Reforming American Government Accounting in the 20th Century

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Government accounting and public management in the United States have an ambivalent relationship. Public managers are responsible for their organizations' accounting and financial reporting, yet they have little control over the rules that tell them how to account for and report to the public. During the 20th century, these rules evolved from a few precepts to voluminous codifications that only skilled professionals could decipher. The need for public managers to understand these rules has never been greater regardless of whether they work in federal, state, or local governments. They are required by the accounting standard-setting bodies to provide a "management's discussion and analysis" in their financial reports. Furthermore, they will have to evaluate, present, and justify ever more costly requests to modernize financial management systems. The ability to discharge these responsibilities depends on an understanding of the reforms aimed at improving accounting and financial reporting standards.

As a consequence of the federal system, the United States has two separate institutional structures and bodies of accounting standards for the federal government and for state and local governments. In this chapter, accounting standards for state and local governments refer pot to the laws and regulations of each jurisdiction, but to professionally sanctioned rules for nationwide application. These are discussed in Sec. I. The evolution of federal accounting standards are described in Sec. II. Each section identifies and evaluates the changes and explains the who, why, and how of the reforms. Sec. Ill summarizes the similarities and differences of these institutional structures, processes, and bodies of standards.

STATE AND LOCAL GOVERNMENT ACCOUNTING STANDARDS

During the 20th century, there were three major waves of reform aimed at transforming how state and local governments keep their books and report to the public. The first wave was part of the municipal government reform during the Progressive era at the turn of the 20th century. The reformers saw better financial record keeping as a way to fight corruption and make governments efficient. During the second wave, covering the 1930s through the mid-1970s, public finance professionals developed accounting principles to facilitate financial management and legal compliance. We are now in the third wave. Stimulated by a series of municipal fiscal crises in the 1970s, the call for public accountability led to major institutional and conceptual changes in government accounting. The significant features of these three waves of reform are discussed in the sections that follow.

First Wave of Reform: Fighting Corruption

During the Progressive era (1890s to 1920), America was transformed from a rural to an urban society. Advances in transportation and communication created large industrial corporations and financial institutions with great demand for labor. Immigrants flocked to

cities, and municipal governments were hard pressed to provide the necessary public services. The existing institutions proved inadequate and official corruption was widespread. James Bryce observed in 1891, "The government of cities is one of the conspicuous failures of the United States" (quoted in Matika, 1988: 17). Book titles such as *The Shame of the Cities* (Steffens, 1904) and *Theft of the City* (Gardiner and Olson, 1974) reflect the sorry state of civic life. The morally upright and the economic elite demanded an end to official corruption, greater popular control, and the expansion of government functions to cope with the rising demands of urban residents. Businessmen feared that without reform higher taxes would simply feed the bureaucracy run by the patronage system. Their trade associations began a campaign for efficiency and economy in government. On the basis of their experience, business leaders realized that sound business practices and good accounting were essential and recruited members of the young accounting profession to join the crusade (Matika, 1988: 17-33).

In Chicago, a merchants' group hired the certified public accounting (CPA) firm Haskins & Sells to study the city's finances. The firm found many financial and accounting problems and recommended changes. The city council promptly engaged them for the job. In Philadelphia, another CPA, William M. Lybrand, suggested comprehensive annual reports. On the basis of his experience focusing on Minneapolis, H. W. Wilmot (1906; quoted in Davidson et al., 1977: 5) reported to the accounting profession that

> it is generally admitted by students of municipal finance that the accounting methods of most cities of the United States are deplorably behind the times, and that similar methods could not be tolerated for a day in any successful commercial corporation. These methods may possibly have met the local requirements when the cities were smaller, but as municipal affairs have become more complex the multiplication of matters to be recorded has rendered these antiquated accounting systems entirely inadequate.

Perhaps the most concerted and influential efforts were made in New York City, where a businessman, Herman Metz, was elected comptroller in 1906. Metz introduced business practices and accounting procedures and later funded the New York Bureau of Municipal Research. Under the leadership of Frederick A. Cleveland, the bureau staff conducted field studies to document current practices and made constructive recommendations. The results were published in a series of Metz Fund Handbooks of City Business Methods, including one on municipal accounting. Their goal was to create an accounting system to supply "complete, accurate, and prompt information about business transactions and results" (Bureau of Municipal Research, 1913: ix).

Cleveland was in a good position to synthesize the best practices of the time. He and Messrs. Haskins and Sells were all members of the Committee on Uniform Accounting Methods set up by the National Municipal League around 1900 to improve municipal accounting practices. As its name implies, the committee stressed uniformity in accounting, e.g., the proper classification of revenues and expenses, to facilitate statistical comparisons. In addition, it advocated independent audits and recommended a prototype for reporting financial data. Through the energetic efforts of a Boston CPA named Harvey Chase, 11 states and 80 cities soon adopted the committee's model (Fleischman,

1987: 297-298). These were the first examples of government adoption of professionally developed accounting standards.

The Metz Fund researchers basically proposed a business accounting model adapted to take into account the public budget as the key instrument of financial control. They stressed the need to gauge government's ability to operate as going concerns. The result was an emphasis on the government's balance sheet. Year-end balance sheets (or statements of financial position) would provide a continuous series of measures of the assets and liabilities (and residual capital) carried over from one period to the next. This way of looking at municipal finances contrasted sharply with discrete annual budgets, each focusing only on one period's money inflows and outflows. The implementation of the multiperiod continuous accounting model required the accrual basis of accounting and the double-entry system of bookkeeping, both of which were (and still are) standard business practices. Under the accrual system, careful distinctions were drawn between revenues and cash receipts and between expenses and disbursements. Similarly, capital assets would be clearly separated from financial resources on the balance sheet, along with long-term bonded debts and short-term payables. In addition to financial accounting, cost accounting was recommended to give city officials data to achieve economy and efficiency.

The Metz Fund model of government accounting, though remarkably modern, was not unique. As early as 1901, a Canadian accountant, F. H. MacPherson (1901: 3), cited the following assertion by an unnamed eminent author:

> The object of all good book-keeping is the exhibition of the growth or decline and present value of capital, and of each of the parts of which capital is made up. A perfect balance sheet shows all this in the clearest and most concise manner. A perfect balance sheet should not only give the *present value* of each of the component parts of capital, but should also indicate its growth and decline since the last statement. The one object of the skilled book-keeper is, therefore, to be able to produce, when necessary, a clear and correct balance sheet. (Emphasis added)

Apparently, the theory was far ahead of practice. MacPherson (1901: 3) went on to observe:

> In very few instances can be found any system of municipal accounts which within itself exhibits the true condition of the affairs of the municipality. Financial reports, as ordinarily presented, may exhibit a correct statement of the receipts and expenditures, but rarely, if ever, is the statement of assets and liabilities anything more than an approximation of the position of the corporation. Why this is so one need not be altogether at a loss to understand, when one stops for a moment to consider the circumstances which usually surround the appointment of the officials charged with the responsibility of preparation of such a statement. The requirements of a perfect balance sheet cannot be satisfactorily met, unless the system of accounts provides for the application of the principle of double entry to all transactions into which money or money values enter.

Since the idealized business firm was their frame of reference, it was natural for the municipal accounting reformers to adopt the business accounting model uncritically. Cleveland, for example, saw no need for a separate set of municipal government accounting principles. At the same time, however, he clearly understood that the business accounting model had to be enhanced by formal financial control devices in government. The recommended system consequently had the added features of fund accounting and budgetary accounting. The funds included current funds and capital funds, as well as sinking and trust funds. To facilitate timely assessment of financial performance, it was recommended that estimated revenues and appropriations be formally recorded in the accounts. Obligations and encumbrances chargeable to the appropriations would be duly recorded also. The accounting function was clearly meant to monitor budget execution (Bureau of Municipal Research, 1913).

In summary, political reformers and their business and professional allies saw the value of good accounting to honest and efficient government. Their political agenda to some extent has overshadowed their intellectual legacy. During the first decade of the 20th century, American city governments were already urged to adopt businesslike accounting augmented by fund and budgetary accounting. The governments' financial and accounting advisers, being practical men of affairs, spent more time on devising forms and procedures than on constructing accounting theories. As a result, though the outline of a framework for municipal accounting was visible, the articulation of formal standards was to be the agenda of the next wave of reform.

Second Wave of Reform: Supporting Financial Management

After municipal bond defaults during the Great Depression in the early 1930s, municipal accounting standards again received the attention of government groups. Institutional sponsorship for standard setting shifted from the National Municipal League to the financial specialists. The newly created Municipal Finance Officers Association (MFOA) in 1934 established the National Committee on Municipal Accounting (NCMA). The committee, consisting of representatives of nine organizations concerned with government and finance, subsequently issued a set of 10 Principles of Municipal Accounting in 1934 and other bulletins until 1941. In the late 1930s the MFOA formally endorsed these as Standard Practices in Municipal Accounting and Financial Procedure (Remis, 1981).

The NCMA principles codified many of the ideas of the first wave of reform. The NCMA urged that a single finance officer be put in charge of accounting and financial reporting. It advocated close links between accounting and budgeting systems by means of consistent terminology and a common account structure. The committee endorsed the use of budgetary accounts and the recording of encumbrances. It affirmed the use of the double-entry system and the general ledger supported by subsidiary records. The committee specified the following funds for organizing the municipal accounts: general, special revenue, working capital, special assessment, bond, sinking, trust and agency, and utility funds. It also required the use of the accrual basis of accounting but exempted general fixed assets from depreciation calculation except for finding the cost of services. Standard classifications were recommended for assets and liabilities, revenues and

expenditures. Finally the committee stressed the consistent flow of information throughout the budget, the accounts, and eventually the financial statements.

The NCMA principles lacked the moral fervor evident in Cleveland's writings (e.g., Cleveland, 1909). The authors, as professional men, valued the systematic nature of accounting. Accounting, after all, was termed "the art of recording, classifying, measuring and communicating 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" (AICPA, 1953: 3). The task of elaborating the principles and explaining the supporting procedures fell on textbook authors (e.g., Morey and Diehl, 1942).

After fulfilling its mission of codifying the principles, the National Committee on Municipal Accounting was dissolved in 1941. After the pause due to World War II, the MFOA in 1948 reactivated the NCMA and renamed it the National Committee on *Governmental* Accounting to reflect the participation of state governments. The new committee revised NCMA publications and worked on auditing procedures as well. A period of inactivity ensued from 1951 to 1966. After that the committee was again activated to consolidate all previous work in a comprehensive volume. The resulting MFOA (1968) publication, *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR), popularly known as the "Blue Book," became the Bible for government accountants, auditors, and other finance professionals alike. For the first time, there was a common thread running through accounting, financial reporting, and auditing.

The National Committee on Governmental Accounting might as well have added budgeting to the GAAFR title to complete the entire financial management cycle. It did more than recognize the importance of the government budget; the 1968 GAAFR explicitly called for the adoption of an annual budget by every governmental unit, "whether required by law or not" (5). Furthermore, the committee required the accounting system to "provide budgetary control over general governmental revenues and expenditures" (5). This was about as far as an *accounting* professional group went in pushing governments to do financial planning as a matter of sound management practice. This willingness to exceed the legal requirement was, however, an exception to the general tenor of the document.

The 1968 GAAFR (3-4) required a governmental accounting system to make it possible for a government to "show that all applicable legal provisions have been complied with." The system should be capable of determining "fairly and with full disclosure the financial position and results of financial operations." The committee apparently assumed that its principles would provide the basis for judging government's fair presentation and full disclosure.

Most principles of the 1930s were retained. For example, governmental accounting systems would continue to be organized and operated on a fund basis. The committee defined a *fund* as "an independent fiscal and accounting entity with a self-balancing set of accounts recording cash and/or other resources together with all related liabilities, obligations, reserves, and equities which are segregated for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions, or limitations" (6-7). The fund structure was modified: Bond funds were renamed *capital project funds;* sinking funds became *debt service funds;* utility funds

were generalized to *enterprise funds;* working capital funds were dropped; and intragovernmental service funds were added (7-8).

However, the 1968 GAAFR modified the accrual basis. The *modified accrual basis* of accounting was defined as “that method of accounting in which expenditures other than accrued interest on general long-term debt are recorded at the time liabilities are incurred and revenues are recorded when received in cash, except for material or available revenues which should be accrued to reflect properly the taxes levied and the revenues earned” (11). Specifically, the accrual basis of accounting is recommended for enterprise, trust, capital projects, special assessments, and intragovernmental service funds. For the general, special revenue, and debt service funds, the modified accrual basis of accounting is recommended (11). The ambiguity and confusion evident in the definition and exceptions would last for the next 30 years!

The modification of the accrual basis reflected a fundamental problem with basing an accounting system on “funds.” The way government accountants used the *term fund* was inconsistent with the common usage of funds as money available for ready use. The committee seemed to think that some funds (as fiscal entities) held liquid financial resources and should be accounted for on a modified accrual basis. Other funds that held economic resources (including capital assets) would use the accrual basis as in business accounting. Unfortunately, the modification could be minor or drastic, making the modified accrual basis an ambiguous concept (Chan, 1998).

The liquidity focus of the general fund also led the committee to exclude fixed assets and long-term liabilities belonging to the government as a whole (but not to specific funds) from the general fund. The committee invented two “account groups” to record these items outside the funds. Couched in terms that only specialists in fund accounting could understand, these accounting artifacts hampered public understanding of government financial reports. The gap between government accounting specialists and laypersons grew wider as a new nomenclature emerged.

Conflict would also arise between local laws and the national standards in GAAFR. On this point, the 1968 GAAFR was rather conciliatory: “If there is a conflict between legal provisions and generally accepted accounting principles applicable to governmental units,” it conceded, “legal provisions must take precedence” (4). At the same time, however, governments should install accounting systems that would “make possible the full disclosure and fair presentation of financial position and operating results in accordance with generally accepted principles of accounting applicable to governmental units” (4).

For the first time, “generally accepted accounting principles applicable to governmental units” was invoked, and in doing so the National Committee on Governmental Accounting apparently assumed itself to be their promulgator. At that time, generally accepted accounting principles for business enterprises were set by the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA). Since the APB lacked the legal standing or the interest in setting accounting principles for governments, no jurisdictional disputes arose. However, as more municipal governments contracted for independent audits performed by CPAs, the AICPA set up the Committee on Governmental Accounting and Auditing to provide technical guidance. The 1974 “industry audit guide” on state and local governmental units on the whole endorsed the 1968 GAAFR principles.

In summary, the main achievement of the second wave of governmental accounting reform was the formalization of generally accepted accounting principles sanctioned by government finance officers and the accounting (i.e., CPA) profession. These principles emphasized compliance with legal requirements and provision of support to public financial management through fund accounting and budgetary accounting. Even conceding the primacy of legal requirements, a body of generally accepted accounting principles began to emerge independently of individual governments' practices. In the process of developing precepts into principles, however, a number of jurisdictional and conceptual issues emerged. These became the agenda for the third wave of reform starting the mid-1970s.

Third Wave of Reform: Promoting Accountability

The third wave of reform began in the mid-1970s and reached a crescendo in 1999 when a new reporting model was definitively proposed and required. In contrast to the earlier period's emphasis on legal compliance and financial management, government accountability to stakeholders—investors, citizens, and their representatives—was the guiding spirit. This goal was promoted by the National Council on Governmental Accounting (NCGA) from 1974 to the early 1980s, and by the Governmental Accounting Standards Board (GASB) from 1984.

NCGA Phase (1974 to 1983)

Shortly after publishing the 1968 GAAFR, the GFOA in 1974 elevated the National Committee on Government Accounting to the National *Council* on Governmental Accounting by broadening its membership. The 21 part-time members of the NCGA represented state and local governments, the accounting profession, the financial community, the federal government, and academe. The AICPA's audit guide for state and local government created the need to reexamine the 1968 GAAFR requirements in order to reconcile conflicting positions. There was some practical urgency as well. The closing of the capital market to New York City in 1975 exposed the weaknesses of its accounting practices. Similar crises, though less severe, in other cities such as Chicago and Cleveland created a broader sense of uneasiness about the cities' financial and accounting practices, and the underlying principles as well. Alternatives were proposed, such as the call for full accrual and consolidated reporting (Davidson et al., 1977).

In this anxious atmosphere the newly reconstituted NCGA adopted a short-term and a long-term program. The short-term program was to reexamine expeditiously and revise the 1968 GAAFR principles. The long-term program was to seek resources to conduct fundamental research leading to a sound conceptual framework for governmental accounting (Greathouse, 1985).

The reexamination of the GAAFR, led by Professor Robert J. Freeman, resulted in NCGA Statement 1, "Governmental Accounting and Financial Reporting Principles" (NCGA, 1979). Statement 1 made a number of significant changes in tone and substance to the 1968 GAAFR principles. First, it tipped the balance in favor of GAAP in case they came into conflict with legal provisions. Acknowledging the importance of legal compliance, the NCGA called for the reduction of conflicts between GAAP and legal

compliance. It advised using the legal compliance basis for accounting during the year and doing a GAAP conversion at year-end for producing external reports. Second, it required the preparation of interim financial reports and the issuance of "general purpose financial statements" that would be lifted and issued separately from the CAFR. These statements, prepared at the level of fund types, would present an overview of the entity's financial picture. The financial statements in a comprehensive annual financial report would resemble a pyramid with successive levels of summarization of financial data. Third, the NCGA classified the fund types into three major groups: governmental, proprietary, and fiduciary. Along another dimension, funds were classified as expendable funds and nonexpendable funds. The expendable funds (i.e., governmental and some fiduciary funds) would use the modified accrual basis of accounting; the nonexpendable funds (i.e., proprietary and certain fiduciary funds) would use the accrual basis of accounting. Fourth, the NCGA explicitly called for reporting of budgetary comparisons in financial reports.

For the implementation of the long-term project, the NCGA received a major grant from a federal agency. The grant enabled the NCGA to hire three academic researchers, including the author, to work on a conceptual framework for government accounting. A broad range of actual or potential users of government financial information, based on the criteria of the need or right to know a government's financial affairs, were identified. The researchers recommended that the objectives of state and local government accounting and financial reporting were to provide "(1) financial information useful for making economic, political and social decisions, and demonstrating accountability and stewardship, and (2) information useful for evaluating managerial and organizational performance" (Drebin et al., 1981: 107). The research report formed the basis of NCGA Concepts Statement 1 and influenced GASB's Concepts Statement 1, both on the objectives of accounting and financial reporting.

The NCGA went on to deliberate and issue several other standards on topics such as pensions and leases. However, its attention was distracted by the protracted negotiations on the possible formation of a Governmental Accounting Standards Board (GASB) to succeed it (Chan, 1985). Eventually, the board was established under the auspices of the Financial Accounting Foundation, the sponsor of the Financial Accounting Standards Board, which succeeded the APB to set GAAP for businesses.

The GASB Period (from 1984 to the Present)

The GASB inherited much unfinished business from the NCGA. In order to ensure continuity, it required the continued enforcement of existing NCGA standards (Antonio, 1985). The board undertook its own research project on user needs in order to arrive independently at a set of objectives emphasizing accountability and decision-making usefulness (Patton, 1992). In 1986 it was recognized by the AICPA as the promulgator of generally accepted accounting principles for state and local governments. The GASB explored the possibility of incorporating non-financial measures of service efforts and accomplishments in financial reports but retreated after encountering resistance and difficulties (Brown and Pyers, 1998). In the next 15 years, the GASB adopted a total of 34 standards of varying breadth and depth on diverse topics (GASB, 1998, 1999). The

most significant standards were Statement 11, which attempted to change the measurement method, and Statement 34, to recast the reporting model.

In order to appreciate the significance of GASB Statement 11, it is necessary to recall how general governmental activities were accounted. These activities were typically financed by governmental funds, i.e., general, special revenue, capital projects, and debt service funds. The balance sheets of these funds reported current financial resources and current liabilities, i.e., cash and short-term claims to/by others. As a result of this narrow measurement focus, capital assets and long-term debt (capital as well as operating, such as pension and other retirement benefits) were relegated to the account groups shown far away from the governmental fund balance sheets. Their revenues, mostly taxes and grants, would be recognized on a modified accrual basis, i.e., when they were available to finance current operations. The extent of modification could be so much that it could approximate the cash basis (Chan, 1998). Consequently, "significant unpaid expenditures that result from current-period transactions and events" would not be reflected in the operating statement. Furthermore, "long-term debt issued to finance current operating expenditures could be reported as operating inflows rather than as a fund liability," observed the chairman, James Antonio, and the vice-chairman, Martin Ives (GASB, 1993). These flaws had to be addressed.

The GASB from the outset recognized these problems and made concentrated efforts to solve them over a 6-year period. The result was Statement 11, issued in May 1990 to be effective 3 years later. The long waiting period was set to give the GASB time to complete the remainder of the reporting model, as Statement 11 was confined to dealing with the operating statement of the governmental funds. A complete reporting model would encompass at least the balance sheet and the operating statement; besides it would have to deal with the degree of aggregation of funds.

An operating statement reports on an entity's financial performance as measured by revenues and expenditures (or expense) for a period. The GASB decided that the flow of financial resources was the proper measurement focus for the governmental funds' operating statements. Furthermore, an accrual basis would be used. The board reasoned that this combination of measurement focus and basis of accounting would better promote accountability by enabling users to judge whether current-year revenues were sufficient to pay for that year's services. The board termed this criterion *interperiod equity* (GASB, 1990).

Instead of using cash receipt as a criterion for recognizing revenue, the board was concerned with whether the underlying transaction had concurred and the government had demanded payment (in the case of taxes) or had a legally enforceable claim (in the case of fines, licenses, and permits). Expenditures would be recognized to the extent of claims against the government's financial resources. Furthermore, expenditures were to be categorized as capital expenditures (i.e., those giving rise to capital assets) or operating expenditures.

These changes might seem relatively minor as the board had only dropped the adjective *current for financial resources.* This action, however, would have enabled governments to pick up longer-term receivables (for revenues) but longer-term liabilities (for expenditures) as well. The standard was adopted by unanimous vote. Subsequently, as its impacts were assessed when government began considering its implementation, opposition emerged. Eventually, after a change of membership, a 3-to-2 majority of the

board voted in favor of postponing the effective date of Statement 11, thus effectively killing it (GASB, 1993).

In a sense Statement 11 was only a conservative change of the status quo by reducing the extent to which accrual was modified. The status quo amounted to a strong modification of the accrual basis, whereas the position of Statement 11 was for a weak modification, i.e., allowing more accrual. The mildness of the change from a theoretical point of view belied the potential financial consequences of changing the measurement rule. Under Statement 11, revenue recognition would have been advanced, while postponing payment for current services would not reduce expenditures. The net effect would depend on the balance of the changes.

The requirement for separately identifying operating expenditures seemed innocuous. But analysts were able to anticipate the potential impact of Statement 11 on the balance sheet, even though the board excluded the balance sheet from the scope of Statement 11. The accumulation of unpaid operating expenditures would give rise to greater long-term liabilities. If these liabilities were to move from the general long-term debt account group to the responsible fund, the absence of corresponding assets would result in a reduction in net assets or fund equity. This would signal a worsened financial position.

After decade-long research and deliberations, the GASB released a definite new reporting model in Statement 34, "Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments," in June 1999. Governments will be required to include both fund financial statements and *governmentwide* financial statements in a package of basic financial statements. In addition, a management's discussion and analysis is required to give an overview of the government's financial activities. Interested readers are encouraged to refer to the GASB document for a full description and justification of the model.

Briefly, the governmentwide, i.e., consolidated, financial statements resemble the business and nonprofit financial statements required by the FASB. They consist of a statement of net assets (formerly the balance sheet or statement of financial position) and a statement of activities (formerly the operating statement). Governmental and business activities are to be distinguished, whereas fiduciary activities are excluded. The financial statements will adopt economic resources as their measurement focus and use the (full) accrual basis of accounting. This means that capital assets, including infrastructure assets, will be included and report their historical costs. These assets are to be depreciated. Depreciation expense is reported in the statement of activities, and net book value in the statement of net assets. Depreciation is exempted for infrastructure, that is part of a network (e.g., a highway system), if certain requirements to ensure its maintenance are met.

To report additional information, GASB has required the presentation of fund financial statements for governmental and proprietary funds. Large funds are to be presented individually, and the others are grouped together. The measurement methodology would remain the same: modified accrual for governmental funds and full accrual for proprietary funds. The differences between the governmentwide and fund financial statements are reconciled and reported.

It is likely that the merit of the new reporting model will be debated for the foreseeable future. Several issues are involved. First, the addition of another set of financial statements would increase information overload and compliance costs. Second,

collecting information about infrastructure is costly, and the historical costs and depreciation expense derived therefrom are of dubious value. Third, the link between the reports and enhanced accountability and better decision making is tenuous and has not been empirically demonstrated. Fourth, accruals would lead to greater divergence between accounting and budgeting, raising contentious issues especially on the funding of long-term liabilities. For these and other reasons, the implementation of GASB Statement 34 will present great challenges to state and local governments and the GASB.

As we complete this review of efforts to improve state and local government accounting, it is worth recalling that the "perfect balance sheet" was the quest of government accountants 100 years ago. Financial integrity, legal compliance, sound financial management, and public accountability guided reforms in the 20th century. Their values may well last into the 21st century.

FEDERAL GOVERNMENT ACCOUNTING

Federal accounting reform has always been conceived as part of improving federal financial management (Comptroller General, 1985; Bowsher, 1987; Hildreth, 1993; Jones and McCaffery, 1992, 1993; Jones, 1993; Chan, 1995). Discussions over the decades have revolved around two separate but related issues: who should determine federal accounting principles and what those principles should be. This section examines these institutional and conceptual issues.

Institutional Issues

Which branch of government—executive or legislative—should set accounting standards for the federal government and its agencies? Specifically, should it be the Treasury Department, the Office of Management and Budget, or the General Accounting Office? This question has been debated at least since the 1930s and was resolved only in the early 1990s. A brief historical review helps put the matter in perspective.

The Constitution of the United States requires the Congress to make appropriations before the Treasury can spend money. It also requires the secretary of the Treasury to produce periodic financial reports. The 1789 Treasury Act established an auditor and comptroller in the Treasury Department and required the department to submit an annual report to the Congress. The Dockery Act of 1894 further required the Treasury Department to submit to Congress annual combined statements of receipts and expenditures. The Treasury Department fulfills its reporting obligation by issuing an Annual Report as the official financial reports of the U.S. government.

Two other players arrived on the scene when the 1921 Budget and Accounting Act created the Bureau of the Budget and the General Accounting Office (GAO) in the Treasury Department. To ensure the GAO's independence of the executive departments, the comptroller general would enjoy a 15-year term. The 1921 act required the comptroller general to "prescribe the forms, systems, and procedures for administrative appropriation and fund accounting in the several departments and establishments, and for the administrative examination of the fiscal officers' accounts and claims against the United States" (Trask, 1996: 563-564). This combination of the accounting and auditing functions in one office became a contentious issue over the next 70 years.

There were two contending schools of thought. The executive perspective was articulated by the President's Committee on Administrative Management (the Brownlow Committee) during the Roosevelt administration and reiterated by the Hoover Commissions in the next two decades. The Brownlow Committee (1937) called for strengthening the Bureau of the Budget "as the right arm of the president for central fiscal management." But it recognized that effective fiscal management required that the budget be reinforced by the accounting system to direct and control expenditures. Since the committee believed that expenditure control was "essentially an executive function"—apart of the president's constitutional duty to execute the law faithfully—it followed that accounting was also an executive prerogative. The committee recommended that the control and audit functions be separated. Specifically, "the authority to prescribe and supervise accounting systems, forms and procedures in the Federal establishments should be transferred to and vested in the Secretary of the Treasury." This would enable the GAO to focus on the postaudit function and not be involved in approving financial transactions.

The congressional perspective has been quite different. Even before the Budget and Accounting Act in 1921, the Dockery-Cockrell Commission in the 1890s had "reaffirmed congressional preeminence with regard to the modes of federal financial management" (Mosher, 1979:29; quoted in Trask, 1996: 2). Thus the Brownlow Committee's assertion of accounting as an executive function would not be acceptable to Congress and the GAO. In their view, setting accounting policies and procedure was an extension of the congressional budget function and an expression of legislative oversight. Insistence over institutional prerogatives led to numerous clashes over a 50-year period.

It was futile for the executive and the legislative branches to claim exclusive jurisdiction over accounting standard setting, because accounting is inseparable from budgeting and auditing. A good accounting system supports budget execution; it also provides facts for the audit function. Being situated between budgeting and auditing in the integrated financial management cycle (Comptroller General, 1985), accounting is subject to the tug-of-war between the administration and the auditor. The turf war was detrimental to improvement of financial management in the federal government. In 1947 the comptroller general, the Treasury secretary, and the budget director agreed to cooperate in a joint program to improve federal accounting. The GAO agreed to limit its role to developing standards and guidance and providing expert assistance, leaving the operation of accounting systems to the agencies. After its decline during the tenure of his predecessor, Comptroller General Elmer B. Staats in the 1960s reinvigorated the program and broadened its scope to financial management. This Joint Financial Management Improvement Program (JFMIP) in 1991 was chosen as the institutional umbrella for cosponsoring the Federal Accounting Standards Advisory Board (Bramlett, 1991).

It would be simplistic to view the interagency conflict only as a bureaucratic rivalry. The constitutional principle of separation of powers was involved. Both sides of the issue recognized the importance of accounting as a tool for managing and controlling the financial operations of the federal government. They were also concerned with the how the financial picture of the government would be portrayed, as will be clear in the next section.

Conceptual Issues

The main conceptual issue facing the U.S. government was whether to adopt the accrual basis of accounting and to present consolidated financial statements. As generally accepted accounting principles (GAAP) have required these methods for business firms, the debate was sometimes couched in terms of whether the federal government should adhere to GAAP. Clearly the federal government was not (and is not) subject to FASB and GASB pronouncements. GAAP was used as a shorthand for business accounting principles.

The first Hoover Commission in 1949 and the second Hoover Commission in 1956 both recommended that the federal government use accrual accounting. Indeed accrual accounting was required by legislation passed in 1956, but the law was not effectively implemented (Rita and Eisenhart, 1992). Contemporary debate on this issue resumed in the mid-1970s, when Arthur Andersen & Co., a major accounting firm, acting on its own initiative, studied the accounting practices of the U.S. government and published the first consolidated financial statements of federal government based on its interpretations of the accrual basis of accounting. Next year, Secretary of the Treasury William E. Simon was sufficiently persuaded to name an advisory committee to follow up on Arthur Andersen's recommendations. The committee developed a guide, and the Treasury Department for the next two decades annually refined and published unaudited *prototype* consolidated financial statements, while continuing to publish its Annual Report as the official report of the U.S. government.

In 1986, Arthur Andersen & Co. reiterated its case. First, the budget deficit measured on the cash basis did not reflect the financial condition and the real cost of government programs. The lack of an appropriate definition of "balanced budget" and budget deficit hindered public debate on how to reduce federal deficits, which had been escalating since the late 1960s. Second, the U.S. government exempted itself from generally accepted accounting principles while requiring publicly held corporations and state and local governments to follow GAAP. Accrual accounting was required by law based on the second Hoover Commission's recommendation and by GAO accounting guidance to federal agencies. Third, the cash basis hid the cost of current programs and could lead to misallocation of national resources. Disclosure of unfunded liabilities for federal employee retirement pensions and for social security benefits and other entitlement programs was inadequate.

These observations led Arthur Andersen & Co. again to urge the U.S. government to regard consolidated financial statements prepared on the accrual basis as the official financial statements of the U.S. government and subject them to independent audit by the U.S. General Accounting Office. The federal government should improve its accounting system and should concentrate central financial reporting in a single agency. Perhaps the most controversial recommendation was that the federal government should prepare the annual budget in accordance with generally accepted accounting principles.

Arthur Andersen & Co. believed that these recommendations would improve elected officials' accountability, lead to more informed decision making, prevent financial crisis, and facilitate improvement of performance measures. Raising the stakes even higher, it declared, "It is not simply a matter of dollars, but of whether a nation of 240 million free people can govern themselves effectively" (Arthur Andersen & Co., 1986: 1).

At about the same time as the Arthur Andersen update, Comptroller General Charles A. Bowsher issued a major document, *Managing the Cost of Government: Building an Effective Financial Management Structure* (Comptroller General, 1985). The document catalogued a long list of problem areas: poor quality of financial management information; poor linkages between the phases of the financial management process; inadequate attention paid to monitoring and comparing budgeted activities with actual results; primary emphasis on fund control; inadequate disclosure of assets, costs, and liabilities; antiquated and fragmented financial management systems. To address these problems, the comptroller general proposed a structure to integrate planning and programming, budgeting, budget execution and accounting, and audit and evaluation. Specifically, he recommended the following:

Make resource allocation decisions within a unified budget.
Budget and account on the same basis.
Use accounting principles that match the delivery of services with the cost of services.
Encourage financial accountability through management reports that match accomplishments with costs.
Measure outputs as well as inputs.
Prepare consolidated reports.

Similarly to that in the Arthur Andersen proposal, the accrual basis and consolidated financial reporting were the conceptual foundation of the GAO system. The GAO buttressed its case by linking consolidated financial reporting to the unified budget, which had been the cornerstone of the federal budget since 1968. "Consolidation of annually audited financial statements provided an overall picture of the federal government's financial condition," argued the GAO. The GAO also pointed out that by focusing on the balance sheet, "(d)isclosure of the cumulative financial effects of past decisions aids the public and policy formulators in analysis of resources and commitments" (Comptroller General, 1985: 4).

With regard to measurement, the "same basis" the GAO had in mind for integrating the budgets and accounts was the accrual basis. "Accrual principles," the GAO argued, "provide policymakers and managers with consistent information to compare program/service costs between period or agencies. Interperiod distortions are minimized, and better informed cost/benefit evaluations become possible" (Comptroller General, 1985: 4).

A year earlier, the GAO had already revised its accounting rules—Title 2 of *GAO Policy and Procedure Manual for Guidance of Federal Agencies*—to require the preparation of agencywide (consolidated) financial statements using the accrual basis of accounting. To demonstrate the superiority and feasibility of the proposed accounting rules and reporting model, the GAO conducted a Federal Government Reporting Study with the Office of the Auditor General of Canada (OAG and GAO, 1986). The study cited results from surveys of actual and potential users in support of consolidated financial statements prepared on the accrual basis. Clearly considerable momentum had been generated for a new kind of federal accounting and financial reporting.

According to Rita and Eisenhart (1992: 3-15), it was the *reporting* requirement of Title 2 that upset the executive branch most. Noncompliance with the reporting requirement would be more visible and easily verifiable than noncompliance with the *accounting* requirement. In addition to the jurisdictional issues mentioned earlier, there were genuine conceptual problems with the proposal, especially concerning the accrual basis.

The first and foremost issue is that the federal government is unique. Not only is it a sovereign with the power to print money, it is not accustomed to thinking about its financial condition in terms of the balance sheet. The federal government has many unique assets, among them federal land and weapon systems. Rarely is it feasible or meaningful to talk about the historical costs or market value of these assets. The scope and definition of the federal government's liabilities are particularly problematic. Whenever Congress passes and the president signs a law creating certain rights, their future costs in a sense become a federal liability. If so, federal liabilities include the future costs of promoting general welfare. The bottom line for the federal government is often not financial in nature; even economic considerations are sometimes overridden by political and social concerns. It is therefore doubtful that a body of principles developed to account for commercial transactions could accommodate the unique character of the federal government.

The federal budget community in general had reservations about the assertiveness of the accountant. The first OMB director, Roy Ash, called accrual accounting a "bottomless pit." David Stockman, OMB director under President Reagan, ridiculed corporate accounting for the federal government as "Alice in Wonderland nonsense, not remotely possible or useful" (Chan, 1995: 34). From their perspective, federal accounting should complement the federal budget by playing a supportive role. Over time and especially since the 1968 *Report of the President's Commission on Budget Concepts,* a body of federal budgeting rules or norms has evolved. The idea that accounting rules could or should challenge them struck the federal budget community as presumptuous (Cuny, 1995). First of all, generally accepted accounting principles have been developed primarily for business enterprises, whose objectives and operations are quite different from those of the federal government (Mautz, 1991). Furthermore, the accounting rules in GAO's Title 2 had not been accepted by the other central finance agencies or the line agencies.

Although the accrual basis drew most attack, the usefulness of consolidated financial reporting was also doubted. Consolidated financial reporting would call for the preparation of financial reports on the basis of organizational units (e.g., the Department of Commerce or the General Service Administration) and ultimately of the United States government as a whole. The latter is the accounting counterpart to the unified budget and could be justified on similar grounds. However, budget accounts are what really matter in the federal budget process. Congress appropriates funds to the budget accounts, and these accounts become the accounting entities to track. Furthermore, the federal budget is structured in terms of programs and functions, whereas accountants tend to focus on organizational units.

In summary, the GAO and Arthur Andersen proposals were so different from the established budget practices that they engendered strong negative reaction from the federal budget agencies. The conceptual issues became connected with the jurisdictional

issues, making it virtually impossible to have rational discussions at the technical level. Fortunately by the late 1980s, the leaders of the central finance agencies concluded that the prolonged stalemate would have dysfunctional consequences. After considerable negotiations, they reached an agreement to cosponsor a body to work on these issues.

Resolution of the Issues

The jurisdictional issue discussed earlier was resolved by means of the Joint Financial Management Improvement Program (JFMIP). The JFMIP principals— the secretary of the Treasury, the director of the OMB, and the comptroller general—agreed to establish jointly an advisory body—the Federal Accounting Standards Advisory Board (FASAB). FASAB would conduct the necessary research and deliberations in order to recommend accounting standards applicable to the federal government. The assumption was that the JFMIP principals would have sufficient confidence in their own creation that they would require compliance by federal agencies (Bramlett, 1991; Bramlett and Rexford, 1992).

The Chief Financial Officers Act required federal agencies to furnish "complete, reliable, timely and consistent financial information for use by the executive branch of Government and the Congress in the financing, management, and evaluation of Federal programs" (CFO Act, Sec. 102[b][3]). The CFO act also gave OMB the authority to specify the "form and content" of financial statements. Therefore the OMB representative at FASAB for a period argued that FASAB should set accounting—as opposed to financial reporting—standards only. To complicate the matter further, Congress was, however, reluctant to delegate accounting-standard-setting authority completely. For example, the CFO act required congressional approval of accounting standards on capital, including human capital.

Under the watchful eyes of Congress, its sponsors, and the federal agencies, the FASAB thus became a forum for discussing federal accounting issues. The membership of the board was carefully specified to ensure that the perspectives of these stakeholders would be reflected. The agreement creating the FASAB specifies that the Treasury Department, OMB, and GAO, along with the Congressional Budget Office, each have a representative on the board. Two other federal members represent civilian and defense agencies, respectively. There are three public members as well.

The technical issues were so numerous and complex that the board simultaneously adopted a comprehensive and an incremental approach. On the basis of staff research on users and their needs, the board adopted a broad set of objectives for federal financial reporting and specified a reporting model. The FASAB believes that federal financial reports should help users evaluate the government's budgetary integrity, operating performance, stewardship over the government's impact on the nation, and adequacy of systems and control. FASAB has provided an inclusive definition of federal entities and requires their preparation of management discussion and analysis and a half-dozen statements on financial position and changes thereof, net costs, custodial activities, budgetary resources, and program performance measures. Other relevant information is to be provided in supplementary reports.

These concepts statements provided a framework for addressing specific technical issues in almost a dozen documents (FASAB, 1997). FASAB statements give guidance on the measurement and reporting of specific elements of the financial statements. In

contrast to the budget, the financial reporting model stresses the reporting of financial position as much as periodic results of operations. The statements attempted to identify the myriad federal assets and liabilities. The assets range from cash and other financial resources to inventories and fixed assets. Given their diversity and the inconclusiveness of debates over measurement bases, the FASAB has largely allowed the existing practices to continue. The federal government's liabilities are equally numerous and huge in amounts. Besides the familiar national debt, there are other legal and contractual obligations, such as pension and retirement benefits for federal employees. The FASAB soon found itself entering the gray area of commitments and obligations that strain the traditional definition of liabilities. In view of the potential legal and political consequences of defining something (e.g., future benefits under entitlement programs) as a liability, the FASAB prudently refrained from assuming too broad a conception of liability and settled for their reporting off the balance sheet in supplemental disclosures. In one particular area, credit reform legislation called for the use of present value to measure the cost of federal subsidies for loans and loan guarantees. The FASAB accepted this requirement and has developed consistent accounting and reporting requirements. In general then, the FASAB embraced the philosophy of accrual accounting and, subject to measurement technology, provided for a meaningful balance sheet.

The FASAB readily endorsed the recognition of revenues from sales of government services when the services have been rendered. Influenced by current budget practices that regard such revenues as offsetting collections and receipts to reduce expenses, the FASAB coined the concept of *net cost* to reflect share of cost of services (expenses) borne by taxpayers. Costs of services are calculated on the full-accrual basis; that means that even the cost of using equipment and noncash expenses (e.g., future pension benefits of employees) are included.

With regard to revenues, the FASAB believed that in principle revenues from so-called nonexchanged transactions (e.g., taxation) should be recognized when the government has established a legally enforceable claim. Practical considerations arising mainly from the government's inability to have timely information push the recognition to the point near cash collection. Accurate measures of the government's taxes receivable remain a major administrative challenge to the government.

In view of the significant differences between budget and accounting concepts (Cuny, 1995), the FASAB called for their reconciliation and disclosure in the financial statements. This compromise approach acknowledges the budget's power and the division of labor between accountants and budget makers.

It was not realistic to expect to resolve all the complex accounting issues in the federal government. After establishing the basic standards, it has entered the refining phase as agencies encounter difficulties in implementing the standards.

On the whole, the current wave of reform in federal accounting has some positive attributes. Accounting has assumed a strategic position of supporting financial management reform legislation, making it possible to recruit political allies. Both the GAO and the OMB have refrained from insisting on their constitutional prerogatives and have found common grounds. There is team work: Central finance agencies work with line agencies and the central finance agencies cooperate among themselves. The FASAB has adopted a top-down approach. Starting with the U.S. government as a whole, the reporting model views agencies and programs as component units. This ensures

consistency and prevents capture by the peculiarities of the existing funds and budget accounts. The board has benefited from multidisciplinary staff research support. Budget experts, many of whom are economists, joined the research process early and made substantial contributions. As a result, professional respect and camaraderie facilitated consensus building. Finally, the board has struck a delicate balance between the ideal content of financial reports and the reality of imperfect accounting systems. FASAB members and staff spent considerable time hearing out the agency representatives on their current practices and unique problems. On the whole, however, it has leaned toward pursuing its mandate for meaningful reports, while being mindful of the need to improve the system producing them.

The FASAB principles have been in use for several years now to guide the preparation of two governmentwide financial reports and scores of agency financial reports. After settling on the major conceptual issues, technical issues are resolved through the refinement and interpretation of existing standards. It will be many years before the federal government will need another major overhaul of its accounting standards.

CONCLUSION

The federal system in the United States has resulted in two separate paths of reforming government accounting standards at the federal and state/local levels. State and local governments have a history of almost seven decades of reforming government accounting standards (Johnson and Langsam, 1991). For the federal government, which has a long history of *budget* reform, contemporary accounting standard setting began in earnest only in the early 1990s. However, in a relatively short period, the federal government made a more clear-cut break from tradition. The similarities and differences between accounting reforms at these two levels of American government are summarized in Table 1.

Table 1 Differences and Similarities

State and local governments	Federal government
• GASB standards that cover external reporting exclusively	• FASAB standards that cover management and cost accounting
• Creditors and investors among primary users	• Congress and managers among primary users
• Discrete presentation of major funds	• Separation of financial reports by agency
• GASB an extragovernmental body	• FASAB an interbranch cooperative mechanism
• Indirect government oversight through public interest groups	• Direct government oversight
• GASB standards enforced through CPA audits and rating agency requirement	• FASAB standards enforced through legislative and administrative requirements
• Long-term goal of integrating financial and performance measures to promote accountability	
• Emphasis on external reporting with a user orientation	
• Addition of management discussion and analysis (MDA) to enhance user	

understanding of financial statements
• Adoption of complete financial reporting model with a balance sheet
• Commitment to accrual, with concessions in implementation
• Commitment to governmentwide reporting
• Requirement for actual and budgetary comparison
• Extensive due process and openness in standard setting

After several decades of reform, government accounting standards for the federal government and for state and local government have finally achieved a conceptual convergence. Both are requiring governmentwide consolidated reporting using the accrual basis. Such an accounting system is significantly at odds with the public budget systems organized around budget accounts to keep track of the flow of financial resources. This chapter has explained this conceptual convergence as a reflection of the combined effects of several influences. The first is the shift of the objective of accounting from primarily a management tool of budget execution to the government's demonstration of accountability to resource providers. The second is the influence of private-sector accounting where consolidation and accrual are the norm. But this influence probably would not have succeeded if it were not for the public demand that government be run more as businesses are. The third influence is the tradition of independent accounting standard setting and external auditing. This has enabled public finance professionals and the CPA profession to become a major and continuous force in championing changes when individual governments and officials lack the incentive and power to make them. These influences led the German scholar Klaus Luder (1989) to conclude that the social, political, and administrative factors in the United States were favorable to the adoption of major conceptual changes in government accounting. These changes have at long last fulfilled Thomas Jefferson's dream in 1802:

> I think it an object of great importance ... to simplify our system of finance, and to bring it within the comprehension of every member of Congress ... the whole system [has been] involved in impenetrable fog. [There is a point... on which I should wish to keep my eye ... a simplification of the form of accounts... so as to bring everything to a single center[;] we might hope to see the finances of the Union as clear and intelligible as a merchant's books, so that every member of Congress, and every man of any mind in the Union, should be able to comprehend them to investigate abuses, and consequently to control them.

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