

American Govt. Accounting: Environment, Theory, and History

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Issues to Address

- Who is accountable to whom? -- The main features of the American political and economic system
- Who can have access to govt. financial information? -- The stakeholder theory of government accounting based on H. Simon's organization theory
- What is government accounting for? -- Four waves of reforming American government accounting during past 100 years

Primary Background Readings

- *J. Chan, American Government Accounting Standards:*
 - * Chapter 2 “The American Political and Economic Environment...”
 - ** Chapter 2 “... and Government Accounting Theory Development”
 - *** Chapter 3 “The History of American Government Reform”

THE POLITICAL AND GOVERNMENT SYSTEM

Levels of Government

- The [Constitution of the United States](#) (1789) provides for a [federal system](#) of government.
- The Federal Government or United States Government
- The 50 States and 87,000+ local governments subject to [State oversight](#), and the capital city of Washington, D.C.

Nature of Political System

- A republic
- A **democracy**
 - Mostly **representative democracy**
 - Some direct democracy at the local level
- **Presidential system** (vs. cabinet system)
- **Separation of powers, checks and balances**
- **Three branches of government:** legislative, executive and judiciary

Federal System

- The federal government has only powers expressly granted by the U.S. Constitution.
- Each State has its own fiscal system: taxation, budgeting, accounting, and auditing.
- Each state supervises its local governments, including fiscal affairs.

Government and Law

- Rule of Law and Rule by Law
 - The Constitution
 - Statutes
 - Court opinions
- Separation of powers, checks and balances
 - Legislature: makes law
 - Executive: faithfully executes law
 - Judiciary: enforces law

Legislature

- Organization: Bi-cameral (two chambers) or unicameral (one chamber).
- Membership: elected officials.
- Political parties: majority and minority.
- Operations: committees do most deliberations.
- Decision rule: decision by majority vote.
- Finality: presidential veto, judicial review.
- Of particular interest: **power of the purse** and **legislative oversight**

Executive Branch

- Headed by elected officials.
- Elected officials appoint heads of executive units.
- Bureaucracy organized as a **hierarchy**.
- “**Administrative**” vs. “**management**”

Judiciary

- Separation of federal and state jurisdictions.
- Judiciary: the courts, and not the prosecutors.
- Independent of the courts: life-tenure of judges in many cases; some judges are elected, others appointed by the executive subject to legislative confirmation.
- Function: interprets the law (“**judicial review**”) and renders decisions in law suites.

The Founding Spirit of the USA Shared By All

- The political philosophy of [Montesquieu](#) (France) and [Locke](#) (England)
 - Limited government: constitutional democracy.
 - Federalism.
 - Separation of powers; checks and balances.
- The political economy of [Adam Smith](#) (England)
 - Respect for private property.
 - Voluntary market exchange.
 - Laissez faire.

Two Competing Philosophies 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

Power in “Good Government”

Hamilton

- “Energy in the executive is a leading character in the definition of good government.”

Jefferson

- “It is not by the consolidation or concentration of power, but by their distribution, that good government is effected.”

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.” (1821)

THE PUBLIC SECTOR IN THE AMERICAN ECONOMY

Fiscal Federalism

Nature of Economic System

- GDP as measure of size of the economy
- Mixed economy
 - 70% private-sector, market economy
 - 30% public sector
- Public sector
 - 70% federal
 - 30% state and local

Federal Role in Public Sector

- Federal Govt. has its own **fiscal system**: tax, spending, borrowing, fiscal administration
- The Federal Govt. has preempted the most resourceful tax source: individual and corporate income
- Unique Federal function: national defense and foreign policy; social welfare; macroeconomic functions
- Federal grants to State and local governments mostly to carry out national objectives

Federal Government Finance

- Chronic annual **Federal budget deficits** (in cash) in most of the last forty years and will likely continue
- Reasons include: global role, cost of Iraq war, domestic entitlement spending
- Unique position of the U.S.: only superpower with U.S. dollar as common reserve currency, position challenged by Europe and China

State and Local Government

- 50 States and a few other jurisdictions
- **States** create and oversees local governments in their jurisdictions;
- 87,000 **local governments**
 - **General purpose govts**, e.g. municipalities, counties
 - **Special purpose govts**, e.g. school districts
 - District of Columbia (Washington, D.C.), and recognized Indian tribal govts.

State and Local Govt. Finances

- Mostly responsible for education, health, fire and police, and other **governmental activities**, financed by diverse tax sources, mainly property, sales taxes, income taxes
- Many **business-type activities** charging fees for services
- Separate **operating budget** and **capital budget**, with capital budget financed mainly by borrowing from the **capital market**

Summary

- Refer to Exhibit 2.7 in Chapter 2 of Chan's *American Govt. Accounting Standards*
- Examples of “who produces what public service”
- Key concepts:
 - **Public goods**, quasi-public goods, private goods
 - Related financing sources: general and special **taxes**, general and special **grants**, fees

A THEORY OF GOVERNMENT ACCOUNTING

At the Level of
Individual Governments

Searching for a Useful Theory of Government

- Criterion: useful for developing a theory of government accounting
- Such a theory must address:
 - The non-market activities of govt., namely taxation and public goods
 - The dispersed decision-making authority of many democratic governments
 - The supply of and demand for information

Preliminary Attempts

- Public sector version of the **theory of the firm** does not meet the requirement: focus on ownership interest, no govt. counterpart
- Government as a **system** and as part of **political and economic markets** (Exh. 2.8 and 2.9) – in the right direction but too general

Stakeholder Theory Based on Simon's Theory of Organization

- An organization is a **coalition of stakeholders**
- **Stakeholders** acquire interests in the survival of the org. because of contributions
- Management provides **inducements (I)** to obtain **contributions (C)** from stakeholders
- Management seeks **org. equilibrium**: I/C is the same for all stakeholders
- Management is itself a stakeholder group: **internal stakeholders**

Elaboration of Stakeholder Theory of Government

- Exh. 2-10: Stakeholders' Contributions and Inducements
- Exh. 2-11: Interactions Among Stakeholders of Government
- “Management” in a representative democracy consists of voters, elected officials, and appointed officials

The Functions of the Government Executive

- Achieving 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 <small>Chan, Cagliari 2008 Seminar 2</small>	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

Potential Users of Govt. Financial Information

- Primary reference: Research study for the National Council on Govt. Accounting (NCGA) by Drebin, Chan and Ferguson (1981)
- Why “potential” users? – based on normative theory of accountability of the **right to know** and **need to know**. See Exh. 2-11
- Actual users have decided benefits are greater than cost in “**using**” government financial information

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?

REFORMING AMERICAN GOVT. ACCOUNTING

State And Local Governments

Accounting and Reporting Reform Agenda

- First Wave: Clean Government
- Second Wave: Efficient Government
- Third Wave: Transparent Government
- Fourth Wave: Communicative Govt.
- Keep good financial records
- Support budgeting control and management
- Provide comprehensive financial reports
- Provide comprehensible financial information

First Wave: The Environment

- Time Period: The Progressive Era from circa 1890 to early 1920s
- Environment:
 - Industrialization and expansion.
 - Influx of immigrants.
 - Urbanization.
 - Great demand for government services.

Business and Professional Involvement

- Business community:
 - Concern: government services and corruption would lead to higher taxes.
 - Mentality: make government more business like.
- Chicago:
 - Commercial Club hired Haskins & Sells to study and propose improvements
- New York:
 - Businessman Metz elected city comptroller.
 - New York Bureau of Municipal Research created.
 - Intellectual leader: Frederick A. Cleveland.

Business Methods and Uniform Accounting

- National Municipal League created a Committee on Uniform Accounting Methods.
- Intellectual Legacy:
 - National Municipal League: Model municipal accounting practices.
 - Metz Fund: *Handbook of City Business Methods*.

Core Accounting Recommendations

- Adapt business accounting model to government (more later).
- Focus on government as a going concern.
- Pay attention to the balance sheet.
- Use the accrual basis of accounting.
- Measure costs.
- Adopt double-entry bookkeeping.

Adapt Business Accounting to Government

- Use fund (a pool of resources) accounting:
 - separate current funds and capital funds.
 - create sinking fund and trust funds.
- Add budgetary accounting:
 - record estimated revenues and appropriations in the accounts.
 - record obligations chargeable to appropriations.

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)

Second Wave: Environment

- Time Period: From the New Deal (1930s) to Great Society (1960s).
- Environment:
 - Great expansion of government functions, programs, bureaucracy and expenditures.
 - Power and resources shifted to Washington.
 - Active fiscal policy for macroeconomic goals.
 - Need for sound financial management.

Codification of National Norms for Professional Practice

- Municipal Finance Officers Association in 1934 created a National Committee on Municipal Accounting.
- Coalition of 9 organizations (more later).
- Legacy: “Principles of Municipal Accounting” endorsed by MFOA as “Standard Practices in Municipal Accounting and Financial Procedures”.

Major Players: Public Finance Professional Specialties

- Government Finance Officers
 - budget directors and analysts.
 - accountants (comptrollers)
 - Treasurers
 - Auditors
- Monitors of Government Finance
 - Bond rating agencies and insurers
 - Underwriters and investors

1934 NCMA Principles

- NCMA = National Committee on Municipal Accounting
- **Consistent terminology** and account structure to link budgeting, accounting and financial statements.
- Budget accounts and encumbrance recording.
- Double-entry system.
- **General ledger** supported by **subsidiary ledgers**.

More NCMA Principles

- Fund structure: general, special revenue, working capital, special assessment, bond, sinking, trust and agency, and utility.
- Accrual basis of accounting, but no depreciation on general fixed assets.
- **Chart of accounts** for assets, liabilities, revenues and expenditures.

NCMA Became NCGA in 1966

- State government representatives added.
- Significance of States' participation:
 - States create and oversee their local govts.
 - NASACT (National Association of State Auditors, Comptrollers and Treasurers) could have set up a competing standards committee.
- Legacy: 1968 *Governmental Accounting, Auditing and Financial Reporting (CAFR)*

1968 GAAFR Provisions

- Status: generally accepted accounting principles (GAAP) applicable to governmental units; **in case of conflict, legal provisions take precedence over GAAP.**
- Required governments to adopt an annual budget.
- **Accounting to provide budgetary control.**
- **Comprehensive Annual Financial Report.**

More GAAFR Provisions

- **System capacity** for producing reports to
 - demonstrate legal compliance.
 - fair present financial position & performance.
- Fund structure retained w/ modification.
- **Accrual basis modified** for governmental funds to track current financial resources.
- **Account groups** for general fixed assets and general long-term liabilities.

Third Wave: Accountability Through Transparency

- From mid-1970s to 1983 National Council on Governmental Accounting (NCGA).
- 1984 to present: Governmental Accounting Standards Board (GASB).

NCGA Phase

- Environment:
 - Major municipal financial crises, e.g. New York and Chicago.
 - Critical role of financial markets and bond rating agencies.
 - State oversight strengthened.
 - Federal concern about local financial management capacity.

NCGA's Response

- Broadened membership and became a “council”.
- Short-term response: restated 1968 *GAAFR* to emphasize GAAP over law (NCGA Statement No. 1)
- Long-term strategy: research on conceptual framework leading to overhaul of standards.

NCGA Statement No. 1

- Legal provisions to govern special-purpose financial reports; **GAAP to determine general-purpose financial reports.**
- **General-purpose financial reports** to be liftable from CAFR and separately issued.
- **Financial reporting pyramid:**
 - Overview statements by **fund type.**
 - Statements for individual funds in a fund type.

More on NCGA Statement No. 1

- Full accrual basis for non-expendable funds and modified accrual for expendable funds.
- Account groups retained.
- Financial reports include: balance sheet, operating statements, cash flows (for expendable funds), **budget comparisons** (for funds w/ legally adopted budgets).

NCGA Research Study: User Needs and Objectives

- Identification of actual and potential users of a government's financial information:
 - right to know – accountability.
 - need to know - decision-making.
- Objectives of accounting and reporting:
 - info. useful for decision making.
 - info. useful for demonstrating accountability.
 - info. useful for performance evaluation.

GASB Phase

- Governmental Accounting Standards Board (GASB):
 - Under auspices of enlarged Financial Accounting Foundation, sister board to the FASB.
 - Five then seven members, mostly part-time.
 - Full-time research staff.
 - Large and diverse advisory council.
 - Standards gained GAAP status from AICPA in 1986.

GASB's Direction

- Focus on general-purpose financial reports, excluding cost accounting, budgeting, auditing.
- Accountability and decision usefulness as objectives.
- Three major users groups:
 - the public as voters and taxpayers.
 - legislatures and oversight bodies.
 - investors and creditors.

An Attempt at Greater Accrual

- **Governmental funds**
 - monitor flow of current financial resources.
 - exclude general long-term liabilities.
- **Statement 11 (1990) on operating statement of governmental funds:**
 - recognize revenues when legally enforceable.
 - recognize operating debt: service costs deferred to future.

Statement 11 Thwarted

- Balance sheet implications of operating debt:
 - Distinct from capital debt.
 - For services given, but no assets created.
 - $\text{Assets} = \text{Liabilities} + \text{Net Assets}$.
 - More liabilities; worse net financial position.
- Statement 11 indefinitely postponed.

Lessons from Statement 11

- Changing the operating statement would disturb the balance sheet because these statements are articulated.
- Narrow agenda item and piecemeal standard setting had unintended consequences.
- Stakeholders (e.g. governments affected) formed expectations about impact of standards, and reacted rationally.

The Impact of Statement 11 on Future GASB Standards

- Realized the whole $>$ the sum of the parts.
- Required almost ten years to require a new reporting model (Statement 34).
- **Basic dilemma: GASB was torn between:**
 - fund-based reporting oriented to legal compliance and budgetary control.
 - government-wide reports oriented to holistic appreciation.

GASB Statement No. 34

- Importance of educating users: requires Management's Discussion and Analysis
- Basic Financial Statements: both
 - Government-wide financial statements under the accrual basis, and
 - Fund-based financial statements under full or modified accrual depending on nature of funds;
 - Reconciliation.

Likely Consequences of GASB Statement No. 34

- Greater information overload and higher compliance costs.
- Historical costs and depreciation expense of general fixed assets of dubious value.
- Greater divergence between financial reports and budget presentations.
- Uncertainty about better decisions and greater accountability.

State and Local Government Accounting: A Summary

Traditional Model

- Financial statements organized by funds and fund types.
- Emphasis on operating statement and fund balance.
- Matching expenditures with revenues.

New Model

- Basic fin. statements:
 - Government-wide.
 - Major funds.
- Emphasis on balance sheet and net assets.
- Matching program revenues against expenses.

State and Local Government

Traditional Model

- Full accrual basis for enterprise funds.
- Accrual basis modified for governmental funds
- Govt-wide fixed assets and long-term debt in “account groups”.

New Model

- Full accrual basis for govt.-wide reports
- Accrual basis modified for governmental funds
- Govt-wide fixed assets and long-term debt in balance sheets & notes

State and Local Government

Traditional Model

- Budget and actual comparisons.
- No requirement for Management Discussion and Analysis (MD&A).

New Model

- Same; original budget to be disclosed
- MD&A as “required supplementary info.”

4th Wave of Reform: Communicative Government

- Too much data, too little information
- Not available on demand
- Not targeted to personal needs
- Too hard to understand
- Different numbers from the budget and accounts

Examples of Experimentation

- GASB No. 34 requires Management Discussion & Analysis, and some governments produce “popular reports”
- Many governments put CAFR on the Internet
- GASB produces “plain English” versions of its standards, and a guide to analysts.
- GFOA produces pamphlets for elected officials

Federal Government

Key Issue: Who Should Set Federal Accounting Standards?

- Executive Branch:
 - Department of the Treasury (1789).
 - Office of Management and Budget (1921).
- Legislative Branch:
 - General Accounting Office (1921) - headed by the Comptroller [Auditor] General of the United States.

Constitutional and Legal Framework

- U.S. Constitution requires Congressional appropriations before Treasury spending, and period financial reports by Treasury.
- 1789 Treasury Act created an auditor and comptroller and required an annual report
- 1894 Dockery Act required annual combined statements of receipts and expenditures

Early Institutional Mechanism and Controversy

- Extensive legislative involvement in financial management.
- 1921 Budget and Accounting Act:
 - Created the Bureau of the Budget, and the GAO headed by the Comptroller General.
 - Required the Comptroller General to
 - prescribe budgetary and fund accounting rules;
 - audit the accounts.
- 1937 Brownlow Committee:
 - Accounting is an executive function.
 - Separate accounting from the auditing function.

From Exclusive to Shared Power

- Basic Institutional Issue:
 - Accounting as extension of budgeting and a means of legislative oversight?
 - A conflict of interest for the auditor to set the rules for what is to be audited.
- Resolution: cooperation
 - Joint Financial Management Improvement Program (started in 1947 and revived in the 1960s).

Conceptual Issue: Cash or Accrual Basis

- **Cash Basis:**
 - Constitutional requirements of reporting receipts and expenditures.
 - Used in Annual Report of the Treasury.
- **Accrual Basis Recommended:**
 - The Hoover Commissions (1949, 1956)
 - Arthur Andersen & Co. (1970's through 1980s)

Basic Issues Sharpened

- Entity: Consolidated financial statements.
- Measurement Rule: the accrual basis of accounting.

The GAO's 1985 Recommendations

- Allocate resource within a unified budget.
- Budget and account on the same basis.
- Determine the cost of services.
- Match accomplishments with costs.
- Measure outputs and inputs.
- Prepare consolidated reports.

From Accounting to Reporting

- 1950 Budgeting and Accounting Procedures Act authorized the GAO to set accounting standards.
- GAO used Title 2 of its Policy and Procedure Manual for Guidance to Federal Agencies to make accounting requirements
- 1985 GAO required federal agencies to prepare **agency-wide (consolidated) financial statements under the accrual basis.**
- GAO requirement was controversial and non-compliance became a visible issue.

The Federal Government's Unique Accounting Problems

- Many unique assets: federal lands and weapon systems.
- Blurred distinction between financial liabilities and macroeconomic and social welfare responsibilities.
- Federal budget community's view of accounting:
 - Accounting should follow budget rules.
 - Accrual accounting has a business bias and is not applicable to federal government.

Breakthrough:

The 1990 CFO Act

- Immediate impetus: agency financial management scandals and problems.
- Requirements:
 - Govt-wide and agency chief financial officers.
 - Financial management office in OMB.
 - Agency audited financial statements.
 - Using applicable accounting standards

Accounting Standard-setting Mechanism

- Treasury Secretary, OMB Director, and Comptroller General retain authority.
- Federal Accounting Standards Advisory Board (FASAB) created under JFMIP to recommend standards.
- Upon joint approval by JFMIP Principals, agency follow FASAB standards.
- FASAB standards recently recognized as GAAP by the AICPA after FASAB restructuring for greater independence.

Purpose of Federal Financial Reporting: To Help Users

- Evaluate government's accountability and budgetary integrity.
- Assess government performance.
- Determine change in government financial position and effect on the nation.
- Assess adequacy of systems and control.

Federal Government Accounting: A Summary

Traditional Model

- Budget accounts.
- Cash basis.
- Current financial resources; short-term liabilities, notes and bonds.
- None.

New Model

- Agency, govt.-wide
- Accrual basis.
- All economic resources; short and long term liabilities.
- Disclosure of heritage assets and social insurance liabilities.

Federal Government

Traditional Model

- Brief financial overview
- Liquidity position
- No budget reconciliation

New Model

- Comprehensive “management discussion and analysis”.
- Cost of service borne by taxpayers.
- Budget reconciliation.

Summary of Federal Financial Reform

- 1st wave during the Progressive Era: executive budgeting and congressional audit
- 2nd wave from the 1920s to present: accounting in support of budget execution
- 3rd wave from 1970s to present: shift of emphasis to external reporting with consolidated financial statements on an accrual basis
- 4th wave started recently: concern about lack of public understanding of the inability of the Fed. Govt. to sustain public pension and health programs

Examples of Reaching Out to the People

- The AICPA's 360-degree financial literacy project
- The Concord Coalition of Fiscal Wake-up Tour
- Citizen's Guides to the budget, to financial report, to cash and accrual deficits ...

CONCLUSION

- The political environment produces demand and the economic environment produces incentives for govt. financial information.
- The stakeholder theory is useful for developing a theory of government accounting.
- Successive government accounting reforms have built on earlier ones emphasizing financial integrity, financial management, financial transparency and now financial literacy.

Toward a *American Model of Government Accounting*

- Discharging the government's public accountability through financial reports.
- “Management Discussion and Analysis”.
- Government-wide financial statements.
- Comparison with the budget.
- Disclosure of long-term debts and long-lived assets through accrual accounting.

American Government Accounting: Current Practice

- 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 for external users.
- GAAP for governments are set by boards with a degree of independence, and are enforced by independent auditors.

A Scorecard of Accomplishments and Challenges (2008)

Good News

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

Bad News

- Internal dissention and external pressure
- More standards to come
- GAO disclaimers for 11 years
- So much data, how much information?

The 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)