Accounting for Government Interventions in the Corporate Sector Consolidation to be revisited

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1. Government interventions during the Global Financial Crisis

During the Global Financial Crisis governments around the world were forced to take action in response. Ultimately, governments had to stabilize the economy as a whole and key economic entities in particular. They had to make sure that savings were not withdrawn at once and borrowings were still possible, at least at very cautious levels. They also had to make sure the consumption was not plunging too much. Governments did so by a suite of more or less coordinated interventions. It wasn't just a single measure taken, but several measures which were often combined in order to best achieve their goals. This article is not evaluating the interventions and measures. It is only considering the accounting and reporting of governments about the measures taken. Obviously, the accounting and reporting is not directly affecting the outcome of the intervention. It has to reflect the intervention as it was taken, with all its possible shortcomings. However, size and relevance of the measures clearly require transparency and accountability. Many interventions took place in a specific moment during the crisis, but remain in effect for a much longer period of time. This increases the need of proper accounting and reporting, as the future outcome may indeed be affected by the accounting and reporting applied.

This paper looks at the accounting and reporting from a conceptual perspective. It takes interventions in various European countries into consideration. However, the diversity of the interventions, as well as the diversity of accounting policies, makes it impossible to undertake a comparative study. Comparisons are made, when there are comparable situations. Yet, this is not often the case. Either differences in the substance of the intervention or differences in the accounting policies make a direct comparison useless. On the conceptual level, on the other hand side, it is possible considering issues arising and the feasibility of the accounting and reporting applied.

1.1 Government interventions in a nutshell

Before the accounting and reporting is examined more closely, it is necessary to understand – at least very broadly – the kind of interventions taken. As mentioned before, the interventions varied quite substantially between the countries, if we consider the substance of the measure taken. But there were some high-level commonalities. Governments tried to achieve their goals mainly by five types of interventions (Hummler, 2009):

- Exchange of assets (e.g. troubled securitized loans, provision of liquidity);
- Nationalization of troubled corporate entities (e.g. banks, car makers);
- Recapitalization of troubled corporate entities (e.g. banks, car makers);

- Provision of (financial) guarantees (e.g. in favour of depositors);
- Legal changes (e.g. different status of banks).

Changes to the legal status are not investigated any further, as they have no immediate influence on accounting and reporting. Arguably, the exchange of assets and nationalization or recapitalizations of corporate entities are quite similar at the first glance. In both cases the government gives money and receives an asset. However, the exchange of (individual) assets were usually undertaken in order to relief commercial banks from the burden incurred by write downs in those assets. Mostly, the assets were financial assets, i.e. financial instruments such as securitized loans. The nationalization or recapitalization of troubled entities, which was technically a purchase of shares or other financial instruments, was a more radical solution in the sense that individual assets of a troubled entity were not identified, but the entire entity addressed. The exchange of assets also included the provision of liquidity by the central bank to commercial banks, as this typically includes some transactions with underlying securities, e.g. in repo transactions. Obviously, the schemes under which these interventions took place were variable and so were the entities involved. In some countries, e.g. Switzerland, the interventions were directed almost exclusively at the banking sector and there at one single entity. In other countries, e.g. the United Kingdom or Germany, larger group of entities and different sectors of the economy were involved.

	By government	**By central bank**
Exchange of assets (including provision of liquidity)		CH, UK, D
Nationalization of corporate entities	UK, D	
Recapitalization of corporate entities	CH, UK, D	
Provision of financial guarantees	CH, UK, D	

Exhibit 1: Measure taken by selected European government and central banks

Within one country, usually both the government and the central bank were involved. This will be an issue which needs to be considered more closely. This duality reflects the fiscal and monetary policy. The different measures were clearly assigned between governments and central banks (see exhibit 1). Governments were focussing on the corporate entities as well as financial guarantees, while central banks rather focussed on asset relief including the provision of liquidity. If the scope of countries examined would be extended, for instance to the United States, this clear cut picture might have been blurred, because government in this case undertook asset exchanges through its TARP programme. However, in Europe, there is usually a relatively strict definition of the role of governments and central banks. Nevertheless, the well coordinated action by governments and central banks also raises the question of control of central banks by governments. This will be examined in more details.

1.2 Independence of the actors

It is a generally accepted macroeconomic principle, that monetary authorities such as central banks should be independent from governments. However, in the previous section it became obvious that interventions often included both the government, as well as the central bank, with some coordination between the two. This raises obviously the issue of independence. However, from an accounting and reporting perspective, not the potential macroeconomic issues should be considered, but the governance arrangements of central banks. Central banks are usually not part of the government. Nevertheless, governments exercise some influence, if not control, on the central banks. For instance in Germany or the United Kingdom, the central bank is effectively owned by the Federal Government. In the United States of America as well as Switzerland, the government influences the appointments of key management of central banks, although the central banks in these countries are not owned by the governments, at least not the national governments. This means that we have to consider two semi-independent actors, governments and central banks when analysing the accounting and reporting.

2. Government accounting for interventions

The four types of interventions outlined in the previous section can be categorized into three groups of accounting issues. The exchange of financial assets as well as the provision of liquidity falls into the area of financial instruments. Also recapitalizations with relatively low levels of engagement are generally accounted for as financial instruments. The nationalization and recapitalization of corporate entities, with levels of engagement allowing significant influence, fall into the area of consolidation. Finally, financial guarantees are either financial liabilities or – if they are probably not exercised – contingent liabilities. The Global Financial Crisis has thus not led to interventions that fall out of the scope of traditional accounting literature. However, it is worth examining the accounting issues more closely.

2.1 Financial instruments in the financial crisis

Financial instruments are by many seen as the main reason of the Global Financial Crisis. Securitized mortgage loans were certainly one of the main reasons why the burst of a property bubble in the United States could affect the worldwide financial markets. The consequential accounting requirement to revalue and write down these financial assets led to losses for the owners of these financial instruments. Accounting was therefore blamed for spreading the disease rather than containing it (for instance by Pounder, 2009; Magnan, 2009). It was also blamed for using inadequate valuation models in the case of non-liquid markets. However, others see this critics as media rhetoric, as accounting could only reflect the underlying economic situation, which deteriorated for other reasons, such as market conditions (Ryan, 2008; Smith et al, 2010).

However, the role of the financial instruments in the rescue phase is less well known. As we have seen, existing financial instruments were often transferred to new owners, either the government itself or the central bank. During the transfer, there were sometimes additional financial instruments created, for instance if the transfer could not take place instantly but the risk needed to be transferred at a specific cut-off date. Examples included the transfer of UBS's assets to the so called Stab-Fund established by the Swiss National Bank (central bank). In other countries, for instance the United Kingdom and Germany, the central banks directly acquired the assets. The transfer of financial instruments was effectively a stop-loss type of arrangement for the previous owner. For the new owner, the government or the central bank, it was an opportunity to acquire the financial instruments at an already reduced price and hold it till maturity, in the hope that it will actually recover and be settled. In terms of accounting, this new and different intention of the owner allowed the use of different valuation approaches.

But also more traditional measures taken by central banks, e.g. repo transactions which provide commercial banks with liquidity in exchange for financial instruments, are itself financial instruments. They are accounted for as financial instruments.

Bottom line, financial instruments played an important role in stopping the Global Financial Crisis – as they initially did in creating and spreading the crisis. Only to some extent this congruence is due to the dealing with troubled financial instruments themselves, to some extent new, additional financial instruments were created in rescuing the economy.

The main accounting issue, both initially and in rescue, was valuation or to use the accounting terminology – measurement (Ryan, 2008). Critical was for both the troubled owners of these assets as well as the government/central bank that in many instances there was no longer a liquid market of the respective financial instrument. In absence of liquid markets, accounting is using models, namely the discounted cash flow model. This raises the question whether such models are adequate of non-market situations. The other, related, issue is the classification of financial instruments. Accounting requires identifying the purpose of a financial instrument in order to decide on the appropriate measurement. For many of the previous owners there were re-classification issues, as the crisis changed their intended purpose. For governments and central banks this was less of an issue, as their strategy is less volatile.

Bottom line, the accounting issues in respect of financial instruments are the same for private sector corporations, governments and central banks. While it is undisputed that they need to recognize such financial instruments in their financial statements, the measurement of such instruments is sometimes difficult. It needs to reflect the intended purpose of the instrument, as well as the economic substance.

2.2 Consolidation

As described in the first section, namely governments and rather not central banks, took ownership of commercial corporations. Such corporations were mainly commercial banks or other financial corporations, such as property financing corporations for instance in the United Kingdom. Generally, if one owner controls more than 50 percent of the votes, control is assumed. But there might be circumstances, such as golden shares with some veto power, in which less votes or even different mechanisms can lead to control. In the circumstances of the Global Financial Crisis taking control was not usually the primary objective of government intervention, although in some cases the government effectively took control, for instance in the case of Northern Rock and the Royal Bank of Scotland in the United Kingdom or HypoRealEstate (HRE) in Germany. In other cases, the government provided some equity or equity like capital, however not enough to control the entity. Examples include the Lloyds Banking Group in the United Kingdom. For instance in the case of UBS the Swiss Government provided equity like capital in the form of a mandatory convertible note. If this note would have been converted into equity, the government's share did not exceed ten percent of the capital of UBS and therefore the government did not control UBS at any time. Also, the government sold the notes, actually making a profit, only about one year later and there was no longer any capital involvement.

Arguably, in cases the government took control of a commercial entity, this entity should be consolidated into the government's financial statements. This is not only a requirement of IPSAS 6, but a more widely accepted accounting principle which can be found in all current accounting standards, for instance IAS 27 which is applicable to government of the United Kingdom. Accounting standards generally only see exceptions for temporary control, which is restricted to twelve months from acquisition (IAS 27.23). In those cases in which the government effectively took control, there was no disposal of the entities within twelve months and therefore this exception is not applicable. However, in the scholarly literature, the control criterion and the consequential requirement to consolidate are much less widely accepted. Heald and Georgiou (2009) question the temporary control argument used by the government of the United Kingdom. Newberry and Pont-Newby (2009) and Walker (2009) come to the conclusion that the application of the control criterion in the public sector is not necessarily aligned with the purpose of financial reporting, which is public accountability. However, they are leaving it unanswered if a different criterion, for instance accountability (Walker, 2009) is doing a better job. Chow et al (2007) and Day (2009) report difficulties, amongst other things due to differences between the control criterion and the market revenue criteria used by Government Financial Statistics. There is also a considerable degree of subjectivity interpreting the control criterion (Wise, 2006). On the other hand side, Brusca and Montesinos (2009), Grossi and Mussari (2008), Grossi and Pepe (2009) as well as Bergmann and Bietenhader (2009) showed that not providing consolidated information leads to a substantial loss of accountability. They all highlight that entities which would be consolidated according to the control criterion are of substantial size and risky by the nature of their activity. Omitting this kind of information can therefore be very misleading and therefore damaging to accountability. Bottom line, the scholars are summarizing both the necessity to provide consolidated information, as well as the deficiencies of the control criterion in the public sector.

As mentioned in section 1.2, the Global Financial Crisis raised yet another issue related to consolidation, the potential control of central banks by governments. Obviously, if there was control, the same accounting requirements would also apply to governments controlling central banks. If the accounts of central banks were consolidated into government accounts, this would also mean that crisis intervention typically undertaken by central banks, such as the acquisition of financial instruments or the provision of liquidity, would ultimately be included in government financial statements. Consolidation of central banks into government accounts is currently only practised by the Australian and the New Zealand Government, both countries are not or at least not dramatically affected by the Global Financial Crisis. All the European countries considered not to consolidate their central bank, neither does the United States. Statutory independence of central banks is the most common argument, other reasons include a more diverse ownership, e.g. in the case of Switzerland, where the federal government actually has no ownership at all. However, in all cases, even when there is no government ownership, there is definitely some risk exposure of governments due to interventions made by central banks. If these measures result in losses, not only the central banks' future ability to undertake such interventions might be damaged. In some cases, for instance in Switzerland, the government also benefits from dividend payments by central banks, which could obviously be endangered and therefore expose the government to some of the possible losses central banks might eventually incur.

This very brief discussion of the issue of consolidation highlights, that it is indeed a major issue in the context of government accounting for interventions during the financial crisis. In fact, the financial crisis exemplifies the urgency of the consolidation issue, by adding a previously unknown magnitude and perhaps also a new dimension, the issue of central banks controlled by governments, to the problem.

One possible solution of this controversy, however, dated from before the crisis. Clarke et al (2002) came to the conclusion for a corporate environment, that accountability could be improved by supplementing consolidated information at group level with financial reporting at individual entity level. The rational for this conclusion is that both consolidated and separate financial statements lack some crucial information and only a set of financial statements including both levels provide the necessary information for accountability. In fact, this view was also taken – at least very timidly – by the IPSAS Board with its 2007 amendment to IPSAS 6. For the government sector this basically means that governments should prepare and present financial reports for a more narrowly defined public administration entity, usually in accordance with the budget perimeter, as well as for the entire group of administrative and controlled entities. While most governments, including the ones in Switzerland, do present financial statements for the narrower perimeter, there is traditionally no consolidated financial statement at group level. The Cantons of Geneva, Zurich as well as the Swiss Federal Government have only recently started presenting their financial statements for two different perimeters.

2.3 Financial Guarantees

The third and last area of accounting touched by the government and central bank interventions are financial guarantees. In many cases, the government or the central bank did not actually have to acquire assets or entities; they did not even have to provide liquidity. Especially governments, to lesser degree central banks, also provided explicit or implicit guarantees. Examples for explicit guarantees include deposit insurance schemes, implicit guarantees are guarantees provided by the sheer fact that governments were standing by to rescue banks, if necessary. As we all know, with some well known exceptions, namely Lehman Brothers.

Accounting requires different treatment of such guarantees depending on the likelihood the guarantee might be exercised. If a guarantee is more likely than not to be exercised, accounting standards require a provision in the form of a liability on the balance sheet (e.g. IPSAS 19, IAS 37). If it is less likely, but still possible, that the guarantee is exercised, it is a contingent liability according to the same standards.

The Global Financial Crisis shows, that estimating the likelihood of bank collapses are difficult. Even more difficult is the assessment of the financial exposure in such a case. In the past, most explicit guarantees, such as deposit insurance schemes targeted relatively small entities and even then were not regularly exercised. Large, system relevant banks were not the primary focus. The implicit guarantees obviously targeted the system relevant banks, but are generally associated with a relatively small likelihood. Both explicit and implicit guarantees of the government are therefore not really comparable guarantees of commercial enterprises, i.e. car manufacturers. In most cases, the government financial guarantees are therefore only contingent liabilities. Also in both cases, there is a certain degree of information asymmetry and therefore some moral hazard associated with such guarantees. Governments are therefore sometimes reluctant presenting these guarantees, even in the notes – which would be the appropriate treatment in these cases. However, the both the governments of Switzerland and the United Kingdom disclose such contingent liabilities, in compliance with the standards, and there are no adverse consequences so far.

3. Conclusion and further research

The analysis of three European governments' and central banks' financial accounting and report of interventions due to the Global Financial Crisis reveals that most measures taken do have some impact on financial accounting and reporting. While the issues faced by the accounting and reporting of financial instruments and financial guarantees are following the lines of traditional accounting guidance and literature, there is evidence that the measures taken are highlighting conceptual weaknesses in the area of consolidation. If governments take control over commercial enterprises, they expose themselves to substantial risks, both with upward and downward potential. The case of Global Financial Crisis interventions showed, that these risks are of substantial magnitude, as the entities concerned are typically of relevance even on a macroeconomic scale. Traditional accounting and reporting of governments does not consider this situation adequately and more recent guidance provided by internationally accepted accounting standards is not generally applied as the case seems to be somewhat different. Unlike private sector takeovers, government interventions are not really at arm's length between willing and able parties. They are rather a last resort both for the governments and the entities involved.

Furthermore, the Global Financial Crisis shows that some interventions are made by central banks, however, in coordination with governments. This highlights yet another consolidation related issue, the one of consolidation of central banks into governments' accounts. This is even less widely practised than the consolidation of commercial entities controlled by governments. Statutory independence is a generally accepted issue in this context, however, risk exposure includes governments and therefore the issue at least needs to be considered. Accountability could be improved by a set of consolidated and separated financial statements.

Thus, bottom line, the Global Financial Crisis did not highlight any new and unknown issues in government accounting and reporting. However, it recalled the unresolved problem of consolidation in the context of the government sector.

Zusammenfassung

Der Artikel analysiert die Rechnungslegung des Staates in Zusammenhang mit der Globalen Finanzkrise. Im Zentrum stehen die Behandlung von Finanzinstrumenten, die Konsolidierung von Einheiten sowie die Gewährung von Garantien. Die gängigen Standards bieten eine solide Basis für Finanzinstrumente und Garantien. Dagegen ist die Konsolidierung von staatlich beherrschten Einheiten ein ungelöstes Problem. Ein Lösungsansatz ist die gleichzeitige Publikation des Einzelabschlusses und der Konzernrechnung.

Résumé

L'article analyse la comptabilité de l'Etat dans le contexte de la crise mondiale financière. Particulièrement difficiles à mettre en oeuvre sont les instruments financiers, la consolidation des comptes et les garanties. Les normes courantes donnent des réponses pour les instruments financiers et les garanties, mais pas pour la consolidation des entités contrôlées par l'Etat. Une solution envisageable est la présentation conjointe des comptes au niveau de l'entité et du groupe consolidé.

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Exhibit

Exhibit 1: Measure taken by selected European government and central banks