The Musings of Frustrated Government Accountants

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Introduction

Government accountants are well versed on preparing financial statements on the accrual basis of accounting and interpreting those statements to assist in making critical financial decisions. However, political issues will often override those logical financial recommendations made by the accountants. It is difficult to find the balance between social needs and financial sustainability. Implementation of accrual accounting in government is a case in point. The International Public Sector Accounting Standards Board (IPSASB) was established in 1997 to develop international accounting standards for the public sector. Using the International Financial Reporting Standards (IFRS) as the foundation for the development of the standards for the public sector, the IPSASB issued pertinent cash and accrual bases standards after due process specifically for the public sector. In addition, the IPSASB issued case studies identifying action taken by three countries [France (2002), UK (2002), and USA (2006)[1]] in their efforts to implement accrual accounting. Even though countries were warned about the overly sophisticated aspects of accrual accounting, the EU, IMF, UN, and World Bank have been strong supporters of the movement toward accrual accounting for governments throughout the world since better accountability and transparency in government finances will be available to its citizens.

a. The following are some of the actions taken in the USA since publication by the IPSAS Board of the USA case in 2006:

Central Government

The Budget and Accounting Procedures Act of 1950 had legislated that the Government Accountability Office (GAO) was responsible to set accounting standards for federal agencies. By law, the Director of Office of Management and Budget (OMB) is responsible for identifying the form and content of the financial statements and the Treasurer in the U.S. Treasury is responsible for preparing the financial statements. These two individuals and the Comptroller General (head of GAO) agreed to establish the Federal Accounting Standards Advisory Board (FASAB) in 1991. The Board is an advisory board and their recommendations for new accounting standards require the approval of the three positions that had established FASAB. Since then, FASAB has issued a number of accounting standards and is moving closer to be in line with the internationally approved accrual IPSAS. As a result of implementing Generally Accepted Accounting Principles (GAAP), the published federal consolidated financial statements provide a higher level of transparency and hold the elected officials more accountable for their actions (or inactions).

The Chief Financial Officer's (CFO) Act was approved by Congress in 1990 to establish CFO positions for 24 federal agencies and to have audited financial statements. However, the qualifications for the CFO positions were not specified. The first CFO (Ed Mazur) for central government was the State Comptroller from Virginia and he was a well-qualified Certified Public Accountant (CPA). He took aggressive action to move toward a more fiscally sustainable position but was relieved from his duties with the change in political bodies in 1993. A new CFO was appointed with much less qualifications and much less interest in fiscal sustainability. And recent CFOs have had good political connections but not had stellar

[1] See reports in IPSASB.org.

qualifications for the job. Candidates for the Presidency or Congress are elected on their promises of how much they can give away; they are not elected on how much they can take away if there is a political crisis!

The Government Management Reform Act of 1994 is one of several financial reforms that received bipartisan support from Congress and the President. The law requires that 24 major departments and agencies in the executive branch of the government prepare annual, audited financial statements. These reports are to be submitted to the OMB by March 1st. The law also requires the Department of the Treasury to prepare annual consolidated, government-wide financial statements and the GAO to audit and report on these financial statements by March 31st. In their audit of the 2017 Consolidated Financial Statements, GAO expressed the following: "The comprehensive long-term fiscal projections presented in the Statement of Long-Term Fiscal Projections and related information show that absent policy changes, the federal government continues to face an unsustainable long-term fiscal path."[2]

At the federal level, financial management has always been on a cash budget proposed by the OMB, submitted to Congress by the President, and legally approved by the legislators after much deliberation. Cash budgeting is very beneficial since it provides the basis for fiscal discipline within government. However, budgeted cash can be manipulated. If a bill is due and there are no budgeted funds available, payment can be delayed until the next budget cycle when budgeted funds are available. In many countries, this creates arrears in the delay and frustration among vendors who have not received payments when due. Accrual accounting and accrual budgeting can correct that problem by recognizing the expenditure when the liability is incurred not when the cash is paid.

Much has been done in the USA to improve accountability and transparency at the federal level by preparing consolidated financial statements on the accrual basis of accounting. However, debt is a real problem in the United States with a debt to Gross Domestic Product (GDP) ratio[3] of 76%[4] in 2017. The first USA CFO has carried on his fight for more control over debt after he left government service in 1993. In addition, David M. Walker (prior Comptroller General) resigned his appointed 15-year term to enter the fight with Congress for less debt. Even though there is a legally approved debt limit from Congress, this limit is routinely raised by Congress when debt approaches its legally mandated limit. As noted earlier in the GAO report, the current fiscal path is not sustainable. Not only is debt a problem in the USA, it is also a problem in many other countries especially in the underfunding of government pensions. Based on a study by OECD[5], eight countries (Australia, Canada, France, Netherlands, Norway, Sweden, UK, and US[6]) had a funded ratio for public pension plans ranging from 9.3% to 112.5% in 2008 with an average of 77.9%.

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[2] https://www.gao.gov/products/GAO-18-316R

[3] The informal international standard is 60% established by the Maastricht Treaty in 1992 for countries to enter the European Union.

[4] https://www.fiscal.treasury.gov/fsreports/rpt/finrep/fr/fr_index.htm (p. 19 of Management's Discussion and Analysis).

[5] Ponds, E., C. Severinson and J. Yermo (2011, p. 23), "Funding in Public Sector Pension Plans: International Evidence", *OECD Working Papers on Finance, Insurance and Private Pensions*, No. 8, OECD Publishing,

http://dx.doi.org/10.1787/5kgcfnm8rgmp-en

[6] State and local governments only since the federal government does not reflect its funded ratio in their consolidated financial reports.

Even though consolidated financial statements are being prepared on the accrual basis of accounting for the U.S. government, they are seldom used for decision-making by elected officials. Congressional committees often deliberate the value of the consolidated statements but little action comes from these committee hearings. GAO made the following comments in their audit report concerning the 2017 consolidated financial statement: "Three major impediments continued to prevent GAO from rendering an opinion on the federal government's accrual-based consolidated financial statements: (1) serious financial management problems at DOD that prevented its financial statements from being auditable, (2) the federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal entities, and (3) the federal government's ineffective process for preparing the consolidated financial statements."[7] In addition, the Association of Government Accountants has a Certificate of Excellence in Accountability Reporting (CEAR)® program[8] that reviews the consolidated statements prepared by the 24 federal agencies and make recommendations for improvement, where necessary.

With respect to the FASAB standard for pensions, Other Retirement Benefits (ORB), and Other Post-Employment Benefits (OPEB)[9], there is some question as to whether the full costs of administering the dedicated collections for those trust funds are allocated to the 24 agencies. If true, the full costs of services provided in these agencies are not included in their financial statements. This is especially important for the Social Security Administration where the trustees forecast that the Social Security scheme will be bankrupt by 2034 and Medicare for Hospital Insurance will be bankrupt in 2029.[10] These programs will be bankrupt much sooner if the questioned full costs of pensions, ORB, and OPEB for retired civil service employees were included in their financial statements.

Local Government

In 1968, the Accounting Principles Board implemented a version of the modified cash basis of accounting for the 87,000 state and local government entities (S&LG). This was changed to a modified version of the accrual basis of fund accounting in 1984. Then, in 2002, GASB 34 established government-wide accrual accounting for all 87,000 S&LGs. Since that time, the S&LGs have been implementing the accrual GASB standards with various degrees of success and publishing their results annually in 200+ pages of a Comprehensive Annual Financial Reports (CAFRs). The GASB standards are very similar to the accrual IPSAS.

However, at the S&LG level, most governmental decisions are still based on the cash budget since it is a good tool to assure fiscal discipline. And all of the 50 states except one (Vermont) require a balanced budget where expected expenditures do not exceed anticipated revenues. Cash is king and more easily understood by the decision-makers (both elected and appointed) in government. Accrual accounting is more concerned with fiscal sustainability and is difficult for most decision-makers in government to fully understand. This is especially true of the elected officials since they are more interested in good performance within the legally approved cash budget in the immediate future if they hope to be re-elected. Using accrual accounting, any deficit reported in the Statement of Financial Performance is of less concern to these decision-

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[7] https://www.gao.gov/products/GAO-18-316R

[8] https://www.agacgfm.org/CEAR/About.aspx

[9] SFFAS 33. Pensions, Other Retirement Benefits, and Other Postemployment Benefits: Reporting the Gains and Losses from Changes in Assumptions and Selecting Discount Rates and Valuation Dates

[10] https://www.ssa.gov/OACT/TRSUM/index.html

makers since most voters are not aware of the statement's contents. Even though a deficit in the Statement of Financial Performance is reconciled to a deficit in the cash budget, most voters do not understand the explanation of the difference between the two.

Most S&LGs in the United States attempt to fund 70% of their outstanding pension costs since this is the measure that bond rating agencies informally use to rate investment grade government bonds. "A state pension plan's annual funded ratio gives an end-of-fiscal-year snapshot of the assets as a proportion of the accrued liabilities. In aggregate, the funded ratio of these plans dropped to 72 percent in 2015 from 75 percent in 2014. Across the country, funded ratios for plans reviewed by The Pew Charitable Trusts ranged from 37 percent in New Jersey to 104 percent in South Dakota."[11] Anything less than 70% will generate General Obligation Bonds at a higher interest repayment rate than those that are greater than 70%. Further, the bond rating agencies do not appear to look at the funding of OPEB. Consequently, most S&LGs do not fund the OPEB liabilities.

b. The following are some of the actions taken in the UK since publication by the IPSAS Board of the UK case in 2002:

The UK started to reform government financial management and reporting as long ago as 1995 with the decision to introduce "resource accounting", a form of accrual accounting[12]. Implementation took place over the period to 2001, by which date departmental accounts and "supply estimates" (the UK terminology for departmental expenditure budgets) were all accrual based. Today the entire UK government budget, accounting and reporting systems are all accrual based. Accounting standards are based on IFRS, adapted for the UK public sector as set out in the UK Treasury Resource Accounting Manual (RAM). The UK Financial Reporting Advisory Board (FRAB) provides an independent oversight of resource accounting and the RAM standards.

Despite the early adoption of accrual budgeting and accounting, government financial reporting in the UK has continued to be criticized. In part this is the result of the unique structure of government financial management in the UK, too complex to describe in a short article, but the main features are as follows. The UK government budget as approved by parliament is very high level. Responsibility for the detailed expenditure budgets is devolved to the Treasury (the UK equivalent of a Ministry of Finance). The Treasury sets out Departmental (in the UK, Ministries are referred to as Departments) expenditure limits in the "supply estimates". Each Department is then left to establish its own accounting system and chart of accounts - provided it complies with Treasury RAM standards. Similarly, each Department publishes its own financial reports, referred to as resource accounts i.e. accrual financial reports.

This makes it difficult to find financial information. As the UK Guardian newspaper commented "public spending by government departments is a mystery. It shouldn't be: the Treasury publishes a guide to public spending every year. But if you want detail - and final figures the departments will stand by, you have to go direct to departmental annual reports."[13] This newspaper article goes on to raise various criticisms of Departmental reports, including a

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[11] http://www.pewtrusts.org/en/research-and-analysis/analysis/2017/07/19/measuring-the-fiscal-health-of-state-pension-plans

[12] "Resource accounting and Budgeting in Government", HMSO, 1994

[13] The Guardian Newspaper, December 4, 2012

lack of consistency of format, lack of consistency between years, problems of reconciling with government budgets and with other financial data.

A study of the implementation of resource accounting in one region of the UK[14] recorded a comment by one accountant “What is produced is not worth doing because, frankly, the accounts themselves are so complicated that nobody understands them. . . They are just totally incomprehensible”. The same study concluded “Overall, the arguments presented by various proponents of accruals accounting systems in many countries often contain similar themes and claims … these claims should be treated with caution …. is quite possible that the rhetoric of government about accruals accounting (often in advance of implementation) can be very different from the reality”.

There have been a series of reforms by the UK Treasury in attempts to make better information on government finances available to the general public, each known by a series of acronyms - Public Expenditure System (PES), Government Online Data System (GOLD), General Expenditure Monitoring System (GEMS), Combined Online Information System (COINS) and the latest iteration “Online System for Central Accounting and Reporting (OSCAR)”. More recently there have been moves to simplify and make more accessible government financial reports.

Despite these reforms, a Parliamentary Committee in 2017 concluded “The consensus of evidence to our inquiry makes it clear that many Government Departments’ Annual Reports and Accounts remain badly written and difficult to understand or follow, despite recent reforms, and despite being prepared to a high technical standard”. One problem cited was that “Departments’ current reporting is primarily based around their organisational structure … for an area such as Child and Adult Mental Health Services, for instance, it is almost impossible for the public to find out from the Department of Health’s Annual Report and Accounts how much is being spent on this, or other types of service, and therefore to assess the value for money of that spending”[15] The report makes a number of suggestions including some which are of generic importance, summarised as follows:

- Financial data should clearly link measurable outputs and outcomes
- Report not just by organisational unit but also by policy area
- Clearly relate spending to outputs
- Publish unit costs (on a consistent basis) for key services
- Reports should be published in Excel or another similar usable format
- Reports should enable the reader to see how final outturn compares to original plans
- There should be an audited statement reconciling, as far as reasonably practicable, the financial commitments made with what eventually happens
- The materiality level applied should be disclosed

There is an ongoing programme to implement the above recommendations.

The UK Government has also initiated the publication of Whole of Government Accounts. (WGA) – financial reports embracing the whole of government. These were first published for the financial year 2009/10. As with Departmental accounts, WGA are prepared on an accrual

[14] “The Actual Implementation of Accruals Accounting”, Ciaran Connolly and Noel Hyndman, Accounting, Auditing & Accountability Journal Vol. 19 No. 2, 2006

[15] UK “The Public Administration and Constitutional Affairs Committee Report” April 2017, HMSO Hansard

basis in accordance with IFRS with various adaptions to meet the requirements of the public sector. In consequence the reporting standards are close to IPSAS. The latest available WGA is for the year 2014-15 – one of the criticisms has been the delays in the publication of the WGA, currently some 14 months after the year end. The WGA are audited by the UK National Audit Office (NAO). So far, the NAO has qualified its opinion on all of the published WGAs, though the number of qualifications has been reduced over time. The overall NAO comment on the 2014-15 WGA is that "better analysis by the Treasury of the nature of the assets across the government's portfolio, the extent and sources of liabilities and the financial risks it is exposed to, will help Parliament and the public to understand better the full range of the government's financial commitments and its approach to managing them."[16] The NAO qualifications on the 2014-15 WGA all relate to scope and coverage of the financial reports.

Despite of all of the above reforms, the London Telegraph newspaper of March 18, 2018, stated "official figures gave an "over-optimistic picture" of the country's debt because they excluded billions of pounds in future payments, including on private finance initiative (PFI) contracts and state and public sector pensions. … the figures for net public sector debt, currently around £1.8 trillion (approximately $2.4 trillion), are largely based on the value of gilts." Yet the latest available WGA indicate that total UK government liabilities, including pensions, PFIs, and other liabilities, are £3.6 trillion (approximately $4.8 trillion.

The conclusion must be that reforming government financial reporting and making useful information publicly available is a major challenge. Despite more than 20 years of reforms, the UK has not as yet been able to resolve all of the issues and problems. The very scale and complexity of the accrual financial reports works against their utilization, even by those who are responsible for the preparation of such reports.

c. Since many countries around the world have public corporations (state-owned enterprises), recent research about the world of commercial financial reporting is reflected below:

The above experience of the usability and impact of financial reports is mirrored in the world of commercial financial reporting. An important recent book by Baruch Lev and Feng Gu[17] finds that in the USA corporate financial reports provide only 5% of the information relevant to investors and concludes that financial report information is "largely unfit for twenty first century investment and lending decisions". The authors' research indicated that over time the correlation between reported earnings and book value, on the one hand, and share value on the other hand, had declined. A major cause is identified as what the authors refer to as dispersion – the very complexity of financial reporting makes the figures less certain and their interpretation more dispersed. This reflects the above comments about public sector financial reports in the USA and UK.

The study further identified three causes for the decreasing relevance of corporate financial reports:

1. The treatment of intangible assets – increasing corporate value is determined by intangible assets, yet these are not properly recognised in financial reports.

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[16] https://www.nao.org.uk/report/report-of-the-comptroller-and-auditor-general-whole-of-government-accounts-2014-15/

[17] "The End of Accounting and the Path Forward for Investors and Managers" Baruch Lev and Feng Gu, Wiley New Jersey, 2016'

2. Financial reports are increasingly based on estimates, e.g. the value of assets, pension liabilities, provisions for bad debts, etc.
3. Increasing importance of unrecorded events, e.g. software development, gain or loss of contracts, new regulations, etc.

Finally, the study makes three recommendations for the future of financial reporting:

1. Capitalize the cost of intangibles;
2. Avoid valuations of assets and liabilities that are not traded in active markets; and
3. Reduce financial reporting complexity.

The Lev and Gu study cited above relates to commercial entity financial reporting. Yet in many ways the challenge for the public sector financial reporting is even greater because accrual reporting is relatively new and has to establish its importance to both decision makers and citizens.

Conclusion

It can be very frustrating for a dedicated government accountant to sit in on financial decision-making meetings and to have the accrual information ignored. So often, government decision-makers manage on the cash basis but report on the accrual basis. These decision-makers are well meaning but they are interested in the here and now for re-election not in the future for our children and grandchildren. It is often said that "government employees are mediocre; they are mediocre when employed or they are beaten into mediocracy".

Hopefully, in time, the value of government accountants' recommendations will be recognized and fiscal sustainability of the current benefits provided by governmental entities for our children and grandchildren can be assured. Perhaps, the USA (and other countries) will implement accrual budgeting as some countries have done, i.e. Australia and the UK. It may be necessary to have two types of budgets; one on the cash basis for fiscal discipline and the other on the accrual basis for fiscal sustainability with a statement to explain the difference between the two. The IPSASB does not have the authority to establish standards for budget preparation but they have published a Recommended Practice Guide for Reporting on the Long-Term Sustainability of an Entity's Finances[18]. These recommended reporting practices may be of assistance in transitioning to accrual budgeting.

[18] RPG 1-Reporting on the Long-Term Sustainability of an Entity's Finances (July 2013), IPSASB 2017 Handbook Volume 2 (Secured) at the IPSASB.org website: www.ipsab.org