The Benefits to Portugal of Implementing the “New Zealand Model” of Public Financial Management: Balance Sheet Insights

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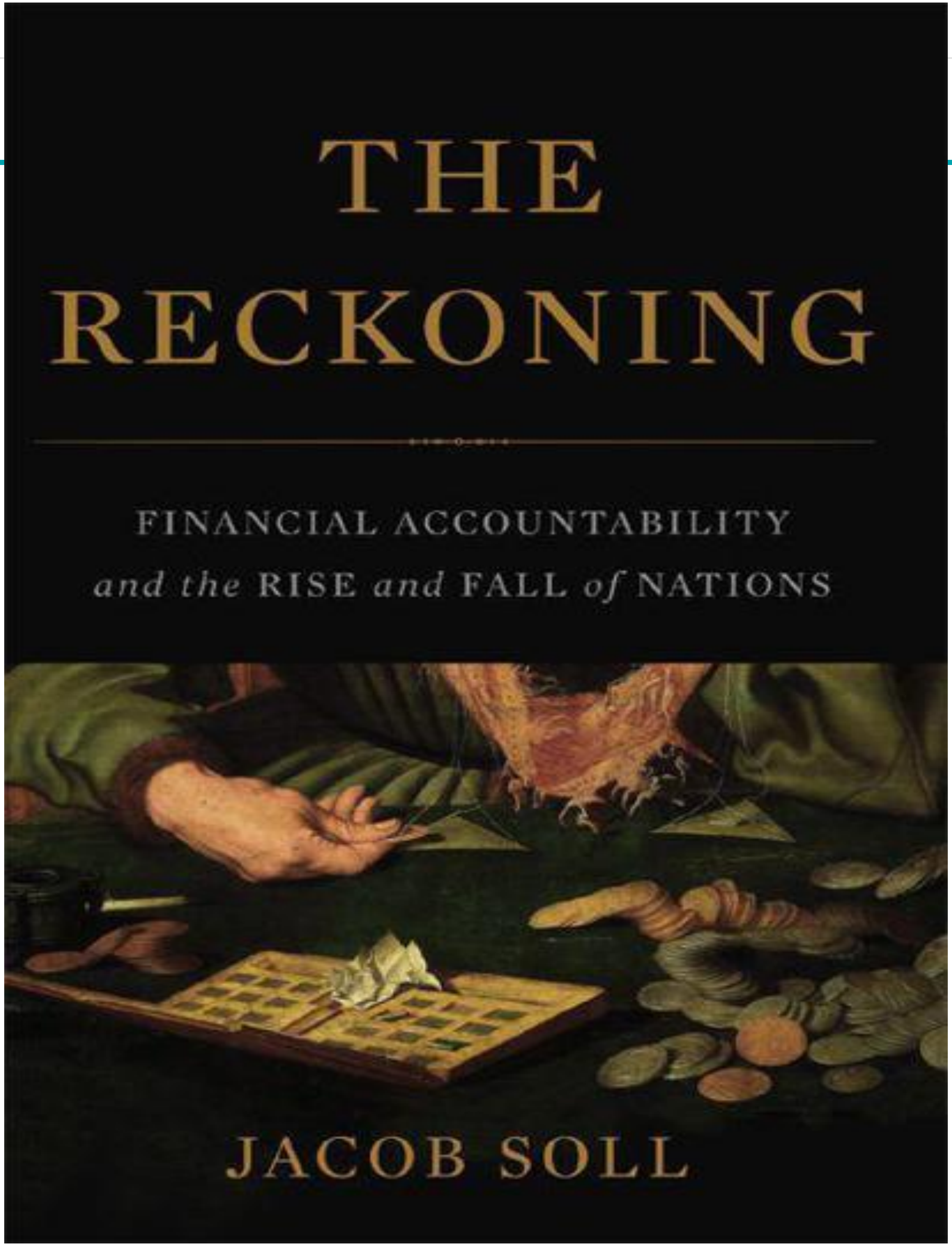
THE
RECKONING
FINANCIAL ACCOUNTABILITY
and the RISE and FALL of NATIONS
JACOB SOLL

It is Essential that Governments Use Change in Net Worth (also known as Taxpayers' Equity) as a Fiscal Objective in Decision-Making and Performance Assessment

Total Assets [-] Total Liabilities = Net Worth

(Governments do have a net worth, which is a measure of Taxpayers' Equity, and it changes over time.)

- Net Worth definition is Total Assets minus Total Liabilities.
- All entities have a Net Worth including governments.
- Government Net Worth is also known as Taxpayers' Equity.
- Government Net Worth and changes in Net Worth are much more robust numbers than the single balance sheet line item of debt.

What are the Traits of Government Consolidated Financial Statements?

"Functional Areas"

	Financial Performance	Risk
Knowledge *(Stage 1)*	To have true and fair **internationally comparable knowledge of government financial performance**, the balance sheet, the supporting consolidated financial statements, and notes are the starting point for decision-making and accountability.	The balance sheet at the core of consolidated financial statements provides **standardized and quantified knowledge of risks** (especially large, complex, and expanding liabilities) and helps expose masking of financial risks.
Management *(Stage 2)*	Capable management using three balance sheet related decision-making tools (T-accounts, financial statements, and performance gaps) **can improve financial performance and changes in net worth, and minimize errant decisions**.	Early risk management of potential asset impairment or opaque liabilities is an effective process to **reduce costs by limiting or avoiding the materialization of these risks and strengthens accountability**.

In Absence of Portugal General Government Balance Sheet, a Working Draft Estimate of Over €700 Billion in Total Assets and Liabilities

(€, Billions; as of 31 December 2015)

Balance sheet Item	Amount	% of Total Assets and Liabilities	% of GDP
Financial Assets	€ 66	9%	37%
Non-Financial Assets	€ 145	20%	81%
Total Assets	**€ 211**	**29%**	**118%**
Financial Liabilities	€ 208	29%	116%
Non-Financial Liabilities	€ 304	42%	169%
Total Liabilities	**€ 512**	**71%**	**285%**
Net Worth	**€ -301**	**-42%**	**-168%**
Total Assets and Liabilities	**€ 723**	**100%**	
GDP	**€ 179**		

Notes: Working draft balance sheet is an illustrative best estimate prepared under the direction of the working group based on IMF, EC, and Eurostat data. Assumes 10% increase in NFA and 33% increase in pension liabilities from 2012 to 2015.

Eurostat: Portugal General Government Financial Assets - Year-End 2015

(€, Millions)

Balance Sheet Item	Consolidated	% of GDP	Non-Consolidated	% of GDP
Currency and deposits	€18.178	10%	€28.431	16%
Short-term debt securities	€137	0,1%	€1.051	0,6%
Long-term debt securities	€3.273	2%	€20.138	11%
Short-term - Loans	€472	0,3%	€2.836	2%
Long-term - Loans	€8.942	5%	€36.833	21%
Listed shares	€900	0,5%	€900	0,5%
Unlisted shares	€11.960	7%	€10.591	6%
Other equity	€17.127	10%	€17.127	10%
Investment fund shares/ units	€2.768	2%	€2.776	2%
Insurance, pensions and stand. guar.	€18	0,0%	€18	0,0%
Fin. Deriv. and empl. stock options	€2.538	1%	€2.538	1%
Total Financial Assets	**€66.314**	**37%**	**€123.239**	**69%**
GDP	**€179,379**			

Notes: Financial assets data from Eurostat (excludes accounts receivable); GDP from EC AMECO database; accessed 18 October 2016.

Portugal and Peer Balance Sheet Debt and Net Debt (IPSAS/IFRS): 2016

(€, Billions)

Working Draft Estimate

Balance Sheet Item	Portugal	Cyprus	Greece	Ireland	Italy	Spain
Balance Sheet Debt	€219	€16	€132	€189	€2,219	€1,094
Financial Assets	€73	€7	€48	€75	€339	€312
Balance Sheet Net Debt	**€146**	**€8**	**€84**	**€114**	**€1,880**	**€782**
GDP	€185	€18	€176	€266	€1,671	€1,115
Balance Sheet Debt / GDP	119%	88%	75%	71%	133%	98%
Financial Assets / GDP	40%	41%	27%	28%	20%	28%
Balance Sheet Net Debt/ GDP	**79%**	**47%**	**48%**	**43%**	**113%**	**70%**
Future Value of Debt	€241	€19	€317	€200	€2,219	€1,112
Future Value / GDP	**131%**	**108%**	**180%**	**75%**	**133%**	**100%**

Notes: Financial assets estimates based on Eurostat data (excludes accounts receivable); GDP and Future Value of Debt from EC AMECO database; accessed 13 February 2017.

(Working Draft)

Working Draft Estimate Portugal Balance Sheet GDP Value Created/Lost Ratio and ROA: 2012 – 2015

(€, Billions)

Balance Sheet Item	2012	2015	€ Change	% Change
Total Assets	**€207**	**€211**	**€4**	**2%**
Total Liabilities	**€433**	**€512**	**€79**	**18%**
Net Worth	**-€226**	**-€301**	**-€75**	**-33%**
GDP	**€168**	**€179**	**€11**	**6%**

GDP Value Created/Lost Ratio *(Change in GDP +/- Change in NW) / GDP (Latest)*	**-36%**
GDP Value Created/Lost Ratio (Annualized) *(Change in GDP +/- Change in NW) / GDP (Latest) / Number of Years*	**-11.9%**
Return on Assets (ROA) *Change in Net Worth / Total Assets (Latest) / Number of Years*	**-11.8%**

Notes: Working draft balance sheet prepared under the direction of the working group. GDP Value Created/Lost Ratio is cumulative over the period; Return on Assets annualized due to data limitations.

Performance Gap Framework: Portugal Summary Fiscal Objectives

(€, Billions)

		GDP Value Created/Lost Ratio				Return on Assets	
SN	Balance Sheet Item	Ratio	NW Increase	GDP Increase	Value Created/ Lost	Ratio	Net Worth Change
1	Portugal (Estimated)	-11.9%	-€25	€4	-€21	-11.8%	-€25
2	Portugal at New Zealand Benchmark	5%			€9	2%	€4
3	Performance Gap	17%			€30	14%	€29
4	GDP (2015)				€179		€179
5	**Performance GAP % of GDP**				**17%**		**16%**

Notes: Working draft estimates prepared under the direction of the Working Group. 2015 GDP of €179.4 billion (EC AMECO accessed 15 October 2016). Portugal ratios based on 2012-2015 estimates. Benchmark (New Zealand) Ratios based on 2005-2015 data. Benchmark Value Created and Net Worth Change calculated by applying Benchmark (New Zealand) Ratios to Portugal GDP and Total Assets respectively.

EU Member State Total Expenditures Average 46% of GDP

#	Country	Total Expenditure % of GDP
1	Finland	58%
2	France	57%
3	Denmark	56%
4	Greece	55%
5	Belgium	54%
6	Austria	52%
7	Hungary	51%
8	Italy	51%
9	Sweden	50%
10	**Portugal**	**48%**
11	Slovenia	48%
12	Croatia	47%
13	Slovakia	46%
14	Netherlands	45%

#	Country	Total Expenditure % of GDP
15	Germany	44%
16	Malta	43%
17	Spain	43%
18	United Kingdom	43%
19	Czech Republic	43%
20	Luxembourg	42%
21	Poland	41%
22	Bulgaria	40%
23	Cyprus	40%
24	Estonia	40%
25	Latvia	37%
26	Romania	36%
27	Ireland	35%
28	Lithuania	35%
	Average	**46%**

Source: EC AMECO database; 2015 data (5 July 2016).

Government Balance Sheet Status in the EU

- Consolidated balance sheets are the exception not the rule.
- Single-entry accounting (in contrast to double-entry) is the most common.
- Knowledge and use of consolidated financial statements as a management tool to improve performance and minimize risk is almost non-existent.
- Limited management capability exists to realize better balance sheet performance.
- Significant performance gaps exist between potential balance sheet performance and current status.

Rationale for Using Accrual Accounting For All Functions of Government

Decision-making, fiscal objectives, budgeting, appropriations, reporting, and external audit on an IPSAS accrual basis means that the Government's financial management system:

1. Reflects economic reality in a more complete and relevant manner than using cash numbers, enabling better fiscal and management decision-making;
2. Ensures that the six major components of the "New Zealand Model" PFM system are based on the same concept of resources and their stocks and flows, meaning the system is coherent and integrated, and the six components are mutually reinforcing;
3. Creates correct and consistent incentives for managers – avoiding the negative consequences of budgeting and/or appropriating on a cash basis and reporting on an accrual basis; and
4. Enables better accountability of the Government to the Parliament and the electorate, enhancing trust and confidence.

The Need to Go Back to the Foundations of Accounting

In order to improve knowledge of financial performance and risk, governments should make use of the key accounting principles:

1. Accrual rather than cash.
2. Double entry rather than single entry autonomous ledgers.
3. International accounting standards (applied properly) to reflect economic reality rather than politically determined rules.
4. Independent audit of financial statements under international rules rather than expense audits.
5. Used during decision-making and reporting rather than reporting only.

The Status Quo: Destructive Populism

- Governments see cooking the books after the outcome as the goal, rather than better financial management.
- Fictional fabrication of government numbers is the norm.
- Media, many think tanks, rating agencies, and mainstream economists have a counter-productive understanding of international accounting standards and economic reality.
- Citizens have almost zero education in understanding a balance sheet, their own or their government’s.

The Alternative: Effective Management and Communication of Government Balance Sheets Prepared in Accordance with International Accounting Standards (IPSAS)

The Focus on Headline Debt (FV) and Cash Deficits Cultivates Destructive Short-Termism and Misleading Reporting Schemes: Examples

- Focus on debt at future value (FV) and cash balances are two of the most easily manipulated financial numbers.
- Focus on FV ignores changes in Taxpayers' Equity, which is vastly more meaningful.
- Focus on FV and cash increases pressure to sell government assets rather than increase value through better management.
- Focus on cash balances increases pressure to spend more money on vote buying (consumption) and less on capital expenditures (e.g., infrastructure).

Market Forces Profit from Volatility and Risk Assessment Swings

Hedge Funds

- Increases trading profits
- Increases frequency of trading
- Create relational profit anomalies
- Improves CDS profit opportunities

Investment Banks

- Wider bid-ask spreads
- Increases the price of liquidity
- Increases trading commissions

Media

- Volatility sells papers and generates profitable internet activity

Portugal Background Observations: Findings

Uniquely Positive Findings:

1. Portugal has a rich culture of respect for accounting and accountability.
2. Portugal has one of - if not the - highest per capita number of certified public accountants according to international standards in the world.
3. Medium and small enterprises use IFRS-based accounting and micro enterprises use IFRS-simplified.
4. There is a public information campaign to educate citizens on the importance of the "New Zealand Model" of PFM.

Challenging Findings:

1. No discussion of balance sheet, other than future value of debt.
2. Little to no discussion of assets or non-financial liability management other than cash.
3. No discussion of status and plans of financial controls and processes.
4. No discussion of government human capital management or professional team and skills building.
5. Very little discussion of efforts to improve government financial transparency to win the trust and confidence of all key stakeholders, including voters.
6. No disclosure of government's Taxpayers' Equity, annual changes, or impact of the government's largest financial decisions (e.g., €500 million plus decisions).

Global Leaders' Advice to Portugal on Public Financial Management

Ian Ball

Chair of CIPFA International and former chief executive of the International Federation of Accountants

"Portugal can capture the benefits of the 'New Zealand Model' with successful implementation of the full system of public financial management (PFM)."

Vincent Truglia

Former Co-Head of Sovereign Ratings Unit at Moody's

"It is very reasonable for Portugal to merit a solid investment grading with credible progress in implementing the 'New Zealand Model' of PFM."

George Serafeim

Associate Professor of Business Administration at Harvard Business School

"The Portugal government has the opportunity to create substantial value by using the 'New Zealand Model' of PFM to better financial performance and financial position."

Global Leaders' Advice to Portugal on Public Financial Management

Sheila Fraser

Former Auditor General of Canada

"Improving the financial performance and financial position of government is greatly enhanced with a system of quality PFM."

Andrew Likierman

Dean of London Business School and former Head of UK Government Accountancy Service

"To realize significant financial benefits, internationally agreed upon accounting standards should be used as part of a full system of PFM and not only for reporting."

David Walker

Former managing director of public reporting at the Audit Commission

"Portugal can improve the management of its assets and liabilities with a full system of PFM."

Global Leaders' Advice to Portugal on Public Financial Management

Dag Detter

Co-author of The Public Wealth of Nations and former investment banker

"Huge value can be created by using the 'New Zealand Model' of PFM to maximize the value of government assets and minimize related government liabilities."

Paul B. Kazarian

Founder, Chairman, and CEO of Japonica Partners

"Effective implementation by Portugal of the 'New Zealand Model' of PFM will provide significant rewards by improving the trust and confidence of key participants in the global capital markets."

Jacob Soll

Professor at the University of Southern California

"History show us that good accounts lead to great countries, bad accounts lead them to destruction, which provides strong support for Portugal to use the 'New Zealand Model.'"

Jorge Núñez Ferrer, Ph.D.

CEPS Senior Research Fellow and public financial management specialist

"PFM, while undervalued, is totally essential for prosperity and stability."