Sovereign debt and public finance today – Lessons learned and looking forward

Speech given by James S. Turley, Chairman and CEO of Ernst & Young, to the International Federation of Accountants (IFAC) on March 20, 2012 at its seminar in Vienna, 'The Sovereign Debt Crisis, a Matter of Urgency – from Lessons to Reform'.

Good morning everyone.

It's great to be here with you today to talk about one of the most pressing issues we face – sovereign debt. I've been asked to share with you a few ideas on what the accounting profession can do to help governments address the challenges they face – with a focus on public sector accounting and some of the lessons we have learned from the recent financial crisis.

From my perspective, the biggest lesson we all learned was one we shouldn't have had to re-learn – and that is that incentives have consequences. Both good consequences and very bad, unintended consequences.

Think of the dot-com crisis. The positive impact of the proliferation of stock options, the aligning of workers' interests with other share owners. And the negative consequences that came when some companies saw leaders driving up short-term share prices to drive personal wealth.

Think of the banking crisis, and how compensation and bonus systems positively incented traders to make trades that drove large profits for their bank. But, which had the tragic unintended consequences of not considering the long-term risks of the trade, because bonuses were never clawed-back or calibrated to what happened over the long term.

Think of the capital requirements that regulators had in place for the banks – resulting in significantly reduced capital needed for mortgage-backed securities in the United States (compared to commercial loans or traditional mortgages). And in Europe, in many cases, no capital required for its banks to hold sovereign debts. In each case, the banks – whether in the US or Europe – "followed" the incentives in a herd, which led to very serious problems.

So, incentives have consequences – both good and bad.

Let me turn briefly from fairly recent history to more distant history to make a point. I grew up in the United States – a country where, during my lifetime and career, we've seen at least three industry sectors go bankrupt. The steel industry in the 1970s. The airline industry in the 1980s/1990s. The car industry just a few years ago. To these three sectors I think we are perilously close to adding a fourth sector, both in the US and Europe, and that is the public sector.

When you get failures like the three sectors I just mentioned, people like to pin blame, and many put the blame squarely on the labor unions. The unions, many would say, brought these industries to their knees. They demanded too much, they didn't think of the long term. But in my view the unions were just doing their job – trying to get a better deal for the workers.

So I don't blame the unions. Personally, I blame the accountants. Yes, the accountants. But, before I see the headlines '*Big Four boss blames accountants for US industrial decline' …* let me explain just what I mean.

When the unions came to the management of their day asking for better pay, management – with an eye on the accounting standards of their day – said no, we can't give you better pay, but we can give you a great pension. We can give you and your family lifelong health and other benefits.

I am sure they chose to reward their workers through pensions and welfare provisions for many reasons. But a very big reason was that, at the time, such benefits didn't hit the current P&L. And so, the benefits were free, or at least "sort of free".

Doing this meant that companies were storing up costs for the future – costs that were actually higher than the wage raises would have been – and sweeping the costs under the carpet. And of course, that bulge under the carpet continued to grow, until the steel companies, the airlines and the car companies eventually tripped over it.

What this neatly illustrates, in my view, is that rules create incentives that directly influence behavior. And that accounting rules and budgetary policies create definite incentives … just like stock options, just like incentive compensation policies, just like bank capital requirements.

So when I say that accountants were to blame, what I mean is, ultimately, accounting standards, and the way they were implemented, were in many ways responsible for the wrong kind of behavior.

So, why bring this up today? Well, fast-forward and switch the scene to government and I think we face a similar situation – whereby rules are incentivizing the wrong kind of behavior. And – importantly – this is one of the key lessons of the sovereign debt crisis.

We have a situation where, unlike commercial businesses of today, many governments are still accounting for pensions and post-retirement health benefits, and potentially a whole host of other entitlements, on a cash basis. They don't have the processes or systems in place to take stock of the assets and liabilities they hold – at a time when the need for governments to be accountable for their decisions around resource allocation is more important than ever before.

Before I get down to the detail, and to what I think our profession can do to help, I'd like to come back to my point that rules create incentives that drive behavior.

As former US Senator Judd Gregg, who served on the US Ways and Means Committee, recently pointed out in a keynote address to the American Institute of CPAs – 'when a massive demographic shift hits a democratic political system built around entitlement, you get unsustainable debt – as seen in Europe, the US and Japan.'

To that, I would add, when you have government accounting processes and standards that fail to reflect reality and fail to provide transparency to stakeholders, the results … well, we've seen the results.

Too often in governments around the world, archaic accounting has been used to hide the true costs of decisions. Election and budgetary cycles have incentivized governments to concentrate on the short term. Unlike well-run companies, today's governments are actually incentivized to mortgage their long-term future for short-term benefit.

Europe, of course, is getting the lion's share of the attention these days, but it is not alone in facing the challenges of sovereign debt.

Japan has the highest debt to GDP ratio in the world – at well over 200%. Yet its government continues to be able to borrow at extraordinarily low interest rates, largely because most of the debt is held by domestic investors.

In the US, which recently lost its triple-A credit rating for the first time, some estimate that between 1950 and 2010 the number of workers paying payroll taxes per social security beneficiary dropped from 16.5 to 2.2.

And, some predict the debt burden per child will increase from US$85,000 in 2009 to US$196,000 in 2017 – more than the net worth of most Americans.

Back home, I should add that in addition to the record Federal deficits, many of the largest states, including California, Illinois, New York and others, are swamped with debt … and the situation would look multiple times worse if the states' long-term commitments were reported using commercially accepted accounting treatments.

Things have to change

What's clear is that things have to change.

The sovereign debt crisis exposed the seriousness of poor financial management and sub-standard reporting by the public sector.

It exposed the problems of short-term reporting cycles; the problems of archaic accounting; the hidden costs of pensions, healthcare and other social provisions; the need for modernizing control systems and financial infrastructure; and the problems of commingling operating and capital budgets.

It exposed the far-reaching consequences of unrealistic commitments founded on poor financial information.

Yet, still today, governments are taking far-reaching decisions, which will impact their countries for years to come, with limited discussion and almost no disclosure of the long-term consequences of these decisions.

Now, I have to say, I am privately of the belief that leaders of governments often do know the true long-term costs of the things they propose … but the rest of us don't know those costs because of the way governments keep score. And in that environment, the incentives on government officials to do what is needed to get re-elected simply become too hard to ignore.

Governments, the IMF, bond markets and investors need to be making the right decisions more than ever. But they need much better information to do so – and the public has a right to see such information. And I think this public sunshine, by itself, may well inspire more of the right decisions.

So it's inevitable that questions are being asked today about the appropriateness of government accounting.

One of the factors driving this is that the lines between the private and public sector are increasingly blurred. We've seen it happen in a number of ways – through government intervention in banks and other sectors, public infrastructure financing and banks holding sovereign debt.

This has led to demands for governments to be held accountable in the same way as private companies – for their accounting, their systems of control and their transparency.

In the past, it is actually pretty remarkable, that many governments have been issuing qualified statements and disclaimers year after year – without the taxpayer seemingly caring. Those days are over.

Governments – previously viewed as "risk free" – are finding the credibility of their decision-making, the credibility of their financial stewardship, is being called into question. The financial information used as a basis for their decisions, is also being called into question.

So, for me, one of the real lessons learned from the sovereign debt crisis is that governments should start to ask themselves if their accounting and reporting models, and their transparency and governance, are fit for purpose.

Looking forward, it's in addressing these issues, that progress can be made.

What can the accounting profession do to improve the situation?

We can help to fix things. As a profession, we can challenge governments to provide better quality information. We can support governments in modernizing their financial management and reforming their accounting methods. And, we can help them build a more sustainable future through better reporting, transparency and comparability.

Doing so, will help set the right conditions for recovery.

Accounting alone can't guarantee that governments will always make the right decisions. But it can help lower the risk of decisions being made that burden future generations, and the risk that if decisions such as this are made, that the impact will be hidden from sight until it is too late.

So, I think there are three things that governments can do to build a more sustainable future, and that our profession can help them with:

First, improve transparency in government accounting

Second, improve consistency and comparability by adopting international public sector accounting standards

And third, improve clarity of communications and therefore accountability

And of course, to achieve each of these, governments will need to build skills and capabilities.

I'll touch on each of these.

1. Improve transparency in government accounting

First, improving transparency in government accounting.

Over a generation or so, the private sector has had to incorporate measures that address the transparency and usability of financial statements. This has been one of the most important focus points in our profession since I became leader of Ernst & Young in 2000-2001. In my view, the public sector urgently needs to do the same.

The sovereign debt crisis has focused the need for transparency on government finances – within Europe in particular. But it's important that governments around the world ensure their financial statements are as accurate as possible.

How? By using modern, stable accounting processes, including sufficient controls. And by using modern technology, such as ERP systems. Doing so will give a more complete picture of government in an appropriate timeframe.

We have to go into this with our eyes open though – with improved transparency, the financial situation of many governments might well look worse before it looks better. The truth is sometimes pretty ugly! But I firmly believe that better quality financial information is a must for governments to perform efficiently and effectively.

More widespread adoption of accrual accounting is an important step. While many countries have moved to accrual-based accounting, there are exceptions such as Germany, Italy, The Netherlands and Japan. And, while not impacted by sovereign debt in the same way, major economies like India, Brazil and China are still using cash-based accounting.

Antiquated, cash-based accounting systems make the complex financial challenges that countries face all the more difficult to resolve.

For example, in Germany, where many municipalities still use cash-based accounting systems – a number of cities face huge liabilities that have arisen from interest rate swap contracts. The main factor behind the losses is down to capital market trends – but there's an argument that discussions about the accounting consequences, beyond the cash-flow consequences, could have highlighted the potential risks of these investments.

Of course, there are hurdles to change. The link between financial accounting and budgetary accounting and appropriations is one challenge. A history of finance ministries used to working within the idiosyncrasies of their own cash-based systems is another. And a lack of resources to fund reforms is a third.

But these are not insurmountable challenges. And organizations like the World Bank and IMF are very active in funding capacity building, conversion and implementation.

And even if accrual accounting is applied, governments need to provide more comprehensive reporting to constituents. It's no longer enough to judge governmental performance based on a single balance-sheet date.

Governments should consider other General Purpose Financial Reports such as 'Reporting on the long-term sustainability of Public Finances' or 'Service Performance Reporting'. They need to move beyond the four-year election window and take a longer-term view say over 40, 50 or even 75 years.

And closely linked to transparency, the issue of governance is gaining more ground in the public sector – just as it did in the private sector not so long ago.

Shouldn't we expect from governments a level of oversight more akin to private companies? Perhaps in the form of audit committees? Some of the more self-sufficient government agencies already do. The Defense Finance and Accounting Service and NASA in the US come to mind. And I think there's much to be said for this approach.

But in today's globalized world, transparency alone is not enough. And this brings me to my second recommendation: improving consistency and comparability by adopting international public sector accounting standards.

2. Improve consistency and comparability by adopting international accounting principles

Just as I, and the organization I lead, support IFRS, and are calling for a single set of high-quality accounting standards around the world for private-sector companies, we'd like to see the same kind of consistency for governments.

We've long argued that today's complex and interconnected world demands a single set of standards – to aid the comparability that cross-border companies, cross-border investors and global capital markets need in today's globalized environment. The same holds true for the public sector.

Yet, governmental accounting and financial reporting standards are still mostly unique. A large majority of countries use their own, custom developed, accounting and financial reporting systems, which means most are unable to compare their level of efficiency with other governments. In English, we sometimes use the expression "once you have seen one you have seen them all". Well, as someone once said to me, once you've seen one government accounting system, you've seen one government accounting system! They are all different.

This has to change.

As governments across Europe increasingly work together on coordinated rescue efforts – and as such share a common liability – it becomes more and more unacceptable for these differences between accounting standards and levels of transparency to be continued.

In fact, global financial regulatory convergence is something that the G20 and many other countries have called for to create stability for capital markets and investors.

We think IPSAS are a large part of the answer.

You all know this. IPSAS are a robust, well-considered set of accounting standards specifically tailored to the needs of the public sector.

They are focused on accrual accounting.

They address reports beyond financial statements. Going back to my point about moving beyond the four-year election window – just recently the IPSAS Board issued an exposure draft of a Recommended Practice Guideline strongly encouraging governments to deliver long-term projections showing the results and impact of their policies over a 50 or 75 years period.

The IPSAS Board, together with IMF and Eurostat, are working towards aligning statistical accounting standards and a common Chart of Accounts – a huge step towards cross-border harmonization.

And, in time, I hope that we'll see a standard on accounting for social policy obligations in the broadest context, such as for pensions and other social security schemes. The Board has postponed this standards project until the finalization of the Conceptual Framework Project, but it's still on their agenda and is, in my view, very important.

But today, only a few countries are applying IPSAS in their entirety. We'd like to see that increase.

Of course the temptation is for countries to say "oh, we'll adopt them when they're finalized". We all heard that with IFRS, didn't we? But the reality is that all accounting standards are always a work in progress. And I'd challenge the "wait until they are done" crowd by saying – get on board now, use IPSAS to help you get where you need to go, and influence the standard setting process so that future refinements suit your needs.

Last year, a proposal by the European Parliament's monetary and economic affairs committee to mandate all 27 member states to adopt IPSAS within three years was rejected – as some countries viewed conversion as unnecessary and costly.

While this rejection was not surprising, it was disappointing – but the proposal itself is at least a start. And we're pleased that a study is being conducted on the average gap between current Governmental Accounting and IPSAS, which Ernst & Young is helping Eurostat with. And, based on the results, Eurostat will assess the feasibility of an EU-wide conversion before the end of the year.

3. Improving clarity of communications and therefore accountability

Now, let me turn to our third recommendation – improving the clarity of communications and therefore accountability.

Worryingly, our *Toward Transparency* study, found that many governments around the world do not see essential stakeholders as key users of governmental financial statements.

*W*hen asked who their key users of information were, around two-thirds of governmental financial officials across 33 countries did not mention international financial institutions and ratings agencies. And, only half mentioned their own citizens – who presumably have a great, and growing, interest in how their taxes are being spent.

As governments come under increasing scrutiny from stakeholders questioning their response to the current economic situation – governments will be forced to change their approach.

Presenting information to a broader range of stakeholders, in a clear and digestible form, helps to improve stakeholder understanding. Just as importantly – it helps to foster a culture of accountability, which aids better decision making.

There are some examples of leading practice.

A good example is France's *Les Comptes de l'État* – a four-pager that gives an easily digestible overview of the important financial facts – and compares assets and liabilities with the budget and budget allocations and tax revenues. The United States' *Citizens Guide to the fiscal year 2011* is another example.

And as I said earlier, adopting accrual accounting would also be a big help – as governments would face the consequences of their financial decisions now, rather than passing them onto future generations … and future politicians.

Of course there are some fundamental cultural issues that need to be addressed. How can politicians, facing short-term election cycles, be encouraged to take a longer-term view? How can we incentivize politicians to be more transparent when it may conflict with their electoral aims?

That brings me back to my original point on incentives. Politicians need a framework that incentivizes them to take decisions that better align to the long-term public interest – not the electoral or annual budgeting cycle. The framework that politicians operate in – the organizations they deal with, the law and processes they have to abide by – have a crucial role in shaping outcomes.

As a profession, and indeed as citizens, we must call for institutional arrangements that change politicians' incentives and effectively constrain their behavior – avoiding the potential for decisions to be taken that mortgage our future for short-term benefits.

As a firm, Ernst & Young believes that the work that IFAC and the UK's Chartered Institute of Public Finance and Accounting (CIPFA) are jointly pursuing to establish a governance framework for public sector organizations is a very positive and encouraging step in this regard.

This requires a commitment to building skills and capacity

Finally, a quick word on one of the other barriers to progress. Achieving improvements will require a commitment from governments to build their financial management skills and capabilities, and a hard thing to do.

As an example, just a couple of weeks ago in Australia, the Auditor General's report to the New South Wales' parliament highlighted the need for more senior accountants after finding 1,256 mistakes in the state's financial records submitted last year. One thousand, two hundred and fifty-six! 540 of those needed to be corrected before an audit opinion could be issued.

The auditor general noted that there simply were not enough qualified finance personnel in many agencies to correctly interpret accounting standards and to produce high-quality financial statements. Recognize one thing – Australia is by no means alone. They are just very honest.

Our profession can and should help advise on a wide range of related issues from bridging skills gaps or dealing with high staff turnover; to helping with better education, training and development; to providing technical support on the ground to implement new initiatives. And I'm pleased that Ernst & Young has just agreed to partner with CIPFA in this field.

We all have a role to play

So, the accountancy profession clearly has a role to play in helping governments improve transparency, consistency and communications.

Just as in the private sector, consistent high-quality financial reporting standards are the basis for enhancing comparability, and more importantly, strong standards like IPSAS are essential for increased financial stability.

Organizations like IFAC are doing a lot in bringing together the various stakeholders to address the issues more broadly – and this conference is a great example of that. Thank you for your leadership.

Conclusion

Now, I really don't want to conclude by being some kind of Johnny Raincloud, because I am a born optimist. But let's be clear, the current situation can't continue indefinitely. The costs are too high in terms of fiscal instability, loss of investor confidence, loss of employment and challenges to growth. If we don't tackle this issue head on – where does that leave the next generation? We in this room, we in this profession, must do all we can to help.

Thank you for having me here and thank you again for all you are doing. I'd be delighted to take any questions you have.