

Lectures in American Government Accounting

Professor James L. Chan

Beijing, China

May 2010

Lecture 5. Better Accounting for a Better World

Professor Yang's Prescription

Yang's Law

“关于建立我国政府受托责任制的意见”

杨时展教授

(circa 1992)

Inspirations

Premier Zhu Rongji

- 坚持准则
- 不做假帐

Professor Yang Shizhan

- 天下未乱计先乱
- 天下欲治计先治

Yang's Law

Diagnosis

- 天下未乱计先乱
- **“Mismanagement of accounting and auditing leads to misrule of the state”**

Prescription

- 天下欲治计先治
- **“To rule the state requires first regulating its accounting and auditing”**

Economic Development, and Accounting and Auditing

- “未有经济发达的国家而二计不发达的；
- 亦未有二计不发达的国家而经济能发达的。”

Unanswered Questions

- 天下: economy, society, state
- Government runs the state.
- However, role of government in the economy and society various from one country to another.
- Research is need to find out the causal relationships between
 - Regulating accounting and auditing, and
 - Managing government, state, economy and society

“Governmental Accountability System” “政府的受托责任体制”

- Accounting 会计管理体制
- Auditing 审计管理体制
- Budgeting 预算管理体制
- Treasury 国库管理体制
- “互相配合，互相推动，同时运作”

Chinese Govt. Acctg. Reform

Components of “Budget Accounting”

- General budget accounting conducted by the finance departments (财政总预算会计)
- Accounting for extra-budgetary resources (预算外基金 财政专户会计),
- Administrative unit accounting (行政单位会计)
- Public service institution accounting (事业单位会计)
- Specialized accounting functions:
 - Basic construction unit accounting (基本建设单位会计)
 - Treasury accounting (国库会计)
 - Revenue accounting (收入征解会计) -

Major Deficiencies of the Current System

- Lack of uniform and rigorous requirements in standards and system specifications.
- The separate components of the current system not constituting an organic whole.
- Due to cash basis, narrow focus on revenues and expenditures and neglect of assets and liabilities.
- Final accounts not as comprehensive as financial statements.

Strategy of Reform

- Developing an overall design (总体规划)
- First handling easier cases, then tackling the difficult ones (先易后难)
- Achieving breakthroughs on major topics, gradually moving ahead (重点突破， 逐步推进)

Agenda of Reform

- Specifying the boundaries of government and designating entities to be included.
- Developing standards (e.g. extent of accrual) and system specifications.
- Developing government annual financial reports.
- Developing information systems.

Learning and Contributing

“As a developing country promoting government accounting reform, China needs to extensively absorb and consult the valuable experiences of advanced countries. At the same time, China has to actively participate in setting international standards, reflecting the viewpoints and concerns of developing countries” – Assistant Minister of Finance Zhang Tong (December 2008)

Major Sources of Experience

- International Public Sector Accounting Standards (IPSAS) would seem most direct.
- Continental European countries.
- “ABC” (advanced British Commonwealth) countries.
- The United States of America.

Global Govt. Acctg. Reform

Timelines of Govt. Acctg. Reform

U.S.

- 1900-1920s: good financial record keeping for clean govt.
- 1930s-1970s: professional financial management and codification of practices
- Since mid-1970s: adding accrual acctg. and consolidated financial reporting to traditional fund acctg. and budgeting.

Australia/New Zealand

- 1980s: New Public (Financial) Management: also accrual acctg. and consolidated financial reporting

Thought and Action

U.S.

- Adding business-style acctg. and reporting to traditional govt. acctg. model.
- Budgeting unaffected by accrual acctg.
- Domestic in scope with little inclination to influence other countries.

Australia/New Zealand

- Business-style acctg. supplanting traditional govt. acctg. reform.
- Budgeting adopts accruals.
- Spreading the new model and exercising leadership in creating an international movement for setting and adopting IPSAS.

Main Features of the Global Revolution in GA

- Business-type accrual accounting is proposed to replace cash accounting commonly used by government.
- Whole-of-government (consolidated) financial statements at year-end are proposed to replace detailed budget execution reports.
- These features are evident in International Public Sector Accounting Standards (IPSAS).

“ipsas”: International Public Finance Reporting Standards and Codes

- Financial reporting requirements in international treaties, agreements and contracts
- Government section of the UN and European System of National Accounts (SNA)
- International Monetary Fund (IMF) Government Finance Statistics (GFS)
- IMF Fiscal Transparency (FT)
- Organization for Economic Cooperation and Development (OECD) Budget Transparency

What Is New and Different About IPSAS

- Professional recommendations (“standards”) for general-purpose external financial reporting by public sector entities world-wide
- IPSAS converge with IFRS unless public sector uniqueness requires a departure
- Set by a group of accounting experts under the auspices of IFAC – the global federation of national organizations of professional accountants and auditors
- IPSAS are endorsed by influential international donors and lenders
- Government are encouraged but not compelled by international treaties to adopt IPSAS

In Other Words...

- IPSAS is not set by government officials in their official capacity. Current and former officials participate in their individual professional capacity
- IPSAS is “international” in the sense that persons from several nations participate in the process, but IPSAS is not the result of official (governmental) agreements
- IPSAS has become *de facto* global GA standards by virtue of endorsement of powerful institutions

Conceptual Issues

What's Good for Business Is Good for Government?

- So far, IPSAS is largely modest modification of business accounting and financial reporting standards set by the International [Business] Accounting Standards Board (IASB).
- Under sector/transaction neutrality, public sector would follow business accounting standards, except when government is unique.
- The standards are written by accountants for accountants/auditors familiar with business accounting.

Progress to Date

- First phase (1996-2002): changing terminology of IASB standards to look applicable to public sector.
- Second phase (since 2002): standards on issues specific to public sector
 - Taxes and transfers
 - Budget information and budget comparison
 - Definition of govt.
 - Fixed assets that do not generate revenues

Work in Progress

- In search for a conceptual framework for general-purpose financial statements
- Specific issues
 - Long-term sustainability of public finance
 - Public Private Partnerships
 - Social benefits
 - Heritage assets

Conceptual Issues

- The wisdom of setting standards before agreement on a conceptual framework.
- The wisdom of starting IPSAS by modifying existing international business accounting and financial reporting standards (IFRS)
- Accrual basis vs. cash basis
- Aggregated vs. disaggregated reporting
- Budgetary reporting and comparison in financial reports: yes or no; if yes, where and how

A Critique of the Strategy of Emulating Business Accounting

- A set of IPSAS without dealing with issues unique to government cannot be called “core” standards.
- The PSC incurred not only actual expenditures, but also opportunity cost for six years.
- The PSC overlooked the valuable experiences of developing *GA* standards in the United States since the 1970s at least.
- The PSC ignored the critical differences between the firm and government that affect their accounting and reporting.

Premises of Business Accounting

- Primacy of owners and creditors
- Valuation of the firm = value to owners
- Recognition of private property rights
- Voluntary market exchanges to determine prices
- Legal system for enforcing contracts
- Sufficiency of monetary measurement

In Contrast to Business, the State ...

- Is sovereign and has power to tax and make laws
- More symmetrical status of various stakeholders
- Pursues macro-economic goals sometimes to the detriment of its own short-term financial standing
- Promotes equity by redistributing income/wealth
- Unique role in producing public goods
- Generates hard-to-measure non-financial outputs and outcomes

Governmental Accounting

Uniqueness of Govt.

- Public goods
- Redistributive function
- Power to tax
- Regulatory power

Acctg. Consequences

- Cannot individualize prices and match expenses
- Equity as performance criteria
- Non-reciprocal transactions
- Not obligated to accept private-sector rules

Some Characteristics of Government

- Divided power in constitutional government
- Nature of public property in terms of origin, value other than economic value, longevity
- Broad interpretation of government responsibility for general welfare
- Tax and “transfer” revenues cannot be recognized on the basis of services rendered

Not All's Well With Business Accounting

- “Rational expectations”: transactions structured to avoid or take advantage of accounting rules.
- Accounting rules – accruals and reporting entity – susceptible to manipulation to boost earnings.
- Inconclusive debates on values vs. costs.
- Multiple acceptable methods for depreciation and inventory, with huge impacts on numbers.
- Ad hoc and strategic earnings forecasts.

IPSAS Board's Stance on Accrual

- Accrual of revenue and expense is tied to recognition and measurement of assets and liabilities
- Fundamental commitment to accrual basis is contradicted by cash-basis IPSAS for countries which are the target adopters of IPSAS.
- No clear alternative to full accrual of revenue based on service effort and accomplishment
- Cash and accrual are viewed as polar opposites, while accrual is really a matter of degree.

Premise of Consolidated Financial Statements in Corporate Reporting

- Management control over all resources
- Majority ownership interest in subsidiary as quantitative criterion of consolidation
- Users of financial statements prefer economic substance over legal form
- Investors and creditors need to know about the whole reporting entity
- Additional disclosures can be made for dissimilar lines of business

Nature of Public Sector Entities

- The range of government functions depends on political and economic system
- Government functions can include: state or governmental activities, business-type activities, and fiduciary activities (e.g. pensions)
- Besides ownership, there are other complex and indirect methods of control and influence
- Political power is often diffused among levels of government, and among branches of government at the same level

Sources of the Problem with Govt. Financial Reporting

- One set of general-purpose financial statements for diverse user groups
- Lack of consensus on external user groups
- Lack of information about intermediary and end users, and their needs and capabilities.
- Appropriate level of appropriation cannot be determined without adequate info. about users.

Sources of Problems with the Budget

- The budget is inherently speculative and financial statements are necessarily tardy
- Separate institutional structures for setting budgeting and accounting rules
- Different theoretical foundation, professions and training
- Different concepts, standards and methods due to differences in purpose

Institutional Issues

Who sets standards for whom?

The Standard Setters

- IPSAS Board is a part of the International Federation of Accountants (IFAC), composed of 157 national associations of professional accountants in 123 nations
- IPSAS Board has 15 members nominated by national bodies, and 3 public members
- IPSAS Board is assisted by a Consultative Group

Funders and Observers

- Observers who provide(d) financial support:
 - International Monetary Fund
 - World Bank
 - United Nations Development Program
 - Asian Development Bank
- Observers who do not provide financial support:
 - International Organization of Supreme Audit Institutions
 - Organization for Economic Cooperation and Development
 - International Accounting Standards Board
 - European Commission

Due Process

- Wide dissemination of research studies and exposure drafts of proposed standards
- Consideration of comments
- Open meetings around the world
- Adoption of standards by at least $\frac{3}{4}$ of members present (9 members constitute a quorum).

The Success and Leadership Role of Business Accountants and Auditors

- By virtue of expertise, IFAC is understandably closely allied with IASC
- In most countries and globally, accounting and auditing profession is dominated by members working in the private [not public] sector
- Business accounting has the longest and most successful professional standard setting globally and in some countries
- Harmonization of specialties enhances the unity of the accounting profession and discipline

Reverse Regulation

- The accounting and auditing profession argues for greater independence, i.e. free from government and political interference
- Professional licensing and standards rest on a legal foundation.
- Governments have the legal authority to setting and enforce their own accounting standards.

The Virtual Absence of Official Representatives of Governments

- Legislators, who have the authority to write laws on a jurisdiction's government accounting and can provide/withhold legal basis and appropriations for IPSAS
- Finance ministers, who oversee a government's accounting
 - Budget directors, who provide/withhold resources
 - Chief Accounting Office, who implement any changes
- Government auditors, who use financial data in investigations and attest to financial statements

Distribution of Board Seats

- Nomination by IFAC institutional members vs. public members
- Possible bases of distribution of membership
 - Geographical, nationality
 - Stages of national economic development
 - Types of government accounting system
 - Professional experience and expertise
- Issue: relationship between adoption of standards and representation on IPSAS board

What Does “Adoption” Mean?

- “Adoption” and “process of adoption” are too vague for the list of adopter nations to be complete and reliable.
- At issue is the varying interpretation of “accrual”
- Is adoption of cash-basis IPSAS equivalent to accrual-basis IPSAS? Not in my view
- *De facto* adoption by nations whose GA standards are “*broadly consistent*” with IPSAS
- Adoption should be a formal decision accompanied by an implementation plan with adequate resource commitments

IPSAS and Developing Countries

- The cash-basis IPSAS, in effect, is an escape clause for many developing countries
- Personal view: Accrual in principle for all nations, but implementation in stages:
 - Step 1: The willingness to leave an audit trail.
 - Step 2: The ability to analyze transactions and record effects in a double-entry system.
- Gradual advance from mild to moderate degree of accrual.

Conclusion

A Premature Revolution

- Intellectually:
 - Transferability of business GAAP to govt.
 - Competing models: good, better, and best?
 - Uniform rules for a diverse world.
- Institutionally:
 - Professional authority over govt. authority.
 - Accounting profession over other professions.
 - IFAC over other international organizations.

Personal Recommendation

- That China not adopt IPSAS as they stand, because they are both inappropriate and infeasible for China.
- Promoting financial integrity and ensuring sound financial management are pressing priorities.
- China does not have operational capability to implement accrual accounting and reporting.
- Learning from the full range of American govt. accounting reform in the past 100 years.

Crucial First Step for China: A Chart of Accounts for Balance Sheets

Assets

- Cash
- Other Current Financial Resources, e.g.
 - Receivables
 - Investments
- Long-term Fin. Resources
- Non-capital Economic Resources (e.g. prepayments)
- Capital Economic Resources
 - Land
 - Building
 - Equipment

Liabilities

- Current Liabilities, e.g.
 - Accounts Payable to employees
 - Wages Payable to employees
- Long-term liabilities, e.g.
 - Pension Payable to retirees
 - Bonds Payable to creditors
- Contingent Liabilities
 - Insurance
 - Guarantees

Personal Recommendation

- “ABC” variant is an extreme version of the Anglo-American model of govt. accounting.
- The American variant encompass elements of
 - the traditional emphasis of budgetary control and management support, and
 - The new emphasis of accountability and transparency to the general public
- Need for comparative international govt. accounting research (CIGAR)

Objectives of CIGAR

Scientific vs Practical

Scientific Objectives of CIGAR

- The focus of CIGAR: the international similarities and differences in government accounting (GA) policies and practices.
- Scientific objectives of CIGAR:
 - To describe – to find concepts to represent observed phenomena, i.e. national GA policies and practices;
 - To explain – to find the causes of the international differences in GA policies and practices at a point in time;
 - To predict – to find the causes of future international differences in GA policies and practice.

Practical Objectives of CIGAR

- To understand GA in terms of
 - Content of GA
 - Context (environment) of GA
- To evaluate GA practices
 - Choose “good” or “best” practices as benchmarks
 - Perform gap analysis: “what is” vs. “what ought to be”
- To improve GA practice
 - Conduct pilot projects to determine feasibility
 - Disseminate innovations

Comparing and Reconciling Science and Practice

- In search of
 - Timeless truths
 - Global generalizations
- Scientists hold neutral attitude
- Scientists try to be objective
- Scientists are content with the intrinsic value of knowledge
- Scientists seek peer recognition
- In search of
 - What works now
 - What works here
- Practitioners are committed to values
- Practitioners advocate causes (policies)
- Practitioners use knowledge to achieve desired results
- Practitioners seek sponsor's approval

How to Describe a Nation's GA?

Goal: Accurate and parsimonious description by replacing observations with concepts

Characterizing a Nation's GA System

- Context: Institutional framework (organizational environment and larger political and economic environment)
- Content: Accounting and financial reporting policies and practices

Source: Chan/Jones/Lueder (1996), Appendix, pp. 17-20.

Characterizing a Nation's GA System

- Institutional Framework
 - Professionalism and independence of government accountants vs. political, legal and administrative control
 - Private-sector influence (of business accounting standards) vs. insulation and autonomy of GA laws and regulations
 - Functional integration with budgeting vs. separate and independent accounting regulations or standards
 - Centralization vs. decentralization in terms of the authority of the national government to set and enforce standards throughout the country

Characterizing a Nation's GA System

- Accounting and Financial Reporting
 - Objectives
 - Accounting Recognition and Measurement
 - Financial Reporting
 - Contents of Financial Reports
 - Information Dissemination

Recommended: Move from Exploratory to Conceptual Analysis

- Eventual goal: a general theory that relates GA to its probable “determinants”.
- “General” in the sense of being valid under a variety of environments around the world
- Theory: policy makers in an accountability relationship rationally weigh the costs and benefits of adopting GA policy alternatives that are favorable to themselves.

Costs and Benefits of Government Accounting

- Political costs and benefits: the redistribution of power between, for example,
 - A particular country and international donors/lenders
 - A Government and the people
 - National and local governments
 - Legislature and the executive branch
 - Budgeters and accountants
- Economic costs and benefits, such as
 - Investment in people and information technology
 - A lower interest rate due to a better bond rating

Two Major Approaches to Comparative Research

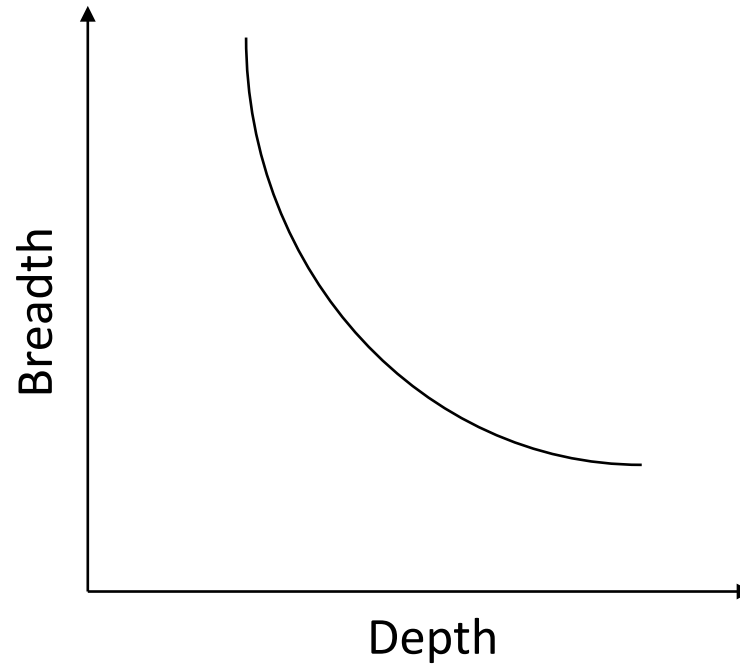
Case-oriented

- To provide a rich description of the content and context of GA in two or a few countries.
- Focus: how GA evolves in content and in relation to its environment.

Variable-oriented

- Toward establishing the causal relationships between GA and its “determinants” such as its environment.
- Focus: the relationships of variables measured over multiple cases at a point in time (cross-section) or over time (time series)

Fundamental Dilemma: Breadth vs. Depth



Making the Most of a Dilemma

- The dilemma due to:
 - The necessity of a large N for meaningful statistical analysis.
 - The limitations of case studies.
- Objective: to increase the number of observations regardless of research approach
- Constraints: time, money, access and others
- A realistic way out: focused comparisons with a small number of countries

Virtues and Limitations of N=1 Studies

- Virtues:
 - Lower cost due to easier access and language proficiency in addition to native's insights about culture
 - Indepth description and analysis
 - Rich contextual description
 - Tracing processes and events over time: each historical period resembles a case
- Limitations: Uniqueness resulting in weak
 - Generalizability of findings
 - Replicability of findings

The Importance of Comparison

- Scientific skepticism: questioning the representativeness of any country (case)
- Conflicting objectives of research and practice:
 - Scientific research thrives on diversity in search of variability to find a pattern (connecting the “dots”).
 - Professional accountants/organizations push for uniformity.
- Concern: premature global GA homogenization
 - Inadequate factual information about diversity
 - Inadequate justification for good, better, best practice

Moving from N=1 to N=2

- Usually the one country is the researchers' home country
- Strategic decision on 2nd country:
 - Common but indefensible choice: easy data collection
 - Very similar (e.g. U.S. and UK), or
 - Very dissimilar (e.g. U.S. and China).
- With respect to:
 - GA as source of dependent variables, or
 - The environment (ENV) as source of independent variables

Moving from N=2 to N=3

- Binary comparisons (N=2):
 - Most alike: e.g. U.K. and U.S.
 - Most unlike: e.g. China and U.S.
 - Use and limitations of binary comparisons
- Tripartite comparisons (N= 3):
 - For example: China, U.K. and U.S.
 - Advantages and limitations of tripartite comparisons.

Range of Possibilities for Comparison

| GA \ Env. | Similar | Dissimilar |
|------------|--------------------------------|-------------------------------|
| Similar | I: GA is affected by Env. | II: Env. has no effect on GA. |
| Dissimilar | III: Env. has no effect on GA. | IV: GA is affected by Env. |

What Variables to Study?

- Shifting from holistic descriptions to identification of critical variables
- Practitioners' view: GA a tool to promote accountability
- Researcher's hypothesis: GA as manifestation of accountability
- Research questions: who reports what to whom? Why? When? How? With what effects?

Focus on Accountability Patterns

- A GA system's rules and outputs reflect the pattern of accountability:
 - Managerial accountability: subordinates report to superiors in the executive branch
 - Legislative accountability: the executive reports to the legislative oversight bodies
 - Public accountability: the government (in part or in whole) report to the public

Accountability-driven GA Models

- Focus on a small number of important differentiating criteria
- Whose financial performance is measured and reported?
 - Subunits in government, and/or
 - Government as a whole
- With What? When?
 - Budgets before fiscal year,
 - Interim reports due the year,
 - Financial reports at year-end: With or without budget comparisons.

Study the Process

- “Thick” description is the competitive advantage of focused case studies.
- In addition to identifying causes and effects, case studies should provide detailed documentation about, for example
 - the GA system
 - the organizational, political and economic context
 - the process of maintaining the status quo or changing the GA system
- Reminder: make sure that the description is guided by an explicit theory

Building a Positive Theory

- Scholars' task is to build and test positive theories.
- A useful theoretical framework: GA reflects accountability relationships.
- Behavioral assumption: self-interested rational actors
- Key ideas:
 - A GA system lasts so long as it is compatible with the incentives in the accountability relationship of a country.
 - A corollary: Changing the incentive structure may lead to changes in GA.

Conclusion

- Case studies are necessary preparatory steps for variable-oriented CIGAR
- Intermediary steps: $N=2,3,4,5,\dots$
 - case studies with a common theoretical framework.
 - Comparable case studies
- Variable-oriented comparison is needed to build and test positive theories of international GA similarities and differences

Join the CIGAR Network!

www.cigar-network.net

Further Readings

- “Yang’s Law and Premier Zhu’s Mandate: The Role of Accounting in Governing the Chinese State” Working Paper (2010).
- American Govt. Acctg. Standards (2009), Ch. 7 on lessons for China.
- Yang Shizhan (circa 1992), “My Views on Establishing a System of Government Accountability in China”.

Further Readings (continued)

- “IPSAS and Govt. Acctg. Reform in Developing Countries” (2006).
- With R. Jones and K. Lueder, “Modeling Govt. Acctg. Innovations: An Assessment and Future Research Directions” (1996).
- “CIGAR Methodological Issues and Strategies” (2002)

Thank you!

Visit www.JamesLChan.com

Send comments to jimchan@uic.edu