
Transition to Accrual Accounting – Cross Country Experience

U.S. Pant

The Session on 'Transition to Accrual Accounting–Cross Country Experience' in the form of panel discussion was held on the second day. The panellists were *Mr. Tej Prakash* (IMF), *Mr. Gert van der Linde* (World Bank), and *Mr. Nandasiri Warusamitharana* (DGSA, Sri Lanka) who chaired the session.

Opening the discussion, the Chairman mentioned that Accrual Accounting Concept was alien to Governments till the 1980s, when New Zealand started working towards it. Today the Global trend is to move from Cash based accounting system to accrual accounting. He mentioned that Sri Lanka had prepared the financial statements for the year 2002 on IPSAS. He also mentioned that they are moving towards Accrual Accounting to strengthen an efficient management information system and to be in line with global developments.

Gert van der Linde, the first speaker made a presentation on implementation of Accrual Accounting System in South Africa. He stated that Public entities as well as Government business entities are now keeping account on Generally Recognized Accounting Practices (GRAP). To support the new system a Legislation to set up a Board of Accounting Standards was promulgated and the said board has been established recently. In all nine provinces and the national Government are to follow the new system.

Gert van der Linde elaborated on the agenda that covered the efforts to ensure that all revenue, expenditure, assets and liabilities of the Governments are managed efficiently and effectively to provide for responsibilities of persons entrusted with Financial Management in these Governments and to provide for the matters connected therewith. Describing the weaknesses of the old system he mentioned that without accrual accounting we compromise on the abilities of the organization to manage the expected and the system to hold accountability.

He mentioned that South Africa system suffered from almost all traditional weaknesses of Cash based Accounting system and its associated problems. The outcomes that were desired from the new system were transparency in budget system, efficient financial balance system and processes; effective management of revenue, expenditure, assets and liabilities; and useful performance measurement reports; and unqualified financial statements in terms of GRAPs.

He referred to the main problem areas which were:-

- ❖ Cash Utilization was the key measure of performance
- ❖ Focus on inputs and not on results
- ❖ Fragmented and unclear accountabilities and legal frameworks
- ❖ Poor quality and late information

- ❖ Poor compliance with existing legislation
- ❖ Weak financial management
- ❖ Wastefulness, inefficiency, fraud and theft

The above problems had led to an overall **Poor Accountability** in the systems. The desired **outcomes of the change to an accrual system** are:

- ❖ Transparent budgeting process
- ❖ Sound financial management systems and processes
- ❖ Effective management of revenue, expenditure, assets and liabilities
- ❖ Reliable and useful reporting on performance, annual reports and annual financial statements
- ❖ Unqualified consolidated financial statements in accordance with “GRAP” and reconcilable to GFS requirements
- ❖ Improved accountability of departments, other government agencies and public entities

The **transition agenda** envisaged the following:

- ❖ Clear vision, especially on accountability arrangements
- ❖ “Mindset” changes for all stakeholders
- ❖ Legislation on the Public Financial Management
- ❖ Budgetary reform
- ❖ Norms & standards of processes and activities
- ❖ Systems approach and drawing from the best practices
- ❖ Build capacity of finance and non-finance staff
- ❖ Change leadership

Narrating the South African experience, he mentioned that Accrual Accounting is not an end in itself. To support the Accrual Accounting System, responsibilities of accounting officers has to be fixed and offences and penalties have been prescribed for criminal proceedings under the legal system of South Africa under Public Financial Management Act. The PFMA restructured its treasury system and introduced outputs and outcomes. It streamlined the scope and framework of the financial management aspects imposed limitations on borrowings and guarantees; and fixed a time frame for reporting and auditing the annual financial statements.

The PFMA that was promulgated in January 1989 was implemented in terms of most of the Sections from 1.4.2000. Certain sections were delayed further to make a progressive change. With the vision and commitment of the Government the new system will soon be operational under full accrual accounting system.

The **PFMA enabled** the following:

- ❖ Repealed 10 exchequer acts and established national treasury and 9 provincial treasuries
- ❖ Provided clarity on accountability of executive authority, director general (accounting officer) and staff
- Introduced concepts of outputs & outcomes

- Introduced new incentives and sanctions
- ❖ Widened Scope – introduced concept of “ownership control” that led to oversight over public entities and paves way for consolidations
- ❖ Provides for frameworks in place of procedures – flexibility but with improved accountability
- ❖ New Treasury Regulations
- ❖ Established an Accounting Standards Board for GRAP
- ❖ Limitations on borrowing and guarantees.

Specific provisions were made in the PFMA for the following:

- ❖ Managerial performance
- ❖ Annual Reporting
- ❖ Annual Financial Statements
- ❖ Internal Audit
- ❖ Cash Management
- ❖ Loans and Guarantees
- ❖ Procurements

For both, Government departments as well as public entities, similar approach was aimed at. As a result, a clear holistic and agreed vision was ensured and strategic plans based on sound accountability fundamentals were drawn. Further, emphasis was laid on building strengths and eliminating weakness. *Gert van der Linde* concluded with the remarks that South Africa experience has been a very important landmark in revamping and upgrading the financial management system in the Public Sector.

The second speaker of the Panel, *Tej Prakash* mentioned that adequate deliberations have been made on the subject of Accrual Accounting and as such he would rather focus his discussion on GFS. To dispel any doubts about GFS 2001 and the policy of the IMF, he mentioned that the Fund unequivocally supports Accrual Accounting system for all countries and GFS 2001 is, in fact, accrual based.

He stated that Accrual Accounting includes the Cash basis within it and it is not an ‘either’ ‘or’ situation. The IMF looks for answers to questions like what are the country norms on non-financial assets; and targets consistency of definitions and fundamentals. About GFS he mentioned that it is a comprehensive conceptual and analytical framework for analyzing and evaluating fiscal policy in a consistent manner in the government of the country. It covers the Public Sector that contains general government, and government controlled entities such as public corporations (since they carry out government’s fiscal policy in a variety of ways) and Government controlled entities. There are many kinds of entities that are in the public sector. In some cases, the boundary between what is within the general government and what is outside it (but within the public sector) can be a little fuzzy.

The public sector includes the general Government and the enterprise sector. General Government includes the central Government, governments at the provinces or the states level, and local Governments. For analytical purposes GFS recognizes these three levels although many countries can have more levels. The general government also includes all non-market not-profit institutions controlled and financed by the government.

The GFS takes the position that if an entity provides non-market service and is financed by the government, it is a part of the general government.

How is GFS useful?

Public finance analysts use fiscal statistics to analyse the size of public sector, its contribution to aggregate demand, investment and saving; the impact of fiscal policy on economy, resource use, taxation, and social safety net. In addition, stakeholders are interested in efficiency of spending, sustainability of fiscal policy, net debt and net wealth, and impact on social safety nets and poverty. GFS allows analysis of data on fiscal and financial performance including liability and asset measurement, liquidity position of the government, and assessment of performance in different areas of government function. It allows analysis of data on fiscal and financial performance including liability and asset management.

How does the GFS define its function?

- ❖ Government executes public policy
- ❖ Provides primarily non market services
- ❖ Redistributes income and wealth

GFS also allows determination of the net position of the government through a set of balancing items-net operating balance, net borrowing/lending, and net worth in a consistent and systematic manner. He mentioned that GFS has been largely harmonized with the Statement of National Accounts (SNA) framework. While SNA focuses on production and consumption of goods and services, GFS focuses on taxing, spending, borrowing and lending and other financial flows in the government. There is no clash between the SNA's and the GFS. It follows the GAAP and concepts of accounting that are followed in businesses.

The basic entity in the GFS is an *Institutional Unit*, while the recording of the accounting transactions are in the form of *Stocks and Flows*. An 'institutional unit' is defined as an entity that is capable, in its own right, of owning assets, incurring liability, and engages in economic transactions with other institutional units. Government units are institutional units that carry out the functions of the government as their primary activity. That is they have legislative, judicial or executive authority over other institutional units within a given area. They provide goods and services to the community on a non-market basis, they make transfer payments to redistribute wealth, and they finance their activity by taxes or transfers from units in other sectors. All

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Stocks and flows

It is viewed that all government units are members of the general government.

- ❖ All GFS data is organized as stock and flows.
- ❖ Basic GFS identity is:

$$S1 = S0 + F$$

Where S_0 is stock at the beginning of first period, F is flow through period one and S_1 is at the end of period one or at the beginning of period two.

Stock refer to a unit's holding of assets and liabilities at a specific time, and the unit's resulting net worth equal to total assets less total liabilities.

Flow reflects the creation, transformation, exchange, transfer or extinction of economic value. They involve changes in volume, composition or the value of a unit's assets, liability, and net worth. It can be a single event such as cash payment for goods, or a continuous one such as interest payment on zero-rated bonds.

Transaction is an interaction between two units by mutual consent. Mutual consent implies knowledge and not agreement. Payment of tax between government and citizens is a transaction. Transaction can either be 'exchange' or 'transfer'. It can be monetary or in kind. He further mentioned that GFS follows double entry system and prescribed balance sheet that indicates assets, liabilities and net worth of a unit or sector. The deriving measures are based on the aggregates.

Accounting rules of the GFS are very similar to the accounting rules of businesses, and of the government financial statements GFS advocates double entry system for recording flows. Each flow gives rise to two equal value entries—a debit and a credit, that increase or decrease asset or liability and thus affect net worth.

Balance Sheet is a compilation of a unit or a sector's assets, liabilities and net worth. The basic balance sheet identity is that the total value of assets equals total value of liabilities plus net worth.

Timing of recording flows

Once a flow has been identified, the time when it has occurred must be determined so that so that result of flow within an accounting period can be compiled. Timing of flow also affects the

balance sheet. GFS recognizes four methods of recording flows: cash, commitment, due for payment and accrual. GFS uses the accrual basis because the time of recording matches the time of actual resource flow. As a result accrual basis provides the best measure of impact of fiscal and macroeconomic policies of the government. The accrual basis provides the most comprehensive information because all resource flows are recorded including internal transactions, in kind transactions and other economic flows. However, GFS recognizes that accrual information will some cases will need to be supplemented by specific information. For example, information on payment arrears and for assessing liquidity will need to be prepared. GFS provides specific guidance on timing of recording different kinds of flows.

Valuation

GFS recommends that all stocks and flows should be valued at the amounts for which goods, services, assets other than cash, labour or the provision of capital are exchanged or could be exchanged for cash. These are thus valued at current *market prices*.

Derived measures

These measures consist of aggregates and balancing items. Aggregates (such as total tax revenue) are important tools for summarizing the value of selected flows or stocks. Balancing items are derived by subtracting one aggregate from another. For example, net worth is equal to total assets less total liabilities.

Netting of stocks and flows

GFS generally favours recording transactions in gross terms. However, in some cases, data on net basis is more meaningful. For example, tax revenues can be recorded net of refunds for the same fiscal year.

Consolidation

In the GFS data is presented for the general government sector along with data for each of the sub sector on a consolidated basis

The *analytical framework of the GFS* has four different components:

The opening balance sheet that provides a measure of net worth that equals non-financial assets plus net financial worth. To the opening balance sheet is added:

Results of government operations during the year

Basic operating balance is revenue minus expense. This is arrived at by:

- ❖ Transaction in financial assets minus transactions in liabilities is equal to net lending or borrowing,
- ❖ Add transactions in non-financial assets (which equals changes in net worth due to transactions),
- ❖ Add to this the Statement of other economic flows. This will include the sum of holding gains or losses from both financial and non-financial assets. That takes us to the closing balance sheet.

- ❖ *Closing balance sheet* provides us with a measure of net worth at the close of the accounting period. Net worth is the sum of net financial worth (financial assets minus liabilities) and non-financial assets.

About implementation of GFS, *Tej Prakash* recommended a step-by-step approach depending on the capacity of the country, in terms of human skills and preparedness that generally varies. He broadly categorized three phases of implementation:

Phase 1 Countries

These countries will continue to record revenue, expenditures and financing mainly on a cash basis, and will move budget classification in the direction of GFS, and will develop institutional capacity to move to Phase 2.

Phase 2 Countries

These will record revenue and expenditure transactions (other than depreciation) and transactions in financial assets and liabilities (but not non financial assets) on an accrual basis. This is partial accrual basis, and these countries shall develop the capacity to move to Phase 3.

Phase 3 Countries

They will recognize depreciation, record transactions in non-financial assets on an accrual basis, and complete the development of their institutional capacity.

Tej Prakash reiterated that the GFS 2001 is a comprehensive approach that includes all aspects of accounting to suit the requirements of the statistics, fiscal reporting and accounting principles.

Concluding the session, the Chairman thanked both the Speakers for their excellent presentation and expressed the desire for more interactions of the types, such as been in this seminar. He further desired that separate conference on accrual accounting would be immensely useful for all the participants.

Conclusions & Recommendations:

- ❖ Transition to accrual accounting is called for. However, a cautious and calculated approach is desirable. A clear, holistic and agreed vision should be the basis for strategic planning in this regard. The emphasis should be on building upon strength in the existing system and eliminating weakness.
- ❖ Accrual accounting should be seen as a component of the Public Financial management system. It should, therefore, be supported by a clear accountability protocol and a system that focuses on outputs and outcomes. Appropriate incentive and sanctions must also be provided for in the new system.
- ❖ Treasury regulations should be reviewed to align them with the changed scenario.
- ❖ Transition to Accrual Accounting requires sustained commitment on the part of top management.

- ❖ Governments should provide greater exposure to accounting personnel to benefit from cross-country experiences of countries, which have successfully implemented this transition.
- ❖ Given the multi-faceted challenges posed by the transition to accrual accounting, a separate workshop on this theme needs to be organised at the earliest.