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ACCOUNTING AND REPORTING STANDARDS, AN ISSUE FOR GOVERNMENT CREDIBILITY

Good morning ladies and gentlemen; it is a pleasure to be with you here at your 64th Annual Convention. While I am in the introductory stage of my remarks, I would like to acknowledge the contribution that your president, Bill Snodgrass, has made toward fostering better understanding between the Federal and State Governments. Bill was one of the State people who, about 6 years ago, conceived the idea of an organization of Federal, State, and local auditors that would solve some of the problems that existed among them. Today, a National Intergovernmental Audit Forum and 10 regional forums exist, and while not all the problems have been solved, the relationship among auditors at the various governmental levels is much closer. Moreover, I believe that, in time, most of the serious problems in coordinating auditing at the different governmental levels will be solved and these audit forums will have been an important factor in developing the solutions.

I could talk much longer about the value of these forums but that is not my subject today, so I will move along to accounting and reporting standards.

Accounting and reporting standards for State and local governments are receiving a great deal of attention these days. In fact, I believe that now, more than ever before, people are concerned about how our various levels of Government keep their books, do their financial reporting, and set their budget priorities.

These concerns have been spawned by a number of events with which I am sure you are all familiar. Many commentators have directly related the recent crisis in New York City's financial situation to its accounting and budgeting practices. New York City is not alone in having problems of this type. When the District of Columbia Government sought to reduce its interest cost by borrowing money directly from investors instead of borrowing from the U. S. Treasury, it found that to borrow directly it needed certified financial statements. Such statements could not be provided because as we in the General Accounting Office (GAO), together with a major accounting firm, agreed the District's accounting system was so poor that its financial statements could not be audited. A major redesign of the District's system is now in progress. Other cities have encountered problems as well--problems which at least in part have been attributed to poor accounting.

Inflation has also had its effect upon governmental accounting. The rise in taxes resulting from inflation is of concern to all responsible Government officials. Moreover, the spectre of "Proposition 13" and "balanced budget amendments" hangs over legislators and Government officials across the country. From our vantage point, these issues have heightened most everyone's interest in how governments set priorities for spending the money they collect. And this interest has, in turn, prompted concern about accounting and financial reporting, as well as budgeting.

CRITICISMS FREQUENTLY JUSTIFIED

I am afraid we must acknowledge that many of the criticisms of governmental financial reporting are justified. Although some notable improvements have been made in recent years, the financial reports issued by many governmental organizations are almost impossible to decipher by even the most financially sophisticated reader. The pages and pages of statements of individual funds are difficult to understand. Certainly, one cannot get a feel for the financial condition of the whole entity by reading such statements.

Lack of clarity is not the only problem with governmental financial statements. Many of them do not show true financial conditions because important assets and liabilities are not included. For example, many governments have large liabilities for pension benefits due their employees in future years and for accrued vacation pay and other employee benefits that are not shown on their financial statements. If these sizable liabilities are not included, it is virtually impossible to get a good picture of the real financial status of the government involved.

Until recently, we in the Federal Government did not go as far as many State and local governments in meeting this need. While we adopted a unified budget in 1967 and published considerable consolidated information as a supplement to the budget, it was not until 1976 that we prepared any consolidated financial statements. Anyone who wanted such data for the Federal Government as a whole had to obtain the information from each of the 100 or so Federal agencies and consolidate it.

When I think about the type of financial information that was available on the activities of most governmental organizations, it seems that it was really only useful to those people who were involved daily in the business of government. The needs of investors and citizens who were less involved were scarcely served at all. In the Federal Budget we have gone to great lengths to provide easily readable summaries for the public, but we have not done this for our accounting reports.

MUCH IMPROVEMENT HAS TAKEN PLACE

Having painted a bleak picture of the status of governmental financial reporting, let me now describe some recent changes that promise to brighten this situation. They are considerable.

The National Council on Governmental Accounting (NCGA) recently issued a restatement of its long-honored publication, "Governmental Accounting, Auditing, and Financial Reporting" (GAAFR). Major improvements to this document should be helpful in bringing about the kind of accounting and financial reporting changes that are needed. We have long supported the NCGA's efforts. A GAO representative served on the committee that produced the GAAFR in 1968, and we have been represented on the NCGA by a division director since the council's inception in 1974.

Improvements in financial reporting are not only contained in the restated GAAFR. A large number of cities, counties, and states send us copies of their financial statements, and we have noted that many of these governments are devoting a great deal of effort to making their financial information more understandable.

FEDERAL EFFORTS TO IMPROVE FINANCIAL REPORTING

In 1975, Arthur Andersen & Co. prepared illustrative consolidated financial statements for the Federal Government for fiscal 1974. In its published booklet, Arthur Andersen stated that the Federal Government

> "produces an enormous amount of financial data and a wide variety of financial reports. However, such information is often duplicative and is not accumulated in one place or consolidated into reports or statements which permit an assessment

of the overall financial condition or operating results of the entire Government."

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"Financial management systems and functions of the Federal Government should be strengthened and integrated to achieve financial accountability at all levels."

We have taken steps at the Federal level to respond to Arthur Andersen's challenge to us. As you may know, the Department of the Treasury has an ongoing project to publish consolidated financial statements for the Federal Government for each fiscal year. Prototype issues have been prepared for fiscal 1975, 1976, and 1977. I was a member of the advisory committee established in 1976 by then Secretary of the Treasury, William E. Simons. That committee was to oversee the development of the first prototype consolidated statements that were published by the Treasury in early 1976. I am now chairman of the Federal Interagency Advisory Committee that was set up by the Treasury to continue assessing major conceptual issues that must be resolved before a fully reliable set of consolidated financial statements can be prepared. Task forces established by this committee are currently studying the following subjects:

--Accruing personal and corporate income taxes with acceptable accuracy.

--Establishing appropriate allowances for losses on accounts and loans receivable.

--Computing accurate liabilities for Federal employee retirement plans and social security.

--Establishing reasonable values for federally-owned assets.

--Determining appropriate ways of showing liabilities for Federal loan guarantee and insurance programs.

--Properly reflecting the effects of inflation in Federal financial information.

We expect to make major improvements in the consolidated Federal financial statements with the information these task forces are providing to us.

DIFFERENCES IN ACCOUNTING FOR GOVERNMENTAL AND PROFIT-MAKING ENTITIES

When it comes to setting accounting standards for governmental entities, some people take the position that the accounting done for governmental and profitmaking entities should use the same basic standards. We, in GAO, do not agree with this view. To get a perspective on this, one need only look at the Financial Accounting Standards Board's (FASB) statement of Financial Accounting Concepts No. 1--"Objectives of Financial Reporting by Business Enterprises." The repeated emphasis in that statement on accounting for profits makes one realize that its objectives do not fit most government units.

The basic cause of the difference in governmental and commercial accounting information needs is the difference in their goals. Industry's basic objective is to make profits. It has a host of other lesser objectives, but without the profit objective, a firm's ability to stay in business would be limited.

Government, on the other hand, is not in business to make a profit. Its objectives are to protect and serve its citizens and to promote their general welfare. Government operates primarily through programs established by legislative bodies, and its managers are responsible for assuring that the programs accomplish their objectives. These managers are also concerned with keeping their costs low and not spending more money than they have been authorized, but this does not constitute making profits.

This point was illustrated and reinforced recently in Harvard University President Bok's 1978 annual report, in which he outlined his view regarding the role of the University's Business School. In that report, he stated,

> "Although business may have much to teach the health care administrator or the government bureaucrat, nonprofit institutions and public agencies are still very different from the private corporation. * * * Their managers must function in a more political environment where decisions are subject to the checks and balances of other

public agencies. Above all, whether they devote their efforts to health, education, or public service, they have goals that are less tangible, less precise, and quite different in nature from the profit margins and market shares that preoccupy the businessman. These differences may only be matters of degree, but they are substantial nonetheless."

Of course, some government organizations are reimbursed for the services or products they provide and thus operate much like private companies. For these organizations, financial information will disclose numerous facts about whether established goals are being achieved (often, the goal is to break even) and, to some extent, whether resources are being managed efficiently and economically. The part of government that would not be served well by commercial accounting, in our judgment, is the nonbusiness area designed to regulate, protect, and promote the general welfare of its citizens. These programs make up the major part of the Federal budget and, I suspect, the major part of State budgets as well.

Another difference is that governmental entities are accountable to the citizens and not to shareholders. I do not pretend to speak for all citizens because they are such a diverse group, but I believe that they too are interested in more than just budgetary compliance.

Taxpayers can see how much money is spent, but they often wonder where it goes. They do not really know if elected and appointed officials have accomplished their work effectively or if they have set budget priorities and spent tax dollars with the same care they would use with their own money.

Therefore, I believe that governmental accounting standards must be considered separately from those established for profitmaking entities even though some of the standards will turn out to be the same.

SIMILARITY IN GOVERNMENTAL ACCOUNTING STANDARDS

At this point I would like to comment on a question that is often posed to me: Should Federal accounting standards be the same as those for State and local government? I hope so, but I am not sure. Certainly, similarities exist. But the differences in function between the Federal Government and State and local governments are considerable and may require differences in accounting.

In GAO, we are developing a conceptual framework for the Federal Government, after which we will revise the accounting principles we have established for Federal agencies. We plan to observe closely what is done by State and local governments within their conceptual frameworks and in setting accounting principles. If we have differences, they will be based on an identified need. However, we recognize that the Federal Government is, in many respects, a unique entity and we are prepared to prescribe different measures when they are called for.

WHO SHOULD SET THE STANDARDS FOR STATE AND LOCAL GOVERNMENTS?

The question of who should set standards for State and local governments is one that has received a great deal of attention in recent months. The traditional source of standards was "Government Accounting, Auditing and Financial Reporting" or GAAFR, for short. This book, which was originally written in 1968 by a predecessor to the NCGA, was accepted, with minor modifications, as the generally accepted accounting principles for State and local governments. As I mentioned earlier the book has recently been revised.

Earlier I mentioned some problems occurring in certain cities, those problems created a concern about the accounting and financial reporting practices of State and local governments--particularly in large cities. This concern has put pressure on the Financial Accounting Standards Board to take on the project of setting accounting principles and financial reporting standards for State and local governments.

As many of you know, I have been a strong supporter of the FASB since its inception. I serve on the Financial

Accounting Standards Advisory Council and have consistently encouraged reliance on the FASB instead of on the alternative that is generally proposed--Federally prescribed accounting principles for commercial businesses. I believe that, unless proven otherwise, an independent board like the FASB is an appropriate vehicle for setting such standards. However, it has been my view that the best interests of the FASB, State and local governments, the accounting profession, and the citizens of the United States would not be served if the FASB alone also set the standards for State and local accounting. There are several reasons for my views.

First, the FASB is a private organization, not part of Government. To have it set the standards for Government would be a reversal of roles--that is, a non-elected private organization would regulate a part of elected Government through accounting principles.

Second, the FASB has its hands full with private accounting. Recently the Board took on the responsibility of reviewing and accepting or rejecting accounting principles that are in statements of procedures and audit guides issued by the American Institute of CPAs. Also, the FASB must deal with the issue of nonprofit organizations in the private sector. If the Board takes on State and local accounting as well, I think it could be the straw that breaks the camel's back.

Third, the all important question of acceptance must be considered. State governments have the right to set their own accounting standards just as the Federal Government does, and it is doubtful that they would accept the FASB's work in this area. All but a few State governments have assigned specific responsibility for setting standards to a particular State official.

Finally, the NCGA has already done considerable work on this matter. The NCGA has taken a two-pronged approach to the problem of standards. The first approach was the short-range effort called the GAAFR restatement, which is to update and clarify the GAAFR. As I mentioned earlier, this restatement was completed and issued this Spring. The NCGA's second approach is a longer range and more ambitious project--to establish a conceptual framework for the accounting of State and local governments and to rethink the accounting and reporting principles in light of this conceptual framework.

With respect to State governments, the Council of State Governments committee on State government accounting principles and practices has joined with a project committee jointly representing the State accounting task force of the NCGA and several national organizations of State governmental officials and public accounting firms. This group has undertaken a project to develop an inventory of current state accounting principles and preferred practices. This data is being accumulated in cooperation with and will be used by the NCGA.

As mentioned above, the NCGA has initiated a project to develop a conceptual framework for the accounting systems of municipalities and has developed plans for reconsidering existing accounting and reporting principles for all local governments. The result of this work would be a new version of the GAAFR. The NCGA has received a grant from the Department of Housing and Urban Development (HUD) to help it secure appropriate staff for its work, and it has engaged William Holder, Associate Professor, Texas Technological University, to begin the research necessary to develop the conceptual framework. Professor Holder began work on the project about November 1, 1978; the project is estimated to take 36 months to complete. 21

While we do not believe that the FASB should take over setting standards for State and local governments, we strongly believe that the NCGA and the FASB should cooperate closely. This cooperation has begun with a joint effort to develop objectives for State and local governmental financial statements. We believe that such joint efforts are not only desirable but necessary because some organizations in each of the three sectors (business, government, and nonprofit) perform the same functions. For instance, there are profit-making hospitals, government-operated hospitals, and nonprofit hospitals.

A similar situation exists for some educational institutions and libraries. If the NCGA and the FASB cooperate, each could take advantage of the experience and research capabilities of the other, and their joint efforts would likely lead to maximum similarity in the principles applicable to each sector. Maximum similarity between the principles of such organizations could prove to be very advantageous--especially when comparing the financial results of organizations in each sector that performs similar functions.

THE WILLIAMS BILL

A further development in this area is S.1236, a bill introduced by Senator Harrison Williams called the "State and Local Government Accounting Act of 1979." This act provides for an eleven-member, federally financed institute that would assume responsibility for setting accounting and financial reporting principles for State and local governments. The institute would be represented by members of the:

--Federal Government (1 member),

--State government (3),

--local government (2),

--public accounting profession (2),

--financial analyst community (1), and

--public sector (2).

The members would be appointed by the Secretary of the Treasury, the Chairman of the Securities and Exchange Commission (SEC), and the Comptroller General. These officials would have the authority to approve bylaws, but would not be permitted to change the principles and reporting standards adopted by the institute.

I recognize that to many of you, Federal involvement in such standard setting would be repugnant, but I suggest that you look at the idea with unbiased eyes. The NCGA has consistently had problems with funding, and even though it now appears that the HUD grant may provide the NCGA with the support it needs currently, this grant only covers a 3-year period. If the experience of the FASB is any guide--and I think it is--the need for an institute that is responsible for setting standards for State and local government could extend considerably beyond that period. This institute, with its representative board, might prove to be the long-term answer to this problem.

ENFORCEMENT A MATTER OF CONCERN

Of course, setting standards for State and local accounting is only part of the problem. Getting people to comply with them is equally important. Judging by the MFOA Certificate of Conformance Program, compliance with the standards in GAAFR has not been good.

As you know, any State or local governmental unit can participate in the MFOA Certificate of Conformance Program. In order to receive a certificate, an entity must submit a comprehensive annual report in conformance with the accounting principles established by NCGA in the GAAFR.

A careful review is made of these reports to see that they follow the GAAFR principles. Presently, Alaska is the only State that has obtained a certificate of conformance. Approximately 230, or less than 1 percent, of the 40,000 local governments have obtained this certificate. We recognize that some State and local governments probably comply, or are close to complying, but have not attempted to obtain the certificate. Nonetheless, these statistics indicate that the record of compliance with the GAAFR standards could be greatly improved.

Everyone should be concerned with enforcing of the standards once they are set. Whether you support the FASB, the NCGA, or the institute specified in the Williams bill as the body responsible for setting standards, you should consider the matter carefully; no standards can be effective if they are not enforced.

Enforcement of FASB standards for profitmaking enter-
prises is done indirectly through the Securities and Exchange 159
Commission. The SEC, which generally supports the accounting standards established by the FASB, requires audits from companies listed with the stock exchanges. The accounting profession makes these audits, and its ethics require the auditor to follow the accounting standards set by the FASB. Thus, the independent auditor is the enforcement mechanism. If the standards are not complied with, the company gets a qualified audit opinion or a disclaimer, and this leads to trouble with the SEC.

Things work differently in the governmental sector. Many State and local governments do not use outside auditors and, even if they did, it is questionable whether they would feel restricted by the accounting standards set by NCGA or by whomever might do the job.

We have not worked extensively to determine what enforcement mechanisms might be used to see that such standards, once established, are actually followed. However, we have some thoughts on the subject that we would like to share with you.

One possibility would be to enact uniform State legislation mandating the use of such standards. In most States requirements could be established to prevent a local government from going into the bond market unless the State auditor indicated that the government's financial statements were prepared according to the established standards.

Another approach would be to amend the code of ethics of the public accounting profession to clarify that those who make State and local audits must comply with such standards. A further possibility would be to include in Federal grant legislation the requirement for compliance with such standards. I think that you should consider these and other possibilities because establishing standards without appropriate enforcement is doing only half the job.

Before closing, I would like to make one more point about good accounting. Most of you are no doubt aware of the serious situation we have had in the General Services Administration (GSA) involving extensive fraud and other illegal activities. There are two basic approaches to stopping fraud and similar illegal activities. One way is to make examples of some of the perpetrators by identifying them and seeing that they receive appropriate punishment. This is a necessary part of the fraud prevention picture but--as most law enforcement officers will tell you--one of limited effectiveness. We need only see how many criminals currently occupy our jails to realize that the threat of punishment is not always an effective deterrent. 17

A second approach to stopping fraud is to tighten up an organization's internal controls making fraud, embezzlement, and other illegal activities as difficult as possible. We find that Federal internal controls need a great deal of improvement, and we have an extensive effort underway to identify problems and get the involved agencies to solve them. Also, some congressional committees are considering the feasibility of having Federal executives report annually on the effectiveness of their internal controls, just as industry heads are required to do under the Foreign Corrupt Practices Act. We support these efforts because we believe that better internal controls are the best defense against fraud and other illegal activities.

CONCLUSION

In conclusion, we in GAO are very much interested in the financial reporting of State and local governments because we are responsible for informing the Congress of whether State and local funds are used effectively and for authorized purposes. We rely on State and local governments' accounting systems to provide us with the information we need on how they spend Federal grant and revenue sharing funds. Those funds now total about $85 billion annually, which constitutes approximately 25 percent of all State and local outlays.

We are optimistic that State and local accounting--and financial reporting--will greatly improve in the next few years. We are also optimistic that productive working arrangements can be made between the FASB and the NCGA so that the best thinking of both organizations can be brought to bear on the needs of managers, legislators, financial analysts, and the public for better information. In my opinion, much progress has been made in reaching a better understanding of the issues involved and the need for cooperation between the two standards-setting groups. On this note of optimism, I wish you a successful meeting.