Government, Law, and Accounting

Government plays three distinct roles in accounting: as a contracting agent in other organizations, as an organization itself, and as a super organization that defines the templates for contracts of other organizations that operate within its jurisdiction. As a contracting agent in most firms, the government collects taxes and supplies them with public goods and services. Government may participate in firms as a supplier of private goods and services (electricity, nuclear fuel), as a customer (ordnance), as a lender (U.S. Small Business Administration), and even as a shareholder (e.g., Continental Illinois Bank, Lockheed, and Crown Corporations in Canada). As a contracting agent, government affects accounting systems in its roles as the tax collector and sometimes a monopsonist customer. These and a few special characteristics of accounting systems that arise from the government’s role as a contracting agent in various firms in society are discussed in the first section of this chapter.

In its second role as a firm, the citizens and organizations within the government’s jurisdiction are the agents whose mutual contracts define the government. Like other organizations, government, too, must design and operate an accounting and control system to efficiently execute and enforce these contracts. The special features of accounting and control systems to serve government and other non-business organizations are the subject of Chapter 13.

In its third role, the government is a superfirm, a superset of contractual arrangements, meant to set the laws or rules that define the environment under which other firms operate. Coase states:

The government is, in a sense, a super-firm (but of a very special kind) since it is able to influence the use of factors of production by administrative decision . . . It is clear that the government has powers which might enable it to get some things done at a lower cost than could a private organization. . . .
From these considerations it follows that direct governmental regulation will not necessarily give better results than leaving the problem to be solved by the market or the firm. But equally there is no reason why, on occasion, such governmental administrative regulation should not lead to an improvement in economic efficiency. This would seem particularly likely when, as is normally the case with the smoke nuisance, a large number of people are involved and in which therefore the costs of handling the problem through the market or the firm may be high.²

Just as a firm substitutes certain market transactions among individuals by administrative action and rules, the government or superfirm also replaces certain transactions among individuals and firms by laws, regulations, and administrative actions. Just as some, but not all, market transactions can efficiently be replaced by administrative action within organizations, some, but not all, transactions among individuals and firms can be replaced by organization of the superfirm or government in the form of laws and rules. The government defines the environment of accounting for individual firms through laws that govern the charter of firms, the sale of securities, accounts and audits of firms, the discipline and training of auditors, the publication of financial reports, and other information. The role of government as a superfirm is discussed in the second section of this chapter.

The Government as a Contracting Agent

The government occupies at least one, and often many, contractual slots in firms. Tax collection is the best known and the least admired of these roles. The rights of the government as a tax-collecting agent are defined by statutes and subsidiary regulations. In this role, the government has the general obligation to provide public goods (such as the provision of a legal framework of property rights, judicial and police protection and enforcement, communications, and certain utility and municipal services) to society as a whole. The government has no reciprocal obligation to contribute resources to any specific firm. How does the tax collector role of government shape the accounting system of business firms?

The Government as Tax Collector

Governments levy taxes on income, property, production, sales, import, export, and employment. Instead of negotiating directly with numerous taxpayers, the government announces rules for the determination of taxes owed, and allows each firm to adjust its actions and affairs to these rules. The government must anticipate how taxpayers might adjust their activities in response to the tax laws. For example, higher payroll taxes may induce firms to hire fewer people. Indeed, many features of tax laws—subsidies, deductions, credits, and exemptions—are deliberately designed to induce changes in the economic behavior of the taxpayers. Although the ability of government to unilaterally change the tax laws makes it ap-
Pear otherwise, the actual tax liability of a firm is a joint result of choices made by the firm and the government. In this limited sense, the government's contract as tax collector is customized in individual firms.

The accounting system of the firm helps determine its liability to the government. Income taxes owed are computed from revenue and expenses, with exemptions, credits, and surtaxes for specified types of transactions. As is the case for determining other entitlements, a firm must maintain an adequate system of records to support its tax return. Primary evidentiary documents and bookkeeping entries constitute the foundation of the firm's accounting system. These primary data may be aggregated variously to prepare tax returns, financial statements, and managerial performance reports. Maintaining a common primary accounting database presents obvious economies in costs of data collection, entry, storage, and audit. When the cost of creating and maintaining a primary database declines sufficiently, it is possible that the tax accounting system of the firm may be completely separated from the rest of the system. However, at the level of primary data, the additional cost of auditing a second system yields few advantages.

Accounting systems for tax and financial reporting are interrelated. Proprietorships and closely held firms do not need financial statements to provide "unbiased" estimates of wealth or income—these statements may only increase the taxes owed to the government. In such organizations, minimizing taxes is a primary criterion in designing the accounting system. The proprietor may also prepare informal statements for personal use.

Financial reporting is more important in publicly held firms because the body of shareholders is diffuse, and accounting rules for reporting to this diffuse body must be selected efficiently to solve the agency problem between shareholders and managers and other agents. These accounting rules are not necessarily efficient for the enforcement of the contractual relationship between the firm and the tax collector.

It would be prohibitively costly for tax collectors to negotiate and enforce a separate accounting contract with each firm. It is useful to think about the rules of tax accounting as tax collectors' attempts to economize on such costs without sacrificing too much tax revenue. Where measurements of resource flows used in accounting for financial reporting are relatively objective, the tax collector accepts the financial accounting methods for tax purposes. The accounting rules for wages and perquisites of administrative employees are an example of this type. In certain areas, financial standards permit a range of practices, but once an acceptable method of accounting is picked by the firm, managers have little discretion in its application. In such cases, the tax collector allows individual firms to pick their own accounting method and accepts it as the basis for tax computation if one or both of the following conditions are fulfilled: The firm must use it on a consistent basis over time, and the method must be included in the generally accepted accounting principles. Accounting for inventories is an example of this type.

Finally, managers exercise significant discretion in certain aspects of accounting for financial reporting. In such cases, the tax collector must specify a
reduced discretion accounting method for tax purposes to preserve revenue and minimize the costs of tax adjudication and enforcement. Financial accounting standards allow much discretion in accounting for leases, and the income tax authorities use their own rules to determine tax liability. No formal financial accounting standards exist for depreciation and revenue recognition, and the tax collectors specify their own reduced discretion methods of accounting.

Accounting methods for financial and tax reporting overlap and influence each other. Tax laws and rules have a direct effect on financial reporting. Depreciation accounting became prevalent in U.S. nonregulated industries only after the Internal Revenue Act of 1913 introduced taxation of income and allowed a deduction for depreciation in computing taxes owed. Prior to 1913, few industrial firms systematically recorded depreciation in their financial statements. LIFO has been allowed for tax purposes since World War II. To discourage the loss of tax revenue, the government does not permit the use of LIFO for tax purposes unless it is also used for financial reporting. A large number of firms adopted LIFO in years of high inflation, especially during the 1970s. In 1954, when accelerated depreciation was first permitted for tax purposes, a large number of publicly held firms switched their tax and their financial reporting method to accelerated depreciation.

Financial reporting methods also affect tax accounting. To collect revenue with minimum effort, the government takes a free ride on financial reporting methods as long as the loss of revenue to managers’ discretion is not too high. Tax collectors try to minimize the differences between tax and reported amounts subject to the tax revenue constraint. The taxpayer, on the other hand, is interested in minimizing taxes through the judicious choice of accounting options subject to the cost of accounting constraint. The tax-paying firm, in selecting its reporting policy, must also consider the possibility that the tax collector may try to exploit this publicly available data and increase the firm’s tax liability. A good example is the U.S. Tax Reform Act of 1986, which included half the difference between reported and taxable income in the computation of the alternative minimum tax liability.

Determining the corporate income tax requires comprehensive involvement of accounting and control because corporate income is affected by practically all the transactions of the firm. However, there are other taxes where a firm’s liability depends on some specific parts of the accounting system.

Property, production, and sales records help determine property, excise, and sales taxes, respectively. The custom duty on import and export is usually collected through physical inspection at the port of entry or shipment, and the role of accounting systems in payment of these taxes is to ensure that invoices on which these duties are imposed are properly prepared. The payroll accounting system is designed to ensure proper collection from employees and remittance to the government of the employees’ and employer’s share of the payroll taxes (e.g., Social Security and unemployment insurance). U.S. pension laws impose detailed accounting and disclosure requirements on employee pension plans, and employers risk losing corporate income tax deductions for pension costs if they fail to meet these requirements.
Different taxes are levied by different governmental units. Customs duties are levied by federal governments, excise, income, and sales taxes by federal and many state and local governments, and property taxes by local governments. Different governmental units do not necessarily coordinate the accounting requirements for their respective levies and they are occasionally in conflict, especially at coordinate levels of government. A corporation may face conflicting accounting requirements in different tax jurisdictions. Taxing authorities in states with higher marginal rates of taxation often suspect that the firm may be shifting income to other states and may therefore seize on financial reporting and other data to assess their share of taxes. The problem becomes even more difficult for multinational corporations, which must deal with the tax laws of many sovereign states. The tax laws of different countries can be consistent only by design. Some bilateral tax treaties simplify the taxpayers' task but they do not eliminate the accounting problems that arise from interaction between tax laws and financial reports. National tax jurisdictions can be even more paranoid, often rightly so, that multinational firms operating within their boundaries use transfer prices to siphon off their taxable profits to low-rate tax havens, depriving the governments of taxes due to them. They may impose tax accounting requirements that extend beyond the usual concerns of tax accounting and extend into cost allocation and transfer prices among subsidiaries and divisions of the firm.

The Government as Customer

The government buys many goods and services. When it purchases in the open market, it plays no special role in the accounting system of the vendors. However, a substantial proportion of government purchases, especially for defense, occurs through bilateral monopolies or monopsonies in which the government is the only or major buyer of those goods or services. The developmental nature of weapons systems requires large investments by vendors in the face of substantial uncertainties about their feasibility and ultimate cost. The government effectively underwrites these development projects and buys on cost-plus-profit contracts. This contractual form directly involves the government in the cost accounting system of the firm. In 1973, the U.S. government created the Cost Accounting Standards Board (CASB), which wrote accounting rules, primarily for defense contractors, to define the participation of the government in the accounting of its vendors.

The Government as a Superfirm

Many agents with diverse interests enter into mutual contracts to form a firm when they believe they can advance their welfare by doing so. Each individual can be, and often is, a member of many different firms, sometimes in a different capacity. The government, too, is a special type of firm. The participation of all citizens and their other organizations in government is automatic. One can refuse to participate only by moving to another jurisdiction and becoming a participant in a different
government. Common law and statutes define the rights and obligations of each participant. General obligations include taxes, obedience to the constitution and laws, and, occasionally, military service. Special obligations to the government might be accepted by individuals in exchange for special rights. General rights consist mostly of public goods and services. Special rights include private goods that are either produced under economies of scale by the government or received through redistribution of wealth in society.

At the time of entering a firm, an agent may face uncertain returns, even a positive chance of undesirable outcomes. The choice to participate is based on a whole bundle of possible consequences. If they were allowed to unbundle the rights and obligations, agents might accept the rights and reject the obligations, making the contract set infeasible. In stable contracts, the rights of each participant are in equilibrium with the obligations.

If the value of rights is equal to the value of obligations, why would anyone want to enter into such an arrangement? At first it may look like the apparent paradox of the third law of motion: the force applied by object A on B is exactly equal to the force applied by B on A. If the horse and cart always apply equal force on each other, why should the horse pull the cart, and not the other way around? Of course, whether and in which direction the cart moves depends not on what forces it applies on other objects but on what forces are incident on it. Whether an agent accepts a set of rights in exchange for a given obligation depends not on what these obligations are, but on how much more or less desirable is this set of rights compared to others for which the obligation can be exchanged. In other words, it depends on the opportunity cost of one’s resources.

Business firms operate in the legal–social–economic environment defined by the superfirm called the government. Individual economic agents transact in the superfirm as well as in individual business firms. There is a continuum of organizations of increasing size and diversity—from family, neighborhood, city, state, nation, to the world—in which individuals participate. Agents’ participation in government and business organizations, and their effect on agents’ welfare, may differ in degree, but not in nature.

It is tempting to apply loaded terms, such as mandatory, involuntary, and coercive, when it comes to fulfilling one’s obligations in a contractual arrangement. But such terms are used when the resolution of uncertainty is adverse (the realized obligation of the agent exceeds its expected value). Settling a bet gone sour can hardly be called coercive or involuntary, just because the contract involved is labeled government.

As shown in the previous chapter, the distinction between voluntary and involuntary economic behavior is tenuous. A government action may induce an individual to choose option A instead of option B. We may refer to this change in individual choice as having been mandated by government and, thus, involuntary. An action of the firm may similarly render one option more attractive than an-
other for an investor, manager, or employee. The firm would then be said to have mandated that choice. The argument is applicable to all environmental factors that could cause behavior to change, and to all organizations. It renders the set of voluntary choices empty.

A distinction is sometimes made between private sector versus public sector mechanisms for setting accounting rules and standards in discussions of accounting standards and related laws. Voluntary standards are said to be associated with the private sector, while the term mandatory is reserved for standards issued by the government. When we think of government as a superfirm, this distinction becomes less clear. The difference between private-sector rule making (e.g., by the FASB) and the public-sector rule making (e.g., by the SEC) is in the degree of representativeness, scope, and power of the organization that sets the rules and standards.

A body that is more representative of the various types of agents it affects is more public. In this sense the FASB is more public than its predecessor bodies, the Accounting Principles Board and the Committee on Accounting Procedure, which consisted of the members of the professional association of public accountants. The “publicness” of a social mechanism depends not on whether its expenses are paid for by the exchequer, but on how well it represents the interests of the relevant publics.

Being part of the government does not necessarily make an organization effectively public, and being outside the government does not always make it private. Governmental regulatory agencies are known to have been captured by narrow interest groups. On the other hand, reasonably representative public conflict resolution mechanisms can exist outside the government. The presumption that a government body is also a public body is not always correct.

Each type of transaction can conceivably be organized in the market or in organizations of varying scope or size. Whether and which accounting rules are best left to the market—agreed upon at firm level through its charter or shareholders’ resolutions, determined at the industry level by industry associations, or determined economy-wide by a public body—is a matter of economics, not ideology.

The Charter of Firms

In the United States, state laws govern the charters of most limited liability firms. A large proportion of publicly held firms have come to be chartered in the state of Delaware. Consequently, laws of that state have become especially important for the larger, publicly held firms.

Since the special privilege of conducting business under limited liability is conferred by the government, the laws that govern the charter of such limited liability firms have been designed to protect the interests of lenders and others who conduct business with such firms. The law defines legal capital, surplus, dividends, and the like, and prevents shareholders from transferring creditors’ wealth
to themselves through dividends, purchases of treasury stock, and so on. State laws rarely specify the detailed financial reporting methods and requirements. Since the vast majority of limited liability firms are closely held, the inclusion of additional accounting requirements in the state charter laws would be quite inefficient. A large part of the burden of additional financial reporting requirements would fall on the privately held firms, whose shareholders hardly need to be protected from themselves.

**The Sale of Securities**

When a firm’s securities are sold publicly, the cost of direct negotiation between a diffuse, unorganized group of investors and the firm is large. It is more efficient to choose the rules that govern the market transactions between firm and investors, or between insider and outside investors, at the societal level. Accounting and disclosure rules for publicly held and publicly traded firms are specified by the stock exchanges and the government. Since securities are traded in a national market, the federal government sets the rules. In the United States, the SEC sets the accounting and disclosure rules for publicly held firms.

As we discussed in Chapter 11, it is difficult to ascertain which accounting rules are efficient. People do not always reveal their preferences truthfully, and various social choice mechanisms are vulnerable to manipulation. With a few notable exceptions, the SEC has confined its rules to requiring prompt and adequate disclosure of accounting policies and important economic events of the firm. The SEC has largely refrained from requiring the use of specific accounting measurement methods. In the 1970s, it deviated from this general policy in the case of accounting for leases, inflation, and oil and gas exploration. The disclosure requirements have been far less controversial than the specification of accounting measurement methods.

**Certification, Licensing, and Discipline of Auditors**

State laws govern the entry of individuals to the auditing profession. The laws that govern entry to various professions are said to save the public from the unscrupulous and the incompetent. Such legislation does raise the average quality of professional services sold in the market. Whether such legislated action is socially efficient is controversial, especially because its enforcement is controlled by professionals who are securely within the fence themselves.

The laws of the United States that govern the certification, licensing, and disciplining of auditors vary across the fifty states. This variety provides a healthy environment for trial and error and the evolution of laws through competition among states. Dodd and Leftwich present a similar argument for state laws governing the charter of corporations. Kaplan argues that if the disclosure laws were set by states instead of the federal government, a healthy competition could prevent bureaucratic excesses. But this argument cuts both ways. The capture of regulatory
institutions by interest groups occurs when the general public fails to coalesce into effective opposition because the benefits of doing so are small compared to the cost of organizing.

The cost of organizing has a fixed component, making it less likely that the public will organize at the state level to resist special-interest legislation. Thus, the state-regulated apparatuses for disciplining auditors and other professionals often remind one of the fox guarding the henhouse. In the United States, state boards of public accountanty are dominated by the state CPA societies.

Since the federal securities laws gave U.S. public accountants the exclusive franchise to audit the financial reports of publicly held corporations, the disciplining of firms (as distinct from individual auditors) that audit such corporations has fallen within the jurisdiction of the SEC. Over the past half-century, the SEC has gradually nudged the audit profession to (1) accept a more objective criterion for auditor independence, (2) move audit programs from bookkeeping audit toward field audit, including direct verification of inventory and receivables, (3) develop specific and detailed audit standards, and (4) create the Public Oversight Board and a system to monitor the quality of work done by the audit firms that practice before the SEC.

These changes have been gradual. When the SEC was created in 1934, it was not unusual for an auditor to be a member of the board or even a major shareholder of the client. In the 1970s, the SEC pressured audit firms to limit the sale of advisory services to their audit clients to reduce the chances of compromising auditor independence.

The expansion of the scope of audit started with the McKesson & Robbins case in 1938. Under the Foreign Corrupt Practices Act of 1977, an audit now includes a review of firms’ internal controls. The creation of the Public Oversight Board, which organizes quality control measures for audit firms, was also triggered by the Foreign Corrupt Practices Act.

Summary

In most firms, the government plays the role of a major contracting agent as tax collector, customer, or vendor. In these roles, the government has substantial influence on the design of a firm’s accounting and control. In addition, the government acts as a superfirm to set the rules by which various individuals and organizations in its jurisdiction interact. State and federal laws and standards relevant to accounting can be thought of as template contracts for firms. They save everybody the cost of negotiating contracts from scratch. In this role, the government produces public goods to increase the efficiency of social-economic exchanges. Finally, the government itself can be seen as an organization or firm that requires its own control system to implement and enforce the relevant contracts. This problem is discussed in the next chapter.
Notes

1Public goods can be provided to additional beneficiaries without incurring additional cost and they cannot be withheld from some people without affecting the others. Few goods are purely public or purely private, and I use these labels in relative terms. See Mancur Olson, The Logic of Collective Action (Cambridge, Mass.: Harvard University Press, 1965).


6Kaplan, op. cit.

Additional Reading


