CPA Australia

International Public Sector Convention

The Long and Winding Road to Governmental Financial Transparency

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Thursday, March 10, 2011 - Melbourne, Australia

Keynote Speech

Thank you, Tony for the introduction. Good morning everyone.

It is always a pleasure to be in Melbourne. And it is a particular pleasure to be participating in this convention, both as a member of CPA Australia, and someone who, admittedly a very long time ago, was on the public sector committee of the Tasmanian branch.

Why the "long and winding road'?

Thinking about what to cover in this presentation lead me to a personal reflection on what has been achieved in governmental financial reporting over the past 40 years, where we are now, and what remains to be done.

Even as a very new graduate in accounting, working in the public service in New Zealand 40 years ago, I could not understand why governments did not seem to use good accounting information.

- How could you not know what assets you had, what they were worth, and where they were located?
- How could you not know what it cost to produce your services?
- How could you not know what your liabilities are?

Without anticipating too much of what I will say later, and accepting that this is no longer the situation in Australia or New Zealand; I have come to the view that internationally there is a systematic, pervasive, though possibly not deliberate, ignorance of the critical value of good accounting to governments.

It is now nearly 25 years since I joined the New Zealand Treasury, and was involved in the development of the Financial Management Reforms, as they were called. I remember a conversation between a few of the Treasury economists, the then secretary (an economist and an accountant), and myself. One of the economists made reference to it being a good idea to “have accountants on tap, but not on top.” The secretary’s response was, “Maybe, but, isn’t it interesting how valuable businesses seem to find them.” The response reflected an atypical understanding of the value of good accounting information within government.

It is over 20 years since the New Zealand Parliament passed Public Finance Act (PFA) 1989. The PFA mandated a move to accrual appropriations, budgeting, and accounting, forcing a radical shift in both financial management and financial reporting. Similar developments were taking place in Australia around the same time.

It is nearly 20 years since the New Zealand Government produced its first set of financial statements on an accrual basis, revealing that the government’s negative equity was equivalent to about ten percent of GDP. In the intervening period, the government’s net worth climbed to just under 60 percent of GDP just prior to the financial crisis, and is still over 50 percent.

While good accounting and financial management were by no means the only causes for this, I do not believe it could have happened without them.

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. As you know, the IPSASs were based on International Financial Reporting Standards (International Accounting Standards as they were then), which were amended only insofar as it was necessary to reflect the situation in the public sector.

So I hope you will understand that at least for me personally, it has been a long road. It should be clear, that the road I am referring to, has accrual based reporting at its heart. Cash accounting is simply not transparent. However, my point in looking back is not to demonstrate my age, it is to get perspective on where we are, and what we yet need to do.

As to whether it is a winding road, I think we are at an important, if not critical, juncture. The sovereign debt crisis, triggered by the financial reporting fraud of the Greek government, has cast some light on the seriousness of the results of poor financial management.

Obviously, government actions to limit the impact of the global financial crisis have exacerbated their financial positions, as many governments acquired assets and liabilities, and gave guarantees of various kinds, and engaged in massive fiscal stimulus. But, the situation now would be by no means as bad if so many governments had not already made commitments that they did not account for properly, and arguably will not be able to meet.

We are at this critical juncture, I believe, for two reasons. First, the crisis makes it abundantly clear that governments in general are accounting very badly for their financial performance and position. This could, and should, lead to significant reform. We saw how financial reporting failure in the private sector early in this century lead 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 has occurred and at least to date there has been very little call for action.

There has been a lot of debate about the need for action to reduce deficits and spending, but little serious consideration of the role that accounting and auditing have played in the crisis. It was, however, refreshing the week before last to hear Bill Gates calling for accounting reform at the state government level in the United States. He is quoted as saying that state governments “use tricks that would make Enron blush.” [1]

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—would you believe—modified cash accounting.

The point is the road can wind back on itself. Bad policy can be as infectious as good policy.

My objective today is to answer some questions about our collective journey down this road to high-quality accounting by governments:

- What is the destination?
- What is at stake?
- Where are we on the journey?
- Who is on this journey with us? And who is not on the journey?
- What are the obstacles?
- What can others do, and what can we, as a profession do to keep on track?

In the course of answering I will certainly allude to the Australian and New Zealand experiences, but my comments have an international focus. In this international setting Australia and New Zealand are the exceptions, not the rule.

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

What is the destination?

The easy answer is:

- IPSAS endorsed by the key international financial institutions (such as the Financial Stability Board, International Monetary Fund, World Bank), and;
- Universal adoption and high-quality implementation at the national, state, and local levels across jurisdictions.

A more nuanced answer is:

- The ultimate destination is not about IPSAS, but about governments around the world performing more effectively and efficiently.
- In order to achieve this, we need high-quality financial management, and as a necessary component of that, high-quality financial reporting, which in turn means…
    - Much wider adoption of the accrual basis for budgeting, appropriations and accounting.
    - This is assisted by having a set of financial reporting standards that are:
        - Independently set
        - Of high-quality
        - With international acceptance and legitimacy
- This is the role I believe IPSAS can, and should play within the international financial system.

What is at stake?

I need to be careful not to overstate what I am about to say. But, the failure of governments to manage their finances has in the past, and could again in the future, have dramatic consequences. Some loss of democratic control by citizens is one of the most immediate consequences when poor financial management in the public sector leads to the need for a bailout (as happened in Greece and Ireland). This was exactly what happened in New York in the mid-1970s, when the city was bankrupt, and budget control passed to the Financial Control Board, made up primarily of bankers. If it can happen to New York…

It was interesting and disturbing in a meeting last week in New York to hear, from IFAC's member bodies in Ireland, the consequences for Ireland of its bail-out package. The loss of financial sovereignty was clearly, and rightly, a matter of great concern and regret. In the recent election in Ireland, the previous government was severely punished for their role in the crisis. But, and I will come back to this, the answer lies not in replacing one set of politicians with another, while leaving the major institutional arrangements for budgeting, appropriations and accounting the same. In the long run, the result is likely to be the same, as the incentives have not changed.

In a more extreme situation, the failure of a government to control its financial position can lead to the loss of democracy. This can occur, and has occurred, when a democratically elected government cannot institute changes as dramatic as are necessitated by the financial situation, and an authoritarian government, which is able to enforce change, steps in.

Certainly, in Europe, the current crisis has lead to public debate about the future of the euro. The failure of the euro would be a severe blow for Europe and European integration, and its collapse would at the very least be seriously destabilizing, and not just for Europe.

Finally, without envisaging the dramatic outcomes I have just alluded to, failure by governments to control their financial positions can lead to significant and painful economic adjustments, with the potential for social unrest. Such measures as increasing the retirement age or renegotiating public service conditions of employment can have serious repercussions. I do not know whether this has been reported in Australia, but in the United States one of the measures being proposed in the Congress (though apparently with little prospect of success) is to allow states to file for bankruptcy. The idea behind this is, of course, to allow states to renegotiate contracts into which they had previously entered. This would certainly provoke a serious situation with the public sector unions.

The seriousness of the situation in the U.S. was emphasized earlier in this conference by David Walker former comptroller general, who has stated that, “It’s time for us to wake up—and wake up America—to the lethal threat of our own fiscal irresponsibility.” [2] To cover rising federal commitments, every man, woman and child in America are already more than a quarter of a million dollars in debt! Think about that—every person in the US with a quarter of a million dollar obligation. David Walker has previously referred to this as being like having a mortgage, but no house. And think about the consequences of trying to correct that situation.

So, what is at stake? A lot!

Where are we on the journey?

Forgive me for being parochial, but I do believe a key step in this journey was taken in New Zealand and here in Australia. Until the initiatives by these governments in the early 1990s, government accounting at the national level was cash accounting. The first steps were bold ones, as there was not a lot of precedent for what was being done, and none at the national government level. I think it is accurate to say that in NZ the initial impetus came from within the government, whereas in Australia, it came from within the profession. Either way, the initial developments were regarded at the time as being “courageous”— in the Sir Humphrey sense of being almost certain to fail—and at the very least eccentric and probably naïve.

The next key milestone was the development by IFAC in 1996 of the program to establish IPSAS, with the support of The World Bank, the ADB and others. IFAC members provided the technical expertise, while The World Bank and others provided both financial support and a degree of legitimacy.

This is probably an appropriate point to recognize and acknowledge the huge contribution that the Australian and New Zealand professions have made to the IPSAS program. Both countries have been represented on the IPSASB (previously the Public

[2] David A. Walker, *Comeback America: Turning the Country Around and Restoring Fiscal Responsibility*, 2010: Random House.

Sector Committee) since the program was started, and they have brought a unique perspective to the Board's deliberations, as they were able to provide input based on direct experience of working within an accrual framework. Only relatively recently have other members of the IPSASB been able to bring these same insights.

The IMF's subsequent move to put the Government Finance Statistics onto the accrual basis reinforced this trend.

These two developments made a significant contribution to the accrual basis of accounting becoming the benchmark for governmental financial reporting, which is where I believe we are now. We should not underestimate either:

- What a truly significant shift this is in respect to the accounting by organizations that represent somewhere between 33 percent and 50 percent of economic activity in most countries, or;
- How far, internationally, we have to go to put into practice high-quality financial reporting and financial management.

In relation to financial management (including budgeting and appropriations) the overall situation is still pretty dismal. To illustrate the problems in financial management, I would like to use two examples—one from the US, and one from the UK. I have taken these two examples because they are from countries that see themselves, and are seen by many others, as being at the very least in the leading pack when it comes to governmental financial reporting and financial management.

And the two examples are from agencies that have no excuse, in the sense that under their statutory mandate they require high-quality financial reporting from the private sector. The first example is the US Securities and Exchange Commission (SEC). To quote*: "In its latest report on the SEC's financial statements, the GAO said the SEC did not maintain effective internal control as of its September 30, 2010 fiscal year end, as a result of material weaknesses in its financial reporting and accounting processes. In fact, the GAO notes, the SEC has struggled with its internal controls since it began* *preparing financial statements in 2004 under the Accountability of Tax Dollars Act of 2002."*[3]

Without drawing undue attention to the fact that prior to 2004 the SEC did not produce financial statements, the point is that they are the enforcer of legislation that requires listed private sector entities to have effective systems of internal control over their financial reporting, so they should know why it is important.

The second example is from Her Majesty's Revenue and Customs (HMRC). The quote below is taken from a recent report of the House of Commons Committee of Public Accounts:

"*The Department has failed to tackle a backlog of 18 million PAYE cases from 2007-08 and earlier, affecting an estimated 15 million taxpayers. The exact amounts of tax involved are not known, but estimates suggest £1.4 billion of tax was underpaid, and there is £3.0 billion of overpaid tax to be refunded. The Department failed to understand the impact of the Finance Act 2008 on the deadlines for collecting tax, and so is now unable to collect any of the estimated £650 million underpaid in 2006-07 and earlier."*[4]

HMRC requires that companies and individuals in the private sector maintain reliable and complete accounting records.

And finally, as a piece of light relief, this from the US Department of Defense (DOD). You will be aware of the "too big to fail" debate that has focused on banks and accounting firms. The DOD argues not that it is too big to fail, but that it is too big to audit. The quote below is from a recent CNN story, itself quoting a DOD report:

"The DOD obligates an average of $2 billion to $3 billion every business day and handles hundreds of thousands of payment transactions, which take place in thousands of worldwide locations, including war zones," the Defense Department said in its latest

[3] Tammy Whitehouse, Compliance Week: *GAO Gives SEC More Black Marks on Internal Controls,* November 18, 2010.

[4] Report by the Comptroller and Audit General on *HM Revenue & Customs 2009-10 Accounts*, HC 299, Session 2010-11.

financial report. "Because of DOD's size and mission requirements, it is not feasible to deploy a vast number of accountants to manually reconcile our books."

Last year, the Government Accountability Office, the investigating arm of Congress, concurred. In a statement explaining why it was unable to put forth an opinion on the consolidated financial statements of the federal government last year, it cited, *"serious financial management problems at the Department of Defense that made its financial statements unauditable."*

Just to be clear, the GAO gives a disclaimer on the financial statements of the US Government —it will not express an opinion.

So even government agencies—which have every reason to understand the importance of good financial information and enforce that requirement in respect of the private sector—do not themselves demonstrate adequate financial management performance. And this relates to governments that are, relatively speaking, doing well. I wish these agencies were an exception, but I see no reason to think that is the case. Not to belabor the point, we have a long way to go before we can be comfortable about the quality of financial management, even in developed countries.

However, perhaps one positive feature of where we are today is that government finance is at the center of much of the policy debate. However, very little of the debate is focused on the poor quality of either financial reporting or financial management. And much of the debate is not informed by reliable information. Just one example: in the US, the estimates of the aggregate value of state and local government employee pension obligations range from $700 billion to $3 trillion.

Who is on this journey with us?

Based on the more nuanced view of what the destination is, there is a growing band on this journey, as jurisdictions and international institutions move to adopt the accrual basis of accounting and/or IPSAS.

Currently included in the IPSAS adoption group are:

- The United Nations system
- The European Commission
- The Organization for Economic and Commercial Development
- The North Atlantic Treaty Organization

National governments, including:

- Switzerland
- Spain
- South Africa
- Austria
- Brazil
- Costa Rica
- Kenya
- Peru
- Cambodia
- Vietnam

Do you notice which country is not listed here?

But the accrual (rather than IPSAS) adopters are a much larger group including for example: the US, the UK, Canada, Australia and New Zealand, and many others.

I might also ask "Who is not on this journey?"

In general, politicians are not. While unquestionably some politicians see the value of transparency, the general situation appears to be that politicians welcome transparency with the same enthusiasm as turkeys welcome Christmas. They do, of course, welcome transparency from the corporate sector, as they should.

Also, in general, Ministries of Finance are not on this journey. This may be partly because they reflect the preferences of the ministers, but is also because in many cases they are working within highly idiosyncratic cash-based budget and accounting systems. A move to accrual based accounting and budgeting would force them outside their area of expertise and would, effectively, require them to write off a significant component of their own human capital. This is not something people are generally keen to do.

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 can be an inhibition

Let me pause for a moment on the question of resources. In developing countries this obstacle is real, and hence there are a cash-based IPSAS for those jurisdictions that wish to be transparent, but do not have the necessary resources. But, in developed countries, this is no excuse. Imagine a listed 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. After being on this long and winding road for so long, and encountering this obstacle many times in different contexts (as a public servant talking to other public servants, as a consultant, as an accounting standard-setter and in my current role), I would like to spend a little time dissecting it.

First, I work from the premise that the other problems can be overcome if, within a government, there is a serious commitment to having high-quality financial information and financial management. So why is it that even in the middle of a sovereign debt crisis, triggered as I said earlier by financial reporting fraud by the Greek Government, there is not a strong will by governments for better financial reporting?

My answer is that the structure of incentives faced by politicians makes them keen to avoid transparency, and 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.
- The current institutional arrangements, such as the budgeting and appropriations rules, requirements for fiscal responsibility and transparency, and accounting methodologies, and so on.

The first point requires us to recognize and accept that politicians, like public servants and like people working in the private sector, are not angels working tirelessly and exclusively in the public interest. 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. If transparency puts those benefits at risk, we should not be surprised that politicians resist it. Put bluntly, a well-argued case demonstrating how the global public interest is served by having uniform and high-quality public sector accounting standards will not cut much ice. This should not surprise us. Replacing one set of politicians with another, who face the same incentives, will likely lead to the same result.

The trick lies in the second point—the institutional arrangements. Politicians need to work within a framework where they have incentives to leave a government in a better financial condition than it was when they arrived, or at least to do no harm. Key elements of such a framework include, amongst other things, the budget, appropriations and accounting rules, and a fiscal responsibility regime.

What can others do, and what can we, as a profession do?

Let's start with the others…

More accountants at the highest level of government might help, but would be hard to achieve, and unlikely to be effective unless it was demand rather than supply driven. In other words, it would be effective if it came from senior officials and ministers requiring the kind of information that could only be supplied by qualified financial professionals. It would be much less likely to be effective, if there were a requirement to employ a specified number of accountants. Obviously, if ministers and senior officials saw the need for high-quality financial information, and demanded that information, then that would translate into a demand for accounting resources in the agencies. I do not see this as a realistic source of change.

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, a respected economic commentator, has argued recently in the Financial Times that assets also need to be considered when addressing fiscal position—what is surprising to an accountant is that this might be thought novel. What he omitted to say is that it is also necessary to have information on total liabilities, and not just debt. This is particularly the case where public, private infrastructure projects have been used as a mechanism to reduce the size of the Government's borrowing requirement— the United Kingdom is a case in point.

It might help if analysts and credit rating agencies would not accept, and would question publicly, the quality of the information presently available to them from such significant capital market participants as sovereign debt issuers. And we should remember that the value of trades of government securities can be, as it is on the NYSE, multiples of the value of all other trades, including equities.

It would certainly help, if securities regulators would require of sovereign and sub-national debt issuers, the same quality of financial information that is required of listed companies. This is starting to happen, I am pleased to say. The SEC has in the last year, brought an action against the State of New Jersey in relation to its disclosure of pension obligations. And in a very recent *Financial Times* article, the following:

The $3,000bn municipal bond market where states and local governments raise money has become a "top priority" for the Securities and Exchange Commission amid concerns of mounting risks for investors, said the head of the regulator's enforcement unit for the area.

"To the extent you may have states and municipalities experiencing financial difficulties and not disclosing that information in official statements or other continuing disclosure documents, then that's real cause for concern," [5] *said Elaine Greenberg, chief of the SEC enforcement division's municipal securities unit.*

I see this as a very positive development.

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 IPSASs, and their becoming an international benchmark.

At the national level, where the situation is commonly not as good as it is in Australia, professional accounting institutes being outspoken on the need for financial management reform in government is critical. They must call for institutional arrangements that change the incentives faced by politicians, and effectively constrain their behavior.

And for Australia and New Zealand, there is an obligation on the profession to be vigilant in ensuring that governments do not find ways to undermine the existing level of

[5] Kara Scannell, Nicole Bullock, Financial Times, *SEC Makes Muni Bond Disclosure a 'Top Priority,'* February 14, 2011.

transparency, for example by identifying new performance measures that are easier for them to comply with.

If the sovereign debt crisis does not stir us, as an international profession, 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.

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 government action in this area, for example through our submissions to the G-20.

Another reform we have been actively promoting is for the Public Interest Oversight Board, which has oversight of the International Auditing and Assurance Standards Board, to have oversight of the IPSASB. We believe this will further enhance the legitimacy of the IPSASB, and make it easier for reluctant governments, those who do not wish to be too "courageous" —to make the decision to adopt IPSAS.

The long and winding road I have been describing, has so far, been a journey of 40 years. I have now been talking for 40 minutes, and that is probably enough.

Thank you for your attention, and I look forward to questions and discussion.

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