The Fatal Defect in the Federal Accounting System

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For many years, the federal accounting system has focused on obligations. Beginning in 1949, several blue-ribbon committees recommended changing the focus to expenses. Focusing on expenses provides more useful information than focusing on obligations for both planning and control purposes. Unfortunately, the House Appropriations Committee continues to make appropriations on an obligation basis. The Federal Accounting Standards Advisory Board (FASAB) has developed a system that focuses on both expenses and obligations that was supposed to be operational in 1997 but in fact will not be operational until 2003 at the earliest. Even then, users will not pay much attention to the expense focus if funds continue to be appropriated on an obligation basis.

INTRODUCTION

Since the end of World War II, there have been four major attempts to modernize the federal accounting system. Some improvements have been made, but none changed the focus of the federal operating system from an obligation basis to an expense basis, which is the most needed change. The federal government has entered the twenty-first century with this basic defect.

In this article, I first explain the difference between expense accounting and obligation accounting. Then I describe each of the attempts to implement an expense accounting system, the obstacle that has prevented these attempts from succeeding, and the actions needed to overcome this obstacle.

The analysis focuses on the system used for planning and control of operating activities. The current system for planning and controlling capital acquisitions is excellent. The special accounting system used by agencies that lend and borrow also is excellent.

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OBLIGATION ACCOUNTING AND EXPENSE ACCOUNTING

Throughout the twentieth century, the House Appropriations Committee has been responsible for the legislation that governs the financial operations of federal agencies. It has written such legislation with a focus on obligation authority. An obligation is a contract between the government and a supplier or employee to provide goods or services. Obligation authority states the maximum dollar amount of such contracts that can be entered into in the budget year. The advantage of the obligation system is that control over the amount authorized is easily determined; it is stated in the contract. Legally, a contracting officer who signs a contract that exceeds the authorized amount must personally repay the excess. This penalty is stated in the Anti-Deficiency Act (R.S. 3679). Consequently, the authorization is rarely exceeded. Most identified excesses are the result of a clerical error, and they are forgiven.[1]

An expense accounting system focuses on resources consumed by an agency—specifically, by a responsibility center within that agency. This is the same focus that businesses use in reporting resource outflows. Expenses for employees include salaries, pensions, and other fringe benefits. Expenses for supplies and utilities are the amounts used during the year (as stated in invoices), and expenses for purchased services, such as maintenance, travel, and outside experts, are the cost of the services received during the year.

The following examples illustrate the difference between expense and obligation accounting:

- A contract made by an officer in the Naval Supply Depot in Mechanicsburg in 2000 to buy widgets that will be used in the Charlestown Navy Yard in 2001 is a Mechanicsburg obligation in 2000 and a Charlestown expense in 2001.[2]
- In the obligation focus, the cost of a "borrowed" employee is reported by the agency to which the employee is permanently assigned; in an expense focus, the agency that borrows the employee is charged for the cost.
- A contract signed in 2000 to paint a building is reported as a 2000 obligation; if the building is painted in 2001, it is a 2001 expense.
- A 2000 contract for travel costs is a 2000 obligation, but it is a 2001 expense if the trip was made in 2001.

Expense accounting reports the costs of resources used and matches them with the results obtained, and it holds the manager who authorizes the use of these resources accountable for them. Associating expenses with the results obtained is a useful measure of efficiency in many responsibility centers. Even if there is no valid quantitative measure of results, the comparison of actual expenses with budgeted amounts is an important mea-

1. Some years ago, the Army overspent its obligation authority by $225 million because its control system broke down, but no one went to jail and no one paid back the $225 million.

2. My examples are taken from the Department of Defense because I am familiar with this organization. Similar examples can be found in other agencies.

sure of performance. An expense system is much more useful to managers in making decisions—and for judging their performance—than an obligation system.

An obligation system can be easily manipulated. If the obligation authority exists, a contract can be charged to it, even if the goods or services are not actually needed. In an expense system, unnecessary expenses are less likely to be incurred because the resulting amount usually can be compared with some measure of performance.

A "Beetle Bailey" comic strip is my favorite example of the basic defect of an obligation system. Lieutenant Fuzz is in a staff meeting called by General Halftrack. In the first panel, Fuzz reports with obvious pleasure, "Sir, the battalion will have $281 left over for the remainder of the fiscal year." General Halftrack responds, "So?" Fuzz says, "I thought you'd like to send it back to Washington so they can give it back to the people." The final panel shows Lieutenant Fuzz sitting in the corner, bound and gagged, and General Halftrack asks, "Any more reports?"

Most business and nonprofit organizations use expense-based systems, as do the governments of other countries, including Canada, the United Kingdom, Australia, and New Zealand.[3] U.S. state and municipal organizations do not now use expense-based systems, but Statement 34 of the Governmental Accounting Standards Board requires that they do so by 2003.[4]

There is some overlap between the obligation system and the expense system. In recent years some agencies have included fringe benefits as part of employee expenses. Some agencies do charge the cost of borrowed employees to the office that borrowed them. As mentioned below, some costs can be held in working capital funds and later charged to the responsibility center that used the resources. But these are exceptions to the general rule.

HISTORY

Early Years

Shortly after the Republic was founded, the Treasury Department began keeping records of cash receipts and disbursements and the resulting assets and liabilities. Treasury also keeps accurate records of appropriated funds. Until the General Accounting Office (GAO) was created in 1921, these Treasury Department records were the only government-wide financial records, although some agencies had internal accounting systems for their own management purposes.

The GAO is responsible for auditing all government expenditures. Until World War II, it required that agency records be sent to Washington for auditing. This approach became

3. U.S. General Accounting Office, *Accrual Budgeting Experiences of Other Nations and Implications for the United States,* GAO-AIMD-00-57 (Washington, D.C.: GAO, February 2000).

4. Although GASB 34 deals only with financial statements, the budget system is necessarily consistent with it. The financial statements give the "rules of the game"; the budget system must be consistent with these rules.

unworkable in the 1940s: the number of documents awaiting audit literally filled a warehouse. Consequently, the GAO made the agencies responsible for keeping their own records, and it audits these records from field offices—the same practice businesses use.

In 1947 the GAO established an Accounting Systems Division. In 1950 the Budget and Accounting Procedures Act made the GAO responsible for developing accounting principles for use by federal agencies. One of its requirements was that agency systems should be placed on an expense basis "as soon as practicable." The Accounting Systems Division helped several agencies, on a voluntary basis, develop expense accounting systems.

First Hoover Commission

The report of the first Hoover Commission (1949) recommended that the federal system focus on expense accounting. Many of its recommendations were controversial, however, and no law mandating expense accounting was enacted.

In the Department of Defense (DoD), the assistant secretaries of the various services asked the assistant secretary of defense (comptroller) what they should do to implement the Hoover Commission recommendations. The reply was, "Nothing."

Second Hoover Commission

The second Hoover Commission (1955) also recommended expense accounting for the federal system. This recommendation led to Public Law 863 (1956), which required agencies to install expense systems "as soon as practicable." Two agencies thereupon submitted budgets on an expense basis to Congress. The House Appropriations Committee rejected both budgets without comment. That was the end of expense accounting. P.L. 863 is still on the books.

Other Developments

Although there was no legislation relating to federal agency accounting practices for many years after the second Hoover Commission, several actions relating to expense accounting were taken. In the DoD, each of the three services developed accounting systems that reported expenses. In the 1960s the DoD developed a system that reported both obligations and expenses. It received a citation for this work from the Federal Government Accountants Association. Two days before the banquet at which this citation was to be presented, the House Appropriations Committee issued a letter refusing to appropriate additional funds to test the system.

When the Bureau of the Budget became the Office of Management and Budget (OMB), the new "Management" division was given responsibility for developing management accounting systems. However, this division was small. It was somewhat successful in persuading agencies to adopt expense accounting systems for internal purposes, although it had no power to require such action.

The Joint Financial Management Improvement Program, formed in 1948, was a small organization that exchanged ideas among the agencies with some success. In 1993 the vice president's *Report of the National Performance Review* recommended that an expense accounting system be developed. [5]

None of these efforts had much effect on accounting systems. The obligation system had the "power of the purse," and managers paid little attention to a system that did not have this power.

Working Capital Funds

A working capital fund is a device for holding costs in suspense in the interval between the time and place in which they are obligated and the time and place in which they are consumed. It therefore permits some expense items to be reported within an obligation system. It charges the cost of using some inventory items to the responsibility center that uses them and charges the obligation when an item is issued to the user. Working capital funds also permit the cost of certain services, such as motor pools, to be charged to the responsibility center that used their services. In the 1960s the DoD created working capital funds totaling $5 billion.

However, the applicability of working capital funds is limited. The DoD attempted in the 1990s to develop a Defense Business Operations Fund (DBOF); it used working capital funds more broadly than is practicable. The DBOF, established in October 1991, accounted for annual operating costs of $77 billion. It was supposed to charge the cost of goods and services provided by support and overhead activities to the responsibility centers that received these products. The original plan was to implement the accounting system for this agency by December 1993.

The DBOF had difficulties from the beginning. In August 1995, its manager admitted that disbursements of $16 *billion* could not be traced to the agencies that actually received the services. The system never produced reliable reports for managers of support and overhead activities or for managers of the agencies receiving the services. On December 11, 1996, the DBOF was discontinued. The lesson from this experience is that the working capital fund device will work only for inventories and for specific agencies, such as repair facilities and motor pools.

FEDERAL ACCOUNTING STANDARDS ADVISORY BOARD

The Federal Accounting Standards Advisory Board (FASAB) was created in 1991 by the heads of the three agencies responsible for developing accounting systems: GAO, the Treasury Department, and the OMB. The Government Management Reform Act of 1994, sponsored by the Senate Governmental Affairs Committee rather than the House Appropriations Committee, required the FASAB to develop a system that would produce government-wide financial statements, with the first such statements to be published for FY

5. Albert Gore, *Report of the National Performance Review* (Washington, D.C.: 1993).

1997. The Federal Financial Management Improvement Act of 1996 strengthened the requirements of the 1994 act.

The FASAB developed a system that reported both expenses and obligations. Because obligation information is likely to overshadow expense information, one wonders why the FASAB perpetuated the obligation system. Elmer Staats, the first chairman of the FASAB, is one of the most astute persons in Washington. My guess is that he decided that if obligation information was excluded, the House Appropriations Committee would oppose the FASAB legislation.

In 1998 the Treasury Department issued the first set of government-wide financial statements from the system the FASAB developed. In its letter accompanying these statements, the comptroller general stated:

> In summary, significant financial system weaknesses, problems with fundamental recordkeeping and financial reporting, incomplete documentation, and weak internal controls, including computer controls, continue to prevent the government from accurately reporting a significant portion of its assets, liabilities, and costs. . . . They also affect the government's ability to accurately measure the full cost and financial performance of programs and manage its operations.

The comptroller general described these weaknesses and problems in a nineteen-page letter. Accountants call such a letter a "disclaimer." It is similar to a failing grade in school. If a business corporation whose securities are listed on a stock exchange were to receive such a letter from its auditors (which is extremely rare), trading in its securities would be suspended immediately.

Financial statements are supposed to report the financial status of an entity as of the end of the fiscal year and its financial performance during the year. The comptroller general's letter said that these statements did not report either status or performance. It is no exaggeration to characterize the statements as worthless.

The financial statements generated a few newspaper stories, journal mentions, and congressional testimony. The Dow Jones story carried the headline "Budget Surplus Could Have Been Less under Private Accounting Rules," but the text made it clear that such a conclusion was not warranted by the headline. The effect was just as if a headline said "Riding Hood Girl Attacked in Her Home," but the accompanying text made it clear that this was a fairy tale and no attack had in reality occured.

Similar statements were reported for FY 1998. Donald V. Hammond, assistant secretary of the treasury, testified about these statements before a subcommittee of the House Government Reform Committee on March 31, 1999. Presumably, he was supposed to report progress. Actually, however, he did not describe a single item of useful information in the financial statements. Instead, his testimony mostly described implementation problems and offered promises to solve them.[6]

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6. Donald V. Hammond, "Testimony Before a Subcommittee of the House Government Reform Committee," March 31, 1999.

The comptroller general's report on the FY 1999 financial statements also took the form of a disclaimer letter from the comptroller general and generated even less interest on the part of the media. The most favorable comment that the comptroller general could make about the FY 1999 financial statements was that more agencies were complying with the FASAB standards each year. However, the numbers were far short of those needed to remove the disclaimer. A student who receives failing grades in all subjects in one semester and passes one of five subjects in the next semester has improved, but he or she is still a poor student. The FASAB system to date is a poor system.

It now appears that the FASAB system will not produce valid information until at least 2003. That means the data it provides, for at least the next three years, will continue to be inadequate. In fact, a balance sheet will never report numbers for the assets of the federal government that even remotely resemble the assets' actual cost or value (see Appendix). Records for assets acquired many years ago—for example, for the Louisiana Purchase, more than 100 years ago—simply do not exist.

Implementing the FASAB system will require a huge development effort and, equally important, a program that educates managers in how to use the new information. But because the expense-based part of the system will not be used in appropriating funds, obligation accounting will continue to dominate federal agency accounting practices.

The resources devoted to developing accounting systems compliant with FASAB have been inadequate. The Winter 1999 issue of *Armed Forces Comptroller* has eighteen articles about aspects of financial management systems in the DoD; only two mention the FASAB system, and they focus on bookkeeping mechanics rather than on the potential usefulness to managers of information the system could provide.

WHY THE OBLIGATION SYSTEM LIVES ON

As mentioned earlier, the House Appropriations Committee makes its appropriations on an obligation basis. Most other committees accept the obligation format; their decisions are easily incorporated into it. The Senate Governmental Affairs Committee has mandated an expense-based format, but this is in addition to, rather than instead of, the obligation basis.

There are several reasons why Congress has not shifted its budget to an expense basis. First, at the level of aggregation at which Congress works, there is only a slight difference between obligations and expenses. The important differences occur in responsibility centers within agencies. Therefore, there is little evidence at the congressional level that the obligation system needs fixing. Budget analysts at the OMB have the same attitude. A succession of OMB assistant directors for management have tried, unsuccessfully, to interest the OMB director and the president in expense-based budgeting.

Second, budgeteers in Congress and in the OMB are accustomed to the obligation system. They are highly competent and they are dealing with highly complicated problems. They have developed procedures for evaluating the thousands of line items proposed for the budget. They will accept change only if they are convinced that the benefits of changing will be worth the considerable effort of learning how to use the new information.

Third, agency officials are well aware of the proverb "Don't bite the hand that feeds you." They believe it is in their interests to concentrate on getting funding, not on persuading the appropriations committee to change.

Fourth, people who want to keep the existing system argue that it is easier to manipulate an expense-based system because expenses are more difficult to document than numbers stated in contracts. Ironically, as noted earlier, the opposite is true. Budgeteers oppose an expense-based system because this system would make their manipulations more difficult. In an expense-based system, control can be exercised over *both* obligations and expenses. Congress can legislate a ceiling on total obligation authority and account for the movement of funds from obligations to expenses by accounts for undelivered orders and for inventories.[7] Playing games with the budget will always be possible, but gaming is more difficult in an expense-based system.

Finally, there are few, if any, federal accounting lobbyists. Not many people understand—or care about—the difference between expenses and obligations. Consequently, the advantages of an expense system do not interest many representatives, senators, or their staffs.

CONCLUSION

The fact that information in the congressional operating budget system conflicts with that in the FASAB system is the greatest weakness in the FASAB system. The essential cause of this defect is a difference of opinion among congressional committees. The House Appropriations Committee continues to make appropriations on an obligation basis, but other committees recognize the merits of the expense basis. Because the appropriations committee has the power of the purse, federal agencies will not pay much attention to calls for an expense-based system. If both obligations and expenses are accounted for, managers at all levels will continue to base their decisions on information in the obligation system. Neither accountants nor managers will pay attention to the information in the expense-based accounts and, consequently, this system will simply atrophy.

7. The mechanics are described in Robert N. Anthony and David W. Young, *Management Control in Nonprofit Organizations* (Burr Ridge, Ill.: Irwin McGraw-Hill, 1999), 536–538.

APPENDIX
THE FEDERAL BALANCE SHEET

This Appendix expands on the brief statement in the text about a federal balance sheet. The FASAB probably assumed, without analysis, that a balance sheet is a necessary component of any accounting system. All business systems have a balance sheet; therefore, the government should have one. I think this assumption is unfortunate.

A balance sheet has two sides. The assets side of the balance sheet for the federal government lists the resources owned by the government, and the liabilities side lists claims against the government. The assets that the FASAB requires on its balance sheet, however, are only a small fraction of the government's assets. They do not include the millions of acres of land used for parks and grazing. They do not include the rights to minerals beneath the surface of this land, the forests on this land, or the minerals in the continental shelf. They do not include weapons systems, space exploration equipment, monuments, or other "natural heritage" assets. They do not include the assets of the legislative and judicial branches.

Moreover, the federal government has resources that are far more important than conventional assets in judging its ability to meet its obligations: It can levy taxes, and it can print money.

The long-lived assets to be reported on the FASAB balance sheet include only those items owned by agencies that carry out normal government activities. These assets are a small fraction of total government long-lived assets, but there is no way of knowing the size of that fraction. The balance sheet, therefore, does not accurately report the resources owned by the government, nor does it remotely resemble the coverage of a business balance sheet.

For assets that are to be reported, the FASAB rules are similar to those used in business—that is, items of property, plant, and equipment are to be reported at their original cost less depreciation. The resulting book value presumably measures that portion of the cost that so far has not been written off as an expense. Businesses have recognized depreciation ever since the amount of depreciation claimed became tax deductible in the 1920s. Except for business-like agencies (e.g., utilities, landlords, and agencies that provide services for which they are reimbursed), few government agencies have records of the book value of their long-lived assets.

Even if reporting book value were feasible, the numbers would be meaningless. Book value is not what an asset could be sold for. It is not an amount that must be recovered in some way or other. It is not an amount that is pledged to meet liabilities. Although omitting depreciation does understate costs, there is no feasible way of reporting, even approximately, what the actual depreciation on U.S. government assets has been. The total for property, plant, and equipment assets on the 1998 U.S. government balance sheet is $299 billion—a ridiculously low amount. The correct amount, if it could be determined, would be in the trillions.

At the state and local levels, the numbers for property, plant, and equipment have some meaning. Acquisition of these assets usually is financed by issuing bonds, and the debt service (i.e., principal and interest) on these bonds must be recovered by taxes or other sources. In the federal government, there is no such relationship between assets and liabilities.

The FASAB has not described a use for balance sheet information. Its lengthy description in its *Statements of Federal Financial Concepts* lists many uses for operating statement information but offers only one sentence about the usefulness of the balance sheet as a whole, indicating that the balance sheet helps readers to determine "whether the government's financial position improved or deteriorated over the period."[8] Because it lists only a tiny—but unknown—fraction of the government's assets, the FASAB balance sheet does not come close to doing this.

A balance sheet for a lending agency is useful to analysts. Government electrical generating plants, water distribution systems, the postal service, and similar business-like activities whose prices are based on recovering costs should prepare conventional balance sheets that include fixed assets. Balance sheets also are useful for agencies whose primary function is borrowing or lending. A balance sheet that lists monetary assets of the whole federal government may be useful to economists; such a balance sheet already exists in reports prepared by the Treasury Department.

The government does need a record of its assets. Agencies must record the cost of newly acquired assets; this is a necessary part of any accounting system because debits must equal credits. There should be a way to keep track of an agency's assets. The General Services Administration, the State Department, and a few other agencies do have such records. All agencies should have them. These records should be audited, but they need not be aggregated into a balance sheet.

The federal accounting system does not need to record depreciation in most agencies. Depreciation accounting involves much work, and it would provide misleading information in agencies whose assets were acquired by capital appropriations. These agencies do not need to recover the cost of depreciable assets from operating appropriations or from charges to users; taxpayers have already paid for them via the capital budget. Capital appropriations should be based on a demonstrated need for specific assets. This need and the acquisition cost have no relationship whatsoever to depreciation numbers, either in the government or business.

In 1956, during my first appearance before a congressional committee, I took a dim view of the usefulness of a depreciation number in the planning and control of operating activities of the federal government. More than forty years later, I feel the same way. I do not believe it reflects mere stubbornness.

8. Federal Accounting Standards Advisory Board, *Statement of Federal Financial Accounting Concepts No. 1: Objectives of Federal Financial Reporting* (Washington, D.C.,: 1993) and *Statement of Federal Financial Accounting Concepts No. 2: Entity and Display* (Washington, D.C.: 1995).