JOINT ICAEW-PWC SERIES ON SUSTAINABLE PUBLIC FINANCES – EU PERSPECTIVES

Government Accountability and Reporting: Citizens' Attitudes and Financial Markets Scrutiny

Summary of discussion on 9 December 2014, Brussels

Achieving sustainable EU public finances remains a matter of major public interest, as confirmed by recurring political debate and regular media headlines on national public debt levels and budgetary deficits.

Within the framework of the EU's efforts to enhance economic governance there is growing recognition of the importance of appropriate accounting and financial management in the public sector, as a key means of achieving sustainable public finances. The European Commission is expected to propose important new steps to move all member states in this direction. This follows Eurostat's preparatory work in 2013 and 2014 to highlight the shortcomings in public sector accounting and reporting in many member states and to begin discussion on harmonising standards on an accruals basis.

On 9 December 2014, ICAEW and PwC organised the fifth in a series of informal discussions to address particular issues within this overall policy sphere. The meeting brought together a senior group of decision-makers and stakeholders to exchange views on citizens' trust in public finances and financial markets scrutiny.

This brief summary seeks to capture the key elements of the discussion to encourage feedback and further development of the ideas raised. It aims to inform other key stakeholders who have an interest in the overarching theme of sustainable public finances in Europe and who may wish to contribute to the next discussions taking place in 2015.

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

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Next Discussions

ICAEW and PwC are continuing the discussion series 'Sustainable Public Finances - EU Perspectives' in 2015 and 2016.

Roundtables this year will focus on the following themes:

How can governments achieve more with less?

Why accounting is good for governments and citizens?

5 May 2015

Assurance as a driver of trust -

How can audit enhance confidence in public finances?

October 2015 (tbc)

Government accountability and reporting: citizens’ attitudes and financial markets scrutiny

> There is a clear case for governments to rethink the way they communicate financial information to citizens.

Citizens’ trust in public finances

In the context of anticipated policy developments at EU level aimed at enhancing public sector accounting and financial management among member states, the discussion on 9 December 2014 focused on how greater scrutiny can drive accountability. The debate centred on the critical role citizens, media and financial markets can play in holding governments to account for their financial decisions. Consideration was given to the role of key intermediaries, including the profession, and of communication intermediaries such as the media.

The debate was informed by the findings of a joint ICAEW-PwC survey of 10,000 people across 10 different EU member states.[1] The survey revealed limited awareness and understanding of public finances, and low levels of trust in governments’ handling of public finances across all genders and age groups. It also confirmed strong support for better planning and management of public spending.

Key findings

Trust in public finances: A survey of citizens in 10 European countries

- A majority of those surveyed struggle to assess and understand the state of public finances in their country.
- Only 1 in 5 Europeans have trust in their government’s ability to manage public finances.
- Countries with the highest levels of distrust are also the ones where there is greatest demand for information.
- There is a clear correlation between low levels of trust in governments’ financial management and lack of confidence in governments’ plans for financing core public services in the future.
- 8 in 10 Europeans believe that more can be done to ensure better value for money in how taxpayers’ money is spent.
- 7 in 10 want their governments to do more to reduce public debt.
- 2 in 3 want their government to improve the provision of comprehensible and transparent information.

1 The survey was conducted on a diversified sample of citizens in Sweden, Finland, the UK, the Netherlands, Belgium, Germany, Poland, France, Spain and Italy. A short summary of key findings set the scene for the further discussion.

Accountability, transparency and financial literacy

> Any off-balance sheet scheme is potentially a vehicle for putting financial burden on future generations.

Regaining citizens' trust

The economic and financial crisis severely challenged the trust held by European citizens in financial institutions and in their governments' finances. The ICAEW-PwC survey confirms the size of the challenge that continues to exist today for governments to regain that trust. When considering how they can do so, it is important to distinguish between, on the one hand, the provision of financial information by governments and, on the other, the level of citizens' trust. This analysis inevitably raises the question as to the degree to which financial information is understood and used by citizens, the media and the wider political and policy-making system.

We have to accept that it is unrealistic to expect that all citizens will want comprehensive information on their country's finances and that they will have a thorough understanding of the complex and often technical issues involved in national finances. Still, there appears to be a considerable gap to close in order to raise financial literacy among citizens to a level which is conducive to more informed public debate on public finances. The 'man on the street' is likely to struggle to define what a trillion is or to explain the difference between debt and deficit. However, as the survey confirms, there is significant appetite for better information on the state of public finances and this needs to be met. Recognition of the acute public interest dimension of government finances can, in itself, be an important driver for improving financial literacy.

It should also be acknowledged that financial literacy is not always at the expected level among politicians and policymakers, recognising that greater understanding should be required by those with decision-making responsibilities. Politicians and other policymakers are not always fully aware of the degree to which effective management decision-making relies on having relevant, comparable and high-quality information. A lack of such information, or a failure to use it to the full potential, necessarily reduces the effectiveness of decision-making. It ultimately also reduces the degree of accountability in public finances and makes it even more challenging to achieve sustainable public finances.

Enabling scrutiny

There is a clear case for many governments in Europe to reform the way they prepare, use and communicate financial information. Reform in this direction needs to be based on providing a true and fair view. It is widely recognised that accruals accounting is the most appropriate accounting basis for such a comprehensive picture of a country's financial position. Cash accounting is severely limited in comparison. Recognising long-term obligations, as well as long-term assets, provides a more accurate picture and also clear information as a basis for better decision making. Any off-balance sheet items are potential vehicles for putting financial burden on future generations. Reform can be challenging, even though the benefits in the longer term are clear. Greater transparency may raise critical short-term concerns, for example by disclosing larger liabilities in the balance sheet, but these should not be used as an excuse to avoid greater transparency.

If financial information is to facilitate scrutiny by citizens and enhance political accountability, it will need to take different forms, while retaining throughout the principles of a true and fair view. The scale and complexity of countries' public finances necessarily creates challenges in making information comprehensible and relevant. This makes it all the more important for governments, and in turn wider policymakers, media and other intermediaries to prepare information on public finances in terms which have relevance for daily lives. For example, aggregate national expenditure on healthcare, social services and pensions may appear inaccessibly high. Breaking down such figures into a 'per day' or 'per person' basis can help to illustrate relevance. This can encourage scrutiny and discussion on the basis of comparability.

Within Europe there are already some positive examples of national governments producing comprehensive information on public finances, as well as other national initiatives to assist debate on public sector budgeting and discussion among citizens on public finance issues. These individual experiences can be used as potential examples for Europe as a whole. In the UK, for instance, the publication of Whole of Government Accounts (WGA), based on International Financial Reporting Standards (IFRS) since 2011, has been an important step towards greater transparency. WGA is a consolidated set of accruals-based accounts covering around 3,800 public sector bodies; including central government, devolved administrations, the health service, local government and public corporations. Another important component and evolving actor in the UK system is the Office for Budget Responsibility (OBR), created in 2010 as an independent fiscal watchdog to provide impartial and authoritative analysis of the UK's public finances.

In recognition of the fact that comprehensive financial statements such as WGA will not be accessed or understood by the majority of citizens, other formats for presenting key information have been developed. Simplifying material and using plain language can help make information more intelligible for the wider public. As users' requirements may vary, tailored approaches to the provision of information are also important. Tailoring, however, must not impact the underlying principle of a true and fair view in the presentation of information. Integrity in this respect is critical. Irrespective of the efforts in presenting and communicating information, there is still a need for better financial education of users, and broader awareness among citizens of the relevance of public sector finances. The accountancy profession can support this broader education process. This is in addition to the profession's role in helping to ensure that the right skills are available and the appropriate structures are in place within the public sector to enable it to fulfil its role of preparer of financial information and manager of public funds.

The media plays a key role as intermediary between governments and citizens. Criticism is often made – and is often due – of the way in which public sector finances are presented by the media. This is most notable in relation to challenging deficits and debt levels. There can sometimes be a tendency for journalists to use selected information to tell a 'dramatic' story, rather than seeking to convey all relevant and available information which may result in a more nuanced picture. To achieve this, key actors, including the accountancy profession, may need to play a more prominent role in the communication sphere to help ensure that a true and fair view is given of public sector finances.

Improving public finances can be a long and often painful road. Particularly at times of economic stress, citizens rightly want to understand the reasons for cuts to public sector expenditure and for other austerity measures – and to be given a realistic picture of what the future may hold. The danger that citizens will feel alienated by policy decisions because they do not understand the reasons for reform is a real one. Acceptance of reform requires objective information as a basis of understanding and trust. In order for citizens to have this understanding and trust there is a need to accept liability and responsibility. In this sense, Europe faces as much a political 'trust' challenge as it does an economic challenge. European governments need to establish a new basis for citizens to regard sovereign debt as ultimately being the tax-payers debt. Tackling this requires a fundamental change by European governments to enable greater citizens' scrutiny of public sector finances. We should reflect on why some citizens predominantly speak of 'the public debt', whereas others refer to 'our public debt'. In order for citizens to engage appropriately and recognise that there is at least some common liability for 'our debt', a new approach is required.

The role of financial markets

Financial markets scrutiny

To date, key financial actors such as rating agencies and financial analysts seem to have paid limited attention to the underlying accounting standards used by governments. The nature of the interaction between government reporting and the allocation of market funds needs to be better understood.

Greater scrutiny of the underlying financial position of governments by financial markets could be a significant driver for greater government accountability. This in turn could be a driver for improvements in the management of the public sector finances. Although markets can react to changes in a country's (perceived or real) financial situation in widely divergent ways. They are important drivers of efficiency and can provide effective disciplinary mechanisms, where public finances are concerned. It is important, however, to recognise where the responsibility of financial markets starts and ends. There is a widespread, but mistaken, belief among many citizens and some stakeholder groups in Europe that the sovereign debt crisis was largely the fault of financial markets. This is a distortion. It is in the underlying financial situation of countries that the cause of the sovereign debt crisis is to be found. In such cases it is often easier to blame markets rather than accept that the fundamentals were wrong.

We may also have to accept the need to reconsider the key question in relation to the post crisis regulatory architecture and attitudes of banks in relation to risk-weighting. It is plainly not the case that bonds issued by different countries are the same, as the attitudes of investors within financial markets regularly demonstrate. This fact has an important bearing for how both banks and regulators will treat these assets.

The ability to accurately compare information on government financial statements could therefore give bond holders a clearer comparative basis for their investment decisions. Creditworthiness ultimately needs to reflect underlying financial fundamentals, based on a clear view of existing and future liabilities. At the moment, critical intermediaries and bond holders analyse many factors, for example, trade balances, the wider economic environment, as well as different institutional and political factors, including the functioning of the tax system. There appears to be an assumption that there is already a solid basis for analysing the underlying financial data of European countries. This may to some degree be due to the existence of the Maastricht criteria (a national budget deficit needs to be at or below 3% of GDP and public debt may not exceed 60% of GDP), and the surrounding institutional framework, which is seen as a key reference indicator of greater transparency. But the quality of the source data should also be looked at.

Harmonised accruals-based accounting and reporting according to best international practices across all European countries would provide bond holders with a more comprehensive, accurate and comparative picture. The analysis of macroeconomic indicators should be combined with a good understanding of a government's assets and liabilities. There are also clear benefits for financial management within the public sector, as accruals accounts allow decision-makers to measure the real cost of activities, programmes and public policies over time. Yet it is unclear to what extent financial markets appreciate the benefits of accruals accounting over cash accounting. Greater engagement of financial market actors in the debate on better government reporting would be helpful in aligning the interests of investors and bondholders in accurate and comparable financial information with that of citizens in ensuring more efficient scrutiny, accountability and management of the public purse.

Europe's reform and international perspectives

There is growing recognition in Europe that the comparability of national fiscal data is not fit for purpose in relation to the needs of EU (and eurozone) economic governance. Some governments provide data based on cash accounting and others based on accruals. There are other major differences which also require further attention.

In the first place, there are questions about the standards used – and how they are set and implemented. While there are examples in Europe of international best practice for accruals, the overall picture is nuanced. Secondly, there are critical questions regarding the scope of consolidation: the degrees to which member states include the whole panoply of different structures (including regional and local tiers, state owned entities, joint ventures with private interests, etc.) in their accounting and reporting. Thirdly, there is also a major question about the degree of assurance on the financial information, recognising that third party assurance is a key element in ensuring objectivity and robustness in the accounting and reporting.

All three elements are critical: it is not possible to miss one out, as one element cannot replace or compensate for the absence of the others. There is more recognition today of the importance of appropriate accounting standards, which indicates important progress. The question of consolidation is a tricky one, given the considerable dimension of state economic interests in companies and other initiatives (such as public-private partnerships), with a strong 'temptation' to leave items off balance sheet. We need a consistent approach to consolidation across Europe. The question of independent assurance will also require significant attention, in order to ensure that the economic governance of Europe as a whole is strengthened.

It is in this overall context that the major policy debate at EU level over public sector accounting and reform, led by Eurostat, will take place. An overriding 'political' question in the debate will relate to the degree to which standards and rules across Europe should be harmonised. This question will manifest itself in many ways, but from a technical perspective focused on the provision of the most accurate and comprehensive picture of public sector finances, it is indisputable that accrual accounting must be in place for all. The debate will doubtless include many different contributions on how to achieve this, but there should be no deviation from the fact, as already recognised for private sector companies, that accruals accounting, unlike cash accounting, provides the most comprehensive picture and reflects the true long-term implications of political decisions.

The international nature of capital markets makes enhanced financial transparency and comparability a global concern. Europe's debate on better public sector accounting needs to be seen within this international context. At the recent World Congress of Accountants in Rome, accounting professionals from developing countries stressed the benefits of international standards for all. Developing countries are often required by the donor community to use such standards. A European deviation from international standards would send out a discouraging signal. Furthermore, using reporting in line with best international practices would reinforce the credibility of government financial statements on international markets.

Europe can also learn from best international practice, for example, looking to see how non-EU countries have achieved a better understanding of the correlation between public sector accounting reform and sovereign debt and deficit reduction.

A country like New Zealand has a longstanding tradition of accrual-based accounting and budgeting, associated with a high degree of transparency towards the public. The interest of the citizens for sound public finances has in certain circumstances influenced the political debate.

The experience of EU member states, along with others such as New Zealand who have already invested in change, can help inform the EU's reform path. Steps towards increasing recognition of all citizens and stakeholders that 'the debt' is actually 'our debt' may be very challenging in the short term, but equally they would be key steps towards sustainable public finances over the medium and long term.

> European governments need to establish a new basis for citizens to regard sovereign debt as ultimately being the tax-payers debt.

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