Our Governments Make Their Own Accounting Rules – and Mislead Us

The accounting rules our governments make for themselves result in financial reports that mislead the public. Citizens are not receiving the accountability they deserve; they do not have the financial reports needed to responsibly exercise their right to vote.

> *". . . (I)t is difficult to overstate how efficient reporting of government financial information contributes to a healthy democracy. Without accurate fiscal information, delivered regularly, in an easily understandable format, citizens lack the knowledge they need to interact with—and cast informed votes for—their leaders. In this regard, a lack of government accountability and transparency undermines democracy and gives rise to cynicism and mistrust."*
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> - Association of Government Accountants, 2008

Who Makes Accounting Rules?

In the United States of America, private and government financial reporting practices are driven primarily by government. Free will and market exchanges matter, but only on a foundation of government law and regulation. Reports are required by law, and are based on a set of principles overseen or directly developed by government. Some of the players are nominally "private" entities, but the web of control is mainly spun with government power.

To avoid using the accounting rules corporations are required to follow, our federal government established its own standard setting boards. It operates under accounting principles established by the Federal Accounting Standards Advisory Board (FASAB), which it controls. This board is controlled by the Secretary of Treasury, the director of the Office of Management and Budget and the Comptroller General, who heads the Government Accountability Office.

The Governmental Accounting Standards Board establishes Generally Accepted Accounting Principles, also known as GAAP, for state and local governments. Since its inception, government officials and others with a vested interest in the way financial information is disclosed on government financial reports have dominated this board.

Government Budget Accounting Doesn't Qualify as Accounting

Our governments produce two basic types of financial reports: annual reports and budgets. Annual reports are developed in the GAAP framework, while budget reports are not. Annual reports cover past results, budgets include forward-looking plans and statements of intention.

Government GAAP delivers less-than truthful reports, but budgets are even worse. Government GAAP-based reports are based at least in part on accrual accounting methods, albeit imperfectly. Budgets, by way of contrast, are based more closely on "cash-based" accounting. In cash-based accounting, real expenses can accumulate without cash being paid out, and real revenue can be earned without cash coming in the door. For local, state, and federal governments, one way in which cash-based budgeting can understate real expenses and debt is if the government distributes underfunded promises to pay money, as opposed to real money, either for employee compensation or for social insurance programs like Social Security or Medicare. Accrual-based accounting takes account of real expenses, not just cash payments, as a way to more closely reflect economic reality. Cash-based accounting can understate or overstate trends in real financial health.

For example, a purely cash-based bottom line can suffer during a period of accelerated capital spending, when cash goes out the door for equipment and projects with positive long-term benefits. On the other hand, organizations can distribute promises of future payment (like pensions and health care benefits) as current compensation, without current cash payments. This can understate expenses, as well as debt.

Balanced budget requirements can discipline governments to live within their means, and refrain from buying short-term political success with long-term consequences for citizens. Unfortunately, cash-based budget reporting helps elected officials hide real expenses and liabilities, including those related to pensions and other retirement benefits. Cash-based budget reporting provides a key means by which elected officials can claim balanced budgets, yet accumulate debt anyway. This form of budgeting does not provide citizens with the information needed to hold their elected officials accountable.

Illinois provides some clear testimony to the pitfalls of cash-based budgeting. For example, the Illinois state constitution has had a balanced budget provision since 1970. And Illinois politicians regularly claim to balance the budget, as required by law.

The Illinois constitution's balanced budget requirement is found in "Article VIII – Finance." The relevant text reads:

> The Governor shall prepare and submit to the General Assembly, at a time prescribed by law, a State budget for the ensuing fiscal year. The budget shall set forth the estimated balance of funds available for appropriation at the beginning of the fiscal year, the estimated receipts, and a plan for expenditures and obligations during the fiscal year of every department, authority, public corporation and quasi-public corporation of the State, every State college and university, and every other public agency created by the State, but not of units of local government or school districts. The budget shall also set forth the indebtedness and contingent liabilities of the State

> and such other information as may be required by law. Proposed expenditures shall not exceed funds estimated to be available for the fiscal year as shown in the budget.[1]

The last sentence provides some of the keys to understanding how Illinois government leaders can regularly claim to balance the budget while the state has accumulated massive debts. The constitution is talking about "proposed expenditures," not "expenses," leaving two holes to drive through, depending on your legal interpretation. The government can propose balanced budgets, and not necessarily achieve them in practice, one could argue, given that the provision doesn't use the phrase "actual expenditures." Since the provision refers to expenditures, not expenses, this suggests a creative politician could use cash-based expenditure accounting, not accrual-based expenses, to measure how balanced a budget is. Distributing employee compensation in the form of promises for future payments like pensions and health care benefits can minimize "expenditures," while accumulating out-of-budget expenses and debt.

In turn, wiggle room arrives when proposed expenditures "shall not exceed funds estimated to be available." The sentence does not say the proposed expenditures should not exceed "accrual based revenue." Clever politicians have long included borrowing proceeds, as "funds estimated to be available" in the Illinois balanced budget calculation. In other words, governments claim to balance the budget by borrowing more money, because it technically creates an short-term inflow of cash, albeit one with long-term consequences. This provides another tool in the tool chest to misinform the public.

Illinois is not alone. Forty-nine of the 50 states have some form of a balanced budget requirement, either in state law or a state constitution. Many of the states have spent more than they have taken in, thus increasing their debt significantly faster than their state's economy, despite these requirements.

Accounting for Words, and Accounting for Deeds

There are words, and there are deeds. The world of budgets is a world of words, and the world of results is a world of deeds.

As misleading as the budget world can be, the world of GAAP-reported results is also an imperfect world. Many state and local governments have accumulated debt far in excess of their GAAP-audited financial statements, all the while claiming to have balanced their budgets. Truth in Accounting calculates that the 50 states have accumulated nearly $1 trillion in retirement obligations that are not reported on their balance sheets. This amount represents about three-fourths of their total retirement obligation, and will lead to very large increases in reported debt in coming years, as GASB implements new standards for reporting retirement obligations.

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[1] Illinois General Assembly, *Illinois State Constitution*. Article VIII – Finance.

Unfortunately, when it comes to the differences between the world of words and the world of deeds, our federal government has driven a much bigger wedge than all 50 states have put together. Truth in Accounting estimates that more than ***$67 trillion*** of the benefits the federal government has promised seniors are not reported on the federal balance sheet, nor are they included in the "debt ceiling" calculation. In turn, the accumulation of these obligations over time – a real expense – has not been included in federal budget and deficit/surplus calculations.

Why Does the Government Try to Mislead the People?

Mancur Olson penned a key contribution to the public choice school of economics in 1965. Olson's *The Logic of Collective Action: Public Goods and the Theory of Groups* showed how individuals in a group may not necessarily cooperate for the group's collective interest.[2] Concentrated, narrow groups sharing a high per-capita interest in a certain policy or outcome tend to organize more successfully than larger groups with a broader but smaller per-capita interest in policies or outcomes.

A related school of academic interest arose in the area of the "economics of regulation," where leaders like Nobel-prize winning economist George Stigler developed "capture theory." We commonly hear business leaders cry out against regulation, but in Stigler's view, businesses do not necessarily dislike regulation.[3] Businesses and other concentrated interest groups often seek out regulation and government support, and "capture" their regulators to maximize their returns. Broader, less well-organized groups like consumers and the general welfare pay the price.

Capture theory can work in reverse, as well. Consider FASAB, GASB and the AICPA.[4] In theory, these are "independent" accounting standard-setting organizations. In practice, at least historically, their governance might be viewed as an example of capture theory in reverse, as governments and related special interest groups drove accounting standards for their own benefit, at long-term public expense.

This perspective can illuminate why our governments' misleading financial reports can actually make sense. The field of economics is based on assumptions, including a presumption that people tend to be rational. This is not necessarily saying that people can add up 2 and 2 and get to 4, not 5. In economics, people are rational in the sense that they tend to try to improve themselves, and promote their own self-

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[2] A good obituary for Olson appeared in The Economist in May 1998. See also Jane Shaw, "Public Choice Theory," Library of Economics and Liberty.

[3] See "George J. Stigler," Library of Economics and Liberty. See also Sam Peltzman, "The Economic Theory of Regulation after a Decade of Deregulation," Brookings Papers: Microeconomics, 1989.

[4] AICPA stands for the American Institute of Certified Public Accountants. See Appendix.

interest. In turn, economics develops respect for the ability of free markets to promote the common good, as free exchanges among individually selfish people can maximize the general welfare.

Economics can also deliver some bad news about free exchange. Markets can "fail," due to things like externalities, public goods, and asymmetric information. Economists are far from agreed about how pervasive these problems are, as well as the role for government in solving them, but the concepts provide a basis for illustration.

Consider the problems of "asymmetric information." One person may have better information about the quality of a traded good than another person. For example, the owner of a used car has significantly greater knowledge about the quality of the car than a possible buyer. Consumers are aware of their information disadvantages, and free markets may not necessarily reach a general-welfare-maximizing outcome if trust in the car marketplace falls.

People who tend to respect government solutions for problems like this might promote legal requirements governing disclosure of the quality of cars, with an assigned government regulator and penalties for less-than-truthful disclosures. On the other hand, people more respectful of free market forces would point to the role of used car dealers, with a selfish interest in maintaining a good reputation, as one solution for the "asymmetric information" problem.

How do we really know what is going on, under our government hood? On whom can we rely?

Government Financial Reporting – Why It Matters

Lessons from the private sector can help us understand the role of financial reporting in government. Corporate managers serve shareholders, and financial reports help shareholders monitor and manage the performance of their company. In the public sector, government managers serve citizens, and financial reporting should promote accountability of the representatives making and executing policy for the rest of us.

The concept of a "fiduciary duty" matters here. Legally, two parties may have a "principal-agent" relationship, where the agent has a duty to serve the interest of the principal first, before their own interest.

Financial theory has developed the concept of "agency costs" to describe and address the problems that arise when corporate managers do not live up to their fiduciary duties, and serve themselves at shareholder expense.[5] Financial reporting and disclosure requirements provide a way to help bond managers to their fiduciaries, giving shareholders information and tools to hold their agents accountable.

Likewise, government leaders may or may not live up to their duty to their "shareholders" – taxpayers and citizens generally.

In 1970, George Akerlof wrote a classic economics article titled *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*.[6] Akerlof explored the used car market to illustrate the economic costs of dishonesty, and to develop a framework for evaluating solutions for asymmetric information problems in general.

A used car may or may not be a "lemon," and can be sold honestly or dishonestly. Akerlof applied some rigorous mathematics to show how trust can shrivel up, with the possibility of a complete market breakdown – where no trades take place despite gains to be had by buyers as well as sellers.

"Lemon" problems can arise in a wide range of social interactions. They can be solved by private arrangements, as well as public intervention. Unfortunately, solutions for "lemon" problems can pose lemons on their own.

Consider a corporation, with managers serving shareholders and other parties. How do shareholders know whether the managers are honestly serving the shareholders? How do shareholders know what is really going on "under the hood?" Financial reports are a means for managers to deliver information necessary for this judgment. But financial reports can be a tool for deception, as well as revelation.

What, then, should we do?

In the United States, government has come to the rescue, most fundamentally in the disclosure requirements developed under in the Securities Act of 1933 and the Securities Exchange Act of 1934. Periodic breakdowns in the integrity of corporate financial reporting were subsequently addressed in legislation like Sarbanes-Oxley and Dodd-Frank.

Markets may fail, and call for government solutions. But markets do not hold a monopoly on failure. Governments can fail, too, and not just in the sense like we are seeing in bankruptcies in cities like Stockton, California. Governments can fail in the "solutions" they provide for market failures, too.

The concept of agency costs in corporate finance helps illustrate the risk of government solutions for market failures. Managers of companies may shirk their fiduciary duties to shareholders, but

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[5] See for example Michael C. Jensen and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, (1976)

[6] George A. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism," Quarterly Journal of Economics, August 1970. Article link is here.

government leaders can similarly shirk on their duties to serve the people. The latter case arises for a simple reason captured in the economic presumption that people are rational, in the sense that they tend to pursue their self-interest. The public choice school of economics has arisen on this assumption, urging us to abandon our presumption that government leaders serve the public. Government leaders are also rational, and pursue their self-interest, first. In turn, concentrated, well-organized special interest groups tend to drive "public" policy, to better themselves at the expense of the general welfare.

People are aware that government may not always work as it should, and develop safeguards for the general welfare. Back in 1787, the modern United States of America came into being under a Constitution. That document listed the powers and constraints for a new federal government, and its relationship with the several states. One of the key safeguards developed to promote the fidelity of government representatives was the "Statement and Account Clause,"[7] which called for "a regular Statement and Account of the Receipts and Expenditures of all public Money …"

In 1833, constitutional historian Joseph Story described the motivation for this provision in the following terms:

> The object is apparent upon the slightest examination. It is to secure regularity, punctuality, and fidelity, in the disbursements of the public money. … In arbitrary governments the prince levies what money he pleases from his subjects, disposes of it, as he thinks proper, and is beyond responsibility or reproof. It is wise to interpose, in a republic, every restraint, by which the public treasure, the common fund of all, should be applied, with unshrinking honesty to such objects, as legitimately belong to the common defence, and the general welfare. Congress is made the guardian of this treasure; and to make their responsibility complete and perfect, a regular account of the receipts and expenditures is required to be published, that the people may know, what money is expended, for what purposes, and by what authority.[8]

These inspirational observations capture the importance of financial reporting in our republic. Sadly, after reviewing the historical development our current state of affairs, they also serve as a benchmark illustrating how far we have fallen.

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[7] We will explore the history of the Statement and Account Clause in future articles, including a comparison of the financial reporting requirements in the Articles of Confederation with those in the Constitution.

[8] Joseph Story, *Commentaries on the Constitution* (1833), as reported in The Founders' Constitution, edited by Philip Kurland and Ralph Lerner, University of Chicago Press.

In 2008, the Association of Government Accountants (AGA) commissioned a study by a leading market research firm, Harris Interactive. That survey concluded "Government at all levels is failing to meet the needs of its citizens with regard to financial management reporting."[9]

Governments derive their just powers from the consent of the governed. Governments have a special responsibility to report on their actions and the results of those actions. These reports must provide useful information that enables the citizens and their elected representatives to make informed decisions. To be useful, financial information must be understandable, reliable, and relevant. To be relevant this information must be available on a timely basis.

The AGA/Harris survey found, "Across all levels of government, those surveyed held being 'open and honest in spending practices' vitally important but felt that governments did extremely poorly in terms of being 'responsible to the public for its spending.'"

An informed electorate is the basis of our democratic form of government. Providing relevant information is an essential part of accountability in government. Accurate financial reporting is needed to determine accountability. The words "accounting" and "accountability" share common roots, and for good reason.

Truth in Accounting asks you to join us in our federal project.

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[9] Association of Government Accountants, "Public Attitudes Toward Government Accountability and Transparency," 2008

Appendix – Government Accounting Standards Governance

The Securities Exchange Act of 1934 created the Securities and Exchange Commission (SEC), and laid the initial framework for today's financial reporting requirements for companies with publicly-traded securities. SEC regulations require these companies to issue periodic reports based on "generally accepted accounting principles," or GAAP. The SEC does not directly set GAAP, but the SEC can rescind its delegation of authority for setting accounting standards.

The seeds for current regulation of GAAP were sown in the late 1930s, after the creation of the SEC. In 1939, the American Institute of Certified Public Accountants (AICPA) created a new Committee on Accounting Procedure (CAP), under the direction of the SEC. This committee was tasked with the development of accounting standards recognized as GAAP. CAP was supplanted by the Accounting Principles Board in 1959. In theory, CAP and APB were private-sector entities, but concern grew about their independence from government influence, leading to the development of the Financial Accounting Standards Board (FASB) in 1973.

Today, FASB develops and publishes GAAP for private sector companies. FASB is effectively a subsidiary of the Financial Accounting Foundation, a private not-for-profit entity that has an important related subsidiary -- the Governmental Accounting Standards Board (GASB). The GASB develops standards for state and local governments. The SEC has effectively delegated its statutory responsibility for setting accounting standards to the FAF, FASB and GASB. But the SEC retains the statutory authority to set accounting standards, and can rescind its delegations.

The Financial Accounting Foundation (FAF) Established 1972:	
The Financial Accounting Standards Board (FASB) Established 1973 *Sets GAAP for Corporations and Non-Profit Entities*	**The Governmental Accounting Standards Board** (GASB) Established 1984 *Sets GAAP for State and Local Governments*

The web of control suggests "GAAP" stands for a misleading phrase. These principles did not flower as a matter of free development and willing adoption. They exist as a matter of law and regulation, established and overseen by the government.

An important role remains for a "private" regulator of GAAP, however. AICPA requirements for member behavior include important references to GAAP. For example, the AICPA forbids members from expressing opinions whether financial statements fairly present information based on GAAP, if those principles depart from principles those of the organization that the AICPA designates as the source of GAAP.

GAAP are not so "General" – GAAP Depends on Who You Are

The FASB develops GAAP for private companies, while the GASB develops GAAP for state and local governments. These GAAPs are not the same thing. In turn, federal government accounting standards are developed today by the Federal Accounting Standards Board (FASAB). FASAB is *not* a subsidiary of the private FAF. FASAB was created in late 1990, following a "Memorandum of Understanding" among the Secretary of the Treasury, the Director of the Office of Management and Budget (OMB), and the Comptroller General. These three "principals" appoint FASAB members, and two of the three have veto power over proposed standards.

<table>
<tr><th>Office of Management and Budget</th><th>Treasury Department</th><th>Government Accountability Office</th></tr>
<tr><td colspan="3">Federal Accounting Standards Advisory Board
(FASAB)
Established 1990

Sets GAAP for Federal Government</td></tr>
</table>

The composition and governance of the FASAB has evolved since 1999, but it remains dominated by government influence. We will return to the history of FASAB in future articles.[10] For now, we simply note that as bad as the hidden liability problem is among state and local governments,[11] this problem is much worse at the federal level. It is not just a coincidence that the federal government has more directly controlled its accounting standards-setter. Indirect control can also be effective, however, as indicated by the history of the role of the AICPA and GASB in the governance of accounting standards.

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[10] Interested readers could review David Cotton, "Federal Accounting Standards: Close Enough for Government Work?" in the Summer 2000 issue of *Armed Services Controller,* and an article by James Patton and David Mosso, "Can the Federal Accounting Standards Advisory Board be More Independent?" Journal of Government Financial Management (Fall 2009).

[11] Truth in Accounting, Financial State of the States (2014)