

# American Government Financial Condition and Accounting

James L. Chan

Professor Emeritus of Accounting  
University of Illinois at Chicago, USA  
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# Perspectives on Government Financial Condition

Public finance / budgeting

Vs. Financial accounting

# Personal Scoring of “Chimerican” Fiscal Policy and Administration

## Fiscal Policy

- U.S.: F
- China: A –

Based on

- Short and long-term deficit and debt
- Effects on economic growth, inflation and employment, income & wealth distribution

## Fiscal Administration

- U.S.: A -
- China: ?

Based on

- Rule of law and rule by law
- Integration/corruption
- Functioning of financial infrastructure
- Public access to info.

# Information for Rational Financial Management

- Planning
- Performance
- Evaluation and Feedback
- Budget
- On-time (“Management”) Accounting
- Retrospective Accounting (“Financial Accounting” and reporting) and auditing

# At Any Point in Time...

- Retrospective financial accounting, reporting and auditing for the last fiscal year;
- Performance or executing the budget for the current fiscal year;
- Planning and budgeting for the next fiscal year and beyond.

# Balancing Timeliness and Reliability of Information

- As of early March, 2010, available fiscal information about the U.S. Government:
  - President's budget proposal for FY 2011
  - Implementation of budget as approved by Congress for FY 2010, and on-time budgetary accounting
  - Actual cash receipts, outlays and balance for FY 2009 ended 30<sup>th</sup> September, 2009
  - Accrual-basis financial statements for FY 2008 available, awaiting FY 2009 report.

# Perspectives on Measuring Financial Condition

## Budget

- Projected cash deficits = outlays – receipts
- Other measures, such as appropriations

## Accounting

- Actual cash deficit = outlays – receipts
- Actual accrual-basis deficit = expenses – revenues
- Potentially large discrepancy between cash and accrued deficit numbers: why?

# Three Basic Financial Statements Based on Accounting Data

- Statement of Cash Flows: from operations, financing and investment activities for Yr 2
- Statement of Operations: revenues and expenses → net annual results for Yr 2
- Statement of Financial Position:
  - assets - liabilities = net position, end of Yr 1
  - Net results of operations, for Yr 2
  - Net position, end of Yr



# Products of Typical Financial Accounting Systems of Firms

- As required by generally accepted accounting principles (GAAP);
- Called general purpose external financial statements;
- For investors and creditors of a business.
- *Question: Should governments also do the same?*

# Government Accounting and Business Accounting

# Arguments for Govt. Acctg. to Emulate Business Acctg.

- Separation of management accounting and financial accounting.
- Use of double-entry accounting system in organizing and recording financial information.
- Use of accrual basis of accounting

# Government Management Acctg. and Financial Acctg.?

- Future-oriented
- For planning and control of operations
- Managers as users of budget and cost info.
- Accounting rules set by management  
Data subject to internal audit
- Retrospective
- For assessing financial condition and performance
- Investors and creditors as users of information
- Accounting rules set by independent boards
- Data subject to external audit

# Government to Use Double-entry Financial Accounting System?

- An accounting entity apart from others.
- Can own property and be liable for debt.
- $\text{Assets} - \text{liabilities} = \text{owners' equity or OE}$  in the case of a business firm.
- Could government
  - Be an accounting (legal, economic) entity?
  - Own assets? Owe debt?
  - Have owner's equity? Who owns govt.?
- Government to produce the three basic financial statements? For whom? What for?

# Government to Use the Accrual Basis of Accounting?

- For a business, profit = revenues – expenses
- Revenue is earned by selling goods or providing services; expenses are assets used or liabilities increased in earning rev.
- Applicable to “private goods” sold by govt.
- How about “public goods” financed mainly by taxes?

# Govt. Accounting to Emulate Business Accounting?

- Strong Yes:
  - ABC (advanced British Commonwealth) countries
  - Int'l Public Sector Acctg (IPSAS) Board
- Qualified Yes: the case of the U.S.
  - Business accounting for govt. business-like activities and govt. business enterprises.
  - Selective good ideas from business acctg.

# Attractive Features of Business Accounting

- Focus on results: no service, no profit.
- Separation of debt and equity: borrowed money is not revenue.
- Debts include long-term and contingent liabilities.
- Beyond cash, assets include economic resources.
- Consolidated financial statements provide overview on an economic group of firms.



# Difficulties in Adopting/Adapting Business Acctg. to Govt.

- Technical difficulties in identification, recognition and financial measurement:
  - Indivisibility of public or collective goods
  - Infeasibility or reluctance to sell public goods to individual customers
  - Collective ownership of public property, such as natural resources, cultural/heritage assets

# Difficulties in Adopting/Adapting Business Acctg. to Govt.

- Resulting difficulty in
  - Measuring performance or results on the basis of service efforts and accomplishment (SEA), and therefore applying SEA-based accrual of revenue, expense and profit;
  - Transferring owner-centric theory of the firm to the public sector;
  - Interpreting “owners’ equity” and “profit” that are derived from economic theory of the firm.

# Budgeters and Accountants

- In American government, budgeters tend
  - To work in a budget office separate from the accounting department;
  - To be political appointees;
  - To be educated in political science, public administration, economics.

# Typical Budgeter Perspective

- Budget deficit/surplus is the single most indicator of govt. fiscal performance.
- Cash receipts and outlays are of cardinal important for normal govt. operations.
- Job 1 of budget control: monitor contractual obligations.
- Job 1 of accounting as tool of budget management: timely info. during the year.

# Budgeters and Accountants: Partnership or Rivalry?

- Budget concepts and scoring rules are independent of accounting concepts and rules.
- Accounting follows budget concepts and measurement rules.
- Budget concepts and rules used in year-end actual-to-budget comparison.
- Accounting concepts and measurement rules are independent of budget concepts and rules.
- Budgeting uses accounting concepts and measurement rules.

# Target of Reform?

## China

- Budget Accounting
  - Fiscal General Accounting
  - *Xingzheng danwei*  
行政单位  
(administrative unit) accounting
  - *Shiye danwei*  
事业单位 (public service institution) accounting

## Western Nations

- Government Accounting
  - ABC: sector-neutral approach (govt. acctg. to be like business acctg.)
  - Continental Europe: budget law-based approach.
  - American: a hybrid approach

# What Is Government Accounting?

The United States as  
as an Example

# Three Interpretations of Government Accounting

- Accounting *of* government
- Accounting *by* government
- Accounting *for* government



# Accounting *of* Government

- Official accounts assured by internal control.
- Government officials' acknowledgment of responsibility for validity and reliability:
  - Validity: conformity with accounting standards.
  - Reliability: numerical accuracy
- Public trust in the accounting numbers.
- Credibility enhanced by independent audit.
- Issue: What is the scope of “government”?

# Accounting *by* Government

- By government officials and finance staff – internal stakeholders (权益者) of govt. acctg.
- Issue: Who does what during the accounting process:
  - Setting acctg. & financial reporting standards,
  - Implementing standards (“accounting policy”),
  - Designing info. systems and software,
  - Operating information systems,
  - Preparing financial reports,
  - Auditing financial statements/reports.

# Accounting *for* Government

- Outsiders' involvement in a government's accounting.
- Issue: who are the external stakeholders of a government's accounting?
  - Creditors, bondholders, bond rating agencies;
  - Grantors, donors;
  - Professional accountants, auditors;
  - Other participants in the financial system;
  - Others?

# Conclusion

- Government accounting has become too important to be left to
  - The accountant, or
  - The government
- Importance of accounting according to Professor 杨时展:
  - 天下未乱计先乱
  - 天下欲治计先治

# Classification of Government Accounting

- Business accounting is divided into:
  - Management accounting (budgeting, cost analysis) – proprietary data
  - Financial accounting – external regulation
- Should government accounting also be similarly separated?
- Issues:
  - Who manages (管理, 治理) government?
  - Does government have “privacy rights” (隐私权) ?

# Budgeting and Accounting

- Fact-based accounting serves as a “reality check” for ever forward-looking budgeting.
- The budget serves as a benchmark for accounting as performance measurement and interim reporting for timely feedback:
  - Revenue to be collected,
  - Appropriations to be spent.
- Budgetary disclosure reduces the “newsworthiness” of year-end financial reports.
- Issue: What is the value-added of year-end reporting?

# Value-added of Financial Accounting

## Budget

- Cash receipts and outlay; revenues and expenditures
- Annual, discrete periods
- Parts of government
- Budget rules set by politicians & officials of a jurisdiction

## Financial Accounting

- Revenues & expenses, assets and liabilities
- Annual, cumulative
- Whole of government
- Acctg. rules: GAAP and jurisdictional laws and regulations

# GAAP and Jurisdictional Rules

- Financial Accounting Standards Board (FASB)
- [State and local] Governmental Acctg. Standards Board (GASB)
- Federal Acctg. Standards Advisory Board (FASAB)
- Rules of Securities and Exchange Commission (SEC)
- Finance laws of each of the 50 states, and municipal codes
- Finance laws of the Federal Govt.



# Financial Accounting, and Statistics

- Primary data generated by actual transactions & events
- Financial accounting standards
- Government with unclear boundaries
- Secondary data, relying on accounting data sources
- Government finance statistics, part of national economic accounts
- General government, public sector

# Financial Accounting, and Financial Statement Audit

- Financial statements are prepared on the basis of GAAP applicable to:
  - Business firms
  - Nonprofit organizations
  - State and local governments
  - Federal government
- American Institute of CPAs recognizes FASB, GASB, FASAB.
- CPAs use GAAP to judge fairness of presentation of external financial statements.
- Govt. auditors conduct other types of audits.

# Structure of Government Accounting Standards

GAAP

For Financial Accounting

# Ten Issue Areas

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

# Issue Areas (cont'd)

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

# Issue 1. Objectives and System Capability

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

# Principle 1: Objectives and Capability

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

# Issue 2:

## Relationship with Budgets

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



## Principle 2: Relationship with Budgets

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

# Issue 3:

## Accounting and Reporting Entity

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

# Principle 3:

## Accounting and Reporting Entity

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

# Issue 4:

## System Architecture

- Range of possibilities:
  - Single-entry recording system.
  - Double-entry recording system.

# Principle 4: System Architecture

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

# Issue 5:

## Financial Statements

- It follows from Principle 4 that a package of financial statements should include at least:
  - A statement of assets and liabilities at the end of a period, and
  - A statement of revenues and expenses for the period.
- An additional statement of cash flows is a possibility, along with any number of additional schedules for detailed disclosures.

# Principle 5: Financial Statements

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

# Issue 6:

## Time Orientation and Realization

- Financial accounting is fundamentally historical in nature. However, it is possible to consider:
- Realized distant future consequences of past transactions and events; and
- Unrealized consequences of transactions and events that have not occurred.



# Principle 6: Time Orientation and Realization

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

# Issue 7:

## Accounting Recognition

- Accounting recognition stipulates the criteria for considering certain economic resources as assets, and certain responsibilities as liabilities of an entity. What should those criteria be?
- Asset recognition may depend on: e.g. ownership, control, future benefit.
- Liability recognition may depend on: e.g. reciprocal benefit, future sacrifice.

# Principle 7: Accounting Recognition

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

# Issue 8: MF: The Scope of the Balance Sheet

## Assets

- Current financial resources
- Long-term financial resources
- Capital resources

## Liabilities

- Current financial liabilities
- Long-term financial liabilities

# Principle 8: Measurement Focus

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

# Issue 9: Basis of Accounting

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

# Issue 9 (cont'd).

## Which Degree of Accrual?

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

# Principle 9: Basis of Accounting

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



# Issue 10:

## Unit of Measurement

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

# Principle 10:

## Measurement Unit and Valuation

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

# Conclusions

- American government accounting standards emphasize financial reporting over accounting system issues.
- The recursive incremental process used by the GASB and FASAB has produced a total of almost 100 standards.
- The standards may be reduced to ten principles dealing with main issues.

Questions and Comments  
are welcome.

[jimchan@uic.edu](mailto:jimchan@uic.edu)

[www.JamesLChan.com](http://www.JamesLChan.com)