International Federation of Accountants

Global Seminar on the Sovereign Debt Crisis

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Thank you, Ian, for these words of welcome.

Good morning ladies and gentlemen.

Let me start by pointing out something that many of you – but perhaps not all of you – know: For the past 15 years, the US Government Accountability Office has been unable to express an opinion on the U.S. Government's consolidated financial statements.

This is because of the government's inability to demonstrate the reliability of significant portions of the information contained in these statements due to material weaknesses in internal control. The GAO routinely cautions readers that amounts reported in the financial statements may not be reliable. Perhaps even more troubling is the fact that these statements are actually a vast improvement over those put out by the government a decade ago. Today, the problem areas in the U.S. government's financial statements are limited to only a couple of important agencies.

I mention this, by way of introduction to my remarks this morning, since much of our time over the next couple of days will be spent discussing the quality of financial reporting by governments. Right up front, it's worth reflecting upon why it is that one of the largest – if not <u>the</u> largest – reporting entities in the world cannot produce a set of financial statements that, in its entirety, can be said to present fairly the results of its operations, its assets and liabilities?

Were a private sector-listed corporation to receive such an opinion it would be front-page news. Yet this one goes largely unnoticed. And the fact that it goes largely unnoticed goes to the heart of today's lingering financial crisis.

In my remarks today, I'd like to cover the following issues:

- First, how developed country sovereign debt is no longer priced as if it were risk-free;
- Second, what this means for governments trying to find their way out of the aftermath of the crisis;
- Third, how governments with better financial management will have an edge in the competition for lower-cost funding; and
- Last, next steps, including some institutional proposals.

We should be cautious about underestimating the global impact of the financial crisis. What started out as the collapse of the sub-prime mortgage market in the United States quickly spread through the financial system, eroding the value of capital, and undermining the creditworthiness of global financial institutions. Concerns about underlying asset valuations caused liquidity to dry up, making it difficult to finance transactions in the real and the financial sectors. This in turn resulted in a contraction in both demand and jobs, and in a collapse in consumer and business confidence.

These results have been bad enough. But what is making this crisis far more serious than previous ones is the severity of the second-round losses and the extent to which such losses have been nationalized. In many countries, governments have had to take large ownership stakes in systemically-important financial institutions. The combination of losses on securities during the first wave of the crisis and shrinking tax revenues as a result of the recession has placed intense pressure on government finances. In some cases, unwelcome surprises about the true level of government debt have critically damaged investor confidence.

As governments have had to increase borrowings to stay afloat, some have started to have difficulty attracting investors. It is clear from the pricing of new issues and refinancings that investors no longer see all developed country sovereign debt as a low-risk asset, not to mention a safe haven.

Why is this? The answer is complex. Spiraling levels of government debt have delivered a body blow to market confidence. This has affected different countries differently, and we are seeing greater differentiation based on risk. The macro fundamentals matter, as does how investors perceive a country's capacity to handle financial management issues. This may explain why the perception of "riskless" debt may continue for US Treasuries, but not for other sovereign debt.
That being said, it is clear that information asymmetry has a cost – as does the absence of information. Debt investors are also often uncertain as to the financial position, performance, and prospects of sovereign issuers, therefore driving up the risk premium.

In the past, a characteristic of developed country sovereign debt was that it appeared to provide investors with a risk-less rate of return and a reference for the valuation of other risky asset classes. This can no longer be taken for granted. One of the reasons is that investors are less confident that what governments tell them about their finances is complete and accurate. In other words, pricing is affected now more than ever by the quality and timeliness of the information that governments make available about their finances, not just by the macro, solvency, and liquidity picture.

The perception of a risk-free rate of return on sovereign debt also used to be a function of the fact that governments could always raise taxes or issue more currency (or both) to ensure redemption at maturity. This is not the case in the Eurozone, where issuing currency is, of course, no longer an option for an individual government – unlike in the US and the UK, for example. Regaining the confidence of markets is therefore particularly critical for the Eurozone countries – although it is, of course, important for the US and the UK as well.

If – as seems likely – we are **not** to return immediately to a state where sovereign debt is automatically the risk free benchmark for valuation, sovereign debt analysts are likely to become more demanding in their search for **timely, comprehensive**, and **reliable** economic and financial figures.

In the aftermath of the 1994-95 international financial crisis, the international community asked the IMF to take the lead in setting standards for countries to provide economic and financial data to investors. As a result, the IMF developed a series of data standards which are viewed as having improved the functioning of international financial markets. This includes reporting on public finances within the IMF's Government Financial Statistics framework. Nonetheless, the recent global crisis shows clearly that there is room for further work in this area, with analysts more interested in the kind of information that is **provided in financial accounts** and is typically made available to **equity and corporate debt analysts**. This demands a degree of disclosure and transparency that we do not typically find in government accounts today.

As we know, the quality of financial reporting by governments is typically not the highest. With a few noticeable exceptions, reporting tends to be tardy (hence of limited utility from a risk assessment standpoint), frequently omits significant transactions, and is characterized by inadequate disclosure. In addition, the entity used for financial reporting purposes is generally different from the one used for budget purposes, making meaningful comparisons difficult if not impossible.

That being said, there has **definitely been progress**. A number of countries have adopted **accrual accounting** in the public sector. They produce a full balance sheet and an income statement. Their government finances are open and transparent, and government decisions are made on the basis of the best information available. As competition for lower-cost funding intensifies, we should expect to see more countries following this lead.

Here in Europe, Eurostat has been active in promoting the reforms that will be needed. It has been a consistent voice in support of reporting on an accrual basis, for both statistical purposes as well as in financial statements. And it is currently managing the assessment of the suitability of International Public Sector Accounting Standards for adoption by EU member states. These are both important steps.

But making a shift to full accrual accounting is a costly exercise that can take years. However, plenty of improvements can be made in the interim. Take the case of Chile – a favorite example of mine, because it illustrates the kind of progress that can be achieved in a dynamic emerging economy.

Chile is a small economy that is exposed to significant risks. It is in a major earthquake zone. It is heavily dependent on its extractive industry, particularly copper, and hence is open to commodity price shocks. And it has an ageing population. Put all these factors together, and it's a recipe for fiscal shocks.

But Chile is tackling these risks head on, and has become a model of transparency. Under its Fiscal Transparency Law, a Report must be published annually showing the magnitude and characteristics of its contingent liabilities.

Chile has adopted countercyclical fiscal policy so that surpluses accumulate during economic booms, but politicians can't spend them. By following this path, Chile has accumulated around 9% of GDP in sovereign wealth funds, to be used as a buffer against future shocks.
Since mid-2010, Chile's sovereign debt rating has been upgraded by two of the three international rating agencies, and the third agency has it on positive outlook.

We need to be careful about inferring causation, but I think that lessons can be drawn from Chile's experience for the benefit of other countries. I also think that countries that are willing to take this kind of an approach to greater openness and transparency will be in better shape to compete for scarce funds.

The World Bank is supporting similar efforts to improve budget transparency and fiscal risk management in other countries, for example in Mexico. The Bank is also taking initial steps to require member countries to publish their budgets, and is actively considering what more needs to be done to bring greater transparency to public financial management.

I find it remarkable that in the wake of the crisis there have been relatively few calls for reform of governmental reporting. Bankers' bonuses, fair value accounting, prudential capital requirements, rating agency behavior have **all** had their day in court, and rightly so – but nobody has been talking about the elephant in the room: **the state of reporting by governments**.

I think that, as a profession, we need to reflect on whether we are doing everything we can to serve the interests of the public in this respect. The World Bank is reflecting on this and, through its transparency initiative, is encouraging others – including the accounting profession – to get **ahead of the curve** in addressing the information gap in public financial management.

As we all know, most governments do not produce a balance sheet, and do not even have a clear picture of what their balance sheet might look like. Other than financial assets and liabilities, governments do not pay much attention to resources and claims, and therefore have little idea of how much capital is available to absorb shocks, and what risks and contingencies they might be exposed to. The lack of a balance sheet also impedes taking a long-term view of fiscal prospects, or assessing how sustainable current policies are.

Luca Pacioli first codified the system of double-entry bookkeeping in the 15th century. Why did it take so long for governments to catch on?

Reluctance to change is linked to the danger of unintended incentives. Why be transparent about your activities if you can avoid it – especially if your job is subject to a public selection process every few years? And in a time of crisis, the incentives to keep things opaque are even stronger – because managers are too focused on the short-term. Opening up means having to reveal mistakes and being willing to address critics, which, while difficult, ultimately makes government more effective.

The lack of a comprehensive, consistent framework for reporting government accounts means that public officials could under-report or misreport their net debt position – which wouldn't be much different from what we have seen in recent cases of financial reporting fraud. However, what may have been marginally acceptable reporting practices in the public sector during better economic conditions are now exacerbating the problems in financial markets – and contagion is affecting perceptions of all sovereigns. The sheer scale of the losses incurred during the crisis, coupled with the substantial additional risks to which governments are now exposed via their ownership stakes in either stressed or, in some cases, failed financial institutions, means that greater transparency – rather than less – is what is truly needed to rebuild investor confidence.

In practice, most governments have the luxury of making their own rules for financial reporting, and can change them as they see fit. However, very few sovereigns have made a credible commitment to comply with a set of financial reporting standards developed and issued by an independent body outside their control.

In the private sector this is commonplace: a substantial body of research supports the notion that the setting of accounting standards should be independent; standard-setters need to listen to the views of

various stakeholders – preparers, investors, regulators, and others. But the final decisions and judgments need to be made by the independent experts. This is a central plank of building confidence in modern financial markets.

The public sector, we are told, is different. Governments are sovereign, and make their own rules and laws. They cannot be expected to cede their authority in this area. Yet governments enter into international treaties all the time which place obligations on them: look at the European Union; the World Trade Organization; NATO. Why not in the area of financial reporting?

The lack of a reporting framework, and the ability of governments to write their own rules, are both defining characteristics of the **regulatory gap** that exists in governmental accounting.

Corporate issuers are typically subject to extensive, externally-imposed and increasingly demanding financial reporting and auditing requirements. Significant time and resources have been devoted over the past decade to developing a single set of financial reporting standards for private sector corporations, to facilitate cross-border listings, and to give global investors some assurance as to the reliability of the financial statements.

Governments, on the other hand, act as their own preparer, quasi-regulator, and auditor. Is it not a little ironic that governments impose financial reporting requirements on the corporate sector? Yet the size of the market for traded government debt is significantly larger than that for corporate sector equities. This seems to be a clear case of "do as I say, not as I do".

Yes, there is a substantial body of independent credit rating work done on government debt as well as credit analysis done by various types of investors – but this type of work is only as good as the information on which it is based.

And, yes, the IMF's efforts to develop timely and accessible data have had a clear, positive impact on strengthening data transparency – but there is an acknowledgement that producing internationally comparable balance sheet data would be a critical development and needs to be given greater prominence.

The reporting and regulatory asymmetry that currently exists between the public sector and the private sector is not sustainable. Inadequate government financial reporting practices have contributed to the depth and longevity of the recent downturn. It is going to take years to emerge from this crisis, so no speedy recovery will allow us to get away with not doing what is right.

We need the best possible information about the state of government finances. This is not just a technical accounting argument – it is good economics. The greater the commitment by governments to transparency and openness, the greater will be the confidence of market participants. Better governmental accounting is not the only factor in the mix of measures necessary to speed up recovery; it will not, in and of itself, solve our current problems. But it will make an important contribution to the stability of markets.

The alternative would lead to the kind of market behavior we have seen in recent months becoming the norm. When potential investors lack the information required to have confidence in the securities they are being offered, we face real economic consequences. This is as true for accounting information as it is for budget forecasts and funding projections.

If for no other reason, the sheer size of government operations calls for transparency and openness. National governments are responsible for the management of significant assets and liabilities, and the associated inflows and outflows of resources. Some of these government operations are – whether we like it or not – too big to fail. To be properly accountable for their stewardship of these resources, governments must be able, **at a minimum**, to:

- Report on a more sophisticated basis than simply cash inflows and cash outflows. Cash accounting is simply not fit for purpose in the 21st century. As well as telling only part of the financial performance story, it is highly susceptible to manipulation and gaming – such as keeping the books open after year-end (at least for inflows), and not reporting on all inflows and outflows.

- Governments and government agencies must also account for all the activities under their control, including pension funds, extra-budgetary accounts, financial institutions and other businesses. Constructing arbitrary boundaries for the reporting entity is one of the oldest tricks in the book: there needs to be a generally accepted basis for determining which entities and activities are controlled by the government, so that reporting is both comprehensive, and consistent across time periods.

- Furthermore, these government operations must account for assets, liabilities, revenues, and expenses in a manner consistent with private sector practice. This is perhaps the most challenging argument for defenders of the status quo: "governments are not the same as businesses" is the standard critique.

  Now, I agree that governments are not the same as businesses, in that they are not motivated by profit, they have welfare obligations, they provide public goods and services, and ideally they stabilize the economy.

But what does this mean in accounting terms? Governments have assets and liabilities, and they have revenues and expenses just like corporations. Is the rationale that the context for your operation is different sufficient for accounting for the underlying transactions differently? The income statement and balance sheet components may be labeled differently from those of a corporation, but the underlying principles are the same.

For example, if a corporation takes on pension obligations as a result of a business combination, it must recognize the liability once it becomes legally obliged to pay the pensions. Similarly, it seems reasonable to expect a government to account for tax revenue when it is probable that it will gain control of the underlying receivable, and the amount is measurable -- just as a car dealership does when it sells a car. The fact that tax revenue is a non-exchange transaction does not make a meaningful difference from an accounting perspective.

The notion that governments are so different from businesses that they need to account differently is, for the most part, a smoke screen. It enables governments to substitute opacity for clarity in reporting on their activities.

That being said, obviously we cannot assume that all private sector financial reporting practices are acceptable. Many of the shortcomings in private sector reporting that exacerbated or hid problems that became evident in the last two crises were able to happen because the standards were not robust enough. This also needs to change, but the basic principles that I have just outlined can be adopted by governments now.

The objectives of governments and investors are often at cross-purposes. But I believe that an enhanced reporting framework like the one I have described makes sense for both groups. Moreover,

making available a better set of information will allow a more nuanced approach to sovereign debt ratings, and greater efficiency in the functioning of the financial markets.

So what needs to happen to bridge the regulatory gap?

I'd like to put forward three ideas, to at least start a discussion:

First, the governance of the IPSASB needs to be settled. In order for there to be acceptance of a system of regulation of governmental financial reporting based on IPSAS, the standard setter needs to have legitimacy and authority, and be seen to be responsive to its constituency. The IPSASB needs to be put on a sound and sustainable footing, both financially and operationally. As a first step therefore, there will need to be a thorough review of all aspects of its operations, governance, oversight, membership, finances – and its host organization.

This last point is critical. The IPSASB has made remarkable progress in a relatively short space of time with the development of its standards, and IFAC and others have been very generous in committing resources to keep it going. But it is vulnerable in a couple of respects. First, its host organization, IFAC, is perceived – rightly or wrongly – as a private sector professional organization. Governments have been able to ignore its standards on the grounds that they have not been developed with the public sector in mind. And second, the IPSASB does not yet have a complete suite of standards.

There is plenty of scope to debate these points – and it is important that we have the debate. The IPSASB has made a good start and, to some extent, has been able to fly under the radar. But if it is to take on the legitimacy and authority it needs to fulfill the role of the global standard-setter for governmental financial reporting, we need to think about the evolution of the IPSASB. For example, more needs to be done to reach out to IPSASB critics, and to strengthen quality. As debt market analysts demand increasingly sophisticated data from governments, the IPSASB should be ready to respond to changing user needs – and it should re-energize its earlier work on social policy obligations.

Second, we need to design a new system of regulation and oversight of governments' financial reporting. This could be done either by assigning new responsibilities to existing international organizations, or by creating a new supra-national regulator. Realistically, the first option is more practicable – but what is really critical is that governments acknowledge the need to address the issue and give it their full support. This is not an issue of sovereign rights – it is a matter of market transparency and efficiency.

And third, there needs to be consistency in governmental financial reporting, based on the IPSASB framework. The G-20 should announce that it expects all national governments to put in place concrete plans to explore the possibility of adopting International Public Sector Accounting Standards within a reasonable timeframe (that is, no more than 5 years).

These are bold proposals. But I think that this crisis has changed the game. We are in for a long haul to pull out of the fiscal hole we got ourselves into. But we will be in for a far longer haul if we don't do something drastic about the practice of financial reporting by governments.

Thank you for your attention. I look forward to the discussion over the next couple of days.