

CORPORATE ACCOUNTING ILLUSION: DOUBLE-ENTRY BOOKKEEPING AND ACCRUAL BASIS SOLVE PROBLEMS IN LOCAL GOVERNMENTS?

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. INTRODUCTION

These days, fiscal crisis of local governments is in the air. For Example, Yubari city in Hokkaido prefecture was “bankrupted” in March 2007. It was a very shocking incident to Japanese people. Indeed, the bankruptcy of local government itself was very surprising, but it was more shocking that we could not know the serious situation owing to accounting abuse until the bankruptcy. This was a symbolic case. But, in general, the financial situation of local governments is serious.

After the Bubble Economy collapsed at the beginning of the 1990s, a business recession started. And so, tax revenue of central and local governments declined. In order to make business good, governments exercised fiscal policy by issuing bonds. Finally, the amount of bonds for the central and local governments came up to a tremendous amount. Japan is in a crisis situation. On this point, the central and local governments need to readjust their finance. This is a crucial issue. In order to cope with this, the central government made a law called “Decentralization lump-sum law,” which was introduced in April 2000. This law provides that local governments are not agencies of the central government but that they are independent administrative bodies. In June 2003, the central government decided “Trinity Reformation.” Trinity Reformation involved three elements; reduction in fiscal subsidy, reduction in tax grants to local governments, and transfer of taxation rights from central to local. This reform meant that local governments gained the right of taxation, giving up grants from the central government. However, as mentioned above, because business was slow, tax revenue of local governments declined. Local governments were in a stringent situation. On this point, too, local governments need to readjust their finance.

It is an accounting reform that is expected to be an effective tool to readjust their finance. Although local governments prepare financial statements, their effectiveness is doubtful. Why? In this paper, I aim to clarify the reason why objectives of financial statements prepared by local governments are not attained, and meanings of recent accounting reform in terms of new institutional theory. The following sections are organized by four parts. Section surveys recent accounting reform. Section examines objectives of financial statements prepared by local governments. Section examines meanings of recent accounting reform. And last section gives a conclusion.

. RECENT GOVERNMENTAL ACCOUNTING REFORM

1. Toward Solid Financial Statements

In Japan, accounting reform of local governments does not have a long history. It was the latter half of 1990s that accounting reform started substantially in some local governments, such as Mie prefecture, Usuki city in Oita prefecture and Musasino city in the metropolis of Tokyo. But, at that time, they independently struggled to reform their financial reporting, therefore there was no comparability among their reporting.

In February 1999, the Meeting for Economic Strategy released the report which declared that governments should prepare financial statements based on fundamental elements of Accounting Principles for Business Enterprises. To support those efforts by some local governments, the Ministry of Home Affairs established a study group on financial analysis of municipalities in June 1999. As a result of this working group, the Ministry of Internal Affairs and Communications (the successor of the Ministry of Home Affairs, hereafter the Ministry) released the standard for a balance sheet on ordinary accounts in March 2000. Here, ordinary accounts mean a total of general accounts and local accounts except for municipal enterprises accounts, that is, local government's all accounts except for municipal enterprises accounts. So, the balance sheet on ordinary accounts shows a financial position of a local government. And, in March 2001, the Ministry released the standard to prepare an administrative cost statement and a balance sheet of a local government as a whole. An administrative cost statement shows costs (inputs) for public services. And a balance sheet of a local government as a whole involves general accounts and local accounts including municipal enterprises accounts, though a balance sheet on ordinary accounts lacks information concerning municipal enterprises accounts. The Ministry also announced a method to prepare these statements, called "Somu-sho Method," meaning the method proposed by the Ministry.

Somu-sho Method basically based on data of final accounts which was ordinarily prepared in local governments. On this point, Somu-sho Method does not demand a drastic change in practice. But it has at least two outstanding features. Firstly, it proposes a depreciation on fixed assets. Before that, local governments administered fixed assets in terms of physical number. Somu-sho Method implies to administer them in terms of monetary number. Secondly, it proposes to report retirement allowance. Before that, local governments did not deal with retirement allowance. Somu-sho Method implies to report future-oriented information, though target is quite limited.

In June 2005, the Cabinet released the report, The Policy on Economic and Fiscal Management and Constitution Reform 2005. This report declared that governments of prefectures and big cities should prepare and disclose consolidated balance sheet. And, in September 2005, the Ministry proposed the standard to prepare a consolidated balance sheet of local government. This consolidated balance sheet includes an information about organizations which provide services in cooperation with a local government, such as independent administrative institutions and third sectors.

In May 2006, the Ministry released an influential report by working group on local government accounting system (hereafter The Report). The Report has four outstanding features. Firstly, it proposes an introduction of double-entry bookkeeping and accrual basis to local government accounting. Secondly, it proposes a consolidated financial statements. So these statements include information not only on local government itself but also on organizations which provide services in cooperation with a local government. Thirdly, it proposes four statements; balance sheet, profit and loss statement (administrative cost statement), net worth matrix (statement of changes on net assets), and cash flow statement. Fourthly, it proposes another option to prepare financial statements, i.e. a revised Somu-sho Method. This method is a kind of simplified Somu-sho method. In July 2006, the Cabinet released the report, The Policy on Economic and Fiscal Management and Constitution Reform 2006. This report declared that central and local governments should try to make financial information solid for assets and liabilities management together. And in August 2006, the Ministry made a notice to enhance the administrative reform in local governments. It required following points:

- To be, in principle, based on standards for preparation of central government's financial statements.
- To adopt accrual basis and double-entry bookkeeping.
- To normally prepare four statements: balance sheet, administrative cost statement, cash flow statement, and statement of changes on net assets.
- To prepare a consolidated financial statements.
- To use Somu-sho Method or revised Somu-sho Method.
- Prefectures and big cites etc. should prepare four financial statements defined by The Report or disclose information which is needed to prepare them within three years and little cites etc. should within five years.

TABLE 1 shows the saturation level of financial statements among local governments.

TABLE 1: The saturation level of financial statements
(Investigation Date: 2007.3.31)

	Prefectures	Cities, Wards, Towns, and Villages			
		Big Cities	Cities and Wards	Towns and Villages	
Balance Sheet	47 (100%)	1,113 (60.9%)	15 (100%)	631 (79.9%)	467 (45.7%)
Profit and Loss Statement	47 (100%)	725 (39.7%)	15 (100%)	478 (60.5%)	232 (22.7%)

Balance Sheet of a Local Government as a Whole	44 (93.6%)	191 (10.5%)	14 (93.3%)	135 (17.1%)	42 (4.1%)
Consolidated Balance Sheet	47 (100%)	117 (6.4%)	15 (100%)	84 (10.6%)	18 (1.8%)
(Total Number)	(47)	(1,827)	(15)	(790)	(1,022)

Note: The term “big cities” means Sapporo, Sendai, Saitama, Chiba, Yokohama, Kawasaki, Shizuoka, Nagoya, Kyoto, Osaka, Sakai, Kobe, Hiroshima, Kitakyushu, and Fukuoka cities.

Source: Ministry 2007, 1.

2. From Single-entry Bookkeeping and Cash Basis to Double-entry Bookkeeping and Accrual Basis

Advocates of accounting reform criticize single-entry bookkeeping and cash basis, which have been adopted in local governments for a long time. And they claim a changeover to double-entry bookkeeping and accrual basis. As defects in single-entry bookkeeping and cash basis, they maintain following points:

- We cannot grasp stock information exhaustively. We cannot know all assets and liabilities which a local government holds. As an example, retirement allowance is often referred.
- We cannot grasp events which involve no cash flow, for example, depreciation.
- We cannot distinguish revenue expenditure from capital expenditure.
- Flow information isn't articulated to stock information.
- Record isn't systematic and we cannot verify the record automatically.

In order to overcome these defects, they advocate an introduction of double-entry bookkeeping and accrual basis. However, these points are well-known as shortcomings of those accounting system for a long time. So, indeed they are an indirect cause for recent accounting reform, but are not a direct one. That is, in terms of defects in single-entry bookkeeping and cash basis, we cannot realize why accounting reform came to be advocated these days. Moreover, some point out as a merit of single-entry bookkeeping and cash basis that we rarely make mistake in managing public money, that we can audit records easily, and that record is objective because there is little estimation and judgment. Then, what is a direct cause of recent accounting reform in local governments? That is the fiscal crisis of local governments. It is corporate accounting methods, i.e. double-entry bookkeeping and accrual basis, that is expected to be a remedy for the fiscal crisis. But, how can corporate accounting methods solve financial crisis problems in local governments? In order to examine this point, in next section, we discuss the objectives of financial reporting by local governments.

. OBJECTIVES OF FINICIAL REPORTING BY LOCAL GOVERNMENTS

In The Report released in May 2006, the objectives of preparing financial reports by local governments are explained as follows (Ministry 2006a, pars.23-24):

The objective of preparing financial statements in local governments is to provide useful information for users such as citizens in making economic or political decisions. To be specific, information about (1) “financial position,” (2) “performance,” (3) “changes in net assets,” (4) “condition of cash flow” of local governments should be provided.

Besides, from the viewpoint of fundamental concepts in public sector accounting, the objective to prepare these financial statements is to fulfill “public accountability” in the sense that local governments should demonstrate their duties in terms of accounting. To be specific, the information for final accounts analysis (.....) should be demonstrated in terms of accounting, and information to harmonize decisions in policy making such as budget with interests of citizens should be provided.

The former objective mentioned above is clearly based on “decision usefulness approach,” which is employed by Financial Accounting Standards Board (hereafter FASB) and Governmental Accounting Standards Board (hereafter GASB) in the US. Needless to say, decision usefulness approach is a fundamental accounting theory that financial reporting should provide information which is useful for users in making decisions. Above all, who are the users of local government’s financial statements? As users, GASB recites three groups: “(a) those to whom government is primarily accountable (the citizenry), (b) those who directly represent the citizens (legislative and oversight bodies), and (c) those who lend or who participate in the lending process (investors and creditors)” (GASB 1987, par.30). In contrast, The Report recites, as users, (a) the citizenry, (b) investors and creditors, (c) other external interest groups such as connections, nation and rating institutions, and (d) internal group of local governments such as the lord, the assembly and subsidiary institutions (Ministry 2006a, par.21). Indeed, both users groups are different in some respects, but they accord with each other in that the citizenry are the primary users of local government’s financial statements.

Then, what kind of decision do the citizenry make? GASB recites voting and funding decisions (GASB 1987, par.42). In contrast, The Report recites voting (Ministry 2006a, par.22). Truly, it is possible to use financial information in deciding which candidate to vote. But it is not often the case with Japanese people. In voting, the other factors are made much of, for example, policy in issue and supporting political party. So, in Japan, it is hard for the citizenry to voluntarily make the most of financial reporting by local government in voting. Besides, GASB assumes funding to be a decision making point by the citizenry. Here, of course, funding as the citizenry means paying tax. But, as GASB admits, “taxpayers are involuntary resource providers” (GASB

1987, par.17a). The citizenry have no choice not to pay tax or to discount tax. So paying tax is far from decision making. This is why not only decision usefulness but also public accountability are the objectives of financial reporting by local governments (Fujii 2005, 7).

To investors and creditors, voting is irrelevant. It is in investing or lending money that they make decisions. If investors and creditors were assumed to be the first users of financial statements by local governments, the situation would be identical to corporate accounting defined by FASB. But, in fact, they are not the first users. So, rules are not always defined in terms of investors and creditors in both GASB (1987) and Ministry (2006a).

The latter objective mentioned above is public accountability. According to The Report, public accountability is ramified into two sub-objectives. The first one is to demonstrate information for final accounts analysis in terms of accounting. And the second one is to provide information to harmonize decisions in policy making such as budget with interests of citizens. As to the first sub-objective, FASB explains as follows (FASB 1978, par.50):

Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it. Management of an enterprise is periodically accountable to the owners not only for the custody and safekeeping of enterprise resources but also for their efficient and profitable use

If the phrases “an enterprise” and “the owners (stockholders)” are interchanged with “a local government” and “the citizenry and so on”, this remark is applicable to local governments. In present situation, do local governments discharge this kind of accountability? No. As some discussants pointed out, truly local governments discharge their explanation responsibility, but they don't focus on whether they used the entrusted resources efficiently (Sakurauchi 2004, 46-47; Yamazaki 2005, 174; Kobayashi 2007, 26). In this sense, profit and loss statement which is proposed by The Report is not enough. This is because profit and loss statement provides only costs (inputs) information. In order to assess efficiency of local government services, accomplishments information is needed. Of course, their accomplishments are not expressed in terms of profit as enterprises. And so, it may not easy to define accomplishment indicators. But an elaboration of accomplishments reporting is necessary by referring to, for example, the service efforts and accomplishments reporting proposed by GASB.

The second sub-objective bases on a concept of public governance. In order to impose discipline on local governments by financial reporting, response by users is inevitably essential. If they have objection about the use of resources they entrusted, their opinion must be communicated to local governments. This makes it possible to harmonize decisions in policy making with interests

of citizens. However, as I discussed in Yamada (2007), in Japan the awareness by the citizenry of what it means to be taxpayers is not strong. The citizenry, that ought to be main users of financial statements of local governments, are hardly interested in resources they entrusted to local governments. For example, in Usuki city, though financial statements such as balance sheet are disclosed to the public via internet, there are few responses from citizens (Otsuka 2005, 132). To increase responses, Usuki city makes some efforts: sending out questionnaires about governmental services, distributing “claim sheets” to citizens, and so on. Mayor of Usuki city emphasizes the importance of response, saying “I believe that the best way for citizens to participate in city management is to make a claim. Officials as staffs react customers’ claims and improve the management by referring to them” (Goto 2006b, 36). But this is just a rare case, and conversely, it means that citizens would make no response without these efforts. So, even if financial information is provided, public governance cannot be expected.

. IMPLICATIONS OF GOVERNMENTAL ACCOUNTING REFORM

As I discussed above, accounting reform is not sufficient in terms of objectives of financial reporting. We cannot expect the present accounting reform will result in a fiscal recovery. But, whatever exists must have a meaning. In this section, I examine the implication of accounting reform by local governments.

1. In Search of Legitimacy

In section , I discussed the fiscal crisis of governments. And it is an accounting reform that is expected to be an effective tool to readjust their finance. Single-entry bookkeeping and cash basis accounting are regarded as old-fashioned and considered not to be accommodated to present circumstances of local governments. Therefore, double-entry bookkeeping and accrual basis accounting come into fashion. It is taken for granted that corporate accounting methods solve fiscal problems of local governments. Namely, an introduction of corporate accounting methods is “the practices and procedures defined by prevailing rationalized concepts of (local governments’) organizational work and institutionalized in society” (Meyer and Rowan 1977, 340). By reforming accounting methods, local governments try to exhibit their positive attitude toward reconstruction of their economy, and to be regarded as substantial organization. That is, “organizations that do so increase their legitimacy and their survival prospects” (Meyer and Rowan 1977, 340). The local government that does not adopt corporate accounting methods fails to gain legitimacy and may be criticized. Legitimacy is very important for local governments. So, incorporating corporate accounting methods means a step to gain legitimacy for local governments.

However, by doing so, local governments increase their legitimacy, “independent of the immediate efficacy of the acquired practices and procedures” (Meyer and Rowan 1977, 340). It

seems to be taken for granted that corporate accounting methods can make local governments managements efficient and improve their finance. But it is doubtful. We cannot make an immediate decision on this point. This is because some enterprises, which of course adopt corporate accounting methods, are managed inefficiently. So, what is important for local governments is not efficiency but legitimacy. Local governments' performance is hard to measure, and so they don't have a definite performance measure such as income of enterprises. This feature of local governments makes legitimacy crucial. "When organizational output is easily measurable, when productive technologies are well defined, and when criteria of success are unambiguous, then technical efficiency matters. It is when outputs, technologies and criteria are highly uncertain that the mythical aspect of rationalized structure matters most" (Carruthers 1995, 316). In this sense, the adoption of corporate accounting methods can be regarded as "rationalized myths" (Meyer and Rowan 1977, 343).

It is also considered isomorphic process to "incorporate the practices and procedures defined by prevailing rationalized concepts of organizational work and institutionalized in society" (Meyer and Rowan 1977, 340). DiMaggio and Powell (1983, 150) classified isomorphic process into three categories: coercive, mimetic, and normative isomorphism. "Coercive isomorphism results from both formal and informal pressures exerted on organizations by other organizations upon which they are dependent and by cultural expectations in the society within which organizations function" (DiMaggio and Powell 1983, 150). Mimetic isomorphism is modeling to cope with uncertainty. "When organizational technologies are poorly understood (.....), when goals are ambiguous, or when the environment creates symbolic uncertainty, organizations may model themselves on other organizations" (DiMaggio and Powell 1983, 151). And, normative isomorphism "stems primarily from professionalization" (DiMaggio and Powell 1983, 152). There are two aspects of professionalization that are important as sources of isomorphism. "One is the resting of formal education and of legitimation in a cognitive base produced by university specialists; the second is the growth and elaboration of professional networks that span organizations and across which new model diffuse rapidly" (DiMaggio and Powell 1983, 152).

Among these types of isomorphism, accounting reform by local governments can be regarded as coercive isomorphism. As I surveyed in section -1, many reports and standards were released by authority such as the Ministry and cabinet. Accounting reform by local governments is guided by these reports and standards. These reports and standards were "formal and informal pressures exerted on organizations by other organizations upon which they are dependent" (DiMaggio and Powell 1983, 150). Moreover, because of a fiscal crisis, there was a growing tendency to demand governmental administrative reform in the society. This was an "informal pressure (.....) exerted on organizations (.....) by cultural expectations in the society within which organizations function" (DiMaggio and Powell 1983, 150). In these senses, local governments' isomorphic process toward corporate accounting methods is coercive.

Accounting reform by local governments is regarded as coercive isomorphism, as I discussed above. But there are exceptions. They are pioneering reforms by some governments such as Mie prefecture, Usuki city and Musasino city. What kind of isomorphism is applicable to these pioneering reforms? Apparently, mimetic isomorphism seems to be applicable. However, it is not valid. Excluding public utilities such as bus services, services provided by governments are usually different from those by business enterprises. So, local governments don't share organizational field with enterprises. Here, organizational field means "those organizations that, in the aggregate, constitute a recognized area of institutional life: key suppliers, resource and product consumers, regulatory agencies, and other organizations that produce similar service or products" (DiMaggio and Powell 1983, 148). When there is no government which overcame fiscal crisis by adopting corporate accounting methods, mimetic isomorphism cannot occur in such an organizational field.

2. The Meaning of Somu-sho Method

As I surveyed in section , the Ministry proposed Somu-sho Method and made a deadline to complete the preparation of financial statements. Apparently, it seems that introduction of corporate accounting methods to local governments progresses steadily. However, it is not true. Somu-sho Method bases on data of final accounts which was ordinarily prepared in local governments, as I pointed out above. The final accounts are prepared independent of everyday double-entry bookkeeping. Besides, Somu-sho Method truly introduces some accrual basis items, but the number of those items is quite limited. This means that Somu-sho Method does not necessarily base on accrual basis as business enterprises. According to Otsuka (2005, 128), this was because it was necessary for Somu-sho Method to be the standard for financial statements preparation that even a small local government could follow. Otsuka (2005, 128-129) continues as follows:

Since Somu-sho Method is the guideline which the Ministry publishes, it must be what is applicable to all local public sectors in Japan including a small organization. Therefore, (.....) the option to demand a drastic change could not be chosen. For example, it was *impossible* to demand financial statements for which local public sectors needed the drastic change of accounting system, such as *an introduction of double-entry bookkeeping*. So, as the method to prepare financial statements which even a small organization can use, the realistic option was adopted to use data which was distilled from final accounts, i.e. financial statistics, system (Italics mine).

The notice which the Ministry released in August 2006 demanded to adopt accrual basis and double-entry bookkeeping, and at the same time, to use Somu-sho Method or revised Somu-sho Method. So this notice contradicts itself. On one hand, there is a trend toward an introduction of

corporate accounting systems, but on the other hand, drastic change to corporate accounting system may cause a confusion in small local governments. Somu-sho Method is a minimum guideline not to make small governments confused by a drastic change in accounting system. In this sense, Somu-sho Method can be regarded as decoupling. “To maintain ceremonial conformity, organizations that reflect institutional rules tend to buffer their formal structures from the uncertainties of technical activities by becoming loosely coupled, building gaps between their formal structures and actual work activities” (Meyer and Rowan 1977, 341).

At the beginning of the release of Somu-sho Method, it was a minimum guideline, namely the start of accounting reform. But in fact, it is considered the end (Otsuka 2005, 137). This is a consequence of the decoupling. This decoupling was made for fear that small governments got confused because of drastic accounting reform. But there must be governments large enough to cope with more drastic accounting reform than Somu-sho Method. As TABLE 1 shows, the saturation level of financial statements among prefectures and big cities is almost 100%. These prefectures and big cities governments must be such organizations. Therefore, it is possible to make another guideline which demands more drastic accounting reform for large governments such as prefectures and big cities.

3. In Order to Make the Most of Financial Reporting by Local Governments

In accounting reform of local governments, decoupling is not limited to Somu-sho Method. Financial information is hardly used for the control of operations in local governments, that is, local governments don't establish a management accounting system of financial information. In business enterprises, accounting information is used not only for an external reporting but also for an internal reporting, i.e. as a management tool. But this is not true of local governments. So, it is also considered decoupling. Ishihara (2006, 4) emphasizes the problem of system reform in governments as follows:

Government reform consists of three phases: reform in officials' consciousness, in governments' system (mainly, budget, organization and quorum), and in partnership with citizens. Above all, it is reform in governments' system that is most difficult to carry out and governments are in arrears with.

However, as I discussed in section , the objectives of financial reporting are hardly attained. If local governments were frequently bankrupted throughout Japan, citizens would be keen to government's operations and would make, if any, claims to government actively. But this is not realistic in present situation. In contrast, reform in government is a matter of the government itself. Therefore, in the short run, the reform of accounting reporting for internal management can be more

realistic and effective than the reform of external accounting reporting (Otsuka 2005, 138). It is important for local governments to build an incentive system of officials by using accounting information. “Performance reporting systems should ideally be institutionalized in all management process including strategic planning and should involve a broad cross section of the government, and in particular both executive and legislative functions and senior administrators” (Cunningham and Harris 2005, 42). From the field studies, Cunningham and Harris (2005) emphasizes the importance of communication, saying “a commitment to investment in communication and information management technology (.....) seems to be essential for the implementation of performance reporting systems” (Cunningham and Harris 2005, 38). It should be noted that “performance reporting systems per se are not sufficient to achieve the desired accountability and effectiveness and that the ability of the system to foster communication is more important than performance indicators themselves” (Cunningham and Harris 2005, 42). So, how to utilize accounting system as a communication tool is a critical issue for local governments.

. CONCLUDING REMARKS

Indeed many local governments prepares financial statements, but fiscal crisis doesn't seem to be improved at all. One of the most crucial reason, if not the most crucial, is that formal adoption of corporate accounting methods becomes the end for local governments. Here, “it should be noted that an introduction of accrual basis is not the end” (Shimizu 2007, 18). If accounting reform is no more than a means to gain legitimacy for local governments, the objectives of financial reporting cannot be attained.

As I discussed in section -2, prefectures and big cities may be capable of more radical accounting reform. It must be one of the solutions to use financial information for management accounting purpose. Here, the linkage between accounting information and incentive system of officials is important. Indeed it is easy to claim citizens should be active in public management. But it is not such an easy task to change citizens' consciousness in reality. The crucial problem lies in the fact that financial reporting, which should have been expected to be useful for users and to be used for the discharge of public accountability, became a means to gain legitimacy for local governments. It would be easier for local governments to change themselves, which depends on their own will.

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