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YANG'S LAW AND ZHU'S MANDATE

The Roles of Accounting in Managing the Chinese State

杨氏规律和朱总理指令：会计的治国角色

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1. ACCOUNTING POWER

会计的力量

1.1 What is Accounting and Auditing?

Accounting is no longer regarded as a technical field practiced by colorless clerks and bureaucrats. It is an institutional and social practice that affects and is affected by the political, economic, and social environment (Hopwood and Miller, 1994); see Exhibit 1 for a primer.

Exhibit 1. A Primer on Accounting and Auditing

Accounting is a financial measurement and communication system for entities as diverse as business enterprises, nonprofit organizations, and governments. National accounts (though belonging nominally to accounting) are practiced mainly by economic statisticians. Due to its micro perspective, accounting is typically concerned with one entity and is divided into two main branches: management accounting and financial accounting.

Management accounting aims to improve the planning and control of an organization by preparing budgets, cost data collection, analysis, and performance evaluation. Thus, management accounting is forward-looking and the “accounting

entity” could be a product, an activity, or a sub-unit of an organization. In addition to scorekeeping, management accountants direct managers’ attentions to problem areas and serve as their consultants in solving problems.

Financial accounting is retrospective and concerned with the financial consequences of transactions and events that have already occurred. Since financial accounting is comparatively better developed in business enterprises, business financial accounting is often held up as a model for financial accounting for nonprofit organizations and governments. Although financial accounting can be done for any levels of an entity, general accounting is concerned with the entity as a whole as a legal person apart from its owners or other stakeholders. The financial accounting process has several major steps that can be remembered as “IRMeD”:

- **Identification** of the financial consequences of past transactions and events in terms of effects on the resources and obligations of the entity.
- **Recognition** of some of the resources as assets and some of the obligations as liabilities on the basis of some predefined recognition criteria.
- **Measurement** of the assets and liabilities, and changes thereof, in terms of money.
- **Disclosure** of the financial position of the entity at the end of the period in terms of assets, liabilities, and net assets; financial performance during the period in terms of revenues, expenses and net income or loss; as well as cash flows to show the change of liquidity during the period.

This information is presented in so-called general purpose financial statements for presentation in periodic financial reports issued annually or even quarterly.

For greater credibility with investors, creditors and other users, financial statements use “IRMeD” rules that are recognized by **generally accepted accounting principles (GAAP)** by the auditing profession. Members of the profession as independent auditors use GAAP to evaluate the extent to which a set of financial statements **fairly present** the financial conditions of an entity. A favorable judgment is conveyed through a “clean audit opinion.”

In addition to performing the **financial audits** mentioned above, government auditors (in the United States) also conduct audits to assess compliance with applicable laws and regulations, the economy and efficiency of operations, and effectiveness in meeting objectives. Collectively, these types of audits are called “**3E**” or “**comprehensive audits.**”

1.2 Government Accounting and Auditing

Although the field of government accounting is closely linked to accounting, political science, public budgeting, and financial management, it remains a

historically under-appreciated branch of knowledge. Government accounting's potential effects on governments are so great that attempts to improve its actual operations have run into many obstacles. As the old Chinese saying goes, "It is only in muddy water that you can catch fish" (浑水摸鱼). **When financial records are missing or messed up, internal control breaks down, resulting in the loss or misuse of public money or property and other forms of financial malfeasance,** some of which were found by auditors. See Exhibit 2.

Exhibit 2. "China Finds Huge Frauds by Officials"

Chinese officials misused or embezzled about \$35 billion in government money in the first 11 months of the year [2009], according to a national audit released this week....

The National Audit Office... said that it surveyed nearly 100,000 government departments and state-owned companies, and that more than 1,000 officials were facing prosecution or disciplinary action because of the audits.

Auditors said government officials engaged in everything from money laundering and issuing fraudulent loans to cheating the government through the sale or purchase of state land or mining rights....

Experts say the audits revealed one thing: many in government are finding ways to steal public money...

Source: David Barboza "China Finds Huge Frauds by Officials," *New York Times International Harold Tribune*, Global Edition, December 29, 2009.

1.3 Yang's Law and Zhu's Mandate

The situations described in Exhibit 2 are examples of what Professor Yang Shizhan (杨时展) called "乱计" or "chaotic accounts." Professor Yang further enunciated what may be called **Yang's Law (杨氏规律)**, which gives a diagnosis "天下未乱计先乱" (chaotic accounts precede social disorder) and provides for its own prescription "天下欲治计先治" (to successfully rule the state, you must first put its accounting and auditing in order).

天下 could mean anything under the heaven. In this paper, it is taken to mean government (政府) or the state (国家). Professor Yang meant it as a lesson from thousands of years of Chinese history. However, two examples could be cited from two periods in contemporary Chinese history. During both the Great Leap Forward Movement (大跃进运动), fictitious reports of great achievements in crop yields and steel production were made to impress Party leaders. Then, during the Cultural Revolution (文化大革命), government institutions—including finance offices—were dismantled and accounting staff were disbanded. In these cases, it was a situation of "天下先乱计便乱" (in an upheaval, it is impossible to practice orderly accounting). Liberthal (1995, p. 60) explains why **administration, of which accounting is a part,**

is incompatible with revolution:

Governance and revolutionary changes are...antagonistic. Government administration works best in an environment that permits development of long-term programs, staffed by competent individuals, who agree on the basic goals they wish to nurture... Revolutionary change, by contrast, is by its very nature unsettling. Its adherents must maintain a level of frenetic intensity and passion that rarely is compatible with smooth administration. Revolutionaries tend to view complex administration as an obstacle to their goals, which civil servants often want to temper the enthusiasm and lack of technical expertise that accompany the policy thrusts of revolutionary.

In comparison with the Great Leap Forward Movement and Cultural Revolution periods, during past thirty years China has been characterized by political stability and economic development. Ironically, the great wealth generated by economic reform combined with political stability to have produced the situations found by the National Audit Office (NAO). Rule of law (依法治国) has become national policy. A

lawyer views fighting corruption as a necessary step in the “long march toward rule of law” in China:

... the causes of corruption are many. Economic reform has clearly been a major factor. Price reforms and the dual pricing system have created opportunities for profiteering. Decentralization has created more opportunities for local officials to use their new-found authority to approve projects and to make resource allocation decisions to extract bribes. The lack of separation between the state and enterprises has created incentives for local governments and ministries to steer resources and opportunities toward companies in which they hold an interest. The emergence of a private economy has created new resources to be exploited by government agencies needing to bolster their revenues in light of cut-backs in funding from the central government. Many businesses may find that paying bribes to expedite the frequently inefficient approval process of administrative agencies is well justified on economic grounds. (Peerenboom, 2002, p. 407)

There are two ways of looking at the “audit storm” (审计风暴), which has uncovered many kinds of corruption (see Exhibits 3 and 4 for two classifications). The good news is that the NAO discovered the fraud *and* published the results—a remarkable sign of accountability and transparency. The bad news is that the financial control system had apparently failed to prevent the fraud in the first place.

Exhibit 3. Manion's Taxonomy of Corruption

- Bureaucratic commerce: “business activities of companies created by party and government departments... for purposes of generating profits”
- Predatory exactions: “excessive compulsory and irregular non-tax charges”
- Corrupt exchange: “bribery or illegal commissions”
- Public funds as private capital: “the misappropriation of public funds as interest-free capital for private investments”
- Illegal privatization of state enterprise assets: “corruption in the process of legally authorized enterprise privatization... fairly direct embezzlement of enterprise profits... asset stripping”

Source: Manion (2004), pp. 96-110.

Exhibit 4. Hu Angang's Taxonomy of Corruption

胡鞍钢对腐败的分类

1. 官员贪污贿赂挪用公款
2. 海关走私与腐败损失
3. 垄断行业腐败损失
4. 税收财政收入流失
5. 公共支出腐败损失
6. 公共投资腐败损失
7. 资本外逃损失
8. 国有企业私有化腐败损失
9. 乱收费腐败损失
10. 金融业腐败

来源：胡鞍钢（2002），“巨大的腐败黑洞：公开披露各类腐败的经济损失”

《中国国情分析研究报告》

1.4 Audit Success, Accounting Failure

Government officials' corruption is a government failure. Why did the government, represented by officials, fail in the cases found by the NAO? It could not be attributed to the absence of finance law and regulations or the lack of oversight institutions. Imperfect as they may be, there are plenty of laws and regulations about finance conduct (see references) and there are layers of party, legislative, and executive bodies to enforce them. The CCP operates many Party schools and the training of government officials is a veritable industry.

There is an economic explanation of public corruption (Rose-Ackerman, 1978 and 1999). (In this regard, I am generally inspired by Gary Becker's economics of crime and punishment, and Oliver Williamson's transaction cost economics.) On the demand side of enforcement, the officials who have been caught intentionally committed these acts (明知故犯) on the basis of a **rational calculation** that the expected gains would be greater than the expected costs. They figure that, in the presence of pervasive corruption, the costs of enforcement would be so high that their chances of getting caught are small enough for their actions to be worthwhile. On the supply side of enforcement, the financial malfeasance uncovered by the NAO resulted from an **implementation gap**—the discrepancy between actual performance and enunciated standards. The government and the CCP have similarly made the rational decision that the political and financial costs of enforcing the laws and regulations are too high relative to the gains in the form of greater credibility, losses prevented, and benefits from using the stolen or misappropriated money. These costs and benefits were built into the “system” under which the government and government officials operate. At any point in time, the amount of corruption represents an equilibrium of the demand for and the supply of corruption counter-measures. The extent of corruption is potentially so large that it overwhelms the capacity of the oversight institutions. **To the extent that oversight institutions fail to deter corruption, individual acts add up to systematic failure.**

The supply side of enforcement is where accounting, in particular government accounting, fits into this analysis. The 计 in the second part of Yang's Law, refers to both 会计 (accounting) and 审计 (auditing). Yang's prescription that “天下欲治计先治” implies that accounting and auditing have a role in managing government, the state, and perhaps the society as well. Before it can help to govern the state, accounting and auditing has to reform itself.

1.5 Distinguish Two Types of Accounting Sins

In the past two decades, China has made great strides in improving its accounting and auditing mainly with regard to business enterprises, many of which are owned by

the state. Much of the credit should go to Premier Zhu Rongji's (朱镕基) who, more than other Chinese leaders, appreciated the importance of accounting and auditing. Among other actions, he was instrumental in establishing three National Accounting Institutes (NAI) in Beijing, Shanghai, and Xiamen. **The primary mission of these training centers is to make sure that government officials, business managers, and accountants, in the premier's own words, "do not keep fake accounts" (不做假帐).** A corollary of the premier's mandate is that in the event of fake accounts, auditors should succeed in catching them.

While the former premier had every right to issue his mandate, defining fake accounts and preventing them are by no means simple tasks. **There are two types of accounting sins: the sin of commission and the sin of omission.** The sin of commission entails recording inaccurate numbers but it also involves using inappropriate concepts. That is why accounting is more than simply counting. Accountants have to decide what to account (or identify and recognize, see Exhibit 1) as well as to measure accurately. If an accountant should have recorded something but did not, he or she had committed the sin of omission. The sin of omission is no less serious than keeping fake accounts because it would oblige the audit to become a detective, doing "forensic accounting," in order to discover what should have been recorded. In this regard, the NAO reports issued during the annual "audit storm" may represent the tip of the iceberg: **what is revealed in the auditor's report is interesting; what is hidden or not found by the auditors may be vital.**

For anti-corruption and other reasons, the rest of the paper will argue that an effective government accounting system is an integral part of the institutional infrastructure of a state (国家制度基础设施) in Section 2, describe recent and current efforts to improve it in Section 3, and makes a few recommendations about adopting Western practices in Section 4.

2. GOVERNMENT ACCOUNTING AS A STATE INSTITUTIONAL INFRASTRUCTURE

政府会计是国家制度基础设施

2.1 Institution Building in China

Government accounting and financial reporting relate to almost half of the functions of a successful state identified by Ghani and Lockhart (see Exhibit 5), namely: administrative control, sound management of public finances, management of public assets, and effective public borrowing.

Exhibit 5 Functions of a Successful State

1. Rule of law

2. A monopoly on the legitimate means of violence
3. Administrative control
4. Sound management of public finances
5. Investment in human capital
6. Creation of citizen rights through social policy
7. Provision of infrastructure services
8. Formation of a market
9. Management of public assets
10. Effective public borrowing

Source: Ghani and Lockhart (2009)

In the context of China, after staging political and social transformations for thirty years since the establishment of the People's Republic of China, China renewed its push for modernization. **The modernization began in the economic sphere and now a second transformation is needed to build effective institutions of the state.**

Explains 胡鞍钢 (Hu Angang, 2003, p. 4):

一个国家的现代化至少包括两个最主要的方面：一是经济现代化，如农业现代化、工业现代化、科学技术现代化和国防现代化；另一方面是制度现代化，即实现国家基本制度现代化，并实行“良治”（Good Governance），确保国家利益最大化，全体人民福利最大化。国家制度建设是一个现代国家的基本制度和国家“基础设施”，它与一个国家现代化的经济建设具有很强的关联性和互补性。实现国家制度现代化不仅是现代国家最重要的目标，而且也是典型的国家性公共物品，没有国家制度的现代化就无法实现国家的经济现代化。”（“第二次转型：从经济建设为中心到制度建设为中心”）

Hu (2003) identifies eight mechanisms to be created or strengthened in building China's basic state institutions (国家基本制度). They are:

- (1) 强制机制 (coercive mechanism): the ability to use legitimate force in national defense and law enforcement;
- (2) 汲取能力 (extractive ability): the ability to extract resources in support of public expenditures for service provision;
- (3) 共识机制 (consensus mechanism): the formation of common values for social cohesion;
- (4) 监管机制 (regulatory mechanism): the ability to supervise or influence the conduct of other organizations in the economy and society;
- (5) 协调机制 (coordinative mechanism): the ability of public institutions to act in concert to achieve public policy objectives;

- (6) 表达机制 (expression mechanism): the opportunities for the public to voice their opinions and participate in the political process;
- (7) 整合机制 (integration mechanism): the availability of channels to coalesce diverse public opinions;
- (8) 再分配机制 (redistribution mechanism): the vehicle for the redistribution of income and wealth to reduce economic inequality.

Government accounting and reporting is implicitly incorporated in the state institutional framework. As a public financial management function, government accounting is part of the revenue extraction mechanism and coordination mechanism of the state. Judging from the outpouring of public reactions to the release of the NAO's annual audit report, there is a high level of consensus in demanding government financial accountability and transparency. When that is the case, government financial reporting for accountability becomes a part of the consensus mechanism.

Furthermore, **Hu's proposal for government reform makes the following recommendations to strengthen government auditing in China:** increasing the independence of the NAO by providing it with direct appropriations from the National People's Congress; requiring the NAO to annually report to the NPC and its Standing Committee, as well as making audit reports and actions on audit results public; improving audit procedures so as to increase the effectiveness of audits (Hu, 2004, p. 20).

2.2 Government Accounting as a Critical Institutional Infrastructure

It is not widely recognized that a sound government accounting system is an important component of a country's institutional infrastructure. Rather, government accounting is commonly perceived as a bureaucratic function. To make matters worse, similar to the foundation of a house or the sewer lines under the street, **the accounting system as a critical institutional infrastructure is often invisible until it fails:** when public money is lost and wasted, when taxes are not collected, or when employees are not paid on time. Effective government accounting makes it possible to manage the government's finances smoothly and provides audit trails to prevent and detect financial misconduct. In light of the pervasiveness and severity of government corruption in many developing countries (Rose-Ackerman, 1999), financial integrity assurance is a critically important function of their government accounting systems, argues Chan (2003). Only ethical and competent public management can efficiently and effectively implement programs to reduce poverty reduction and achieve other socioeconomic goals. Sachs (2005) declared: "No country should receive greater funding unless the money [for poverty reduction] can be audited."

It is important for accountants to educate the public and public officials about the social value of government accounting. The accounting system is, in effect, the

“nerves of government”—to use Karl Deutsch’s phrase (Deutsch, 1966)—because it is the core of a government’s financial command and control center. A government accounting system can be rudimentary or sophisticated. As in business (Simon, 1954), **a good government accounting system, at the minimum, keeps accurate financial scores; a better government accounting system directs the attention of policy makers and managers to problem areas; and at its best, a government accounting system provides information useful for decision making.**

Thus it takes a certain amount of foresight and insight to make investments in government accounting reform: the foresight to anticipate the consequences of bad or no accounting and the insight to link accounting to government performance and eventually the achievement of societal goals. Government accounting can contribute to a country’s socioeconomic development by providing information to public managers and those who hold them accountable to perform the fundamental functions of the state. As a support function, accounting does not have values of its own, and does not decide the allocation of resources. However, once these decisions are made, the accounting system performs the critical function of following these resources. As such, accounting and its allied functions - including information system design, internal control, pre- and post-audit, revenue administration, and public expenditure management - ensure that resources are used for their intended purposes. When the purpose is socioeconomic development, accounting can help meet this goal by ensuring legal and contractual compliance, facilitating financial management, and promoting transparency and accountability (Chan, 2006).

2.3 Priority of Government Accounting Functions in China

China is not a weak state and certainly not a failed state (in the ways defined by Fukuyama, 2004; and Ghani and Lockhart, 2009) in a political sense or especially in the macro-economic sense. There was a time in the early 1990s when some academics (Wang and Hu, 1994) were concerned about a financially weak central government. But that problem has been largely solved, so successfully that it is the provincial and local governments that depend on fiscal transfers to solve their financial problems and reduce their disparities (Wong, 1997; Wong, Heady and Woo, 1995). Furthermore, China faces enormous challenges in deploying public finance measures in creating a harmonious society (Lou and Wang, 2008). **But the Chinese state is weak in one sense: as evidenced by the consistent findings of the National Audit Office over the past ten years when those findings were made public, the Chinese government has apparently not been able to successfully enforce existing laws and regulations against corruptions and other forms of financial malfeasance.** The performance of the accounting system in this regard is mixed. On the one hand, it kept sufficient data so that auditors could use them as evidence to make their claims. On the other hand, the same system had failed to deter the consummation of transactions or commission of financial malpractice that the auditors found objectionable. This raises the disturbing possibility that the accounting system is

controlled and used by the powers that in executing their actions.

Therefore, it is necessary to set priorities in response to public demand for financial accountability. **The basic purpose of government accounting in China is to safeguard the public treasury by preventing and detecting corruption and graft.** Unless this issue is effectively addressed, the technical achievements would sound hollow as far as the people are concerned. **The intermediate purpose of government accounting is to facilitate sound financial management.** Financial management includes activities such as collecting taxes and other revenues, paying bills, borrowing and repaying debts. In a well-run government, these activities are budgeted or otherwise planned. **The advanced purpose of government accounting is to help government discharge its public accountability.** Public accountability exists in three levels of the principal-agent relationship: accountability of the bureaucracy to the chief executive, of the executive to the legislature, and of the government to the people (Chan, 2003, p. 21).

GOVERNMENT ACCOUNTING AND REFORM IN CHINA

中国的政府会计和改革

3.1 Status Quo and Weakness

Government accounting in China, called budget accounting, is actually a collection of disconnected sub-systems (for details, see 张伟和李启明, 2009). In brief, currently the budget accounting system encompasses mainly general budget accounting operated 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), public service institution accounting (事业单位会计), basic construction unit accounting (基本建设单位会计), and treasury accounting (国库会计) and revenue accounting (收入征解会计) as part of budget execution.

The deficiencies of the current systems are widely noted in the professional and academic literatures, and are candidly acknowledged by a senior Ministry of Finance official (张通, 2008, p. 14). The first is the lack of uniform and normative requirements for both accounting standards and accounting systems. The components of the current budget system do not constitute an organic whole; they are separate and independent, and yet intersect each other in various ways. As such, they cannot accurately and in a timely manner reflect the overall operations of government funds and resources. Second, the coverage of the budget accounting systems operated by the finance departments at various levels of government is relatively narrow. They measure the current year's revenues and expenditures as budgeted and overlook extra-budgetary resources, social security funds, and the government's assets (including financial investments) and liabilities (including bonds payable). Third, the cash basis (现金收付制), instead of the accrual basis (权责发生制), does not permit

the recognition of certain events (such as capital consumption) and cannot comprehensively reflect the government's financial resources and financial accountability, thus hampering the effective prevention of fiscal risks. Fourth, the budget final accounts (预算决算报告) submitted by the finance organization to the People's Congress do not amount to a financial reporting system (财务报告制度). They are incomplete and lacking in information about assets and liabilities. Even though administrative units and public service units have financial final accounts (财务决算), their contents are hardly comprehensive.

3.2 Encouragement for Reform

The Ministry of Finance is actively engaged in research to promote government accounting reform in China. The National People's Congress, in passing the "11th Five Year Plan of China's National Economic and Social Development" in March 2008, specifically called for "promoting government accounting reform." This reform is intended to strengthen the management of public expenditures in order to build a harmonious society through social and economic development, as decided at the Seventh Congress of the Chinese Community Party (CCP). Successful government accounting reform is essential for increasing public trust in the government's management of the people's money and for promoting the policy of emphasizing public service, as indicated by Prime Minister Wen Jiabao's report on government operations to the National People's Congress in March 2008.

3.3 Reform Agenda and Strategy

Currently, in pursuing government accounting reform, the Ministry of Finance is using the basic approach of "developing an overall design; first handling easy cases, then tackling the difficult ones; achieving breakthroughs on major topics; gradually moving ahead" ("总体规划, 先易后难, 重点突破, 逐步推进"). Specifically research is conducted in the following areas:

- Specifying the boundaries of the government sector and designating entities to be included therein.
- Establishing a system of government accounting standards and systems.
- Establish a system of government annual financial reporting.
- Deciding the extent of accrual to implement.
- Adopting complementary measures, such as information system development (张通, 2008, p. 15).

During the past twenty years, the Chinese government has adopted the approach of widely consulting the experiences of advanced Western countries and emulating international norms or so-called best practices. Currently, China and all countries are being urged to adopt International Public Sector Accounting Standards (IPSAS). Accordingly to the IPSAS Board (February 2010, p. 3)., China is among the countries

that “have also signaled their intention to adopt [IPSAS], though specific deadlines have not been set.”

The next and last section of the paper will argue that China should not adopt International Public Sector Accounting Standards (IPSAS) as they stand.

3. A PROPOSAL FOR REFORMING CHINESE GOVERNMENT ACCOUNTING

改革中国政府会计的建议

4.1 Recommended Priorities

Globally, government accounting reform is driven by advanced British Commonwealth (ABC) countries and the United States. These countries have largely attained a high level of financial integrity and professional financial management, and are now focusing on producing financial information to satisfy public accountability by perfecting what are called year-end general purpose financial statements and reports. Their national standards boards and the IPSAS are dealing with tactical problems, but **China has to deal with some huge strategic and fundamental problems.**

At a time when there are powerful forces advocating the view that “what’s good for business is also good for government” in government accounting, China can advance the view that government accounting in developing countries and transitioning economies have a different set of priorities in order of: first, ensuring financial integrity; second, promoting financial management, and third, reporting to the public. Unless the first two tasks are done competently, financial accountability and transparency will sound hollow: it would be impossible to ensure the quality of data going into the reports.

This section will suggest that the International Public Sector Accounting Standards (IPSAS) are both inappropriate and infeasible for China, and will propose that Chinese government accounting makers pay attention to the entire body of American experience in reforming government for both examples to emulate and lessons to avoid.

4.2 Why China Should Not Adopt IPSAS As They Stand

I recommend that China not adopt IPSAS as they stand, because they are both inappropriate and infeasible for China. They are inappropriate because they are in many ways conceptually flawed and do not meet China’s needs. Furthermore, China does not currently meet the technical requirements necessary to implement IPSAS.

IPSAS are not “international” in a legal sense. The IPSAS Board is a technical committee appointed by the International Federation of Accountants (IFAC). Members of the committee serve in their individual professional capacities and are not representatives of governments even if some of them are government officials. Furthermore, the IFAC is a federation of national professional associations of accountants and auditors. It is an international organization in the sense that its institutional members are from many countries. It would be more accurate to describe it as a multi-national organization instead of an international organization in order to avoid confusing it with official organizations created by states or governments. Thus, the IFAC-sponsored IPSAS Board has the power of recommendation and persuasion but no authority to oblige compliance. **Other things being equal, a government has a greater obligation to observe requirements or recommendations made by official bodies of which it is an institutional member.** An example of international requirements would be the specifications in the International Monetary Fund (IMF) Government Finance Statistics Manual (2001). An example of international recommendation would be the IMF’s Guidelines for Fiscal Transparency.

IPSAS, despite the label, are mostly not “public sector.” They are based the assumption that there are so many common transactions in the private and public sectors that it is possible, and indeed preferable, to have one set of standards for both sectors, i.e. the standards promulgated by the International [Business] Accounting Standards Board (IASB) (Newberry, 2007). Additionally, the IPSAS Board would establish standards for transactions and events unique to the public sector. There is a further assumption that since business firms annually prepare consolidated financial statements under the accrual basis, governments should do the same. Consolidated financial statements cover a primary organization (e.g. a parent corporation) and its subsidiaries in which the primary organization has a majority ownership interest. The accrual basis used by business firms regards sale—not production—of goods and services as the criterion for judging financial performance. The applicability and merit of these requirements for governments are debatable.

IPSAS pay too little attention to accounting. IPSAS are actually mostly financial reporting standards for producing so-called general purpose financial statements for external users. In the public sector, the distinction between external users and internal users is not clear-cut. For example, members of parliament are external to the bureaucracy but are viewed as government officials by the public. The idea that a set of financial statements could satisfy the information needs of multitudes of users of diverse needs and abilities is of dubious validity. Furthermore, it would require a great amount of technical knowledge to do “reverse engineering” to infer the chart of accounts, recognition criteria, and measurement rules that are necessary to produce those financial statements.

Without doubting the symbolic value of transparency and accountability to the

general public, I believe that the Chinese government faces the more fundamental and concrete challenge of reducing the political and economic cost that result from pervasive and serious financial corruption and malfeasance. The Chinese government has made significant progress in creating more detailed departmental budgets and instituting more streamlined treasury management systems. Nevertheless, due to the sheer size and dispersion of government bureaucracies, **sound financial management is an on-going challenge for the Chinese government. Furthermore, instead of a full set of financial statements and voluminous financial reports that few would read and fewer could understand, producing concise issue-based financial briefings for people's representatives would be more useful.**

Currently and for the next few years, it would not be possible for China to produce the financial statements required by IPSAS. The Ministry of Finance is still at the conceptual research stage of attempting to resolve a number of theoretical issues, so blueprints for designing a new accounting system could not be made at this time. There does not exist a chart of accounts that encompass assets and liabilities, without which it would not be possible to implement accrual-based accounting and reporting. The infrastructure for collecting, transmitting, and processing an immense amount of financial data probably does not yet exist. Finally, even though China has a large number of people working in the accounting function, their needs for advanced training in analyzing transactions and making estimates under the accrual system would be huge.

For all of the above reasons, I am in favor of a multi-task program to address the challenges facing government accounting in China. Such a program would be similar to one adopted by American governments, except that it took the United States one hundred years to execute and it is still not finished; China probably has a greater sense of urgency.

4.3 Lessons from 100 Years of American Government Accounting Reform

I am certainly not against consulting the experience of advanced Western nations. What I am not in favor of is to take a snapshot of another country's experience and attempt to replicate it. **One should instead study the historical context of other countries' experiences and inquire into the details.** For example, what happened in the Progressive Era in the United States took place nearly one hundred and fifty years after the founding of the country, and that is not the end of the American government accounting reform story (Chan, 2000).

The American state-building experiences during the Progressive Era offer some useful lessons for China. Since then, there have been three more waves of reforms focusing on: codification of good practices, providing comprehensive information to the public, and improving the comprehensibility of financial information. These reforms also hold some useful insights for Chinese

government accounting reform.

In Wang Shaoguang's view (王绍光, 2002, p. 6) , the American Progressive Era experience provides three lessons for Chinese reform: first, public finance system is the most important component of a nation's political system; its importance ranks no lower than elections, party politics, legislative system, or public opinion. Second, improving public finance in terms of revenues and expenditure provides the institutional condition (制度条件) for curtailing corruption, raising government transparency, regulation income distribution, resolving social conflicts, and raising state capability (国家能力). Public finance reform makes it possible to realize the effects of political reform. The process of public finance reform is also the process of political reform. Third, improving public finance is the best entry point (切入点) for political reform. It is low key, not excessively raising people's expectations. It is concrete and more operational than abstract discussion, not "democratic politics." It is practical and can produce visible results in a relatively short period of time.

In the first wave of reform in the first two decades of the 20th century, **political reformers and their business and professional allies saw the value of effective accounting for honest and efficient government.** They left a major intellectual legacy. One hundred years ago, American city governments were already being urged to adopt businesslike accounting augmented by fund and budgetary accounting. The governments' financial and accounting advisers, being practical men of affairs, spent more time on devising forms and procedures than on constructing accounting theories. As a result, though the outline of a framework for municipal accounting was visible, the articulation of formal standards was to be the agenda of the next wave of reform.

The main achievement of the second wave of governmental accounting reform from the 1930s to the mid-1970s was the formalization of generally accepted accounting principles (GAAP) sanctioned by government finance officers and the accounting (i.e. CPA) profession. These principles emphasized compliance with legal requirements and supporting public financial management through fund accounting and budgetary accounting. Even conceding the primacy of legal requirements, a body of generally accepted accounting principles began to emerge independently of individual governments' practices. However, in the process of developing precepts into principles, a number of jurisdictional and conceptual issues emerged. These became the agenda for the third wave of reform starting in the mid-1970s.

During the third wave of reform that began in the mid-1970s, there were institutional and technical developments at all levels of American government. The Governmental Accounting Standards Board (GASB) was created as a result of cooperation between public sector and private sector organizations. The authoritativeness of GASB standards has been recognized by the American Institute of CPA's and by state and local governments. Efforts were made to streamline the

presentation of financial statements so that the public would be willing and able to use them to evaluate the financial conditions of government. After experimenting with various ways of aggregating fund financial statements, in 1999 the GASB added government-wide financial statements to fund financial statements. In contrast to the earlier period's emphasis on legal compliance and financial management, government accountability to stakeholders—investors, citizens, and their representatives—was the guiding spirit. Parallel developments occurred in the federal government: the Treasury Department began preparing consolidated financial statements for the U.S. Government since 1976, and the Federal Accounting Standards Advisory Board (FASAB) was created in 1990 to set GAAP on the accrual basis for the federal government.

Americans have achieved what many Chinese advocates of financial accountability and transparency are asking for. Most governments make their detailed budget documents and year-end financial reports available in public libraries or on the Internet. **These documents are primarily used by bond ratings agencies and taxpayer interest groups. But there is hardly any published evidence that individual taxpayers, voters, and service recipients use these reports to make political, economic and social decisions,** as suggested by Drebin, Chan, and Ferguson (1981). While disappointing, this situation would hardly surprise Anthony Downs, who more than fifty years ago (Downs, 1957, Part III) cited the high cost of becoming informed as the reason why voters were rationally ignorant about their government. These costs include the cost of acquiring the information, understanding the information, and relating the information to one's personal situation or decision. **Therefore during the last ten years, there emerged a financial literacy movement in the United States:**

- Although the U.S. Government has not restored the Citizen's Guide to the Federal Budget published during the Clinton Administration, there is a citizen's guide to the financial statements of the U.S. Government.
- There is a Management Discussion and Analysis that is written in plain English and full of charts and graphs that precedes the financial statements that are full of numbers and technical terms.
- The Concord Coalition conducts Fiscal Wake-up Tours throughout the country to warn Americans of the looming financial crisis.
- A billion-dollar Peterson Foundation was recently created to increase public awareness of the unsustainability of the country's fiscal policy.
- A movie "I.O.U.S.A." (meaning the U.S.A. has a large amount of "I owe you" or debt) was made to warn Americans about how heavily indebted the U.S. is.
- The AICPA, the professional group of accountants and auditors, has created a website teaching people how to make better financial decisions.

In my view, the implication of the American experience is that it is not advisable for the Chinese Government currently to go through the process of preparing and

publishing lengthy and complex financial reports only to realize that few people would or could read them. Instead, **I would suggest that effort be devoted currently to:**

- **Educating senior party and government officials on their proper roles in the budgeting and financial decision making process because they occupy important positions of authority to make major economic decisions and approve financial transactions.**
- **Educating people’s representatives at all levels of government so that they can ask good questions of the government.**
- **Augment the annual “final accounts” presentation by informative accrual information.**

In summary, these are useful lessons from the four waves of American reforms in government accounting during the past one hundred years: keeping accurate financial records, professionalism in financial management, comprehensive and comprehensible financial reporting. These four agenda points are consistent with former Premier Zhu’s mandate of keeping honest accounts and Professor Yang’s prescription of using accounting and auditing to better manage the state. However, these tasks are by no means easy, as Niccolo Machiavalli once cautioned reformers:

There is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all who profit by the old order, and only lukewarm defenders in all those who would profit by the new order. This lukewarmness arises partly from fear of their adversaries, who have the law in their favor; and partly from the incredulity of mankind, who do not truly believe in anything new until they have actual experience of it.

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[to be refined and coordinated with text in revision]

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