Assessing Sovereign Risk and Performance with Financial Statement Analysis in a World of Recurring Crises
TUESDAYS 8.30 AM-11.45 am EST, TERM A FALL 2020

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Paul B. Kazarian, pkazarian@japonica.com

Course Description and Objectives

In a world of recurring crises characterized by unstinted financial responses by government, financial recklessness, and pervasive financial illiteracy have increased the importance of assessing sovereign risk and government financial performance from financial statements. Historically unprecedented zero to negative interest rates, G7 governments breaching 100% debt to GDP, emerging economies collapsing, central banks ballooning balance sheets, modern monetary theory popularity, government pension debts dwarfing borrowings, collapsing infrastructure, calls for debt relief from collective action clauses to debt jubilees, and governments using fiscal illusion to misrepresent their performance and position are topics making the daily news headlines. The market for sovereign bonds runs into trillions of dollars and is far larger than equity markets in several countries. Yet, it is highly suspect that sovereign risk, inherent in these bonds, is properly analyzed and priced correctly.

A unique and very important foundation of B8024 is that it seeks to break down and create synergies from the professional silos that claim varying levels expertise on government financial topics and the related economic factors.

Governments continue to increase their share of the economy with some approaching 70% when full cost of regulation is included. A major driver of such mispricing is the lack of awareness of deficiencies in governments’ financial statements among major bondholders, the rating agencies, and citizenry and their elected or appointed representatives. Only a small number of countries in the world (e.g., U.S., Canada, U.K., Israel, Switzerland, Australia, and New Zealand) actually report something close to accrual accounting, the standard in the corporate world, to reflect their assets and liabilities. Some governments, such as Austria and Switzerland, even leave out legally contracted public employees’ pensions from their financial statements. Many advanced countries, such as Japan and Germany, report results on a cash basis and more worrisome do not report consolidated financial statements. For instance, Japan reports a list of financial and non-financial assets and liabilities at different places on the websites of the Ministry of Finance and the Bank of Japan. Some governments, such as the Vatican and Abu Dhabi do not release any financial statements. In the absence of financial statements, stakeholders have little information related to how specific assets and liabilities are measured, whether the liabilities, especially contingencies and commitments are comprehensive, and what is the actual net debt owed by the Government.

When firms run into financial difficulties, the pressure to misreport obligations and spending goes up. These incentives work in the same way for governments. The recurring financial and economic crises have created a mountain of government debts and deteriorating assets and the consequent
pressure to misrepresent financial performance and position. Unlike the corporate sector, one cannot rely on boards of directors or competent auditors or even short sellers to keep governments honest. Several finance ministries in the world are populated by officials who under emphasize the importance of reporting standards and of accounting measurement. Perhaps the sovereign bond market provides the only mechanism for enforcing accountability on government finances. As we will see in the course, even the ability of the bond market to enforce reporting transparency is limited.

In this class, you will learn how (i) to assess the fundamentals of governmental financial statements; and (ii) to exploit these fundamentals to make better investment decisions related to sovereign risk and their financial performance and position, especially in comparison to their peers.

In particular, we will ask one simple question over and over again: “what would these governmental obligations, assets, spending and revenues look like if we applied accounting and measurement policies designed to provide a true and fair picture of financial reality as prescribed by IPSAS (International Public Sector Accounting Standards), IFRS (International Financial Reporting System), or the IFRS public sector comparable, and U.S. GAAP (Generally Accepted Accounting Principles) and?” IPSAS based accounting principles are used by the sovereign global benchmarks, and GAAP and IFRS are the standard measurement and disclosure frameworks employed by corporate America and global companies. A systematic approach to answering these questions will lead to insights on (i) the glaring gulf between the reported and the true and fair representation of financial reality performance and position; and (ii) a better appreciation for sovereign risk.

Adjunct Professor: Paul Kazarian is the CEO and founder of Japonia Partners (www.japonica.com) and the Charles & Agnes Kazarian Foundation (www.kazarianfoundation.org). During the 2013 Greek government-debt crisis, Paul became one of the largest investors in Greek government bonds, eventually offering a bond portfolio of €2.9 billion euros (approximately $3.8 billion U.S. dollars). Paul has told me that an accounting insight initiated this Greek bond investment and guided them to work with Greece to make its investment the best since its founding in 1988. Japonica has created its own language for investing in sovereign bonds, and the glossary can be found on the Foundation web site. He has often said that international standards for sovereign accounting are not used within the Eurozone. Instead, the EU opts for a legal framework meant for legal compliance rather than accountability and hence distorts the Eurozone’s financial positions.

The plan is for Paul to share his wealth of experience in the sovereign risk world with the class and assist in moderating the Q&A panels in the other sessions.

Q&A panelists listed below are invited and subject to change based on availability. Depending on the ebb and flow of discussion in the class, we may have to change our emphasis on the topics listed in the class sketch given below. Please be prepared to devote around 60 minutes of reading and video on special guests to be posted prior to class.
# B 8024: Preliminary Course Outline

<table>
<thead>
<tr>
<th>Class #</th>
<th>Subject matter</th>
<th>Specific Topics</th>
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<tbody>
<tr>
<td><strong>1: SEP 8</strong></td>
<td>Overview - Approach to Fundamental Analysis of Government Financial Statements</td>
<td>• A general framework for understanding governmental balance sheets &lt;br&gt; • Computing key performance indicators from governmental financial statements &lt;br&gt; • IPSAS (equivalent of IFRS) relative to Govt statistics (IMF or Eurostat) &lt;br&gt; • Paul will review Japonica’s PFM framework for assessing sovereign risk-reward and KCPF citizens’ Wealth Glossary. &lt;br&gt; • Overview of speaker materials.</td>
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**Guest Speakers:**

Bill Bergman (Truth in Accounting Director of Research; www.truthinaccounting.org)

Christopher Magarian (Japonica Partners): Database Overview


| **2: SEP 15** | Macro-economists view of sovereign balance sheets | • Citizens’ Wealth Metrics (with focus on first four) <br> • Japan, Germany, and US examples <br> • Sensitivities <br> • *Beyond Public Debt: The Hidden Rapid Erosion of EU Government Balance Sheets is a Financial Threat to Society - How to stop it.* CEPS. <br> • Overview of speaker materials |

**Guest Speakers:**

Olivier Blanchard (MIT Peterson Institute for International Economics C. Fred Bergsten Senior Fellow and Robert M. Solow Professor of Economics emeritus; https://economics.mit.edu/faculty/blanchard)

Richard Koo (Nomura Research Institute; CSIS)

Ken Rogoff (Harvard; https://scholar.harvard.edu/rogoff/home)

**Assignment 1 due at the beginning of class 2: Computing key metrics from Governmental financial statements or Eurostat or IMF statistics**
### Revenue
- Understanding revenue
- The revenue is collected from whom, how and where?
- How are government services priced?
- How is the revenue recognized in the books?
- How and when are constituents paying?
- Revenue fudges to reduce reported deficits

### Labor costs and entitlements
- What type of human capital do you need to sustain the revenue, how many and where are they located?
- How are(should) they (be) compensated Cash vs Benefits (pensions and health/opeb)?
- Where and how is the cost reflected in financial statements?
- What are other primary expenditures? Where and how are these reflected in financial statements?
- How are benefits and entitlements to citizens measured and reported?

- Credit Ratings
- Greece Government Debt
- Overview of speaker materials

**Guest Speakers:**

Richard Duncan (Economist and Author of *The Dollar Crisis* and the publisher of the video-newsletter Macro Watch; https://richardduncaneconomics.com/)

Vincent Truglia (former Moody’s sovereign bond head; www.linkedin.com/in/vincenttruglia/) – Rating Agencies

Fergus McCormick (former DBRS sovereign bond head; https://www.linkedin.com/in/fergusmccormick/) – Rating Agencies

**Case Study: Greece**

Assignment 2 due at the beginning of class 3: Summarize your key takeaways from the talks given by the external speakers in classes 1 and 2.

### Understanding Productive Capacity, Intangibles.
- What property and equipment (including technology) does the Government need to sustain the revenue and/or grow (match to the revenue expectations)?
- How much does this cost and how will it be financed?
- Where and how are(should) the physical and financing needs (be) reflected in the financial statements?

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<thead>
<tr>
<th>3: SEP 22</th>
<th>Understanding Revenue</th>
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<tr>
<td>Understanding Human Resources, Labor Costs and other expenses</td>
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<td>Credit Ratings and Greece Government Debt</td>
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<tr>
<th>4: SEP 29</th>
<th>Understanding Productive Capacity, Intangibles.</th>
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<tr>
<td>Opening Questions</td>
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<tr>
<td>What intangible assets are needed, how are they “acquired” and paid for, and how are/should they be reported?</td>
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<td>How do these all compare to competing countries?</td>
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<td>Is government infrastructure more of a liability than an asset?</td>
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<td>Balance Sheet Impact of Covid-19</td>
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<td>Accounting for and Implications of Seigniorage</td>
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<td>Inefficiency of sovereign bond market observations</td>
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<td>Politicizing of US debt</td>
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<td>US and UK Government balance sheet comparison</td>
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<td>US and Japan Government Total Net Worth and debt metrics</td>
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<td>Overview of speaker materials.</td>
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**Guest Speakers:**

Reza Moghadam (Morgan Stanley Chief Economic Advisor and former IMF Director of the European Department; [https://www.morganstanley.com/thoughts-on-the-market-moghadam/](https://www.morganstanley.com/thoughts-on-the-market-moghadam/))

Lawrence Summers (Charles W. Eliot University Professor and President Emeritus at Harvard University. He served as the 71st Secretary of the Treasury for President Clinton and the Director of the National Economic Council for President Obama; former Chief Economist of the World Bank)

Stephanie Kelton (leading expert on Modern Monetary Theory, professor of economics and public policy at Stony Brook University and a former Chief Economist on the U.S. Senate Budget Committee; author of The Deficit Myth; [https://stephaniekelton.com/](https://stephaniekelton.com/))

**Assignment 3 due at the beginning of class 4:** Understanding the quality and sustainability of the country’s revenue, labor costs, expenses and entitlements for a country. Also provide a brief set of key takeaways from talks by guest speakers in class 4.

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<tr>
<th>Date</th>
<th>Guest Speakers</th>
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<tr>
<td><strong>5: OCT 6</strong></td>
<td>Funding, Capital Structure</td>
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<td>What funding choices have governments made?</td>
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<td>How much and when is funding needed?</td>
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<td>How are these reflected in financial statements and performance measures?</td>
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<td>Sovereign government non-financial debts</td>
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<td>Central banks impact on sovereign financial statements</td>
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<td>Credit insights from government audits of financial statements</td>
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<td>Overview of speaker materials.</td>
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**Guest Speakers:**

Willem Buiter (former Global Chief Economist at Citigroup; expert in central bank accounting and seigniorage; [www.willembuiter.com](http://www.willembuiter.com))
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<th>6: OCT 13</th>
<th>Catch up and putting it all together</th>
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<td>• Catch up</td>
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<td>• Bringing all the pieces together</td>
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<td></td>
<td>• US and Japan Government Total Net Worth and Debt Metrics</td>
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<td>• The Great Debate: Reconciliation</td>
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<td>• New Zealand Case Study</td>
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<td></td>
<td>• Overview of speaker materials.</td>
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Guest Speakers:


Dimitri Tzanninis (former IMF Economist, member of the Economic and Financial Committee and of the Eurogroup Working Group of the European Union, Deputy to the Minister at the ECOFIN Council of Finance Ministers and at the Eurogroup Council of the European Union)

Ian Ball (formerly of the New Zealand Treasury credited with design and implementation of New Zealand's financial management reform process and Professor of Public Financial Management at Victoria University of Wellington; www.linkedin.com/in/ian-ball-a209678)

Case Study: New Zealand

Assignment 5 due at the beginning of class 6: Understanding and critiquing liabilities reporting for a country. Also provide a brief set of key takeaways from talks by guest speakers in class 5.

Assignment 6 due: Final report due a week after class ends, OCT 19 11.59 pm. Also, please provide a brief set of key takeaways from talks by guest speakers in class 6.

GRADES TENTATIVELY DUE: OCT 25
Class 1: Introduction to financial statements and measurement approaches employed by various national statistical agencies

- Introductory preliminaries and the basics of financial statements
- Aren’t Governments different from private firms?
- Excessive focus on headline deficit numbers
- Highlight the international accounting bodies with different measurement standards
- Define and clarify all terms and concepts used in future sessions
- Budgets v/s financial statements
- Highlight how simple KPIs (key performance indicators) can potentially change management behavior
- Outside speakers on the state of public accounting

Class 2: Institutional background

- Star outside speakers on the macro-economic situation underlying the large negative net worth numbers of various countries

Class 3, part 1: Understanding and critiquing revenue streams for a country

- In the U.S. context and to some extent for the U.K.
  - Where does the revenue come from?
    - 27% of accounts receivable and 75% of tax receivable on the U.S. balance sheet are doubtful
    - Student loans and loan guarantees are the biggest asset on the U.S. balance sheet and subject to valuation fudges
    - Revenue shenanigans in the U.S. and in the E.U.

Class 3, part 2: Understanding and critiquing labor costs and entitlements for a country

- Understanding the components of Labor and Entitlement costs, how they are reported
  - Govt personnel costs and citizen entitlements conflated in the U.S. unlike NZ

- Economic versus accounting for some of the larger components
- Post-employment benefits: pensions and healthcare
  - Private sector standards for pension and health care accounting not followed in the U.S. Govt. books
  - Pension deficits are a huge headache at the state and local level in the U.S.
  - Accounting for Medicare and the HI Trust Fund
  - Off balance sheet related to social security and Medicare/Medicaid is around $60 trillion for the U.S.

- A few comments on the three big arms of the U.S. Govt
  - Department of Health and Human Services
  - Department of Defense
  - Social Security Administration
Outside speakers on the state of public sector balance sheets

Class 4: Understanding the country’s assets

- Does the government’s definition of an asset include economic control?
- What are the physical resources the U.S. Govt has invested in?
  - PPE
  - Investment in Government Sponsored Enterprises
  - Freddie and Fannie’s balance sheets not consolidated into the U.S.’s books
  - Freddie’s debt to equity ratio is 400 and Fannie’s is 550
    - What if we see a 20% decline in housing prices?
  - Federal Deposit Insurance Corporation (FDIC) not consolidated
  - Pension Benefit Guarantee Corporation (PBGC) not consolidated
  - The notional value of loan guarantees is upwards of $1.8 trillion
  - Stewardship and heritage assets
  - Potentially repurposing federal real estate and buildings

- Highlight shenanigans that countries employ in reporting of assets with examples
- Non-financial assets
- Outside speakers on fiat currency

Class 5: Understanding and critiquing reporting of liabilities for a country

- Distinction between gross and net debt
- Understanding budget deficits and links to income and cash flow statement
- Understanding the liabilities on the U.S. balance sheet
- Debt ceiling shenanigans
- Greek debt overstated to extract concessions from EU and Greek public
- Highlight shenanigans that countries employ in reporting of liabilities with examples
- Outside speakers on sovereign bond markets

Class 6: Wrap up

- Paul’s Greek debt experience
- Hotspots in sovereign risk today
- Outside speakers on the macro-economist’s perspective on sovereign balance sheet

Graded Learning

The only way you will internalize the information in the course is by actually reviewing and commenting on the financials or the financial statement of a country.

In the assignments, you will be asked to analyze key aspects (e.g., revenue, labor, etc.) of a country of your choosing (following the framework provided in the class) on an individual basis. However, feel free to talk with each other or with others to help you maximize your learning.
At the end of the class, the deliverable is a **final project for your chosen country**. Details can be found in the assignment memos attached to the syllabus. Ideally the country you choose to analyze will be one that you are interested in understanding deeply.

The grades will be based on your engagement in the class, the assignments, and the final deliverable but we have **no exams**.

**Final project of your chosen country:**

In general, students are free to choose any country for analysis with the BIG CAVEAT that not all countries report financial statements. If you are interested in a country without financial statements, you will have an intellectually rich and but also a difficult journey into recreating some of the financial statements from supplementary sources.

We recommend that you choose one of the following four countries for whom financial statements are available: (i) European Union; (ii) Australia; (iii) New Zealand; or (iv) U.K. The U.S. also produces financial statements but we heavily use U.S. disclosures in the class. Hence, we would rather not have you use U.S. for your project.

If you are set on working on emerging markets, the following four countries are potential hotspots worth studying: (i) Argentina; (ii) Brazil; (iii) China; and (iv) Venezuela. But beware that these countries do not produce financial statements.

**What you will get out of this**

Every student **who puts in effort** should walk away with an approach and concepts that you can use in almost any country. It is usually a fun and stimulating journey for students. **At the same time, I want to emphasize that a “30,000” foot perspective does not work in this class. This is a detail-heavy intense experience.**

**Is financial expertise critical?**

The course presumes that you have a solid understanding of the subject matter covered in B6013 and other core courses. We have had many students in the past in similar classes without additional financial accounting or finance backgrounds, and by investing in their learning, they end up with H or even H+ grades. So, while financial analysis expertise may be helpful it is not necessary at all.

High quality investment decisions in the real world are grounded in a lot of detail about the sustainability of the country’s finances. Without careful analysis, we cannot hope to ferret out price moving information that the market has overlooked. Following that objective, this is a detail-heavy class that gets deep into financial and non-financial data to assess the country.

**Required Text and Background Readings** *(Material meant to be read selectively based on areas of interest.)*

1. Weekly handouts/posts on Canvas substitute for a course packet
2. There will also be additional references provided for those students who want to get more background and a deeper understanding of some of the technical accounting aspects of any topic, but this is not required. I am more interested in the willingness to learn and less in prior technical accounting backgrounds. Some of my best students in the past have surprisingly had nothing more than introductory accounting. But they probably worked the hardest they ever had on this course.

- External Website Resources https://kazarianfoundation.org/library/other-resources/

Grading

You have two sets of deliverables with different grading components as follows:

1. There will be approximately six other written assignments during the semester. All these assignments relate to the understanding and forecasting of the specific line items on the income statement and balance sheet for an actual company of your choosing. These
assignments will be done by you using the Type B assignment scheme (see below) and cover 50% of the grade. In particular, the first five assignments cover 45% of the grade whereas the sixth one is allocated 5% of the final grade.

2. The remaining 50% of your grade will be based on FIVE 10 minute in-class quizzes based on the material covered in previous classes, your attendance at class in general and my perception of your preparation and understanding of the class.

How are the five weekly assignments graded?

TAs grade each assignment looking for whether or not the team has satisfactorily covered the checklist we assign for evaluating every important line item on the financial statements: revenue, labor and entitlement costs, assets and liabilities.

Seeking Alpha

In the past, students in my other classes with outstanding project reports have had their case for shorting or longing a stock (here country) accepted for publication at the website “Seeking Alpha” http://seekingalpha.com/. I encourage you to shoot for such a publication at the end of the class. Well written and well analyzed articles get thousands of page views in Seeking Alpha and might represent a credible way to get noticed in the analysis world.

Audits

I do not encourage auditing/observing the class. The only way you learn the material is by actually working through the assignments and quizzes.

TA

The TA for the class is MJ Song (msong21@gsb.columbia.edu).

You can communicate with MJ via email to discuss the course and assignments. You should also copy me on all correspondence.

Office Hours: By appointment

Relation to the Core:

This course incorporates elements of every core class.

This course adheres to the Columbia Core Culture. Students are expected to be:

Present:

• On time and present for every session
• Attendance tracked
**Prepared:**
- Complete pre-work needed, expect cold calls
- Bring nameplates and clickers

**Participating:**
- Constructive participation expected and part of grade
- No electronic devices unless explicitly called for by the instructor (look under “tablets/computers” below)

**Code of Conduct: aka our Contract**

The value of the course will depend on how much effort you are willing to put in, and on attendance and participation in the lectures and assignments.

You are expected to treat the class as you would your job, i.e., as a business professional, demonstrating mutual respect for each other, and performing as if it is an important business assignment. This means you need to be prepared, be on time, and be attentive during the class.

*Tablets/Computers:* I am open to letting you use these for access to the class materials or to take notes. BUT if this is abused for personal activities and distracts other students, I will change the policy.

*Cellphones:* All classes in this course have a ‘no cellphone’ policy. In respect to your fellow classmates and myself, please have your phone’s volume and vibration turned off during class and keep your phone in your bag/pocket. We will have one break (10 to 15 minutes) when you can catch up on calls, emails, etc.

If you need to be reachable immediately during class (e.g. your wife is going into labor any minute), please let me know ahead of time.

**My commitment to you:**

I will give you as much personal attention as feasible to maximize the benefit from your work. As people come in with different expertise, we can (partially) tailor the output to your strengths and expertise. I appreciate constructive feedback during the course to help optimize your learning, but I have to consider the class as a whole, so individual needs are best dealt with by me or MJ one-on-one.

<table>
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<tr>
<th>Type</th>
<th>Designation</th>
<th>Discussion of Concepts</th>
<th>Preparation of Submission</th>
<th>Grade</th>
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<tr>
<td>B</td>
<td>Group/Individual</td>
<td>Permitted with designated group*</td>
<td>Individually (No sharing of any portion of</td>
<td>Individual</td>
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*The designated group is a self-selected study group to be used for the duration of the course.