GOVERNMENT BORROWERS FORUM

May 9-12, 2011

Hosted by the Ministry of Finance, Chile

Wednesday, May 11, 2011

Panel Discussion: New Rules and Regulations for All

2:30 – 3:45

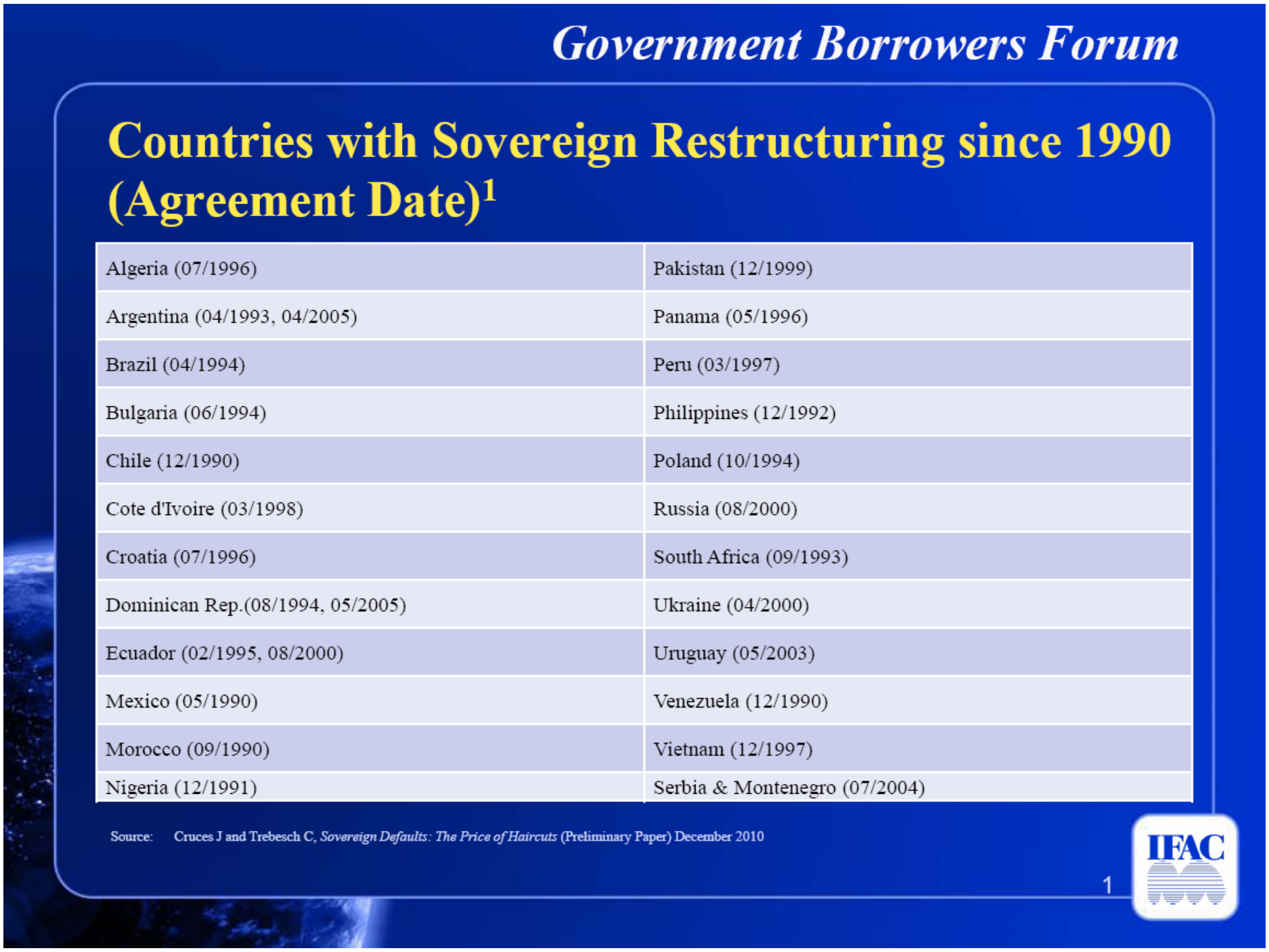
What Role Can Accounting Standards for the Public Sector Play in Promoting Government Transparency?

Thank you, Tim, for the introduction. Good afternoon, ladies and gentlemen. It is a pleasure and a privilege to be here today. I note that I am in the after-lunch panel, I am the last of four speakers, and my topic is accounting. Not a good start!

As I have no doubt that some of you are not familiar with IFAC, I should very briefly explain who we are, and what relevance our activities have to this forum. IFAC is the global body for the accountancy profession—our members (164 of them in 125 countries) are professional accountancy organizations like the Collegio de Contadores de Chile, or the American Institute of CPAs in the United States. Amongst other things, we are involved in setting professional standards in a number of areas, including auditing; but for the purposes of this forum our relevant activity is that we set International Public Sector Accounting Standards (IPSASs), through an independent International Public Sector Accounting Standards Board (IPSASB). IPSASs are best seen as the public sector equivalent of International Financial Reporting Standards (IFRS) for the private sector. IFAC is based in New York.

My topic is government transparency and the role financial reporting standards can play. I will draw particular attention to IPSASs, but I will come to that rather than start there. The subject of this panel discussion is "New Rules and Regulations for All." My component of this session is not so much new—as more necessary and more urgent than ever before.

One of the comments made yesterday by a forum speaker was that the assumption that Developed Market sovereigns were risk-free was being called into question. I think that is clearly the case. And let's remember that sovereign restructurings are not that unusual.



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Countries with Sovereign Restructuring since 1990 (Agreement Date)[1]

Algeria (07/1996)	Pakistan (12/1999)
Argentina (04/1993, 04/2005)	Panama (05/1996)
Brazil (04/1994)	Peru (03/1997)
Bulgaria (06/1994)	Philippines (12/1992)
Chile (12/1990)	Poland (10/1994)
Cote d'Ivoire (03/1998)	Russia (08/2000)
Croatia (07/1996)	South Africa (09/1993)
Dominican Rep.(08/1994, 05/2005)	Ukraine (04/2000)
Ecuador (02/1995, 08/2000)	Uruguay (05/2003)
Mexico (05/1990)	Venezuela (12/1990)
Morocco (09/1990)	Vietnam (12/1997)
Nigeria (12/1991)	Serbia & Montenegro (07/2004)

Source: Cruces J and Trebesch C, *Sovereign Defaults: The Price of Haircuts* (Preliminary Paper) December 2010

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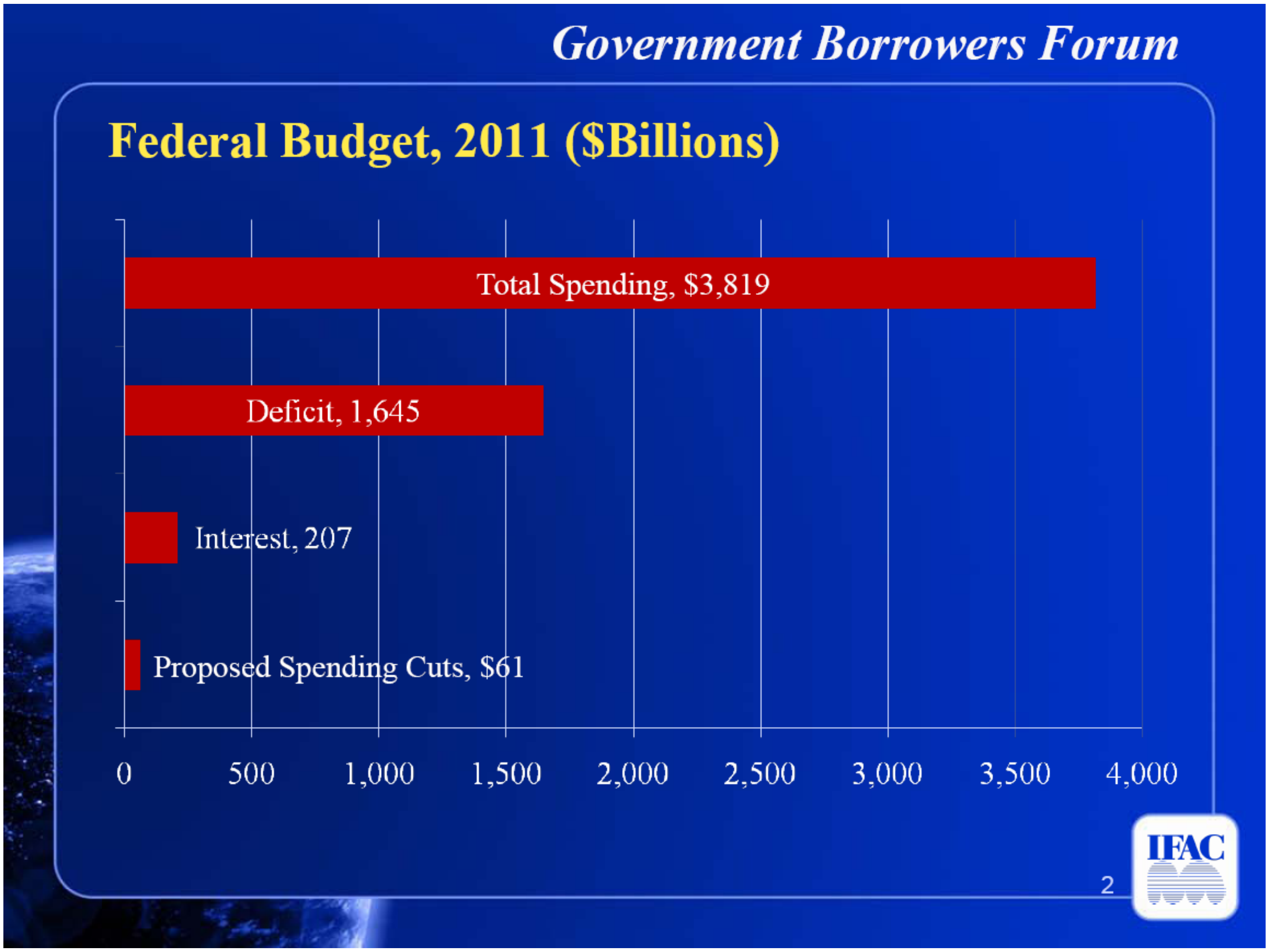
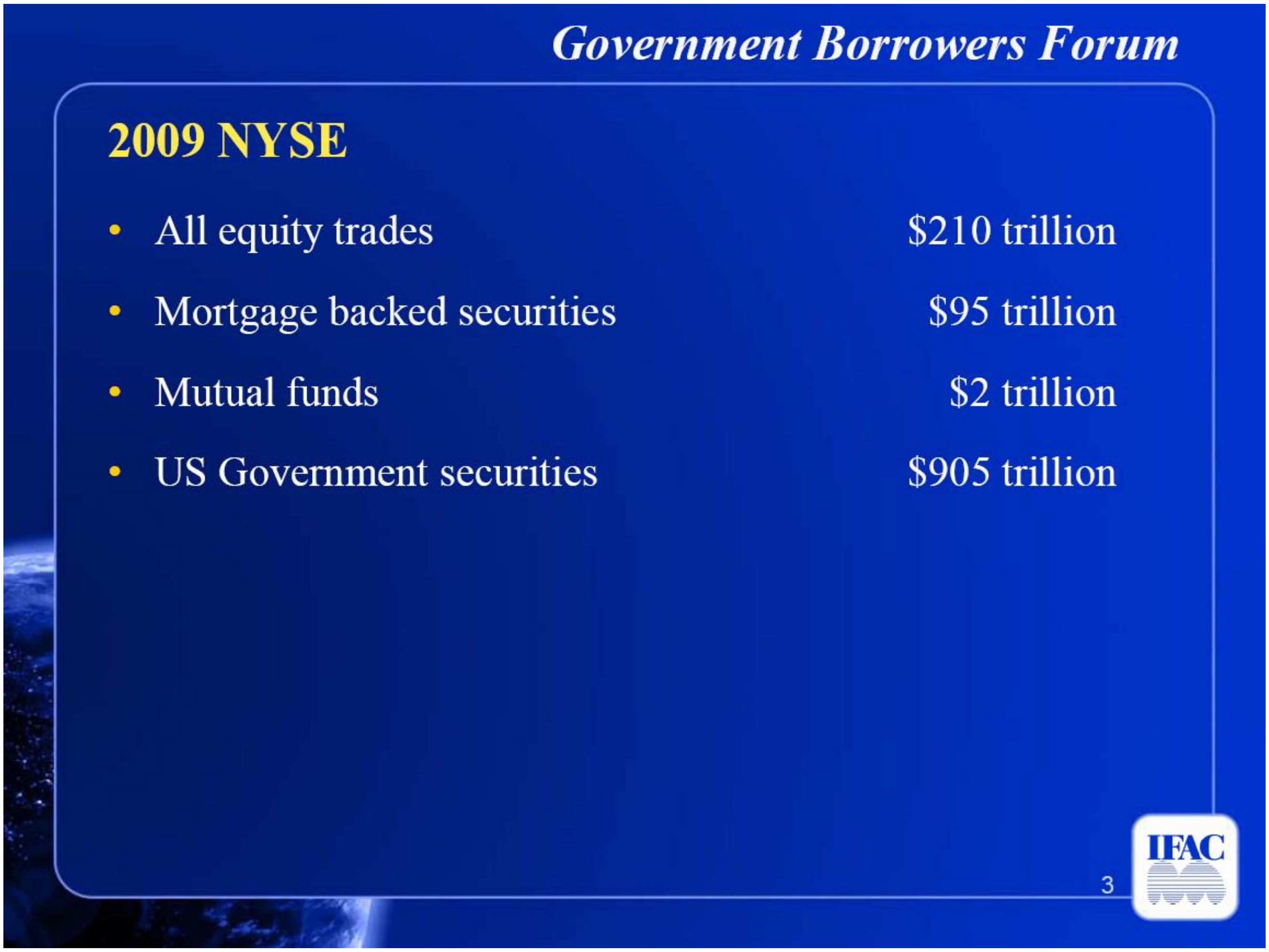
He also noted in relation to the international role of the US dollar that “there is no alternative,” and that any change from that situation would be “a very, very long story”. I am inclined to agree, but recently I saw the following chart, which I think paints a pretty unsettling picture. If you think first about how sustainable this position is, and then consider the capacity of the American budgetary system to unwind it, it is at the very least troubling.



I should also note what a significant part of capital market activity are trades in sovereign debt. The following relates to NYSE activity for 2009. You might note that the very rigorous reporting requirements that apply to equity trades do not apply to the much larger category of U.S. Government securities.



Finally, by way of introduction, let me recall another point he made, that in some respects government bonds are now trading more like corporate bonds. Or as another speaker said this morning, “the whole concept of investing in government bonds has changed” and that they are now subject to micro-analysis, requiring detailed financial information.

These points all bring me to the conclusion that we should regard investors in government securities as being entitled to essentially the same high-quality financial information as they receive in relation to investments in corporate bonds or equities. Increasingly they are asking for that information.

I should note in passing that there are other than securities market reasons why governments should produce good financial information—political accountability and effective financial management are two—but I will put those to one side, important though they are.

The incoming Chairman of the IASB (until recently chair of the Technical Committee of IOSCO) Hans Hoogervorst, said at a recent conference in Brussels, “Without transparency, there can be no enduring stability.”[i] In response to a question from the floor, he noted that this was as valid for public finances as it was for the private sector. So what is required for transparency in governmental financial reporting?

It is little different to what you would expect in the private sector. Two key elements are:

- Reporting according to a set of accounting standards, determined through a process which by virtue of its independence gives those standards legitimacy;
- An independent audit to give assurance that the information reported is reliable.

My focus today is largely on reporting—auditing of course has relatively less value if it is not against an appropriate set of accounting standards—so accounting standards are the first order of business.

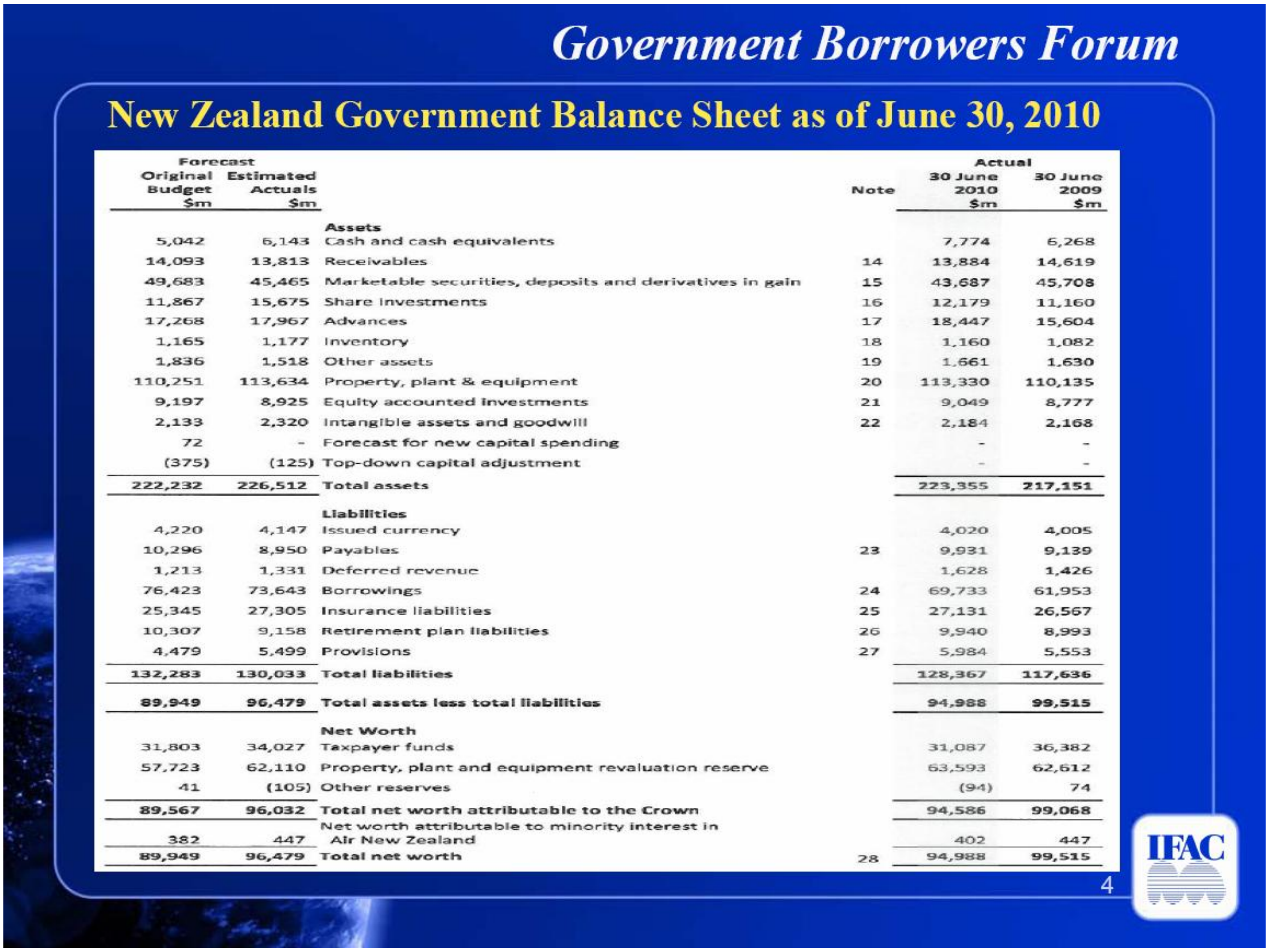
In relation to the first point, the information is of greater value if it enables comparisons to be made between entities—in this case sovereign governments. This objective, comparability through convergence, is one which in the private sector has given rise to the G20 seeking early convergence between IFRS and US GAAP, and the respective boards investing significant effort into achieving that.

What would those financial reporting standards look like for governments? Without seeking to give a comprehensive answer in the time available today, some obvious points are:

- Cash based accounting, though still commonplace even in developed countries, is simply inadequate. That is why GFS is, in principle, on an accrual, not a cash basis. It is why companies listed on every capital market are required to report on an accrual basis. The cash basis fails to provide sufficient information to enable a reasonable assessment of financial performance or position
- The entity should include in its financial reporting <u>all</u> the activities or sub-entities that impinge on its position and performance, and the associated risks—including all governmental financial institutions and all commercial activities
- Unless there is a good public sector specific rationale for a different treatment, an asset, liability, revenue or expense, should be accounted for in the same way as it is in the private sector

At present investors in sovereign debt generally do not get such high-quality financial information. In other words, transparency is lacking.

In the discussion yesterday and today, and commonly in discussion of government debt, there is reference to "sovereign balance sheets." Of course in fact most governments do not produce a balance sheet as I understand the term. A very few do. Here is one, and in selecting this one, I plead guilty to any charge of bias!



New Zealand Government Balance Sheet as of June 30, 2010

Forecast Original Budget $m	Forecast Estimated Actuals $m		Note	Actual 30 June 2010 $m	Actual 30 June 2009 $m
		Assets			
5,042	6,143	Cash and cash equivalents		7,774	6,268
14,093	13,813	Receivables	14	13,884	14,619
49,683	45,465	Marketable securities, deposits and derivatives in gain	15	43,687	45,708
11,867	15,675	Share investments	16	12,179	11,160
17,268	17,967	Advances	17	18,447	15,604
1,165	1,177	Inventory	18	1,160	1,082
1,836	1,518	Other assets	19	1,661	1,630
110,251	113,634	Property, plant & equipment	20	113,330	110,135
9,197	8,925	Equity accounted investments	21	9,049	8,777
2,133	2,320	Intangible assets and goodwill	22	2,184	2,168
72	-	Forecast for new capital spending		-	-
(375)	(125)	Top-down capital adjustment		-	-
222,232	**226,512**	**Total assets**		**223,355**	**217,151**
		Liabilities			
4,220	4,147	Issued currency		4,020	4,005
10,296	8,950	Payables	23	9,931	9,139
1,213	1,331	Deferred revenue		1,628	1,426
76,423	73,643	Borrowings	24	69,733	61,953
25,345	27,305	Insurance liabilities	25	27,131	26,567
10,307	9,158	Retirement plan liabilities	26	9,940	8,993
4,479	5,499	Provisions	27	5,984	5,553
132,283	**130,033**	**Total liabilities**		**128,367**	**117,636**
89,949	**96,479**	**Total assets less total liabilities**		**94,988**	**99,515**
		Net Worth			
31,803	34,027	Taxpayer funds		31,087	36,382
57,723	62,110	Property, plant and equipment revaluation reserve		63,593	62,612
41	(105)	Other reserves		(94)	74
89,567	**96,032**	**Total net worth attributable to the Crown**		**94,586**	**99,068**
382	447	Net worth attributable to minority interest in Air New Zealand		402	447
89,949	**96,479**	**Total net worth**	28	**94,988**	**99,515**

It has some interesting features—assets (physical and financial), liabilities (debt and non-debt), and equity or net worth. All these elements are essential for a coherent picture of fiscal position. It enables the investor to see all the claims against the government, including those that are not debt, and it reports the assets available to meet those claims. It also, importantly, reports net worth, giving information which is useful in assessing vulnerability to shocks. And note that it is possible not only to produce a balance sheet, it is possible to produce one each month.

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New Zealand Government Balance Sheet for the nine months ending March 31, 2010

As at 30 Jun 2010 Actual $m	As at 31 Mar 2010 Actual $m		Note	Current Year Actual vs Forecast: Actual $m	Forecast $m	Variance $m	%	Annual Forecast $m
		Assets						
7,774	6,915	Cash and cash equivalents	11	8,752	9,892	(1,140)	(11.5)	9,687
13,884	11,456	Receivables	11	18,704	12,754	5,950	46.7	14,970
43,687	42,795	Marketable securities, deposits and derivatives in gain	11	43,756	41,312	2,444	5.9	42,375
12,179	13,398	Share investments	11	14,285	12,901	1,384	10.7	13,704
18,447	17,704	Advances	11	19,694	20,169	(475)	(2.4)	19,642
1,160	1,175	Inventory		1,266	1,231	35	2.8	1,245
1,661	1,833	Other assets		2,079	1,975	104	5.3	1,705
113,330	111,774	Property, plant & equipment	12	115,205	115,796	(591)	(0.5)	117,328
9,049	8,811	Equity accounted investments [1]		9,321	9,298	23	0.2	9,345
2,184	2,164	Intangible assets and goodwill [2]		2,453	2,241	212	9.5	2,369
-	-	Forecast for new capital spending		-	-	-	-	292
-	-	Top-down capital adjustment		-	(140)	140	100.0	(350)
223,355	**218,025**	**Total assets**		**235,515**	**227,429**	**8,086**	**3.6**	**232,312**
		Liabilities						
4,020	4,281	Issued currency		4,370	4,112	(258)	(6.3)	4,137
9,931	7,329	Payables	14	8,567	8,437	(130)	(1.5)	9,562
1,628	1,649	Deferred revenue		1,690	1,633	(57)	(3.5)	1,436
69,733	67,454	Borrowings		84,290	82,696	(1,594)	(1.9)	85,876
27,131	24,923	Insurance liabilities	15	29,942	27,551	(2,391)	(8.7)	29,604
9,940	9,162	Retirement plan liabilities		9,372	9,539	167	1.8	9,436
5,984	5,272	Provisions	16	5,672	5,722	50	0.9	6,452
128,367	**120,070**	**Total liabilities**		**143,903**	**139,690**	**(4,213)**	**(3.0)**	**146,503**
94,988	**97,955**	**Total assets less total liabilities**		**91,612**	**87,739**	**3,873**	**4.4**	**85,809**
		Net Worth						
31,087	35,271	Taxpayer funds	17	27,892	23,967	3,925	16.4	22,010
63,593	62,398	Revaluation reserve	17	63,384	63,516	(132)	(0.2)	63,516
(94)	(161)	Other reserves	17	(66)	(146)	80	54.8	(119)
94,586	**97,508**	**Total net worth attributable to the Crown**		**91,210**	**87,337**	**3,873**	**4.4**	**85,407**
402	447	Net worth attributable to minority interest in Air New Zealand		402	402	-	-	402
94,988	**97,955**	**Total net worth**		**91,612**	**87,739**	**3,873**	**4.4**	**85,809**

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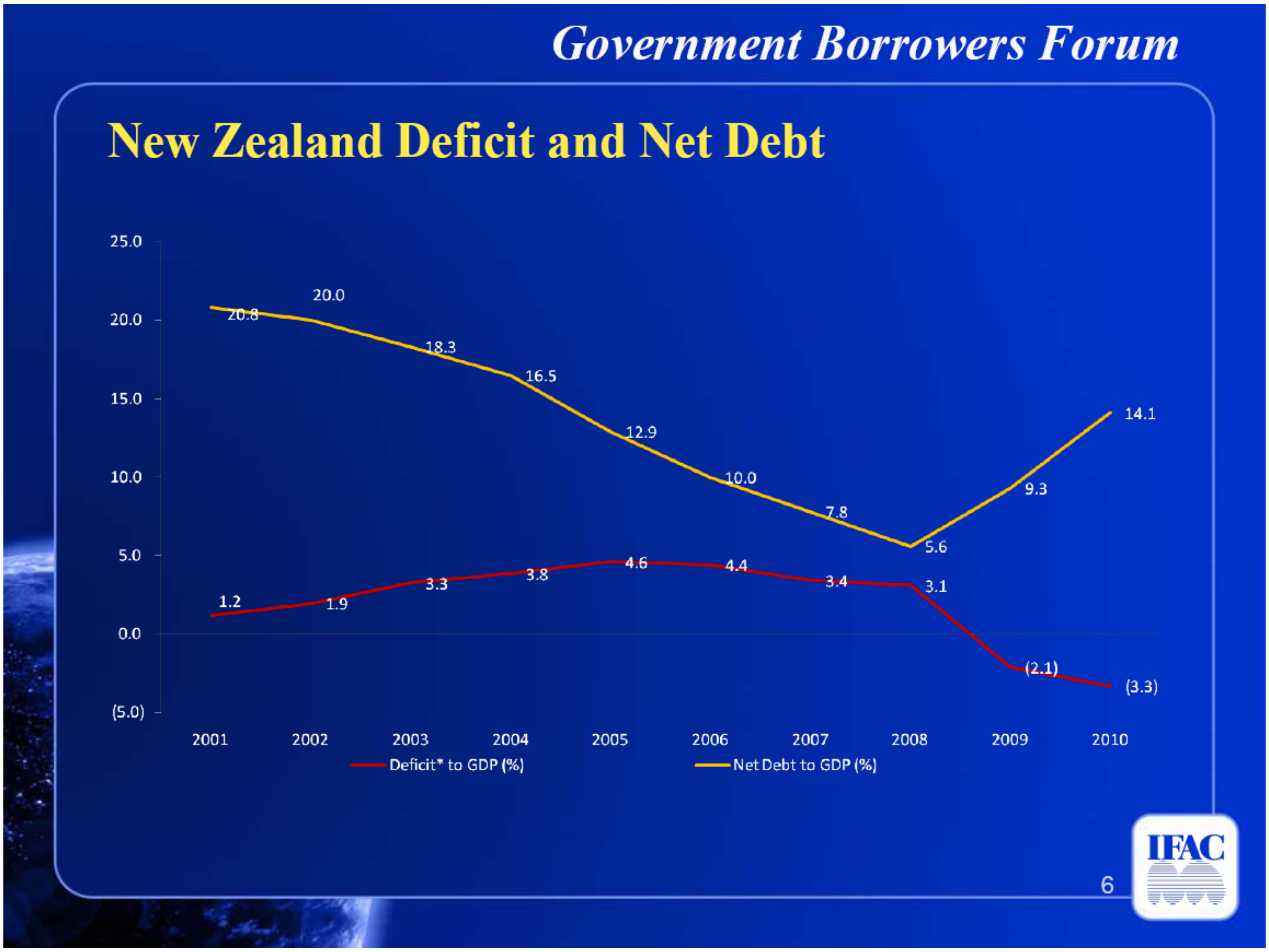
To take the New Zealand example a little further, I believe the second of the two graphs I am about to show presents a better picture than the first of financial position, capacity to withstand shock and to meet obligations.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New Zealand Deficit and Net Debt
25.0
20.0
15.0
10.0
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(5.0)
20.8
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18.3
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3.8
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4.4
3.4
3.1
(2.1)
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2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Deficit* to GDP (%)
Net Debt to GDP (%)
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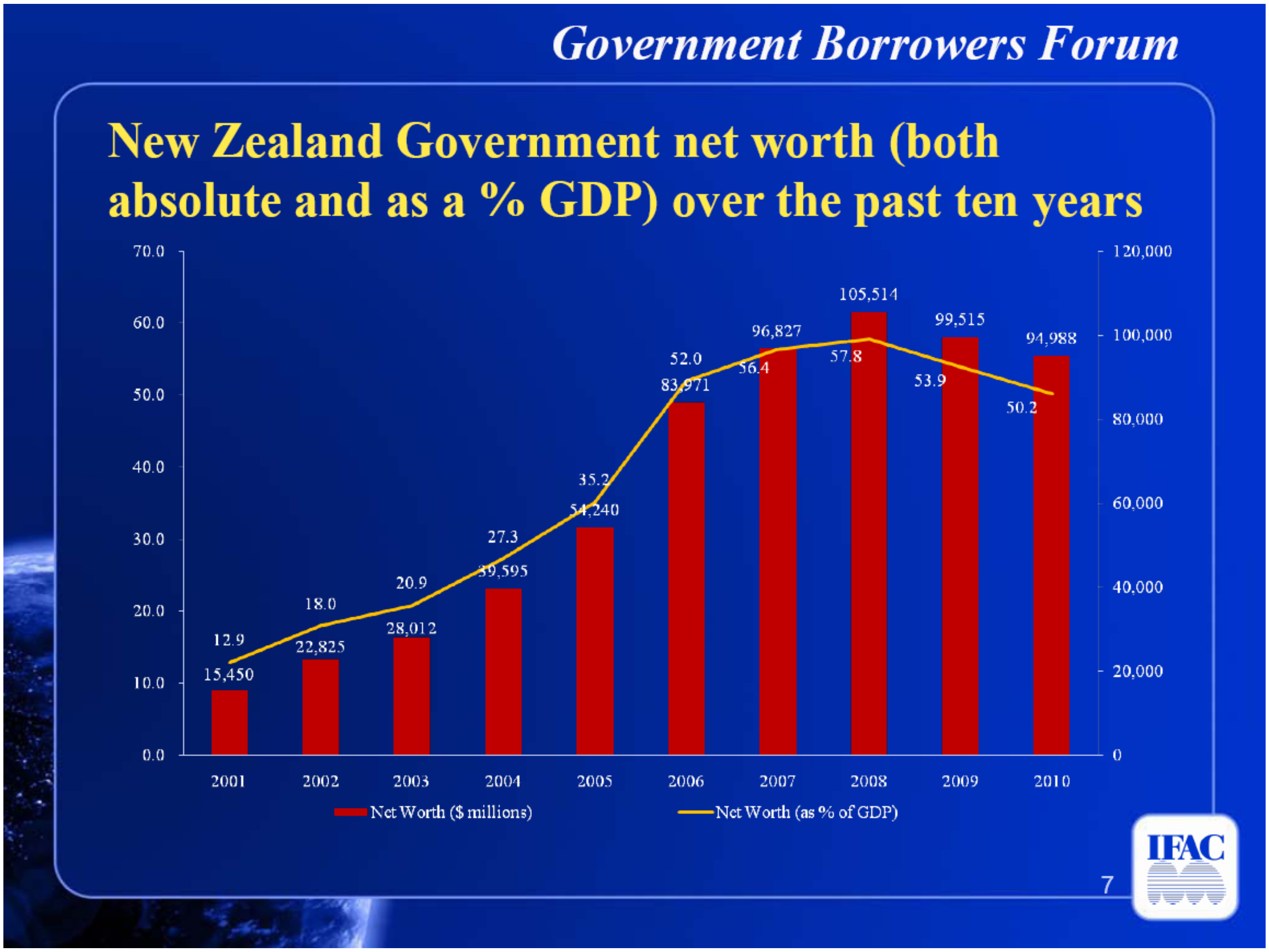


It would be interesting to consider what the net worth graphs would look like for those peripheral countries in Europe who have recently encountered sovereign debt problems. Or indeed for some of those not at the periphery, who do not produce a recognizable balance sheet. Unfortunately, we do not generally have this information, though in fairness some European governments are moving in this direction.

My point is simple; governments should provide essentially the same information as issuers that they, through their securities or corporation laws and regulations, require of corporates. Not only should they provide the information, it should be subject to independent audit.

Again, to stress the difference between what governments require of corporate issuers and how they behave themselves, I would draw an example from one of the governments that actually does better than most—the U.S. Government. It does produce accrual based financial statements, which puts it in the leading bunch. But to quote from a CNN report, in a statement explaining why it was unable to put forth an opinion on the consolidated financial statements of the federal government last year, (the Government Accountability Office) cited, "serious financial management problems at the Department of Defense that made its financial statements unauditable."[ii]

Just to be clear, the GAO gives a disclaimer on the financial statements of the US Government and it will not express an opinion because the underlying information is too unreliable.

The sovereign debt crisis makes it abundantly clear, if we did not already know, that governments in general account very badly for their financial performance and position. This could, and in the present circumstances should, lead to significant reform. We saw how financial reporting failure (Enron et al) in the private sector led to dramatic action, including the passage of the Sarbanes-Oxley Act, and the creation of regulatory bodies for private sector audits in most major countries. But that was the private sector. In this case, it is the public sector where the reporting failure, and in at least one case financial reporting fraud, has occurred. Not only has the situation not been remedied, it is attracting amazingly little attention—though it was heartening to see Bill Gates recently, in the context of reporting by US states, refer to reporting practices that "would make Enron blush."[iii] So perhaps there is some cause for optimism that the crisis will lead to recognition of the need for change.

But, and it is a very big "but," the crisis also creates even more powerful incentives than previously existed for governments NOT to be transparent. Recently a number of smaller European countries proposed that something should be done to address one of the most egregious areas of government accounting—pensions. They were firmly rebuffed by the larger countries in the European Union. In a similar vein, the German Government has recently decided not to proceed with its move from cash to modified cash accounting—to an accountant it seems rather like not wanting to make the shift from a land-line phone with a circular dial to one with buttons you could press—in a world of mobile technology both are outdated.

What are the obstacles?

There are many obstacles, but in my view just one serious one, at least for middle-income and developed countries.

Obstacles that are often identified include:

- Financial reporting policy issues
- Accounting resources:
    - people
    - systems

- Constitutional and legal restrictions

Let me pause for a moment on the question of resources. In developing countries this obstacle is real. But in developed countries, it is just an excuse. Imagine a listed corporate entity going to its regulator and explaining that while they were keen to meet the financial reporting requirements, they did not have the resources to operate such a sophisticated accounting system.

The serious obstacle is the absence of a political will for transparency on the part of too many governments. Why is it that even in the middle of a sovereign debt crisis, triggered at least in part by the financial reporting fraud of the Greek Government, there is not a stronger will by governments for better financial reporting? My own answer is that the structure of incentives faced by politicians makes them keen to avoid transparency, and the institutional arrangements that would be effective in forcing this transparency do not exist in most countries. There are two elements to this answer:

- The incentives, which for an individual politician, as well as a political party, are generally short term and often less strongly related to serving the public interest than we might wish
- The current institutional arrangements, such as the budgeting and appropriations rules, requirements for fiscal responsibility and transparency, accounting methodologies—which provide weak incentives for high-quality reporting and financial management.

Politicians like to get re-elected, and in general they like the benefits they receive from being in office. I see nothing wrong in this. But if transparency puts those benefits at risk we should not be surprised that politicians resist it.

I cannot be sure of this, but I would still hope that out of the current crisis we will get pressure for improved reporting. <u>You</u> may be one source of that pressure, especially when investors are asking you for better information than many of you are currently able to provide. My own view is that this type of financial information should make the job of a DMO easier, but perhaps when we move to the discussion stage of this session Phil Combes, the Treasurer in the New Zealand Debt Management Office, might make a few comments, from his perspective, about the value of good financial information.

<u>The IPSASB</u>

I would like to end by spending just a couple of minutes introducing the IPSASB. It is 15 years since the International Public Sector Accounting Standards (IPSAS) program started within IFAC, aimed at developing a single accounting language for the public sector. The IPSASB encourages public sector entities, including sovereigns, to adopt the accrual basis of accounting. 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, in the context of the sovereign debt crisis, we have pressed for government action in this area, for example through our submissions to the G-20. The IPSASs are based on International Financial Reporting Standards, which are amended only insofar as it is necessary to reflect the situation in the public sector. Since 1997, the IPSASB has developed and issued a suite of 31 accrual based standards—plus a cash-basis standard for countries moving toward full accrual accounting.

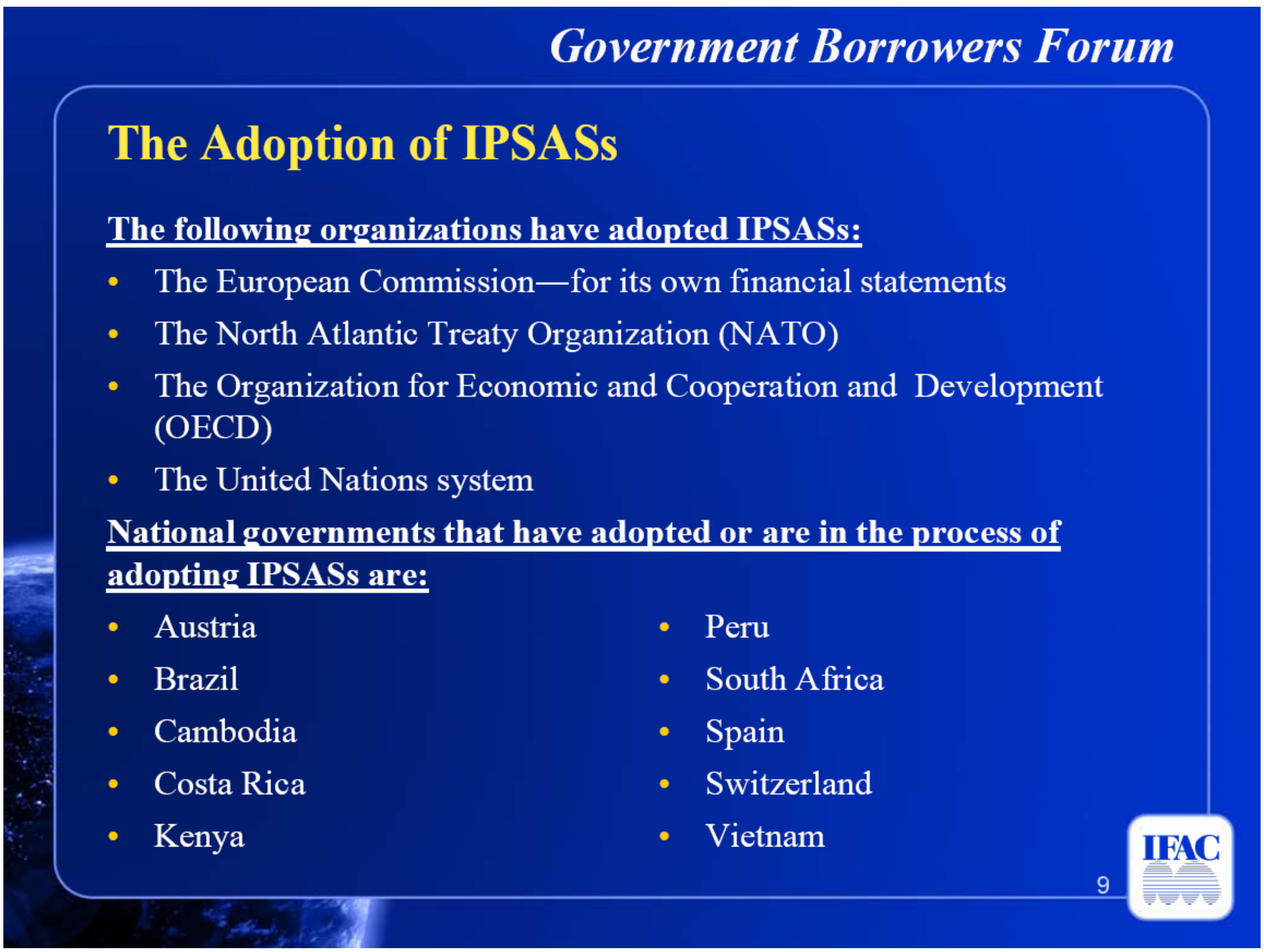
The current board, which is independent in its standard setting role—is made up of 18 members from around the world who have a variety of different roles and expertise, including people from Ministries of Finance, audit office staff, people from accounting firms, and academics.

It also has observers from a range of different international organizations, including:

- Asian Development Bank

- European Commission
- Eurostat
- International Accounting Standards Board
- International Monetary Fund
- International Organization of Supreme Audit Institutions
- Organisation for Economic Co-operation and Development
- United Nations
- United Nations Development Programme
- And, last but not least, the World Bank, which has been one of our strongest supporters for the past 15 years.

Adoption of IPSASs to date:



There are also a number of countries that have moved to adopt accrual accounting, but for a variety of reasons have not adopted IPSAS. This list includes Australia, Canada, New Zealand, the United Kingdom, and the United States. While I would like to see all developed market governments adopt accrual based IPSASs, just moving to accrual accounting, and not adopting IPSAS, is still making very significant progress towards transparency. But failure to adopt and comply with international, independently set standards, leaves room for local variations which might, in a tight spot, seem particularly attractive, but may, for example, leave off balance sheets the liabilities associated with employee pensions.

Finally, I should stress that the financial information I have been talking about is necessary, but not sufficient. While fiscal performance and position are reflected in the financial statements, other factors also have a bearing. This is no different than the private sector where the financial statements are helpful, but they need to be viewed in the context of the organization's business model, market position, technological readiness etc. So with governments—but this is not an excuse for not producing the basic financial information.

Thank you for your attention. I look forward to the discussion.

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[i] European Commission Conference, A Time for Change?, *The Objectives of Financial Reporting*, February 3, 2011.

[ii] CNN, *Pentagon Says It's Moving Toward Being 'Audit-ready,* February 25, 2011.

[iii] TED Conference (Technology, Education, Design), *The Rediscovery of Wonder,* March 1-4, 2011.