

Lectures in American Government Accounting

James L. Chan

Beijing, China

May 2010

Intended Audience

- Chinese students in public economics, public finance, public budgeting
- Who want to know what happens after fiscal policies are made and budgets are prepared:
- Budgeting => **Performance** => Evaluation

Besides Deficit and Debt...

- Budget deficit and public debt numbers are used to gauge fiscal performance and conditions.
- Why are these numbers necessary but not sufficient,
- When governments try to save cash now and solve current problems (by creating future problems).

1. American Government Accounting in Perspective

- Main features of American govt. acctg:
- Embodiment of diversity in Western practice,
- Result of three waves of reform in past 100 years, and on-going campaign of financial literacy.
- 10 Questions whose answers lead to current standards.

2. Government Accounting in Words and Numbers

- “5P Model” of govt. acctg. and reporting
 - Purpose: Why?
 - Preparer: Who?
 - Policy: What?
 - Process: How?
 - Products: What?
- Financial statements issued by American national govt., and state and local govts.

3. Government Accounting Standards and Choices

- 10 government accounting policy questions
- That can be answered in different ways.
- Explaining cash deficit and accrual deficit.
- Comparing budgeted and actual performance.
- Usefulness and limitations of financial accounting.

4. Major Issues in Government Accounting

- Fair presentation vs. false accounts.
- How American govts. report their finances?
- Reporting entity: What's in, what's out?
- Off-balance sheet: Out of sight, out of mind?
- Bad fiscal policy, good accounting?
- Who cares about govt. acctg. and reporting?

5. Better Accounting and Better Government

- Yang's Law: acctg. and governance.
- Global govt. accounting reform: IPSAS.
- American role in global govt. acctg. reform.
- Chinese govt. accounting reform: domestic priority and foreign influences
- Cultivating a taste for CIGAR (Comparative international govt. accounting research

American Govt. Accounting Is (Still) Worth Studying

- Flawed fiscal policy; good fiscal admin.
- Reforms have avoided extreme stance.
- For academics and students: there is a large body of literature documenting the debates over theoretical and practical issues.
- For policy makers and their staff: America the deliberate reformer offers valuable experiences.

My (Tiny) Roles in Government Accounting

- Before 1976: learning from books.
- Since 1976: academic participant observer
- 1979-81 at NCGA, 1991-92 at GAO
- Since 1981: international consulting
- Since 1986: CIGAR and IPSAS
- Since 1994, watching Chinese govt. acctg.
- Since 2008: nowhere to go, except ...

Why I Like Govt. Accounting

- A fascinating window to watch the world of power and money.
- A rigorous discipline that combines political science, economics, finance and management – and accounting.
- A useful profession that seeks to improve government and society.

My Secret Formula of Success

- Know yourself: what can I do
 - As well as everyone else?
 - Better than most people?
 - Best?
- To be at your best needs staying power: your interest powered by curiosity.
- My curiosity: What is / was going on in the world?

Learning Sources

- Further readings after each lecture.
- My book *American Government Accounting Standards and Their Relevance to China* in both Chinese and English (2009)
- www.JamesLChan.com
 - My papers: discussion & analysis; opinions
 - Internet links to information sources

American Government Accounting in Perspective

Lecture 1

American Government Accounting: Current Practice (2010)

- All government accounting systems produce interim and annual reports of budget compliance according to law and regulations.
- Most governments publish annual financial statements according to GAAP (Generally Accepted Accounting Principles) in a comprehensive annual financial report (CAFR).
- GAAP for governments are set by boards with a degree of independence, and are enforced by independent auditors.

A Balanced Scorecard (2010)

Accomplishments

- Accounting standard -setting structure firmly in place
- Almost 100 standards
- Consolidated financial statements on the accrual basis are the norm

Challenges

- Relevance, funding and independence
- Again searching for conceptual foundation
- 12 years of Federal auditor disclaimers
- So much data, how much information?

Technical Terms

- *Consolidated financial statements*: year-end reports about financial position and performance for the whole government
- *Accrual basis*: a method of accounting measurement that emphasizes the occurrence of rights and obligations instead of cash receipts and payments.

American Govt. Acctg. Embodies Old and New Western Ideas

Continental European Tradition

- Government sets own acctg. rules
- Acctg. rules are laws and regulations
- Acctg. monitors budget execution for administrative and legislature oversight

Current ABC* Challenge

- Independent boards set govt. acctg. rules
- Acctg. rules are professional standards
- Acctg. produces financial reports for external users

* ABC: advanced British Commonwealth

Accounting as the Practice of Accountability

- Accountability: responsibility to answer for and report for authority or resources.
- Levels of accountability
 - Democratic accountability: government answerable to the people.
 - Executive accountability: administration answerable to the legislature.
 - Bureaucratic accountability: civil servants answerable to political executives.

Constitutional Mandate of Disclosure

- American constitutional principles:
 - Federalism;
 - Separation of powers, checks and balances.
- Constitution of the United States (1789):
 - “No money shall be drawn from the Treasury but in consequence of Appropriations made by law,
 - “and a regular Statement and account of the Receipt of Expenditures of all public Money shall be published from time to time.”

Two Views on the Public Debt

Hamilton

- “A national debt, if it is not excessive, will be to us a national blessing.”

Jefferson

- “There does not exist an engine so corruptive of the government and so demoralizing of the nation as a public debt.”

Two Ways of Governing

Hamilton

- Strong national.
- Government power
- Executive leadership
- Administrative discretion
- Experts

Jefferson

- Strong States and local communities.
- Popular control
- Legislative supremacy
- Legislative prerogative
- Laymen

Two Types of Accounting

Management Accounting

- Managers as primary users of information
- Management planning and control
- Budget and cost analysis

Financial Accounting

- The public as primary users of information
- Legislative monitoring and public oversight
- Year-end financial reports

Current Practice as the Sediment of Past Reforms

- First Wave (1910-20's):
Clean Government
- Second Wave
(1930s-1970s): Efficient
Government
- Third Wave (since 1970s):
Transparent Government
- Fourth Wave (since
1990s): Communicative
Govt.
- Keep good financial
records
- Support budgeting control
and professional
management
- Provide comprehensive
financial reports
- Produce comprehensible
financial information

Major Changes in American Government Accounting

- From fund accounting and reporting to government-wide accounting and reporting.
- From reporting short-term liquidity to long-term financial solvency and economic viability.
- From cash basis to accrual basis in measuring financial performance.
- From following to critiquing budgeting practices.

A Modern Idea from 100 Years Ago

“The object of all good bookkeeping 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.... The one object of the skilled book-keeper is, therefore, to be able to produce, when necessary, a clear and correct balance sheet.” --F.H. MacPherson, *Municipal Accounting* (1901)

The Lasting Challenge: Simple But Not Simplistic

- “I think it an object of great importance... to simplify our system of finance, ... a simplification of the form of accounts... [so that] we might hope to see the finances of the Union as clear and intelligible as a merchant’s book...” (Thomas Jefferson as President of the United States, 1802)

Government to Use Business Accounting Standards?!

Two Views of Government

Different from Business

“A country is not a company.”

-- Paul Krugman (1996)

Same as Business

“... I can't see why the accounts of government, which is no more than a huge business, should differ from the accounts of companies.” – R. Voormeulen (1993)

What's Good for Business ...

- No revenue – and no profit – unless goods are sold or services rendered.
- Assets include economic resources, rather than only cash or financial resources; liabilities include all debts without time limit.
- Note: not all's well in business acctg.

Is Good for Government?

- Sale as basis for recognizing revenue is not feasible for government services that are “public goods” consumed collectively.
- Government has unique assets (e.g. heritage assets, public property) that defy financial measurement, and undertakes unlimited obligations for societal welfare.
- Govt. has stakeholders, not stockholders.

Two Views of Government Accounting

American View

- “A country is not a company.” Paul Kruegman (1996)
- There are fundamental differences between govt. and business acctg:
 - Govt. power to make laws
 - Dominating role of the budget
 - Taxation, grants, subsidies
 - Unique resources and obligations

IFAC *View

- “... I can’t see why the accounts of government, which is no more than a huge business, should differ from the accounts of companies.” – R. Voormeulen (1993)

*IFAC: International Federation of Accountants, sponsor of the International Public Sector Accounting Standards Board

A THEORY OF GOVERNMENT ACCOUNTING

At the Level of
Individual Governments

Stakeholder Theory Based on Simon's Theory of Organization

- An organization is a coalition of stakeholders.
- Stakeholders acquire interests in the survival of the organization because of their contributions.
- Management provides inducements (I) to obtain contributions (C) from stakeholders.
- Management seeks organizational equilibrium by equalizing I/C for all stakeholders.
- Management is itself a stakeholder group (internal stakeholders) and is in a privileged position to enrich itself.

The Functions of the Government Executive

- An effective executive achieves organizational equilibrium by balancing inducements to and contributions from stakeholders.
- Stakeholders: owner of resources valuable to the organization (government).
- Primary source of insight : Herbert Simon (1945), *Administrative Behavior*.

Government as a Coalition of Stakeholders

Stakeholder	Contribution	Inducements
Voters	Legitimacy	services
Taxpayers	Tax revenues	services
Customers	Fees	services

Government as a Coalition of Stakeholders

Stakeholder	Contribution	Inducements
Grantors	Grants	Services to public
Bond holders	Financing	Interest and repayment of principal
Vendors, Contractors	Goods and services	Payments, promise to pay

Government as a Coalition of Stakeholders

Stakeholder	Contribution	Inducements
Governing boards, oversight bodies	Authority, policy, monitoring	Power, re-election
Political executives	Coalition building skills	Salary, career advancement
Employees	services	compensation

Implications for Government Accounting

- The theory answers the question: Who is accountable to whom?
- The theory justifies stakeholders as potential users of government financial information
- The theory stresses the importance of “common knowledge”

Accountability

- Definition: responsibility to answer for and report for authority or resources.
- Levels of accountability
 - Democratic accountability: government answerable to the people.
 - Executive accountability: administration answerable to the legislature.
 - Bureaucratic accountability: civil servants answerable to political executives.

Three Levels/Kinds of Financial Accountability

	Principal	Agent
I	The people	Government
II	Legislature branch	Executive branch
III	Political executives	Bureaucrats

Common Knowledge

- Aims at reducing information asymmetry among the stakeholders, and in effect reducing the power of the “internal” stakeholders
- Provides a rationale for “general purpose financial statements” for external users, produced by using “generally accepted accounting principles” (GAAP).
- The stakeholder theory still does not answer the central question: what determines the production and distribution of government financial information in general?

Common Structure, Different Choices

Ten Areas for Setting Financial
Accounting Standards for
For Govt. and Business

Ten Issue Areas

1. Objectives and system capability.
2. Relationship with budgets.
3. Accounting and reporting entity.
4. System architecture (accounting equation and elements)
5. Form and contents of financial statements

Issue Areas (cont'd)

6. Time orientation and realization.
7. Accounting recognition criteria.
8. Measurement focus for determining financial position.
9. Basis of accounting for determining financial performance.
10. Measurement unit and valuation.

Issue 1. Objectives and System Capability

- Relative weight of the following:
 - For determining and demonstrating compliance with finance-related legal and contractual provisions;
 - For supporting financial management, including budget execution;
 - For fair presentation in accordance with generally accepted accounting principles.

Principle 1: Objectives and Capability

- A govt's accounting system should be capable of producing information for: (1) determining and demonstrating compliance with finance-related legal and contractual provisions; (2) supporting financial management, and (3) fair financial presentation in accordance with GAAP.

Issue 2: Relationship with Budgets

- Range of relationships:
 - Reconciliation of actual results with budgeted results on the budgetary basis.
 - Comparison of actual results with budgeted results on the budgetary basis.
 - Comparison of actual results with budgeted results on a GAAP (accrual) basis.
 - Budgeting on a GAAP (accrual) basis.

Principle 2: Relationship with Budgets

- A government should produce and make public its annual budgets in terms of projected revenues and authorized expenditures. Its financial report should include at least a reconciliation and preferably a comparison of the actual and expected financial performance.

Issue 3:

Accounting and Reporting Entity

- Range of possibilities:
 - Organizational units and whole-of-govt., component units and related organizations.
 - Individual and groups of activities or functions
 - Fund, fund type, category of fund types.

Principle 3:

Accounting and Reporting Entity

- Accounting and reporting entities should be defined on the basis of scope of authority and accountability. Financial data should be sufficiently disaggregated to allow for flexible formation of reporting entities. Summary financial statements should disclose significant internal financial relationships.

Issue 4. Accounting System Architecture

- Should the asset accounting system be based on

- A single-entry recording system? Illustration

Beginning balance of any account		xxx
Addition		+
Deduction		-
Ending balance	xxx	

- A double-entry recording system? Illustration

	Assets = Liabilities + Net Assets	
Building and Equipment	+ 1,000	
Bonds Payable		+1,000
Net Assets		+ 0

Principle 4:

System Architecture

- A government's accounting system should use the double-entry recording system based on the accounting equation: $\text{assets} = \text{liabilities} + \text{net assets}$, where changes in equity are revenues and expenses. A uniform chart of accounts should be used in budgeting, accounting and financial reporting.

Issue 5:

Financial Statements

- A package of related financial statements should include at least:
 - A statement of assets and liabilities at the end of a year,
 - A statement of revenues and expenses for the period.
- Issues:
 - To require a statement of cash flows?
 - To require budget comparison statement/schedule?
 - To require schedules that reconcile numbers?
 - How many supplemental disclosures to require?

Principle 5: Financial Statements

- For any fiscal year, a government should at least present a statement assets and liabilities to show its financial position, and a statement of revenues and expenses to report its financial performance. A cash flow statement is recommended, so are additional disclosures to supplement and complement these financial statements.

Articulated (Interlocking) Financial Statements

- Assets – Liabilities = Net assets or
 $A - L = NA$
- Revenue = increase in NA; Expense =
decrease in NA
- Therefore:
 - Revenue: increase in A, decrease in L
 - Expense: decrease in A, increase in L

Issue 6:

Time Orientation and Realization

- Financial accounting is fundamentally historical in nature; it is possible to consider:
- Realized [deleted] future consequences of past transactions and events; and
- Unrealized consequences of transactions and events that have not occurred
 - Very few items (e.g. financial investments)
 - Some items
 - Many items

Principle 6:

Time Orientation and Realization

- Financial accounting data and financial statements reflect the effects of past transactions and events regardless of the length of time required for those effects to be realized, and historical cost is the basic valuation method. The inclusion of unrealized effects in financial statements should be rare and justified.

Issue 7:

Accounting Recognition

- Accounting recognition stipulates the criteria for considering certain economic resources as assets, and certain responsibilities as liabilities of an entity.
- Issue: What should those criteria be?
 - Assets: future benefit, ownership, control
 - Liability: future sacrifice due to reciprocal benefit, certainty

Principle 7: Accounting Recognition

- Assets are economic resources acquired, owned or controlled by an entity that are capable of producing future economic benefits. Liabilities are the responsibility to pay cash or provide service in the future as a consequence of past transactions or events.

Issue 8: Measurement Focus of the Balance Sheet

Assets

- Current financial resources
- Long-term financial resources
- Other economic resources
 - Non-capital resources
 - Capital resources

Liabilities

- Purpose
 - Operating debt/liability
 - Capital debt/liability
- Timing
 - Current financial liabilities
 - Long-term financial liabilities

Principle 8:

Measurement Focus

- A government's balance sheet may be developed in three stages:
- Stage 1 should focus on current financial resources and current financial liabilities.
- Stage 2 generates data on long-term financial resources and long-term financial liabilities.
- Stage 3 further generates data on capital resources, beginning with those used in government operations.

Issue 9:

Basis of Accounting

- Full accrual of revenue on the basis of service delivery and matching related expenses are generally not possible in governmental activities.
- Alternatively, accruals in govt. measure the availability and use of resources.
- The issue boils down to the timing of availability and use of resources, and the kind of resources being measured.

Issue 9 (cont'd).

Which Degree of Accrual?

- Mild accrual: increase in short-term receivables as revenue and increase in short-term liabilities as expenditure.
- Moderate accrual: increase in long-term receivables also as revenue, and increase in long-term liabilities also expense
- Strong accrual: receipt of non-financial resources also considered as revenue, and use of non-financial resources as expense.

Principle 9: Basis of Accounting

- The full accrual basis should be used to account for a government's business-type activities.
- The cash-basis is not an acceptable method for measuring financial performance.
- A government's financial performance should be measured by using an accrual basis of the highest degree possible, subject to cost-benefit comparison.

Issue 10:

Unit of Measurement

- The elements of a government's financial statements are usually stated in the units of its national currency.
- Issues arise in translation of foreign currency.
- Two valuation issues exist:
 - Whether to adjust for general or specific price level changes
 - Whether to allow for fair values (net realizable value or current replacement cost).

Principle 10: Measurement Unit and Valuation

- Ordinarily a government's annual financial statements are not adjusted for inflation. Such adjustment is recommended for trend data over a long period of time. Financial assets are generally stated in terms of their fair market value , and fixed assets in their historical costs adjusted for depreciation. Current liabilities are stated in contract price, and long-term liabilities in present value of future cash outflows.

Summary

- Financial accounting adds a long-term perspective by focusing on “Assets – liabilities = net assets” and changes thereof.
- American government accounting balances demands of management planning and public accountability.

Summary (continued)

- American govt. acctg. has a long history of reforms with moving targets.
- American govt. acctg. acknowledges both the usefulness and limitations of ideas from business acctg.
- Financial accounting has a logical structure of ten areas in which selections are made in setting standards.

Further Readings

- “American govt. acctg. principles and major changes” (1994)
- “Business acctg. and govt. acctg.” (2010)
- “Structure of govt. acctg. standards” (2010)
- “History of American govt. acctg. reform” (2009)

Distribution

- Concise Chinese/English glossary of govt. acctg. terms
- U.S. Govt. financial statements, FY 2009
- A local govt. financial statements, FY 2009

Next Lecture

How to think about govt. acctg.
Making sense of financial statements