

LOCAL GOVERNMENT ACCOUNTING: STANDARDS, CONCEPTUAL ISSUES, AND R&D ACTIVITIES*

JAMES L. CHAN, Researcher, National Council on Governmental Accounting

This paper discusses in nontechnical terms the essential features of current governmental accounting standards and practices. Alleged weaknesses and proposed changes are briefly analyzed and the sources of difficulty in making changes are pointed out. Some major organized efforts to improve governmental accounting are presented. Finally, several concrete suggestions are made as to how public administration educators/researchers and practitioners can participate in attempts to make governmental accounting more responsive to the needs of its diverse potential user groups.

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Accounting has been called the language of business, but it has increasingly become a language of government as well. Indeed, it is an integral part of what Karl Deutsch aptly calls "the nerves of government."¹ At its best, government accounting facilitates rational decision-making in or about government. Accounting information thus can be, and should be, a useful tool for public administration. However, its effective use for administrative decision-making requires that the user understand its changing capabilities and possible limitations.

This paper analyzes in nontechnical terms the essential features of current governmental accounting standards.² Both the conceptual issues that are embedded in the current framework and those transcending it are discussed, and the last section introduces several major research and development efforts to improve governmental accounting.

AN ANALYSIS OF GOVERNMENTAL ACCOUNTING STANDARDS

The essence of contemporary local government accounting has been embodied in the principles enunciated by the National Committee on Governmental Accounting in the 1968 **Governmental Accounting, Auditing and Financial Reporting** (GAAFR). These principles have been restated in *Statement 1* of the National Council on Governmental Accounting, *Governmental Accounting and Financial Reporting Principles*, published in March, 1979.³ This section interprets these standards under three headings: Fund Structure of Accounts, Integration with the Budget, and Fair Presentation.

Fund Structure of Accounts

The classification of the accounts of an organization tends to be influenced by the structure and functions of the organization. The structure of accounts sorts the multitude of financial transactions of a local government into a particular framework. The current

framework states in effect that a local government performs three basic fiscal functions: (1) The *governmental* function of providing public goods and services by using financial resources with various restrictions on resource utilization; (2) The *business-like* function of providing essential community services by self-sustaining enterprises, and of providing goods or services to subunits of the government on a cost-reimbursement basis; and (3) the *fiduciary* function of holding resources on behalf of others. These three functions correspond to the three categories of fund types—governmental funds, proprietary funds and fiduciary funds. Within each of these categories, further segregation of financial resources into fund types reflects the restrictions placed on them by the providers of resources through the budgetary process or contractual provisions. When a fund is regarded as a responsibility center for managerial stewardship, a fund-based account structure has the implicit objective of enforcing compliance with the constraints on administrative discretion.⁴ The fund types recommended by the NCGA are briefly explained below:

Governmental Funds The number of governmental funds is influenced by the need for explicit recognition of resource restrictions. Several examples will illustrate this point:

- A government levies an assessment against owners of specific individual properties that benefit directly from public improvements or services. The owners have an economic self-interest to know whether their financial contributions will indeed be used for their benefit. The government's accountability is discharged partly by establishing and operating *special assessment funds*.

- Sometimes financial resources are budgeted to the government for acquiring or constructing major capital facilities to generate benefits in future periods. In order to make sure that these resources are not diverted to other uses, e.g., to meet current financial obligations, *capital project funds* are established.

- Long-term creditors of government look to the accumulation and safeguarding of financial resources in the *debt service funds* to ensure that the borrower will be able to pay debt principal and interest when due.

- When financial resources are made available (e.g. from restricted tax levies) to provide specific services, they are separated from other governmental funds and accounted for in *special revenue funds*.

- Perhaps the most significant governmental fund is the *general fund*, which accounts for most of the current operations of a governmental unit. Compared with the other governmental funds, the general fund is relatively free of external nongovernmental restrictions. The allocation of the general fund to subunits or programs of a local government is determined through the budgetary process. The resource allocations in turn give rise to numerous other sub-classifications of the general fund consistent with the establishment of administrative accountability.

Proprietary Funds Certain essential community services, such as water and electricity, can be more economically provided by quasi-public monopolistic enterprises on a nonprofit basis. Since these enterprises are financed primarily by user charges, *enterprise funds* are accounted for in a way similar to that of business organizations. For reasons of economy and control, a governmental agency may be designated to provide centralized services (such as motor pools and purchasing services) on a cost-reimbursement basis to other governmental units. *Internal services funds* are therefore

established to facilitate financial control and the allocation of the agency's costs to the recipient units.

Fiduciary Funds Explicit recognition for resource segregation is most evident when the government holds financial resources in a trustee or agent capacity. This is reflected in the establishment and safeguarding of *trust and agency funds*.

In summary, funds are the basic accounting entities in government in order to facilitate internal financial management and demonstrate compliance with legal and contractual provisions. However, critics have argued that the proliferation of fund types in external reporting tends to obscure the overall picture of the government.⁵ This suggests a need to determine the appropriate level of aggregation in light of the information needs of identified users.

Integration with the Budget

Another significant feature of governmental accounting is the formal integration of the adopted budgets into the local government's accounting system. Indeed, accounting systems should be designed to facilitate budgetary control and comparisons. This is achieved by using common terminology and consistent account classification in the budget and accounting system. Estimated revenues and estimated expenditures are recorded in the accounts at the beginning of the fiscal year and continuously compared with actual amounts during the year. This integration serves the dual purpose of (1) providing a basis for evaluating actual performance and (2) using actual performance as feedback to improve budgetary projections.

One problem with budgetary comparisons is that the budget does not, and often should not, remain unchanged during the fiscal year, particularly if the premises underlying the original budgetary estimates are no longer valid. Accounting standards have not yet addressed the issues of (1) which of the revised budgets should serve as the basis for comparing actual performance, and (2) how significant budgetary revisions should be disclosed in financial statements. Also, there are currently no standards governing budgetary disclosure prior to the fiscal year.

Fair Presentation

Despite their diversity, all the funds share a basic framework which calls for the *fair* presentation of a financial position at the end of an accounting period and of the result of financial operations during the period. Accounting standards attempt to make the criterion of fair presentation operational. Generally accepted accounting principles are an authoritative basis for judging the fairness of financial reporting. The principles promulgated by the NCGA are applications of generally accepted accounting principles to the governmental environment. While there have been many debates about the standards, the overall framework of governmental accounting has remained quite stable over the years, and may be characterized as follows:

1. The accounting process begins with an analysis of the financial effects of the transactions or other economic events that have already occurred. This historical perspective of accounting is regarded by some people as an almost intrinsic characteristic or constraint of financial reporting to external parties. However, the usefulness of

historical cost information to decision-making in a dynamic environment may be limited.

2. Financial effects of transactions or events are recognized along two interrelated dimensions: effects on financial position (stocks of resources) and effects on the result of financial operations (flows of resources).

3. The financial position of an entity at a particular time is represented by (a) the historical costs of the different kinds of resources acquired and available for future use, and (b) the claims against those resources. The accounting equation of assets = liabilities + equities shows that resources have come either from borrowing or from the operations of the organization.

4. The net result of financial operations is measured by matching the outflows of resources with the inflows of resources. Within this basic framework, two somewhat different accounting measurement systems are used. When the emphasis is on periodic spending control, as in the case of governmental funds, the focus of accounting measurement is on *expenditures* (the decreases in net financial resources) and revenues are recognized when financial resources become measurable and available to finance expenditures in the fiscal period. On the other hand, if the emphasis is on the determination of the costs of services and user charges, as in the case of enterprise and internal service funds, accounting measurement focuses on the proper periodic matching of *expenses* and revenues. Expenses are the costs of economic resources utilized in providing goods and services, and would include depreciation on the fixed assets used. Revenues in this context are sales proceeds from having provided the goods or services. These two operational interpretations of resource outflows and inflows, in light of the difference in measurement focus, have not been uncritically accepted. Recent accounting reform proposals have called for the use of expenses in all fund types.⁵ Unfortunately, early resolutions of this and other issues are unlikely to occur because the criteria for judging the preferability of government accounting methods have not been clearly specified and generally accepted. Therefore it will be beneficial to explore the major conceptual issues facing governmental accounting in the next section.

MAJOR CONCEPTUAL ISSUES IN GOVERNMENTAL ACCOUNTING

Numerous papers and publications have discussed the conceptual issues in governmental accounting. While there are some common themes, issues have been posed differently. This section expresses this author's perception of the major conceptual issues facing governmental accounting. Many of these issues stem from the lack of consensus on a definition of governmental accounting, or of accounting in general.

Thirty years ago, the Committee on Terminology of the American Institute of Certified Public Accountants defined accounting as:

the art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.⁶

This definition is more concerned with the procedures of accounting than with its goals. The deficiency here was rectified by the Committee to Prepare a Statement of Basic Accounting Theory, of the American Accounting Association (AAA), which regarded

accounting as:

the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions of users of the information.⁷

The AAA definition formally acknowledges accounting as a means of facilitating decision-making by users. The activities of recording, classifying and summarizing are significant only if they produce information useful for decision-making purposes. The following definition by Langenderfer further specifies the objectives of user decision-making in this way:

Accounting is a measurement and communication system to provide economic and social information about an identifiable entity to permit users to make informed judgments and decisions *leading to an optimum allocation of resources and the accomplishment of the organization's objectives* (emphasis added).⁸

The Langenderfer definition, though not formulated for accounting in the public sector, is sufficiently general. It implicitly contains several major conceptual issues in governmental accounting, as briefly stated below.

1. The approach of judging accounting information by its usefulness to users requires the clear identification of users of governmental accounting information. However, at the present time, user identification is seldom based on some well-specified theory of the potential users' right or need to know, or on systematic empirical evidence of who actually utilizes accounting information in decision-making. There are many lists of users of governmental accounting information, but these lists at best imply and do not explicitly state the political and economic determinants of being a user of the accounting information of a governmental entity.

2. Assuming that users of governmental accounting information have been successfully identified, it is then necessary to know their decision models. Users may make decisions by "muddling through" or by using an approach of rational comprehensiveness. The informational requirements of such divergent decision-making styles can be substantially different. Furthermore, decision-makers may not be able to articulate their decision-making models to the extent that their information needs are apparent.

3. Assuming that the information required to implement user decisions has been determined, there remains the problem of separating accounting information from other types of information. This situation implies that accounting information has some unique attributes. The attributes used to be verifiable financial information based on past transactions. However, as governmental accountants and auditors venture into the areas of the measurement and evaluation of operational efficiency and program effectiveness, the domain of governmental accounting is by no means clear and fixed.

4. An implicit objective of accounting in the Langenderfer definition is to facilitate decision-making so that resources will be optimally allocated and the organization's objectives will be achieved. While conceptually appealing, defining "optimality" and "organization objectives" are among the most difficult problems in the public sector.

In short, the major conceptual issues facing governmental accounting are not substantially different from those in other areas of accounting. The government accounting profession does not seem to be content with supplying historical financial information in the traditional format, and is striving toward the goal of providing *relevant* information to a wide range of users. Consequently, accounting policy-makers and researchers have to know a great deal more about user behavior. Due to the lack of generally accepted theories or empirical evidence of users' decision-making behaviors, government accounting standard-setting bodies cannot confidently predict that the information required to be disclosed will be useful, if used at all.

The next section introduces a number of projects in governmental accounting research and development which will hopefully advance the state of knowledge about user behavior.

SELECTED GOVERNMENTAL ACCOUNTING R&D ACTIVITIES

This brief introduction of selected governmental accounting research and development projects is intended to provide readers with the most current information available. Interested readers can obtain further information by using this guide. This section is not a comprehensive literature review, but an attempt to inform the public administration community about a number of current or recently completed efforts.

*The NCGA/HUD Governmental Accounting Research Project*⁹

This project, formally called *Governmental Accounting and Financial Reporting Conceptual Framework and Standards Research and Dissemination*, is funded by a grant from the Division of State and Local Government Financial Management Capacity Sharing in the Office of the Assistant Secretary for Policy Development and Research, U.S. Department of Housing and Urban Development. This three-year project started in the Fall of 1979. The first phase of the project is to develop the objectives and concepts of governmental accounting, followed by the establishment and dissemination of accounting standards consistent with objectives and concepts.

The basic approach to the initial phase of the project is as follows: (1) A study of the structure and environment of state and local government is intended to lead to the identification of legitimate potential users of these governmental units' accounting information. (2) Information requirements will be derived from the decisions made by these users. (3) These information requirements will be analyzed to derive a set of objectives and basic concepts of governmental accounting. By the Fall of 1980, the project is expected to have produced a research report and a NCGA exposure draft on the objectives and concepts of governmental accounting.

It may also be noted that the NCGA has recently published a research report by William Holder entitled *A Study of Selected Concepts for Government Financial Accounting and Reporting*. Holder's study presents his own conclusions on the objectives and concepts of governmental accounting. It was intended to stimulate public discussion and to provide inputs for the current research at the NCGA.¹⁰

MFOA GAAFR Restatement Project

After the issuance of NCGA *Statement 1*, the Municipal Finance Officers Association (MFOA) embarked on a restatement of the 1968 GAAFR. The objective of this project is to provide guidance to preparers of financial statements as to how best to apply the principles set forth in *Statement 1*. The restatement will use *Statement 1* as its first chapter, followed by individual chapters dealing with each fund type mentioned earlier in this paper, as well as with financial reporting and auditing. There will also be chapters on school districts and special districts. The document is expected to be available by mid-1980.¹¹

*The AICPA Experimentation Project*¹²

The American Institute of Certified Public Accountants (AICPA) State and Local Government Accounting Committee recently requested state and local governmental units of all sizes to prepare financial statements for a recent period by using the principles proposed by the committee. These principles call for the preparation of consolidated financial statements using the accrual basis of accounting commonly employed by businesses and by the proprietary funds of government. The committee is interested in the feasibility of this approach to government accounting.

*The Frederick O'R. Hayes-Nova Institute Project*¹³

In June 1978, the HUD Office of Policy Development and Research sponsored a conference on the financial management needs of local government. One of the needs identified was the integration of budgeting, performance, accounting and auditing to better serve local government financial management. Frederick O'R. Hayes Associates and the Nova Institute were awarded a grant by HUD to develop a guide to achieving integrated financial management, a college-level course and workshop manuals. These materials are intended to be useful to busy local government officials.

*The COMP Auditing Manual*¹⁴

With the financial assistance of HUD, the Council on Municipal Performance (COMP) has produced a manual for public officials entitled *Local Government Auditing*. The manual explains the potentials and limitations of compliance and financial audits. It also discusses the significance of the management letter in a performance audit, and provides some practical advice on how public officials should manage the audit process. Readers may find the illustrations and the appendices on governmental accounting and auditing especially helpful.

*State Government Accounting Projects*¹⁵

This NSF-supported project is conducted under the supervision of the NCGA and the Council of State Governments. On the basis of a questionnaire survey administered in all the states, Phase I of the project developed an inventory of current and preferred state

accounting and financial reporting practices. The current Phase II of the project seeks to develop a document on "Preferred State Government Accounting Practices" based on analyses of current practices and the issue papers produced by eight task forces. These issue papers will be available by June 1, 1980. The results of the State Government Accounting Project will be available to the NCGA in its effort to improve accounting and financial reporting for state and local governments.

*The GAO Exposure Draft*¹⁶

On February 29, 1980, the U.S. General Accounting Office issued an exposure draft on the objectives of accounting and financial reporting in Federal Government. It reached the conclusion that the primary objective is to provide information useful in the assessment of management performance and stewardship in three areas: financial viability, fiscal compliance and program activity. Even though the exposure period ended on April 21, 1980, continuing discussion should further clarify the objectives of Federal Government accounting and financial reporting.

*The FASB Exposure Draft*¹⁷

The Financial Accounting Standards Board (FASB) is the private sector body which sets generally accepted accounting principles for business enterprises. Its involvement in the nonbusiness (including government) area is fairly recent. In May 1978, the FASB published a research report entitled *Financial Accounting in Nonbusiness Organizations* by Robert Anthony of Harvard University. Most recently, on March 14, 1980, the Board issued an exposure draft of a proposed statement of financial accounting concepts entitled *Objectives of Financial Reporting by Nonbusiness Organizations*. The objectives in this statement are those of general purpose external financial reporting aimed primarily at the information needs of resource providers. The exposure period for this document will end on September 15, 1980.

CONCLUDING REMARKS

The public administration community should be the beneficiary as well as the active participant in research and development activities in order to improve local government accounting and reporting. To some extent these two roles are mutually reinforcing, since the values of R&D can be better evaluated and appreciated if their users have been involved in the process and are familiar with the products. It behooves all organizations and individuals concerned with local government administration to establish regular and meaningful communication with each other. This paper is a modest attempt to further stimulate the interest of the public administration community with regard to accounting issues.

NOTES

¹Karl W. Deutsch, *The Nerves of Government* (N.Y. The Free Press, 1966).

²While many of the accounting standards and issues discussed in this paper may be applicable to both Federal and state government, it focuses on local government accounting.

³Both of these documents may be ordered from the Municipal Finance Officers Association, 180 N. Michigan Avenue, Suite 800, Chicago, Illinois 60601.

⁴A fund is defined as “a fiscal and accounting entity with a self-balancing set of accounts receiving cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations.” NCGA **Statement 1**, p. 2.

⁵Coopers & Lybrand-University of Michigan, **Financial Disclosure Practices of the American Cities: A Public Report** (NY: Coopers & Lybrand, 1976); Sidney Davidson, et. al., **Financial Reporting by State and Local Government Units** (Chicago: Graduate School of Business, University of Chicago, 1977).

⁶American Institute of CPAs, Committee on Terminology, **Accounting Terminology Bulletin No. 1** (NY: AICPA, 1953).

⁷American Accounting Association, **A Statement of Basic Accounting Theory** (Evanston: AAA, 1966), p. 1.

⁸Harold Q. Langenderfer, *A Conceptual Framework for Financial Accounting*, **The Journal of Accountancy**, July 1973, 50.

⁹Further information may be obtained from the National Council on Governmental Accounting, 180 N. Michigan Avenue, Suite 800, Chicago, Illinois 60601.

¹⁰Holder’s study may be ordered from the NCGA for \$5 per copy.

¹¹At that time, it may be ordered from the MFOA.

¹²AICPA State and Local Government Accounting Committee, **Experimentation Booklet** (NY: AICPA, September 1979). Further information may be available from the AICPA Accounting Standards Division, 1211 Avenue of the Americas, New York, NY 10036.

¹³Further information may be obtained from Frederick O’R. Hayes Associates, 87 Hancock Street, Lexington, Mass. 02173, or the Nova Institute, 853 Broadway, New York, NY 10003.

¹⁴Peter F. Rousmaniere, General Editor, **Local Government Auditing** (NY: COMP, no date). COMP’s address is 84 Fifth Avenue, New York, NY 10011.

¹⁵Further information may be obtained from the State Government Accounting Project, Council of State Government, P.O. Box 11910, Iron Works Pike, Lexington, Kentucky 40511.

¹⁶U.S. General Accounting Office, *Objectives of Accounting and Financial Reporting in the Federal Government*, Washington, DC, 1980. Comments should be sent to R. J. Points, Financial and General Management Studies Division, Room 6106, U.S. General Accounting Office, 441 G Street, N.W., Washington, D.C. 20548.

¹⁷Copies of the FASB exposure draft are available from Order Department, Financial Standards Board, High Ridge Park, Stamford, Conn. 06905. Written comments should be sent to the Director of Research and Technical Activities, File Reference 1042-017 at the same address.