Global Government Accounting Principles

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I. Introduction

Globalization has increased the financial interdependency and vulnerability of governments and international financial institutions. Regional integration, such as the creation of the European Monetary Union, has also given rise to the need for policy coordination in the monetary and fiscal areas. International and regional organizations have therefore increasingly called for greater transparency and commonality in government finance statistics. In this context the Public Sector Committee of the International Federation of Accountants (IFAC), whose institutional membership includes the professional accountancy bodies in the world, has proposed a set of International Public Sector Accounting Standards (IPSAS).

While there is an emerging consensus that governments should be held financially accountable, there are different definitions of accountability. This has led to two major competing models of government accounting. One model emphasizes hierarchical accountability within the executive branch and executive accountability to the parliament. The other model stresses the entire government's accountability to the electorate and general public. Adherence to these different modes of accountability has led countries to adopt these different models of government accounting or their variants. In this essay, I argue that in the absence of persuasive evidence or consensus about the superiority of either one of these models, it is premature to endorse one of them for world-wide adoption. I further observe that the IFAC Public Sector Committee (PSC) has taken an inappropriate approach in developing the IPSAS by essentially imitating business accounting standards. I propose a sample set of global government accounting principles and urge the IFAC PSA to analyze the costs and benefits of policy alternatives for consideration by national bodies in their standard setting process.

II. Competing Models of Government Accounting

1. Government Financial Accountability

Financial accountability has emerged as an international norm for government conduct. The ascendancy of democracy reaffirms the view that governments are politically accountable through the ballot box. Furthermore, the widespread adoption of market economy has given rise to a greater appreciation of the importance of contractual accountability under the rule of law.

As money is an essential element in many political and contractual relationships, government financial accountability has become a focal point of many political debates and economic discussions. In particular, international aid and loan agreements, by including conditionality clauses requiring recipient accountability for financial resources, are more able to induce responsible conduct. In a domestic context, financial accountability in a democracy exists at three levels. The first level is hierarchical accountability within the executive branch, where lower-level officials (e.g. civil servants) are accountable to their superiors (e.g. ministers). The second and higher level of accountability is that of the executive branch – often called the government in Europe and the administration in the United States – to the legislative branch, be it called congress, assembly or parliament. This kind of accountability is based on the proposition that elected officials occupying seats in the legislature are more directly accountable to the people than are appointed officials in administrative positions. The third and highest level of accountability is the entire government's accountability to the electorate. In this context, government encompasses all the legislative, executive and judicial branches.

As resources in the public sector are – or should be – allocated through the budgetary process, the budget has become a primary instrument for creating and enforcing accountability at all the three levels mentioned above. Even after recognizing the many budget reforms in the past decades, the basic government budget remains the traditional type. This type of budgeting focuses on one period and is concerned mostly with cash receipts and disbursements, even though appropriations may be expressed in terms of obligations authorized to be incurred. Besides allocating resources, the budget may also serve as an accountability tool in the exercise of administrative control, legislative control and popular control. In this regard, it needs the support of the accounting system, which measures and communicates **actual** financial performance.

Though budgeting and accounting are both concerned with money, chronologically the budget leads and accounting follows. Furthermore, as academic disciplines and professional practices, they tend to adopt two rather different views, as summarized in Table 1.

Dimensions of Comparison	**Budgeting**	**Accounting**
Primary Tasks	Resource allocation	Financial measurement and reporting
Time Perspective	Future	Past
Measurement Focus	Flows: revenues and flows	Stocks: assets, liabilities
Foundations	Law, politics, economics	Economics, finance and business management

Table 1: Accounting in Contrast to Budgeting

2. Accounting in Relation to the Budget

In view of the close relationship between budgeting and accounting, it is possible to define government accounting in terms of its relationship with the traditional budget. For ease of exposition, I distinguish between Model X and Model Y of government accounting (Table 2).

Dimensions of Comparison	**Model X**	**Model Y**
Relationship between Budgeting and Accounting	Accounting is subordinated to budgeting.	Accounting exerts influences on budgeting
Type of Accountability Emphasized	Hierarchical accountability; executive accountability to legislature	Government accountability to the electorate and general public

Key Financial Measures	Obligations, cash flows	Assets (rights), liabilities (obligations) — accruals

Table 2: Model X and Model Y

Model X is concerned with government operations. It is based on the belief that, in a representative democracy, parliamentary control of bureaucracy is a sufficient basis for designing the accounting system. Since such control requires a legal - and ultimately a constitutional - basis, politicians and lawyers are the professions supporting and operating Model X. On the other hand, Model Y reflects public concern and is based on the necessity of popular control of government in a democracy. In this model, independent public monitoring of government finances is crucial. Accountants and auditors - especially those outside of government - tend to embrace Model Y. This position is not just a matter of political conviction. Model Y is more familiar to people trained in business accounting, and its adoption could potentially lead to the expansion of their professional services to the public sector. Model X tends to be adopted primarily by Continental European countries (e.g. Germany and France). Model Y is practiced mostly by the so-called "Anglo-Saxon" countries (e.g. Australia and New Zealand). It should be stressed that variants of these "pure" models are practiced in different countries, and they may be used in combination and in different time periods. For example, American state and local governments have long been using Model Y. On the other hand, the Federal Government for decades used Model X until it switched to Model Y during the 1990s.[1]

3. Competition between the Two Models

Until recently, Model X and Model Y coexisted without much interaction. However, they are now competing internationally for influence, with Model Y being on the offensive. One forum of competition is the Public Sector Committee of the International Federation of Accountants, where Model Y apparently has won. In many ways, this outcome is not surprising. The IFAC represents professional accountants and auditors, most of whom work in the private sector. The level of their training, interest and involvement in the public sector is generally much higher in Anglo-American countries than in Continental European countries. That being the case, it is understandable that the PSC has been led by representatives from Canada and New Zealand, which have adopted Model Y. Besides, whereas there are at least a half dozen major languages spoken in Europe, English has become a common working language among business and finance professionals world-wide. This has greatly facilitated the dissemination of ideas expressed in English, thus enhancing the influence of Model Y. Furthermore, the model's advocacy of transparency and external accountability is consistent with goals of international financial institutions, which in the 1990s became actively involved in assisting new democracies and transitional economies. Finally, there is already a precedence in harmonizing business accounting standards with the adoption of the Anglo-American model.

So, after a decade and half of institutional building and research study, the IFAC's PSC was poised to take advantage of the favorable conditions in the mid-1990s to adopt an activist agenda of standard setting. The next section will evaluate the outputs of this effort after providing some brief background information.

III. IFAC PSC'S IPSAS

1. Objective and Process

In developing and promoting the adoption of the IPSAS,[2] the IF AC Public Sector Committee seeks to: raise the quality of government financial information, improve government decision making, avoid fiscal and economic crises, increase fiscal transparency, strengthen governance arrangements, and contribute to a higher standard of living. It is fair to say that government accounting standards have a more direct influence on fiscal transparency and governance arrangements than the other objectives. These two objectives provide the rationale for the financial support by the United Nations Development Program, the International Monetary Fund, the World Bank, and the Asian Development Bank.

The committee has followed a "due process" in developing the IPSAS. The process requires extensive deliberations by committee members, and periodic meetings open to observers. Documents of the committee, including exposure drafts of proposed standards, are widely circulated for comments. These comments are analyzed by committee staff and members, and are presumably taken into account in developing the final standards. Standards are adopted by majority votes and are released in the committee's name.

2. Outputs

The outputs of the process described above are a series of standards patterned after the business accounting standards promulgated by the International Accounting Standards Committee (IASC). Table 3 lists the titles of the standards that have been issued as well as exposure drafts being circulated for comments.

1. Presentation of financial statements.
2. Cash flow statements.
3. Net surplus or deficit for the period; Fundamental errors and changes in accounting policy.
4. The effects of changes in foreign exchange rates.
5. Borrowing costs.
6. Consolidated financial statements and accounting for controlled entities.
7. Accounting for investments in associates.
8. Financial reporting of interest in joint ventures.
9. Financial reporting under the cash basis of accounting.
10. Revenue from exchange transactions.
11. Inventories.
12. Construction contracts.
13. Financial reporting in hyperinflationary economies.
14. Property, plant and equipment.
15. Leases.

Nos. 1-8 are standards; Nos. 9-15 are exposure drafts.

Table 3: International Public Sector Accounting Standards

IV. A Critique of the Current IPSAS

1. General Considerations

The Committee claims that, by virtue of the IPSAS, "for the first time there is an authoritative set of independent financial reporting standards for government." This assertion of independence and authoritativeness bears some examination. It is the case that the Committee is independent of the world's governments. However, it understandably reflects the interests of its parent organization, the IF AC. It is not financially independent of the major international financial institutions, whose continued support would presumably be contingent upon whether their objectives are well served. Importantly, the Committee is not conceptually independent of the IASC, on whose standards it has greatly relied upon. These dependency relationships could have influenced the Committee's perspective and products, and ultimately their acceptance by governments around the world.

While independence from governments has its merits, the Committee runs the risk of the standards being ignored or opposed by governments, even if they are endorsed by the accountancy bodies around the world. The IFAC's professional authoritativeness is not operative unless private-sector auditors are engaged to perform government financial audits based on the IPS AS. Only in a small number of countries are governments audited by private-sector auditors. Nor should one assume that governmental auditors are ready to embrace the IPSAS, even though the INTOSAI (International Organization of Supreme Audit Institutions) is an observer of the committee's proceedings. For the standards to be accepted - and become authoritative legally and administratively - the involvement of senior budget or accounting officers is almost indispensable. In this regard, this group is conspicuous by their virtue absence from this global initiative, thus casting doubts about the prospect of the acceptance of the IPSAS. It is worth remembering that the aura of professional authoritativeness may not be so compelling in the political arena and government process.

The possible reluctance of governments to accept and implement the IPSAS as they have been promulgated should not be attributed to politics. One can have some legitimate concerns about the IPSAS, as elaborated in the next section.

2. Specific Criticisms

a) Areas of Neglect

The IPSAS are largely based on what is called Model Y in this essay. Despite its rationale and strengths, Model Y is not universally adopted. Similarly, Model X is not practiced in all countries either. Nevertheless, it is an alternative to Model Y and, as such, deserves more consideration than the Committee has given it. In other words, the

Committee is well-advised to acknowledge the legitimacy and widespread use of Model X, and then argue the case for the global adoption of Model Y. Similarly, the IPSAS has emphasized financial accounting and external reporting to the neglect of budgeting and cost analysis ("managerial accounting"). This neglect is unjustifiable in view of the importance of budgeting and cost analysis in the public sector. Finally, in view of the implicit agenda of assisting developing countries, the Committee should have paid more attention to how accounting might contribute to the early detection and solution of financial problems commonly faced by these countries. It is not enough to say that developing nations may continue to use the cash basis until they have developed the capacity to implement accrual-based accounting.

b) Uncritical Acceptance of Business Accounting Standards

The Committee chose to develop the IPSAS in parallel to the IASC standards. Even if one accepts the policy choices made in each of the IPSAS, to consider and modify the existing IASC standards would not produce a body of coherent government accounting standards. At a minimum, one would expect the Committee to differentiate general standards from topical standards, as illustrated in Table 4.

- General Purpose External Financial Reporting
    - Presentation of Financial Statements (No. 1)
    - Cash Flow Statements (No. 2)
    - Consolidated Financial Statements and Accounting for Controlled Entities (No. 6)
    - Financial Reporting Under the Cash Basis of Accounting (ED for No. 9)
- Specific Issues
    - Net Surplus or Deficit for the Period, ... (No. 3)
    - The Effect of Changes in Foreign Exchange Rates (No. 4)
    - Borrowing Costs (No. 5)
    - Accounting for Investments in Associates (No.7)
    - Financial Reporting of Interests in Joint Ventures (No. 8)

Table 4: Reorganizing the IPSAS

Besides the argument that government accounting is deservedly different from business accounting in many ways, it should be pointed out that not all is well with business accounting. After more than a half century of research and several decades of standard setting at least in the United States, many fundamental issues remain. For example, there does not exist a consensus on the most preferred valuation method for assets in external reporting. Generally accepted accounting principles sanction multiple inventory methods and depreciation methods. Indeed, the current financial reporting in the U.S., the country with presumably the most rigorous standards, came under serious criticism from a committee sponsored by American Institute of Certified Public Accountants. The Jenkins' Committee, among other things, called for greater disclosure of more business environment and future-oriented information. Indeed, one might argue that business firms lag behind governments in disclosing budgets and contractual obligations, and in reporting actual performance in relation to the budget.

c) Failure to Address Governmental Issues Early

In view of at least two decades of research and standard-setting in the United States and other countries, the "value-added" of the IFAC PSC's project would have been insights on the accounting consequences of the uniqueness of government. For example, the public goods nature of many services produced by government makes it impossible to develop individual market prices for them. In addition to the government's power to tax, this makes it difficult, if not impossible, to recognize revenue on the basis of services rendered to individual taxpayers. In general, non-reciprocal transactions constitute a major category of thorny issues for which commercial accounting concepts and standards are either non-existent or inapplicable. Furthermore, business preoccupation with efficiency is replaced by the public sector's concern for equity. The accounting and financial reporting of this concern may be far reaching, and yet it has hardly attracted any attention in government accounting standard setting. In short, the "standards first, conceptual framework later" approach is not only intellectually unsatisfying, it is also an inefficient and ineffective way to produce a set of coherent standards applicable to the public sector.

d) Insufficient Justification

As stated earlier, the IFAC Public Sector Committee has not made a persuasive case that Model Y is superior to Model X. Nor has it presented evidence that the standards would achieve the identified objectives of the Committee. More specifically, it has not provided adequate justification for some of the major accounting or reporting policy position it has taken. For example,

- A government should be reported as a whole.
- The accrual basis is preferable to the cash basis.
- The historical cost basis is generally preferred to the other alternatives.

3. Overall Assessment

Having voiced some critical concerns about the Committee's approach, I could still rationalize its strategy on the following grounds. It cost less to produce the IPSAS by modifying existing IASC standards. The IPSAS are, so far anyway, quite harmonious with business accounting standards, thus minimizing conflicts within the accounting establishment. Standards similar to business accounting standards can be more readily accepted by the membership of the IFAC's constituency – mostly private-sector accountants and auditors, and the financial community. Unfortunately, the above benefits are offset by some costs. By overlooking or deferring consideration of the issues unique to government, the Committee missed the opportunity to advance the development of government accounting. It also made the initial set of standards less useful and credible to governments. Indeed it is difficult to see how, as they are, the IPSAS are capable of providing a solid foundation for a nation's government accounting standard setting.

V. A Proposal

1. Global Principles

The reservations expressed above have led me to the conclusion that it would have been preferable for the IFAC Public Sector Committee to recommend global government accounting principles. In contrast to the detailed technical rules that have a strong overtone of regulation, such principles should be broad enough to appeal to governments of under diverse political, economic and social systems. This approach is not intended to reduce government accounting practices to the lowest common denominator, but to set a threshold level that can be endorsed by financially accountable governments. A sample set of such principles appears in Table 5.

Principle 1 specifies the objective of government accounting, and Principle 2 places accounting in the context of the entire financial management cycle. Principle 3 provides the basis for the possible introduction of the accrual basis of accounting. Principle 4 identifies the key financial variables to be accounted for. Principle 5 introduces users' right and need to know as the primary determinants of financial reports. Collectively these principles provide a foundation for the development of government accounting standards.

1. The objective of government accounting is to accurately measure and communicate the government's financial condition so as to demonstrate financial accountability and facilitate decision making. 2. A government should prepare and publish its budgets, maintain complete financial records, provide full financial disclosures and subject itself to independent audits. 3. The accounting system should measure the cash and other financial consequences of past transactions and events, including but not limited to budget execution. 4. The accounting system should be capable of keeping track of the levels and changes in assets, liabilities, revenues and expenditures/expenses. 5. The form and content of financial reports should be guided by their intended users' right and need to know.

Table 5: Global Government Accounting Principles: A Sample

2. Accounting Issues Unique to Government

Hopefully the principles described above may be useful to the IF AC Public Sector Committee as it considers a conceptual framework for government accounting. The Committee faces a challenging task of dealing with the accounting issues unique to government. These issues include:

- The relationship between accounting and budget
- Non-reciprocal transactions, such as taxation, grants in aid and subsidies
- Valuation and presentation of infrastructure and heritage assets.
- Responsibilities under social insurance and entitlement programs.

It is therefore all the more important for the Committee to work closely with the government accounting standard boards and finance officers who have grappled with these difficult issues. For example, the Federal Accounting Standards Advisory Board and the Governmental Accounting Standards Board in the United States, among others, have researched and deliberated these issues at length. At this point, the contribution of the Committee would be its additional insights about the costs and benefits of various alternatives. If the Committee is determined to go beyond the analysis of costs and benefits of alternatives, the advisory nature of IPSAS should be emphasized. The setting of government accounting standards is, or should be, the proper province of national bodies.

References

Chan, James L., Reforming American Government Accounting in the 20th Century, Kuotsai T. Liou (Ed.), Handbook of Public Management Practice and Reform, New York 2001, pp. 97-121

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Please note that the quotations and descriptive information in Section 3 come from the IPSAS documents available from the International Federation of Accountants. Earlier versions and parts of this paper were presented at the First Globalization Conference held at the University of Cambridge in July 2000, the 8th Biennial CIGAR Conference at the University of Valencia and the Third International Public Management Symposium at Mannheim University both in June 2001. I have benefited from the questions and comments at these conferences. I have also been enlightened by discussions on different intellectual and legal traditions in Europe and the United States with Professor Gabriel Montagnier of the University of Lyon Law School and with Dr. Dietmar Bräunig of Mannheim University. Of course, I am solely responsible for the opinions expressed in this essay.

Additional comments are welcome and may be addressed to me at Email addresses: jimchan@uic.edu, or at the following mailing address: Professor James L. Chan, Department of Accounting (MC 006), College of Business Administration, University of Illinois at Chicago, 601 S. Morgan Street, Chicago, IL 60607-7123, USA.