Government Accounting: An Assessment of Theory, Purposes and Standards

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Government accounting and financial reporting aims to protect and manage public money and discharge accountability. These purposes, and the nature of public goods and tax financing, give rise to differences with commercial accounting. This is not yet reflected either in government accounting standards in English-speaking developed nations or in international public sector accounting standards. All of these are heavily influenced by private sector practices, which favour the accrual basis and consolidated reporting. This article argues for a gradual symmetric approach to accruals and a combination of government-wide and fund reporting. The author also proposes some broad accounting principles to promote political and economic accountability.

At the international level, government accounting has attracted considerable attention for several reasons:

- The scale and functions of modern governments, in both relative and absolute terms (World Bank, 1997). More money requires more financial accounting. Managing with less money necessitates a different kind of accounting—cost accounting—for improving efficiency and economy.
- Accounting is regarded as a weapon against fraud and waste in government. Donor nations and international organizations have realized the value of accounting in maintaining sound financial systems. Without reliable accounting numbers, they do not know where the money went, let alone how well it was spent.
- The accounting profession has discovered the potential for extending its skills and services to the public sector.
- English-speaking developed nations have coalesced to champion a new kind of government accounting.
- Two global networks—Comparative International Government Accounting Research (CIGAR) and the International Public Management Network (IPMN)—have created visible forums for lively exchange among academics and practitioners across borders and in cyberspace.

From Accountability to Accounting

The global rise of government accounting is fundamentally due to the greater demand for accountability in a democracy and market economy. Democratic governance and market transactions require and foster the norm of reciprocity—the expectation of exchange of benefits of comparable value—upon which accountability is based. Accounting information can be used to monitor and enforce the terms of economic, social and political contracts. When a government engages in market transactions—whether buying or selling services, lending or borrowing money—it is subject to economic accountability. When it levies taxes to finance public services, it incurs political accountability.

The development of government accounting is related to the constitutional form of government that provides for separation of powers, and checks and balances among the legislative, executive, and judicial branches of government (Chan and Rubin, 1987). While all governments engage in some degree of planning and control, only democratic governments are mandated to open their books—directly to auditors and indirectly to the public through financial reports. Fiscal transparency is therefore an attribute of limited government, for to give out information is to cede authority. Government officials rationally do not volunteer more information than is required or in their interest. It is therefore not surprising that, while some accounting is done on a voluntary basis, financial disclosure is often made only in response to demand.

The regulatory structure for government

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financial disclosure mirrors the pattern of accountability in government and the political system. In an administrative hierarchy, the superior holds subordinates accountable and requires feedback information on their performance. A legislature monitors the conduct of the executive branch, for example, in executing the approved budget. Furthermore, a government has the incentive to disclose information in order to induce others to provide resources to it. These include potential buyers of government securities; vendors of goods and services on credit; and grantors of financial aid. In these voluntary exchanges, information is used to predict a government's ability to carry out the terms of contracts. After the transactions are made, accounting information is used to monitor contractual performance. Governments are less inclined to disclose financial information to those without leverage over it, at least in the short-term, such as individual taxpayers. It is here that mandatory standards seek to increase the information access of those who are least able to demand it, or to enforce their right to know.

The exercise of accountability requires *institutions* in both senses of the term: namely, organizations; and rules of the game (World Bank, 2002, p. 4). In government accounting, these refer to standard-setting bodies and the standards they promulgate. These institutions of government accounting in individual countries are extensively documented in the CIGAR literature and will not be covered in this article. It is, however, important to describe the general purposes of government accounting, in order to contrast it with commercial accounting.

Purposes of Government Accounting

Government accounting has three purposes. Its *basic* purpose is to safeguard the public treasury by preventing and detecting corruption and graft. Corruption in government exists in various forms, and is nurtured by incentives (Rose-Ackerman, 1978). This is an acute problem in poor, developing countries, but corruption is not limited to them (Rose-Ackerman, 1999). Citing a recent report by the International Monetary Fund (IMF) and the International Development Association, Thomas (2001, p. 38) observed that heavily indebted, poor countries 'lack the practices and procedures necessary for budgeting, monitoring, and reporting on the use of public resources'. While it is tempting to link corruption with dictatorship, corruption can also occur in a democracy, despite the checks and balances built into the machinery of government to thwart and expose fiscal misconduct. For example, more than a century after its Declaration of Independence, the United States still needed a municipal reform movement to emphasize basic financial record-keeping to fight corruption in local governments (Chan, 2001).

The *intermediate* purpose of government accounting is to facilitate sound financial management. Financial management includes activities such as collecting taxes and other revenues, paying bills, borrowing and repaying debts. In a well-run government, these activities are budgeted or otherwise planned. Their execution through duly authorized transactions is recorded in the financial accounting system. Reformers want governments to operate in an economical, efficient and effective manner. In that case, governments will also need a management or cost accounting system to find out the cost—or better still, the least cost—of providing government services. Almost 50 years ago, Herbert Simon and his associates counselled corporate controllers to go beyond their score-keeping function to direct management's attention to problem areas and help solve problems (Simon *et al.*, 1954). That advice may well apply to government accountants, who face competition from other professionals eager to provide information and financial services to government.

The *advanced* purpose of government accounting is to help government discharge its public accountability. Public accountability exists in three levels of principal–agent relationship: accountability of the bureaucracy to the chief executive, of the executive to the legislature, and of the government to the people. This purpose can be better achieved by increasing the agent's incentive to disclose and by lowering the principal's information costs. Downs (1957) has cautioned that it is rational for voters to be ignorant because of the high cost of becoming informed.

The purposes of government accounting are labelled as 'basic', 'intermediate' and 'advanced' to convey the order of priorities in building the full capacity of a government accounting system. Such a system is different from commercial accounting in some fundamental respects.

Government versus Commercial Accounting

Business accounting has often been used as a benchmark for evaluating government accounting. Two hundred years ago, Thomas

Jefferson (quoted by Arthur Andersen, 1986) wished to see 'the finance 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'. Is it possible that government and business accounting are fundamentally alike in unimportant respects—as public and private management are (Allison, 1980)? What are the important respects that set government accounting apart from its business counterpart?

In order to serve the three identified purposes, financial accounting and management accounting cannot be so neatly compartmentalized in the public sector, where management accounting refers to budgeting and control, rather than accounting solely in the service of managers. The budget is an expression of public policy and political preferences. It is an instrument of fiscal policy on revenue and spending to achieve macroeconomic objectives. It provides benchmarks for performance measured partly by the accounting system. Given their close relationship, it is often difficult to tell where budgeting ends and accounting begins. They reinforce each other in demonstrating and discharging fiscal accountability to the government's stakeholders, who are more numerous and diverse than the owners of a firm. Indeed, governments do not have owners.

The absence of ownership in government makes it problematic to apply the accounting equation (assets = liabilities + owners' equity) and its corollary (profit = revenues – expenses) to the public sector. An exception may be local governments. These are municipal corporations chartered by the state to perform certain public services, which in many cases are private goods (for example water) or only quasi-public goods (for example elementary education). These entities have clear origins, and own identifiable assets and liabilities.

Unfortunately, the assets and liabilities of the national government of a sovereign state are difficult to identify and harder still to measure in financial terms. With regard to assets, except in rare instances (such as the United States' purchase of Louisiana from France, or Alaska from Russia), few nations acquire new territories through buy-and-sell transactions. Most occupy their ancestral lands and some acquired their territories through military conquests or colonization. Historical costs, even if data are available, are not meaningful, yet market prices, even if justifiable, are hard to come by. The same problems arise in the case of natural resources and heritage assets. On the liability side, it is not easy to draw the line between a national government's contractual or legal obligations and its political commitments and social responsibilities for the general welfare. In contrast to corporations' limited liabilities, governments in a democracy are prone to expand their responsibilities, resulting in larger budgets and frequent deficits (Buchanan and Wagner, 1977).

Accounting principles allow a business, whether private or state-owned, to recognize revenues only to the extent of goods or services provided. Governments uniquely provide public goods and finance them through taxation. Public goods are consumed collectively, and non-payers cannot be excluded—hence requiring tax financing. These characteristics sever the link between service delivery and revenue recognition, making it impossible to match revenues and expenses (Sunder, 1997). This accounting problem is also exacerbated by the involuntary nature of many transactions between government and people. The government's operating statement tracks resource flows, and only incidentally measures the government's service efforts and accomplishments.

These unique characteristics of government are the primary source of the differences between government and commercial accounting. These differences, argues Sunder (1997, p. 198), 'do not constitute *prima facie* evidence that the former are defective and should be altered to conform to the latter'. More specifically, Nobes (1988, p. 198) challenged the assertion that 'Anglo-Saxon commercial accounting involving accruals-based annual financial statements is necessary for accountability, control and decision-making relating to government'.

From the research perspective, theories underlying government accounting standards are mostly normative, in contrast to the development of positive theory in (business) financial accounting. The latter (Watts, 1977; Watts and Zimmerman, 1978, 1990) draws its inspiration from the contract-cost theory of the firm originating from Coase (1937). A similar incipient conceptual revolution started tentatively with Zimmerman's (1977) paper linking government financial reporting to political incentives. It is time to resume the search for a positive theory of government accounting standards. One way would be to build on the work of Chester Barnard and Herbert Simon.

At about the same time Coase wrote his famous paper explaining the existence of the firm in terms of transaction costs, Barnard (1938) identified the functions of the executive as securing the co-operation of the stakeholders of an organization. Barnard's work is currently enjoying a revival, primarily through the efforts of Oliver Williamson (1990). Much earlier, Simon (1945) applied Barnard's insight to government in his book *Administrative Behavior*. In Simon's view, an organization is in equilibrium if Barnard's executive succeeds in securing the contributions of stakeholders by offering them adequate inducements to stay in the organizational coalition. A business can be viewed in the same way (Cohen and Cyert, 1965). In both types of organization, the challenge for managers is to negotiate satisfactory terms of contracts to keep the coalition intact. In such a theory, owners are important as contributors of equity capital, but they are not the only group managers try to please. In other words, the owner-centred theory of the firm and the single-principal agency theory are a special case of the Barnard-Simon organization theory.

This theory can be used to identify potential users of government's financial information by postulating that they use the information to predict their inducements from government (Chan, 1981). Recently, Sunder (1997) applied contract-cost theory to explain and justify the differences between accounting for government and nonprofit organizations and business accounting. Much more research is needed before the multiple-stakeholder perspective can have an impact on standards. In the meantime, government accounting has shifted closer to the business (financial) accounting model.

Changes for the Better?

Among the numerous changes in government accounting in recent years, the emergence of International Public Sector Accounting Standards (IPSASs) stands out as the most significant development (see Sutcliffe, 2003). The initial set of IPSASs, unfortunately, has rather uncritically emulated the business accounting standards set by the International Accounting Standards Board's predecessor (Chan, 2002). They are detailed technical provisions designed by accountants for accountants, not for public policy-makers whose support is critical for their successful implementation. Even so, IPSASs have some symbolic value. By basing the initial IPSASs on IASC standards, the IPSASs might benefit from the popular notion that business accounting (at least before the 2002 Enron/Arthur Andersen scandal) stood for financial discipline and integrity. Furthermore, the New Public Management literature has raised expectations about the ability of accounting to make government more efficient (see Olsen *et al.*, 1998, for a review). IPSASs could raise the prestige of government accountants, who are often regarded more as bureaucrats than credentialled professionals like certified/chartered accountants. IPSASs might facilitate the entry of private sector accountants and auditors into the public sector. Perhaps IPSASs might serve as a catalyst for including government accounting in the common body of knowledge expected of all accountants. Finally, the financial support of international organizations, such as the World Bank and the IMF, constitutes a favourable assessment of the expected contribution of IPSASs to government financial accountability.

However, it would be naive to exaggerate governments' propensity to reform their accounting systems on the basis of IPSASs. A sovereign nation is likely to zealously guard its authority to determine its own government accounting standards. This resistance might be overcome if the introduction of IPSASs were made a condition for receiving international grants and loans. The enforceability of IPSASs would be higher if it were invoked in international agreements or treaties (similar to the Maastricht Treaty) specifying convergence criteria for fiscal policy. Another way to promote IPSASs is to link it to membership obligations to international organizations, such as the United Nations, the World Bank, the IMF, the Organization for Economic Co-operation and Development (OECD), and the European Union. Better still, is for these international organizations to set an example by adopting the IPSASs themselves, as the OECD has done.

Each country's own way of adopting government accounting standards will affect their likelihood of using IPSASs. Countries using independent boards may find it easier to import IPSASs than those that legislate government accounting standards. Unless there are scandals or financial crises linked to bad accounting or reporting practices, changes would be slow and infrequent. As Machiavelli (1513, quoted by Rogers, 1983) counselled his *Prince*: 'There is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new order of things'. Lüder (1992) emphasized the uncertain prospect of adopting government accounting innovations and the necessity of overcoming numerous barriers. As in corporate accounting and financial reporting (Ball, 2001), IPSASs need infrastructural support in the form of a robust legal system and a culture of accountability. Rigorous accounting standards may run counter to the interests of a government. The support of the institutions that hold resources of value to governments—the international lenders, donors, bond-rating agencies—may prove to be indispensable.

IPSASs and the latest accounting standards in English-speaking developed nations have two things in common: they all favour the accrual basis of accounting and government-wide financial presentation. Are these changes for the better?

Accrual Basis of Accounting

The case for the accrual basis in business (including state-owned enterprise) accounting is strong: no revenue (and therefore no profit) can be recognized in the accounts and reported in the income statement until the firm has provided goods and services. Since what sets government apart from business is the tax financing for the production of public goods, this 'operating statement' rationale for accruals in the public sector is not particularly persuasive. The principal argument for accruals lies in the balance sheet.

Governments hold cash or its equivalents, short-term and long-term financial assets (for example taxes receivable), and a variety of capital assets (for example office buildings and equipment, military equipment, cultural artifacts, infrastructure and natural resources). They also owe short-term debts (for example wages payable) and long-term obligations (for example bonds payable, employee pensions payable), and possibly payments under social insurance and welfare programs. Given these arrays of potential assets and liabilities, a government has choices to make. It could opt for:

- 'Mild' accruals to show only short-term financial assets and short-term liabilities.
- 'Moderate' accruals to additionally show long-term financial assets and long-term liabilities.
- 'Strong' accruals to further bring various categories of capital assets onto the balance sheet.
- 'Radical' accruals, which would show legislated entitlement benefits as liabilities.

From this perspective, the real issue is, therefore, not whether to accrue, but how far down the above list to admit items onto the balance sheet (Chan, 1999). A gradual symmetric approach to accruals is preferable. Accrual accounting should proceed gradually because stronger forms of accrual are more risky. They create more measurement problems, have less theoretical support, and are more subjective. Few accountants would argue against mild and moderate forms of accrual. But consensus begins to break down with capital assets, and radical accrual hardly has any support. Symmetrical accruals means aligning assets and liabilities of similar nature and maturity. This would avoid distortion and manipulation (for example recognize more assets and less liabilities).

When a government's budget is expressed on the cash basis, the accrual bases of accounting add value to a government's financial disclosures. They provide more reliable measures of a government's solvency position over a longer time horizon, and force the disclosure of the amounts of unfunded liabilities, such as public employee retirement pension and other benefits. Accrual accounting could therefore trigger debates on intergenerational equity, the idea that each generation should shoulder its own financial burden for the services it receives.

Government-Wide Reporting

The main attraction of government-wide financial reporting is that it might reduce the information analysis and evaluation costs of users. Over 40 years ago, Downs (1957) warned that high information costs would discourage voters from obtaining more and complex information about government. Voters are rationally ignorant after weighing the marginal benefits and marginal costs of information search, in a manner similar to consumers' behaviour (Stigler, 1961). By reducing the volume of information, government-wide reports could become more accessible to the general public. There are a few other benefits:

- Properly constructed government-wide financial statements show the span of accountability in government. For example, no matter how large or complex the US Federal Government is, ultimately the Congress and the President are responsible. No matter what and how many special entities are created—some in order to circumvent constitutional or statutory debt limitations—the line of authority is traceable to the highest authority in the government structure. Government-wide financial statements could therefore deter the evasion of accountability.

- The data collection, analysis and summarization necessary to produce those reports has the salutary effect of forcing the government to improve the quality of data. For example, it took the United States Government at least 15 years to develop the operational mechanism for consolidating hundreds of accounts and scores of departments. Only after departments learned to produce their own consolidated financial statements could the US Treasury construct the first audited government-wide financial statements (US General Accounting Office, 1998).
- Consolidated financial statements match a government's unified budget, giving government a more effective feedback mechanism.

The cost-reduction argument, in my view, is outweighed by the inability of government-wide reports to serve the financial integrity and financial management purposes mentioned earlier. Therefore I favour the more discerning approach of the Governmental Accounting Standards Board (GASB) in the United States (Chan, 2001). In the GASB's reporting model for state and local governments, the government-wide financial statements are augmented by those of funds—entities created for resource allocation and stewardship purposes. The government-wide financial statements include not only the government itself, but also, in a separate column, legal entities for which it is accountable. Furthermore, governmental (that is, unique to government) and business-type activities are shown separately. The GASB approach is superior because users can choose the level of detail to match their needs and information-processing capability.

As this analysis of accruals and reporting format shows, accounting standard-setting requires the evaluation of options in terms of costs and benefits. Further research is needed to gauge the amounts and pinpoint the incidence of costs and benefits—preferably in quantitative terms—to the government and its stakeholders.

Summary and Proposals

Over the past 25 years, there have been some notable institutional and conceptual innovations in government accounting, contributing to its greater visibility and influence. Its emphasis has shifted from bureaucratic control to accountability reporting to the public. In some countries, government accounting standards are no longer set by government officials, but by relatively independent boards. While acknowledging the importance of cash—the lifeblood in government as in business—contemporary accounting standards aim at tracking the long-term consequences of decisions and actions. Government officials are held accountable for their stewardship of both financial and capital assets. Finally, it is not enough to keep the books accurately; the books have to be open to the public. When the public does not have the time or ability to inspect the accounts, governments have to make the task easier by preparing comprehensible—as well as comprehensive—financial statements.

Many challenges remain, especially at the global and international level. A major issue is the proper balance between international norms and domestic practices arising from national political ideology, economic system and culture. As a mechanism of governance, government accounting is subject to political forces that distribute power, and economic forces that determine the supply of and demand for resources. Therefore, unless accounting standards boards ally themselves with the institutions that can withhold something of value to a government—a grant, a loan, an unqualified audit opinion, a favourable bond rating—their pronouncements would remain ineffectual. Unfortunately, at the international level, there are relatively few levers available to a body such as the IFAC Public Sector Committee to enforce its standards. However, accountants could make the case that fiscal accountability is an international norm applicable to all governments regardless of their political and economic system.

Once this transcendent value of fiscal accountability is embraced, it is a technical matter to work out the means of implementation. These include not only year-end financial statements—the current focus of IPSASs—but also budgets, internal controls and external audits. I urge the IFAC Public Sector Committee to rectify its neglect of the budget and to include 'actual versus budget' comparisons in financial statements. Furthermore, putting aside differences of opinions on accounting choices, the entire body of detailed standards should be framed by a set of broader principles aimed at promoting government fiscal accountability, such as:

- The objectives of government accounting are to safeguard the public treasury and property, to accurately measure and communicate the government's financial condition so as to demonstrate financial accountability, and to facilitate decision-making.

- A government should prepare and publish its budgets, maintain complete financial records, provide full financial disclosure, and subject itself to independent audits.
- The form and content of financial reports should be guided by the rights and need to know of intended users.
- The accounting system should measure the cash and other financial consequences of past transactions and events, including, but not limited to, budget execution.
- The accounting system should be capable of keeping track of the levels and changes in assets, liabilities, revenues and expenditures or expenses, relative to budgeted amounts.

These principles do not prescribe accounting choices. Rather, they provide a foundation for deliberating and setting government accounting standards. ■

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