Chapter 3
The History of American Government Accounting Reform

INTRODUCTION

The founding political philosophy and constitutional principles of government accountability in the United States, largely unchanged in the past two hundred and thirty years, have served as the guiding light for the development of government accounting. At the beginning of the 20th century, during the Progressive Era in American history, a good government reform movement was launched. Many ideas were proposed and implemented to make government work better and less corrupt. Most of the modern ideas, upon closer examination, have their roots in that period.

The historical account of American government accounting reform experience is included in the present volume for both theoretical and practical reasons. The theoretical reason is that it provides evidence in support of the hypothesis that accounting is susceptible to environmental influences. While accountants hope that the information they produce can influence decisions and policies, at most this effect takes place at the organizational or micro level. In the larger scheme of things in a country or political system, accounting ideas and practices reflect more than affect political, economic and social change, at least in the short or intermediate term. Nevertheless, through the process of slow accretion and aggregation over a long period of time, policies and practice that insist on accurate financial record-keeping, systematic financial management, and openness can – with the reinforcement of favorable political and economic factors – induce a culture of accountability and transparency. So the practical reason for recounting the American experience is to counsel patience and persistence: government accounting reform cannot proceed faster than government reform.

This chapter has two major sections. The first sections describe three waves of government accounting reforms in American state and local government during the 20th century. The second section on the Federal Government describes the struggle between the legislative and executive branches over the power to set accounting rules and the eventual compromise, and the conflicts over the adoption of accrual accounting. The concluding section draws lessons from these historical experiences.

AMERICAN STATE AND LOCAL GOVERNMENT ACCOUNTING REFORMS

During the past hundred years, there have been three major waves of reforms aimed at transforming the way American state and local governments keep their accounts and report their financial affairs. The first wave took place as an important part of the municipal government reform during the Progressive Era at the dawn of the 20th century. The reformers saw better financial record-keeping as a way to fight corruption and make governments function more efficiently. During the second wave, from the 1930s to the mid-1970s, public finance professionals recommended uniform accounting principles primarily in support of systematic financial management. Finally, the third and current wave of reform has focused on making government more accountable through greater transparency. The significant features of these reforms are described in this section.

Exhibit 3.1

Milestones in State and Local Government Accounting

1900 The National Municipal League established the Committee on Uniform Accounting Methods.

1906 The National Association of Comptrollers and Accounting Officers was established; its successors would sponsor government accounting standard-setting bodies for almost eight decades.

1913 The New York Bureau of Municipal Research published *The Metz Fund Handbooks of City Business Methods*.

1934 The National Committee on Municipal Accounting enunciated ten principles of government accounting.

1968 The Municipal Finance Officers Association (MFOA) published *Governmental Accounting, Auditing and Financial Reporting*.

1979 National Council on Governmental Accounting issued *Statement No. 1* "Governmental Accounting and Financial Reporting Principles".

1984 Governmental Accounting Standards Board (GASB) was established.

1986 The American Institute of CPAs recognized GASB standards as generally accepted accounting Principles (GAAP).

1999 GASB *Statement No. 34* requires government-wide financial statements in addition to fund statements.

First Wave of Reform: Ensuring Financial Integrity

During the Progressive Era, which lasted from the 1890s to around 1920, America changed from a rural community to an industrial society with growing urban populations. Technical and managerial advances in transportation and communication led to the creation of large financial institutions and industrial and commercial corporations with a great demand for labor. Immigrants, mostly from Europe, flocked to American cities in large numbers. Municipal governments were under great pressure to provide basic public services. Existing institutions were inadequate to the task and corrupt government officials engaged in grafts and filled government jobs on the basis of personal connections rather than competence. As James Bryce, an astute British observer of American politics, said in 1891, "The government of [American] cities is one of the conspicuous failures of the United States." Book titles such as *The Shame of the Cities* and *Theft of the City* reflect the sorry state of civic life. The morally upright and the economic elite demanded an end to official corruption, greater popular control over government, and the expansion of government services to cope with the rising demands of urban residents. As government expenditures increased, so did taxes. As political and social reformers fought against corruption and injustice, businessmen motivated by enlightened self-interest sought greater economy and efficiency in government, because they feared that without reform higher taxes would simply feed the bureaucracy staffed by the patronage system. Business trade associations began a campaign for efficiency and economy in government. Based on their own experience, these businessmen believed that sound business practices and good accounting would be essential for better government.

They attracted idealistic members of the American accounting profession to improve the accounting practices of municipal governments.

The most concerted and influential efforts took place in New York City, where the city comptroller is an elected position. City Comptroller Herman Metz, a former businessman, introduced business practices and accounting procedures in city government. After leaving office, he established the New York Bureau of Municipal Research under the leadership of Frederick A. Cleveland. The bureau conducted fact-finding studies to document current practices and made many recommendations for improvement. These recommendations were contained in a series of *Metz Fund Handbooks of City Business Methods* published in 1913.

The handbook on municipal accounting argued that government should have an accounting system that was capable of supplying "complete, reliable and prompt information about business transactions and results." The Metz Fund researchers proposed a business accounting model that took into account the public budget as the key instrument of financial control. They stressed the need to gauge government's ability to continue as an ongoing concern. The result was an emphasis on the government's balance sheet. Year-end balance sheets, or statements of financial position, would provide a continuous series of measures of the assets, liabilities and residual capital carried over from one period to the next. This way of looking at municipal finances contrasted sharply with discrete annual budgets, each focusing on one period's money inflows and outflows. The implementation of the multi-period continuous accounting model required the accrual basis of accounting and the double-entry system of bookkeeping. Furthermore, the handbook recommended cost accounting to give city officials data to make government operations more economical and efficient. Another suggestion was the segregation of financial resources into funds for greater control. Finally, the handbook recommended the recording of estimated revenues, appropriations, and contractual obligations in the accounts for assessing financial performance.

The Metz Fund apparently was not the first one to advocate a greater emphasis on the balance sheet. As early as 1901, F.H. MacPherson, a Canadian accountants, complained that financial reports "may exhibit a correct statement of the receipts and expenditures, but rarely, if ever, is a statement of assets and liabilities anything more than an approximation of the position of the [municipal] corporation." He went on: "The requirement of a perfect balance sheet cannot be satisfactorily met, unless the system of accounts provides for the application of double entry to all transactions into which money or money values enter" (MacPherson, 1901, p. 3)

As early as 1900, some American state and local governments began adopting professionally developed accounting standards. The reform activities in New York City, Chicago, Philadelphia and Minneapolis were the first organized attempt to establish uniform government accounting standards in the United States. In 1900, the National Municipal League, which is a civic organization with cities as institutional members, set up a Committee on Uniform Accounting Methods. The committee stressed uniformity in accounting, and the proper classification of revenues and expenses to facilitate statistical comparisons among the cities. It also advocated independent audits of city governments by private-sector auditors, and recommended a prototype for reporting financial data. A Boston CPA named Harvey Chase took the ideas around the country, and persuaded 11 states and 80 cities to adopt the committee's accounting model.

In brief, one hundred years ago, American business leaders and accounting professionals were already involved in government financial reforms. They urged American city governments to add fund accounting and budgetary accounting to business accounting practices. These practical men of affairs were mainly concerned about installing systems and procedures for greater control to ensure financial integrity. The formulation of formal standards was deferred to the future.

Second Wave of Reform: Supporting Law-based Financial Management

During the Great Depression in the 1930s, revenue shortfalls forced many American municipal governments into defaults on their bonds. Public officials again called on financial experts to help deal with serious financial problems. As early as 1906, local government accountants had formed a national organization, which was later renamed the Municipal Finance Officers Association (MFOA). The MFOA encouraged professional financial management in city governments, and in 1934 established a National Committee on Municipal Accounting (NCMA) with members from nine other organizations with similar interests. The committee formulated principles of municipal accounting, which the MFOA formally endorsed as Standard Practices in Municipal Accounting and Financial Procedure.

The NCMA principles codified and elaborated many of the ideas in the *Metz Handbook* and advocated close links between accounting and budgeting systems. The committee endorsed the use of budgetary accounts for recording projected revenues and appropriations, as well as the recording of encumbrances or contractual obligations. The group also affirmed the use of the double-entry system and a general ledger supported by subsidiary records for financial control. Ten types of funds were specified for organizing a municipal government's accounts, and the use of the accrual basis of accounting was required. Standard classifications were recommended for assets and liabilities, revenues, and expenditures as well. Finally, the NCMA stressed the importance of common terminology and account structure to ensure consistency of data in the budget, the accounts and eventually the financial statements. To put all these recommendations in action, the NCMA also urged every government to appoint a single finance officer to manage accounting and financial reporting.

After the accounting principle codification project, the National Committee on Municipal Accounting went out of existence, but was reactivated in 1948 as the National Committee on *Governmental* Accounting, as representatives of state governments also joined the committee. The new committee revised NCMA publications as well as working on auditing procedures as well. After an inactive period, the committee undertook a major project to consolidate all previous work in a comprehensive volume entitled *Governmental Accounting, Auditing, and Financial Reporting* (GAAFR) published in 1968. For the first time, there was a common thread running through the entire financial control cycle of budgeting, accounting, auditing and financial reporting. The GAAFR, known as the “Blue Book” among practitioners, have been periodically updated up to the present time.

The original 1968 edition of the GAAFR retained most of early principles mentioned above and made some modifications. It stressed the importance of budgeting in government and called on every government to adopt an annual budget regardless of whether it is required by law or not. It also required that the accounting system make it possible for government to show compliance with all applicable requirements in appropriation laws and other finance-related laws and regulations. At the same time, a government’s accounting system should be capable of determining “fairly and with full disclosure” the government’s financial position and results of financial operations.” If a conflict between its recommendations and the laws of a particular state or local government arose, the 1968 GAAFR took the position that legal provisions “must take precedence.” But the publication hastened to add that government accounting systems should also be able to make full disclosure and fair presentation in accordance with “generally accepted principles of accounting applicable to governments.”

Apparently this was the first time that the phrase “generally accepted principles of accounting” or GAAP applicable to governments was invoked. GAAP for government was a provocative idea for several reasons. The term GAAP had previously been used to refer only to business accounting principles set by a technical committee of the AICPA, initially the Committee on Accounting Procedures and then Accounting Principles Board (APB) of the American Institute of Certified Public Accountants (AICPA). Using the term in connection with government reflected the long-term influence of business accountants and auditors on government accounting that began since the beginning of the 20th century.

By referring to GAAP applicable to governments, the 1968 GAAFR triggered a controversy that was going to last up to the resent time. The the word “applicable” raised the issue of whether government accounting should be similar to or different from business accounting. There was also the related issue of who should set GAAP for government. The AICPA’s APB would soon be replaced by the Financial Accounting Standards Board (FASB) in 1973 under the auspices of the Financial Accounting Foundation (FAF). A decade later, the FAF would also sponsor the Governmental Accounting Standards Boards (GASB) for state and local governments.

The AICPA became involved in the controversy of who should set government GAAP because its member audit governments, and the term GAAP had traditionally refer to business accounting. As early as 1913 New York’s Metz Fund urged governments to have independent financial audits. Since that time, an increasing number of local governments engaged independent CPAs to audit their financial statements to improve credibility with the capital markets, a major source of funding for capital projects. CPAs’ code of professional conduct requires them to use GAAP to evaluate their client’s financial statements for the purposes of expressing their audit opinions. The standards developed by the MFOA's committees were not recognized by the AICPA as GAAP. In response to its members' need for technical guidance, the AICPA appointed a Committee on Governmental Accounting and Auditing, which produced an "industry audit guide" for state and local governmental units in 1974. The guide adopted many of provisions of the GAAFR, and served as the *de facto* GAAP applicable to government.

In the meantime, in the mid-1970s a series of municipal fiscal crises erupted and ushered in the third wave of government accounting reform. Before proceeding to the next period, we pause to recall that the main achievement of the period from the 1930s to the mid-1970s was the codification and formalization of government accounting principles for national wide application. These principles emphasized the use of fund accounting and budgetary accounting as an information system to support financial management in accordance with legal and contractual requirements. Formulated by experienced government finance officers in their professional capacity, these principles were non-binding on government accountants in their official capacity. Under the second meaning of rule of law (see Chapter 1), government finance officers' primary obligation is to obey the laws and regulations of their jurisdictions. The prevailing view was that those laws and regulations should override recommended accounting practices when the two came into conflict, even if the latter would lead to better information.

However, legal supremacy had its limits when American state and local governments depend on the capital market to finance their capital expenditures. Governments cannot force people to buy their bonds or banks to lend them money. When bondholders and other creditors were reluctant to lend or would charge higher interest because they were not given adequate financial information, governments began to respond. The response created the third wave of government accounting reform that began with the municipal financial crises in mid-1970s.

The Third Wave of Reform: Promoting Accountability and Transparency

The municipal government fiscal crises that began in New York City and later spread to Chicago and Cleveland had complex political, economic and social origins. These crises also had one thing in common: all these cities did not have financial statements that could clearly reveal the magnitude of their fiscal problems. Without reliable information, the financial consultants loaned by business firms, financial institutions and accounting firms were helpless in diagnosing problems and offering solutions. The consultants recommended: use GAAP, make full disclosures, have independent audit. Governments had heard such advice before and many apparently had not taken it seriously. However, when the bond ratings agencies warned them that unless they produce financial statements using GAAP and receive an unqualified audit opinion, their bond ratings would be adversely affected, they began to pay attention.

The hallmark of this round of reform was transparency and accountability through more streamlined financial communication, involving the National Council on Governmental Accounting (NCGA) from 1974 to 1983, and the Governmental Accounting Standards Board (GASB) from 1984 to the present.

NCGA Phase (1974 to 1983). In 1974, the National Committee on Governmental Accounting was renamed and expanded to become the National Council on Governmental Accounting (NCGA), but continued to be sponsored by the Municipal (later Government) Finance Officers Association. In the anxious atmosphere created by the financial crises, the newly reconsistuted NCGA felt that it had to act fast by revising the 1968 GAAFR. The revision resulted in the issuance of NCGA *Statement 1* "Governmental Accounting and Financial Reporting Principles." This document made a number of significant changes in tone and substance to the 1968 GAAFR: (1) The NCGA tipped the balance in favor of national accounting standards when those standards conflicted with state or local legal provisions. It advised accountants to observe legal compliance during the fiscal year, but at the end of the year to convert the accounts to conform to national standards in order to produce external reports. (2) In order to produce more aggregated financial statements, the NCGA grouped the funds with common characteristics into a half dozen fund types, which are further classified as governmental, proprietary, and fiduciary categories. Financial statements of these fund types would then be presented as "general purpose financial statements" for wide dissemination to the public. (3) The NCGA required the preparation of interim financial reports and explicitly called for the reporting of budgetary comparisons in financial reports.

Using a grant from the Federal Government's Financial Management Capacity Sharing Program, the NCGA also undertook a longer-term research project to develop a sound conceptual foundation for government accounting. The research team used the "need to know" or "right to know" a government's financial affairs as criteria to identify actual or potential users of government financial information. State and local governments were urged to provide these users with financial information that would be useful for (1) making economic, political and social decisions, (2) demonstrating accountability and stewardship, and (3) evaluating managerial and organizational performance.

The NCGA did not have the opportunity to use the research. After the grant was prematurely terminated by the Reagan Administration after the Republican victory in the 1980 election, the research staff was disbanded due to lack of funding. Efforts intensified to find an acceptable and sustainable institutional structure for setting state and local government accounting standards. Finally, a private- and public-sector coalition succeeded in establishing the Governmental Accounting Standards Board (GASB).

The GASB Period (from 1984 to the present). The GASB was formed in 1984 as a companion board to Financial Accounting Standards Board (FASB) under the auspices of the Financial Accounting Foundation. In order to ensure continuity, the GASB required the continued enforcement of existing NCGA standards. The board then undertook its own research project on user needs in order to determine a set of objectives of financial reporting with a strong emphasis on accountability and usefulness of information for decision-making purposes. In 1986 the AICPA recognized the GASB's authority to set generally accepted accounting principles (GAAP) for state and local governments in the United States. The GASB explored the possibility of incorporating non-financial measures of service efforts and accomplishments (SEA) in financial reports. But it retreated after encountering opposition from finance officers. From 1984 to 2007, the GASB has promulgated almost fifty standards of varying breadth and depth on diverse topics. In general, these standards urged state and local governments to adopt the accrual basis to a fuller extent and to produce government-wide financial statements. However, mindful of the importance of legal and budgetary compliance, the GASB still requires fund financial statements.

As we complete this review of efforts to improve state and local government accounting, it is worth recalling that the "perfect balance sheet" was the quest of government accountants one hundred years ago. Throughtout the 20th century, financial integrity, sound financial management, and accountability and transparency have guided government accounting reforms. Similar reform efforts also occurred in accounting for the Federal Government, which had unique institutional and conceptual issues to resolve. These are described in the next section.

FEDERAL GOVERNMENT ACCOUNTING REFORM

Under the constitutional principle of separation of powers, and checks and balances, the Congress of the United States has almost unlimited power to demand virtually any information it deems necessary from the executive branch. Furthermore, it is possible for the President to face the opposition party with a majority of seats in either or both houses of Congress. Political parties have strong incentive to be critical of each other. Furthermore, as explained in Chapter 1, the American political culture is characterized by the people's distrust of government and pitting political ambitions against each other. In the financial area, Congress' ultimate control of the Federal Government's purse strings gives Congress considerable leverage to demand information in exchange for appropriations. Congress has always seen financial control— and therefore accounting and auditing— as an extension of its appropriation power and a part of its oversight function. For over one hundred years, Congress was reluctant to cede its financial control authority to the executive branch. This posture has kept the executive branch in a submissive role until the beginning of the 20th century. This account of the development of Federal Government accounting began in the first two decades of the 20th century when the Federal Government began to build a strong administrative structure. The story is dominated by the competition for institutional power, although there are substantive conceptual issues as well.

Exhibit 3.2

Milestones in Federal Government Accounting

1921	Budget and Accounting Act creates the Bureau of the Budget and General Accounting Office (GAO)
1937	The Brownlow Committee calls for separation of the GAO's accounting and auditing functions.
1950	Hoover Commission advocates accrual accounting.

1975	Arthur Andersen & Co. proposes consolidated financial statements on the accrual basis for the federal government.
1976	Treasury Department begins issuing annual prototype government-wide financial statements on the accrual basis.
1984	GAO requires audited agency statements on the accrual basis.
1986	Comptroller General endorses accruals and consolidated reporting.
1990	Chief Financial Officers Act requires audited agency-wide financial statements.
1991	Federal Accounting Standards Advisory Board (FASAB) is established.
1998	GAO begins auditing government-wide financial statements on the accrual basis.
2003	AICPA recognizes FASAB standards as GAAP after FASAB's restructuring.

Institutional Issues

The Constitution of the United States states: "No money shall be drawn from the Treasury, but in consequence of Appropriations made by Law, and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time." This constitutional mandate effectively makes Congress the first among equals in financial matters among the three branches of government.. In the same year 1789 when the Constitutional was ratified, Congress passed the Treasury Act, which established an auditor and comptroller in the Treasury Department, and required the Treasury to submit an annual report to the Congress. In the second half of the 19^{th} century, Congress tried several times to prevent illegal and excessive spending by requiring the quarterly apportionment of annual appropriations and reporting of budget execution. In 1894, Congress passed the Dockery Act to further require the Treasury Department to submit to Congress annual combined statements of receipts and expenditures. Even now, the Treasury fulfills its reporting obligations by issuing an Annual Report of cash flows and balances as the official financial report of the U.S. Government.

During the Progressive Era, the reformers advanced the idea of an executive budget system. Under such a system, the chief executive would prepare the government's budget; the legislature would then examine and act on it, followed by implementation by the executive. This proposal appealed to President William Howard Taft so much that he appointed Frederick Cleveland, the pioneer of financial reform in New York City, to head a Commission on Economy and Efficiency. In due course, the commission produced a report recommending that the President of the United States be given the authority to prepare and present the Federal Government's budget for consideration by Congress. After almost ten years of political maneuvering and debates about the constitutionality of certain provisions, the Budget and Accounting Act was passed and signed into law in 1921.

The 1921 Budget and Accounting Act created the Bureau of the Budget (BOB) and the General Accounting Office (GAO). In order to ensure the GAO's independence from the executive departments, the Comptroller General of the United States, head of the GAO, was given a fifteen-year term and could be removed only by a joint resolution by the Senate and the House of Representatives. The 1921 Act in effect required the Comptroller General to be the chief accountant and chief auditor at the same time. As the chief accountant, he was authorized to prescribe the accounting forms, and set up systems and procedures for executive branch agencies. As chief auditor, he was empowered to examine the books of executive departments, as well as determine what constituted legitimate claims against the United States. This combination of the accounting and auditing functions in one office continued to be a contentious issue over the next seventy years.

The executive branch's perspective on this issue was articulated by the President's Committee on Administrative Management (the Brownlow Committee) during President Franklin D. Roosevelt's Administration, and reiterated by the Hoover Commissions in the next two decades. The Brownlow Committee in 1937 called for a stronger Bureau of the Budget to help the president and centralize fiscal management. It recognized that effective fiscal management required a good accounting system to control spending. Since it is the duty of the President to faithfully execute the law—including appropriations laws—the committee reasoned that accounting was also an executive function. The committee therefore advocated separating the GAO's accounting and audit functions. Specifically, it recommended that "the authority to prescribe and supervise accounting systems, forms and procedures in the Federal establishments should be transferred to and vested in the Secretary of the Treasury." This would limit the GAO to performing the post-audit function after the executive branch had completed its tasks.

The Congressional perspective has been quite different. Even before the Budget and Accounting Act in 1921, the Dockery-Cockrell Commission in the 1890s had reiterated the Congress's preeminent role in the financial management of the federal government. The commission based its position on the U.S. Constitution, which grants Congress the authority to approve spending and levy taxes. The Brownlow Committee's assertion of accounting as an exclusive executive function was not acceptable to Congress. Congress viewed accounting policies and procedure as an extension of the Congressional budgeting function and an expression of legislative oversight. Understandably, the executive would view this involvement as Congressional micro-management of the government's fiscal affairs. The competing claims of authority led to numerous clashes over a fifty-year period. (In the author's opinion, perhaps there would be less confusion if the General Accounting Office were named the General Auditing Office. In any event, the GAO was renamed the Government Accountability Office in 2004.)

It seemed futile for either the executive or the legislative branch to claim *exclusive* jurisdiction over accounting standard setting, because accounting is inseparable from budgeting and auditing. A good accounting system supports budget execution, as well as providing factual data as audit trails. Such a position between budgeting and auditing inevitably subjects accounting was subject to the tug-of-war between the administration and Congress.

The turf war was detrimental to efforts to improve financial management in the federal government. In any event, after the Federal Government's expenditures greatly expanded and its operations spread to many parts of the world during and after World II, the GAO found it impossible to audit all the vouchers on a timely basis. In 1947 the Comptroller General, the Treasury Secretary and the director of the Bureau of the Budget agreed to cooperate in a joint program to improve federal accounting. The GAO agreed to limit its role to developing standards and guidance and providing expert assistance, leaving the operation of accounting systems to the agencies. In the 1960a, Comptroller General Elmer B. Staats reinvigorated the program and broadened its scope to financial management. The Joint Financial Management Improvement Program (JFMIP) in 1991 became the institutional vehicle for the principals of the JFMIP to co-sponsor the Federal Accounting Standards Advisory Board (FASAB).

It would be simplistic to view the inter-agency conflicts as only bureaucratic rivalry. Actually the constitutional principle of separation of powers, and checks and balances, was at stake. Both Congress and the Administration recognized the importance of accounting as a tool of managing and control the financial operations of the Federal Government. They were also concerned with how the financial picture of the government would be portrayed. Therefore there were disputes over substantive conceptual issues as well.

Conceptual Issues

From the earliest years of the Federal Government, the Treasury Department has been keeping track of the government's cash balances, receipts, and disbursements. The accounting system also monitored budget execution in compliance with the Anti-Deficiency Act, which prohibited spending and contractual obligations in excess of appropriations. Questions arose as to whether Federal accounting should go beyond these basic cash and budget execution monitoring functions.

The first Hoover Commission in 1949 and the second Hoover Commission in 1956 both recommended that the Federal Government use accrual accounting. Indeed accrual accounting was required by legislation passed in 1956, but the law was not effectively implemented. The President's Commission on Budget Concepts in 1967 also supported accrual accounting. The debate over this seemingly technical issue became public when in 1975 Arthur Andersen & Co., a major accounting firm, studied the accounting practices of the U.S. Government and published the first consolidated financial statements *for* the Federal Government based on the firm's interpretation of the accrual basis. The Secretary of the Treasury was sufficiently intrigued that he named an advisory committee to follow-up on Arthur Andersen's recommendations. The committee developed a guide and for the next two decades the Treasury Department annually refined and published unaudited *prototype* consolidated financial statements. Concurrently, Treasury continued to publish its Annual Reports on the cash basis as the official financial reports of the U.S. Government.

The Treasury's accrual and consolidation experimentation received considerable encouragement from the General Accounting Office, which influenced Federal agency accounting through Title 2 of the *GAO Policy and Procedure Manual for Guidance of Federal Agencies*. In 1984, the GAO revised Title 2 to require Federal agencies to require the preparation of agency-wide consolidated financial statements using the accrual basis of accounting. Concurrently, the GAO undertook a joint study with the Office of the Auditor General of Canada on federal government reporting. The study concluded that this new method of accounting and reporting was feasible and would better meet user needs. Furthermore, in 1985, Comptroller General Charles A. Bowsher, who had been a partner of Arthur Andersen & Co., issued a major document entitled *Managing the Cost of Government: Building an Effective Financial Management Structure*. The document justified the need to change Title 2 by pointing out many problem areas in the Federal Government: poor quality of financial management information; poor linkages between the phases of the financial management process; inadequate attention paid to monitoring and comparing budgeted activities with actual results; primary emphasis on fund control; inadequate disclosure of assets, costs, and liabilities; and antiquated and fragmented financial management systems. In order to address these problems, the Comptroller General proposed the integration of budgeting, accounting, and auditing.

The Comptroller General argued for consolidated financial reporting by drawing a parallel with the unified Federal budget, which provided a single deficit or surplus number to focus public attention on the effects of the Federal Government as a whole on the economy. The accrual basis would result in a more meaningful balance sheet by disclosing the cumulative financial effects of past decisions. Furthermore, the accrual method would attribute cost of service to the period of service delivery, thus reducing inter-period distortion.

In 1986, Arthur Andersen & Co. supported the GAO's stance. Referring to the rapidly rising Federal budget deficits at the time, the firm advocated using the accrual basis in Federal budgeting as well. It also challenged the Federal government not to exempt itself from generally accepted accounting principles. Clearly the forces in favor of accrual accounting and consolidated reporting were gathering strength.

Budget officials resented what they considered an encroachment of accountants and auditors in their sphere of authority and competence. One Office of Management and Budget (OMB) director regarded accrual accounting as a "bottomless pit." Another ridiculed the idea of applying business accounting to the Federal government as "Alice in Wonderland nonsense, not remotely possible or useful" (Chan, 1995, p. 34).

The position of Federal budget officials may be summarized as follows. First, they believed that accountants should play a complementary and supportive role to budget officials. It was presumptuous for accounting rules to challenge budgeting rules. Second, generally accepted accounting principles have been developed primarily for business enterprises, whose objectives and operations are different from the Federal Government in many ways. Third, the Federal Government is unique. It has the sovereign power to print money, and has many unique resources as well unique responsibilities.The ultimate criterion for judging the Federal Government's performance often is not financial in nature; even economic considerations were sometimes overridden by political and social concerns. It was doubtful that a body of principles developed to account for commercial transactions could accommodate the uniqueness of the Federal Government.

In summary, by the 1980s the institutional conflicts and conceptual arguments that had been brewing for decades came to a boiling point. Fortunately, by the end of that decade the director of the OMB, the Treasury secretary, and the Comptroller General became sufficiently concerned with the dysfunctional consequences of a continued stalemate. After considerable negotiations, they reached an agreement to jointly sponsor an advisory board to work on these issues.

Resolution of the Issues

In 1990, Congress passed the Chief Financial Officers (CFO) Act to authorize the appointment of a CFO for the entire Federal Government and additional CFOs for Federal agencies, and to require Federal agencies to prepare and issue audited financial statements. The need for a set of Federal accounting and financial reporting standards prompted the three principal Federal fiscal officials mentioned above to suspend their claims of exclusive authority to set those standards. They agreed to jointly sponsor the Federal Accounting Standards Advisory Board (FASAB) through the Joint Financial Management Improvement Program (JFMIP). The word "advisory" was included in the board's name to signify the retention of legal authority by the board's sponsors, whose approval would be required before the board's standards became effective. FASAB's central mission was to facilitate the production of "complete, reliable, timely and consistent financial information for use by the executive branch of Government and the Congress in the financing, management, and evaluation of Federal programs" required by the CFO Act.

The membership of the new board was carefully calibrated to balance the interests of its stakeholders: its sponsors, Federal agencies, and users of federal financial statements. The Treasury Department, OMB and GAO, along with the Congressional Budget Office (CBO), each had a representative on the board. Two other federal members represent civilian and defense agencies, respectively. There were three public members as well. In 2003, in order to persuade the AICPA to designate the FASAB as a promulgator of GAAP, the board was restructured and given greater autonomy. There are now only four Federal government representatives from the sponsoring agencies and the CBO, and public members occupy the other six seats. Furthermore the board's standards would become effective without the sponsors' approval, but are still subject to their veto. To date (October 2006), the FASAB has issued 30 standards.

SUMMARY AND CONCLUSION

From a historical perspective, the current emphasis by American government accounting standard setting bodies on external reporting is the latest evolution of the changing goals of government accounting. Fighting corruption through good financial record-keeping was an early basic function of government accounting. Once this goal was largely achieved, government accounting took on the more ambitious function of supporting systematic and efficient financial management. After the second goal was achieved, the new goal became comprehensive financial reporting to demonstrate and discharge the government's fiscal accountability.

American government at all levels has had one hundred years' experience in improving government accounting. Judging from the Metz Fund's recommendations, American government accounting already had highly developed theoretical knowledge in the early years of the 20th century. Viewed in this way, the progress of American government accounting in the past one hundred years has been quite modest. The lesson here is that technical knowledge is a necessary but insufficient condition of progress. It takes the demand for accountability to trigger the utilization of that knowledge.

The American experience shows that financial accounting standards can fully develop only if it is freed from the constraints of finance-related laws and regulations. This is slightly disconcerting in light of the respect for the rule of law mentioned in Chapter 1. Unfortunately, legislators and budget authorities define public finance rules for their own purposes, and accountants are not in a position to disobey or overturn those rules and regulations. Thus both the GASB and FASAB made a strategic decision to carve out a niche for their activities. They have chosen to limited their standard-setting activities to financial accounting and reporting in general, and to focus on the form and contents of general purpose financial reporting to external users. This approach has enabled government accountants to be both law-abiding civil servants and GAAP-observing professionals.

Another conflict avoidance mechanism is to stay within one's jurisdiction. Because of the federal system in the United States, the states would not let the Federal Government set accounting standards for them, and it is inconceivable that the Federal Government would let the states tell it how to account. The peaceful co-existence between the Federal Accounting Standards Advisory Board and the Governmental Accounting Standards Board, while comforting in some ways, means that probably there will never be truly generally accepted American government accounting principles. However, it is encouraging that given their different development paths, the GASB and the FASAB have converged on a largely similar model. In the next chapter, we will find out how they have done so.

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