Objectives of Financial Reporting and Their Problems in Governmental Accounting

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1. Introduction

It is widely known that the recent deterioration in the fiscal condition of local governments has triggered an attempt to raise awareness among residents of the severity of the situation through the introduction of corporate-style accounting and the release of financial statements such as balance sheets. And in addition to balance sheets, local governments have also started releasing administrative cost calculation statements, which are equivalent to corporate income statements. There therefore seems to have been a rapid expansion in financial disclosures by local governments. At the same time, starting with the announcement in March 2003 of “Public Accounting Conceptual Framework,” a theoretical foundation for financial reporting by local governments and other public sector organizations is gradually being laid down.

The United States, however, is well ahead of Japan in this area. The third edition of Statements of Financial Accounting Concepts (hereinafter referred to as Concepts Statements) and the 42nd edition of Statements of Financial Accounting Standards (hereinafter referred to as Standards Statements) for states and local governments have been already issued. It therefore goes without saying that a study of these concepts and standards will prove useful for conducting a theoretical examination of local-government accounting in Japan.

Although Concepts Statements address numerous issues, in this paper I will focus on the objectives of financial reporting. The reason for this approach is that financial reporting objectives are the key determinant of the nature of a financial reporting system. This is obvious because financial reporting objectives have a significant impact on the content of financial reports. In conducting my analysis, I will highlight the unique characteristics of Japanese public financial reporting by comparing them with those of the United States as defined in Concepts Statements referred to earlier. I hope that my analysis in this paper will enliven the debate on local-government financial reporting, and perhaps make a small contribution to improving such reporting.

2. Objectives of Financial Reporting as Defined in GASB [1987]

In this section, I will survey the objectives and characteristics of financial reporting using GASB [1987] as a guide. GASB [1987] defines three “objectives of external financial reporting by state and

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local governmental entities" (par. 1):

> Financial reporting should assist in fulfilling government's duty to be publicly accountable and should enable users to assess that accountability. (par. 77)
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> Financial reporting should assist users in evaluating the operating results of the governmental entity for the year. (par. 78)
>
> Financial reporting should assist users in assessing the level of services that can be provided by the governmental entity and its ability to meet its obligations as they become due. (par. 79)

Among these three basic objectives, GASB [1987] "gave considerable weight to the concept of accountability" (par. 76). Here, accountability is used in its dictionary sense: "being obliged to explain one's action, to justify what one does" (par. 56). Accountability is also described as "the paramount objective from which all other objectives must flow" (par. 76). As these remarks clearly indicate, GASB [1987] positions the exercise of accountability as the ultimate objective of financial reporting.

But why is the exercise of accountability assumed to be the ultimate objective of financial reporting by states and local government organizations? To begin with, "financial reporting is not an end in itself but is intended to provide information useful for many purposes" (par. 3). Therefore, "financial reporting objectives should consider the needs of users and the decisions they make" (par. 3). According to GASB [1987], there are assumed to be three main groups of users of external financial reports issued by states and local governments; (1) citizens, (2) legislative organs and regulatory organizations, and (3) investors and lenders. What is worthy of attention here is that citizens are mentioned first. Here, the term "citizens" encompasses, among others, individual citizens (whether they are classified as taxpayers, voters, or service recipients), the media, advocate groups, and public finance researchers (par. 31). What is deemed to be more important than anything else is that "government is primarily accountable" to these citizens (par. 30). In other words, the duty of a government organization to explain in detail the financial impact of its administrative activities is most pronounced towards its citizens.

Here, citizens are taxpayers, and there can be said to be a special relationship between taxpayers and services used. First, "taxpayers are involuntary resource providers" (par. 17.a). Even if they feel that certain (or even all) public services are nonessential, unless they move out of the jurisdiction, they do not have the choice of not paying taxes. This is very different from the situation with corporate accounting, because if shareholders are dissatisfied with their company's performance, they may be able to sell their shareholdings on the stock market and recover the money they invested. Taxpayers, however, have to pay taxes whether they like it or not. Second, because the amount of tax a person pays is calculated based on his or her income, "it seldom bears a proportional relationship to the cost or value of the services received by that individual" (par. 17.b). This is easily illustrated with the fact that even if, for example, an individual makes frequent use of a certain road, there will be no increase in his or her tax bill. Third, "there is no 'exchange' relationship between resources provided and services received" (par. 17.c) by citizens, because the services used by a particular citizen are not directly covered by the taxes that he or she pays. Therefore, "the 'matching' relationship that normally exists between resources provided and services received is a timing relationship (that is, both occur during the fiscal year) rather than an exchange relationship" (par. 17.c). These special circumstances[1)]

[1)] In addition to the three points described here, GASB [1987] also mentions that many public services are provided exclusively by the government (par. 17.d), and that it is difficult to determine the optimum quantity and quality of services to provide (par. 17.e). Regarding the first point, because most companies sell their goods or services in competitive markets, it is relatively easy to measure the efficiency of their provision of goods and services because comparisons with other companies are relatively easy to make. However, in the case of public "highlight the need for public accountability in governmental financial reporting" (par. 18). In other words, the government must explain how it compulsorily procured resources from citizens, and what it did with these resources.

After all, "governmental accountability is based on the belief that the citizenry has a 'right to know', a right to receive openly declared facts that may lead to public debate by the citizens and their elected representatives" (par. 56). Because of the special relationship described above between taxpayers and services used, citizens are deemed to have this right to know, and this principle draws on government accountability.

In addition "at a minimum, demonstrating accountability through financial reporting includes providing information to assist in evaluating whether the government was operated within the legal constraints imposed by the citizenry" (par. 58). Here, legal constraints refer to laws and regulations concerning balanced budgets and bond issuance limits. In particular, the intent of legislation requiring balanced budgets is to "require financing and spending practices that enable governmental entities to avoid financial difficulty and to 'live within their means'" (par. 59). Regarding this objective, GASB [1987] explains at length that "the current generation of citizens should not be able to shift the burden of paying for current-year services to future-year taxpayers." GASB [1987] calls this concept of annual balanced budgets "interperiod equity" (par. 60). "Interperiod equity is a significant part of accountability," (par. 61) and it is essential that financial reports are useful for assessing it.

Although, as we have seen, GASB [1987] defines public accountability as the most important basic objective of financial reporting by states and government organizations, it is by no means assumed to be the only basic objective. According to GASB [1987], "governmental financial reporting should provide information to assist users in (a) assessing accountability and (b) making economic, social, and political decisions" (par. 76). In other words, financial reporting is expected to support not only the exercise of public accountability, but also economic, social, and political decision making. However, given the special relationship between taxpayers and services used I described earlier, the decisions that citizens can make based on government financial reports are limited, with deciding (i.e. voting) whether to place confidence in national (or local) government officials one of few such examples. In contrast, financial reports are obviously of use to investors or lenders, the third group of users mentioned earlier, in making decisions about whether to invest or extend credit.

3. Objectives of Financial Reporting as Defined in JICPA [2003a]

In the previous section I described the objectives and major characteristics of financial reporting by states and other local government organizations in the United States. In this section I will examine the objectives of financial reporting by local governments in Japan using JICPA [2003a] as a guide. JICPA [2003a] divides users of public financial information into four groups: (1) the public, (2) those at the helm of state (cabinet members), (3) members of the Diet, and (4) other stakeholders. The last group, other stakeholders, includes investors, creditors, credit rating agencies, foreign governments, international organizations, economists, analysts, and so on. Although this last group encompasses a wider variety of users than the corresponding group in GASB [1987], the other three groups are almost identical. That GASB [1987] and JICPA [2003a] both name citizens (or the public) as their first

services provided exclusively by the government, there is no object of comparison, and measuring efficiency is therefore difficult. On the second point, service users may have differing views on what level of service they consider optimal. When purchasing from companies, individuals can buy the quantity and quality of goods and services that is optimal for them, and the amount of money they pay will reflect this quantity and quality. These same individuals, however, have to pay taxes regardless of whether they use a specific public service or not. Because of these special circumstances, "in government there is no single overall performance measure such as net income or earnings per share. The user of governmental financial reports must therefore assess accountability by evaluating performance through a variety of measures" (par. 18).

group is particularly worthy of note.

JICPA [2003a] gives two objectives for public accounting: to make responsibilities clear and enhance decision-making (pp. 23-28). Regarding the clarification of responsibilities, JICPA [2003a] states that "the fundamental function of accounting is to record and quantify accounting events that result from the execution of stewardship by asset custodians, and by checking these records against the actual condition of assets, explain, in accounting terms, the process from a point where the steward is charged with stewardship to a point where he/she is discharged" (p. 24). Based on this basic idea, it goes on to state that an objective of public accounting is "to make the responsibilities of the government in the area of fiscal administration clear through the disclosure of information, such as the government's overall financial condition, concerning the government's conduct and performance in the execution of stewardship" (p. 24). In addition, JICPA [2003a] also describes the two concepts of public governance and accountability as being related to the objective of making responsibilities clear (p. 24). Here, public governance is defined as "the imposition of discipline on those at the helm of state (cabinet members)"[2)](p. 25). It also states that "public accountability, which is based on the premise that under the national governance structure the government is responsible for stewardship under trust law, refers to the accountability of the government to the public for its conduct and performance in its execution of stewardship, i.e. its duty to report and explain how it makes decisions and determines policy on the use of taxpayers' money, its service efforts and accomplishments, and so on" (p. 26). Expressed more simply, public accountability is the duty of the government, which has been entrusted with tax money by the public and has a stewardship responsibility toward them, to explain to the public, in financial terms, whether it has performed its stewardship role adequately. On this point, JICPA [2003a] has the following to say:

> Those with the biggest stake in the administration of public finance are the public themselves, and they include both the current generation and future generations. The government, which is entrusted by the public with economic resources through their payment of taxes and other public charges, has a duty to report and explain to them the results of its use of these resources in the form of statements about, for example, its overall financial condition (p. 15).

Regarding the second objective of public accounting, namely, to enhance decision making, JICPA [2003a] states that "the public, those at the helm of state, members of the Diet, and various other information users should, when making decisions, be provided with useful accounting information" (p. 28). For example, "information users (the public, members of the Diet, etc.)" can "use public accounting information … to make decisions such as whether to place confidence in those at the helm of state (cabinet members and the cabinet itself) or replace them" (p. 28).

As we have seen, while the objectives of financial reporting set forth in GASB [1987] and JICPA [2003a] differ slightly in terms of the way they are described and on some individual points, they are broadly the same. The two documents are particularly similar in that they both assume that the first group of information users is citizens (which here and in the discussion that follows will mean the same as "the public"), and that they both name public accountability (clarification of stewardship responsibility that leads to public accountability) as the first objective.

[2)] JICPA [2003a] states that "public governance is a structure and mechanism that gives rise to obligations and responsibilities for agents (i.e. the cabinet) to make decisions that do not harm the interests of principals (i.e. the public). It exists under a national governance system in which principals entrust the management of economic resources to agents through the payment of taxes, i.e., a system in which the current generation and future generations of taxpayers entrust fiscal management to their own agents, namely, those at the helm of state (i.e. cabinet members and the cabinet itself), all of whom are from the current generation" (p. 25).

4. Awareness by Citizens of What It Means to Be Taxpayer

As we saw in the previous section, both GASB [1987] and JICPA [2003a] emphasize the importance of public accountability to citizens. This is unlikely to be a mere coincidence. Governments are provided with resources by taxpaying citizens, and it is logical that governments should have a duty to explain to citizens how they are using these resources. This is something that is common to all countries.

However, one matter cannot be overlooked: the differences among countries in the degree to which citizens are aware of what it means to be a taxpayer. Americans are often said to have a high level of such awareness. They are said to keep a constant eye on how their taxes are being used, and to be quick to complain when they feel dissatisfied. Such behavior probably has its roots in a feeling among citizens that they are the providers of the resources the government needs to run the country (i.e. principals), and that the government is merely their agent in charge of administering the country. An agency relationship can therefore be seen to exist. Here, agency relationship refers to "situation in which one individual (the agent) acts on behalf of another (the principal) and is supposed to advance the principal's goals" (Milgrom and Roberts [1992], p. 170).

What, however, of the situation in Japan? The prevailing attitude among the Japanese is that taxes are just something that is taken away from them by the powers that be. In other words, once they have paid their taxes, Japanese people feel that they have nothing more to do with this money, and therefore have little interest in how the government uses it. Although an agency relationship of the type seen in the United States can objectively be said to exist, most citizens are not subjectively conscious of it. The Japanese have little awareness that they are just entrusting their taxes to the government.

In short, Japan and the United States have completely different cultures when it comes to citizens' perceptions of themselves as taxpayers. This difference in the degree to which citizens are conscious of what it means to be a taxpayer is an extremely important issue to consider when thinking about financial reporting by the government. When citizens have a strong interest in how the government is using their tax money, as is the case in the United States, financial reporting by the government will be effective in imposing discipline on government activities. However, when citizens are not particularly aware of what it means to be a taxpayer, as is the case in Japan, even though the government respects that "the citizenry has a 'right to know'" (par. 56) by producing comprehensive financial reports, if citizens are not interested in them, the reports will not be read, and thus rendered ineffective. "Accounting theory and culture are not very readily separable" (Gambling [1974], p. 107), so even though both Japan and the United States share a theory of accounting that positions public accountability as the basic objective of government financial reporting, as long as Japan does not have the culture to support this theory, it will be difficult for financial reporting by the government to adequately perform the functions expected of it.

5. The Background to Public Accounting Reform

In the previous section I showed that because Japanese citizens have little awareness of what it means to be a taxpayer, it is possible that government financial reporting in Japan is not adequately functioning as a means of imposing discipline on government activities. If this is indeed the case, why has a debate on the objectives of public financial reporting begun? What are the circumstances that have led to the recent public accounting reforms?

A look at the series of debates on public accounting reform reveals that the financial crisis facing the national government and local governments has been a major issue[3]. When a local government's actual fiscal-year shortfall in its ordinary account exceeds five percent[4] of its standard financial size, bond issuance limits that prohibit it from issuing bonds to fund the construction of public facilities are imposed. Later, if the local government's fiscal reconstruction plan is approved by the Minister for Internal Affairs and Communications, the local government is designated as a "reconstructing organization" under the Special Measures Law on Local Finance Reconstruction, and the bond issuance limits are lifted. However, while the bond issuance limits are lifted, considerable restrictions on the public services the local government can provide are still imposed. To free themselves from these restrictions, local governments have taken such steps as issuing bonds for tax reduction, stopping additions to bond sinking funds, and tapping into other funds. However, it is difficult to describe such policies as full-scale reforms, for they are merely putting off problems (Daigo [2000], pp. 59-66).

This sense of crisis surrounding the financial condition of local governments is also clearly described in JICPA [2003a]:

> The Japanese government's finances have reached crisis point, and this will result in intergenerational inequality. However, despite this grave situation, the government has not become any more disciplined in its financial management, as even now the balance of outstanding government bonds continues to rise. The cumulative effect of poor decision making by the government will ultimately cause significant harm to the interests of the public, and particularly future generations, who have no means of protesting (p. 11).

Despite the fiscal crisis facing local governments, local government employees are very well paid, and even ignoring the case of Osaka Prefecture, this has frequently been cited as a problem. The problem is that while these employees are supposed to be public servants working in the interests of citizens, they tend to exploit their power for personal gain. In the language of economics, a moral hazard exists. Here, moral hazard refers to "the form of post contractual opportunism that arises because actions that have efficiency consequences are not freely observable and so the person taking them may choose to pursue his or her private interests at other's expense" (Milgrom and Roberts [1992], p. 167).

The reason that this type of moral hazard emerges is this: with the interests of local-government employees at odds with those of citizens, employees engage in inefficient conduct based on their own self-interest and citizens are unable to monitor their conduct effectively[5]. In other words, for a moral hazard to emerge, three conditions need to be met (Milgrom and Roberts [1992], p. 185). First, "there must be some potential divergence of interests between people" (Milgrom and Roberts [1992], p. 185). This point is easy to understand when you think of a situation in which employees are being over-generously compensated. From the employees' standpoint this is obviously a good thing, but the same cannot be said when standing in the shoes of citizens, for whom it constitutes an unnecessary use of their taxes. Second, "there must be some basis for gainful exchange or other cooperation between the individuals – some reason to agree and transact – that activates the divergent interests" (Milgrom and Roberts [1992], p. 185). Third, "there must be difficulties in

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[3] Another issue that has influenced recent public accounting reform is the decentralization of funds procurement. Until now, municipal bond issuance has only required the authorization of the minister for internal affairs and communications or the governor of the prefecture. However, in fiscal 2006 this system will be scrapped, and issuance will have to be preceded by consultations. This will enable local governments to take responsibility for the issuance of municipal bonds. This change has resulted in the financial health of individual local governments coming under increasing scrutiny.
[4] This is for prefectures. For cities, towns, and villages, the figure is 20 percent.
[5] In general, "the moral hazard problem arises when agent and principal have differing individual objectives and the principal cannot easily determine whether the agent's reports and actions are being taken in pursuit of the principal's goals or are self-interested misbehavior" (Milgrom and Roberts [1992], p. 170).

determining whether in fact the terms of the agreement have been followed and in enforcing the contract terms" (Milgrom and Roberts [1992], p. 185). This point is easily understood when you consider that even though people may poke fun at "bungling bureaucrats," this is merely a subjective assessment, as citizens have few methods of objectively measuring the performance of government employees.

6. Controlling Moral Hazard

If, as I explained in the previous section, the financial crisis facing local governments in recent years is regarded as the result of inefficient performance caused by moral hazard on the part of local-government employees, public accounting reforms will be positioned as countermeasures for controlling this moral hazard. Efforts will therefore be made to have financial reports from local governments used as a means of enabling the conduct of their employees to be monitored. In other words, monitoring is expected to be a prescription for controlling moral hazard. Of the three conditions necessary for moral hazard described above, it constitutes a prescription for the third condition. The reason that this kind of monitoring, using financial reports, is considered to be promising is understandable given that JICPA [2003a] emphasizes stewardship as an objective of public accounting and aims to use financial reporting to establish public governance. Financial reporting is seen as establishing a "structure and mechanism for creating duties and responsibilities for agents (i.e. cabinet members or local-government employees) that ensure that agents do not make decisions that conflict with the interests of principals (i.e. the public)" (JICPA [2003a], p. 25) and is aimed at "imposing discipline on those at the helm of state (i.e. cabinet members) or local-government employees" (JICPA [2003a], p. 25). On this point, JICPA [2003a] has the following to say:

> The main issues targeted by this framework are how to get the Japanese government to make efficient use of the economic resources it receives from the public (i.e. taxpayers and voters) through the payment of taxes or other public charges, and how to ensure that decisions made by the government in its management of the country are adequate and disciplined from a fiscal management perspective (p. 11).

As we have seen above, the recent introduction of financial reporting in conjunction with reforms of the public accounting system is being positioned as a means of controlling moral hazard on the part of local governments (and especially as a means of monitoring), and can therefore be seen to be aimed at imposing discipline on local governments. However, as I mentioned in section 4, the citizens of Japan have scant awareness of what it means to be a taxpayer, and their modes of behavior may not yet extend to the monitoring of the ways in which their taxes are used. Given such circumstances, even if local governments issue financial reports, doubts will remain about whether the reports are adequately performing the role they are supposed to be performing.

Even so, this does not mean that financial reporting is a completely ineffective means of solving the problem of moral hazard at local governments. The next thing to do is simply to find an alternative way, besides monitoring, for financial reports to be used to control moral hazard. One such way might be to establish contracts that feature clear incentives (incentive contracts)[6] and employ items in

[6] Milgrom and Roberts [1992] offer several prescriptions for controlling moral hazard: monitoring, clear incentive contracts, security deposits, self-execution, changes in ownership, and organizational change (pp. 185-192). The use of security deposits involves having agents deposit a sum of money as a means of guaranteeing a certain level of performance, such that if the agent acts improperly, the deposit is confiscated. This can be described as a bonding system, as it encourages the agent to win the trust of the principal. The use of self-execution, changes in ownership, or organizational change involve the principal not hiring an agent and doing the work alone, or modifying forms of ownership or organizational structures in such a way as to internalize market transactions within the organization.

financial reports as performance targets. If the results of local government activities are observable, and a system is designed that provides some kind of reward for good performance, it will be possible to impose discipline on administrative activities by giving employees incentives to act in a desirable way. Here, incentive contracts are based on a basic notion called “goal congruence” (Milgrom and Roberts [1992], p. 188). That is to say, a system is designed under which even if local-government employees act in their own interests, i.e. by seeking rewards, their behavior will result in an improvement in public services. Put another way, incentive contracts are a way of eliminating the conflict of interest between employees and citizens, and constitute a prescription for the first of the three conditions, described earlier, that need to be met for moral hazard to emerge.

An example of such an incentive contract might be the design of a system that links compensation and promotion to the state of public services. Under such a system, even if employees act to satisfy personal interests such as increasing their compensation or winning a promotion, their behavior will result in better public services. However, it is difficult to determine comprehensive performance indicators, like the net income or earnings per share indicators normally used to gauge the performance of for-profit corporations, for measuring the state of public services (i.e. performance). Performance therefore needs to be evaluated using a variety of indicators (GASB [1987], par. 18). Looked at from this perspective, more information than just the cost of providing public services will be needed if the state of public services is to be adequately conveyed. In the United States, for example, information such as SEA (Service Efforts and Accomplishments) reports is required. SEA reports “provide more complete information about a governmental entity’s performance than can be provided by the operating statement, balance sheet, and budgetary comparison statements and schedules to assist users in assessing the economy, efficiency, and effectiveness of service provided” (GASB [1994], par. 55). Specifically, these reports contain metrics that measure effort (the financial and non-financial resources used in the provision of public services), performance (what was provided and achieved through the use of the resources), and metrics that link effort and performance (GASB [1994], par. 50).

One thing that should be kept in mind when designing a system that links compensation and promotions with the state of public services is that employees are subject to the risk that compensation and opportunities for promotion might be affected by factors that are beyond their control. For example, if the economy deteriorates and tax revenues fall, public services may need to be pared back. However, the state of the economy is something that is almost impossible for frontline employees to control[7]. Care therefore needs to be taken when deciding what indicators to link compensation and promotions to, what proportion of compensation should be affected, and to what extent the possibility of promotion should be influenced.

7. Conclusion

In this paper I have examined the objectives of, and issues concerning, public financial reporting in Japan by comparing the situations in Japan and United States. Although the introduction of corporate accounting is a key feature of recent reforms of the public accounting system, “the differences between accounting methods of NRIOs (Non-Residual Interest Organizations) and business firms do not constitute prima facie evidence that the former are defective and should be altered to conform to the latter” (Sunder [1997], p. 198). This obviously means that simply transplanting corporate accounting methods will not necessarily lead to improvements in the public accounting system. The recent debate surrounding public accounting has tended to emphasize the

[7] Although certain employees, such as those engaged in economic policy formulation, may have some control over the state of the economy, the discussion here is of the general situation of employees as a whole.

importance of providing information that is useful for decision making by the users of the information (i.e. the decision-making support function). However, given the circumstances surrounding local governments, the most promising role of accounting information is probably to ensure the exercise of accountability. Even so, with differences between Japanese and Americans in their awareness of what it means to be a taxpayer, a focus on accountability alone will not be enough to instill discipline in governments. An important key, therefore, is to design an incentive system that is based on financial information.

The design of an incentive system based on financial information emphasizes the contract support function of accounting[8]. However, care needs to be taken when deciding what kind of contracts will be beneficial. This is a topic that I intend to explore in the future.

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8) The contract support function means that "facilitating the monitoring and enforcement of contracts,thereby reducing conflicts of interest among the parties and lowering agency costs" (Watts and Zimmerman [1987], p. 202).

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