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Developing a Government's balance sheet – does it improve performance?

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Outline

- Development of Government Accounting
 - Development of the Balance Sheet
- Issues in making use of the Balance Sheet
 - Public Choice, Macroeconomics, Behavioural Economics
- A value proposition for the Govt Balance Sheet
 - Reducing uncertainty in the management of public finances
- Practically improving performance
 - Financing, Investing and Social performance

Development of Government Accounting

- Separate the money of the king or ruler from public money.
- Consolidate the management and accounting for public money in a central Treasury, open to scrutiny by the legislature

Development of Government Accounting



A Government Balance Sheet (New Zealand's)

Liabilities and Equity	\$ B	Assets	\$ B
Payables	8	Cash	9
Employee Entitlements	10	Liquid Investments	54
Insurance Obligations	28	Debtors	18
Provisions and other	6	Advances	19
Debt	85	Property Plant & Equipment	115
Net Worth (Equity)	93	Other Assets	15
Total	230	Total	230

- Distrust of balance sheet information (public choice theory)
- Disinterest in balance sheet information (macroeconomic theory)
- Low value placed on balance sheet information (decision theory)

Public choice theory

- Looks at Governments from the perspective of politicians and bureaucrats
- They act rationally
- They avoid constraints
- Transparency represents a constraint
- $\blacksquare \rightarrow$ Politicians and Bureaucrats suspicious

Public Choice theory in action



Macroeconomics

"What is the magnitude of the contribution that balance sheet management could make to economic welfare?"

- Ricardian equivalence
- Fiscal shock absorber
- Structural Impact on Economy
- Economic efficiency

 Confidence in knowledge (overconfidence?)

 Willingness to engage with new information?

Pop Quiz

- 1. What does the S in INTOSAI stand for?
- 2. Which country had the highest level of central govt debt to GDP in 2008 Greece or Japan?
- 3. Did the NZ Government produce its first audited accrual financial statements in 1992, 1994 or 1996?
- 4. Who is the current US Secretary to the Treasury; Hank Paulson or Tim Geithner?
- **5**. What does the acronym PPP stand for?

Pop Quiz

- 6. Which comes first, the IAS on intangibles or the standard on provisions and contingent liabilities.
- 7. Does the A in FRAB stand for Accounting or Advisory?
- 8. Which current member of IPSASB is based in London Ian Carruthers or Mike Hathorn?
- Was the UK public sector net debt (excluding the temporary effects of financial interventions) at 31 Dec 2010 49.3%, 59.3%, or 69.3% of GDP?

10. Is Balmoral Castle on the UK Whole-of-Government Balance Sheet?

Subjective Probabilities: A Skill

- This is the aggregate of 11 studies in how well people subjectively assess odds
- The overwhelming evidence is that everyone is systematically "overconfident" when assessing probabilities
- Fortunately, training and other calibration techniques exist that adjust for this effect

Assessed Chance Of Being Correct

- Distrust of balance sheet information (public choice theory)
- Disinterest in balance sheet information (macroeconomic theory)
- Low value placed on balance sheet information (decision theory)

Accounting Framework

Information has Value if it is relevant

Relevance comes from Feedback Value
Feedback is about confirming or amending views of what has happened

 Relevance comes from Predictive Value
Predictive value is about confirming or amending views of what will happen

The Value of Information

$$EVI = \sum_{i=1}^{k} p(\mathbf{r}_{i}) \max \left[\sum_{j=1}^{z} V_{1,j} p(\mathbf{\Theta}_{j} | \mathbf{r}_{i}), \sum_{j=1}^{z} V_{2,j} p(\mathbf{\Theta}_{j} | \mathbf{r}_{i}), \dots, \sum_{j=1}^{z} V_{1,j} p(\mathbf{\Theta}_{j} | \mathbf{r}_{i}), \right] - EV^{*}$$

The formula for the value of information has been around for almost 60 years. It is widely used in many parts of industry and government as part of the "decision analysis" methods – but still mostly unheard of in the parts of business where it might do the most good.

Douglas W Hubbard

What it means:

- 1. Information reduces uncertainty
- 2. Reduced uncertainty improves decisions
- 3. Improved decisions have observable consequences with measurable value

A value proposition for the Government Balance Sheet:

Government balance sheets reduce uncertainty in the management of public finances

Objectives for Balance Sheet

Management of Financing Activity

- providing a buffer against adverse future events (liquidity and flexibility), and supporting (partial) tax smoothing
- supporting fiscal policy by managing and reducing risks to the Crown's finances
- maintaining a satisfactory credit rating and a low overall cost of capital

Management of Commercial Activity

 ensuring that long-term value is created and maintained for taxpayers

Management of Social Activity

ensuring that domestic resources are effectively employed

Differing Objectives for different components of balance sheet

New Zealand Classification	Proposed IASB Classification	Govt Finance Statistics Classification
Social	Operating	General Government
Commercial	Investing	Public Corporations
Financing	Financing	Financial Institutions

Debt Management

Market risk: Impact of interest rate and foreign exchange rate on portfolio value. NZDMO measures market risk using Value at Risk (VaR). VaR is maintained in both tactical and quasi-tactical portfolios at less than 10% of the overall monthly VaR Limit (\$14m) approved by the Minister of Finance

Commercial Management

Dividend yields of large Crown companies and NZX (stock exchange) companies

Management of Social Resources

Value Metrics

- Utilisation
- Capability / Condition
- Acknowledging the Cost of Capital
- In making lease/make/buy decisions
- In setting user charges

Long Term Planning

Aggregate capital expenditure intentions not yet sufficiently moved by fiscal position

Comparison of surveys over last three years reveals little change in aggregate affordability (\$9 billion gap)

Are we getting best value from spend on major ICT projects?

May need to put more pressure on ICT investments to transform services and generate fiscal benefits

Conclusion

- Government balance sheets reduce uncertainty in the management of public finances
- Achieving this benefit requires that the fear, apathy and overconfidence that can otherwise stunt public sector performance is overcome.
- Using the Balance Sheet is still in its early stages
- Development work still needed for academics, standard setters, auditors, preparers and users
- Benefits already apparent in better targeted and better utilised social resources, more businesslike commercial operations, and more tightly managed financing