Problems and Prospects on Reform of Central Government Accounting System

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1. Introduction

As of the end of March 2001, national and local government total long-term debt balance is expected to be 645 trillion yen, 1.29 times as big as Japan's Gross Domestic Product (GDP). While this GDP ratio is worse than those of other major advanced countries, the figure may get even worse because of sagging revenues, increased burden for failed financial institutions, etc. This has triggered a rigid financial policy, creating a situation in which we may not be allowed, hereafter, to use flexible financial policies to cope with socio-economic changes, such as maturing economic structures and the emerging aging society and declining birth rate.

On one hand, since the early 1990s, the major advanced Western countries have also experienced incremental financial deficits, which Japan is now experiencing. Because such countries introduced New Public Management (NPM) [1] theory to administrative and financial areas to make public finance sound and efficient, GDP ratios against total national and local government long-term debt have leveled off or started to decline, in contrast with the situation in Japan. The final resort in this NPM is public accounting reform and introducing policy evaluation[2]. These major advanced Western countries, by enhancing accountability to the public, have gained public support on reforming their own administrative and financial structures to overcome their critical national finances.

Since Japan faces a similar situation, reforming its administrative and financial structures is essential. To that end, we can consider the option of introducing NPM theory to Japan. In this paper, I will consider problems and prospects on possible public accounting reform, the nucleus of NPM, referring to trends in advanced Western countries (Note that all remarks herein are the author's personal opinions and do not reflect, in any way, Board of Audit opinions).

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1) NPM is a theory of applying private enterprise management methods to the public sector to enhance administrative performance effectiveness and efficiency. Basic principles are market-oriented approach for improving customer, or public, satisfaction; outcome-oriented approach for managing by outcome-centered evaluation; and decentralization-oriented approach for separating planning and executive divisions, transferring implementing power to the executive division.

2) Policy evaluation means the government agency, or a third-party organization, evaluates before, during and after, policy outcomes and results, based on effectiveness, efficiency and economy to permit conclusions to be reflected in future policy planning. Policies are evaluated to cover the entire policy-making structure, layered to include policy in the narrow sense (basic administrative objectives policy) → program (definite plan and measures for realizing policy) → project (specific administrative steps to implement plans and measures).

2. Problems with Current Public Accounting

To understand the need to reform national public accounting, we must be fully aware of current problems, thus, generating incentive to reform. The following three points are considered major problems:

(1) Lack of Comprehensive and Systematic Flow and Stock Information on National Financial Conditions

Since current public accounting uses cash accounting and single-entry bookkeeping, cash flow and cash stock are treated under separate bookkeeping systems, and revenue-expenditure final accounts reflect only flow of funds which are national budget subjects. In other words, despite year-to-year collecting and investing huge amounts of various funds that are out-of-budget funds (e.g. Trust Fund Bureau Fund, Post Office Life Insurance Fund and Foreign Exchange Fund), they are not included in revenue-expenditure final accounts; hence, final accounts reflect only part of fund flow. Also, on assets and debts defined as stock, apart from revenue-expenditure final accounts, each general accounts statement showing each fiscal year end balance is provided under applicable laws, such as “Law on National Credit Management”, “State Commodity Management Law”, and “National Property Law”. However, only part of the assets and debts are stated in general account statements, because of reflecting national assets administration legislative policy.

Thus, grasping fund flow and stock information comprehensively and systematically is now virtually impossible.[3)]

(2) Lack of Cost Information on Policies, Programs and Projects

Since current public accounting uses, as mentioned in (1), above, cash accounting and single-entry bookkeeping, it is not designed to identify actual costs that can be calculated by accrual and, for example, does not distinguish between ordinary and capital-related revenues and expenditures. Also, since revenue-expenditure final accounts are intended to state results of implementing the revenue-expenditure budget for comparison, final accounts state revenue based on character and expenditure based on purpose; hence, policies in the narrow sense, programs, and projects (hereinafter collectively referred to as “policies”) do not have to be stated separately. Also, while some national policies, such as social welfare or public works are handled under plural funds, revenue-expenditure final accounts are provided to cover only each of the general and special accounts (or each individual sub-account if set up in special accounts). As such, no consolidated accounts of overall national revenue-expenditure are produced.[4)]

Thus, obtaining cost information corresponding to each policy implemented by the national government in the fiscal year is practically impossible.

(3) Lack of Linkage between Final Account and Budget Preparation

Since the budget controls the financial aspect of national administration, the most important role of final accounts in Japan is to provide information on whether budget control was effective. In other words, its regularity. Thus, while final accounting of revenue and expenditure is designed to indicate executed revenue-expenditure budget results and, hence, the revenue and expenditure shown in the final accounts are subject to comparison with the estimate (of revenue) and the ceiling (of expenditure), final accounts do not contain information useful for evaluating based on economy, efficiency and effectiveness. (See Chart 1, below, on administrative management cycle and evaluating points.)

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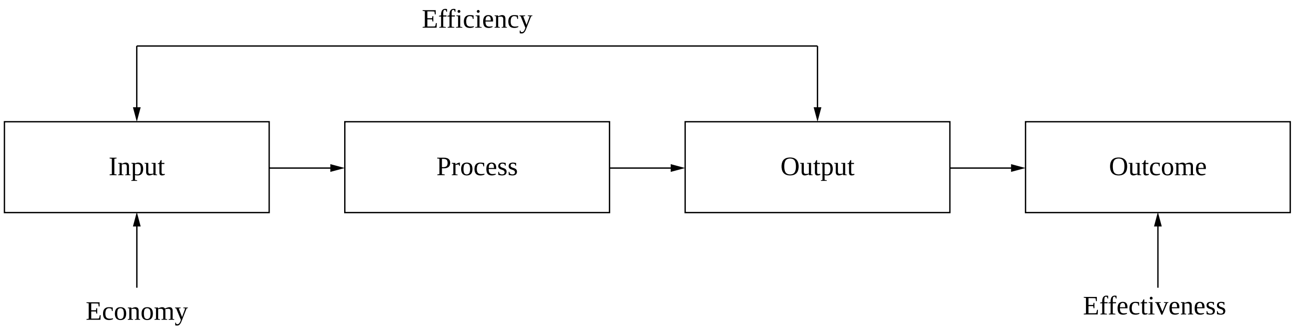
3) For appropriated items in, and notes to, final accounts, and non-appropriated items, see AZUMA, Nobuo, “Kessan no Genkai to Beikokurenposeifu Niokeru Kigyokaikeiteki Shuho” (Final Accounting Limitation and Introducing Corporate Accounting Method by the U.S. Federal Government), Accounting and Audit, pp.27-33, January 1999.

4) For the nation’s attempt to prepare consolidated (revenue-expenditure) final accounts, see AZUMA, Nobuo, “Kessanjunkei Karamita Kunino Zaiseijokyo” (National Financial Condition in View of Net Final Accounting), Accounting and Audit, pp.18-23, May 1998.

Chart 1 Administrative Management Cycle and Evaluating Points



[Notes]
Input : Resources for producing administrative services (personnel, financial administration fund, and financial investment fund)
Process : Administrative performance (planning the New Five-year Highway Improvement Program, land purchase, budget demand, subcontracting road improvement, road planning)
Output : Administrative services produced by administrative performance (enlarging the area and extending the length of the improved high-standard main national highway and metropolitan highway)
Outcome: Policy effects produced by administrative services (increase in driving speed, decrease in traffic accident victims, decrease in noise level)
Road administration examples are shown in parentheses.

Accounting for executing the national budget for a given fiscal year is considered finished when revenue-expenditure final accounts are completed. For final accounting, any surplus would simply be carried over to the following year's revenue, or to the special national reserve bond account (for general accounting). Therefore, current accounting is not designed to reflect final accounting results in budget-making for the following fiscal year.

3. Public Accounting Objectives

For reforming public accounting, the first question to be answered is what the objective for reforming public accounting is, in other words, for what purpose we should design the new system. This requires in-depth discussion, because, specific content for reform to be implemented and time required to apply the new system will differ, depending on which objective we choose. Having considered points in Section 2, "Problems with Current Public Accounting", we have three objectives:

(1) Providing Comprehensive and Systematic Flow and Stock Information on the Nation's Financial Condition

To improve Japan's financial condition, we have the option of reducing expenditure by lowering quality of administrative services or increasing revenue by raising taxes. In any case, getting national consensus on the nation's ability to provide administrative services and on trans-generational burdens for applying resource funds are necessary and critical. This is why we need, through reforming our public accounting, flow and stock information on the nation's financial condition.[5] Similarly, as long as revenue collection depends heavily on

5) For the nation's attempt to prepare a consolidated balance sheet, see AZUMA, Nobuo, "Kuni no Zaiseikozojo no Tokucho to Kadai - Renketsu Taishaku Taishohyo Niyoru Kessan Bunseki -" (Characteristics and Problems of the Nation's Financial Structure - Final Accounts Analysis by Consolidated Balance Sheet -), Accounting and Audit, pp. 22-27, May 1999.

government bond issues and, for normalizing government bond market price, we need to provide institutional investors and government bond underwriter-syndicates financial information on the nation's financial condition.

(2) Providing Cost Information on Each Policy to Promote Better Policy Evaluation

To enhance administrative efficiency, we must continue making ordinary reviews and improving the nation's policy implementation. Evaluating policy is essential to this end. Cost information is a prerequisite for cost-benefit, cost-effectiveness and cost analysis, all used in evaluating policy. Cost information is also useful as supplemental information on performance indicator evaluating method. Therefore, we must reform public accounting to provide cost information for each policy on national policies implemented.

(3) Linking Financial and Performance Information from Final Accounts with Budget Making and Allocation

To properly allocate the budget and streamline administrative services by subcontracting to private enterprises, kinds of financial information must be obtained from final accounts, such as debt-assets portfolio and expenditure for each policy. Performance information from policy evaluation based on that financial information should be fed back into budget-making and allocation. This is why we need to reform public accounting to integrate budgeting and accounting into a single system, and link both financial and performance information with budget-making and allocation.

4. Approaches to Reforming Public Accounting

In reforming public accounting, the next question is what kind of method we should introduce to achieve such an objective. The following methods, each corresponding to a specific objective enumerated in Section 3, above, may provide the answer.

(1) Introducing Accrual and Double-Entry Bookkeeping into Accounting

This method introduces accrual accounting as accounting criteria and double-entry bookkeeping as entry method so overall fund flow, including revenue-expenditure budget cash flow and out-of-budget cash flow, can be linked with stock information. Using this method, we provide individual final accounts, such as an individual balance sheet and other financial statements for general accounts, and for each special account, and for national consolidated final accounts, such as consolidated balance sheet and other financial statements. This way, we can get comprehensive and systematic fund flow and stock information on overall national financial conditions.

(2) Introducing Budget-Making and Final Accounting for Each Policy, besides (1) above.

This method, with introducing policy evaluation, introduces budget-making and final accounting for each national policy; wherein the revenue-expenditure budget is prepared for each policy to relate budgeting with policy-making, or alternatively, revenue-expenditure final accounts for each policy, using budget codes and cost calculations applying Activity Based Costing, to relate final accounting with policy-making. This method provides cost information for each policy needed for effective policy evaluation.

(3) Introducing Accrual Budgeting and Output-oriented Budgeting, besides (2) above.

This method uses accrual budgeting[6)] so the budget allocated to each administrative agency can show direct

6) An ordinary budget can be termed as cash accounting, because revenue and expenditure are counted based on cash inflow and outflow, while in an accrual budget, they are described based on economic consequences, such as asset consumption and debit increase.

linkage with the debt-asset portfolio. We must also introduce output-oriented budgeting[7] embodying the same classifications as for policy evaluation, so both cost information for each policy and performance information based on policy evaluations can be properly reflected in preparing the next budget. This way, budget-making and final accounting can be incorporated into a single system, whereby financial and performance information from final accounts can be linked with budget-making and allocation.

In the U.K., for example, a type of accrual budgeting called Resource Accounting and Budgeting[8], is scheduled to be introduced in which, besides such cash expenditures as personnel costs and subsidies, capital costs, with conceptual cost not accompanied by cash payment, are set down as operating costs. Here, capital cost means: cost of capital charge imposed on a fixed asset as an opportunity cost thereof (i.e. anticipatory profit or interest that could have been obtained if such fixed asset had been invested, set at a flat 6% rate); and depreciation of fixed assets. As explained above, resource accounting and budgeting can show us a linkage between financial information from final accounts and budgeting and allocation. Thus, it provides an incentive for all administrative agencies to use their fixed assets efficiently and effectively, such as promoting sale of unused fixed assets or deliberately purchasing additional assets considering their life-cycle costs.

5. Trends in Advanced Western Countries

Reforming public accounting has now become a global trend and, here in Japan, a trial national balance sheet is being prepared. Corporate accounting in Japan has had to accept global standardization and economic globalization, and advanced Western countries will have a considerable potential impact on our public accounting. Also, within all independent administrative entities to be phased in from April 2001, corporate accounting based on accrual and double-entry bookkeeping is scheduled to be introduced. Among trends in major advanced Western countries and global trends that will supposedly affect our public accounting, those in the U.S. and the U.K. are described below:

(1) Overall Trends

As previously mentioned, approach methods for reforming our public accounting are a) introducing accrual accounting and double-entry bookkeeping into accounting to get comprehensive, systematic fund flow and stock information details on the nation's financial condition; b) besides a), introducing budget-making and final accounting for each policy to get cost information for each policy useful for productive policy evaluation; and c) also besides a), introducing accrual and out-put oriented budgeting so financial performance information is properly reflected in preparing the next budget. Thus, as it proceeds from a) through c), the new public accounting will become more advanced and more complex. Of the 29 current OECD member states, at least 11 countries have already launched, or have been preparing, public accounting systems based on accrual. However, note that not all of these member states are trying to introduce such budget-making and final accounting for each policy or such accrual and output oriented budgeting. We can generally categorize public accounting reform for these 11 countries as: Canada, Spain and France, a); U.S., Sweden and Finland, b); and Iceland, U.K., Australia, Holland and New Zealand, c). (See Table 1, below.)

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7) An ordinary expenditure budget can be termed input-oriented, because in resource fund terms, the amount of cash (input) for appropriation is allocated by purpose, while in an output-oriented budget, quantity and quality of administrative services (output) provided by administrative agencies are first identified. Then, resources are allocated accordingly to provide funds for costs (including non-cash cost such as depreciation) necessary for providing such services.

8) Under the new U.K. public accounting, entry items are expanded from cash-based assets and debts, like tax revenue and government bonds, to cover all economic resources, including fixed assets; and costs and income, and credits and debts are reviewed by accrual. Since this accounting and budgeting focuses on overall economic resources, they particularly use the word "resource". Note, however, that Resource Accounting and Budgeting is an ordinary input-oriented budgeting, and not output-oriented.

Table 1 Trends in Reforming Major Advanced Western Country Public Accounting

Focus point / Reform objective and method	Financial resources	Economic resources (with partial exceptions)	Entire economic resources
Introducing accrual accounting and double entry bookkeeping into accounting to get comprehensive, systematic fund flow and stock information on the nation's overall financial condition	France	Spain	Canada [Footnote 1]
Introducing final accounting for each policy to get cost information for each policy needed for productive policy evaluation; besides accrual accounting and double entry bookkeeping		U.S. [Footnote 1]	Sweden, Finland
Introducing accrual budgeting to link financial and performance information from final accounts with budget making and allocation; besides introducing accrual accounting and double entry bookkeeping		Iceland	U.K., Australia [Footnote 2], Holland [Footnote 3], New Zealand [Footnote 2]

Footnote 1: Accrual budgeting has been introduced for certain budget items.
Footnote 2: Also introducing output-oriented budgeting
Footnote 3: Currently introduced in only 22 executive agencies

Trends shown in these countries on specific reform content are common, since they are all adopting accrual accounting. However, for focus points (balance sheet items), trends are more diverse in that focus point for France is financial resources; for Iceland, U.S., and Spain, economic resources - except certain fixed assets; and for the U.K., Australia, Holland, Canada, Sweden, New Zealand and Finland, overall economic resources. Also shown is lack of commonality in balance sheet types and forms for final accounts and in infrastructure property valuation and depreciation method. As such, these countries' public accountings, whether they have already been reformed or are being prepared, show great diversity.

(2) Trend in the U.S.

In the United States, for basically reforming federal financial management, the Chief Financial Officers Act, the Government Management Reform Act, and the Federal Financial Management Improvement Act were respectively enforced in 1990, 1994 and 1996. In response to opinions of the Federal Accounting Standards Advisory Board, jointly established by the Secretary of Treasury, Director of the Office of Management and Budget (OMB), and Comptroller General of the General Accounting Office (GAO), OMB announced a federal financial accounting brief and a federal financial accounting criteria which serve as the basis of newly reformed public accounting. These documents have been used for administrative agencies in their final accounts since FY1996 and for the federal government as a whole in consolidated final accounts since FY1997.

On the other hand, to improve federal government service's administrative operations, in 1993 the Government Performance and Results Act came into force, making it the duty of each administrative agency to provide a five-year "Strategic Plan" and an "Annual Performance Plan". Thus, each agency is required to set forth in its "Strategic Plan" a general objective (on total policy effect) and in its "Annual Performance Plan" particular performance objectives (numerical targets for each program). At the end of each fiscal year, the Annual Performance Report, including comparative analysis of performance objectives and performance results, is to be submitted to Congress and the President and, accordingly, the 1999 Annual Performance Report, the first under the new system, was scheduled to be submitted by the end of March 2000.

Under the new public accounting, all costs spent by each administrative agency for providing administrative services shall be calculated in the “Statement of Net Costs” and in accordance with policy categories in the “Annual Performance Plan”, as provided for under the Government Performance and Results Act, and are to be totaled by division and policy groups (OMB Bulletin No.97-01). This achieves a certain level of consistency between final accounting and policy-making. However, final accounting and policy evaluation are not integrated into a single system; hence they are still operated independently. In conclusion, in the U.S., cost information on inputs used for evaluating administrative service’s economy can be obtained from final accounts, and performance information on output-outcome, used for evaluating efficiency and effectiveness can be obtained from policy evaluation, independent of final accounting. Thus, to date, these two systems and budgeting have not been integrated.

(3) Trends in the U.K.

In the U.K., to improve administrative operation efficiency, in the late 1980s the government introduced the NPM method including introduction of PFI (Private Finance Initiative) and exective agencies separated from Ministries and Departments. On reforming public accounting, the Diet is now setting up a Government Resources and Accounts Bill based on a Green Paper (“Better Accounting for Taxpayer’s Money: Resource Accounting and Budgeting in Government”) as announced by the Minister of Finance in 1994, and a White Paper (“Better Accounting for Taxpayer’s Money, Government Proposals, Resource Accounting and Budgeting in Government”) in 1995, as amended based on National Audit Office (NAO) opinions. Resource accounting, accounting criteria for the new public accounting, was announced by the Ministry of Finance in response to opinions of the Financial Reporting Advisory Board (nine members from organizations such as NAO), and has been used by each administrative agency for their final accounts since FY1993, and by the national government for its consolidated final accounts since FY1999.

Under this new public accounting, or resource accounting and budgeting, as it is called, the “Statement of Resources by Departmental Aims and Objectives” is prepared so amount each administrative agency spends for its services can be calculated by department group and by their aims and objectives. A “Statement of Output and Performance Analysis” is also prepared for policy evaluation of each administrative agency, to permit assessing policy aims and objectives and percentages achieved. Classifying aims and objectives described in the “Statement of Output and Performance Act” is in line with that used in the “Statement of Resources by Departmental Aims and Objectives”, including cost calculations, keeping mutual consistency between policy-making and final accounting. As mentioned earlier, accrual accounting was also introduced to the 2001 budget. Hence, financial information from final accounts can be reflected in budget-making so capital cost is allocated according to the debt-assets portfolio. This provides a single resource accounting and budgeting system with input-related cost information on output-outcome, and budgeting is systematically integrated. In other words, with resource accounting and budgeting, the U.K. is seeking comprehensive financial accounting and policy evaluation, and, at the same time, permitting feedback of results directly to budget-making and allocation.

6. Technical Difficulties

As previously mentioned, with major advanced Western countries, even if public accounting reform objectives and methods are decided, in practice their approaches to setting up the system are diverse. The following are some difficulties that should be considered in introducing corporate-accounting-oriented methods[9] to Japan’s public accounting.

9) This method is based on an accounting method commonly used among private enterprises (i.e, accounting, preparing balance sheet and other financial statements, consolidated final accounting and cost calculations, all processed by accrual accounting and double-entry bookkeeping) and considering factors peculiar to public accounting.

(1) Cash Flow Entry into Current and Capital Accounts

A. Treatment under Corporate Accounting

Under corporate accounting, all transactions are entered using double-entry bookkeeping so cash flow and stock can be accounted for organically under integrated accounting. Hence, accounts so entered permit preparing a profit and loss statement and balance sheet reflecting the corporation's overall result in any given accounting period. From the standpoint that useful information should always be available, qualitatively or quantitatively significant items are subject to rigid accounting procedures, while those less qualitatively or quantitatively important can be subject to a simpler procedure, but still within regular accounting principles (Corporate Accounting Principles Annotated [Note 1]). Thus, less important items can be treated as off-balance assets or liabilities, while most important items appear in the financial statesments with classified indications.

B. Public Accounting Problems

When we introduce corporate accounting to reform public accounting, determining how to enter fund flow including out-of-budget cash into the current and capital accounts is difficult. For revenue, for example, public fund flow in a given year, such as tax and stamp revenues, insurance premiums, and other charges, is to be indicated in the current account, while those paid by the public in the future, such as government debt, borrowings, and short-term government securities, are to be indicated in capital accounts. Expenditure for providing administrative services in a given year, such as social security benefits, accrued interest on government debt and borrowing, and distribution of local allocation tax, is to be indicated in the current account, and expenditure used to improve administrative services in the future, such as infrastructure assets, military procurement, and loans receivable, is to be entered in the capital account. Balances of such cash flow and items entered in the capital account appear in the balance sheet as a surplus to be carried over to the following fiscal year. This permits us to clarify administrative service and financial burden in a given fiscal year and in the future; hence, provide useful financial information on equity in trans-generational financial burdening.

The biggest flaw in existing public accounting is that, although by consecutive economic spurs infused since 1992, a huge amount of public work has been undertaken using national construction bonds to improve infrastructure properties, public accounting does not identify size of public works by amount of money. This is because of lack of a balance sheet and the National Property Law does not require infrastructure assets, like roads, rivers, and harbors to be listed in "Fluctuation and Total Amount of National Property", thus treating such assets as off-balance assets. This leads to lack of financial information about magnitude of infrastructure assets, which will later become subjects of maintenance and management and renewal or replacement. This makes conducting such financial administration in a way that considers infrastructure from construction through to disposition difficult. Although the government extends loans and invests in bonds, using Trust Fund Bureau funds from postal savings, such funds from postal savings are not recognized as liabilities in final accounting. This is because postal savings are considered out-of-budget cash and do not have to be stated in the "Report on National Liabilities". They are treated as off-balance liabilities. Thus, although postal savings, for which the principal would be warranted ultimately by tax, are heavily involved with generations to come, the public does not have access to information. Therefore, we must, in view of principles of significance, enter infrastructure assets and postal savings in the balance sheet.

(2) Limitations as Performance Evaluation Methods

A. Treatment under Corporate Accounting

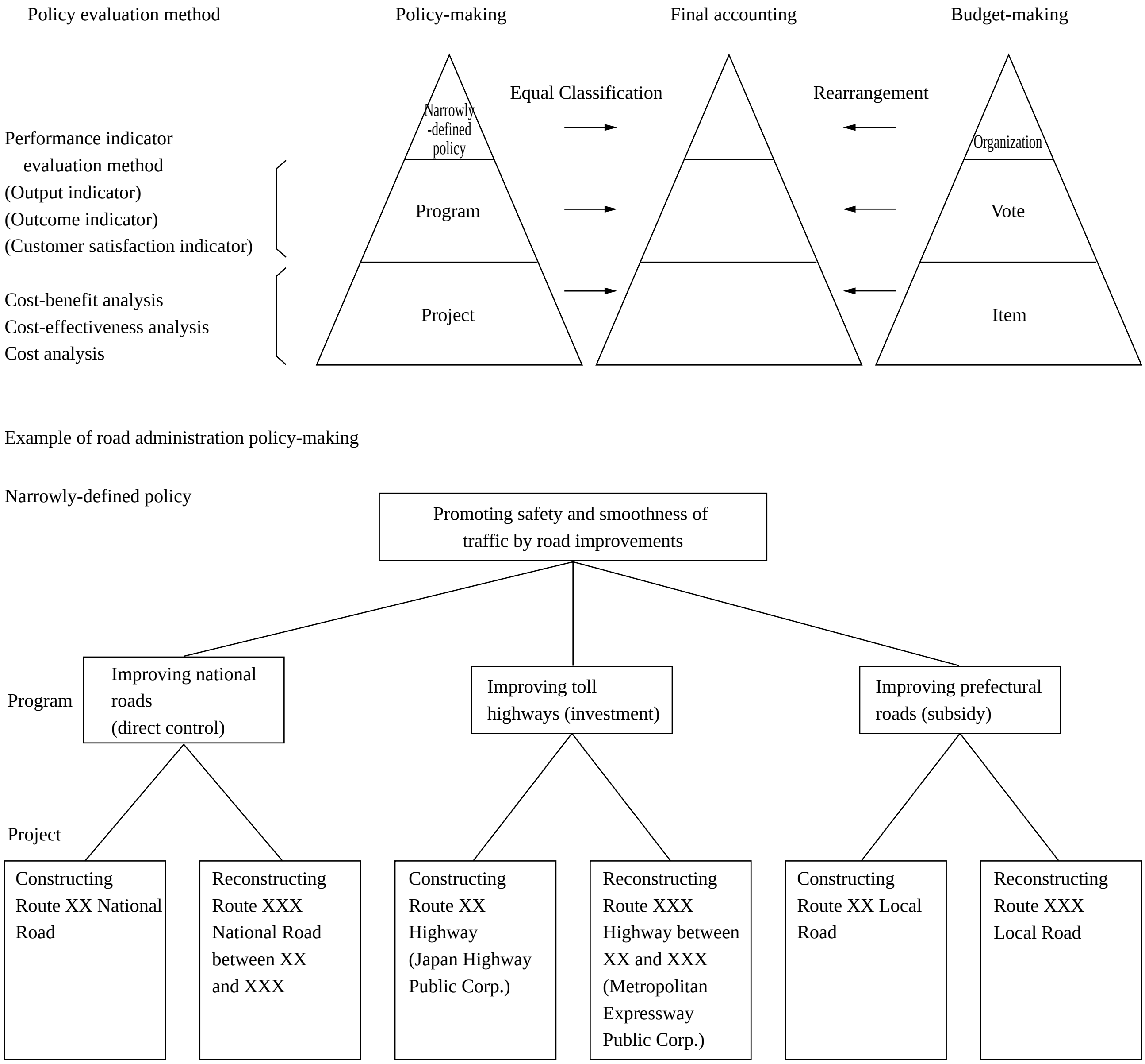
Under corporate accounting methods, all revenues and expenses are accounted for using accrual accounting, and profit and loss, or balance between revenue and expense, shows a corporation's business outcomes (results) in a given fiscal period to help provide a basis for calculating disposable surplus. The reason for calculating profit and loss as an index of business outcomes (results) is so important that, since a corporation is running its business based on original resources such as investments by shareholders and borrowings from creditors to realize profits, the major role of corporate accounting is to provide an accurate computation of profit and loss for a given fiscal year and dispensable surplus. This permits adjusting interest between shareholders and creditors, or between existing and future shareholders. Revenues and expenses are calculated according to cost allocation and matching cost and revenues principles, and revenue is based on income from providing the market with its goods and services, or outputs from its business activities. Expenses are based on costs paid for procuring from the market necessary goods or services for its business activities. This is provided both income gained and costs borne bear a fair market value.

B. Public Accounting Problem

When we introduce corporate accounting to reform existing public accounting, a question comes up on how we should get over the constraint that, because of difference in the kind of goods and services provided by the national government or by a corporation, introducing corporate accounting methods does not automatically provide built-in performance evaluation. The national government, with original resources gained from the public through taxes or insurance premiums, and from government bonds, provides various administrative services to achieve its objectives of enhancing public welfare. Such national administrative services are to be rendered to the public in a way basically free from the market mechanism. Hence, for such services, neither a market valuation nor payment of consideration by the public is expected. It follows that, while the government procures, from the market, goods and services needed for providing its administrative services, revenues from tax, insurance premiums and government bonds do not constitute consideration to be charged for services, but remain, in every respect, as financial resources. Thus, introducing corporate accounting does not help calculate profit-loss for performance evaluation. To evaluate the nation's performance, we need a method differing from corporate accounting.

In Japan, the Central Government Reform Act, enacted in June 1998, and the National Government Organization Law, amended in July 1999, required all national agencies to conduct their policy evaluations after reforming central agencies in January 2001, and a specific system is now being developed. This policy evaluation, unlike re-evaluation used in FY1998 by the six central agencies, all relating to public works projects, is encompassing all policies implemented by national administrative agencies, and, as such, we must establish a system that will provide cost information for each policy to serve productive policy evaluation. For example, we can arrange national administrative activities in groups and classes as narrowly-defined policies, programs and projects. On the other hand, to get policy-making to conform with final accounting, we can arrange final accounts by budget expenditure accounts, such as organizations, votes, and items to make them conform with classification of these administrative activities. Then, based on accrual accounting, we need to prepare an administrative cost statement, calculating the amount of cost for providing administrative services and ordinary revenue appropriated for each policy. When we evaluate policy, this approach, which permits us to grasp each policy's cost structure, would also give us access to useful financial information about economy of costs incurred (input), efficiency of return-on-input ratio (input-output ratio), and effectiveness of results (outcome) [See Table 2].

Table 2 Interrelation among Policy-making, Accounting, and Budget-making Systems



(3) Cash Flow Statement Necessity under Cash Accounting

A. Treatment under Corporate Accounting

Corporate accounting requires financial statements to be profit and loss statements, balance sheets, financial appendices, and profit distribution statements with providing an additional cash flow statement required since the fiscal year ending March 2000. The underlying view is that, since a profit and loss statement prepared by accrual accounting tends to provide room for manipulating profit, brought about by senior management subjective view or by altering accounting principles and procedures, it is not unheard of for a corporation with satisfactory business results shown in the profit and loss statement to go bankrupt because of its tight cash flow. Therefore, a cash flow statement is required so it can permit (a) business result indices to be comparable by excluding subjective management views and effects of altered accounting principles and procedures; (b) evaluating a corporation's liquidity, solvency and financial flexibility; and (c) evaluating a corporation's ability to obtain cash and equivalents. In the cash flow statement, prepared by the direct or indirect method, based on the year's surplus/deficit, both cash inflow and outflow on business, investment, and financing are computed to total the amount of free cash flow, or profit and loss in cash.

B. Public Accounting Problems

When we introduce corporate accounting to reform existing public accounting, it also presents the problem of to what extent we should allow cash accounting to remain intact. The administrative cost statement and balance sheet would play a leading role under public accounting post-reform final accounting, and we should remember that the cash flow statement should also be made by the direct method, comparable with the budget. This is because for the government, to provide its administrative services continuously for enhancing public welfare, other than for budget control, another important factor is financing its financial operations to reflect actual receipt of tax and insurance premiums. It is also important because neither the administrative cost statement nor balance sheet would solely provide cash flow information relating to the year's capital account. Besides collecting revenues from taxes and insurance premiums, the government handles issuing short-term government securities to supplement temporary financial shortages, transferring, for national treasury use, reserves like postal savings, and procuring and operating other financial investment funds. This type of out-of-budget cash, while not counted in existing revenue-expenditure settlement, should be stated in the cash flow statement so we can understand national treasury financing in its entirety. (See Table 3 for a final accounting system (illustrative public works image) related to Sections (1), (2) and (3), above.)

(4) Balance Sheet Assets Evaluation Criteria

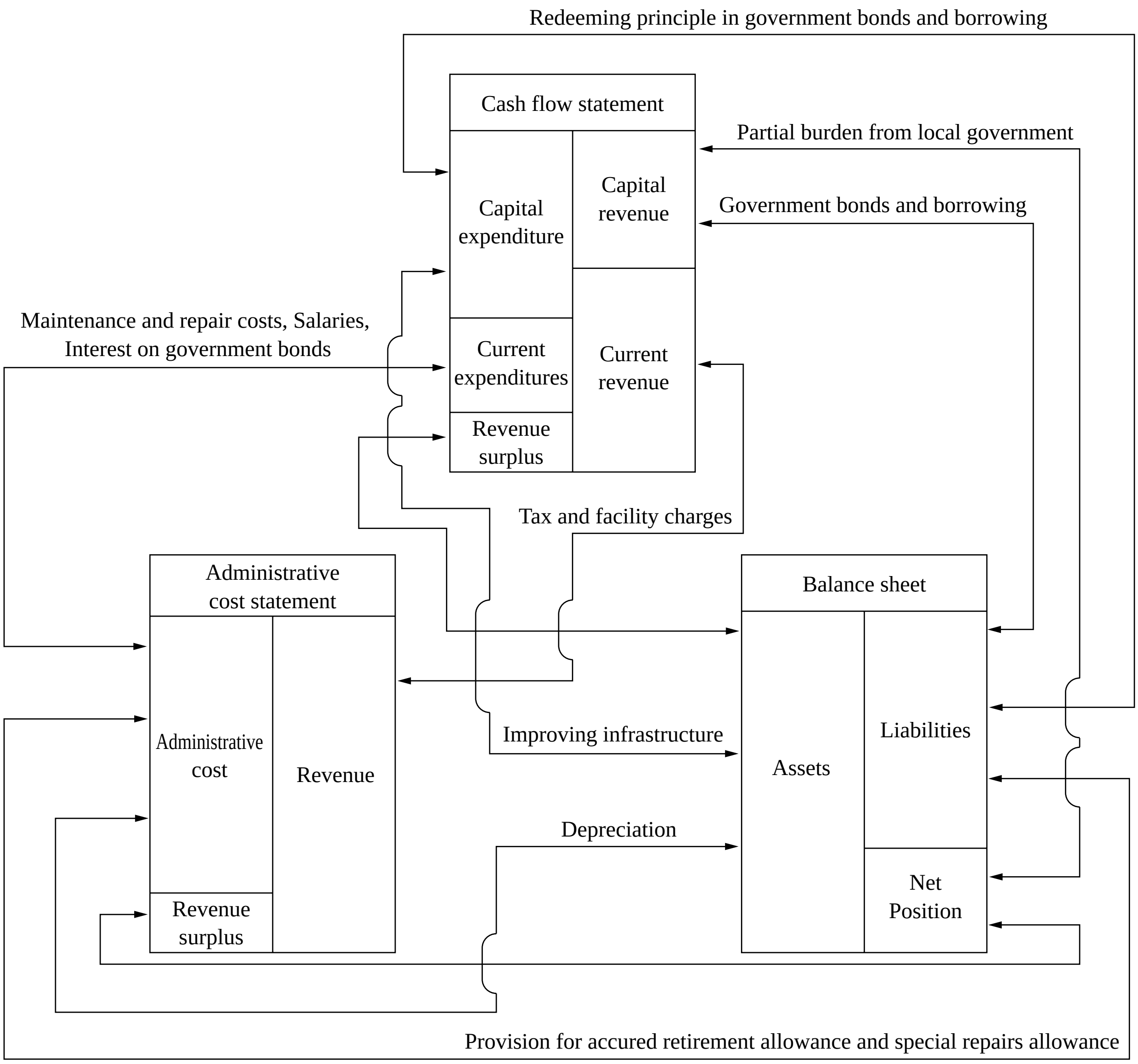
A. Treatment under Corporate Accounting

In corporate accounting, assets value stated in the balance sheet shall, in principle, be based on acquisition costs (Corporate Accounting Principles: 3 Balance Sheet, 5 Principle). Thus, in terms of assets evaluation criteria, acquisition cost generally applies, because it provides (a) calculating certainty; (b) a high level of verifiability; and most importantly, (c) the major objective of corporate accounting, which is to accurately calculate profit and loss in a given period. In other words, if we want to accurately calculate business results and disposable surplus in a particular period, we must, following the cost allocation principle and by distributing assets acquisition cost to corresponding accounting periods according to how assets are used, calculate also costs allocated to the period involved and to following periods, namely assets value to be stated in balance sheets. This way, we can exclude such possession gains attributable to price fluctuations from profit and loss calculations. Incidentally, regarding securities other than subsidiary stocks and bonds to be held by due, in possession, current price (current market price) accounting criteria shall apply from the fiscal year ending March 2001.

B. Public Accounting Problems

When we introduce corporate accounting to reform existing public accounting, a problem comes up as to what evaluation criteria we should use to state balance sheet assets value. For evaluation criteria options, we have acquisition cost, re-acquisition cost, and sales price criteria. The choice depends on the public accounting reform objective, as mentioned above.

Table 3 Final Accounting System (Illustrative Public Works Image)



(1) If the public accounting reform objective is to provide information for each policy that can help effectively evaluate policy, we should use acquisition cost criteria, because for gaining a correct understanding of the relationship between administrative services benefits and burdens for calculating the year's cost spent on implementing policy, we need infrastructure assets acquisition costs, military procurement, and public property allocated within useful lives, according to the cost allocation principle.

(2) If the objective is to link financial information from final accounts with budget-making and allocation, we should use re-acquisition cost criteria, because, for possible comparison of assets balances, such as infrastructure, military procurement and public property, controlled by various administrative agencies, for which construction or acquisition time may differ, and for securing the government's permanent ability to supply its administrative services through repetitive assets renewal, by depreciating assets according to re-acquisition costs, we can evaluate the amount of funds needed to maintain value of those assets.

Incidentally, we should use sales price criteria to understand end-of-fiscal year debts-servicing capacity. However, as long as we apply the "going concern" accounting criteria in public accounting with the premise that a nation will continue to exist infinitely as an accounting entity, using a sales price criteria for final accounting is improper. Note, however, that as a part of public funds investment, the Trust Fund Bureau Special Account, the Post office Life Insurance Special Account, and Special Fund for Financial Liberation in the Postal Saving Special Account are used for investment in securities; hence, with securities other than subsidiary stocks and bonds to be held by due in possession, it may be proper to apply current price (market price) so we can assess risk of price fluctuations.

(5) Handling the Nation's Future Financial Burden under Statutory Provisions

A. Handling by Corporate Accounting

In corporate accounting, debts are defined as (a) legal liabilities, or (b) liabilities not exactly legal but resulting in decrease in assets, which necessitate extra future services. Liabilities defined in (b) are called accounting debts that should be stated in the balance sheet liabilities column from estimated expense entry or deferred income entry, used based on normalizing and rationalizing profit-loss calculations in a given term, under the matching costs and revenues principle. Included in accounting debts are, besides unsettled liabilities such as unpaid costs and advanced income, obligatory reserves that have debt characteristics, such as retirement allowance reserve and special repairs allowance. Entry criteria of such an obligatory reserve are that (a) the reserve should be for a specific future cost or loss and accrual of such cost or loss is attributable to events before the period of the term; (b) such a cost or loss is highly likely to accrue; and (c) the situation allows reasonable estimate of accruable amount (Corporate Accounting Principles Annotated [Note 18]). Also, these liabilities, which currently does not exist in reality, but are contingent upon a certain situation, will be treated as real liabilities, and are called contingent liabilities, with significant ones disclosed as a footnote item in the financial statement.

B. Problems Using Other Possible Accounting Methods

When we introduce corporate accounting to reform existing public accounting, one problem might be what kind of account should be treated as debts or, in particular, how we should treat the nation's future financial burdens as required by applicable laws. One question often raised is whether we should enter in the balance sheet liabilities column such pension obligations related to the basic pension allowance to be borne by the national government in accordance with Article 80 of the Welfare Pension Insurance Law and Article 94-2 of the National Pension Law. Also, to ensure that the resource fund be secured to continuously and suitably provide certain national and local government administrative services, various laws set forth future national financial burdens. Examples are (a) National Treasury Obligatory Shares for such things as job applicants' benefit reserve under Article 66 of the Employment Insurance Law (final accounts for FY1998 was 308.6 billion yen); (b) local allocation of tax under Article 6 of the Local Tax Grant Law (in the same accounts, 14 trillion, 304 billion yen); (c) National Treasury Obligatory Shares for such things as teaching staff salaries, under Article 2 of the Law on National Compulsory Education Allowance (in the same final accounts, 2 trillion, 877.9 billion yen); (d) National Treasury Obligatory Shares used, for example, for medical nursing benefits under Article 70 of the National Health Insurance Law (in the same final account, 2 trillion, 292.5 billion yen); and (e) National Treasury Obligatory Shares used for medical care benefits for the aged under Article 49 of the Health and Medical Service Law for the Aged (in the same final accounts, 2 trillion, 208.5 billion yen).

While these national treasury obligatory shares are required by law to be borne by the national government in the future, they may not be treated as debts for the following reasons: (a) the size of such national treasury obligatory shares may be altered by amending the law or enacting a special law; (b) in general, the resource fund shall be supplied by a future tax; (c) such national treasury obligatory shares are not attributable to events before the term period; and (d) obligatory shares, if term-based debts, would be treated as cost or loss accrued in the term period; hence, deemed not proper as cost information for policy evaluation. In U.S. or the U.K., which have already undertaken public accounting reforms, the nation's financial burdens for pensions, to be borne in the future, are not treated as an obligation, because of the uncertainty of the situation. However, pension obligations, a subject having public attention, can lead to increased social insurance premiums, and a requirement for resource funds to be supplied other than by tax; hence, it may be proper to enter such pension obligations as a note to balance sheet contingent liabilities.

(6) Necessity of Consolidated Final Accounting

A. Treatment under Corporate Accounting

In corporate accounting, when a parent corporation as an independent accounting unit and its subsidiaries form a group of enterprises, the group as a whole is treated as a single accounting unit and consolidated financial statements are made to show business results and financial conditions of the entire group, setting off transactions and debits and credits within the group. This shows that access to information on such an organization is becoming far more important, so it can prevent a parent corporation from using its leverage with subsidiaries to "window-dress" accounts through profit manipulation to promote appropriate investment decisions in diversified and internationalized enterprises. Since fiscal year ending March 2000, switchover to disclosure, centered on consolidated information is in progress. Covering such consolidation has so far included, according to stock-holding ratio (criteria), companies (subsidiaries) with majority of voting stock held by the parent corporation but, since the fiscal year ending March 2000 and by using controllability criteria, coverage has expanded. On the other hand, in evaluating stock investments a parent corporation holds in its unconsolidated subsidiaries and related companies, we need a "holding-in-share" method. Similarly, while the scope of related companies has been previously defined as a company where the parent corporation has more than 20%, but not over 50% stake in that company, this has been expanded using leverage criteria since fiscal year ending March 2000.

B. Public Accounting Problems

When we introduce corporate accounting to reform current public accounting, a problem comes up that, while fully admitting the need of consolidated accounting, how we should prescribe the scope of, and accounting principles and procedures for, consolidation. While national administrative activities are funded by General and Special Accounts, major programs, such as public works and social welfare, are funded by plural accounts. Big fund transfers are regularly made between General and Special Accounts, and between two Special Accounts. Therefore, understanding the nation's administrative and financial situation solely from individual accounts is difficult. In FY1998 national final accounts, for example, simplified total General Accounts and 38 Special Accounts expenditure amounted to 356 trillion, 970.8 billion yen, of which the double-counted amount based on expenditure transfer between accounts, was 170 trillion, 420.9 billion yen, 47.7% of simplified total expenditure. As of the end of FY1998, Trust Fund Bureau Special Accounts, fiscal investment and loans central division, reveals that government bond balance was 94 trillion, 635.3 billion yen and total loans to General and Special Accounts was 92 trillion, 885.1 billion yen. Thus, for assessing the true state of national administrative and financial conditions, we need to consolidate General Accounts with the 38 Special Accounts. For such a consolidation, we have to standardize accounting principles and procedures, such as integrating classification systems on General and Special Accounting revenue and expenditure by introducing into Special Accounting, an expenditure classification similar to that used in General Accounting, or including properties and debts in relation out-of-budget cash.

Part of national administrative activities are funded by government-associated organizations, public corporations, and other government-owned corporations on behalf of the national government, through its financial support, such as subsidies or loans, and administrative authority to approve personnel affairs and budget. At the end of FY1998, for example, the Trust Fund Bureau undertook, within Special Accounts, a 169 trillion, 844.1 billion yen loan and a 14 trillion, 788.3 billion yen bond for these government-owned corporations. This also supports the view that, to accurately assess national administrative activities and financial condition, we need to consolidate corporations under government control and use a holding-in-share method for evaluating national fund investment.

(7) Measures to Ensure Credibility in Final Accounts

A. Treatment under Corporate Accounting

In corporate accounting we have several kinds of accounting principles and procedures for preparing financial statements. They are customarily business practices that can be applied to a single transaction, and allow subjective top management views in determining such things as depreciable life and residual values for assessing depreciation and estimating allowances for bad debts for accounts receivable. To insure financial statement credibility, corporate accounting principles, Commercial Law, and other rules stipulate accounting criteria top management shall follow in preparing financial statements. To further assure financial statement credibility, a certified public accountant or audit firm, as an independent third party having no interest in the corporation, conducts a financial audit to check financial statement regularity. Here again, accounting criteria are used by such auditors to examine financial statement propriety. Audit criteria are also prescribed as a standard for auditors to follow when they conduct financial audits. The criteria ensure audit report equity and adequacy and set the limit on extent of such audits.

B. Public Accounting Problems

When we introduce corporate accounting to reform current public accounting, a question arises as to what measures should be taken to gain public trust in final accounting (consisting of various levels by generation, region and occupation). Under existing public accounting, final accounts to be provided according to Public Finance Law are revenue-expenditure final accounts, showing corresponding budget cash flow only, excluding out-of-budget cash. For stock information on credit, commodity and national property, general statements of accounts showing term-end balance are to be made separately from revenue-expenditure final accounting, according to governing laws. Thus, current final accounting covers only part of the flow of information. Using cash accounting to determine the accounting period to which inflows and outflows accompanying executing the revenue-expenditure budget belong, gives no room for the subjective view of government agencies playing a role during revenue-expenditure final accounting and, as such, no regulation has been established purporting to be the accounting criteria. Thus, revenue-expenditure final accounting credibility may be warranted by verification, as conducted by the Board of Audit, although no regulations purporting to be audit criteria have been stipulated.

When introducing corporate accounting, the range of final accounting is expanded to cover not just a partial flow of information, but overall flow and stock information and allow the subjective government agency view in final accounting. Therefore, as with corporate accounting, proper measures need to be taken to warrant final accounting credibility. To this end, we need to first stipulate accounting and audit criteria and, second, develop a system enabling a third party to conduct financial audit. In Japan, since no administrative agency has an internal and independent audit section, such as the Inspectors General of the United States, one scenario might be that the Board of Audit (BOA), the national finance supervisory body and a constitutionally independent agency, should be in charge of the administrative body for such financial audits.

From examples of advanced Western countries that have already reformed their public accounting, we can say that such financial auditing, if introduced here, should include: (a) evaluating effectiveness of internal control in each agency; (b) preparing an audit schedule; (c) audits to determine actuality of certain assets and debts, their inclusion in financial statement, an accuracy of their evaluation; (d) regularity audits for determining financial periods allocated for each cost and resource fund; and (e) preparing an audit paper. On the other hand, BOA is confirming final accounting two ways: one is computational confirmation, comparing three information sources of (a) revenue-expenditure final accounts; (b) final revenue collection and expense vouchers, filed with BOA by each agency according to Accounts Verification Regulations; and (c) revenue-expenditure receipt and issue of cash specifications, filed with BOA by the Bank of Japan according to the same regulations. The second is a more substantial confirmation, reviewing the same areas based on regularity, economy and effectiveness. Thus, if BOA takes charge of financial auditing as the executive body, using the expertise they have nourished through authenticating final accounts, they can ensure financial accounting credibility. We will then have to develop more standardized approaches to such work.

(8) Necessity of Electronic Data Processing and Data Storage for Accounting

A. Present Situation

Under current public accounting, procedural flow, from budget demands to submitting final accounts to the Diet, is as follows:

Budget demand by agencies, to the Ministry of Finance (MOF) → Preparing the budget by MOF → Allocation of the budget by MOF, to the agencies → Demand of transfer between votes or between items, of transfer between organizations, and of reserve funds by agencies, to MOF → Approving this by MOF, to the agencies → Executing the budget by the agencies → Preparing revenue-expenditure final reports by agencies → Preparing revenue-expenditure final reports by MOF → Confirming this by BOA → Submitting them to the Diet.

In each process in the flow, some agencies handle accounting using electronic processing devices, such as the Ministry of Finance budget-making support system, the Accounting Affairs Data Communication Management System (ADAMS) for agency budget execution, and the BOA final accounting confirmation system. The primary vehicle for transferring accounting data from process to process, however, is paper. With respect to stock information on credits, commodities, and national property, each account is managed by a bookkeeping system independent from that of revenue-expenditure final accounting; hence, the present system is not designed to automatically retrieve and accumulate accounting data from ADAMS. As such, under current public accounting, because electronic data processing and storage systems are not widely used to enable retrieval and sharing of accounting data throughout the entire process and, because flow of information and stock information are not connected, an immense amount of time and labor is spent preparing revenue-expenditure final accounts and general statements of accounts.

B. Problems

When we introduce corporate accounting to reform existing public accounting, a problem comes up of how we should arrange the infrastructure for processing accounts. Accrual accounting, once introduced, would obviate complying with the current practice of setting deadlines for cash-flow accounting and closing date for cash-flow transactions (July 31). Double-entry bookkeeping, if introduced, would permit linking and jointly processing fund flow and stock information and, by introducing these methods, we would expedite preparing final accounts and, as with corporate accounting, we could submit them to the Diet within three months of term end. This way, we could reflect the nation’s administrative results and financial condition, as disclosed in final accounts, in the preliminary budget demand and budget making in the fiscal year after next. Thus, we can consider expeditiously preparing final accounts as a merit of reformed public accounting. However, this is only a theoretical scenario. In reality, we would have to face more complex accounting processes. To expeditiously prepare final accounts, we would have to achieve extensive reduction in labor and time spent by diffusion of electronic data processing and storage for accounting data. This could be achieved by developing software programs and system operations covering the entire process from budget demand to final accounts confirmation.

The national government is trying to expand the extent of applying the above-mentioned budget-making support system and ADAMS. It also uses the existing network infrastructure, such as intra-ministry (agency) LAN and Kasumigaseki WAN, and develops interagency exchange of electronic documents. Thus, administrative work is increasingly conducted on the electronical basis. It also aims to establish an integrated processing system of administrative accounting work permitting preparation of closing accounts. Reforming public accounting, achieved by introducing corporate accounting methods, would require developing such an infrastructure as a prerequisite; hence, requires total commitment.

7. Conclusion

Current public accounting rests on the financial accounting regulations mainly prescribed in the Pubic Finance Law. The law was enacted in the late 1940s and, after more than fifty years, the basic framework remains substantially unchanged. In the meantime, national administrative activities have been expanding, becoming more diversified and more complicated, making it almost impossible to grasp the reality of the nation's administrative results and financial conditions simply through financial information provided under present public accounting. To make reasonable decisions, we need useful financial information; thus, we have to enhance accountability to the public.

In the major advanced Western countries, such as the U.S. and the U.K., for improving administrative efficiency and establishing sound financial operations, they have introduced a method based on NPM theory into administration and financing. The inseparable NPM components are reforming public accounting and policy evaluation. These two, when combined efficiently, can demonstrate their best performance. In Japan, policy evaluation is scheduled to be introduced as a new system. In reforming public accounting, a trial national balance sheet is being prepared. Because systems are immature, it may be too early to fully evaluate reform and policy evaluation now being undertaken by major advanced Western countries. In Japan, however, cost information related to each policy is essential for policy evaluation to work effectively. To get cost information, we must examine that reforming public accounting, through introducing corporate accounting methods, is conducted in independent administrative entities and in the entire public accounting system. Reforming public accounting, with policy evaluation, serves to improve administrative efficiency and establish sound financial operations - providing this as soon as possible is most desirable.

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