

Lectures in American Government Accounting

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Lecture 4. Fair Presentation and Informing the People

Premier Zhou's Command
Downs' Caution

“Do Not Misrepresent”

Premier Zhou's Command
坚持准则，不做假帐

Where Do Mis-representations Take Place?

- Accounting as a victim of “GIGO” (garbage in, garbage out) phenomenon.
- Possible locations of mis-representation:
 - Input: inaccurate raw data.
 - Throughput: faulty accounting rules.
 - Output: misleading financial reports.

Downs' Curse

- “All reporting is biased because the reporter must select only some of the extant facts to pass on to his audience.” – Anthony Downs, *An Economic Theory of Democracy* (1957, p. 207).
- Government financial reporting based on information produced by the government's accounting system is a type of reporting.
- Therefore government financial reporting is biased.

Auditor's Unqualified (Clean) Opinion

- “In our opinion, the financial statements ... present fairly ...[the financial conditions of the government] in accordance with accounting principles generally accepted.” – the auditor
- GAAP define what is fair presentation.

Conceptual vs. Numerical Errors

Conceptual Errors in ACcounting

- Cash basis instead of accrual basis of measuring revenue.
- Historical cost instead of fair value (economic value, market value).
- Fund acctg. and reporting instead of whole-govt. acctg and reporting

Numerical Errors in Counting

- Social demand for truth in accounting: historical data must be (possible to be) objective
- The necessity of estimation even in historical accounting: depreciation, bad debt, unrealized gains/ losses...
- Incentives for distortion

Sources of Conceptual “Errors”

- Identification of
 - Current (and future?) financial consequences of
 - (only?) Past transactions (and events?)
- Recognition of assets on the basis of:
(interpretations of) usefulness, ownership, control, outcome of past transactions or events.
- Recognition of liabilities on the basis of:
(interpretations of) sources of binding (?) obligations or broader responsibilities.

“When you cannot measure, your
knowledge is meager and
unsatisfactory.”

Lord Kelvin, the physicist

Challenging Measurement Problems in Govt. Accounting

- Financial measurement is the unique competence of financial accounting. The govt. environment poses unique challenges with regard to certain public property, such as:
 - Land, natural resources, radio spectrum...
 - Cultural heritage assets
- As well as certain liabilities, such as
 - Long-term pension and other retirement benefits
 - Insurance and guarantees

Error of Commission vs. Error of Omission

Type I Error of Commission

- Something out of nothing
（无中生有）：
- Over-statement of assets
- Over-statement of revenue
- Over-statement of income

Type II Error of Omission

- Something turned into
nothing（有变成无）：
- Under-statement of
liabilities
- Understatement of
expenses
- Understatement of losses

Reducing Mis-representation

- Research and development for standard-setting to reduce conceptual errors.
- Remove incentives and opportunity for entering inaccurate data.
- Improve accounting system reliability.
- Develop sophisticated valuation methods.
- Clear definition of what constitutes “fair presentation” in financial statements and reports.

The Case of the United States Government

Why did the GAO issue disclaimers
(refusal to express an audit opinion)
12 years in a row?

Specific Financial Management and Accounting Problems

- Serious financial management problems at the Dept. of Defense made its financial statements unauditable;
- The govt. was unable to adequately account for and reconcile intra-govt. Transactions (\$30 billion in FY 09);
- The process of preparing the CFS was ineffective.
- Homeland Security and NASA were unauditable or not audited.

Detrimental Effects of Management and Accounting Problems

- Hamper the govt's ability to reliable report a large part of its assets, liabilities, costs...
- Affect the govt's ability to reliable measure the full cost and performance of some programs
- Impair the govt's ability to adequately safeguard assets and properly record transactions;
- Hinder efficient and effective govt. operations.

Unique Problems Due to Intervention in 2008/2009 Financial Crisis

- The Fed. Govt. made investments in troubled financial institutions and companies and provided insurance coverage and liquidity guarantees to them.
- The valuation of the assets and liabilities is subject to potentially large uncertainties.
- The Fed. Govt. and the American Central Bank undertook considerable risks to themselves in stabilizing the financial markets.

The Bottom Line (end result):

The credibility of the U.S. Govt.'s financial reports is jeopardized.

“Voters’ Ignorance about Govt. Is Rational”

Downs’ Caution

Why Are Voters Uninformed or Under-informed about Government?

- Voters are unwilling to incur the costs of becoming informed about govt.
- The costs of becoming informed include
 - Procurement costs of getting the information,
 - Analysis costs of making sense of data, and
 - Evaluative costs of relating data to personal decision-making situation. (Downs, 1957, p. 210)
- Most of these costs can be transferred to someone else, such as experts and interest groups.

Nature of Govt. Financial Reports

- “General purpose” financial statements about the government’s recent
 - Financial position
 - Financial performance
 - Actual performance relative to the budget
- “Contextual”, not specifically applicable to individuals.
- Users face varying amounts of procurement, analysis and evaluative costs.

Economic Approach to Political Decisions

- Economist Gary Becker: time is a scarce resource.
- Economist/psychologist/political scientist Herbert Simon: people's attention is a scarce resource.

The Market for Govt. Financial Reports

Users

- What's the return (reward) on "using" govt. financial reports to make it worthwhile to incur the costs?
- Tentative answer: likely to be quite low.

Government

- With so few actual users, and so many obstacles in producing useful information, why bother?
- Reason: legal requirements, demand of rating agencies and interest groups.

Question: Why legal requirement?

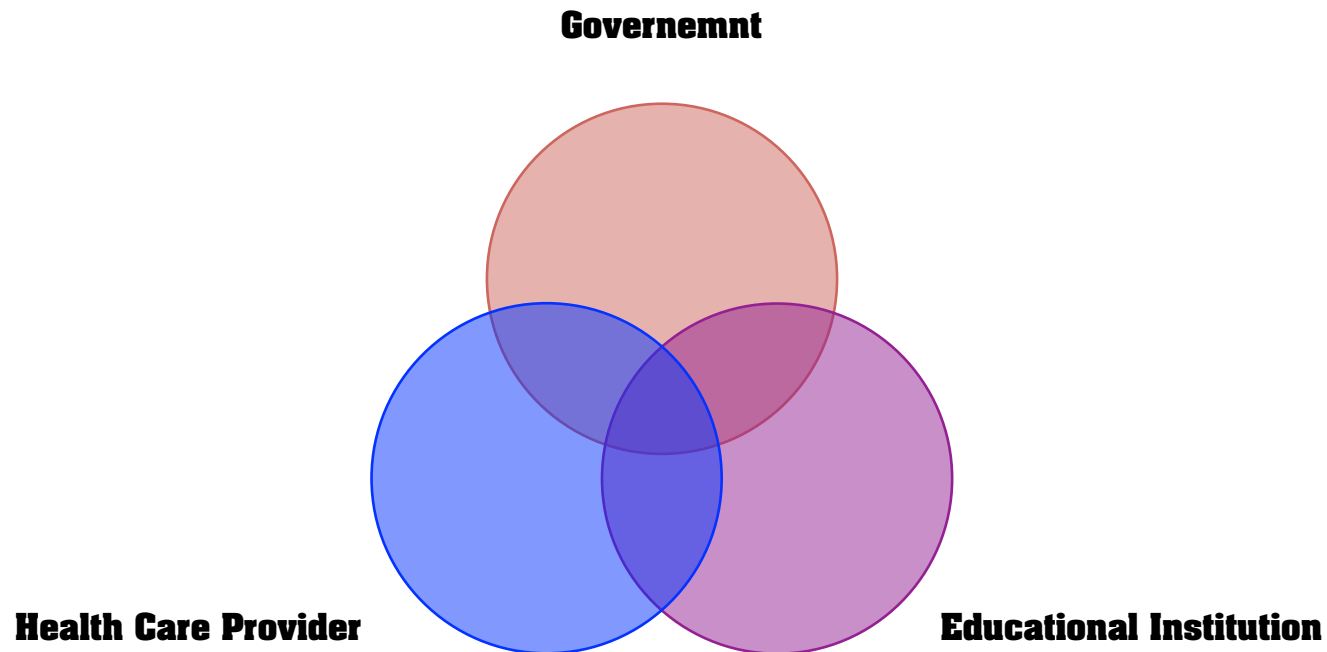
Answer: The belief that govt.
SHOULD be accountable to the
people, and the people SHOULD be
informed about their govt.'s
finances.

Therefore, let's try to solve
conceptual problems
of *moderate* complexity.

Issue 1: Financial Reporting Entity

What's In, What's Out?

Example of Government as a Web of Related Entities



Implications for Govt. Acctg. and Financial Reporting

- What criteria to use in considering public nonprofit organizations and public enterprise as part of government?
- Possible criteria:
 - Funding by the govt. budget
 - Ownership
 - Control.... Influence
- Impossible to make sense of acctg. numbers without knowing *whose* numbers they are.

Exclusions from the U.S. Govt. Consolidated Financial Statements

- Central bank of the United States
 - Board of Governors of the Federal Reserve System -- independence
 - Federal Reserve Banks – owned by private-sector member banks
- Government sponsored enterprises (GSE) – regulated lending institutions perceived to have fed. guarantee – privately owned
- National Public Radio, Public Broadcasting System – not owned or operated by the national govt. at all!

What Is a Government?

- At the subnational level, there are:
 - General purpose govts (such as state and cities)
 - Special purpose govts (such as school districts).
- Are these governments:
 - Public authorities – created by statutes?
 - Public nonprofit organizations – created by charter under a state's corporation or nonprofit corporation laws?
- What difference does it make? – a lot.

Size of “Shadow Government”

“In power, affluence, and assets, public authorities rival the largest state and local govts. and commercial banks in the United States. They borrow more billions of dollars than state and local govts. combined. They have run up a debt that is second only to that of the United States govt. itself... we now have two govts. side by side: the visible general govt. and the shadow govt. of public authorities” from *Shadow Govt.* by D. Axelrod (1992)

What Is Done?

- Federal Govt.
 - Consolidation, included but invisible in the govt. totals of assets and liabilities,
 - but identifiable in the expenses by org. unit.
- State and Local Govts.
 - Discrete (separate) presentation of legally separate but financially accountable entities, and
 - Blended (mixed) presentation of entities similar to a govt's own subunits.

Dealing With Similar Issue in China

- Components of the Chinese public sector:
 - (Broadly defined) administrative units (行政单位),
 - Public service institutions (事业单位), and
 - State-owned enterprises (国有企业)
- Underlying reality: CCP policy guidance and govt. control
- Is “small govt. and large society” a wish or a reality?
- Do financial statements present form or substance?

Issue 2. The Whole and the Parts

What's Revealed Is Interesting;
What's Concealed Is Vital

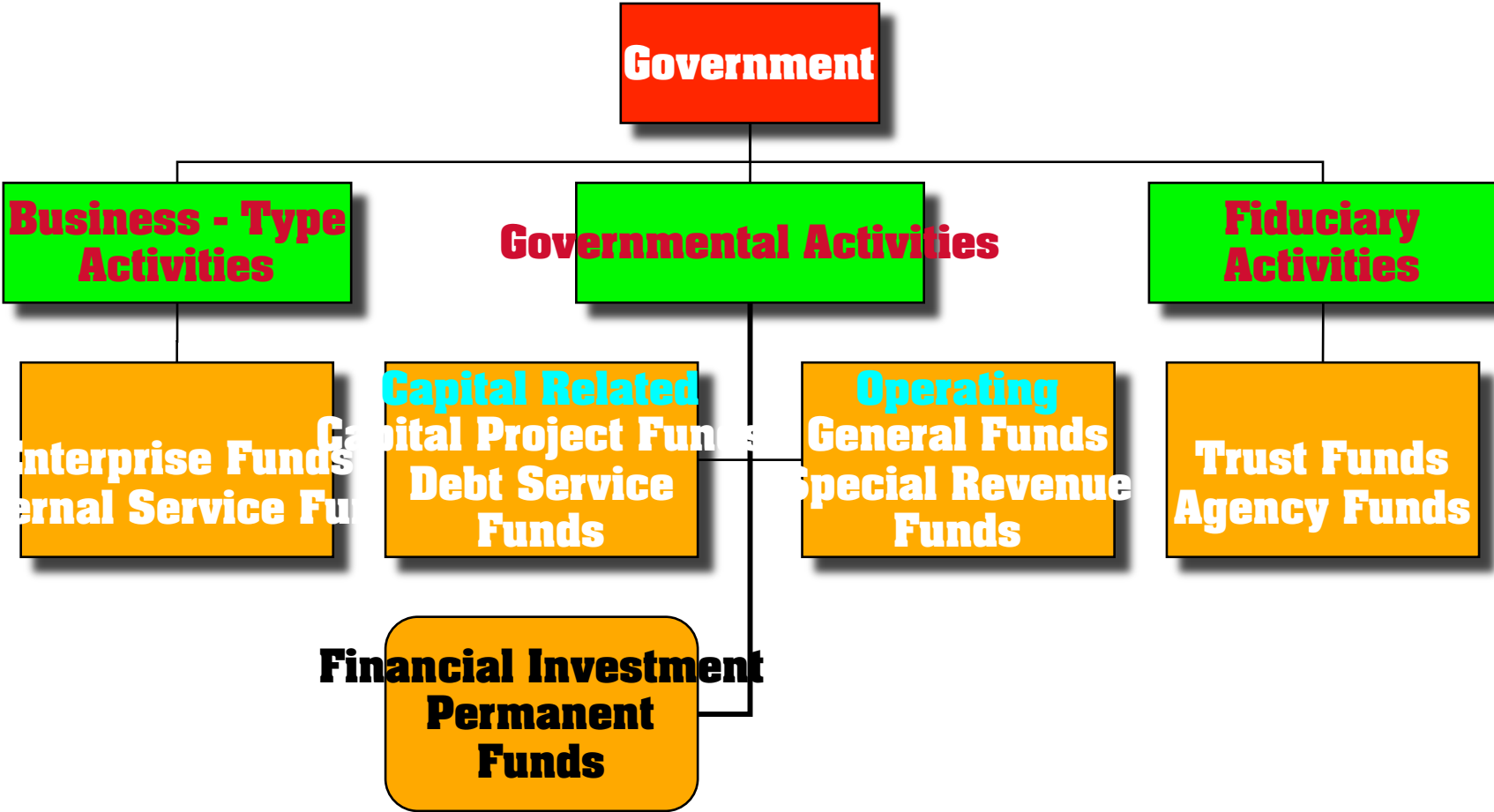
An Assumption Behind Whole Govt. Reporting

- A major assumption behind consolidated (Fed. Govt.) and govt-wide (state and local) financial statements is that external users care only about the govt. taken as a whole.
- A corollary is that it is not necessary – or desirable – to tell users about interactions among the parts of a govt. for fear of information overload and technical complexity.

Major Collapse of Assumption in State and Local Govts.

- Fund financial statements are included along with govt-wide financial statements in annual reports.
- Government-wide financial statements separately display component units (附属单位) .
- Govt activities and business-type activities in separate columns in support of totals of primary govt.

Government Activities and Fund Types



Partial Collapse of the Assumption in Federal Govt.

- Before FY 2006, consolidated totals for the whole govt. with details about internal transactions (buried) in the notes to financial statements.
- Since FY 2006, besides consolidated totals, separate columns for earmarked (with dedicated revenues) funds and non-earmarked funds in
 - Net position (i.e. net assets)
 - tax revenues , with disclosures about
 - Intra-govt al interest and transfers

What Are Earmarked Funds?

- Earmarked funds are Federal programs, many with dedicated (own) revenue sources.
- Different categories:
 - Social insurance (pension, disability, Medicare...)
 - Employee pensions
 - Govt. operations called trust funds in laws

It's Not Hidden, Just Not Accessible

- Extensive description and summary balance sheets of earmarked funds in the notes to financial statements.
- Investments in Treasury securities \$4,155 billion 30th Sept., 2009 in notes to financial statements.
- My recommendation: show internal “I owe you” on the face of the financial statements: sooner or later taxpayers will have to pay.

Lessons from the Greek Tragedy

- When a govt. borrows, it surrenders sovereignty and is subject to market discipline (punishment).
- The market charges a risk premium for (perceived or real) “bad” numbers.
- Financial risks and political risks are inter-twined.
- Domestic risks, contagious and permeating through interconnected global markets, become systematic risks.
- Partially politically connected govts. are a poor match to integrated global capital markets.
- Accounting response: globally govt. acctg. standards ?

Issue 3.

Off-balance Sheet Items

Out of Sight. Ought of Mind?

Value Added by Accrual Accounting

- To cash budgets and cash accounts
- Accrual financial statements show
 - Financial resources: investments, receivables
 - Economic resources: inventories, fixed assets
 - Liabilities
 - Current payables
 - Federal debt securities held by the public
 - Pension and benefits payable
 - Contingent liabilities: insurance and guarantees

Not on the Balance Sheet

Asset Side

- Federal lands
- Natural resources
- Heritage assets
- Stewardship investments
 - Non-fed. physical assets
 - Human capital
 - Research and development-----
- Future tax revenues
- Power to tax
- Tax base

Liability Side

- Procurement contractual commitments
- Legally mandated payments under social insurance programs: present value of underfunding over 75 years = \$46 trillion as of end of FY 2009

Reasons for Omissions On the Asset Side

- Not meeting the realization criterion.
- Financial measurement (\$) not meaningful.
- Not measurable with available methods.
- Not owned or controlled by the Fed. Govt.
- Not readily identifiable.

Reasons for Omissions on the Liability Side

- What is a Federal Govt. liability? - consequences of (actual) transactions, and events for which the govt. is or agrees to be responsible
- Not meeting the realization criterion.
- Are entitlement benefits granted by law a govt. liability?
- Are an individual's payments for future social security benefits (a) a tax, or (b) a personal contribution to a pension trust fund?

Issue 4.

Fiscal (Un)Sustainability

Bad Policy. Good Accounting?

Major Current Concern

- Federal Govt. to report comprehensive long-term fiscal projections beginning FY 2010:
 - Future receipts and spending, public debt
 - Relation to GDP
 - Explanation to increase public understanding
- State and local govt: GASB has begun work on economic condition reporting: fiscal sustainability

Why the Concern?

- Chronic (cash) deficit, habitual delaying costs to the future, and accumulation of debt give rise to a concern of the arrival of the final day of reckoning.
- Routine reporting in the accrual financial statements is ignored.
- Need for a sharper message.

An Emerging Trend in Financial Reporting?

- Lifting topics of particular interest from general-purpose financial statements for emphasis.
- Expanding the list of basic financial statements to include disclosures about the future.
- Relating government finances to tax base and the economy.

Democracy (forever?) in Deficit

- 1969: last year with federal surplus, until
- 1998-2001: 4 years with surplus, otherwise
- Deficits from 1961 to foreseeable future.
- FY 09 deficit \$1,556 billion (11% of GDP) and debt of almost \$9,300 billion (64% of GDP).
- Without policy change, FY20 deficit \$1,004 billion (4% of GDP), debt \$18,600 billion (77% of GDP).
- FY 09 Interest cost = \$190 billion (5% of total expenses)

Ad Hoc Approach, or an Emerging Trend?

- Realization-based financial acctg. is intended to provide imagine-based forecasts/budgets a reality check.
- Accrual financial acctg. is designed to preserve long-term memories of past deeds, and to give a reminder that the present and future lies in the long shadow of the past.
- Historical acctg. has inherent limitations, and
- Repeated attempts are achieve relevancy: fair value acctg, and now futuristic reporting.

Blurring of Distinctions Leading to Confusion or Harmonization?

- The past, the present and the future.
- Retrospective accounting and prospective budgeting.
- The accounting entity and its environment.
- Accounting, finance and economics
- Government acctg. numbers, govt. finance statistics, and macro-economic statistics.
- National practices and international norms.

Issue 5.

Who Cares about American Govt. Finances?

China as a Investor/Creditor of America

“[中方]希望美国方面采取一切必要措施，
稳定经济和金融市场，
确保中国在美资产和投资安全。”

中国国务院副总理 王岐山

中美战略经济对话

北京，2008年12月4日

China as a Investor/Creditor of America

“We hope the U.S. side will take the necessary measures to stabilize the economy and financial markets as well as guarantee the safety of China’s assets and investments in the U.S.”

Chinese Vice Premier Wang Qishan

China-U.S. Strategic Economic Dialogue

Beijing, December 4, 2008.

In general, Stakeholders in American Governments

- Bondholders, creditors
- Employees, vendors, contractors
- Grantors, donors
- Service recipients, voters, taxpayers
- Members of legislatures, oversight boards
- Managers in the executive branch of govt.

Caring about

Government Finances

- Based on individual need for information to assess the amount, timing and degrees of uncertainty of rewards for providing inputs to govt.
- Will use media that provide the necessary information whenever it is needed.

Govt. Acctg. and Fin. Reports

- No particular attachment to this information media.
- Financial reports would be used or ignored, depending on whether they meet the content and cost requirements of users.
- Financial reports have to compete for the attention of users.

4th Wave of Reform: Getting People's Attention and Making Sense of Data

- AICPA - Personal financial literacy:
<http://www.360financialliteracy.org/>
- Peterson Foundation - public affairs education:
<http://www.pgpf.org/>
- The Concord Coalition – making sense of deficit: <http://www.concordcoalition.org/>

Citizen's Guides

- U.S. Treasury Dept.
<http://fms.treas.gov/fr/09frusg/09guide.pdf>
- U.S. Office of Management and Budget:
http://www.whitehouse.gov/omb/financial/reports/citizens_guide.pdf
- U.S. General Accountability Office:
<http://www.gao.gov/new.items/d05958sp.pdf>
- U.S. GAO on cash and accrual deficit:
<http://www.gao.gov/new.items/d07341sp.pdf>

Govt. Acctg. Standards In Plain (English) Language

- Governmental Accounting Standards Board:
<http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804831178>
- Plain language documents
 - Standards
 - Drafts for public comment
 - Publications and speeches for general public

Summary and Conclusion

A Delicate Balance between Usefulness and Reliability

- Policy makers, users and accountants alike realize govt. accounting has become too important to be left to accountants themselves.
- It is easier to demand fair presentation in govt. financial reporting than to achieve it.
- As practitioners strike to improve the accuracy of inputs to accounting systems, standard setters (and academics) struggle with increasing to usefulness of inherently historical accounting.

Current Issues

- Major current issues being tackled include:
 - What public entities should be include in a govt.'s financial statements?
 - How could the preference for an overview covering the whole govt. be reconciled with the desire for details about parts of a govt.?
 - How could the balance sheet be encompassing of a full range of assets and liabilities and remain accurate and reliable?
 - How could future-oriented information about fiscal (un)sustainability be incorporated into the current reporting model?

**Be simple,
without being simplistic.**

The Modern Accountant's Challenge

Thank You!

Send feedback to
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