Chartered Institute of Public Finance & Accountancy (CIPFA)

125th Anniversary Celebration

Keynote Address

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My Lord Mayor, CIPFA President Jaki Meekings Davis, Distinguished Guests, Ladies, and Gentlemen.

Thank you, Jaki, for your kind introduction and for your welcome to this marvelous occasion, being held in such a historic building.

125 years - 1885 to 2010. 1885, apart from being the year in which CIPFA was founded and incorporated not long after as the Corporate Treasurers and Accountants Institute, it was also the year of the first election in which the electoral franchise in England was extended to all men; and the audience tonight evidences significant further progress in this regard! In the same year professional football was legalized in Britain and, close to my heart, it was the year in which Gottfried Daimler patented the first motorcycle. A memorable year!

On a very personal note, as I stand here tonight, my father is waking up in New Zealand on his 90th birthday. And my father is not entirely irrelevant to my standing here tonight, as he thought - once he had become accustomed to the fact that I was going to be an accountant and not a teacher like most of my family- that it would be very suitable that if I were to be a city treasurer. And he must no doubt take some responsibility for my interest in the public sector.

It is now more than forty years since I first studied accountancy at Victoria University of Wellington in New Zealand. Part of my accountancy course covered public sector accounting, and was taught by the late Professor Roy Sidebotham, originally from Manchester, a CIPFA member and indeed a CIPFA prize winner. In my degree I also studied politics and public administration.

And so, in 1972, with:

- a freshly minted degree in accountancy
- an interest in government and politics
- and even then the conviction that governments needed to make better use of accounting

Where would I head but to Inlogov – the Institute of Local Government Studies in the University of Birmingham? Which is where I came first under the tutelage of David Hallows and then under the supervision of the late Bob Armstrong, and where I had the opportunity to be taught by Professor John Stewart and to meet the late Hedley Marshall, to name but four of the many individuals that made the four years I spent at Inlogov so rewarding and enjoyable. My conviction that governments did not make full use of the accounting discipline has, in the time since I was at Inlogov, led me to some interesting places, and along the way to becoming an honorary member of CIPFA. It is a membership of which I am very proud, and makes me all the more honored to be invited to be here this evening. 125 years does not make CIPFA the oldest accounting institute, but you, we, are certainly in the first handful.

CIPFA is celebrating this very significant anniversary at a time that shares some characteristics with the year of its inception. The 1880's and 1890's were a time of unrest and upheaval in the public sector. That is certainly the case in 2010. Issues of public sector expenditure and debt, and financial reporting and accountability, are well and truly in the spotlight today. Government finance is at the center of much of the policy debate concerning the state of the UK, European, and global economies.

But difficult times often produce the greatest opportunities. During the past 125 years CIPFA has contributed a great deal to the management of the public sector in the UK, and increasingly outside of the UK. I believe there is an opportunity for, if not an obligation on, CIPFA to look to an even greater role on the international stage, drawing on its position and reputation as the pre-eminent professional accountancy institute with a focus on the public sector.

In 1885, as you know, John Elliott, borough accountant of Rochdale, reached out to accountants and treasurers across England suggesting they form the organization that later became CIPFA. In the words of Nichols Stacey[1], the establishment of CIPFA "expressly provided a professional organization for men engaged in municipal accounting" and reflected "the first signs of legitimate fragmentation within the profession, brought about by an increasing degree of specialization". Much has been achieved by this organization in the time since, and it has increased its mandate beyond municipal government and beyond the borders of the UK.

Yet despite the efforts of CIPFA and its members, as well as of thousands of other accountants in governments around the world, over a century later, it is still the case that accounting does not contribute to the management of the public sector to the degree it could. This is especially the case in central government. So tonight, I would like to reflect a little on the relationship between government and accounting.

While I feel I know a lot more about this relationship now than I did forty years ago, there is one question in particular which for me remains troubling, especially in the current environment. The question is: "What will it take before governments around the world take their own financial responsibilities seriously?" This is not to suggest that none do, but I do believe that there is a systematic, pervasive, though possibly not deliberate, ignorance of the critical value and importance of good accounting to governments. I will come back to some possible reasons for this and things we can do to address the situation.

It is an important question because the failure of governments to manage their finances has in the past, and could again in the future, have consequences that we would all prefer not to contemplate – including in some places the loss of democratic control.

There are at least two dimensions to the financial responsibilities of governments. The first relates to financial reporting and the second to what I will term broadly as financial management, which includes budgeting, appropriations, balance sheet management, and so forth. The first dimension – financial reporting - is important from an accountability perspective, but also for the incentives and constraints it creates for government policymakers. The second dimension – financial management – has consequences for efficiency and effectiveness, and therefore is important from a social and political perspective.

But while I believe we are still far from where we would wish to be, it must be recognized that there has been significant development in the role of accounting in government. Perhaps the most striking change during recent decades is the shift internationally in the benchmark for accounting by governments, and in particular, for national governments. Just two decades ago, in 1990, no central government produced financial statements on an accrual basis. The cash basis was the norm for accounting, for budgeting, and for appropriations. In some countries, not so many, the accrual basis of accounting was in use at sub-national levels of government, or for state-owned enterprises.

As it happens, New Zealand was the first country to report on a full accrual basis, and it was hugely rewarding in a professional sense to have had a role in that initiative. Today, while the cash basis is still the basis for budgeting and appropriations in virtually all countries, the accrual basis has received widespread acceptance as the benchmark for governmental financial reporting. This is, unquestionably, a significant advance.

Consistent with this shift in the benchmark, many governments have now adopted, or are in the process of adopting, the accrual basis for their financial reporting. I have a number of significant international or regional institutions such as the United Nations, the Organisation for Economic Co-operation and Development (OECD), and the European Commission. These international and regional governmental organizations have gone a step further and adopted an independently determined set of governmental reporting standards - the International Public Sector Accounting Standards (which I will refer to as IPSASs). By doing so they lash themselves more tightly to the mast of transparency, making it harder to change their reporting policies when tempted by the sirens of political convenience.

A few national governments have been sufficiently courageous (not in the Sir Humphrey sense) to have followed suit and adopted the IPSASs. Switzerland is an example. But in most cases governments have chosen not to adopt international standards, preferring instead to either develop their own accrual based standards or to modify the IPSASs. Very few governments have adopted International Financial Reporting Standards (IFRS) even though these are not developed with public sector application in mind - the United Kingdom and New Zealand fall into this category. New Zealand, however, is reconsidering its use of IFRS for the government accounts, precisely because of application difficulties arising from the private sector provenance of the IFRS.

This all sounds like, and is, significant progress. There really has been a paradigm shift in how we think about governmental financial reporting. Like all paradigm shifts, it has taken some time for the new paradigm to become “normal”. And, as in all such shifts, there are those who cling steadfastly to the old paradigm. But this progress, while significant, leaves us with a great deal still to do.

The world economy is, perhaps, just emerging from a global financial crisis which has tested the international financial system to its limits. In the course of this crisis many governments intervened dramatically in their economies, whether through the acquisition of assets and liabilities, or the giving of guarantees and the adoption of other forms of contingent liabilities, or by way of substantial economic stimulus. The majority of those actions will not be accounted for properly. But neither were significant assets, liabilities, revenues, and expenses accounted for properly before the crisis. Some of this may have arisen from negligence – but in many cases it was deliberate. Internationally, for example, many public and private arrangements for the construction of public infrastructure were designed in significant part to limit public sector borrowing requirements, even though these public and private arrangements resulted in substantial liabilities and obligations, conveniently not reported under cash accounting.

We have seen the difficulties associated with Greek (and other countries') sovereign debt. We know that part of the problem, at least in the Greek case, was what in the private sector would be labeled financial reporting fraud. On top of this there is the inadequacy of the accounting "standards" used by most governments. Somehow, astonishingly, financial crises involving either financial reporting fraud, unauditable and unreliable financial information, or reporting against low quality standards by governments do not seem to lead to calls for better accounting by governments. They certainly do in the private sector, and rightly so. Indeed, in the middle of the sovereign debt crisis, and perhaps because of it, major European governments rebuffed the nine smaller countries who wanted the EU to address one of the most egregious areas of government accounting - accounting for pensions. For whatever reasons, the paradigm shift in thinking about governmental financial reporting has not yet been either internalized or translated into action in many countries.

Yet, at its heart, the relationship between governments and accountancy is not about good financial reporting. The more important failure is the failure of financial management, with a consequential failure to meet governmental responsibilities for service delivery and outcome achievement. Ultimately, poor financial management means foregone outcomes in such areas as health, education, public safety, and national security. When governments mismanage (which without good financial information they inevitably and consistently do) citizens now or later pay the price by getting fewer services and services of a lower quality than they might otherwise receive. And if those services have value in addressing human and social needs, then the price of poor management is a lower quality of life.

Even with the limited progress in financial reporting, the budget and appropriations processes in virtually all countries remain on a cash basis. This means that internal management processes also remain on a cash basis. This, in turn, denies governments the benefit of having the relatively high-powered incentives associated with budget and appropriation limits being assessed against accrual based measures of financial position and performance. Without these incentives in play, the prospects of improved financial management within governmental organizations are, in my view, slim.

Poor financial management has two consequences. It reduces efficiency and effectiveness, and therefore the achievement of outcomes. And it leads to greater risk in the management of a government's financial position. The current instability associated with the sovereign debt market in Europe should serve as a reminder of what can happen when governments lose control of their fiscal positions.

As in the global financial crisis, one of the most serious risks that governments must manage in fixing the sovereign debt problem is that of social disorder. In the period since CIPFA was founded, Europe has been the origin of two world wars. The European Union is seen by many as one means of helping to ensure that the countries of Europe do not attempt to resolve future problems by going to war. Yet that Union is under some degree of threat – I would not want to exaggerate it - from the sovereign debt crisis.

So, what are the consequences of governments mismanaging their finances to the point they cannot meet their obligations? They range from policy adjustments which seek to correct the position, tax increases and spending reductions, through to the loss of democratic control. Imposing the level of “discipline” required to make the necessary adjustments has, in some circumstances, lead either to external parties taking control of the government’s finances or to an authoritarian – sometimes military - government taking power. These outcomes constitute a potentially high price to pay for weak governmental institutions.

There is good reason to believe that an appropriately designed financial framework could significantly assist governments in managing their financial positions. Without suggesting that good accounting and financial management is the only explanatory factor, it is worth looking at the New Zealand experience during the past two decades. During this period, the New Zealand Government strengthened its balance sheet to a position in which it had net worth equivalent to nearly 60% of GDP (from just over 10% at the beginning of the last decade and from a negative net worth position a decade earlier). While this did not mean the financial crisis had no impact, the capacity to absorb the shock was significantly greater, and therefore the risk of any potential social disruption reduced.

Throughout this period the New Zealand Government reported its financial position on a full accrual basis and did so monthly, ensuring the fiscal position was subject to discussion or comment each month, as the latest results and associated full year projections were released. And because appropriations are in accrual terms, managers within the New Zealand Government track their expenses, rather than their cash flows – in other words the accrual information is deeply embedded into the management system, and behavior is driven by the accrual numbers, which better reflect a long-term perspective e than do the cash numbers. I could say a lot more about the New Zealand system of financial management, but I will spare you. Suffice to say that from my own, admittedly self-interested position it seems to have worked well.

But these developments in financial management are regrettably atypical. Most governments do not budget, appropriate, and report on an accrual basis. Why not? To return to my question "When will governments take their financial responsibilities seriously?" No doubt there are many reasons why governments do not adopt the best available accounting and financial management technology.

For developed countries at least it is hard to find good ones. The accounting policy issues are entirely manageable. We know how to apply accrual accounting and budgeting in large organizations. And if the issue is resources, imagine a large corporate entity explaining to its regulator that it cannot meet its reporting obligations because it cannot afford a decent accounting system.

I learned a lot at Inlogov. I was there during the era of program budgeting - I am sure there are those of you who remember PPBS - and the Layfield Inquiry into local government finance. There were strong strands of economic thought running through both these developments. One enduring lesson, which my thesis supervisor, Bob Armstrong (an economist) led me to, was the importance of the relationship between accounting and economics. This lesson served me especially well when I was in the New Zealand Treasury, working as the only accountant in a senior management team of economists. The need to convince a group of economists of why the accounting, budgeting, and appropriations reforms we were proposing made sense, for reasons other than that they were good accounting (which they seemed to find unpersuasive), was a serious challenge. Addressing issues from both an accounting and an economic perspective strengthened both the argument and the design of the reforms.

An injection of economic thought may also help answer my question of "When will governments take their financial responsibilities seriously?" I was an academic during significant periods in my career, always with a focus on public sector accounting and financial management, and I was frustrated by the failure of governments to fully utilize the expertise of the accounting profession. Interestingly, economists have felt the same frustration, and that frustration led to a new branch of economics which probably gets us closest to an answer to my question.

In fact, the only literature I have found that seems to have some ability to cast light on the question was the economics of public choice, or public choice theory. Let me quote William F. Shughart II,[2] "Public choice, like the economic model of rational behavior on which it rests, assumes that people are guided chiefly by their own self-interests and, more important, that the motivations of people in the political process are no different from those of people in the steak, housing, or car market. They are the same human beings, after all. As such, voters vote their pocketbooks, supporting candidates, they think will make them personally better off;

bureaucrats strive to advance their own careers; and politicians seek election or reelection to office. Public choice, in other words, simply transfers the rational actor model of economic theory to the realm of politics." This perhaps explains why public choice theory has been referred to as "the economist's revenge!"

So, if you do not assume that politicians, public servants, and voters act entirely in the public interest, but are better regarded in the same manner as economics regards others – i.e. rational and self-interested – then what behaviors might you expect to see in government? In fact, it is behaviors like budget maximization, the extraction of benefits through perquisites such as allowances, and so on. These are behaviors which are not facilitated by transparency and good accounting.

Just to be clear, this is not saying politicians and public servants never act in the public interest, it is simply saying that they are people just like those who work in the corporate sector. Also, it might seem like this argument is somehow "anti-government". I do not believe it is. On the contrary, I believe it can contribute to governments being stronger, more effective, and less likely to be subject to the seemingly endless disclosures of political behaviors that are clearly not in the public interest. If systems were designed in recognition that people, including those in government, are not angels, we would be less likely to see this stream of disclosures which diminishes the political system, and politicians, in the eyes of the public.

As Nobel Prize winner James Buchanan[3] put it, public choice is "politics without romance." Viewed in this way, the differences between the public and private sectors do not lie primarily in what motivates individuals; it lies in the institutions within which they operate – facing as they do radically different incentives and constraints in the two sectors. When we observe rational, self-interested behavior in the private sector leading to undesirable social outcomes, such as pollution or the extraction of monopoly profits, we expect governments to act to constrain that self-interested behavior. In other words, we change the rules of the game to try to get better alignment between the actions of individuals and our social objectives.

So if public choice explains, at least in part, why governments make poor use of accounting and accounting information – because they do not want to be constrained in the same way they almost universally constrain companies in the private sector – what can we do? The institutions - the organizations, laws, processes and roles - which governments design to administer their financial affairs have considerable power in shaping outcomes. Presently, the use of the cash basis means governments are attempting to manage highly complex financial positions with outdated accounting and financial management technology. The results have the potential to be dire.

The European sovereign debt crisis currently appears unresolved and in the US serious risks to the financial system are emerging from the financial positions of state and municipal governments, as well as from the federal government. Indeed, in a recent article in The Washington Post, Sheila Bair[4], Chairman of the U.S. Federal Deposit Insurance Corporation (FDIC) and one of the most senior regulators in the US explicitly raises the possibility that the next financial crisis will originate in Washington, rather than Wall Street.

Whether through deficient accounting standards, off-balance sheet transactions (though I am using this term loosely as most national governments do not have conventionally understood balance sheets), or fraudulent misreporting, the real financial position of the governments are generally obscured. This enables governments to sustain, for a period, levels of cash outlays and debt that their real financial position cannot support. So if the problems arise from poorly designed institutions that is where we should look for solutions. Accrual accounting and financial reporting according to high-quality standards are two such institutions. Auditing on the basis of high-quality auditing standards is another. Balanced budget rules or fiscal responsibility principles are yet others. Reporting the full consequences of financial decisions closer to the point at which those decisions are made means that consequences cannot be bequeathed to the next government or the next generation.

So what can we do?

More accountants at the highest level of government might help (but would be hard to achieve). An academic community that is prepared to be critical of the inadequate frameworks utilized in fiscal debate – rarely going beyond debt and deficit to recognize the significance of the balance sheet and trends in government net worth – might also help. Martin Wolf[5] in the last fortnight has argued in the FT that assets also need to be considered when addressing fiscal position – what is surprising to an accountant is that this might be thought novel. It might help if analysts and credit rating agencies would not accept, and would publicly question, the quality of the information presently available to them from such significant capital market participants as sovereign debt issuers. It would certainly help if securities regulators would require of sovereign debt issuers the same quality of financial information that is required of listed companies.

But it will also, especially, require action by the accounting profession. It will require well-informed pressure from outside governments – this is not a set of changes we can expect governments to undertake of their own volition. It will require action by the profession both internationally and nationally. While the changes required need to occur at the national level, pressure at an international level can help. Peer pressure has a role, as we have seen through the development of the IPSAS and their becoming an international benchmark.

At IFAC, we have, for over a decade, set IPSASs. Our deliberate intent was to change the paradigm for governmental financial reporting and create an international environment in which cash accounting is accepted as being seriously deficient. Increasingly, we have pressed for governments to act in this area, for example through our submissions to the G-20. We have valued greatly the support of CIPFA in these activities, both at the international and at the European level. We know we can continue to rely on that support.

I believe that the work CIPFA has been doing in the development of a whole system approach to public financial management can also contribute a great deal to achieving change around the world. I would see this as an example of the type of activity in which CIPFA can draw on its expertise and expand its international presence. Within the accounting profession, government accounting is a niche market. But globally it is a huge niche. And for the moment there is little competition and great challenge. IFAC looks forward to working with CIPFA in meeting that challenge.

I could not talk about the contribution of CIPFA at the international level without acknowledging my gratitude for the contribution Steve Freer makes to the IFAC Board as a Technical Adviser. I value greatly the perspective he brings to issues – insightful and principled, yet also pragmatic. A rare combination. Of special note is Mike Hathorn, who served as Chair of the IPSASB. I would also wish to acknowledge CIPFA member Noel Hepworth, who served on the IFAC Public Sector Committee when I was involved in it, as well as Ian Carruthers, who currently serves on the IPSASB. Other CIPFA members who are making significant contributions to IFAC are Deborah Williams, who is about to take on the role of Chair of the Professional Accountancy Organization Development Committee and Roger Tabor, who chairs the Professional Accountants in Business Committee.

At a national level, professional accounting institutes being outspoken on the need for financial management reform in government will be critical. If the sovereign debt crisis does not stir us to speak out on this issue we will have missed an opportunity, we will have failed to live up to our public interest obligations, and we will have let down the future generations who will have to pick up the tab. Without such action the international financial system is exposed to significant risk and the global economy to unnecessary waste.

In a recent article, FT columnist John Kay[6] said, “Put simply, governments cannot be relied on both to set targets and to monitor compliance with these targets.” Equally importantly, governments should not set their own financial reporting rules.

CIPFA’s celebration of its 125th Anniversary is a time to look back with great satisfaction and pride and to draw encouragement from the achievements of the past. It is also a time to focus on the challenges of the future, some of which I have addressed tonight.

Thank you, and congratulations on reaching this memorable milestone.

1 Nicholas A. H. Stacey, English Accountancy: 1800 – 1954, A Study in Social and Economic History (Dimensions of Accounting Theory and Practice), February 1981.

2 William F. Shughart II, Public Choice, in The Concise Encyclopedia of Economics, December, 2007.

[3] James M. Buchanan, Public Choice: Politics Without Romance, Policy, the quarterly review of The Centre for Independent Studies, Spring 2003.

[4] Sheila Baer, The Washington Post: Will the Next Fiscal Crisis Start in Washington, November 26, 2010.

[5] Martin Wolf, The Financial Times: Assets Matter Just as Much as Debt, November 25, 2010.

[6] John Kay, The Financial Times: A Fiscal Watchdog Should Not Need a Crystal Ball, September 21, 2010.