Government of Somaliland

PFM Education and Training Phase 2

Foundation Course Workbook 1

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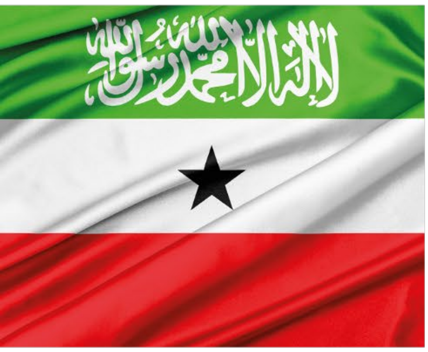

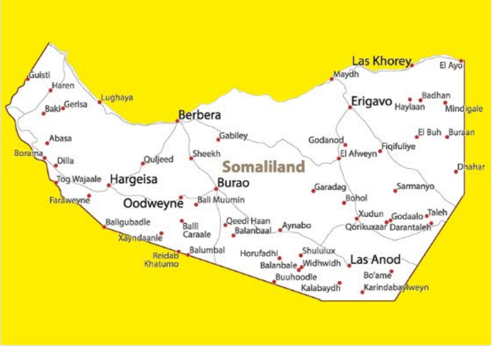

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Abbreviations

CoA	Chart of Accounts
COTS	Commercial off the Shelf [software application]
CSO	Civil Society Organisation
FMC	Financial Management and Control
FMIS	Financial Management Information System
GASB	Government Accounting Standards Board (USA)
GBE	Government Business Enterprise
GFS	Government Finance Statistics
GGS	General Government Sector
HR	Human Resource
HRM	Human Resource Management
IFRS	International Financial Reporting standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ICT	Information and Communications Technology
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
INTOSAI	International Organisation of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
IT	Information Technology
MDG	Millennium Development Goals
MoF	Ministry of Finance
MTEF	Medium-Term Expenditure Framework
PE	Public Enterprise (same meaning as GBE)
PEFA	Public Expenditure and Financial Accountability
PIFC	Public Internal Financial Control
PFM	Public Financial Management
SAI	Supreme Audit Institution
TSA	Treasury Single Account
WB	World Bank

1 Workbook 1 - Introduction to Public Financial Management Learning objectives

Workbook 1 is an introduction to public financial management. At the end of this Workbook, students should:

- Understand the structure of the public sector and its components;
- Understand the PFM cycle;
- Know the benefits of strong PFM and its application in Somaliland, including computerised systems;

This Workbook will:

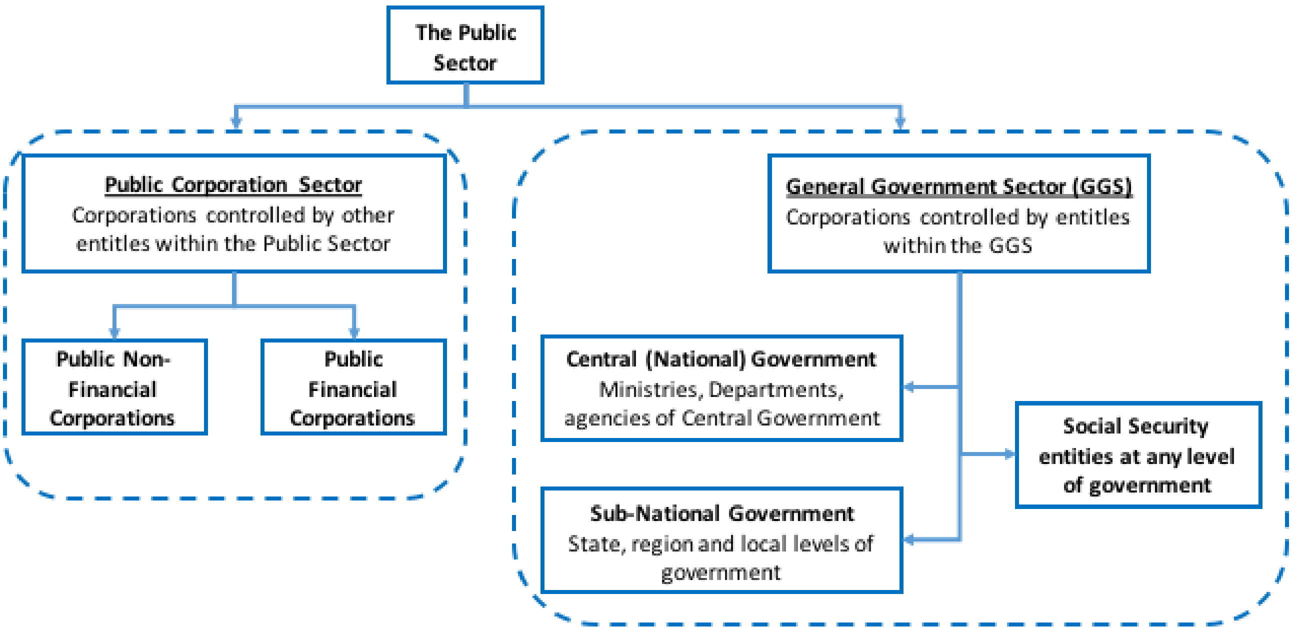
1. Define the public sector
2. Define financial management
3. Explain public financial management (PFM) and the PFM cycle
4. A summary of the benefits of strong PFM
5. Factors driving PFM reforms across the world
6. A brief introduction to PFM in Somaliland

2 The public sector

The UN System of National Accounts (SNA) provides the "official" definition of sectors of the economy. The SNA definitions are used by the IMF Government Financial Statistics Manual (GFSM). This course is concerned only with the Public Sector, i.e. parts of the economy controlled by government.

The SNA and GFSM definition of the public sector is illustrated in Figure 1 below.

Figure 1: The public sector



Explanation:

The public sector comprises two main sub-sectors and various sub-subsectors:

- Public Corporations[1], which sub-divides into:
  - Financial (e.g. banks)
  - Non-financial (e.g. state owned enterprises)
- General Government Sector, which sub-divides into:
  - All central government Ministries, Departments and Agencies (MDAs)
  - All sub-national (State, Regional, Local) government MDAs
  - Social security entities (National or sub-national)[2]

Public Financial Management (PFM) refers to the financial management of the whole of the public sector. However, there are important accounting differences between the General Government Sector (GGS) and public corporations, as will be explained during this course.

3 Financial management

This manual is concerned with the financial management of institutional units in the public sector. The UN SNA definition of an institutional unit that is "*an economic entity that is capable, in its own right, of owning assets, incurring liabilities and engaging in economic activities and in transactions with other entities*".

In this Workbook, the term "entity" will be used to describe institutional units as defined above. Examples would include:

- A Government Ministry or Department
- A University
- A bank
- A business entity would be a company or a firm.

Many of the tools of financial management, including double entry bookkeeping, were originally developed to meet the requirements of private sector business. Historically, as business enterprises grew in scale during the 19th century industrial revolution, so did the requirements for financial control and management. The concept of audited, published annual financial statements arose because of the separation of ownership and management that was necessary for large scale economic activity. The accounting profession and formal training of accountants also developed to meet the requirements of the private sector.

The development of computers and the availability of "Commercial off the Shelf" (COTS) accounting software have taken financial management to a new level of sophistication. Nevertheless, the basic principles of double entry accounting continue to be applicable to computerised accounting (See Section 7.2 below).

An important development in accounting has been of internationally recognised accounting standards. Because accounting allows many different options for measuring flows, valuing assets and liabilities, business entities had considerable scope to manipulate their financial results. Accounting standards were developed to provide rules on valuation and measurement for financial reporting. These standards are now codified into the International Financial Reporting Standards (IFRS). The IFRS are issued by the IFRS Board, an independent trust representing various stakeholders. Standards are continuously modified or added to as new issues are identified.

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[1] Various alternative terms are used to describe public corporations. International Public Sector Accounting Standards (IPSAS) refers to public corporations as "commercial public sector entities". Public Corporations are also sometimes referred to as "State Corporations" or "State Owned Enterprises"

[2] Social security entities do not as yet exist in Somaliland. Such an entity would exist if, for example, the government set up a separate entity to manage a state pension for all citizens.

More recently, accounting standards have been developed for the public sector. Workbook 4 will consider International Public Sector Accounting Standards (IPSAS).

4 Financial management in the private sector

Financial management applies to both the private and public sector. It is defined as the efficient and effective management of money (funds) in such a manner as to accomplish the objectives of the organisation.

Fundamental to financial management is an understanding of accounting. Many accounting concepts were developed first in the private sector, and then applied to the public sector. For this reason, Workbooks 2 and 3 study of the basic concepts of private sector accounting, before considering how these concepts are applied in the public sector.

In a private sector business, the owners invest capital into a business to make a profit. Private sector accounting developed to answer four key questions:

- How much money can the business pay to its owners?
- How much tax should the business pay?
- Is the business solvent, i.e. does it have sufficient money to continue?
- Is the business being well managed?

Over the course of the 20th century, the basic form of the economy of developed countries changed from owner-managed businesses to large international companies with shares quoted on stock exchanges. Financial reporting has adapted to reflect these changes. Formal accounting standards were developed to regulate an increasingly complex business environment. The role of accounting changed as the owners of businesses (shareholders) became more and more distant from the managers of these businesses. Accounting moved from meeting the needs of an owner-manager to providing information to actual or potential shareholders and company creditors (those lending money to a business) to help them decide whether to continue to invest in the particular business or to move their capital and to invest in alternative opportunities.

However, through all the changes, the basic principles of accounting have remained unchanged. The accounting model is the only universal model of a business. Whatever the nature of the business, the accounting model continues to be the information model that provides the answers to the above key questions. For the above reasons, accounting has become the dominant private sector business model.

5 Public financial management and the PFM cycle

Public financial management (PFM) is the financial management of the public sector. This course will explain how financial management of the public sector is similar to financial management of the private sector, but with many unique features. Understanding PFM is built around the PFM cycle.

The four key stages in the public financial management cycle are summarised in Figure 2 below and explained in the following text.

Figure 2: Public Financial Management Cycle

5.1 Planning and budget preparation

Planning and budget preparation includes long term plans, medium term expenditure frameworks and annual budgets.

5.2 Long term planning

May be either formal national development plans, e.g. 5 year plans, or simple statements of long term policy goals. Also includes investment planning.

5.3 Medium Term Expenditure Frameworks (MTEF)

Many countries are now adopting the MTEF approach. The MTEF approach requires Medium Term Fiscal Forecasts (MTFF) and Medium Terms Sector Strategies (MTSS). MTEFs will be examined in the "PFM for Somalia" Course.

5.4 Annual budget preparation

The starting point of the budget process should be the fiscal forecast of available resources - revenues (tax and other), borrowings and grants. Forecasting fiscal resources can never be exact, but reliable forecasts facilitate better decisions on resource allocation. Simple forecasting tools can often significantly improve the reliability of resource forecasts.

The annual budget of a government is a very important component of PFM. Usually the government budget is a consolidation of all of the budgets of the various MDAs that form the general government sector (see above) of a country, e.g. Somaliland.

The budget is a legal document and the end of a process that typically involves:

- Sector plans and strategies;
- Fiscal resource forecasts;
- Initial budget submissions by spending Ministries;
- A negotiation process with the budget authority (Ministry of Finance);
- A final budget submitted to the legislature;
- Enactment as the annual budget.

Budgets drive public financial management. This contrasts with the private sector where the budget is merely a forecast. Budgets are studied in Workbook 5 of this course.

5.5 Budget execution

Budget execution embraces the stages from budget approval through collection of resources and expenditure of money. The elements of budget execution are considered below.

5.5.1 Revenue management and collection

There will be a Government entity responsible for the collection of tax and other revenues. Collections will need to be recorded in the accounting system.

5.5.2 Fund release

The approved budget indicates the allocation of funds to Ministries and other government agencies. There must then be a process that makes such funds available for the Ministries to spend, subject to central controls. In many countries this process is referred to as "warranting".

5.5.3 Cash and debt management

Cash management forms part of the control over the release of funds. It should also be used to ensure cash availability to fund expenditures. Cash management should be linked to debt management so that borrowings can be used to deal with short-term cash shortages. Debt management will also manage all long term borrowings of government.

5.5.4 Budget execution sub-systems such as payroll and asset management

The budget execution will normally involve a number of special sub-systems for specific aspects of spending funds. These may include payroll systems, systems for managing assets and so on. These systems may be computerised alone or as part of an integrated Financial Management Information System (FMIS).

5.6 Accounting and reporting

Accounting records budget execution transactions in the accounting system. Reporting summarises and presents the information in a format useful for the Government and for transparency.

5.6.1 Recording of transactions within an accounting system (usually a computer based system)

The recording of transactions (inflows and expenditures) will take place within an accounting system as described in later sections of this Introductory Course.

5.6.2 Reporting

Reporting should flow from the accounting system. There are two categories of reports:

1. Internal management reporting, e.g. expenditures and commitments compared to budget, expenditures compared to the objectives of expenditure;
2. External reporting - annual financial statements, reports in accordance with IMF GFS, and other published financial reports.

External reporting is an important element of transparency and accountability (see below).

5.7 External scrutiny and audit

This heading includes internal audit, financial control, external audit and Parliamentary scrutiny. Together these further enable transparency and accountability.

5.7.1 Internal audit

Internal audit is a service to management to improve efficiency and effectiveness as well as to ensure compliance with rules and procedures.

5.7.2 Financial (or internal) control

Sometimes referred to "Public Internal Financial Control", this involves the whole system for ensuring that expenditures are made in accordance with government regulations and that there is no theft of public assets or corruption in raising and spending public money.

5.7.3 External audit by the Supreme Audit Institution

Each country should have a Supreme Audit Institution (SAI), e.g. the Auditor General, responsible for the independent audit of all government activities. The SAI should report directly to the legislature.

5.7.4 Parliamentary scrutiny

Parliament should have procedures to scrutinise the financial activities of government. Often this is achieved by a "Public Accounts Committee". This Committee will consider the reports of the Auditor General and financial reports on government.

5.7.5 Transparency and accountability

Governments operate for the benefit of citizens. Their financial performance should be scrutinised through a process of transparency and accountability. This requires the publication of financial reports in a format that is generally available and understandable by citizens.

6 Benefits of good public financial management

The benefits of high quality government financial management are substantial. The matrix below summarizes the major benefits and indicates typical financial management activities related to achieving such benefits.

Table 1: Benefits of high quality public financial management

Area of benefit	Specific activities
1. Enhanced resource mobilization	Collection of tax and other revenues to ensure that the highest feasible level of collection is attained within the legislative framework. Receipt of external resources including loans and official development assistance managed with proper procedures and controls which comply with requirements of lenders and donors.
2. Improved fiscal forecasting and resource allocation in accordance with policy priorities	Effective fiscal forecasting enabling reliable forecasts of resources available in the future. Sectoral plans identifying spending priorities and allocating resources within limits of availability.
3. More efficient budget execution and management of resources	Efficient expenditure systems that minimise transaction costs and ensure that budgeted resources are available where and when required. Cash management that ensures that funds are available when required and minimises financing costs.
4. Effective and efficient management of financing	Managing borrowing to ensure minimal cost of funding and that loan conditions are met.
5. Enhanced transparency and accountability	Recording, accounting for, analysing and reporting on the financial transactions, assets and liabilities of government. Published financial statements and other reports in compliance with international reporting standards.
6. Good management of public funds and assets, resulting in reduction in the levels of corruption and leakages	Protecting and enhancing the rights of government to receive money or money's worth. This entails the management of both income flows and assets (e.g. forests, fishery resources) so that the government and the country as a whole receive as much benefit from them as possible. Controlling expenditure and the exercise of financial authority. Carrying out the necessary financial business of government: government has bills to settle, staff to pay and revenue to collect.

7 Factors driving PFM reforms across the world

7.1 International public sector reforms

Public sector financial management has changed significantly over the last 25 years to reflect wider reforms known as New Public Management. New Public Management reforms typically include:

- Privatisation and outsourcing;
- Deregulation;
- Commodification of public services;
- Creation of purchaser/provider splits or creation of agencies.

It is important that PFM meets the needs of users. How governments make decisions and how they are held accountable for those decisions will impact on the design and use of accounting and financial management systems. As systems of public management change, then the systems of PFM should also change to ensure that relevant and appropriate information is provided internally to managers and externally to the full range of stakeholders.

7.2 Financial Management Information Systems

The computerisation of budget and accounting has been a transformational tool in the development of PFM. The generic name for the systems used in PFM is Financial Management Information Systems (FMIS). An FMIS is likely to include a number of modules, which may be integrated or stand-alone, such as:

- Budget preparation systems;
- Accounting systems;
- Payroll systems;
- Revenue management systems;
- Debt management systems.

The introduction of FMIS has enabled more rapid data entry, analysis and reporting with fewer skilled staff. However, the selection, implementation, operation and control of FMIS also presents a number of challenges. Nevertheless, the benefits of computerisation are so substantial that all countries have either implemented, or are in the process of implementing, computerised systems for all of PFM.

The implementation of an FMIS does not change any of the principles of PFM. Such systems simply enable more effective PFM to be implemented with relatively limited resources.

7.3 Improvising governance

All countries are seeking to improve governance. This involves enhanced transparency and accountability of public sector officials, increased citizen participation in allocating resources, a reduction in wastage through fraud or simply bad management. PFM has a vital role in this process, placing increasing demands for better, more timely and reliable financial information.

8 PFM in Somaliland - Overview

The 2012 Constitution sets out the requirements for legislation on finance as in Box 1 below.

Box 1: Somaliland Constitution Article 124

A law enacted by the Federal Parliament [of Somaliland] shall provide the framework for financial management with the following characteristics among others: (a) The preparation, timetable and procedure for presenting the budgets of Federal Member States and districts in a transparent, accountable and efficient manner; (b) Guarantees by the Federal Government for loans raised by Federal Member States; (c) Procedures that the Government will follow for public procurements; (d) Auditing of accounts of non-governmental bodies that receive government funding; and (e) General measures necessary for the implementation of this Chapter.

The new Public Financial Management and Accountability Act (PFMAA 2016) passed in 2016, replaces the previous financial and accounting regulations and procedures. The Government Gazette indicates the PFMAA has received Presidential assent and is now law.

The financial statements of the government are prepared on a cash basis of accounting. The Auditor General is also involved in the payment process by approving payments before they are processed. The processes in Somaliland will be considered in more detail in the course "Advanced PFM".