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The report was prepared under the general guidance of Edward Olowo-Okere, Sector Director, AFTOS.

LIST OF ACRONYMS

AfDB	African Development Bank
AG	Auditor General
BEAC	Business and Economic Advisory Council
BOB	Bank of Botswana
BURS	Botswana Unified Revenue Service
BWP	Botswana Pula
CF	Consolidated Fund
CSO	Central Statistics Office
CY	Calendar Year
DF	Development Fund
FAD	Fiscal Affairs Department
FY	Fiscal Year
GABS	Government Accounting and Budgeting System
GDP	Gross Domestic Product
GFS	Government Finance Statistics 2001
GIA	Government Investment Account
IFAC	International Federation of Accountants
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
MDA	Ministry, Department, Agency
MFDP	Ministry of Finance and Development Planning
MIC	Middle Income Country
MTEF	Medium Term Expenditure Framework
MTFF	Medium Term Fiscal Framework
NDP	National Development Plan
OECD	Organization of Economic Cooperation and Development
PAC	Public Accounts Committee
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Financial Management
PIP	Public Investment Program
PPP	Public Private Partnership
PSRU	Public Service Reform Unit
RBM	Results-Based Management
SACU	Southern Africa Customs Union

BOTSWANA – ACCRUAL ACCOUNTING POLICY NOTE AND GUIDE

Volume 1 - Table of Contents

A. Introduction

1. **The Botswana Economic Advisory Council (BEAC), which reports to His Excellency the President, identified a gradual transition to accrual accounting as part of a wide ranging set of reforms necessary to improve public service, fiscal and monetary management**.[1] The World Bank's Public Expenditure Review (PER) of August 2010 included key messages that full accrual accounting has been adopted by only a small fraction of OECD countries, and that it implies significant changes to budget systems that should be approached with caution. The PER recommended that a sensible approach would be to phase implementation "from cash to modified cash … and then to modified accrual … once the business case is clear"[2]. The National Strategy Office (NSO) subsequently advised the IMF during its October 2010 mission that – (i) "the BEAC document has been approved by the cabinet and, therefore, sets out the government's decision to implement accrual accounting"; and (ii) "NSO also indicated that while it is appreciated that such a reform could not be implemented overnight, a clear plan or road map should be prepared by the MFDP"[3].

2. **More detailed guidance on the approach to and phasing of implementation of accrual accounting has indeed been given in its October 2010 mission report by the IMF, who also proposed "a phased implementation approach to manage the change process in a manner consistent with the capacity and other resource constraints".[4]** They further recommended "defining the overall desired framework, but undertaking the implementation in a number of phases, starting with relatively less challenging issues and progressively moving toward the full desired framework……. The implementation process could commence with improving the existing cash accounting framework by adopting the International Public Sector Accounting Standard (IPSAS) for cash basis accounting—the Cash Basis (IPSAS)—then implementing accrual accounting for relatively simple financial assets and liabilities. Accrual accounting could then be extended through all material financial assets and liabilities, to finally incorporating nonfinancial assets." This paper supports the overall guidance given thus far to the Government of Botswana.

3. **In tandem with seeking advice from the Bank on the design features of an MTEF and moving towards performance or program based budgeting, the Government of Botswana also requested the Bank to provide further advice and guidance on their decision to implement accrual accounting.** <u>Simplified clarity for the non-financial person</u> is sought on two key areas – (i) on key implications and new policy issues associated with the decision to move towards accrual accounting; and (ii) guidance on the key steps and requirements to move forward with implementing accrual accounting. These then are the objectives of this paper. <u>Note that this paper does not attempt to discuss the matter in all its technical aspects, but merely to highlight and summarize the most critical aspects along the lines of the set objectives.</u>

[1] The Government Implementation Coordination Office (GICO), The Office of the President. November 2008. *Botswana Excellence – A Strategy for Economic Diversification and Sustainable Growth*.
[2] World Bank. August 2010. *Botswana Public Expenditure Review (Report 53959-BW)*
[3] IMF. October 2010. *Botswana – Public Financial Management Reform: Selected Issues and Action Plan*
[4] Reference should also be made to IFAC (December 2003) *Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities* (Second Edition).

4. **In providing its advice in this paper the Bank mission team reviewed materials already provided,** including the Bank's PER, the FAD technical assistance reports, the PEFA study, Botswana's own public financial management reform plan and the Bank's Report on "Specific Issues In Budget Reforms in Botswana" (March 2011).

5. **This paper comprises two volumes** – Volume I, this concise policy and guidance note that deals with the request as outlined in paragraph 3, and a Volume II which provides more detailed technical guidance on the implementation of IPSAS accrual based standards.

B. What is the key difference between cash and accrual accounting methods?

6. **Accrual accounting is a methodology under which transactions and other events are accounted for <u>when they occur, and not only when the associated cash is received or paid</u>.** Following this methodology, revenues are accounted for when income is earned (and not just when the cash is received), and expenses are accounted when liabilities are incurred or resources consumed (and not just when cash is paid). As a consequence financial statements prepared on an accrual basis of accounting will not just report on cash balances, payments and receipts, but fully on all assets, liabilities, net assets/equity, revenue and expenses.

7. **This contrasts with the cash accounting methodology which recognizes transactions and other events <u>only when cash is received or paid</u>.** Cash accounting therefore, generally, does not support reporting on assets, liabilities, net assets / equity and non-cash revenue (such as interest earned but not yet received in cash) and expenses (such as depreciation).

8. **Let us demonstrate this key difference with an example of capital spending on the construction of a new dam.** To simplify the example, let's assume that the dam is constructed in one financial year. Under a cash accounting system, the cash payments on the construction cost of the dam are recorded and reported as an expense. No asset is reported, since the accounting system is not configured to keep track of fixed assets and to report this in a "Statement of financial position". However, under an accrual system the cost of construction of the dam is not treated as an expense in one financial year, but it is treated as an asset and subsequently expensed through annual depreciation charges over what is considered to be the useful life of the asset. There are several consequences to this, including that the "budget deficit / surplus" calculated on a cash basis would differ from the "accrual deficit / surplus" reported under an accrual basis of accounting. This is discussed in more detail in paragraph 34 below.

9. **Cash accounting has traditionally been practiced in the public sector mainly to support accountability for the cash budget as approved by Parliament.** It is still true today that in most developing countries financial planning, control and reporting focus on the management of available cash, funding of the budget deficit and the level of public debt. The budget is a cash flow budget, which results in an annual "Appropriation Act" that legally authorizes spending of cash as allocated in the budget. Cash accounting systems are therefore implemented to account for cash flows against the appropriated cash budget. The

primary accountability report that this system can reliably produce is a report comparing the actual revenue and expenditure on a cash basis with the budgeted revenue and expenditure as approved by the Legislature. Herein lays the problem – the Executive has much larger accountability than just how cash resources were utilized. Investments, fixed or movable assets and inventories are neither recorded in the accounting system, nor reported in financial statements. Debtors (also called receivables – parties owing money to the government) and creditors (also called payables – parties to whom government owes money) are not accounted for. The accounting system also falls short on providing reliable data on liabilities.

C. Why should Botswana consider implementation of accrual accounting?

Helping to meet fiscal challenges

10. **The Bank's PER[5] reports a number of significant challenges that cloud Botswana's horizons.** Stubbornly high poverty rates and inequality; high unemployment; HIV/AIDS challenges; weak private sector activity; overdependence on public employment and spending. These challenges will have to be faced in an uncertain economic outlook, given a likelihood of gradually falling diamond income and less buoyant SACU receipts. Achieving results with fewer resources calls for a far stronger focus on prioritization, effectiveness and efficiency – an area of opportunity for Botswana's public expenditure system.

11. **The PER focused on the need for Botswana to reexamine some of its key public sector institutions in order to make a successful transition to an era of diminished revenues. A number of reforms are recommended** to enable the public sector to fulfill a changing role - "one less focused on the provision of basic infrastructure and social services and more concerned with effectiveness and efficiency in service delivery and with supporting a dynamic, competitive private sector." Recommended reforms directly relevant to this paper include – (i) fiscal reforms on both the revenue and expenditure sides to limit fiscal deficits and ensure a return to a sustainable medium term fiscal path; and (ii) transforming the current planning and budget system which falls short in meeting the usual measures of budget effectiveness by, for example, moving towards government-wide Medium Term Fiscal and Expenditure Frameworks and a program budget in the medium term, in tandem with public sector reform and the necessary changes to the PFM legal framework and the government accounting system. It recommends that accrual accounting reform be approached cautiously, which this paper then also aims to further clarify.

12. **Accrual accounting provides a richer set of financial information to support analysis of the sustainability of fiscal stance and the quality of fiscal decision-making.**[6] Information

[5] World Bank. August 2010. *Botswana Public Expenditure Review (Report 53959-BW)*
[6] *Ibid.*

available under the cash basis supports development of short term fiscal strategy, whereas accrual information (specifically assets and liabilities) can be given the same attention as public debt in terms of contribution to economic policy objectives. It is also possible to consider issues related to "intergenerational fairness" - the degree to which the taxpayer of today is paying the costs of government services today, as opposed to shifting costs for services of today to future generations. More about this in paragraph 34 below.

13. **It also provides complete and reliable information on liabilities and arrears.** Apart from public debt, governments normally have significant other liabilities which are not reported under cash accounting and may well be underfunded. [7] Key examples include – (i) the future obligation to pay civil service pensions; (ii) accounts payable; (iii) interest, salaries and other expenses in arrears;[8] (iv) environmental liabilities; and (v) obligations under accident compensation schemes. In addition accrual accounting standards such as IPSAS require disclosure of contingent liabilities, including guarantees given by the government.

14. **Cash management will improve.** Reliable information that impact on cash flow estimates is more readily available[9] – debtors, creditors (arrears), contract payments, accrued interest, commitments, etc.

Improving accountability

15. **Ultimately, improved accountability should be at the heart of this reform.** For example, if one accepts that it is good enough for the public sector manager not to care about assets (such as buildings, inventories and equipment) under his or her control, or about the fact that his or her budget will be exceeded because of unrecorded liabilities, cash accounting will do. As already explained above, one cannot expect much more than a report explaining how cash was used from a cash accounting system. The saying that "what gets measured gets done" holds true. However, if one is concerned about best use of taxpayers' funds, accrual accounting is not a debate but a necessity. Under accrual accounting the total financial impact of government decisions about and management of **R**evenue, **E**xpenses, **A**ssets and **L**iabilities will be recorded and annually reported. Pun intended - "real" management of and accountability for taxpayers' funds and intergenerational assets and liabilities will be enabled.

16. **"One is accountable for what one controls".** For the authors of this note, one key benefit is that accrual accounting facilitates enforcement of this basic accountability principle. There certainly are decisions by the Executive today that will only result in a cash transaction much later, perhaps even years later. In a typical cash accounting system, such transactions will not be accounted and therefore not reported to Parliament. This is wrong. They are also empowered to control far more than just cash provided by taxpayers, and Parliament must therefore have reliable financial information, produced by a reliable and acceptable accounting technology, which will facilitate accountability in its broadest sense. Rowles

[7] *Ibid.*
[8] IMF. 2001. *Government Finance Statistics Manual.* Washington, DC. Para 3.47–3.53.
[9] *Ibid.*

[10]argues that "availability of accrual accounting information permits economic calculation that improves decision making and results in superior outcomes in the use of scarce resources. Existence of that capacity imposes an increased rigor on standards of accountability…..Its absence implies misinformed decision making and a consequent misdirection of resources that result in lesser outcomes". Herein then also lays the opportunity for development. Letting go of what is right just because of "difficulty" or "capacity constraints" indeed would be a development disservice to humanity.

17. **"Information is the currency of accountability".** Improving the financial information of government is a key step to help improve accountability for the power entrusted to use taxpayers' funds. Consider having unhindered and reliable access to information (consolidated and by entity) on all government investments, fixed assets (property, plant and equipment), inventories, debtors (those who owe money to government), long term loans / debt, creditors (those to whom government owe money), government guarantees and contingent liabilities. Only an accrual accounting and reporting system that complies with the fundamentals of accounting and internationally acceptable public sector accounting standards, such as IPSAS, will be able to provide this. With this new information, and subject to the necessary political will and an enabling legal framework, Parliament will be empowered to hold the Executive to account for the power entrusted to use taxpayers' funds. Equally so the Executive will be empowered to manage and discharge normal fiduciary responsibilities expected by taxpayers. The rest of this note will briefly discuss other benefits and key caveats, and then elaborate key changes that will come about as a result of accrual accounting. As regards the latter it will broadly discuss the policy issues and other matters that will be required to implement the change, assuming the continuation of a cash flow budgeting system. It will conclude with suggestions on how to move forward with the implementation of accrual accounting.

Other benefits

18. **Several other benefits can be expected from the implementation of accrual accounting.** Without attempting to provide an exhaustive overview of the literature in this regard, key other benefits that can be expected include the following –

    a. **Broader accountability**. Accrual based financial statements allow users to assess accountability for all resources entrusted and how those resources are used. This contrasts with the focus on cash alone under cash accounting.

    b. **Financial information is more comparable and consistent.** Accrual information improves understanding of the underlying fiscal position over time by removing year-to-year variability caused by the timing of cash receipts and payments, specifically in respect of large capital payments.[11] This, for example, enables improved analysis and evaluation of budgets, cost drivers and actual results.

[10] Rowles, Tom. Accrual Accounting in the Public Sector: its usefulness in economic decision making. *Journal of Finance and Management in Public Services.* CIPFA: Volume 3 Number 2
[11] IMF. 2001. *Manual on Fiscal Transparency.* Washington, DC: Fiscal Affairs Department

c. **Improved decision making and management of all resources.** Accrual accounting discloses existing investments in fixed assets and inventory and the costs of using such assets to deliver services, which will assist in purchasing decisions and better asset management (including maintenance, replacement policies, identification and disposal of surplus assets, and safeguarding).

d. **Improved costing of services and products.** Good financial management practice requires that all costs be allocated to goods or services, otherwise prices will be understated. In addition the ability to then match costs and revenues is equally important. Given the absence of such principles in the cash accounting system the required information to do this is not available, where as in an accrual accounting system it is. This has consequences for taxpayers where, for example, hidden costs could make a public service provider's price artificially low (with severe financial consequence later) and thus impeding fair competition. A cash-based system does not provide accurate information about the real costs of government activities. Only an accrual-based operating statement provides information on the total costs of resources used to deliver government services, which is essential information for government decision makers.[12]

Improved control, which also reduces opportunities for theft, fraud and corruption. Cash accounting systems do not provide integrated internal controls over government fixed assets and inventories to improve stewardship. For example, access control and audit trails in the financial software system coupled with control accounts in main ledgers and regular reconciliation procedures with sub ledgers and physical assets bring about the ability to detect theft of assets, and these procedures are further subject to regular internal and external audit procedures.

Some caveats

Additional capacity is required for implementation

19. **A number of concerns about the implementation of accrual accounting are often raised**. In a study by the Asian Development Bank[13], the conclusion is made that "While generally recognizing that the accrual accounting basis is superior to the cash basis, opponents tend to raise concerns about implementation difficulties". Key arguments levied by opponents include – (i) Few countries have implemented accrual accounting; (ii) implementation is difficult and expensive, mainly because of the cost associated with more extensive system requirements; (iii) ongoing operation is difficult and expensive, mainly because of the need

[12] Mellor, Thuy. 1996. Why Governments Should Produce Balance Sheets. *Australian Journal of Public Administration*. 55(1). March. pp. 78-81.
[13] Athukorala, S. Lakhsman, and Barry Reid. 2003. *Accrual Budgeting and Accounting in Government and Its Relevance for Member Countries*. Manila: Asian Development Bank.

for more qualified accountants ; (iv) that developing countries struggle to implement and run basic cash accounting systems with their existing capacity and that this should be the emphasis; and (v) that accrual accounts are less objective and more difficult to understand. However, the authors of that paper then also present some arguments that actual experience does not support all of these contentions.

20. **There is no argument that additional capacity will be needed for the implementation of accrual accounting, and that the government would have to commit to a plan to address current shortages in this regard.** In the case of Botswana, as in most other countries in the region, professionally qualified accountants and auditors are not easily drawn to and retained in the government. The government will have to commit to a plan that will bring more professionally qualified accountants and auditors into public service. Key issues that underpin the shortage relate to – (i) the perceived need to have professionally qualified persons in certain posts; (ii) the ability of the professional to supply people with the requisite knowledge, skills and aptitude to function in the government; and (iii) the ability of the government to compete with the market for such skills and experience which often are in short supply. Regarding the first point, it should be recognized that, in the opinion of the authors, at levels of middle management and upwards, accountants and auditors functioning in government are indeed performing public duties that should be regulated in the same vein as those performing similar functions in the private sector – this could be achieved inter alia through the new PFM Bill. If recognition for the need to have professional staff in key positions is indeed achieved, a basis for dialogue with the professional bodies regarding the second issue will exist and this will help to formulate a plan to address the key demand and supply side issues to the problem. The issue of remuneration can be resolved in many ways, including appointment of such key officials on a performance contract basis as has been done by some countries in the region. It is advised that the government performs readiness assessment in this regard to assist with the development of a strategy and action plan for this crucial matter.

Costs vs. benefits

21. **The cost of this reform in the case of Botswana is largely dependent on the cost of configuring GABS, obtaining the necessary opening balance data, the training and capacity development needed for staff, additional professional staff for key positions and change management.** There is no need to replace a costly system such as GABS – it is well capable of supporting the accrual accounting reform. Licensing to use all the modules associated with accrual accounting would need to be investigated and budgeted for, if not already done. Other main direct cost drivers will include the following – (i) configuration costs of GABS; (ii) the development of new accounting policies, procedures, controls and the related manuals; (iii) possible changes required to the BURS system and others with which online interfaces will be required; (iv) costs associated with development of new reporting and consolidation templates; (v) training of technical staff in new accounting policies, processes and controls; (vi) cost of data collection and verification of opening balances of assets and liabilities to be recorded for the first time, especially as regards valuation of infrastructure; (vii) recruitment of a core of professionally qualified staff to act as chief

financial officers steering implementation of the reform, especially in larger MDAs; and (viii) change management for all entities / managers in government affected.

22. **There are ways to help minimize the cost associated with obtaining opening balance data for property, plant, equipment and other infrastructure.** Cognizance should be taken of the overarching IPSAS requirement[14] that disclosure requirements need not be satisfied if the information is not material. Omissions or misstatements of items are material if they could, individually or collectively, influence the decisions or assessments of users made on the basis of the financial statements. Materiality further depends on the nature and / or size of the omission or misstatement judged in the surrounding circumstances. Accounting policies should be developed to respond this requirement, which may mean that for certain classes of fixed assets, such as equipment that will fully depreciate during the period of data collection, historical cost data will not be required and that government can start to account for such assets from a future date onwards. For other classes of property, plant and equipment, IPSAS 17 also determines that it should only be recognized as an asset if – (i) it is probable that future economic benefits or service potential associated with the item will flow to the entity; and (ii) the cost or fair value of the item can be measured reliably. All of these and other IPSAS determinations need to be studied before government decides to proceed with potentially costly valuation exercises associated with data needed for opening balances.

23. **It will be more difficult to assess benefits associated with the reform, in order to support a classical cost benefit analysis.** Some countries, such as New Zealand, have attempted to calculate a return associated with the implementation of accrual accounting. This came out positive, on the basis of certain assumptions regarding lower costs of borrowing as a result of improved transparency, etc. The authors would not want to engage in this type of argument, but advise that government must cost the final project plan for the implementation of accrual accounting in order to help prove the business case for realizing the benefits outlined earlier. Many of these benefits in themselves have opportunity cost associated with them should they not realize. For example, the improvements in the reporting and control system will lead to better assets utilization and safeguarding, which will otherwise be lost and have a direct financial impact. It is also advised that the government should actively seek savings to fund the implementation costs of accrual accounting – e.g. in the development budget that may fund the acquisition of new assets even if underutilized assets are available. Like in many other decisions, trade-offs will certainly be required and government needs to have a clear vision with its intent to implement accrual accounting.

Priority

24. **Another matter that requires careful consideration is the priority and sequencing of this reform in the context of other demands on government.** It should be noted that before this reform is started, it is advisable to obtain full commitment to the end state, the associated project plan and its costs, and the impact or results to be achieved. Many other competing

[14] IFAC. 2011. *IPSAS 1 – Presentation of Financial Statements.* New York

demands will have to be considered, including budget reforms. More importantly, the impact of dedicating resources for this project on other projects that could have a real impact on poverty alleviation also requires consideration. Much more can be said and it is advisable for government to also study the impact that similar projects had in other countries. From the available literature it is clear that the often hoped for behavioral changes often do not realize – it is therefore critically important that government cocoon this reform in the wider context of a more performance orientated public sector and implement all of the associated reforms in a manner that would realize the intended behavioral changes.

D. What will be the key changes as a result of implementing accrual accounting and will it have policy implications?

The cash budget, focus on fiscal discipline and control over cash stays

25. **Because of its importance, let's start by confirming that the cash basis of budgeting and appropriation do not have to be changed.** The assumption about continuation of a cash flow budgeting system is a practical one – accrual accounting data is needed before one can move to accrual budgeting, and this is a long way off for most developing countries and not recommend without further detailed analysis of its implications. Cash flow data does not disappear in an accrual accounting system and the production of cash flow reports to support monitoring of implementation of a cash flow budget will still be possible. The Botswana financial management and information system, GABS, is already enabled to run on an accrual accounting basis. Even under accrual accounting two cash based reports are still required and need to be derived from accrual data – (i) a budget report (following the classification in the budget); and (ii) a cash flow statement. The technicalities involved in this are minimal, but it does require a qualified professional accountant to do or oversee this. From a point of view of accountability for the cash appropriation, the ability of Parliament to call accounting officers to account for the cash appropriation will not be impaired.

26. **Equally so fiscal discipline and the focus on cash management need to be retained.** In fact, the additional and improved processes to account for events that will have a cash impact will further strengthen the ability to maintain fiscal discipline and to improve cash management in government.

27. **What about accrual budgeting?** Robinson defines accrual budgeting "as the specification of budgetary expenditure authorisations and revenue estimates in terms of accrual accounting measures – that is, measures which are specific to the accrual system of accounting. This means, in particular, the use of accrual concepts to specify budgetary control totals. Control totals are the quantitative spending limits imposed on spending ministries, whether as appropriations in the annual budget law or by administrative directive (e.g. from the minister/ministry of finance)"[15]. He investigates in the associated article whether an accrual

[15] OECD. 2009. *Journal on Budgeting*. Volume 2009/1

budgeting system serve the needs of good fiscal policy, and if so, how such a system must be designed. He concludes that although in principle an accrual budgeting system is fully compatible with good fiscal policy, in practice considerable risks arise from the complexity of accrual budgeting and therefore would be inappropriate for many countries. He cautions that only if the financial management system is not sufficiently strong to ensure effective implementation of the accrual control totals, accrual budgeting poses a problem for fiscal discipline. It the case of Botswana it is strongly advised not adopt accrual budgeting in the foreseeable future.

A new reporting framework is needed supported by legislation

28. **Starting with the "reporting end" in mind, the financial statements to be produced by or under auspices of the Accountant-general will change.** Two phases are recommended. As already recommended by the IMF, phase 1 could entail moving from the existing "Annual statement of account" with 22 statements, to a cash flow statement using cash-based IPSAS with appropriate notes. Phase II thereafter will entail phased conversion of the accounting system to accruals to enable the development and presentation essentially of two new financial statements – (i) Statement of financial position; and (ii) Statement of financial performance. A cash flow statement in a somewhat revised format than before will also be presented, in addition to others and detailed notes that provide further depth and explain the information as summarized in these main statements. Adopting IPSAS will also require presentation of the statements on a consolidated basis. All of these issues are dealt with in more detail below.

29. **Vital policy issues to initially agree and embody in legislation are to actually define the "reporting entity", whether or not "consolidated financial statements" need to be prepared, the reporting responsibilities and the information that is required (at least from an accountability, performance, management and standards perspective).** From a point of view of IPSAS, consolidated financial statements, which will include all entities controlled by the Government, are indeed required. "Control" is defined as the power to govern the financial and operating policies of another entity so as to benefit from its activities. This requires a careful analysis of relationships between entities, from a point of view of power (that is presently exercisable) of one reporting entity over another for purposes of benefiting from its activities. From a point of view of budget accountability, separate financial statements are also required for each Ministry. In addition, existing laws for public entities may require submission of separate financial statements for them (which in itself may present problems since Parliament may not practically be able to deal with all the separate financial statements). In designing the most appropriate reporting framework, the authors believe firmly that the reporting framework should conform to the basic concept that **"one is accountable for what one controls".**

    Different reporting frameworks can be developed for Botswana, for example –

    a. One consolidated set of financial statements consisting of all budget votes (Ministries), including the Consolidated and Development Funds and other funds currently reported in the "Statement of Assets and Liabilities". This will require tabling of separate reports to Parliament by all other entities under the control of the Executive (including public entities and other statutory funds outside of the budget). However, fair presentation of and accountability for the financial performance and position of all entities in control of Government is impeded by this fragmented information.

b. One consolidated set of financial statements consisting of all budget votes (Ministries), the Consolidated and Development Funds, and all other statutory funds and public entities controlled by Government. Fair presentation of and accountability for the financial performance and position of all entities in control of Government is achieved at the aggregated level, but accountability at the budget vote level for financial position, financial performance and service delivery will be blurred.

c. A three prong approach – (i) separate consolidated financial statements for each budget vote and the public entities and statutory funds in its control, together with an annual report on service delivery performance; and (ii) one consolidated set of financial statements consisting of all budget votes (Ministries) and the Consolidated and Development Funds and other funds currently reported in the "Statement of Assets and Liabilities"; and (iii) a "whole-of-government" consolidated set of financial statements for all budget votes (Ministries), the Consolidated and Development Funds, and all other statutory funds and public entities controlled by Government. Applying the basic concepts and testing for the existence of power and benefit conditions as defined by IFAC[16], this framework achieves fair presentation of and accountability for the financial performance and position of all entities in control of Government at the aggregated level, and maintains accountability at the budget vote level for financial position, financial performance and service delivery by the Ministry and the entities in its control.

In the Africa region the latter framework is successfully pursued by South Africa, strengthened by a legal requirement that the Minister of each budget vote has to table an annual report (which includes the audited financial statements and the audit opinion of the Auditor-general) in Parliament 6 months after year-end. Because of the fact the budget votes are not yet on the accrual basis of accounting, currently two sets of consolidated financial statements are prepared by the National Treasury, audited and submitted in Parliament 7 months after year-end: one for budget votes, and the National Revenue Fund (equivalent of the Consolidated and Development Funds) and another for public entities and funds in control of central government. Each of the 9 provincial governments and approximately 278 local governments follows the same reporting framework, but they are not consolidated at the national level because they are considered to be outside of the control of national government as defined.

Under the assumption that Botswana will in fact adopt IPSAS (no need to redesign the wheel) a final determination will have to be made to what extent others spheres of government will have to be consolidated. In addition consolidated reporting under IPSAS

[16] IFAC. 2011. *IPSAS 6 – Consolidated and Separate Financial Statements.* New York

will also impact on the processes to prepare and report under GFS 2001, and this also need to be further investigated.

30. **The Botswana public sector reporting framework as embodied in current practice and new PFM Bill has room for improvement, especially to help realize potential benefits from the introduction of accrual accounting and to move towards a more performance orientated budget and public management system.**

    a. **There is no requirement for annual reports by each Ministry.** An annual report by each Ministry reporting on service delivery performance and containing the audited annual financial statements as prescribed by IPSAS would support the new public service management model pursued by Botswana.

    b. **There is no requirement for consolidated financial statements.** The requirement for consolidation at budget vote level as well as at central government level will achieve fair presentation of and accountability for the financial performance and position of all entities in control of Government, enabling accountability at the budget vote level for service delivery.

    c. **Public entities are not covered from control and reporting perspectives.** This creates a problem in so far as the application of IPSAS are concerned, which requires consolidation of controlled entities.

    d. **Accounting standards setting is not an independent function.** In this regard there is a key problem in that the preparer of the financial statements is also the standard setter. These functions are normally separated. It will be better to assign authority for the standards to a standard setting body (such as the new "Botswana Accountancy Oversight Authority (BAOA)", established under the Financial Reporting Act of 2007), and to determine a process whereby the Minister can decide when to implement certain standards as and when systems and capacity allow. In addition, for purposes of consolidation the application of standards over the different types of controlled entities need to be managed as the process towards accrual by all evolves.

<u>Policy proposal #1</u>

A three pronged reporting framework should be implemented - (a) separate audited consolidated financial statements for each budget vote and the funds and public entities in its control, together with an annual report on service delivery performance; (b) one audited consolidated set of financial statements for all budget votes (Ministries) and the Consolidated and Development Funds and other funds currently reported in the "Statement of Assets and Liabilities", and (c) one audited consolidated set of financial statements for all budget votes (Ministries), the Consolidated and Development Funds, and all other statutory funds and public entities controlled by Government.

<u>Policy proposal #2</u>

The responsibility to table in Parliament the reports under (a) in policy proposal # 1 should be that of the responsible Minister, whilst the Minister of Finance will have responsibility for the reports under (b) and (c). There should be a time limitation of no longer than 9 months after the financial year-end for the tabling of the audited reports.

<u>Policy proposal #3</u>

Allowing for some time to phase this requirement in, the reports of all entities consolidated should eventually be prepared on an accrual basis (using IPSAS). The responsibility to investigate, adopt and prescribe IPSAS for the public sector should be separated from the role to prepare or audit these financial statements. The Botswana Accountancy Oversight Authority (BAOA) established through the Financial Reporting Act may be used for this purpose.

A new "Statement of Financial Position"

31. **Let us now turn back to the two new financial statements that need to be prepared. Firstly the "Statement of Financial Position" (proposed format available in Volume II).** The key classes of new information that need to be developed are, **<u>in proposed order of implementation priority</u>** -

   a. **Financial Liabilities – payables, provisions, all borrowings (including for example certain leases), unpaid employee benefits and superannuation.** We will not deal with each of these items in detail in this paper. Suffice to conclude that under the proposed reporting framework four major areas of current reporting and control weaknesses will be addressed – (i) invoices for goods and services received before year-end have to be accounted for as expense against that fiscal year's revenue, even though payment has not yet been made at year-end – this helps to control the practice of not paying invoices if budget has been depleted; (ii) at the same time a sound system of recording, control and reporting of valid arrear payments to creditors (suppliers of goods and services to the government) will be established; (iii) all government liabilities, including previous "off balance sheet" financing such as certain leases, will be disclosed at two consolidated levels – by Ministry and also for whole-of-government (as consolidated using the concept of control); and (iv) the inclusion of provisions for retirement benefit obligations for post employment benefits ensures a more transparent and complete picture of government's liabilities, which will also improve the ability of government to control and fund such expenses.

Policy proposal # 4

Generally speaking financial liabilities to be reported for the first time under an accrual basis in consolidated financial statements will increase compared to the normal baseline of public debt previously disclosed. Government should in this regard – (i) develop the necessary accounting policies that will clearly specify the nature and recognition of liabilities, for example items such as leases; (ii) determine the impact of newly disclosed and material financial liabilities on fiscal stance and develop and disseminate an appropriate response; (iii) review current accountabilities and develop regulations for the financial management of newly disclosed and material financial liabilities; and (iv) develop a financial liability management framework for public entities, other statutory funds and other spheres of government.

b. **Financial Assets – all cash equivalents, receivables, prepayments and investments (such as investments in business enterprises).** Again we will not deal with each item in detail in this paper. Suffice to conclude that under the proposed reporting framework three major areas of current reporting and control weaknesses will be addressed – (i) goods and services rendered by government for which payment are due will be subject to a sound system of recording, control and reporting to ensure that such funds are in fact recovered and, if not, the extent of non-recovery will be accounted for; (ii) the same principles will apply to loans and other advances by government to other parties; and (iii) investments in equity of other businesses, property and financial instruments will be subject to a sound system of recording, control and reporting, which will ensure transparency in government's investment decisions.

Policy proposal # 5

Generally speaking financial assets to be reported for the first time under an accrual basis in consolidated financial statements will increase compared to the normal baseline of cash and cash equivalents previously disclosed. Government should in this regard – (i) develop the necessary accounting policies that will clearly specify the nature and recognition of financial assets, for example items such as investments and financial instruments; (ii) determine the impact of newly disclosed and material financial assets on fiscal stance and develop and disseminate an appropriate response; (iii) review current accountabilities and develop regulations for the financial management of newly disclosed and material financial assets; and (iv) develop a financial asset management framework for public entities, other statutory funds and other spheres of government.

c. **Inventories.** Inventories are defined in terms of IPSAS[17] as follows – "inventories are assets – (a) in the form of materials or supplies to be consumed in the production process; (b) in the form of materials or supplies to be consumed or distributed in the rendering of services; (c) held for sale or distribution in the ordinary course of business; or (d) in the process of production for sale or distribution". This is different

[17] IFAC. 2011. *IPSAS 12 – Inventories.* New York

from the current definition of "supplies" in the draft PFM Bill, which also includes plant, furniture and equipment. Inventory constitutes a major element of working capital which needs efficient management. Inventory management covers fixation of minimum and maximum levels, determining the size of inventory to be carried, deciding about the issues, receipts and inspection procedures, determining the economic order quantity, proper storage facilities, keeping check over obsolescence and ensuring control over movement of inventories. Implementation of accrual accounting will address the following major areas of current reporting and control weaknesses – (i) on the assumption that inventory management will be integrated within GABS inventory purchase decisions will be informed by levels of stock already on hand, which will lead to improved inventory utilization and expenditure management; (ii) sound inventory control systems will be in place for ordering, receiving, storing, issuing, write-off, costing and cost allocation of inventory items, which will also enable periodical physical verification of balances on hand with appropriate follow-up action for inventory losses; and (iii) all government inventory will be disclosed at two consolidated levels – by Ministry and also for whole-of-government (as consolidated using the concept of control), which will enable evaluation of stewardship and management of such inventories.

The Six Rights of Logistics

The **RIGHT** goods
in the **RIGHT** quantities
in the **RIGHT** condition
delivered…
to the **RIGHT** place
at the **RIGHT** time
for the **RIGHT** cost.

There are however several key issues that require consideration from an organizational, functional, control, budgeting and accountability perspective – e.g. the benefit of centralized procurement and warehousing of cross-cutting inventory items, and how that affects the other budget votes from a point of view of service delivery and accountability. It would be essential in the final instance to ensure that a model is implemented that would – (i) meet the "six rights of logistics"[18] as depicted; (ii) allocate cost of inventory issued to each user ministry; and (iii) ensure no bottlenecks in service delivery from a point of view of performance and accountability of line ministries.

Policy proposal # 6

Upon full implementation of accrual accounting, inventory will be reported for the first time. Government should in this regard – (i) incorporate the term "inventory" in the PFM Bill and separate this from other fixed assets such as property, plant and equipment; (ii) determine the impact of newly disclosed and material inventories on fiscal stance and develop and disseminate an appropriate response; (iii) review current accountabilities and with due cognizance to sound supply chain management principles establish and operate central stores on agency (i.e. off budget) and cost recovery basis for the supply of cross-cutting inventory items – i.e. line ministries will budget to "purchase" cross-cutting inventory items from such stores; (iv) develop regulations for the financial management of inventory; and (v) develop the necessary accounting policies that will clearly specify the nature and recognition of inventory.

[18] USAID |DELIVER PROJECT, Task Order 1. 2011. *The Logistics Handbook: A Practical Guide for the Supply Chain Management of Health Commodities.* Virginia

d. **Fixed assets, otherwise known as "Property, plant and equipment (PPE)":** PPE are defined in terms of IPSAS[19] as follows – "..tangible items that: (a) are held for use in the production or supply of goods and services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one reporting period". It also includes specialist military equipment and infrastructure assets, but not biological assets[20] and mineral rights or reserves (for which there other internationally acceptable accounting standards). Again this would necessitate a review of the current definition of "supplies" in the draft PFM Bill, which includes both PPE and what IPSAS would define as "inventory". Implementation of accrual accounting will address the following major areas of current reporting and control weaknesses – (i) With the assumption that management of PPE will be integrated within GABS, investment / purchase decisions for new PPE will be strengthened by reliable information of existing investments, which may lead to improved utilization of existing PPE, disposal of surplus PPE and overall expenditure management. (ii) Sound accounting control over PPE will ensure complete and accurate recording of all assets, accurate recording of ownership and movements, provision of reliable management information, effective maintenance and disposals of assets, and an insurance strategy for assets. A reliable asset register will also enable periodical physical verification of assets with appropriate follow-up action for losses. (iii) All government PPE will be disclosed at two consolidated levels – by Ministry and also for whole-of-government (as consolidated using the concept of control), which will enable accountability for evaluation of stewardship over such assets.

There are however several key issues that require consideration from an organizational, functional, control, budgeting and accountability perspective – e.g. the benefit of centralized ownership and management of government properties, and how that affects the other budget votes from a point of view of service delivery and accountability. It would be essential in the final instance to ensure that a model is implemented that would at least – (ii) allocate cost of use and maintenance of properties to each user ministry; and (iii) ensure no bottlenecks in service delivery from a point of view of performance and accountability of line ministries. In this regard the current role of Ministry of Works and Transport as regard the provision and maintenance of property used by other ministries may require revision. One option is to completely decentralize acquisition and maintenance of properties as far as possible to line ministries actually using such properties, with the associated functional, budget and staffing reorganization between the Ministry of Works and Transport and the other line ministries. Another perhaps less disruptive option is to centralize the property acquisition and maintenance functions in a statutory agency in control of government and to implement an arms' length rental system, whereby line ministries may opt not to use the agency for their property requirements in cases where more appropriate and cost effective options are available. This option will help facilitate a sound accountability, performance and service delivery framework,

[19] IFAC. 2011. *IPSAS 17 – Property, Plant and Equipment.* New York
[20] IFAC. 2011. *IPSAS 27 – Agriculture.* New York

in addition to providing additional options for financing of capital expenditure related to government properties without potentially affecting a cash budget deficit. Upon consolidation of such an agency full disclosure of government ownership and investment in properties will still be met. This is a policy option outlined below, but we would also recommend a more extensive analysis of options and impacts of different models before any particular model is chosen.

Of further importance is to note that following the date of first adoption of accrual accounting entities are not required to report on PPE for the first five financial years. PPE also needs to be initially accounted for at cost or fair value, which requires an accounting policy for the different classes of assets that would be easy and cost effective to implement, yet acceptable from an IPSAS and audit perspective. Upfront agreement with the Auditor-general to the accounting policy and the approach to first recognition is essential.

<u>Policy proposal # 7</u>

Upon full implementation of accrual accounting, property, plant and equipment (PPE) will be reported for the first time (after a transitional period of 5 years). Government should in this regard – (i) incorporate the term "PPE" in the PFM Bill and separate this from other assets such inventory; (ii) determine the impact of newly disclosed and material PPE on fiscal stance and develop and disseminate an appropriate response; (iii) review current accountabilities and with due cognizance to implications for accountability, performance and service delivery implement a centralized agency model (i.e. off budget) for arms' length rental of government properties to line ministries a cost recovery basis – i.e. line ministries will budget to "rent" property from such an agency in cases where it is effective and economical to do so; (iv) develop regulations for the financial management of such PPE; and (v) develop the necessary accounting policies that will clearly specify the nature and recognition of PPE.

e. **Infrastructure**. The term infrastructure in terms of IPSAS is also covered under PPE, as discussed in paragraph (d) above. As a consequence the same principles and recommendations apply, although it is recommended that infrastructure be dealt with as a last phase for implementation.

A new "Statement of Financial Performance"

32. **Turning to the "Statement of Financial Performance" (proposed format available in Volume II), most of the new information will be derived from a change in the accounting processes linked to the new classes of information as described in paragraph 31 above**. We will not attempt in this paper to provide an exhaustive overview of these changes, but will illustrate this by focusing on a few key aspects -

a. **Source, timing, rules, method and classification of accounting entries will change** – As we have already explained, the timing of the accounting entry will be when the transaction or event happens, and not just when it has a cash flow effect. For example, expenses will now be recorded when invoices for good or services ordered and delivered are received, and not only when cash is paid. This will also then require a new accounting entry to record the amount payable, which will finally be cleared when the creditor is paid. In a cash accounting system unpaid invoices are not recorded. This also provides an important new control procedure, in that amounts still unpaid in the government's sub-ledger for creditors (payables) can be reconciled on a monthly basis with the account statements received from creditors. This will make it impossible, for example, for invoices to be "hidden" in cases of cash budget shortfalls. In addition, the ability to make payments made for goods and services not yet received (such as contract advance payments) will be better controlled and not accounted for as expenses until the actual goods or services has been received. Thirdly, we will now also have a firm system of control and estimate of amounts still to be paid for goods and services already received.

On the revenue side similar accounting changes will be needed, yielding equally important benefits in control, cash flow management and information. However, it does come with some complexity, for example that taxes assessed but not yet received should only be recorded as revenue if they are expected to be collected – i.e. this would call for estimating the probability of collecting assessed taxes.

<u>Non-cash costs, such as depreciation, have the potential to materially influence the surplus or deficit calculated in this statement</u>. New types of transactions will include for example – capital asset use (depreciation and loss of service potential); non-cash personnel costs, including leave and pension liabilities; interest accrued; changes in the book value of physical assets, and losses; changes in the market value of financial assets, and losses; foreign exchange losses. Each one of these need to be identified and appropriate sources, timing, rules, methods and classification of the resulting accounting entries need to be defined. For some, such as depreciation, the information initially captured in the fixed asset (PPE) register incorporated into GABS as part of the process to create the opening balance sheet (Statement of Financial Position), is crucial – this determines automated entries that is possible in GABS which will lessen the work load. For others, information will have to be regularly obtained from other sources and consistently applied in models to determine the necessary accounting entries. The associated audit trails, to enable subsequent auditing, should receive equal consideration in the design phase in order to ensure that the accrual-based financial statements are not unduly qualified. A few qualified accountants with good knowledge of the IPSAS in terms of recognition, measurement and disclosure will be essential. It is also recommended that the associated changes in sources, timing, rules, methods and classification of all accrual –based transactions be documents and cleared with the Auditor-general before implementation.

In summary then, transaction types and sources, accounting rules, processes, functions, methods and systems (i.e. GABS) should be reviewed for all classes of transactions and amended to ensure adequate internal control and compliance to IPSAS in term of recognition, measurement and reporting. Upfront audit agreement to the changes will be essential.

The level of budget control

33. **In addition to separate and consolidated financial statements recommended earlier, the level of budget control in our view needs revision in order to stimulate management authority, decision making and accountability, and in order to produce financial statements in the format as required in terms of IPSAS.** Currently the "Statement of recurrent expenditure" and "Statement of development expenditure" produced for each vote contains extensive breakdowns of each expenditure item up to sub-item level (e.g. the budget for "traveling and transport" is controlled and reported through at least 7 sub-items. As a consequence the annual report presented to Parliament contains in excess of 750 pages. This detailed level of control does not leave much room for management discretion, overloads the information available to identify and review material budget variances and determine the underlying causes thereof, and potentially weakens the ability of Parliament to quickly focus on material matters of performance and accountability.

> **<u>Policy proposal # 8</u>**
>
> **In order to further support the implementation of the recommended reporting framework, it is also recommended that Government considers implementation of a program budgeting structure, with budget control at the program level and selected expense items, such as salaries.**

Assessment of fiscal stance

34. **Assessing fiscal stance in an accrual environment is unchartered territory for most developing countries. As already said in this paper and in others reviewed, it is highly recommended that Botswana do not move away from its cash budgeting system and its associated measures for some time to come, if ever.** In many developing and transition countries, changing the nature of appropriation and the rules for compliance and measurement could potentially introduce risks to fiscal discipline, <u>especially if the measures are not put to practice correctly.</u> It is not the intent of this paper to present a highly technical and complete discussion of all key measures of fiscal stance and how this may potentially be affected by the introduction of accrual information. It is also not the intent in this paper to develop and present a full array of new measures for the measuring of fiscal stance under an accrual accounting regime. Of importance is to recommend that existing measures for fiscal stance be retained and to recommend that government and users of the new general purpose financial statements develop an appreciation for the fact that new accrual measurements will become available, the meaning and use of which can complement the existing cash-based measures of fiscal stance. We will discuss below a few implications of accrual accounting information on the assessment of fiscal stance.

For example, let's use "deficit" is a key measure of fiscal stance. For most developing countries it continues to be the key measure that assists in the policy objective to ensure that the budget is financed in a sustainable way, while keeping the growth of public debt under control. This is further supported by the "golden rule", i.e. that borrowing to meet the recurrent costs of government, is prohibited.

For purposes of illustration, let's assume that we start with a clean slate and our budget deficit (or "net operating balance" as per GFS 2001[21]) calculated on a cash basis includes the construction cost of our dam (used in the example earlier, but financed by a loan). It should be clear that the budget deficit calculated on a cash basis in this example will be much higher compared to an accrual deficit which will only include the non-cash depreciation cost of that dam for the period in use during that year. The smaller accrual deficit in our example may be interpreted as a more neutral (balanced) fiscal stance, whereas the larger cash-based deficit may be interpreted as a more expansionary stance. Under the fiscal stance of a balanced budget over time the larger cash-based deficit may lead to an increase in tax revenue or a cut in expenses in order to contain further borrowing, whereas the smaller accrual deficit may lead to an opposite stance of more spending and possibly also more borrowing. This may happen even if under both scenarios the same level of borrowing was actually needed to construct the dam. However, the opposite, that an accrual deficit may well be higher than cash deficits, may also happen since in reality governments will not be starting with a clean slate and the consumption (depreciation) of existing PPE may well exceed the cost of acquisition of new PPE in a particular financial year. **But, and this is the important message, the US Government Accountability Office (GAO) concludes on the matter that the cash-based and accrual deficit measures actually "serve different purposes"[22]**. The cash deficit indicates whether a government is able to finance all of its cash outlays in a financial year with the cash revenue it raises in that same financial year – in other words it provides an indication of the government's net financing requirement for that year. In contrast the accrual deficit measure is more "useful to understand the government's annual operating cost, including costs that are incurred today but not payable for years to come. …. Therefore, the cash and accrual deficits present complementary information and can be used together to provide a more comprehensive picture of the federal government's fiscal condition today and over time"[23].

Suffice then to conclude this example by saying that – (i) If comparisons are to be made between current cash-based measures and measures under accrual accounting, care should be taken to compare apples with apples. In other words, don't compare the deficit presented in a cash-based budget with the accrual "deficit" calculated in the "Statement of Financial Performance" - more correct would be a comparison to the "net cash flows after operating and investing activities" in the cash flow statement that is presented under accrual accounting IPSAS. (ii) The different sets of financial statements that will be prepared and disclosed need careful consideration and dialogue with users as regards its support for fiscal policy analysis. For example, the "deficit" analysis should not be done on the basis of whole-of-government consolidated financial statements (which includes all off-budget

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[21] the net operating balance equals revenue minus expense
[22] http://www.gao.gov/special.pubs/longterm/deficit/
[23] *Ibid.*

controlled entities as well), but only the one representing the fiscal position and performance of the Consolidated and Development Funds that constitutes the budget. (iii) New accrual measures, such as "deficit" in the "Statement of Financial Position", require careful consideration in conjunction with existing measures to determine an appropriate fiscal policy response. In an analysis by Boothe[24] it was concluded that only one fiscal rule – the net debt rule – was neutral to the two accounting regimes. He further remarks, and we agree, that "accountability is best served if changes in public sector accounting regimes are accompanied by corresponding changes to (or, at least, clarification of) fiscal rules", and we would add the associated measures.

Let us identify a few additional key fiscal implications of accrual accounting – (i) Assume that government continue to apply the "golden rule" (i.e. that borrowing to meet any of the recurrent costs of government is prohibited). By matching in any financial year all accrual costs such as depreciation with revenue, the current generation will start to pay for current use of costly PPE such as roads and other infrastructure. If the revenue base and/or tax policy do not allow for this to happen, expenditure measures will be needed under the fiscal stance to maintain a budget balance on average over the economic cycle. Also targeting a balanced accrual financial performance (similar to "budget balance" on a cash basis) will ensure that over time government saves enough to cover its future investment needs. (ii) Until accrual accounting has been fully implemented (and PPE is finally accounted for), net assets as an accrual measure may well be negative (and some may want to conclude that government is insolvent). However, this interpretation disregards the power of government to raise taxes in the future. Even with accrual accounting fully implemented, a negative asset position may be appropriate for a period because of government's power to raise taxes. (iii) To support deficit control under a cash-based budget, the accrual accounting system must be set up to control cash outlays on the basis of appropriations. In other words, it should track appropriations, supplementary estimates, virements, and the uses of appropriations (release of funds, commitments, expenditures at the verification stage, and payments). This could be rather technical, but does not present a problem for modern financial software such as GABS. (iv) As already said, net debt (the difference between financial assets and liabilities) continues to be a key measure of fiscal stance under both accounting regimes. The indicator shows the cumulative amount of net borrowing that the government has undertaken over time to finance its expenses – a high level of net debt imposes a call on future revenue to pay for past transactions, which will reduce the ability of government to adjust their expenditure plans to future needs. It raises questions about the sustainability of the government's financial position, facilitates accountability for past decisions and help chart new fiscal responses. Use of this measure must not disappear under an accrual accounting regime and, in fact, needs to be set and managed rather explicitly (as a ratio of net debt / GDP not to exceed a specific moderate ceiling) to ensure fiscal sustainability.

[24] WORLD BANK. 2007. *Accrual Accounting in the Public Sector: Lessons for Developing Countries*. Washington DC: Public Sector Governance and Accountability Series: Budgeting and Budgetary Institutions. Chapter 6: 179-202

Policy proposal # 9

Upon full implementation of accrual accounting, a set of new measures will be available to assist in the evaluation and direction of fiscal stance. Government should in this regard – (i) Continue with it cash budget and appropriation system, maintaining the focus on fiscal balance over time by limiting cash deficits; (ii) Consider the impact of new accrual information on fiscal stance, develop an appropriate response and proactively engage Parliament, analysts and other users of the new financial statements on the interpretation of the new information and Government's fiscal responses. (iii) Consider the interpretation and guide the use of at least the following new measures for the consolidated budget entities – net debt (financial assets minus financial liabilities); change in net debt from year-to-year; surplus / deficit in the Statement of Financial Performance and the accumulated surplus / deficit. (iv) Consider the interpretation and guide use of the new measurements in (iii) also for the consolidated whole-of-government accounts.

Fiduciary responsibilities of management, governance of public entities and external audit

35. **There are also a number of other changes with potential policy implications that will have to be considered** apart from the vital changes to the reporting framework, the types and content of the financial statements and the possible interpretation of new financial measures on the Government's fiscal stance as briefly discussed above -

    a. **Management authority, responsibility and accountability** – although this has been discussed before, several additional points are to be considered which may also affect the PFM Bill as drafted. Key examples would include – (i) Enacting the general fiduciary and reporting responsibilities (in-year and end of year) of accounting officers and that of Ministers; (ii) the need to strengthen the governance framework through independent Audit Committees; (iii) the appointment of professionally qualified Chief Financial Officers in each line ministry; and (iv) extending the scope of accountability to assets and liabilities as well.

    b. **Relationship between ministries and their public entities** – the IPSAS requirement to consolidate entities in control of government brings about important considerations regarding accountability. A conceptual model for the governance of and accountability for public entities may have to be developed and agreed with Parliament. This may also have to be embedded in the legal framework.

    c. **Auditing scope and approach** – the new financial statements would require a different audit approach than before. For example - inventory and PPE balances would have to be verified for ownership, valuation and existence (by comparing accounting records to physical assets and vice versa); debtors and creditors would have to be reconciled, verified and analyzed, etc. The restriction on the time frame for audited financial statements may also require more of a focus on system audits on an interim basis, followed by the final financial statement audit. This may require amendments to the legal framework for auditing. In addition, during the transition phase government will have to agree with the Auditor-general the reporting framework and standards against which auditing will be performed.

Policy proposal # 10

The full implementation of accrual accounting may impact on key other areas of governance as well. In this regard the Government should consider – (i) changing the legal framework for auditing to support implementation of a new audit approach and cycle; (ii) enacting the general fiduciary and reporting responsibilities of accounting officers and ministers respectively; and (iii) developing a conceptual model for the governance of and accountability for public entities.

36. **In summary, the key implication of accrual accounting is that new reliable information will become available which will assist in keeping government accountable not just for cash, but for all resources under its control.** Additional information covering revenue, expenses, assets and liabilities of all entities in control of government will be disclosed; by entity and consolidated. At the same time the ability of government to control and manage its resources will be improved. The focus will shift from a narrow focus on cash deficits and public debt to - these plus (i) net debt (which deducts financial assets from financial liabilities), which helps to decide the affordability of additional spending; (ii) the accrual surplus / deficit, which indicates whether revenues raised in the financial year covered all recurrent costs of government, whether paid in cash or not; (iii) accumulated surplus / deficit, which indicates whether or not the government has any resources left at year-end for the provision of future services and whether it has been financing recurrent costs with borrowing; (iv) full costs of government services and improved performance in services delivery; and (v) issues related to "intergenerational fairness" - the degree to which the taxpayer of today is paying the costs of government services today, as opposed to shifting costs for services of today to future generations, or vice versa. At least the policy issues discussed and summarized above require resolution in advance of and during the process of conversion to accrual accounting.

E. How should Botswana move forward with the implementation of accrual accounting?

At the risk of oversimplifying -

Comply with cash IPSAS

37. **Moving forward to comply with cash IPSAS.** In broad terms, to move forward with implementation – (i) prepare a cash-based IPSAS financial statement reporting template; (ii) perform a gap analysis between the current reporting format and the cash-based IPSAS

template; (iii) develop an action plan to address the gaps, with responsibilities and timelines; and (iv) a designated working group is to implement the action plan under oversight of a Steering Committee, in order to meet a specific date of first compliance to the cash-based IPSAS. During this phase the vital first steps to agree a new reporting framework and matters related to setting of accounting standards will have to be taken (policy proposals #1, #2 and #3). In addition, project mobilization, governance and design for the next step will also have to receive the necessary attention.

Then –

Progressively move towards compliance with accrual IPSAS

38. **Moving forward to comply with accrual IPSAS.** In broad terms, to move forward with implementation – (i) develop and agree a road map, which will phase in the new financial statements with their new classes of information through the same process of progressive new reporting formats and gap analysis; (ii) define for each progressive phase towards full accrual information feasible implementation actions, supported with key milestones, responsibilities and target dates, and taking into consideration the necessary capacity building and funding, data generation and other inputs that will be required; and (iii) a designated working group is to implement the action plan under oversight of a Steering Committee, in order to meet each progressive target date of first compliance to the accrual-based IPSAS linked to that phase. The recommended progression towards full accrual is dealt with under paragraph 31 above.

Developing the accrual road map

39. **The road map referred to in paragraph 38 should build up, over time, the new financial statements with the new information classes and underlying transactions as discussed under paragraph 31 and 32 above. The approach to identify new transaction sources, develop accounting policies and rules, amend accounting processes, methods and systems is rather generic, and to a large extent GABS dependant.** An important first step would be to amend the chart of accounts as explained further below in paragraph 41. Suffice to then further explain that, for example, when introducing creditors (payables) for the first time, the accounting rules, procedures and methods for recording expenses will also have to be changed at the same time. To extend the current commitment and expense recording system towards accrual would require two additional steps – (i) recording invoices for goods and services received and simultaneous creation of the amount payable (and clearance of the commitment); and (ii) to then record subsequent payments against the creditor and to regularly reconcile GABS creditor balances with that statements provided by each creditor. However, to create the individual creditors in the sub-ledger require a number of steps, including obtaining and recording the details of all valid creditors and agreeing the balances on the date that the new accrual accounting regime for creditors and expenses starts. Similar approaches would have to be followed for financial assets, inventories and the finally PPE.

40. **Based on the reporting framework proposed earlier, an example of a possible road map for the implementation of accrual accounting is included in Annex 1**. The time frames are not based on any particular research and would require further analysis by government. Several other factors would need consideration, e.g. (i) whether or not to convert revenue and expenses in the same fiscal year to accrual accounting (which is recommend); (ii) the time and processes involved in the collection of accrual opening data, especially for PPE; (iii) the time required for system, process and staff preparation and possible ways to speed things up; (iv) sequencing of activities in order to best achieve milestones and maintain momentum; and (v) off course, budget availability.

Change the transaction classification system

41. **The transaction classification system will have to be amended – "A chart of accounts is a classification of transactions and events (payments, revenues, depreciation, losses, etc.) according to their economic, legal, or accounting nature"[25]. It is the glue between transactions, the financial software that is used to control and account for them, management information needs and the final reports that are needed in terms of IPSAS and oth**er reporting standards. By now you would already be able to conclude that the cash-based chart of accounts just follows the budget classification system and that it would not identify, for example, assets and liabilities. A new chart of accounts is therefore needed, <u>that would continue to make it possible to report from one data repository against all formal information reporting standards, such as IPSAS and GFS 2001, as well as normal management information needs.</u> Several dimensions need to be included in the revised chart of accounts, including at least – (i) source of funding; (ii) organization; (iii) economic classification (but also providing for the IPSAS definitions of assets and liabilities); (iv) COFOG[26] functional classification; (v) program[27]; (vi) project; and (vii) possibly also geographic location. The economic and functional classifications are essential to comply with the IPSAS requirements to present the Statement of Financial Performance by nature and function of expense[28]. The program dimension would be essential to ensure direct cost allocation under a future performance orientated budget system.

<u>**Policy proposal # 12**</u>

Upon full implementation of accrual accounting, new types of accounting transactions and balances will have to be developed, maintained and managed. This requires the development of accounting policies, and determination of the necessary data sources,

[25] OECD. 2001. Managing Public Expenditure, A Reference Book for Transition Countries. Edited by Richard Allen and Daniel Tommasi. OECD: SIGMA Programme, page 295

[26] Classification of Functions of Government (COFOG) was produced by the Organisation for Economic Co-operation and Development and was published together with the other three classifications in United Nations, *Classifications of Expenditure According to Purpose* (New York, 2000).

[27] Par 39 of the World Bank PER (August 2010) recommends a program structure for the budget which "would enable performance information to be included in the budget document and thus begin a process of making departments accountable for results".

[28] IFAC. 2011. *IPSAS-1 Presentation of Financial Statements*. New York. Par. 109 and 115

accounting processes, timing and methods of recording and new classification requirements. In this regard the Government will have to – (i) agree on a set of accounting policies that will also facilitate a practical conversion, in terms of data requirements, from cash to accrual IPSAS; (ii) agree a new chart of accounts; and (iii) allow upon full motivation for the appointment of additional qualified staff to oversee the implementation of the required reforms over time.

Project management

42. **Sound project management principles and capacity needs to be deployed, with political leadership through a Steering Committee with government-wide authority and strong technical support.** Critically important would be to ensure proper integration of this reform with broader reforms, to ensure a practical and well paced action plan taking cognizance of capacity constraints and delivery of milestones on time and within budget. More guidance on this is available in Study 14[29] and also from authors such as Aggestam[30].

Change management

43. **Crucially important would be change management to prepare managers for their new accountability.** Let's use the example of PPE – for many years managers perhaps had some responsibility for PPE, without them actually being held accountable for its use, maintenance and safeguarding (basically because of a lack of the required information). To just attend to the technical process of initiating accounting and reporting for PPE without building their capacity for sound asset management, will not yield the expected benefits. In fact, the processes to prepare the data, systems and accountants for recording and reporting of PPE need to go hand-in-hand with the development of management capacity to discharge this new accountability. In order to allow for final compliance only when all aspects of the PFM system are ready for PPE, the PFM Bill needs to allow for phasing in of certain of its requirements, under discretion and authority of the Minister of Finance but subject to a final date for full implementation. It would also be crucially important to target and report quick wins, irrespective of the logical need to phase accrual accounting in over time.

Implementation risks

44. **Numerous risks will have to be managed through sound risk analysis and mitigation actions.** Key risks could for example include – (i) that GABS will not be ready to support the capturing and processing of accrual data; (ii) that staff will not be prepared to handle new accounting functions and processes; (iii) that data for opening balances will not be acceptable from an IPSAS and audit perspective; (iv) that project funding will not materialize; (v) that project milestones will not be achieved; (vi) that new functions will not be staffed in time; (vii) that new accrual information will not be used to ensure realization of the intended benefits, and so forth. As part of the project governance and management it is

[29] IFAC. 2010. *Transition to the Accrual Basis of Accounting: Guidance for Public Sector Entities.* IPSAS Board.
[30] Aggestam, Caroline. 2010. *A Project Management Perspective on the Adoption of Accrual Based IPSAS*. Copenhagen Business School.

recommended to implement proactive risk analysis and evaluation, with mitigation actions designed into the project plan.

It all about people

45. **Apart from approaches, action plans and program management, at the end of the day it is people that will make it happen.** Strong political will and leadership, also at the technical level, are required to move implementation forward. Leadership for the technical reform needs to continue to come from the Office of the Accountant-general, which needs to be equipped with the necessary staff with professional skills to lead the design, capacitate and implement the reform. Professional skills could be brought in initially, but this may not prove to be a sustainable solution. A sustainable program to develop the necessary professional competencies and skills for accrual accounting in the public sector at the technical and professional levels is also recommended. Effective advocacy, communication and strong collaboration will be required with all stake holders, in particular the Budget Directorate, BURS and the Office of the Auditor-general.

    Fear of the unknown should be tackled head-on with political will, the right people, sound analysis and technical support.

International experiences

46. **Countries which are well advanced.** Examples of countries which are well advanced in the implementation of accrual accounting include Denmark, Finland, Latvia, Estonia, the United Kingdom, New Zealand and Australia. Generally, these countries are a number of years down the line from when accrual accounting was first implemented. This has allowed them to introduce the principles across most, if not all, levels of government.

47. **Countries which are moving to accrual accounting.** A group of countries fall between accruals and cash accounting. A few examples –

    a. In Austria, fixed assets are recognised at historical cost but depreciation is not charged on depreciable assets. The exception to this is for agencies where assets are revalued to fair value and depreciated. Stocks and provisions are not recognised as assets, but income and expenditure is recognised on an accruals basis.

    b. The Czech Republic is an example of a country which uses the accrual basis for fixed assets and stocks, but not for the recording of tax revenues. Nor does it recognise grants or provisions on an accruals basis. Without performing a detailed analysis on the state of accounting in the country it is difficult to be specific, but this profile is typical of a country in transition from a cash basis to an accruals basis.

    c. In Lithuania there is a similar situation to that in the Czech Republic. Again, fixed assets and stocks are accounted for on the balance sheet but tax revenues and grants are on a cash basis. In addition, whilst income and expenditure are accounted for on a receivable / payable basis no year-end accruals are made, nor are provisions recognised.

These three examples above, and the countries in similar positions, are examples of the situations that can develop during the transitional period. In the Sub-Saharan African region most countries are moving towards compliance to the cash-based IPSAS, with the intention to move towards full accrual once policies, systems, procedures and capacity have been transformed – South Africa, as an example, has made significant progress in this regard. The experience of those who have undertaken this transition shows that it can take a number of years for accrual accounting to become fully embedded.

48. **Countries which are using cash accounting.** A number of countries, such as India, Ireland, Kazakhstan, Lithuania, Pakistan and Slovenia continue to use the cash basis for accounting for the public sector. In Italy the law does permit the use of accrual accounting but budgeting and financial statements are still prepared on a cash basis. In Germany, the federal government operates purely on a cash basis and there are no plans to implement accrual accounting at the moment. Hungary also uses a pure cash basis, in this case for all levels of government, with only limited balance sheet information prepared periodically.

49. **Volume 2 contains a more detailed review of the status and challenges of accrual accounting and budgeting in 100 countries.** It reveals that, although only 25 of the 100 countries listed have implemented full accrual accounting, a significant number (37) of the rest have expressed an intention to do so in future. In addition, several countries (18) have already introduced aspects of accrual accounting.

End of Volume 1

ANNEX 1: EXAMPLE OF A ROAD MAP TOWARDS ACCRUAL ACCOUNTING

Based on the reporting framework proposed, this is an example of a possible road map for the implementation. The suggested time frames are not based on any particular research and would require further analysis by government.