



A discussion series:
SUSTAINABLE PUBLIC FINANCES – EU PERSPECTIVES

VIEWS FROM INTERNATIONAL INSTITUTIONS

Synopsis of discussion on 24 September 2013, Brussels



INTRODUCTION

The global financial and economic crisis is bringing about profound changes in international, financial and government institutions. In Europe, the crisis has also drawn particular attention to the poor quality of financial management, reporting and governance within much of the public sector, highlighting the need for greater action to address these interconnected shortcomings. At this critical stage in policy development, ICAEW is bringing together key decision-makers and experts with a wide range of perspectives to help advance discussion on how to promote better financial management, transparency and accountability in the public sector throughout Europe.

On 24 September 2013, a group of senior representatives from international organisations as well as European institutions and other stakeholders came together to exchange views on such issues. The meeting was the third in a series of informal discussions being organised by ICAEW in 2013 with support from PwC.

This brief synopsis seeks to capture the key elements of the third discussion to encourage feedback and further development of the ideas raised during the dinner. It also aims to inform other stakeholders who have an interest in the overarching theme of sustainable public finances in Europe and who may wish to contribute to the subsequent discussions taking place in Brussels in 2013.

We would be delighted to receive comments on the synopsis, to be addressed to:

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DISCUSSION SERIES

During the course of 2013, four discussions are being organised to encourage an informed exchange of views on reforms to enhance financial management, transparency and accountability in the public sector throughout Europe. Each specific discussion provides an opportunity to comment on the overarching theme of sustainable public finances in Europe. Equally, in order to provide fresh input into the debate, each discussion also explores a particular aspect in greater detail.

Public sector finances – EU perspectives

22 January 2013 (synopsis available)

Regional and central government perspectives

23 April 2013 (synopsis available)

Democratic accountability and fiscal sustainability

13 November 2013

VIEWS FROM INTERNATIONAL ORGANISATIONS

“ At a previous meeting, reference was made to shortcomings in public sector financial management being a burning platform: but is it burning enough to bring about change in the right time frame?

The current debate within the EU on reform of public sector reporting can usefully draw on a range of international experiences and views to help inform debate and shape reform. International organisations have, in many cases, directly undertaken reforms in their own accounting and reporting by adopting accruals accounting. They have also played a role in the reforms undertaken by countries in receipt of external funding and advice.

A number of international organisations are also directly involved in the ongoing discussions regarding international standard setting for public sector accounting standards and related governance and oversight arrangements. The latter discussions are also central to the EU debate on reforming the public sector, given the initiative launched by Eurostat.

The third dinner discussion on 24 September 2013 provided a forum for the exchange of experience and expertise between representatives from various international organisations, a number of European commentators and other interested parties. The discussion aimed to draw out insights which could help the EU seize the current opportunity to effect a wholesale shift towards better public sector financial management, greater transparency and international comparability of public sector accounts.

The discussion covered a range of issues, focusing in particular on three key areas:

Insights from international organisations

- What insights can Europe draw from the moves made by international organisations towards accruals-based accounting and broader financial management reform?
- What major challenges and benefits have international organisations experienced when reforming their financial management and reporting systems?

EU public sector standards and oversight

- What is the best course for the EU to pursue in relation to public sector standards and oversight?
- What are the key components of successful international standard setting, which can also achieve an adequate balance between comparability and respecting differences across countries and regions?

International financial markets and public sector reform

- What is the current relationship between financial markets and public sector reform?
- To what extent can international markets play a more prominent role as a catalyst to more sustainable public finances?

Insights from international organisations

“ The experience of international organisations in implementing IPSAS and other accruals-based accounting standards can be very informative for national authorities with regard to potential benefits for informed decision making and sustainability in public sector finances.

Promoting change around the world

International organisations have a unique vantage point to assess global trends in the sphere of public sector accounting, financial management and good governance. The World Bank and IMF in particular play a key role in promoting and driving reforms at country level. Their own experience and longstanding relationships with governments allow them to function as impartial interlocutors, thereby also helping to familiarise governments with international public sector accounting standards (IPSAS).

Since the start of the global financial crisis, acknowledgement of the importance of good public financial management and accruals accounting has become increasingly widespread. The sovereign debt crisis in many countries has revealed the shortcomings of current public sector budgeting and accounting,

while the global dimension of the crisis has led to calls for a strong international response.

Six years have passed since the onset of the crisis and one can legitimately ask whether more progress should have been made to date. At a previous meeting of the discussion group, reference was made to shortcomings in public sector financial management being a “burning platform”: but is it burning enough to bring about change in the right time frame? What more can be done to move this agenda forward? It is also appropriate to consider whether confidence in the public sector has been restored since the financial crisis. There still appears to be a lot of ignorance of the true financial situation of states just as there was leading up to the financial crisis.

International organisations, in particular those providing loans to governments, have a strong interest in ensuring that governments act in a responsible and financially sustainable manner. And international organisations can act as drivers for change by strongly promoting the introduction of accruals accounting, internationally comparable data and greater transparency. This capacity to act is greater for certain international organisations than others; however, in all cases, the principal contribution is through the promotion of change. The capacity of international organisations to enforce change is weaker.

When seeking to move the agenda forward, the main approach of international organisations is to focus on communicating the benefits which can be achieved when the full cycle of reform is pursued. Better accounting and reporting by governments leads to better information and decision making and in turn this can deliver more sustainable use of public sector resources. Each year the World Bank and IMF hold a joint meeting (known as the “Annual Meetings”) and in October this year there will be a seminar devoted specifically to fiscal transparency and government accounting. This provides a unique opportunity to bring together experts from across the globe to discuss the benefits and challenges of openness in pursuit of economic development. In addition, the OECD has been hosting an annual public sector accruals symposium for more than a decade.

In many countries, enhancing governance and transparency is essential to fighting poverty and to tackling corruption and misspending. Transparency plays a decisive role in driving compliance with agreed financial management standards. The World Bank’s Open Data Initiative is an innovative way to help drive change. It aims to encourage citizens on the ground to report misuse of financial resources, via social media tools. Innovation is also needed in other areas. For example, at the moment, audits can be seen as a “blunt instrument”. There would be benefits from expanding the traditional scope when auditing projects; it will help donors to better understand whether money has been spent as intended.

Leading by example and disseminating experience

International organisations can also lead by example through their own accounting, financial management and governance practices. There is significant experience across these organisations to draw insights that can enrich certain aspects of the current debate in the EU.

Overall, the experience of a range of international organisations indicates that switching to IPSAS has provided them with a far clearer picture of their financial situation. However, the paths taken towards reform have differed considerably between the organisations.

In the case of the European Commission, reform was initiated over 10 years ago. At the time, there was a high degree of public and political discontent. This constituted a real driver for change which sustained reform efforts over subsequent years. This in turn raises the question as to whether a “scandal” or “crisis” is a pre-requisite to initiate real change among member states – or at least whether this can also help set in motion other important drivers for change.

From the experience of other international organisations, it is evident that engagement with the users of the financial information is a critical element. In one example, the users – members of the international organisations – were very clear at the outset about their needs and what the benefits of moving away from cash-based accounts were. This led to a reform process that was user-driven, with appropriate resources deployed to training. When moving to IPSAS, the organisation invested to familiarise employees with the new rules and simultaneously switched to integrated accounts. It did so on the basis that the initial investment would deliver returns in the future.

In other cases, the process of generating greater ‘user interest’ and understanding within an organisation of the need for accruals-based accounting has taken more time. This underlines the importance of initiating capacity building in human resources at the earliest stage possible, recognising that it is probably the most important single issue when moving away from traditional cash-accounts.

While achieving general awareness within an organisation is in itself an important step forward, it is far from the complete answer. Experience shows that there can often be an inappropriate assumption that application of accruals accounting automatically results in good financial management. The experience of international organisations shows that there is a need to ensure an appropriate link between accruals-based accounting and overall financial management, including budgeting. In this context, it is therefore important not to ‘oversell’ the benefits of IPSAS, but to be clear on how the implementation of these standards fits into the wider financial management system.

The experience of international organisations can therefore be very informative for national authorities with regard to the benefits and challenges of

adopting IPSASs and other accruals-based standards. International organisations can work hand-in-hand with the accounting profession and other stakeholders, to successfully promote reform within countries. They can also help generate understanding of the range of complementary measures and policy tools which are needed alongside accruals-based accounting in order to achieve a more accessible and transparent financial architecture, key to achieving more sustainable public sector finances

While there is much to draw on from the experience of international organisations, it is also the case that national governments present some unique challenges. National governments are generally focused on national specificities and are often reluctant to replace often long standing national standards and practices. The financial amounts involved are also considerably larger for countries compared to international organisations, even the largest ones. Budgeting systems may also in some cases be seen as an obstacle or an additional challenge to the introduction of IPSAS or accruals accounting at country level. There are grounds for thinking however that the major issue here does not relate to accounting matters; it is rather the actual nature of the interaction between elected politicians and electorates which predominates in most countries when discussing public sector finances. In a sense, public sector budgets are not actual forecasts, but 'contracts' between politicians and the electorate. In the contractual negotiations, so to speak, a higher level of transparency would certainly help and accruals-based accounting can provide the information required for this transparency.

What direction for the EU on public sector standards and oversight?

Figures are an important instrument to tackle financial mismanagement, but it is important to realize that there is real life behind the figures.

Standard setting in Europe and the world

The question of what direction the EU will take in relation to public sector standards and oversight is highly topical – and no doubt will remain so through the course of 2013 and into the next EU legislative term. As outlined in the Eurostat report in May, assessing the suitability of international public sector standards, there are distinct benefits for member states in moving towards accruals-based accounting standards. There is also a broader need in economic governance terms for more consistent and comparable public sector finances in the EU which would generate greater confidence in relation to member states' assets and liabilities. The key question is how the EU can make real progress in this direction.

Discussion is already concentrating to a considerable degree on the standard setting process, governance

arrangements around this process, and specific standards to be used. The debate can variously be defined, depending on perspectives, as the debate over the introduction of IPSAS in Europe or as the debate over the development of European Public Sector Accounting Standards (EPSAS), using IPSAS as a starting point.

Meanwhile, an important review is being undertaken at international level with regard to the governance of IPSASB – the Board responsible for developing the IPSAS. The intention is to take the views of stakeholders into account and put in place an effective governance system which will further enhance confidence in the standard setting process.

Eurostat is also continuing its efforts and liaison with European stakeholders within the framework set out following the publication of its report in May, pursuing the same goal of more transparency and improved government accounting. Initial parameters are also set out for a distinct EPSAS project. This is said to tackle governance and oversight issues in the EU, the need for legislative measures and also specific concerns regarding standards.

The extent to which EPSAS should be based on IPSAS is a point of discussion. The discussion raised broader questions regarding the desired inputs and outputs of the standard setting process and the relationship between accounting standards and broader public sector finance issues. For example, existing literature on the necessary conditions for achieving legitimacy in standard setting demonstrate that the output of high quality standards alone is not sufficient to secure buy-in. It is also important to consider the range of inputs and the procedure through which standard setting is organised. A key question in this respect regards independence: to what degree should governments be directly involved in setting standards for their own transparency and reporting?

This broad debate underlines the common misconception that accounting is a science: in fact, accounting is an art. The main purpose is to achieve a true and fair view. The debate on public sector accounting demonstrates how intricate an art form accounting can be. Ultimately what counts is the degree of financial transparency and comparability achieved. What is most important is that the final outcome will equip the EU with better financial reporting in the public sector. Any arguments to deviate from accruals-accounting should be assessed against the main purpose of accounting; whether a true and fair picture is given.

Member States and citizens in the debate

Financial management shortcomings have been felt most acutely by those EU member states which have experienced the worst of the crisis. It can be argued that some of the more affluent member states have not experienced a sufficiently severe crisis to date to drive reform. However, there are encouraging signs that public sector accounting is assuming increasing

political importance; this political momentum should be seized. Some member states which have been opposed to any form of EU standardisation in relation to public sector finances preferring to preserve cash-based accounts, have recently made cautious moves in the direction of a more EU-wide solution. In Germany, for instance, the federal parliament has issued a cautiously supportive note asking the federal government to actively participate in the development of EPSAS.

This move is to be welcomed, but equally it is recognised that elected politicians will have little incentive to introduce reforms and follow through with related improvements to the overall financial management process if there are no other strong drivers. The experience of the private sector, where the EU has achieved significant change over the last 10 years, is that an external requirement is needed. Without an external push, it is possible that the desired changes will not be introduced in the public sector, or that they will take a very long time.

Consideration is needed therefore of what other drivers must be in place to achieve change. The concern is that citizens currently do not demonstrate sufficient interest in these issues – which may be somewhat surprising given the backdrop of the economic problems in many countries. Many countries around the world receive qualified opinions from their supreme audit institutions but this does not appear to generate real attention on the part of the taxpayer. One of the most urgent challenges, therefore, is to enhance citizens' understanding and interest in their governments' spending and accounting. Without interested and informed citizens, it will be difficult to hold governments accountable for their financial decisions. Under concerted democratic pressure politicians will be incentivised to act in line with the principles of sustainability and responsibility. And to do this, every politician needs an accounting officer standing closely behind. However, having the best accounting standards in place is insufficient if citizens are not able to understand the language used in financial reports. Publishing abridged financial summaries or 'highlight reports' could facilitate access and generate interest.

Some governments have made great strides in this respect. For instance, New Zealand's auditor general publishes a report on the state of public finances at the beginning of each election period. This allows politicians and citizens to get a sense of what is financially feasible and what is not. This is only one example of the merits of a clear and understandable communication approach, which helps avoid overpromising and generating false expectations.

A number of additional key questions arise within the current EU debate on which path to take. They relate to the way in which the EU currently compiles data and whether it makes sense to continue to have government finance statistics (GFS). Would a complimentary hybrid-system of GFS and EU finance statistics be of added-value? If such a hybrid

system was in place, it will be important to avoid conflicting messages and to avoid unnecessary misunderstandings.

The debate over standards also raises questions as to whether EU member states can move towards accruals accounting without also implementing accruals-based budgets. For now, many member states prefer cash-based budgets. This is the case for the EU budget itself, managed by the European Commission. A separate note is included in the EU 2012 annual accounts for the payment of some EU short-term liabilities and liabilities for pensions, which are beyond the cash-based annual budgetary framework.

In some member states, such as France, accruals accounting has a long tradition dating back to 1962. This legacy was extended over a decade ago when the decision was taken that the French central government should apply accrual accounting (achieved in 2006). However, its budgeting figures are prepared on different bases and subsequently reconciled.

International financial markets and public sector reform

Financial markets can play a key driving role in the reforms needed in Europe today by adding a strong corrective voice to the discussion

Public and private: growing inter-dependence

The crisis in Europe has starkly demonstrated the clear interdependence between public sector finances and international financial markets. The various bail-outs and related financial operations which have taken place underline the serious repercussions which occur when international financial markets lack confidence in national governments' capacity to achieve sustainable public finances.

Governments raise debt in a similar way to how private companies finance their operations. The issuance of government bonds, however, significantly exceeds those of private companies. National governments are major actors on international financial markets.

Consequently, it is entirely appropriate for the same demands for high quality information to be placed on public sector reporting as is the case for private sector reporting. It is also appropriate for investors to hold governments accountable to the same extent as private sector entities are held accountable. As public sector securities directly compete against each other on the international financial markets, sufficient transparency of reporting between countries is required to enable investors to compare public sector financial management and performance. In considering what more could be done to address shortcomings in public sector accounting and reporting, greater engagement of international financial markets as one driver of reform would be highly beneficial.

International financial markets exercise a corrective function vis-à-vis governments, with the interest rates for government bonds being a useful indicator for trust in a country's ability to repay and refinance its debts. However, there seems to be some reluctance by private financial institutions to assume a more proactive role as a driver of reform in the underlying public sector accounting and financial reporting. This apparent reluctance may derive from broader considerations reflecting the relationship between financial institutions and their national authorities and regulators. No-one wants to 'go up against the boss', after all. This being said, should there continue to be insufficient drivers to achieve reform in the right time frame, financial markets may again need to face up to similar problems around a loss of confidence in public sector reporting and the impact this may have for holders of sovereign bonds.

Restoring trust and confidence

Important steps have been taken within the EU, recognising the major component of international financial markets represented by the issuance and trading of sovereign bonds. The European Financial Stability Facility (EFSF) was a child of the economic crisis, established as a temporary private company under Luxembourg law in June 2010 as financial markets were putting significant pressures on Eurozone governments. The EFSF was a first attempt to restore confidence in markets and in sovereign bonds. In setting up the new body, it was critical to implement strong reporting standards which would generate trust among investors. The EFSF had a blank sheet to create a new type of institution, and had to address a number of key operational and financial questions. The decision to apply International Financial Reporting Standards (IFRS) was regarded as the most appropriate way to report back to stakeholders.

The decision to adopt a private company architecture for a public sector institution reflects an increasing desire by market actors to have clearer and more understandable financial reporting by public entities. This should improve scrutiny of balance sheets and help restore confidence in sovereign states on the international markets. The EU needs to continue to address this 'trust issue' in order to find the way out of this crisis.

Similar market preferences also influenced the establishment of the European Stability Mechanism (ESM) about a year ago. The ESM is an intergovernmental institution under international law; the aim has again been to set up an institution that could easily be understood by financial markets. International financial markets played an important role in shaping the current design of the ESM.

The ESM is testimony to the determination to underpin confidence in Eurozone by establishing what might be referred to a "backstop" designed to restore confidence which otherwise individual countries under financial stress would not be able to instil. Over the longer-term,

however, the key test is whether more states really do move to sustainable public finances management, on which the confidence of financial markets will ultimately depend.

KEY OBSERVATIONS AND CONCLUSIONS

- 1** International organisations have a wealth of insights that can help the current debate taking place in the EU on reform of public sector accounting and broader public sector management. Their global perspective on country reform efforts as well as their own experiences of implementing accounting and management reforms can be highly instructive. Seen from a global level, it is clear that lessons still need to be learnt and reform measures implemented. To some degree, this may reflect the fact that the crisis has not been sufficiently severe across Europe as a whole to inject a sense of urgency. The risk is that change will not be pursued speedily enough. To encourage change, the drivers of reform need to be clearly identified. This will also require the interaction between elected politicians and citizens to be based on a more informed understanding of existing and longer-term financial realities. It is also important to communicate the benefits of reform more broadly – emphasising the positive experiences which have already been achieved by international organisations and individual countries.
 - 2** The debate in the EU over which path to take to harmonise public sector accounting standards is becoming more prominent, not only thanks to the work of Eurostat but also in individual member states. This debate will undoubtedly focus on governance structures and legal issues, in a manner similar to that witnessed during the approval of reform of private sector accounting. In this regard, the forthcoming consultation on the governance of IPSAS assumes particular importance with eventual conclusions providing useful input into the EU debate. But it is also important to ensure that the debate pays attention to the “real life” picture. Standards must provide the most appropriate starting point for those charged with decision making in the public sector to make informed decisions regarding the longer-term sustainability of their national finances. The most important test will be whether standards provide the information needed for such decision-making.
 - 3** International financial markets have a key role to play in contributing to the pressure for reform of public sector accounting and reporting. International financial markets have a major stake, given the extent of bond issuance by governments – which outstrips many times that of private companies. To date, markets have tended not to engage directly on issues relating to public sector accounting and reporting by individual countries or regions. They have however exerted their influence by clearly signalling a lack of confidence in the financial position of certain countries. Going forward, a more direct engagement by markets on the underlying financial management of countries could be beneficial, acting as a catalyst for reform. Together with an increased engagement by citizens as well as the efforts of interested stakeholders, markets can exercise an important influence to help achieve change in the right timeframe.
- “** The debate on public sector accounting demonstrates how intricate an art form accounting can be. Ultimately, however, it is the overall end game that counts in terms of the degree of financial transparency and comparability achieved. What is most important is that the final outcome will equip the EU with better financial reporting in the public sector.

APPENDIX: PARTICIPANTS

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