

## **CIPFA's 1<sup>st</sup> International Conference**

### ***Trust and Accountability in Public Financial Management***

#### **CIPFA – IFAC Governance Project**

Ian Ball, IFAC CEO

Thursday, March 17, 2011

10:10 – 10:50 – Keynote Speech

Thank you for the introduction Caroline, and for the kind welcome. Good morning, ladies and gentlemen. It is a great pleasure to be here; my congratulations to CIPFA for organizing such an excellent conference.

The overall theme of this conference is trust and accountability in public financial management. The incoming Chairman of the IASB, Hans Hoogervorst, said at a recent conference in Brussels<sup>1</sup>, “Without transparency, there can be no enduring stability.” I believe that without transparency, neither can there be trust or accountability. And as a basis for what follows, I should be clear that a crucial element of transparency in the public sector is accrual accounting.

Within the overall conference theme, I am speaking about a project in the area of public sector governance in which CIPFA and IFAC will be collaborating. But, I would like to sneak up on the subject, and end my presentation by talking about the governance project and why it is needed. On the way to this conclusion, I would like to focus more on the somewhat narrower topics of financial reporting and financial management; where we are, and how we can progress further and faster within a well-designed governance framework.

In talking about financial reporting and financial management, I would like to start back in time, and then move forward. Even as a very new graduate in accounting, working in

---

<sup>1</sup> European Commission Conference, A Time for Change?, *The Objectives of Financial Reporting*, February 3, 2011.

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?

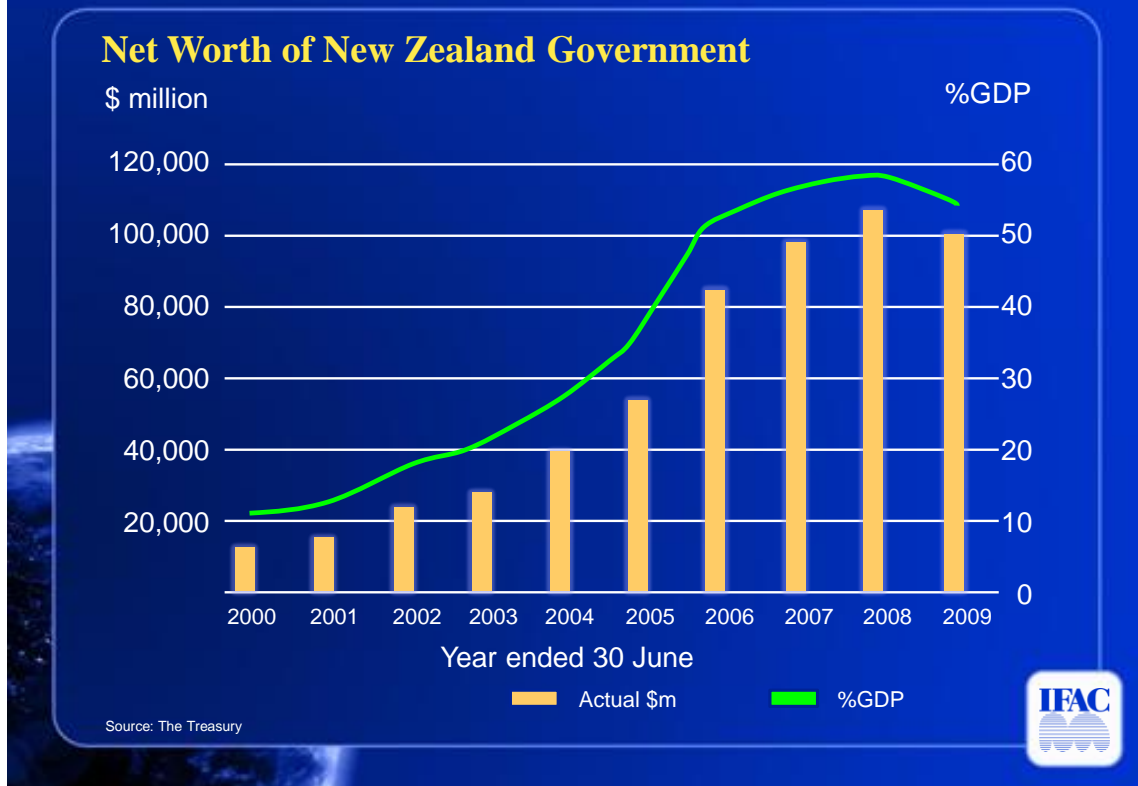
Without anticipating too much of what I will say later, I have come to the view that internationally there is a systematic, pervasive—though possibly not deliberate—ignorance of the critical value of good accounting to governments.

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.

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.

## Public Sector Management in New Zealand



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.

Today, the sovereign debt crisis, triggered in part by the financial reporting fraud of the Greek government, has emphasized the seriousness of the results of poor financial management and financial reporting. 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 programs. 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.

The sovereign debt crisis makes it abundantly clear, if we did not already know, 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 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 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<sup>2</sup>.” Of course the state governments are not alone in this. 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—would you believe—modified cash accounting.

---

<sup>2</sup> 2011 TED Conference (Technology, Education, Design), *The Rediscovery of Wonder*, March 1-4, 2011.

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 we, as a profession, do?

### **What is the destination?**

The easy answer is:

- IPSASs 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. Adoption—let's be clear—is the easy bit.

A more nuanced answer is:

- The ultimate destination is not about IPSASs, 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.
  - And 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 IPSASs 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 led 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 the United Kingdom, 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<sup>3</sup>.” 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 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 all at the national government level. These 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.

---

<sup>3</sup> David A. Walker, *Comeback America: Turning the Country Around and Restoring Fiscal Responsibility*, 2010: Random House.

The next key milestone was the development by IFAC in 1996 of the program to establish IPSASs, 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.

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, correctly, see themselves 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.”<sup>4</sup>*

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.”<sup>5</sup>*

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*

---

<sup>4</sup> Tammy Whitehouse, Compliance Week: GAO Gives SEC More Black Marks on Internal Controls, November 18, 2010.

<sup>5</sup> 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 unauditabile."*

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

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, and I will come back to this when I talk about the need for an appropriate set of governance and institutional arrangements, I believe that the agencies I have instanced are just responding rationally to the incentives baked into the system within which they operate. This suggests that the appropriate response is not to criticize the SEC or HMRC, but to seek changes to the system itself.

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 IPSASs.

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

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

And again, lest anyone thinks adoption is the end point, the implementation challenges remain significant. But these jurisdictions are at least on the journey.

## **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 a period on the opposition benches. 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 cash-based IPSASs 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. I would like to spend a little time addressing this issue. 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 than we might wish.
- The current institutional arrangements, such as the budgeting and appropriations rules, requirements for fiscal responsibility and transparency, and accounting methodologies, provide weak incentives for high-quality reporting and financial management.

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.

This view of political behavior is consistent with the economics of public choice, or public choice theory. Let me quote, “... <sup>6</sup>*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 importantly, that the motivations of people in the political*

---

<sup>6</sup> William F. Shughart II, *The Concise Encyclopedia of Economics*, Public Choice, 2008

*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 re-election to office. Public choice, in other words, simply transfers the rational actor model of economic theory to the realm of politics.”*

So, if you do not assume that politicians and public servants 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 that are found in governments in many parts of the world. I cannot speak for the United Kingdom. These behaviors 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. As Nobel Prize winner James Buchanan put it, public choice theory is “politics without romance.”<sup>7</sup> Viewed in this way, the differences between the public and private sectors do not lie primarily in what motivates individuals; they lie in the institutions within which they operate—facing, as they do, radically different incentives and constraints.

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.

---

<sup>7</sup> Buchanan, James M. and Gordon Tullock (1962): *The Calculus of Consent*, Ann Arbor: University of Michigan Press.

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 way they almost universally constrain companies in the private sector—what can we do?

The trick lies in the second point: the institutional arrangements. Politicians need to work within a framework where the incentives do a better job of making the interests of those in government align to the public interest.

The institutions—the organizations, laws, processes and roles—that governments design to administer their financial affairs, have considerable power in shaping outcomes. Presently, the use of the cash basis for budgeting, appropriations, and reporting means governments are attempting to manage highly complex financial positions with outdated accounting and budgeting technology. The results have the potential to be dire. The European sovereign debt crisis is unresolved after a series of successively more powerful actions at the European and international levels, 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. In a relatively recent article in *The Washington Post*<sup>8</sup>, Sheila Bair, 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 government is hidden. This enables governments to sustain, for a period, levels of cash outlays and debt that their real financial position cannot support.

---

<sup>8</sup> Sheila Baer, *The Washington Post*: *Will the Next Fiscal Crisis Start in Washington*, November 26, 2010.

## **What can we, as a profession, do?**

First, we must recognize that it will require well-informed pressure from outside governments. This is not a set of changes we can generally 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 certainly 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, professional accounting institutes being outspoken on the need for governance reform, including financial management reform, is critical. They must call for institutional arrangements that change the incentives faced by politicians and effectively constrain their behavior. There are few other organizations in society with the authority and expertise to take such a position.

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 IPSASs.



This takes me, in conclusion, to the work that IFAC and CIPFA are developing in the area of public sector governance. This work, in seeking to establish a governance framework for public sector organizations, has the potential to be both a catalyst for action by the profession, and a basis on which governance arrangements in specific organizations or jurisdictions can be evaluated. To the extent possible, the governance arrangements should align the interests of politicians (and public servants) with those of the public at large—the public interest.

We start this work from a position where there is no universally agreed definition for the term public sector governance. What is understood by the term appears to vary considerably between jurisdictions. Our initial work uses the following definition:

*The arrangements in place ensure that a public sector organization fulfills its overall purpose, achieves its intended outcomes for citizens and service users, and operates in a manner that is transparent and accountable, efficient and effective, and ethical and sustainable.*

The work will draw on previous work that IFAC and CIPFA have undertaken, respectively, IFAC's report *Governance in the Public Sector: A Governing Body Perspective (2002)*, and CIPFA's *Whole System Approach to Public Financial Management (PFM)*, which proposes an integrated approach to the design and improvement of public financial management.

CIPFA and IFAC both believe that a principles-based international public sector governance framework or standard is essential to enable the development of robust country PFM systems. It will also help address the incentives problems I have referred to, and emphasize the need for a high-quality and integrated system of financial management and reporting.

Thank you for your attention.

# # #