

The Effect of the Global Financial Crisis and the Sovereign Debt Crisis on Public Sector Accounting: A Contextual Analysis

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Abstract This paper examines the effect of global financial crisis and the sovereign debt crisis on public sector accounting. The global financial crisis and sovereign debt crisis were contextually analysed bringing out clearly its effect on public sector accounting which include accounting issues related to public sector intervention, accounting for recapitalization of investment, accounting for fiscal support, accounting for financial guarantees. The paper found out that, the unresolved fiscal and debt problems in some European countries and elsewhere could threaten the global economy. The implication of this is that, there is need for transparent financial reporting by government and improvement in the management of public sector resources. That, third world countries should avoid sub optimal debts structure.

Key words Financial Crisis, Sovereign Debt, Public sector Accounting, government interventions, Accounting Standards

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1. Introduction

Financial crisis generally refers to a situation whereby the values of financial institutions or assets drop rapidly (Abdul, 2008). A financial crisis is often associated with a panic or a run on the Banks in which investors sell off assets or withdraw money from savings accounts with the expectation that the value of those assets will drop if they remain at the financial institution. Other situations that are often called financial crisis include stock market crashes and bursting of other financial bubbles, currency crisis and sovereign defaults (Kindleberger and Aliber, 2005).

Sovereign debt crisis on the other hand refers to economic and financial problems caused by the (perceived) inability of a country to pay its public debts. This usually happens when a country reaches critical high debt levels and suffers from (perceived) low economic growth. While it may be tempting to label these countries as lazy and profligate, the truth is that they all lured down this part.

These situations normally lead to severed macroeconomic dislocations resulting to decline in real output growth, weakened financial systems, loss of jobs, loss of confidence in financial market, weak consumer demand due to liquidity problems and credit crunch, breakdown of confidence in the banking system, banks failing to improve capital adequacy among others (Kama, 2009). This current global financial crisis was triggered by the credit crunch within the US sub-prime Mortgage market and has continued to spread and deepen in several countries. Sub-prime lending generally refers to lending by institutions which carry a higher level of risk than paper lending. Consequently it is generally accompanied by higher interest rate charges. It also refers to bank loans on certain types of investment properties and to certain type of self employed persons. It covers a variety of credit instruments that include car loans, electronic gadgets credit cards (Ian, 2011).

The global financial crisis has serious consequences for both the developed and the developing countries including Nigeria. Its impact on any particular economy depends on the degree of exposure of its economy to the United States and the other developed economies connected with the crisis. Its impact also depends on the current state of the domestic economy, as well as its capacity to absorb the shocks. The

global financial crisis has brought series of government interventions aimed at restoring confidence in national financial institutions and supporting global demand. How have these interventions by government impacted on public sector accounting? What about the sovereign debt crisis? How has it impacted on public sector accounting? This paper attempts to provide answers to these posers.

2. The Global Financial Crisis

Global financial crisis refers to a worldwide period of economic difficulty by markets and consumers. A global financial crisis is a difficult economic situation; Business finds it difficult to succeed in such an environment since potential consumers tend to reduce their purchases of goods and services until the economic situation improves (Business dictionary.com).

The year 2008 saw the deepest recession since 1930s (Berger, 2012). Since then there have been series of government interventions in the financial sector and the economy at large aimed at restoring confidence in national financial institutions and supporting global demand. Governments had to provide considerable financial resources to help the economy to recover from several disruptions on the world's capital markets. The scale and breadth of these financial crisis and the complexity of the policy responses have created two crucial issues for public sector Accounting.

First, is the nature of these unprecedented government interventions while the interventions took place in many countries, the nature of such interventions were not necessarily identical.

The Second crucial issue has to do with how these interventions should be reported in government accounts. These interventions took place in many different ways. Public sector entities had granted guarantees taken responsibility for bad loans, performed fiscal support and made a number of purchases. Government had put forward different sets of measures to counteract the economic downturn, with different emphasis on a particular policy according to the specific nature of the local environment, industry focus of the country, budgets constraints etc.

The Interventions as analysed by (Berger, 2012) typically include:

- Recapitalization and investment. Bank recapitalisation became fairly common in the crisis especially for financial institutions that were material to the financial system as a whole.

- Takeover risks: Some direct asset purchases had been made in the wake of the crisis with public sector entities purchasing illiquid or toxic bonds from banks. Some countries set up what you call “bad banks” as a means of allowing private banks to take over problem assets off their books. In Nigeria, Asset Management Company of Nigeria (AMCON) was set up for the same purpose.

- Fiscal Support: Economic stimulus offering direct subsidies had been set up by various governments to stimulate the economy as a whole. For instance, injecting capital into banks/companies by government in the United Kingdom (U.K) and the United States of America (USA) interest rate cuts by Central Banks, lending guarantees by governments to restore liquidity, reviving the ailing banking system through recapitalization and strengthening of supervision minimizing market disruptions etc.

- Financial Guarantees: In many countries, State guarantees were provided for bank deposits, interbank loans, and, in some cases, for bonds and even corporate loans.

The world over financial support had been provided mainly to enterprises in the banking, automotive, energy and real estate/construction industries, small and medium scale enterprises. The IMF (2009), World Economic outlook report examined the interventions in various countries as follows; In the USA, measures taken to support their damaged financial system was the provision of a US \$700b scheme known as the “Troubled Asset Relief Programme” (TARP). The scheme allowed the USA Department of the Treasury to purchase or insure up to US\$700b of “troubled” assets from US financial institutions. Again in 2009 the American Recovery and Reinvestment Act was signed into law. The measures were worth a total of US\$787b. The act included Federal Tax relief, expansion of unemployment benefits and other social welfare provisions, domestic spending on education, healthcare and infrastructure including the energy sector.

In Canada, the Economic Action Plan provided support in the region of Canadian Dollars9 (CAD) CAD 30 – 40b to the Canadian economy in 2009.

The French government proposed a Twenty six billion Euro (€26b) plan with Thirty two billion Euro €32b rescue package in November 2008. In 2009, a second rescue plan was approved including the spending of €82b over the next two years.

In the UK, the biggest challenge was the turmoil in the banking sector. The UK government spent Ninety four Billion pounds (GBP94b) to prop up the Royal Bank of Scotland, HBOS and Lloyds TSB, as well as nationalising Northern Rock and Parts of Bradford and Bingley.

The Indian government announced two stimulus packages, involving additional government expenditure of US\$8b. Their main focus was to ensure adequate liquidity in the banking system. Nigeria was not insulated but was better prepared than most other economies to handle the crisis. The Merrill Lynch Report put Nigeria among 10 least vulnerable economies and Greenspan cited Nigeria as one of 4 possible robust economies. Nigeria had secured a debt relief effectively saving \$4billion in annual debt service payments and also embarked on banking sector consolidation exercise, liberalization of the country's economy and building a Robust External Reserves (Ajayi, 2009).

In light of these huge government interventions, the question was how to reflect these actions appropriately in the financial reporting of public sector entities. Many of the interventions were not directly addressed in currently existing public sector Accounting standards because the underlying transactions were new for public sector entities. Especially during the global financial crisis, however, there was a need for a clear and fair presentation of the economic consequences of these interventions.

In May 2009, the International Public Sector Accounting Standards (IPSAS) and the International Monetary Fund (IMF) formed a joint task force to exchange experiences about government interventions made in response to the global financial crisis and to consider how these interventions should be treated in financial statements. The aim of the task force was to achieve consistency in financial reporting between governments.

Although the fact that aftershocks have been observed. Literature concludes that the global crisis ended between 2008 and 2009.

The public sector response to the financial crisis as described above had a significant impact on short and long term budgets. This gave rise to political pressure in many jurisdictions, as citizens questioned the long-term financial consequences of the various interventions that had been adapted to deal with the crisis. As a consequence, the International Public Sector Accounting Standard Board (IPSASB) set up a project on long-term fiscal sustainability. In October 2011 the IPSASB has issued exposure draft 4b. Recommended practice Guide, Reporting on the long-term sustainability of a Public Sector entity's finances, which is the one of the main outputs of the IPSASB project on long-term Fiscal sustainability.

3. The Sovereign Debt Crisis and its effects on Public Sector Accounting

A sovereign debt is a debt that is issued by a national government. Theoretically, it is considered to be risk-free as the government can employ different measures to guarantee payment. Sovereign debt crisis therefore arises when the government is not able to service these debts obligations and have to default. This normally leads to both economic and financial problems leading to low economic growth. While it is tempting to label these countries as lazy and profligate, the truth is that, they are lured down this part.

3.1. Evolution of Sovereign Debt Crisis

At the end of 2009, the sovereign debt crisis started mainly because of the fear of rising government debt levels across the globe. In November 2009 following the Dubai sovereign debt crisis, concerns about some European Union (EU) member states debts arose. Greece in the same year admitted that its current debts were €300b. This amounted to 113% of the Gross Domestic Product (GDP) almost doubling the euro zone limit of 60% (EC, 2010).

In 2010, a report of the European Commission (EC) on Greek Government deficit and debt statistics identified "severe irregularities in the Excessive Deficit Procedure (EDP) notifications including submission of incorrect data and non-respect of accounting rules and the timing of the notification.

The EC report explained that the magnitude of what happened in Greece extremely seldom happens in other EU member States but happens more often in Greece. According to the report these happenings illustrate the lack of quality of the Greek fiscal statistics. The EC concluded that despite the progress in the

compilation of fiscal statistics in Greece and despite the intense scrutiny of the Greek Fiscal data by Eurostat since 2004, these measures had not been sufficient to bring the quality of Greek fiscal data to the level reached by other EU member States.

Later in 2010 concerns, started to rise about other heavily indebted countries in Europe, like Portugal, Ireland, Italy, Spain. One of the main fears was and still is that the crisis could spread to several other countries in Europe. As a result of these developments the euro continued to fall against the dollar and other major currencies in the world. In 2010 and 2011 certain European States besides Greece experienced a wave of downgrading of their government debt for instance Belgium, Italy, Portugal and Spain. As a consequence of downgrading, investors demanded higher interest rates from several governments with higher debt levels or deficits. This in turn made it more difficult for governments to finance further budget deficits and service existing high debt levels. In 2011, Spain and Italy were forced to act; Spain passed a constitutional amendment to add in a “golden rule”, keeping future budget deficits to a strict unit. In 2013, Italy’s parliament approved a supplementary budget which aimed to reach a balanced budget. In Germany a so-called “debt brake” was introduced. This fiscal instrument is an amendment to the constitution that legally limits the size of sovereign debt of the Federal Government and the State Governments in Germany (EC, 2010).

3.2. Measures Taken to Solve the Crisis

Measures taken to tackle this crisis were handled at two fronts, first these countries that came under scrutiny of Capital Markets were forced to act and many of them presented austerity measures mainly to increase tax returns and cut expenditure.

Secondly, supranational organizations like the European Union or IMF took measures in order to help the respective countries (IMF, 2010 & EU, 2010). Such measures taken by the supranational organizations to solve the European sovereign debt crisis are summarized below:

- In 2010 the heads of State and government of the euro area agreed that the euro area member states will contribute to coordinated bilateral loans.
- The euro zone members and the IMF agreed on a €110b bailout package to rescue Greece. The European Union and euro-area member states set up the European stabilization mechanism that consists of the European Financial Stabilisation Mechanism (EFSM) and the European Financial Stability Facility (EFSF). The EFSM allows member states in difficulties caused by exceptional circumstances beyond their control to ask for financial assistance from the mechanism.
- Following the official Irish request for financial assistance from the European Union, the euro-area member states and the IMF, the joint EC/IMF/ECB mission reached agreement with the Irish authorities on a comprehensive policy package for the period 2010 – 2013. This includes a joint financing package of €85b.
- The European Council agreed on the establishment of a future permanent mechanism to safeguard the financial stability of the euro area as a whole (so-called European Stability Mechanism (ESM)).
- In 2011 Euro zone countries and the IMF approved a €78b bailout for Portugal.
- The heads of state or government of the euro area with the IMF set up a second bailout program for Greece. The total official financing amounted to an estimated €109b.
- The European Central Bank announced that it would buy euro zone bonds, following emergency talks on the debt crisis.
- The euro area heads of state or government agreed on a new “fiscal compact” and on significantly stronger coordination of economic policies in areas of common interest.

3.3. Effects of the crisis on public Sector Accounting

3.3.1. Accounting Issues Relating to Public Sector Intervention

The Global financial crisis has raised a number of issues that had to be considered thoroughly in the analysis and development of Accounting Standards. In the light of the IPSASB’s strategic aim to provide a complete set of accounting standards, a discussion started on how the existing future IPSASB’s pronouncements might address relevant accounting issues relating to the different kinds of government interventions.

The recurrent use of the term “transparency” in the context of the discussion underlines that, it represents one of the key values in financial reporting by governments. Transparency raises the issue of whether general purpose financial statements or general purpose financial reports must include all information necessary for accountability purposes. This leads us to the question whether the current IPSASB’s pronouncements give sufficient guidance on financial reporting of government interventions in order to achieve accountability. Besides the recommended practice guideline, reporting on the long-term sustainability of a Public Sector Entity’s finances, the current focus on the IPSASB’s pronouncements is on General purpose financial statement.

3.3.2. Accounting for Recapitalization or Investment

As a result of the financial crisis, public sector entities became shareholders in financial institutions and other corporate entities. In some cases, financial institutions and other corporate entities had even been nationalized. From the perspective of the public sector entity, consideration had to be given to how these interests should be accounted for and whether they need to be consolidated.

When a government purchased interests directly, the question was how to measure these assets. When interest in financial institutions and other corporate entities were purchased, there is a risk that impairment losses might need to be recognized by the public sector entities in subsequent accounting periods. In general, these interventions – most of which relating to the acquisition of cash-generating assets – are addressed in IPSAS 26, Impairment of Cash-Generating Assets. However, the scope of that standard does not cover financial instruments. IPSAS 29 deals with impairment and uncollectibility of financial assets (cf. IPSAS 29.67 et seq.). Thus, in its entirety the IPSASB’s pronouncements should comprise sufficient guidance regarding the treatment of impairment losses on purchases of assets as state intervention.

According to IPSAS 6, the acquired entities may be subject to consolidation in some cases. The decisive criterion for consolidation according to IPSAS 6.20 is control, which is the power to govern the financial and operating policies of another entity in order to benefit from its activities. Some might argue that consolidation is not required because control over the acquired entity is only temporary or because the activities of the acquired entity are dissimilar to those of the public sector entity. Under IPSAS 6, a controlled entity may be excluded from consolidation if there is evidence that (a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within 12 months from acquisition and (b) management is actively seeking a buyer (cf. IPSAS 6.21). However, a controlled entity is not excluded from consolidation under IPSASs when its activities are dissimilar to those of the other entities within the economic entity.

During the financial crisis some governments acted through special purpose entities with no direct interest, often referred to as “bad banks”. A bad bank is a financial institution created by a government to hold “non-performing loans” (which are essentially assets). Currently, IPSASs do not cover the question of consolidation of special purpose entities. Under IFRSs SIC Interpretation 12, *Consolidation – Special Purpose Entities*, address the question when a special purpose entity should be consolidated.

3.3.3. Accounting for Fiscal Support

Against the backdrop of the financial crisis, fiscal support had been implemented by means such as the purchase of goods and services for current use, the purchase of goods and services for the creation of future benefits (infrastructure investments or research spending), liquidity support, tax reduction or transfers (mainly for social security and social benefits).

Where fiscal support is provided by way of direct public expenditure, investments in infrastructure assets are a popular target of investments. Such infrastructure assets are mainly covered by IPSAS 17 (cf. IPSAS 17.21). Furthermore, the IPSASB has developed guidance for service concession arrangements, often referred to as public private partnerships (PPP, cf. IPSAS 32, *Service Concession Arrangements*).

Where fiscal support takes the form of liquidity support involving credit lines rather than direct subsidies, the terms of the credit transactions need to be examined. Concessionary loans pose particular accounting issues to the public sector (cf. IPSAS 29.AG 84 to AG 90). These are loans granted to or received by an entity at below-market terms. They must be distinguished from the waiver of debt. A waiver of debt results from loans initially granted or received at market terms where the intention of either party to the

loan has changed subsequent to its initial issue or receipt. This distinction determines whether below-market conditions are considered in the initial recognition or measurement of the loan, or as part of the subsequent measurement or de-recognition. Where the concessionary loan is granted by a public sector entity, any difference between the fair value of the loan and the transaction price is recognized as an expense in surplus or deficit at initial recognition (cf. IPSAS 29, AG 89 (b)).

To sum up one may conclude that IPSASs give sufficient guidance to achieve accountability on the issues relating to fiscal support.

3.3.4. Accounting for Financial Guarantees

As a consequence of the financial crisis, many public sector entities have provided financial guarantees to banks and corporate entities. As long as the outflow of resources embodying economic benefits or services potential is not probable, financial guarantees fall into the category of contingent liabilities (cf. IPSAS 19.18, 19.20 and 19.37), which, in accordance with IPSAS 19.35, may however not be recognized in the statement of financial position. Accordingly, financial guarantees are treated as an off-balance sheet transaction (cf. IPSAS 19.36 and 19.100), in contrast to direct liquidity support which is reported in the statement of financial position.

In the public sector, financial guarantees are frequently provided for no consideration or for nominal consideration to further the entity's economic and social objectives. In the current financial crisis, financial guarantees have been used to restore confidence in, and protect the stability of, the financial markets. From an accounting point of view there is the difficulty of identifying an accurate measurement. In cases of contractual financial guarantees for nominal consideration, the transaction price related to a financial guarantee contract does not reflect fair value because recognition on the basis of the transaction price would not accurately reflect the issuer's exposure to financial risk.

IPSAS 29 now provides guidance on the accounting treatment of contractual financial guarantees. The IPSASB has concluded that financial guarantee contracts issued for no consideration or for nominal consideration (non-exchange transaction) should be accounted for as financial instruments (cf. IPSAS 29.AG3). An initial recognition, where no fee is charged or where the consideration is not fair value, a public sector entity firstly considers whether the fair value can be obtained through observation of quoted prices available in an active market for financial guarantee contracts directly equivalent to that entered into (level one). Where there is no active market for a directly equivalent guarantee contract, public sector entities should apply a mathematical valuation technique to obtain a fair value (level two). Alternatively, the principles of IPSAS 19 for initial recognition are applied (level three).

In summary it can be concluded that the application of IPSASs on financial guarantee contracts is sufficient from an accountability point of view. However, it has to be stated that currently IPSASs contain no specific guidance dealing with non-contractual financial guarantees announced by governments. For example, a government may give general deposit guarantees to its citizens. This gives rise to financial risks which are not shown in the general purpose financial reports. Finally, one has to add that as soon as the outflow of resources becomes probable, non-contractual guarantees announced by governments may give rise to a provision in accordance with IPSAS 19.18ff.

3.3.5. Effects of the Sovereign Debt Crisis on Public Sector Financial Management

The earlier mentioned European Commission report in 2010 concluded that Greek authorities need to resolve the methodological problems they created. The report also noted that, there is also need to put in place transparent and reliable working practices between the national services concerned and to revise the institutional setting in order to guarantee the professional independence and full accountability of the European national statistical offices and of other services involved in the domain of Excessive Deficit Procedure (EDP) data. As a result of the Greek crisis the European commission identified the quality of statistical data in the context of the excessive deficit procedure as a major issue.

Based on the experience with Greek, the council recognized that, recent developments have also clearly demonstrated that, the current governance framework for fiscal statistics still does not mitigate, to the extent necessary the risk of incorrect, or accurate data being notified to the commission. This been the case, the European council regulation granted Eurostat additional rights of access to a widened scope of

information for the needs of data quality assessment. Eurostat is to undertake measures to assure quality and to manage the quality of the data received from member states.

In 2011, the European parliament discussed a proposal for a council directive on requirements for budgeting frameworks of the member states. In the council's discussions they gave a directive that the commission shall conduct not later than the end of 2012 an assessment of the suitability of the international public sector accounting standards for member states. In addition the council directive contained a more general provision saying that EU member states shall have in place public accounting systems comprehensively and consistently covering all subsectors of general government and containing the information needed to generate accrual data with a view to preparing European system of Account 95 – based data. Those public accounts systems shall be subject to internal control and independent audit. Based on the above position Eurostat was commissioned to conduct an assessment of the suitability of IPSASs for EU member States. This assessment is considered necessary to inform the European policy makers of the advantages and disadvantages of adapting IPSAS.

The Euro area heads of government also took a decision to have a strong impact on the economic governance of the Euro zone. They were ready to participate in the new fiscal compact and engage in a significantly stronger coordination of economic policies. The goal of the compact as a response to the current crisis is to strengthen fiscal discipline and introduce more automatic sanctions and stricter surveillance. The implementation of the compact and the yearly budgetary plans consistent with it will be monitored by the European commission and the council. In addition the member states are also committed to coordinating their economic policies and working towards a common economic policy.

4. The Effect of Sovereign Debt Crisis on the Economy

The sovereign debt crisis that first paralyzed Greece is spreading to other countries and will have a substantial impact on both the public and private sectors. In the year 2011 US Government debt was downgraded for the first time in history, the European Central Bank entered the bond market, trying to prevent crisis from engulfing Italy and Spain and British regulators started looking at banks' exposures to other troubled countries such as Belgium.

While the most urgent problems appear to lie within the Eurozone, many governments have fiscal positions that are highly vulnerable. The sovereign debt crisis has entered a dangerous new phase; just how bad it will get and what effects will be felt in the world economy are yet to be seen (IFAC News, 2011). "Sovereign debt tensions impact core economies and cause adverse regional and global implications. We have seen the difficulties associated with fiscal imbalance in many countries, notably in Europe. While recovery throughout the EU is viable, many including the IMF have warned that unresolved fiscal and debt problems in Greece, Ireland, Portugal, and elsewhere could threaten the global economy. Policies that will enable countries to regain fiscal balance and also resume economic growth are now paramount" (Thomadakis, 2011).

5. Conclusions

The financial problems in Greece that triggered the sovereign debt crisis included concealing deficit and debt positions. This clearly shows that there is need for transparent financial reporting by governments and improvement in the management of public sector resources. Strong accrual accounting standards are essential tenants of solid accounting and reporting for public companies. Government can also switch from cash-based reporting accounting system to accrual accounting reporting standards which we are very sure will enhance government financial reporting and accounting. It is the believe of IFAC that in order to change the paradigm for government reporting and create an international environment in which cash-basis accounting is recognized as deficient, governments should adopt the accrual, based international public sector accounting standards (IPSAS) set by the International Public Sector Accounting Standards Board (IPSASB). What is cheering news here is that, the momentum towards adopting IPSAS is definitely building globally. Bergman, A. (2011) commented that;

"We are all impacted by a governments financial management decisions. A single set of internationally accepted accounting standards for the public sector would improve the quality of financial

reporting, add stability to the global economic system, enhance accounting and efficiency, improve asset, debt and cash management, and enable consistent and comparable reporting”.

While adopting IPSAS won't solve the sovereign debt crisis, enhancing government financial reporting and financial management would be a strong step towards enhancing economic growth and stability worldwide as governments will have to face the consequences of financial decision, today, rather than passing them on to future generations.

Ian, B. (2011) stated that; “While improving financial reporting, by governments is necessary, it is not significant. We are in the current situation because the institutional arrangements for public finance in many countries are simply not up to the job required of them. The profession must speak more loudly in calling for the necessary reforms – no longer can anyone preferred that fiscal responsibility is anything other than the highest priority. Adopting and implementing IPSAS is a critical first step.”

We conclude that, the developing nations should heed the warning by IMF that why recovery throughout EU is viable, the same thing cannot be said of developing nations whose countries are subject to frequent debt crisis which are characterised by low credit ratings and high sovereign spreads. Their low tolerances to debt are driven by poorly diversified economies and are excessively reliant on the export of few commodities. They should avoid sub-optimal debt structure which is partly the consequence of a poorly designed international financial architecture.

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