Implementing the accrual basis – *a step-by-step approach*

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In section 40(1)(b) of the *Public Finance Management Act*, No. 1 of 1999 (as amended), accounting officers of departments, trading entities or constitutional institutions are required to prepare financial statements for each financial year in accordance with generally recognised accounting practice (GRAP). In terms of section 87 of the Act, an Accounting Standards Board (ASB) should be established in South Africa which, in terms of section 89(1), should set GRAP standards. In setting GRAP standards, the ASB should in terms of section 89(2)(a) follow both local and international best accounting practice. From recent literature it would appear that international best practice in the public sector is the accrual basis of accounting and pronouncements by authoritative bodies supports this trend.

At this stage the ASB has not yet been established. In terms of section 93(3) of the PFM Act the National Treasury is authorised to perform the functions of the ASB until such time as the ASB is established. For this reason the pronouncements of the National Treasury with regard to the implementation of accrual accounting, would have the same authority as those of the ASB. Recent pronouncements by the National Treasury would appear to indicate that the implementation of the accrual basis of accounting in the public sector is imminent. This is clear from the following quote from pages 21 and 22 of Chapter 4 of the *Guide for Accounting Officers* published by the National Treasury during October 2000:

> *"In accordance with the Constitution, the financial statements will be prepared under GRAP. GRAP will be defined by the Accounting Standards Board (established under the Act) and will introduce many of the accounting practices used in the private sector. In particular, accrual accounting will be introduced: this recognises income and expenditure when the benefit is received or given, rather than simply reflecting the timing of the cash flow. It also acknowledges the consumption of assets over their useful lives, through depreciation."*

Dr. Gavin Woods of SCOPA shares this view in an article in the *IPFA Journal* of September 2000 where he states that there is no longer any credible argument to prevent the change from the cash basis to the accrual basis of accounting in the public sector

With this in mind it is important to consider how the conversion from the cash basis to the accrual basis would be effected in the public sector. Contrary to expectations, the implementation of the accrual basis, provided one is familiar with its underlying associated concepts and has the relevant amounts available, is fairly simple.

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Where do we start?

Note that until recently an appropriation account and appropriate notes have been prepared on the cash basis by most reporting entities. Recent publications by the International Federation of Accountants (IFAC) point to the demise of the appropriation account in favour of the cash flow statement.

The elements of financial statements prepared under the cash basis according to *ED 9 - Financial Reporting under the Cash Basis of Accounting* as published by IFAC, are the following:

- Cash receipts.
- Cash disbursements.
- Cash and cash equivalent balances.

These elements of the financial statements according to the cash basis will be presented in the financial statements prepared on the cash basis, these being:

- A cash flow statement.
- Notes to the cash flow statement and perhaps other information that may typically be provided under the accrual basis.

In contrast with the cash basis, the elements of the financial statements under the accrual basis according to *IPSAS 1 - Presentation of financial statements* as published by IFAC are the following:

- Assets.
- Liabilities.
- Net assets.
- Income.
- Expenses.

These elements of the financial statements will be presented in the following components of financial statements prepared on the accrual basis:

- A statement of financial position (balance sheet).
- A statement of financial performance (income statement).
- A cash flow statement.
- A statement of changes in net assets (equity = net assets).
- Notes to the above statements.

It should be clear from the above that the financial information generated for preparation of financial statements according to the cash basis would generally not include sufficient information in respect of assets, liabilities, net assets, income and expenses to implement the accrual basis. In fact, the most difficult part of the implementation process would be to establish the values to be attributed to all assets and liabilities at initial implementation of the accrual basis.

The starting point for converting financial information prepared on the cash basis to the accrual basis, would be to prepare an opening statement of financial position on the first day of the period in which the government decides to implement the accrual basis.

The starting point for converting financial information prepared on the cash basis to the accrual basis, would be to prepare an opening statement of financial position on the first day of the period in which the government decides to implement the accrual basis. The values attributed to the assets and liabilities of government as at this specific date will be included in this *first* statement of financial position prepared on the accrual basis. Once the values for all these assets and liabilities have been determined and included in this opening statement of financial position prepared on the first day of the first year in which the accrual basis should be implemented, the *net assets* will be established as a balancing figure.

How do we determine the values of elements to be used in the first statement of financial position prepared on the accrual basis?

Given your knowledge of the well-known appropriation account, and the more recent cash flow statement (both prepared according to the cash basis), it is clear that these statements provide a limited quantity of the information required to prepare a statement of financial position according to the accrual basis. Without proper transitional measures in place, it would therefore be very difficult to move directly from the cash basis of accounting to the accrual basis of accounting. However, the South African government has anticipated this and has already started a process whereby certain information that would normally be required under the accrual basis, is already available from recent sets of financial statements or is in the process of being prepared for future use, for example:

Since the majority of government employees are not fully conversant with the accrual basis, proper training on the fundamental principles of the accrual basis is essential.

1. The financial statements of certain reporting entities, even though they are prepared on the cash basis, already supply information on certain of their financial assets and liabilities in the notes to the appropriation account. This is the case even though these amounts do not strictly belong in a financial report prepared on the cash basis.

2. The SA government has also launched a project whereby a complete fixed asset register is in the process of being compiled for all the items of land, buildings, infrastructure assets, plant and equipment it owns.

The above two steps represent a point of departure for the preparation of the first statement of financial position prepared on the accrual basis as was discussed earlier.

Note that in the first case, care should be taken that all assets and liabilities are identified and that these items meet the definitions of assets and liabilities according to the accrual basis as contained in *IPSAS 1 - Presentation of Financial Statements*. Caution should be exercised to also ensure that the financial assets and liabilities identified specifically relate to the period under review and that they do in fact exist at the beginning of the first financial year when the opening accrual statement of financial position is prepared. Valuation in the case of the majority of these items is fairly simple, as external confirmation of values can be obtained in most cases.

However, in the second case, the main problem that is bound to arise (specifically in the case of the land, buildings, infrastructure assets, plant and equipment) is that it may be difficult to place a value on the assets identified. For instance, these assets may have been in use for many years and may not be saleable on the open market. Such factors would make it difficult to attach a value to them. Even though there may be several ways to determine the value of assets to be included in a statement of financial position prepared on the accrual basis, a final value will have to be placed on these assets at the date on which the accrual basis will be implemented. The value determined at this date should take into account the remaining portion of the useful life of the asset involved (if applicable) and this value will, from that point onwards, be deemed to be the cost of the specific asset. Depreciation or amortization will be written off in years to come on the values identified at this implementation stage, taking into account the remaining useful lives of the assets involved. The depreciation or amortization will appear in the statement of financial performance of the reporting entity.

As mentioned earlier, once the values of all the assets and liabilities have been determined, a statement of financial position at the beginning of the first year in which the accrual basis will be implemented can be compiled. The only figure that would not be available will be the net assets figure that will be a balancing figure on the initial statement of financial position. Since the net assets figure would be the difference between the assets and liabilities of an enterprise, this amount would be accurate provided that all assets and liabilities in existence were identified and valued correctly.

Once the opening statement of financial position has been drawn up, we need to determine the composition of the net assets identified. Several classifications of the net assets are possible, and detailed instructions with regard to the classifications to be used should be issued by a higher authority such as the National Treasury. For example, the initial net assets figure identified may be classified as *Capital funds*.

Example of the implementation of the accrual basis:

The items below were determined using steps 1 and 2 mentioned above and now have to be incorporated into the initial statement of financial position on the implementation date of 1 April 2009.

Elements of the financial statements as at 31 March 2009 determined by using the accrual basis, are the following:

Description	**Value Rand**
Assets:	
Land	100 000
Buildings	500 000
Receivables/Debtors	60 000
Petty cash	100
Amount held at the Paymaster-General	39 900
Liabilities:	
Mortgage bond on land and buildings	400 000
Payables/Creditors	50 000

Required: Prepare the statement of financial position on the implementation date of accrual accounting, being 1 April 2009.

Solution:

STATEMENT OF FINANCIAL POSITION AS AT 1 APRIL 2009

	Rand
ASSETS	
Current assets	100 000
Receivables	60 000
Paymaster-general	39 900
Petty cash	100
Non-current assets	600 000
Land	100 000
Buildings	500 000
Total assets	700 000
NET ASSETS AND LIABILITIES	
Current liabilities	50 000
Payables	50 000
Non-current liabilities	400 000
Mortgage bond	400 000
Net assets	250 000
Capital funds *(1)*	250 000
Total net assets and liabilities	000

(1) This item represents a balancing figure on implementation date and the classification as Capital funds in this example is merely for illustration purposes - other classifications may also have been used.

A summary of the steps to be taken to implement the accrual basis

The following procedure will be followed to convert a set of financial statements prepared on the cash basis to the accrual basis:

1. Identify all assets and liabilities of the reporting entity and establish the values of **all** assets and liabilities as at the beginning of the year in which the cash basis is changed to the accrual basis.

2. Prepare a statement of financial position on the first day of the financial year in which the conversion will take place, using the information determined in 1 above.

3. Classify the balancing figure in respect of net assets in the statement of financial position determined in 2 (above), into its component parts.

What happens subsequent to implementation?

1. Using the accounting systems set up to support the accrual basis, determine the closing balances of the assets, liabilities and net assets determined in 2 and 3 in the above-mentioned paragraph at the end of the first year during which the accrual basis had been implemented. Prepare a statement of financial position at that stage.
2. Now prepare a statement of financial performance for the first year subsequent to implementation of the accrual basis. Note that the changes in assets, liabilities and net assets will indicate whether these items should be classified as revenue or expenses or changes to assets and liabilities.
3. Any changes in net assets identified in 1 which do not end up in the statement of financial performance will be presented in the statement of changes in net assets (neither illustrated here). Examples of such changes would be additional capital contributions by owners, distributions to owners and revaluation surpluses that arose during the current year.
4. Finally prepare a cash flow statement by first adjusting the accrual figures to cash amounts and then by classifying the cash flows in the entity as either operating activities, investing activities or financing activities.

Note that the preparation of a statement of financial performance, statement of changes in net assets and cash flow statement were not addressed in this article.

Conclusion

The use of the accrual basis of accounting in the public sector is a reality, but the process of implementation thereof needs to be approached with great care. Since the majority of government employees are not fully conversant with the accrual basis, proper training on the fundamental principles of the accrual basis is essential.

An approach whereby firstly the building blocks or elements of the components of the financial statements according to the accrual basis are identified, then systems to deliver these elements are implemented and finally employees familiarized with these concepts and systems over time, would ensure a smooth transition. This approach, in combination with a period during which the cash basis is run parallel to the accrual basis, would ensure the least disruption to this important arena of financial reporting in the public sector. Auditing SA

Interesting sites on the WEB

AuditNet is a free resource to the global audit community. The principle web address is: auditnet.org. The e-mail contact is: AuditNet-l@list.auditnet.org. In this issue of Auditing SA we highlight some useful links brought to the global audit community via Audinet.

PC Profile (**www.pcprofile.com/**) provides PC and desktop coverage for issues related to PC usage and software management. The site has links to free tools, PC audit tools, articles and much more. (Product discounts available for AuditNet users).

Software Compliance Auditors Toolkit (**www.pcprofile.com/auditors_toolkit.htm**) CD-ROM based toolkit for auditors, managers and accountants to do a thorough desktop audit, on demand, of any PC with a fitted or external CDROM, to IDENTIFY what is installed on that specific PC. (Discount available for AuditNet users).

Spreadsheet Detective (**www.spreadsheetdetective.com/**) is a financial audit error Excel add-in and Euro conversion tool. A free evaluation copy is available for download from the site.

Spreadsheet Audit Tool (**www.kellogg.nwu.edu/faculty/myerson/ftp/addins.htm**) Web site provides free add-ins for Excel including formlist a simple auditing tool that adds procedures for displaying the formula of selected ranges.