefore motivated to produce and sell children's clothing.

Conclusion

These examples show that the present accounting system rewards the wrong behavior. Of course, this would not be the case if consumers limited their purchasing to high quality merchandise, to items they really need, and to the qualities they need. But given the temporary shortages we have had since World War II (and the low interest rates paid on savings accounts), consumers tend to prefer virtually any merchandise to money. Therefore people buy everything they can get, they get into every line they see without knowing or caring what is being sold at the end of it, and they accumulate inventories of all sorts of things in their attics and basements.

One result of this behavior is that the stores are always sold out and have given up the functions of storing and financing inventories. These functions have been assumed by the consumer. The other result is that people do not go shopping for items they need, since they know that the stores don't have them anyway. Instead they advertise in the periodic *Intelligence* (intelligence has, by now, become very unpredictable) and offer to exchange what they have for what they need.

When I arrived at this point in my thinking, I realized that I had discovered the principle explaining the production of defective and unwanted merchandise by our people-owned enterprises: The Wrong Accounting Results in the Wrong Behavior. This principle I call Pacioli's Law.

NOTES

[1]Paul Dickson, *The Official Rules* (New York: Delacorte Press, 1979) p. 123.
[2]*Ibid.*, p. 154.
[3]*Ibid.*, p. 47.
[4]*Ibid.*, p. 59.
[5]Duenter Goll et al, *Buchfuehrung* (Berlin: Verlag Die Wirtschaft, 1975) p. 1.
[6]J. W. Jakowez, *Die Preise in der Planwirtschaft* (Berlin: Verlag Die Wirtschaft, 1976), p. 75.