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# Governmental accounting: What's wrong with the status quo?

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## What's wrong with the status quo?

vices have expanded, so has the need for information that can help internal and external users judge the effectiveness of governmental operations.

Finally, even the current standards are not uniformly adhered to. As a result, the reporting system of a given governmental unit may be poor, leading to the kind of problems faced in Cleveland and New York.

In addition to these issues, there are four changes now taking place in our nation that have complicated government financial planning and created an urgent need for improved reporting.

These four developments are:

*Growth of government.* The importance of state and local government grows in direct proportion to the numbers and diversity of the people they serve. The estimated revenues of these 39,000 units exceeded \$181 billion in 1975, not counting federal monies of more than \$59 billion.

*Increasing inflation.* Citizens already feel the effects of inflation and do not wish to carry the burden of additional taxes. Thus, the dilemma of either raising taxes or cutting services. Inflation will not allow us to stay where we are.

*Aging of America.* The proportion of elderly people in the American population is increasing. This is going to affect not only the economy—and the need for improved reporting—but also the resources that will be needed to meet pension obligations.

*Sale of Government Obligations.* The bond buyer does not look for a return on that bond in the immediate future; he ordinarily buys for a longer period of time. And so, while it is true that financial statements covering one year provide some

assurance that next year's interest payments will be met, the longer term prospects of payment are not addressed in the financial information ordinarily available to the bond holder.

### Search for Principles

Perhaps the difficulty of developing financial information to meet the needs of taxpayers and creditors starts with the lack of a coordinated effort. Thus, the search for principles is conducted on two distinct levels: on the one hand by state and local governments, and on the other by professional organizations.

#### *Efforts by Governments*

There has been no real agreement to date by those inside government on how to communicate an overall understanding of the activities of any particular governmental unit. A number of attempts are being made to achieve this. One is by presenting financial information that combines a number of interrelated governmental activities, thus providing the external user with an annual financial overview. The information could be presented either in the annual financial statements or in a separate presentation.

This approach has certain benefits: (1) It allows the information to be prepared that is useful to external users while retaining the information needed for internal users. Thus, continuity is achieved with financial information provided in the past. (2) It provides a method of obtaining the views of external users on what information was useful.

However, this combined financial information must be carefully prepared. Otherwise, it will confuse rather than enlighten readers of financial statements.

What are the methods being used to develop such financial information? Three different approaches have been taken.

*Compilation.* As the name implies, this adds together existing fund based financial information. While the compilation gives some idea of the magnitude of the total operations, using different bases of accounting makes compilation the most confusing method of presenting combined financial information. Particular care must be taken to disclose that the information has been prepared on different accounting bases.

*Aggregation.* This method also provides a sum of fund balances. However, when appropriately done, certain funds can be grouped on the same accounting basis. Additionally, inter-fund transactions are eliminated to prevent the inflating of fund balances.

*Comprehensive.* This approach uses one accounting basis for all material items appearing in the financial statements. Such a presentation is valuable to taxpayers and others because it puts all activities of state and local governmental units on the same footing.

#### *Efforts by Professional Organizations*

A number of professional organizations are working on accounting proposals in answer to the needs for improved financial reporting, with a particular emphasis on external reporting. The two most prominent efforts are those by the National Council on Governmental Accounting and by the Financial Accounting Standards Board.

The NCGA is completing its revision of the existing reporting standards (essentially compliance reporting). It is also developing a reporting

framework to meet more directly the need to improve financial reporting.

The FASB also recognized the need to develop an overall conceptual framework for improved financial reporting. It has prepared a discussion memorandum entitled, *Objectives of Financial Reporting by Nonbusiness Organizations*, which is based on a Research Report, *Financial Accounting in Nonbusiness Organizations*, by Robert N. Anthony.

A number of issues will have to be resolved in this discussion memorandum before a framework of information can be developed that will provide useful financial information to internal as well as such external users as taxpayers and creditors. The major questions to be asked are:

- Who uses financial reports of governmental organizations?
- For what purpose is the information in those reports used?
- What type of financial information helps satisfy those needs?
- What, if any, criteria should be employed to differentiate governmental units from other non-business organizations—such as charitable or philanthropic—in establishing objectives of financial reporting?

The general objectives identified in this discussion memorandum are to provide users with a measure of the financial viability, fiscal compliance, management performance, and cost of services performed. In essence, the FASB effort recognizes the importance of this information, presenting a series of possible reporting forms to meet users' needs.

### **A Plan of Action**

The Financial Accounting Standards Board has not yet narrowed down

the number of options that could be used to meet users' needs—and the National Council on Governmental Accounting has not yet issued their recommendations for meeting such needs in a more direct manner. Therefore, it is difficult to judge the accounting principles that might ultimately be adopted.

Some state and local government officials may feel that until this is settled, they should take no additional action. However, to ignore the pressing need for information may be unwise.

On the other hand, having a number of organizations develop proposals to meet the needs of external as well as internal users is almost too much of a good thing. These proposals will probably be different. And differing conclusions, about what information should be prepared and the manner in which transactions should be recorded, create a considerable possibility of confusion. Moreover, since all levels of government operate within narrow financial constraints when it comes to financial reporting, care must be taken not to become involved in experiments unless they have some continuing benefits.

The authors have considered the proposals already released, and those that are likely to be issued, and believe that all of them share certain basic concepts and recordkeeping requirements that are not likely to change.

Meanwhile, since a new approach will eventually be required, it would seem practical to develop financial information that could be of immediate use. These preliminary changes should concentrate on those aspects of record keeping and presentation common to all of the proposals.

Here, then, are five basic concepts

that state and local governments should follow in preparing to meet, in a more direct manner, the needs of internal and external users:

□ All assets (i.e., land, building, and equipment) of governmental units should be identified and values should be assigned.

□ All obligations (i.e., borrowings, advances, grant requirements, and commitments) should be identified and values assigned.

□ The nature of governmental revenues (i.e., taxes, service charges, and grants) should be identified and the requirements pertinent to those revenues be documented. For example, many grants contain specific conditions specifying the purpose of the grant, how the amounts obtained are to be used, and the period during which it should be used. Violating any of the conditions of a grant can lead to forfeiting the grant or being required to refund some of the amounts used.

□ The internal control and record keeping systems of the organization should be documented. The objective should be to determine whether or not these systems provide a basis for a more extensive reporting responsibility.

□ The obligations and reporting responsibilities to other governmental units, grantors, and creditors should be documented.

Once these concepts are implemented, information can readily be prepared that meets users' needs concerning the operations of any state or local government. Obviously, however, professional organizations first need to agree on the information that should be provided.

And, even more obviously, once those standards are promulgated, they should be adhered to by all parties. ▲