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GOVERNMENT OPERATIONS

SELECT COMMITTEE ON NARCOTICS
ABUSE AND CONTROL

Congress of the United States
House of Representatives

Washington, DC 20515

July 28, 1987

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Mr. James Miller
Director
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Dear Jim:

Many thanks for your thoughtful letter of June 23, 1987, responding to my suggestion that accrual accounting based on generally accepted accounting principles (GAAP) should be used for Federal budget and reporting purposes.

Although I am more enlightened by your reply, I am no less persuaded that accrual-basis accounting is essential if we are to establish public accountability. The Congress should not be allowed to enact programs without including the full cost of programs in the budget and in reports on the Government's financial condition.

You made several points (outlined below) to which I would like to reply.

"There are more drawbacks than benefits from across-the-board application of the accrual concepts to the budgets."

When it comes to the threshold issue of accountability, you can not compromise on the basic need for meaningful information. Cash-basis budgets are essential, but so is accrual-basis information. You can't run an organization without information on liquidity and cash flow requirements, but you also need information on costs and liabilities. U.S. Federal Securities laws require a full set of reports by publicly held corporations and it is right in doing so.

When ranking the "drawbacks" of accrual-basis accounting (of which I admit none), against its benefits as a prerequisite for fair and complete reporting and public accountability, you are raising relatively minor mechanical and educational problems against a basic requirement for an informed electorate necessary for effective self-government.

"Although shifting the entire budget to an accrual-basis has major drawbacks, there are benefits to selective use of the accrual concept. As a result accruals are used in three major areas."

Mr. James Miller
Page 2
July 28, 1987

This reminds me of the old phrase--you can't be half pregnant. The result of this hybrid accounting is only greater confusion in the public mind and more rather than less distrust in government. We need one set of reports to show costs and another set to show how the programs were financed. You can't combine these different objectives into one report without clouding the issue. When you record accruals for some pension programs, but not other programs, what has been gained unless all accruals are recorded?

A misleading report results because readers will either believe that all costs are reflected or they will be unable to gauge the actual level of costs. In any event, the "other" section of the budget buries an offsetting amount in order to reflect total cash outlays accurately.

Publishing accrual-basis data for selected programs as an appendix to the budget just adds to the proliferation of data without getting to the heart of the problem, which is to inform the public on the total costs of programs. Just as a public corporation must report earnings per share, the Federal government should be required to report the total cost of government programs.

The economic burden of government programs is spread widely over individuals, corporations, users, etc., and future generations. Only by reporting total costs can the public assess the actions of those it has chosen to formulate public policy. Including accrual data for programs like the TVA and the Post Office as an Appendix to the President's budget, programs which in the aggregate are insignificant to the total unrecorded accruals, and claiming this is fair and meaningful reporting of the total cost of government illustrates the problem--not the solution.

The President's proposal to reform the Federal Credit programs may never have been necessary if budgets had been required to be on an accrual-basis in the years those programs were adopted.

"It appears that using FY1982-85 for President Reagan's First Term might have a significant effect on your conclusions."

While it can be argued that the incoming President should be charged with responsibility for the first nine months of operations, the key point is that an accumulated accrual-basis

Mr. James Miller
Page 3
July 28, 1987

deficit of several trillion dollars was inherited by Ronald Reagan and the annual accrual-basis deficits were on the average larger under Carter than Reagan.

The main reason for this is that President Reagan spent proportionately more on capital items whose benefit gets amortized over future fiscal periods under GAAP. Conversely, President Carter spent proportionately more on items which were consumed immediately, providing no benefit to future periods. Furthermore, President Carter's budgets incurred future obligations to spend which were not recorded as Carter deficits under the cash-basis. As a result, some of President Reagan's cash-basis deficit is actually the accrual-basis deficit of Jimmy Carter.

"The additional workload and reporting burden...are major obstacles."

The overwhelming majority of professional business opinion clearly demonstrates that the production of accurate comprehensive financial data is a mandatory prerequisite towards eliminating waste, achieving high levels of efficiency and cutting costs. Furthermore, the Federal government requires every publicly held corporation and State and local governments to maintain accounting systems that report accrual-basis information to the public in addition to the requirement for cash-basis reporting systems. How then can you declare this to be a major obstacle?

"...estimates of deficits on an accrual-basis will vary considerably depending on the assumptions used to estimate the accrued deficit."

The need for estimates is frequently cited as a reason for not adopting accrual accounting. The fact that judgment is required to be applied in assessing assets and liabilities is a plus factor, not a minus. Under the present cash-basis system, we have literally no information on costs. A recent Wall Street Journal editorial referred to the suggestion by the chairman of the Armed Services committee's proposal to stay within budget guidelines by simply delaying the payment of bills for fourteen days. Is it better to be criticized for apparent fiscal gimmickry of the type New York City used before it defaulted, than to make reasonable judgments which are audited currently?

It is because accrual-basis accounting deals with the substance of events that estimates are necessary. If amounts are

Mr. James Miller
Page 4
July 28, 1987

due to the government, they should be recorded as assets, but only to the extent they are collectible. This requires an analysis of the credit worthiness of the borrower, which hopefully was performed at the time the loans were made. If compensation includes pension obligations, that element should be calculated and accrued, and charged to current operations. This requires an estimate of the average working lives of employees and other factors which management needs to properly manage the affairs of government. The information needed to make accounting estimates is nothing more than the basic facts needed to manage government.

"Accrual deficit outcomes are based upon standards that are not fully developed or agreed upon and, therefore, are not supportive of our need for consistent reporting."

This is merely an excuse. First, a commission established in 1976 made up of leaders in the accounting profession (in and out of government) did develop accounting standards for the Federal government. Second, the General Accounting Office (GAO) has promulgated accounting principles for the government. These standards and principles can easily be re-evaluated and continuously updated.

As I am sure you know, the Government Accounting Standards Board (GASB) has been in operation for a few years and has developed guidelines that can be of use to the Federal government. At least one other major industrialized nation has prepared consolidated financial statements on the accrual-basis and we can learn from that effort. Also, the International Federation of Accountants has started a project to promulgate international accounting standards for government.

The fact that accounting conventions may change is a virtue of accounting, not a liability. Whenever accounting conventions change, the statements are re-cast to meet the Standard of Consistency. If the statements are audited, the officials responsible for their preparation need not worry over confusion or lack of public confidence.

"If the most recent Treasury/GAO assumptions and GAAP principles are used, the accrued deficit for the same year is estimated at \$140 billion" (as compared with the \$333 billion in the Arthur Andersen & Co. assumptions).

First, the GAO has not accepted Treasury's reclassification of social security obligations to "contingent liability" status

Mr. James Miller
Page 5
July 28, 1987

(see paragraph 3 of page V of the 1985 prototype of Consolidated Financial Statements).

Second, the facts that would cause a change in accounting of this magnitude should be clearly understood by public policymakers. Why is it that a document with a by-line on its cover "...Treasury's commitment to full disclosure of financial information to the the public" has over-ridden the unanimous recommendation of a commission established in 1976 and the sole description of social security obligations, the nation's largest government program, is relegated to a line-item on page 30 of a 31 page document, without any information on how the amount was calculated and the impact the change in accounting has on comparative financial information? The amount of \$2.059 trillion appears to be computed on an inconsistent basis with the manner in which the unfunded obligation was calculated in prior years. (The unfunded liability at September 30, 1984, was \$4.2 trillion).

There was no requirement to change the accounting for social security so the inconsistent reporting you were concerned with was not the result of lack of standards, but of a decision to change the accounting treatment that had been followed for a decade and endorsed unanimously by an independent body.

There is little doubt in my mind that accrual-basis budgeting and reporting is an idea whose time has come and that publishing official and credible accrual-basis financial reports should be the top priority of a Chief Financial Officer. The Budget submission should include a cash-basis plan and an accrual-basis plan using the same accounting principles followed in the official annual report.

You can be sure that successive administrations will not take the time to carefully allocate the accumulated deficit Ronald Reagan inherited from prior administrations, going all the way back to New Deal days. There is precious little time to adopt accrual-basis accounting and set the record straight. If this is not done, the opening balance in the "Accumulated Deficit" section of the first Annual Report of the United States Government to the American people will have Ronald Reagan's name on it.

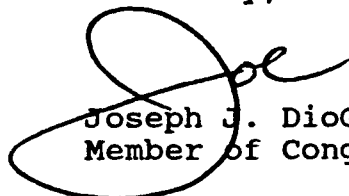
There is nothing as compatible with Ronald Reagan's philosophy and the goals of his administration as the laying out

Mr. James Miller
Page 6
July 28, 1987

of the financial facts and the use of what we have learned about proper accounting in the private sector to tell the truth about how big government really is in this nation.

Let's not paper over the problem! Let's solve it!

Sincerely,



Joseph J. DiGuardi
Member of Congress