A Comparison of Government Accounting and Business Accounting

James L. Chan

1 INTRODUCTION

Business accounting has always been considered to be the model for government accounting. In 1802, Thomas Jefferson, the author of the American Declaration of Independence, wished to "see the finances of the Union as clear and intelligible as a merchant's book,…" In the 1970s, Arthur Andersen & Co,, an innovative accounting firm, tried to realize Jefferson's dream by challenging the U.S. Government itself to render its accounts according to Generally Accepted Accounting Principles (GAAP), since it required business firms to follow GAAP, apparently believing that business GAAP was applicable to the U.S. Government. In the 1980s, the late Professor Robert Anthony of Harvard University was similarly convinced that American state and local governments should use business accounting principles, so that it would not be necessary to have a separate Governmental Accounting Standards Board. (It fell on the author as a young academic in 1980 to inform the Financial Accounting Standards Board how government differed from business.) In the 1990s, opinion leaders from several countries adhering to the "business accounting for government" approach successfully elevated this viewpoint to the international level. International Public Sector Accounting Standards (IPSAS) patterned after international (business) accounting standards were developed, with exceptions only when government differed from business.

The purpose of this brief essay is to answer three questions: What is so appealing about business accounting that it is urged upon government? How is government viewed differently by public budgeting specialists? When these two groups hold conflicting views on government financial presentation, how should those conflicts be resolved?

These questions are answered in the context of the United States. The author acknowledges that business accounting and government accounting in other countries may be very different from American practices. Therefore, international comparative research is encouraged.

2 POSITIVE FEATURES OF BUSINESS ACCOUNTING

Due to the requirements of Generally Accepted Accounting Principles (GAAP), business accounting has several features:

- There is a clear separation between financial accounting and managerial accounting.
- The double-entry recording system is commonly used in financial accounting.
- The accrual basis of accounting is always required in financial accounting.
- Consolidated financial statements are annually published for external users.

The following section explains why these features are positive.

2.1 The Separation of Financial and Managerial Accounting

The separation of financial accounting and managerial accounting makes it possible to regulate them differently. In general, a firm's management has complete discretion over designing its budgeting and cost accounting in support of management planning and control. The exceptions are firms whose products or services are sold in non-competitive markets. In these situations, such as public utilities and defense contractors, cost-based pricing leads customers to be concerned about how costs are defined and measured. So long as a firm operates within the law and customary practices, it is free to conduct its financial management as it sees fit. In contrast, its reporting to the public in general, as well as to investors and creditors, is highly regulated.

The regulation of external financial reporting takes the form of government oversight and market discipline.

The accounting and reporting requirements of the Securities and Exchange Commission (SEC) for corporations whose stocks are publicly traded are a type of government oversight. The regulator specifies the form and content of the reports it requires. Market discipline is exercised by the implicit threat that if a firm does not provide credible financial information to market participants, its access to sources of equity and debt financing would be more costly, limited, or even denied. Audited financial statements prepared in accordance with Generally Accepted Accounting Principles set by the FASB are such a source of information.

These GAAP-based statements are the product of a firm's "general-purpose external financial reporting." This label is intended to distinguish these statements from internal reports to management and the board of directors, as well as from external reports to government regulators, who can require "special-purpose" reports. Thanks in part to the SEC's blessing, the FASB enjoys so much prestige and power that it is considered independent and authoritative, at least with respect to the firms whose financial statements have to follow GAAP and have to be audited by Certified Public Accountants (CPAs).

In short, GAAP set by an independent authoritative body and enforced by external auditors enhance the credibility of the financial statements that a firm issues to investors and creditors.

2.2 Double-entry Recording System

The double-entry recording system obliges accountants to carefully analyze transactions and activities of an entity before data can be entered into the accounting system. The analysis determines how a transaction or activity affects the entity's financial position as described by the accounting equation: assets = liabilities + net assets. In the case of a business firm, the net assets are the owners' equity. Thus the accountant as a financial analyst has to make a basic, but crucial, distinction between debt and equity, so that borrowed cash is not allowed to be recognized as revenue.

Financial accountants use the accounting equation as the conceptual foundation for the balance sheet or statement of financial position on a particular date, such as the end of a fiscal year. A corollary of this perspective is that a firm's financial performance in a period is evaluated on the basis of the amount of change in owners' equity (apart from owners' capital contribution and distributions to owners). The "bottom line" of a period's financial performance is net income or net loss, which results from matching the period's revenues and expenses. As Exhibit 1 shows, in the double-entry recording system, revenue is portrayed as an increase in assets or decrease in liabilities. In contrast, an expense incurred to generate the revenue is portrayed as a decrease in assets or increase in liability. Assets are economic resources with service potential owned or controlled by the entity as a result of past transactions or activities, and are therefore not limited to cash and other financial resources. Liabilities are obligations created by past transactions or activities that will result in cash payments or services in the future without time limitation.

Abbildung 1: Accountant's Representation of Financial Position and Performance

Financial Position and Performance	Accounting Equation and Changes Therein
Financial position, end of period t	Assets - Liabilities = Net Assets
Owners' investment in the business	Increase - No effect = Increase
Creditors' lending to the business	Increase - Increase = No effect
Repayment of loans to creditors	Decrease - Decrease = No effect
Performance in period t+1:	
Revenues from customers	Increase - No effect = Increase
Expenses for resources used and services of employees or contractors	Decrease - No effect = Decrease No effect - Increase = Decrease
Financial position, end of period t+1	Assets - Liabilities = Net Assets

In summary, double-entry bookkeeping requires sophisticated financial analysis. The analysis is based on a theory of the firm that distinguishes creditors' equity and owners' equity. A period's financial performance is judged by whether the owners are made better off or worse off as a result of the operations during the period.

2.3 The Accrual Basis of Accounting

GAAP requires the accrual basis for measuring financial performance in terms of revenues and expenses, which are increases and decreases in net assets, respectively. In recognition of the importance of liquidity, a statement of cash flows is also prepared. Since a firm's primary goal is to provide goods and services, it is permitted to recognized sales revenues—increased assets or decreased liabilities—only to the extent it has done so. This service effort and accomplishment (SEA) based method of measuring financial performance is often called "full accrual." Expenses are matched against the revenue to arrive at the period's net income or loss. Gains and losses are similarly determined in transactions involving individual assets.

Business revenue recognition is outcome-based, and expense recognition follows revenue recognition. This accounting method rewards firms not for production but for making sales. (The percentage of completion method used in the construction business is a rare exception.) In financial accounting, the production of goods merely changes the composition of inventory and may give rise to more liabilities. Accounting for the cost of goods involves accrual because the cost of goods produced (including liabilities incurred) is treated as assets until a sale transaction turns such assets into an expense (the cost of goods sold). However, GAAP is usually silent on the issue of the allocation and attribution of indirect costs to products or service, perhaps because the allocation methods are too numerous and, in the final analysis, arbitrary.

In conclusion, full accrual severely limits the ability of management to claim credit for performance unless such performance results in more net assets.

2.4 Annual Consolidated Financial Statements

Annual consolidated financial statements cover an economic entity consisting of a parent corporation and the subsidiaries in which it has a majority ownership interest. The definition of the reporting entity is based on several ideas: Investors and creditors are more concerned with economic substance than legal form. Managers of the reporting entity have control over all the entity's assets and are responsible for meeting all its liabilities. A high level of aggregation of financial data reduces information overload for users of financial statements. Interested users can refer to additional disclosures elsewhere in the financial reports for details, such as different lines of business.

In summary, a firm and its management are rewarded more for results than for effort. In keeping with this philosophy, business accounting uses the full accrual basis to measure financial performance and relates such performance to changes in financial position. Consolidated statements of financial position, performance, and cash flows constitute an integrated package of general purpose financial statements primarily for investors and creditors. These statements are prepared using Generally Accepted Accounting Principles (GAAP) set by a neutral organization recognized by independent auditors, who use those principles to assess the fairness of financial presentation.

Business accountants and auditors believe that the business accounting principles summarized above are the best way of presenting a business's financial picture to capital market participants. Since government as an economic entity has much in common with business firms, it stands to reason that it should use similar principles.

3 ANOTHER VIEW OF GOVERNMENT FINANCIAL PRESENTATION

Politicians and senior government officials typically are not accountants. In addition to accountants and auditors trained in the business school, lawyers, economists, political scientists, public administrators, budgeting specialists, public policy analysts and possibly other professionals are also involved in public financial management. Furthermore, public financial management is part of the general management overseen by senior public managers and legislators. Despite their diverse roles, public officials have one thing in common: few of them have had formal training as accountants, nor are many of them members of the accounting or auditing profession, which is dominated by members in commerce and industry. Consequently, the business accountant's view is not necessarily shared and may not sound convincing to many government officials. Indeed, to the extent that economists, political scientists, and lawyers concern themselves with public financial management, they tend to hold a different view. Since budgeting is the financial management function most related to accounting, the perspective of the public budget specialist is described below.

In the public budgeting literature and practice, the following views are expressed:

- Financial performance is part of budget execution; accounting is therefore an extension of budgeting.
- Budget deficit or hopefully surplus—the result of comparing revenues and expenditures—is probably the most important indicator about government's fiscal performance.
- Projecting cash receipts and outlays is necessary for determining the need for deficit financing, and monitoring commitments is critical for budgetary control.
- Timely interim reports covering the units or programs under a government officials' control or purview are essential.

3.1 Financial Performance as Budget Execution

Budget specialists tend to view accounting as part of financial management, and financial management as part of budget execution. The annual budget is not only a planning document, it also includes projections of revenue collection as authorized by law, as well as appropriations proposed by the executive and approved by the legislature. Therefore, the budget serves as the basis of management control and legislative oversight. Transactions and activities can be undertaken only according to the approved budget. An important accounting function is to "follow the money" as directed by the budget. Accountants play the operational supporting role (versus the decision-making role) with respect to the budget. This kind of accounting is called "management accounting" in business, and "budgetary accounting" in the public sector.

Budget specialists view supporting budget execution as a necessary and sufficient function of accounting. Accountants, on the other hand, regard their function as more than just supporting budget execution. Certainly budget execution reports are needed to see whether budgetary intentions are carried out. But government annual budgets often have a different scope from the accounts, and use different concepts and measurement rules. Accountants readily concede that the budget is powerful (since it allocates resources) and relevant (since it is about the future). But they believe that their "multi-lens" way of viewing government finances (Exhibit 1) is in some ways superior to the budget's single focus on the deficit. However, the budget department ranks higher than the accounting department in the government bureaucracy, so the budget director's views are more likely to prevail.

3.2 Budget Deficit as the Primary Financial Indicator

In contrast to the accountant's "stock and flow" approach (see Exhibit 1), budget specialists see the deficit of the budget year as the most important financial indicator of government fiscal performance. When measured in terms of cash, the deficit is the excess of cash outlays over cash receipts in a period. As such, the deficit number reveals the amount a government needs to borrow to finance the cash shortage. Important as this number is, the significance of the cash budget is diminished by government's other means of financing: postponing cash payments to the future through creating liabilities. These liabilities include short-term payables to contractors and long-term pension benefits to employees. On the other hand, to its detriment, the cash deficit cannot count increases in receivables as revenue. In either way, the "receipt minus outlay" formulation implemented on the single-entry recording system is incapable of handling the cumulative nature of assets and liabilities. It would take a revolution for public budgeting to adopt the accrual budget concept by means of a projected balance sheet. There is no evidence this is happening anytime soon.

3.3 *Budgetary Basis of Measurement*

Projecting cash receipts and cash outlays is important for determining the need for borrowing to finance cash deficit. For this reason, the cash basis is used in budgeting. Monitoring and reporting cash flows and cash balances is a necessary function of a government's accounting system in support of treasury management.

Another important task of financial control is to prevent government officials from spending in excess of their appropriations. In this regard, purchase orders and other contractual obligations are considered to be spending, and are deducted from the available balance of an appropriation. The budgetary basis of spending is various defined as: cash outlay, expenditure, and commitment or obligation.

Budget officials wish there was a better way to measure tax revenue, but tax revenues cannot possibly be accrued on the basis of SEA because of the collective nature of many government services. Recognizing tax revenue requires the "enforceable legal claim" concept be made operational for a large variety of taxes.

The tasks of financial control are sufficiently demanding that budget offices may not have the time and resources to concern themselves with resources that are not expendable (such as taxes receivable and fixed assets) and multi-period consequences (such as payables left to the future). Furthermore, public officials and their budgeting staff hardly have the incentive of calling attention to their financial maneuvering to reduce the current deficit. They may even resent the release of liability information that puts them in an unfavorable light. As a result, government budget specialists greet the introduction of accrual into budgeting with considerable skepticism.

3.4 *Interim Departmental Reports*

Policymakers and managers are mostly concerned with specific departments and programs, rather than the government as a whole. Even if a so-called "unified budget" is proposed and approved, its implementation will be decentralized. Government is typically organized in terms of units, program areas, or funds (pools of financial resources). Policymakers and managers tend to protect their turfs and mind their own business. Performance or budget execution reports pertain to specific responsibility centers.

Abbildung 2: Contrasting Views of Two Financial Specialties

Dimensions of Comparison	Accountant	Budget Specialist
Time orientation	The past but cognizant with the present and future	The future but constrained by the past and present
Conceptual model	Assets - liabilities = net assets	Revenues – expenditures = deficit or surplus
Recording system	Double entry	Single entry
Measurement method	Full accrual basis	Budgetary basis
Primary financial documents	Statements of financial position, performance, cash flow	Budget execution
Primary users of financial information	External users: investors and creditors	Internal users: legislative overseers, policy makers, and managers
Frequency of reporting	Annual to the public	Quarterly, monthly, or even more frequent as needed
Coverage of financial documents	Whole government	Parts of government

In summary, the influential group of budgeting specialists looks at government finance and accounting from a perspective very differently from that of a business accountant. The budget department regards accounting as an extension of budgeting in the execution phase. Budget analysts focus on the availability and use of short-term financial resources, particularly cash. Preventing cash shortage and overspending is an overriding objective of budget management, which is carried out in specific programs or departments. The views of financial accountants and budgeting specialists stand in remarkable contrast to each other (Exhibit 2).

4 MODALITIES OF CONFLICT RESOLUTION

The previous sections presented the perspectives of business financial accounting and public budgeting. When viewed separately in their own right, both perspectives sound plausible and rational. If government accounting is regarded as strictly the jurisdiction of government, which is the case in many countries, the differences may be interesting in theory but inconsequential in practice. However, if business accountants and auditors believe their superior ideas should be adopted by government, officials in charge of government accounting may (a) readily accept, (b) instinctively oppose, and (c) evaluate the merits of both perspectives and decide how best to resolve the conflicts. The author declines option (a) because the public sector is unique in some respects, and option (b) because business accounting has some useful lessons for government. This section therefore explores several modalities of conflict resolution:

- Harmonize when the same accounting concepts or methods apply equally well to government and business
- Converge when government accounting and business accounting are headed in the same general direction, or when it is possible to make the case that one type of accounting is better than the other type
- Reconcile when legitimate differences exist and it is necessary or useful to explain those differences, and
- Co-exist when the differences are genuine and cannot be reconciled

4.1 Harmonization

Even in a market economy, governments own or operate business enterprises that sell essential goods and services to the public by taking advantage of economies of scale, making it possible to lower prices. Except for public ownership, government business enterprises are almost the same as their private-sector counterparts. The premises of private-sector business financial accounting are valid for government business enterprises as well. These similarities make it possible for government and private business enterprises to have the same set of accounting standards.

4.2 Convergence

Convergence is a sensible approach when government accounting and business accounting are headed in the same general direction. For example, both business and government are urged to be more transparent to the public. Accountants for both sectors go beyond technical measurement issues to stress communication to users of financial information. In government as in business, there is a renewed emphasis on accountability to the public, thus providing the rationale for more and better external financial reporting.

Convergence can be recommended when it is possible to prefer one type of accounting over another. Many governments still use the single-entry system in their accounting. For reasons explained earlier, the double-entry system almost universally used in business is clearly better the single-entry system. In this respect, all government accounting systems should be required to adopt this business accounting method. Similarly, accrual accounting offers many advantages over cash accounting. It should also be required of all government. The caveat here is that governments should be urged to gradually raise the extent of accrual in their non-commercial activities. The convergence to accrual, however, would stop short of the full accrual basis, which is not applicable to these activities.

4.3 Reconciliation

Reconciliation is the preferred strategy when legitimate differences exist between business-type accounting and government accounting, and it is necessary or useful to explain those differences. The reconciliation approach concedes that it is impossible to make a persuasive case for changing from one method to another, and essentially recognizes the merit of both methods. For example, budgetary comparisons in financial statements use the budgetary basis required by law, and explains the differences between the revenue and expenditure numbers due to the use of two different measurement methods. Similarly, when a government puts out a cash deficit number and an accrual deficit number, the "bridging" or explaining of the causes of these numbers is necessary to avoid confusion or misunderstanding.

Harmonization, convergence, and reconciliation represent three constructive approaches to resolving the conflicts between government accounting and the ideas advocated by people who are convinced about the superiority of business financial accounting. Unfortunately, there remain some issues on which reasonable people hold different opinions.

4.4 Co-existence

When differences are genuine and cannot be reconciled, co-existence is the only way to avoid constant battles. This course of action—or inaction—is used in the following situations.

In order to avoid conflicts with legal authorities that regulate government accounting by laws, accounting standard-setting organizations limit their purview to financial reporting, particularly general-purpose external financial reporting. Specifically, the budgetary basis of measuring revenues and expenditures is permitted for use in making budgetary comparisons. This conflict avoidance strategy is used by the International Public Sector Accounting Standards Board, as well as the Federal Accounting Standards Advisory Board and the Governmental Accounting Standards Board in the United States.

To avoid conflict with legal authorities, uniform Generally Accepted Accounting Principles (GAAP) across jurisdictions is used by external auditors to evaluate general-purpose financial statements. Legislatures and government officials with competent authority have complete freedom to pass laws and regulation on the form and content of internal reports.

This mutual respect avoids placing the government officials who are in charge of the accounting function in the predicament of violating the law and disobeying professional standards. It also acknowledges the legitimacy of multiple objectives of government accounting in (a) meeting legal compliance requirements, (b) supporting financial management, and (c) demonstrating government's public accountability.

Accrual is one of the most important and controversial debates in government accounting. Conceptual ambiguity and definitional flexibility have enabled many governments to claim that they practice accrual accounting. Governments are urged to use the accrual basis as business enterprises do, even though accrual in business accounting means recognizing sales revenue to the extent goods and services are avoided. This allows a variety of accrual bases to exist in practice.

In summary, several methods have been proposed to deal with conflicts between government accounting and the influences of business accounting. These methods range from genuine harmonization, to convergence and reconciliation, and candid acknowledgement of legitimate differences.

5 CONCLUSION

Even if a merchant's book were as clear and intelligible as Jefferson claimed two hundred years ago, modern multinational corporations' financial statements probably could not live up to this billing. Nevertheless, a view has persisted that government should emulate business in accounting. Having received formal training in business accounting and worked on government accounting for over thirty years, the author has endeavored to provide a balanced analysis of the recommendation. The recommendation is largely a sound one: accrual accounting captures long-term consequences and directs attention to the balance sheet, and consolidated financial statements reduce users' information overload. However, the public sector is too large, too economically important, and too politically powerful to be considered as just a "special industry." Furthermore, business accounting lacks the concepts and tool to deal with such issues as the accrual of tax revenues, and the recognition and measurement of public property and government responsibilities on the balance sheet. Only through thoughtful dialogues between business accountants and public finance specialists will there emerge generally *applicable* accounting principles for both the private and public sectors.

NOTE

The author expresses his appreciation to Professor Hannes Streim for his 20 years of friendship, and especially for his and Mrs. Streim's hospitality during the author's visit to Bochum, Germany in 2000.

Unlike most academic papers, this essay does not have any references, because it was written without the benefit of access to library collections due to global travel. Another reason is that it contains more opinions than facts. Hopefully these opinions are judged to be based on serious reflections and a balanced analysis.

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