Robert de Koning

PI*f*C

Public Internal *f*inancial Control

A European Commission initiative
to build new structures of
public internal control
in applicant and third-party countries

Public Internal *f*inancial Control

PI*f*C is a concept and strategy developed by the European Commission to support applicant countries in the reform of their public internal control systems. The concept has had a major and important benefit in introducing, or creating the possibility to introduce, much higher standards of public expenditure control with a greater emphasis on value for money than the traditional arrangements that existed in pre-accession countries. Its development started some years after the fall of the Berlin wall when it became clear that Europe would again be united.

The EU Member States had and still have a strong interest in bringing public sector corruption and financial mismanagement in the former communist countries under control. Reform to fight corruption in the public sector requires several concrete steps to be taken by government; structural and institutional reforms are indispensable to the process. An essential condition for successfully fighting corruption is that the control and audit institutions can withstand fundamental changes in political coalitions as well as changes in key personnel and still continue functioning.

This book is for those who have an interest in the background and future of the **PI*f*C** strategy. **PI*f*C** became part of the accession negotiations with countries in central and eastern Europe. As a result, all the new Member States had, by the time of their accession in 2004, adopted the latest international trends and standards in public management, control and audit. Since then, the focus of **PI*f*C** has shifted towards countries in the western Balkans. But it may not stop there. Other governments - e.g., those seeking to upgrade their public internal control systems and benefiting from the European Neighbourhood Programme Instrument - find it also beneficial to use the unique experience of the new Member States and the current applicant countries in the area of **PI*f*C**. The concept of **PI*f*C** provides an example for other countries who might not even aspire to join the European Union.

This book provides a wide range of interested parties with the tools to develop transparent and efficient control and audit institutions: politicians, government officials, managers, controllers, internal and external auditors, accountants and financial inspectors, trainers, twinning partners, academics, students and others. The reader is advised, however, that this book is not about budget preparation, accounting and financial reporting.

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Preface

I am delighted to introduce the book you hold in your hands, which is not only a useful source of information, but which also offers great practical advice for improving Public Internal *f* inancial Control (PI*f*C).

This publication describes the history and evolution in national administrations of the internal control concept as developed by the Commission to prepare the then accession countries to become the new EUR-12 Member States.

As former Minister of Finance of Lithuania, I have been actively involved in the transformation of the public control environment to make it PI*f*C-compliant. From that perspective, I believe that this book contains valuable information, in particular for those administrations which are currently in this re-engineering phase and those who will go through it in the future.

As a member of the Commission services, Mr de Koning has been (and still is) most actively involved in the promotion of Public Internal Financial Control; I note with satisfaction his initiative to share his experiences with the public at large.

Dr Dalia GRYBAUSKAITÉ
Commissioner for Financial Programming and Budget

About the author

Robert de Koning works in the European Commission, DG Budget, and is team leader for **PI*f*C** issues. He holds a Master's Degree in Economics from the University of Tilburg, the Netherlands. He has worked for the Dutch Ministry of Finance, for the Asian Development Bank as alternate executive director and as financial attaché in the Dutch Permanent Representation to the EU in Brussels. He joined the European Commission, DG Financial Control, in 1988. Initially involved in the financial control of the PHARE, TACIS and European Development Funds, he has been leading in developing the **PI*f*C** concept for applicant countries from its inception in 1994. The ideas expressed in this publication are his and do not necessarily correspond with those of the European Commission. He also takes responsibility for any error or omission in this publication.

Contents

Acknowledgments

This book is dedicated to the Directors General who had the foresight to create the basis for and allowed the development of the unique initiative that is the subject of this book: Mr de Moor (Director General DG Financial Control 1987-1994), Mr Pratley (Acting Director General DG Financial Control 1994-1996), Ms Ventura (Director General Financial Control 1996-2000), Mr Mingasson (Director General DG Budget 2000[1]-2003) and Mr Romero Requena who has been Director General of DG Budget since 2003.

The author expresses his appreciation for and acknowledgement of all those who have contributed to or commented upon the gradual development of **PI*f*C** over the years and to all those who provided support or took charge of the implementation of this important element of public administration reform. In Appendix 1 the reader will find a list of "**PI*f*C** Builders", who have, each in his or her own way, devoted an important part of their professional lives to promoting and developing **PI*f*C**.

The following persons (in alphabetical order) deserve a particular mention; they shared with me many hours of collegiality, friendship and discussion since the earliest days of **PI*f*C**: Juergen Andermann, Mike Berrisford, Camil Bojin, Francois-Roger Cazala, Alain-Gérard Cohen, Lakis Demetriou, Dana Dyckova, Noel Hepworth, Agnieszka Kazmierczak, Ulrika Klingenstierna, Monika Kos, Jiri Kuchyna, Ewa Krzyzewsky-Kuran, Jan Pieter Lingen, Ljerka Linzbauer, Nicholas Martyn, Darius Matusevicius, Jurij Milatovic, Dace Nulle, Gjon Ndreja, Vedat Özdan, Pierre Pace, Mihai Spranceana, Josef Svoboda, Nicholas Treen, Tzvetan Tzvetkov, Joop Vrolijk, Edit Weidlich and Maria Zacharczuk-Kakietek.

A special mention goes to those colleagues and friends who supported and encouraged the writing of this book: Pinar Acar, Robert Gielisse, Brian Gray, Ulrika Klingenstierna, Krisztina Kovacs, Paulina Stanoeva and last but not least Nicholas Treen. The author is grateful in particular for their constructive criticisms on the contents of this publication. Finally big thanks to Lindsay Westley and Alexander Brown for seeing me through the hazards of writing in a foreign language.

1 The year in which the **PI*f*C** Unit was transferred from DG Financial Control to DG Budget

Introduction

Rebuilding public internal control systems

The concept of **PI*f*C** was developed by the European Commission during the second half of the 1990's and is nowadays used to guide and support applicant countries[2] attempting to develop modern public internal control systems. The logo **PI*f*C** rather than the straightforward abbreviation PIFC was chosen by the author to underline the uniqueness of the concept, as in much external discussions PIFC has "erroneously" been used to describe any kind of public control system.

PI*f*C is a curious concept and acronym; it is a product of the early days of the accession negotiations. How and why it came into use will be explained in this book. The term was first coined by this book's author in an article published in the SIGMA Public Management Forum of November 1999. The article explained how the European Commission's Financial Control DG[3] developed a strategy to streamline the confusion then generally prevailing as to which model for public internal control systems might or could be considered for adoption by applicant countries within the framework of their accession negotiations. Requests for support first came from the applicant countries themselves. They had the unenviable task of absorbing, understanding and choosing between a large variety of national concepts and interpretations proffered by external consultants and international organisations.

Quite understandably, the Commission had from the beginning focused its concerns on applicant countries setting-up appropriate national control and audit systems specifically designed for the management and use of EU funds. However, the challenge in the accession negotiation chapter on Financial Control, hereafter referred to as the FC Chapter (to avoid using the various other designations Chapter 3.9, 18, 28 or 32[4] under which it has been known) soon went beyond this somewhat narrow concept. It acknowledged that the control environment in a specific applicant country would not be well served by two parallel systems; one based on the acquis-requirements for the control of EU funds while the second followed the control practice of 70 or so years of central command-driven economies. The EU requirements relating to the management and control of EU funds had always been

2 The term applicant country denotes a country which has submitted an application to become an EU Member State, while a candidate country has received the status of candidate to accession. However, in practice these terms and others, like accession or acceding countries have been widely used as though they were interchangeable. For reasons of consistency the author has chosen to use the term applicant country in this book unless otherwise stated.

3 Also called DG XX and later DG AUDIT. After the separation of DG Internal Audit Service from DG AUDIT, the latter was called DG Financial Control again from 2000 until its demise in 2003; its **PI*f*C** activities were transferred to DG Budget in 2000 on the specific request of the Commissioner for Budget and Financial Control.

4 As of 2005, with the negotiations starting for Croatia and Turkey, the Chapter is called Chapter 32

part of the negotiation chapters for Agriculture and Structural Funds. In previous enlargements, i.e. before 2004, no special chapter on Financial Control had ever been negotiated as dealing with national systems of internal control was not (and with reference to Member States still is not) within the Commission's Treaty responsibilities. Countries like Sweden and Austria, for example, were already considered to have internal control systems in the tradition of best European practice.

PI*f*C should be thought of as a part of the entire public finance area extending all the way from national budget formulation, through budget approval and execution, to treasury, fiscal and debt management, incorporating accounting, reporting, procurement, internal control etc. **PI*f*C** gives issues of internal control in the public sector a prominent place in the landscape of public financial reform. Internal control has a right to be seen as a distinct set of comprehensive rules, aiming at transparency and efficiency in the public sector. It therefore deserves to be developed as a separate cluster of activities on its own merits and not merely as an appendix of the budgeting or accounting functions or the fight against fraud, notwithstanding its obvious links with these areas. Also, **PI*f*C** is primarily based on well-established international standards to make public finance more transparent and accountable.

PI*f*C is an important subject for external audit by the national Supreme Audit Institution. It is therefore relevant to develop and assess **PI*f*C** under the watchful eye and counsel of this institution and to design a long-term master plan to make sure that both **PI*f*C** and External Audit work in synchrony, while respecting one another's responsibilities and levels of independence.

This book does not cover the broader financial management issues including financial reporting to stakeholders. Of course, the **PI*f*C** system should ensure that appropriate accounting standards are applied, particularly those laid down by IFAC, called the International Public Sector Accounting tandards (IPSAS). These standards cover both cash and accrual accounting and are therefore relevant to all countries . This book rather intends to give the reader a hands-on guide to building or re-building up-to-date internal control systems in a country's public sector including how to confront and overcome the many bottlenecks that can crop up in the process. The reader will be introduced to the history and background of **PI*f*C** so that he or she will understand why the Commission's policy evolved from "non-intervention" vis-à-vis the existing Member States (EUR-15) into a "coaching" role in the establishment of state-of-the-art internal control systems in applicant countries. The applicant countries were keen to receive authoritative guidance after having lost the proverbial "trail of bread-crumbs" in a forest of often incongruous solutions offered by consultants who advocated the systems used in their respective countries of origin.

This "coaching" process has shown results. All the EUR-12 have taken action to incorporate contemporary international control and audit standards into their national policy and lawmaking; they have adopted framework and implementation legislation based on well-defined policy recommendations and all of them have established central institutions that promote and implement the principles of managerial accountability and of functionally-independent internal audit throughout the public sector. Processes that would normally take fifteen or twenty years of slow and painful administrative developments were compressed into an average period of 6-8 years. This was an extraordinary achievement by everyone involved and looks even more impressive when compared to the pre-negotiation situation.

But there has been a cost. The process has also been disruptive to the existing administrative control structures and the adaptation of many institutions and the staff involved may have fallen hard on them. One will only be able to talk of real success in the field of public internal control reforms if the changes in policies and laws are adequately implemented and refined over time. This is the task for a large number of civil servants who have to acquire a thorough knowledge of current control and audit standards, and need to be motivated and supported by an indulgent and convinced management. The entire process has been – and still is – a major challenge for all those involved. For those in the EUR-12 and applicant countries it has been a cultural change in administrative attitudes.

It is important here to underline the principle that changes of power at government level should not lead to changes in the internal audit structures and internal audit staff. Incoming governments that may wish to insert their own "supporters" into management levels could easily destroy (newly established) systems of trust, integrity and professionality, especially in those systems relating to public internal audit. This is exactly the reason why as much as possible independence is sought for the function of internal audit as well as for the overall General Internal Auditor, the Head of the Central Harmonisation Unit.

Since May 2004, the date of accession for the EUR-10, substantial experience has been gained in implementing **PI*f*C**. The motor is running, supported by Central Harmonisation Units established at the instigation of the Commission. They are the engines which should promote the new standards of public internal control and help the **PI*f*C** institutions shape a consolidated and coherent public effort to improve economy, efficiency and effectiveness in public finance. Whether the Commission policies and strategies really have been successful can only be assessed in the longer term. **PI*f*C** was designed in the absence of existing comprehensive policies as a project-based activity for a specific time-period up to May 2004. However, for all the new Member States May 2004 was just the beginning of a long process of implementation and consolidation.

The know-how acquired from this project will be further used in discussions with the remaining applicant countries and with the prospective new applicant countries in the western Balkans. The countries covered by the European Neighbourhood

Policy (ENP) may also benefit from the experience available and the advice offered by the Commission (DG Budget) and it may not stop there. This book has been written with the needs of civil servants in these countries in mind who need to be trained as managers, accountants, controllers or auditors, both internal and external; but it also aims to serve as a reference book for all those who have a professional interest in the development of internal control in the public sector or, even as a catalyst for a wider discussion on public internal control.

PI*f*C

These days it is hard to attend an internal audit conference and not be reminded of the traumatic fallout from corporate governance failings in recent years. These ghosts are still setting the tone for the deliberations in these conferences. Presentations focus on newly-taken initiatives, the redefinition of principles of good governance, as well as on ways of letting management deal more adequately with that mother of buzz-words in the area of corporate and government governance: **risk**.

Cases like ENRON, WORLDCOM, BARINGS, PARMALAT and AHOLD are not likely to be forgotten by the present generation of auditors. All the text books and presentations state that the main reasons for the failures were "incompetence, executive greed, the bad assignment and definition of roles and responsibilities, neglecting internal audit advice, perverted external audit characterised by conflicts of interest" and so on. The impact of these failures has been disastrous for both employers and shareholders, and more generally for public trust in the wheeling and dealing of corporate management. Accounting standards, not least the accrual accounting ones are capable of manipulation, which is a reason why internal auditors need a thorough understanding of their very complexity.

The only silver lining from these regrettable events would be the emergence of a huge interest in how to improve the quality of internal control and internal audit, translated into a whole new trade of internal control and audit conferences and seminars. A number of new initiatives were taken in the wake of the internal control disasters in corporate governance with probably the two best-known being the COSO Integrated Risk Management Framework (COSO 2) and the US Sarbanes Oxley Act of 2002.

The big question is what the *public* sector should learn from these events and developments and how it should adapt and adopt the various instruments developed for the private sector to improve the quality of government governance. The key issue here is how to define management accountability. In the public sector (and this is certainly the case in the former communist countries) managers such as ministers and directors of government agencies spend budgetary funds while showing little inclination to deploy resources to make financial management sound, transparent and exemplary. Managers are politically driven; they focus on short-term financial results and successes and are less interested in how their departments function and in the adequacy of the underlying procedures. However, taking into account the scarcity of public resources and the mounting call for transparency and accountability, managers should be increasingly interested in whether the results of their policies (and thus their successes) can be improved in terms of economy, efficiency and effectiveness. From this perspective the public sector does not differ much from the private sector, although their respective performance may be measured in different ways. A new public management approach is therefore needed to create a greater focus on the public service customer and on performance, issues to which the internal auditor should be alert.

The managerial accountability principle is the first and most important lock in a double-lock system for sound financial management, according to Jules Muis, former EC director general Internal Audit Service when he spoke at the international conference “Meet your colleague”, organised by the Dutch Ministry of Finance in Amsterdam May 13-14, 2004. He went on to say that the second lock is internal audit supporting management in analysing and understanding the weak areas of the control systems developed by management. If management was fully aware of the quality of its control systems and encouraged its staff to follow the rules by setting a good example (tone at the top/lead by example), there would hardly be need for an internal auditor. Making internal audit redundant, however, requires a sophisticated and well-defined set of rules and responsibilities, well-understood and well-implemented by all those responsible for every aspect of the internal control system. Accomplishing this clearly continues to stretch the imagination and ability of many a national administration! In any event managerial accountability and internal audit are still relatively new concepts, not only in applicant and other countries, but also in a number of existing Member States. For many years to come, these concepts will remain the focus for those who have an interest in strengthening the internal control function of their own and others’ public sectors.

Chapter contents

Chapter 1 "Ten easy steps" towards PI*f*C

Reflections on corruption in the public sector, its causes, features, cost and ways to fight it; the concept of **PI*f*C** and its role as the basis for practical solutions in reforming those parts of the national administration that are responsible for developing management, control and internal audit; the "simple" 10-step implementation.

Chapter 2 Internal Control in the Public Sector

The variety of internal control systems in EU Member States; the Commission's analysis of existing public control systems in applicant countries; the lack of a common concept relating to internal control, internal as well as external audit; developing a strategy for supporting applicant countries in accordance with guidelines developed by SIGMA, the IIA COSO-model and the INTOSAI.

Chapter 3 The three elements of PI*f*C

The need for a strong and lasting political commitment from the government to support the **PI*f*C** project; audit trails; self-assessments; risk analysis and risk management; the three elements of **PI*f*C** and the relationship between (traditional) inspection and modern audit, the organisation and functioning of internal audit units; Central Harmonisation Units; national audit boards or audit committees.

Chapter 4 Financial Control Reform in the European Commission

Developments in the area of public internal control outside the scope of the accession negotiations; Sound and Efficient Management (SEM) 2000 and the 2000 White Paper on Commission Reform; the restructuring of the internal control systems in the Commission; recent discussions on the Commission's roadmap to an integrated internal control framework; internal control developments in a number of EUR-15 Member States.

Chapter 5 The Accession Negotiations

What happens; DG Budget's role in the negotiations, the Europe Association Agreements, Agenda 2000 and the Accession Partnerships; the purpose and structure of the accession negotiation chapter on Financial Control; co-operation with applicant countries; conceptualisation of the **PI*f*C** elements, drafting a **PI*f*C** Policy Paper, drafting and adopting **PI*f*C**-related framework and implementation legislation, establishing **PI*f*C**-related organisations; training needs for management, controllers and auditors.

Chapter 6 DG Budget's Toolbox

Administrative co-operation agreements (ACAs) with applicant countries; multilateral and bilateral screening meetings to inform applicant countries of the obligations and opportunities of introducing adequate internal control systems; fact-finding and monitoring missions to Ministries of Finance and Supreme Audit Institutions; training seminars for national civil servants; contributions to Commission Reports and Council Opinions; CHU meetings, Joint Audit Arrangements and the FccWebsite.

Chapter 7 Networking and Technical Assistance

Networking with the Contact Group for European Financial Control Organisations; the Central Harmonisation Units, Ministries of Finance, the Supreme Audit Institutions; technical assistance and national twinning partners from Member States; the DGs concerned (ELARG, RELEX, AIDCO, ECFIN, OLAF); the CHU workshops; the European Parliament (COCOBU); the European Court of Auditors, SIGMA of OECD, the World Bank, PEFA and other institutions like the INTOSAI, the IIA, the ECIIA and the IIA country chapters, PEM-PAL.

Chapter 8 Assessing PI*f*C Implementation

Assessing achievements; the drive to find a common terminology and vocabulary; culture and age barriers; external assessments made by the Council and Commission, the European Parliament and the European Court of Auditors; **PI*f*C** in algorithms.

Chapter 9 The future role for PI*f*C

A brief overview of the latest **PI*f*C** developments in applicant countries; building public internal control systems in the western Balkans and European Neighbourhood Policy countries: applying the **PI*f*C** concept and drawing benefits from experience elsewhere; a matter of taking a long breath.

Chapter 10 Conclusions

List of abbreviations:

ABM	–	Activity Based Management
AC	–	Applicant Countries
ACA	–	Administrative Co-operation Agreement
ADETEF	–	Assistance au Développement des Echanges en Technologies Economiques et Financières
AFCOS	–	Anti-Fraud Co-ordination Service
APC	–	Audit Progress Committee in the EU
BSS	–	Budgetary Supervising Service (Slovenia)
CARDS	–	Community Assistance for Reconstruction, Development and Stabilisation
CBC	–	Committee of Budgetary Control (European Parliament)
CeeC	–	Countries in central and eastern Europe
CEF	–	Centre for Excellence in Finance (Slovenia)
CGAP©	–	Certified Government Auditing Professional
CG-EFCO	–	Contact Group for European Financial Control Organisations
CHU	–	Central Harmonisation Unit
CIA©	–	Certified Internal Auditor
CIAP	–	Comité interministérielle d'audit des programmes (France)
CIC	–	Consultative Inter-ministerial Committee (Hungary)
CIPFA	–	Chartered Institute of Public Finance and Accountancy
CIRCA	–	Communication Information Resource Centre Administrator
COCOBU	–	Commission du Contrôle Budgétaire (European Parliament)
COSO	–	Committee of Sponsoring Organizations of the Treadway Commission
CPI	–	Corruption Perception Indicator (Transparency International)
CPIA	–	Committee for Public Internal Audit (Romania)
CR	–	Co-ordination Regulation (Council Regulation 1266/1999)
DFID	–	UK Department for International Development
DG-FC	–	DG XX/ DG Financial Control/ DG Audit
DG IA	–	DG for External Relations (now DG ELARG and DG AIDCO)
DIS	–	Decentralised Implementation System
EA	–	External Audit
EAA	–	European Association Agreements
EAGGF	–	European Agriculture Guidancre and Guarantee Fund
EAR	–	European Agency for Reconstruction (EU)
ECA	–	European Court of Audit
ECIIA	–	European Confederation of Institutes of Internal Auditing

ECOFIN – Council for Economy and Finance
EDIS – Extended Decentralised Implementation System
ENP – European Neighbourhood Policy
EPPIA – ECIIA Position Paper on Internal Auditing
EUR-10 – The "new" post-2004 accession Member States
EUR-12 – The "new" post-2004 accession Member States plus Romania and Bulgaria
EUR-15 – The "old" pre-2004 accession Member States
FC Chapter – Accession Negotiation Chapter on Financial Control
FccWebsite – Financial Control Contact Website
FMC – Financial Management and Control
FR – Financial Regulation (EC)
GCO – Government Control Office (Hungary)
GOGO – Government Governance
IA – Internal Audit
IAASB – International Auditing and Assurance Standards Board
IAB – Internal Audit Board
IBRD – International Bank for Reconstruction and Development
IC – Internal Control
ICS – Internal Control Standards Committee of the INTOSAI
IFAC – International Federation of Accountants
IGICS – INTOSAI Guidelines for Internal Control Standards
IIA – Institute for Internal Audit
INCOSAI – International Congress of Supreme Audit Institutions
INTOSAI – International Organisation of Supreme Audit Institutions
InWEnt – Internationale Weiterbildung und Entwicklung GmbH
IPA – Instrument for Pre-accession Assistance
IPSAS – International Public Sector Accounting Standards
ISPA – Instrument for Structural Policies for pre-Accession
ISPPIA – International Standards for the Professional Practice of Internal Auditing (IIA)
IT – Information Technology
MC – Management Control
MoF – Ministry of Finance
MS – Member States
NAO – National Audit Office (UK or other countries) or National Authorising Officer (depending on context)
NGO – Non-Governmental Organisation
NPAA – National Programme for the Adoption of the Acquis

OECD	–	Organisation for Economic and Co-operation and Development
OLAF	–	Organisation de la Lutte contre la Fraude
PEFA	–	Public Expenditure and Financial Accountability
PER	–	Public Expenditure Review
PFM	–	Public Financial Management
PHARE	–	Pologne Hongrie: Assistance à la Restructuration des Economies
PIƒC	–	Public Internal ƒinancial Control
PMF	–	Public Management Forum of SIGMA
PMU/PIU	–	Project Monitoring/Implementation Unit
PRG	–	Permanent Representatives Group (EC)
RR	–	Regular Report (EC)
SAA	–	Stabilisation and Association Agreement
SAI	–	Supreme Audit Institution
SAP	–	Stabilisation and Association Process
SAPARD	–	Special Accession Programme for Agricultural and Rural Development
SIGMA	–	Support for Improvement in Governance and Management in CEEC
SOX	–	Sarbanes Oxley Act (US)
TAIEX	–	Technical Assistance and Information Exchange (EC)
TOR	–	Traditional Own Resources
ToR	–	Terms of Reference
USAID	–	United States Agency for International Development
WGE	–	Working Group on Enlargement (EU Council)

1. "Ten easy steps" towards PI*f*C

Reflections on corruption in the public sector, its causes, features, cost and ways to fight it; the concept of PIfC and its role as the basis for practical solutions in reforming those parts of the national administration that are responsible for developing management, control and internal audit; the "simple" 10-step implementation.

Corruption in the public sector is a worldwide phenomenon, to which weak administrations and countries in transition are particularly vulnerable. Recent academic literature and public policy discussions devote much attention to governance and institutional issues involved (Rose-Ackermann: 1999). High levels of corruption limit investment and growth and lead to ineffective government; corruption creates inefficiencies and inequities. It is very often a symptom of political, economic and institutional malaise. Most causes of corruption are complex and rooted in the policies, bureaucratic tradition, political development and social history of a country. Frequently mentioned root causes are underpaid civil servants, the acceptance of bribery and the circulation of dirty money. Corruption will thrive where there is a monopoly over goods and services, and where there are persons/institutions who cannot be held or are not accountable but who have discretion to decide who receives what and how much. Therefore, reducing the potential for corruption involves eliminating bureaucratic monopolies and arbitrariness, promoting **transparency** and increasing the **accountability** standards and practices applied. This means that better quality of public sector or government governance has become one of the major defences against corruption. The internal auditor should have a keen interest in government arrangements so that he may be able to pinpoint at the risks that are inherent in too much accumulation of power in the hands of one person or a small clique and make sure that the tone at the top of the organisation is appropriate.

The solutions Ms Rose-Ackerman suggests are wide-ranging and comprehensive. Adequate anti-corruption laws should be implemented, but must be in the context of wider structural reforms, such as civil service and public administration reforms. These reforms must be based on detailed assessments, surveys and priority-setting while proceeding from an understanding of the root causes of corruption. Civil service reform is essential and should receive support from the international community. However, the subsequent logical request for extra, well-trained staff to develop sound internal control is often faced with a government drive to cut salaries and numbers of civil servants. Such drives often seem fuelled by WB and IMF recommendations to cut expenditure on public staff and salaries. How should this apparent conflict be resolved? If rather than across-the-board pay or staff cuts, government policies to reduce public spending include incentives to attract efficient, professional and well-motivated staff then they can help the government make considerable savings through establishing transparent procedures. This is very compatible with making the government slimmer and more efficient. Indiscriminately downsizing government, especially in the area of developing sound public internal control may well risk the continuation of bad management and control practices.

Corruption can be fought in the longer run through incremental steps. However, since corruption has an entrenched nature, incremental steps may not seem to be working sufficiently. What is needed is an anti-corruption "revolution" that must originate from the top. In the public sector, the Minister of Finance has an overriding interest in the sound and adequate use of the country's public resources. His position should be strong enough among line ministers and he should guarantee the implementation of the national budget to first set out on and then pursue the road of sound financial management. The discovery of a large corruption scandal can be used positively to prompt a series of measures to ensure better performance in the future. It could also make the public acutely aware of the need for change to substantial tracts of the public administration. Another, more positive trigger (or controlled "big bang") than a huge corruption scandal was the massive preparations needed for the negotiations leading up to the accession of the EUR-10 in 2004. The accession negotiations made it possible to make fundamental reviews of public administrative systems and to steer changes in many of them.

Since the start of discussions on the accession of the EUR-10 in the early 1990s, the "old" EUR-15 Member States have shown a keen interest in all the measures taken by applicant countries to at least reduce levels of corruption in their public sectors. Transparency International (a non-governmental organisation for the coalition against corruption) is well known for its annual report on Corruption Perception Indicators (CPI) of the public sectors of most countries in the world (see appendix 2). Although these "perception-based" indicators cannot claim to be entirely objective; seen in their overall context, they explain why the EUR-15 were anxious to bring public sector corruption in the applicant countries under better control.

The CPI indicators award each country a figure on a scale of 1 to 10. The higher is the number, the lower the corruption, so an indicator of 10 shows a country with little or no perceived corruption. Due to the subjective character of the country-related figures, there is an advantage in comparing groups rather than individual countries (Soccoja 2005). In 2005 the CPI for the EUR-15 was **7.8** on average, whereas the corresponding figure for the EUR-10 was a meagre **4.2**. These figures compare with 7.6 for EUR-15 and 3.7 for EUR-10 in 1998, so there has been a marginal improvement in both cases over the period.

It is an interesting question whether, had the criteria used by Transparency International included the introduction of up-to-date internal control concepts (**PI*f*C**) in the public sector, the figures might have tended to be higher. Obviously this could only be the case in the longer term, as any new systems introduced would have to prove their value over time.

There are many other international efforts at assessing the quality of national public internal control systems with the aim of providing a sound basis for rebuilding and upgrading those systems to levels that can stand comparison with internationally-agreed standards and EU best practice. Among them are the INTOSAI, the IIA, the European Commission, SIGMA of OECD, the CIPFA, the PEFA initiative and the World Bank. These will all be discussed later in the book.

The World Bank produced its second report on Anticorruption in Transition (Gray, Hillman, Ryterman: 2004) in April 2004. The report concluded that better policies and institutions can help reduce corruption over the medium-term. It found that many transition countries (especially in eastern Europe) had undertaken policy and institutional reforms in recent years leading to significant changes in the "rules of the game". The report also thought that these changes and the resulting decline in certain forms of corruption were likely to prove sustainable, underscoring the critical importance of an active, credible and well-implemented reform process.

Fighting corruption means raising awareness, changing habits and administration structures, drafting new legislation as well as chasing and penalising the perpetrators of fraud and irregularities, better financial reporting to enhance transparency. The **PI*f*C** concept developed by the European Commission operates in the area of awareness-raising and prevention through a number of conceptual, legal and organisational actions. It posits that a government realising the need to move to higher levels of transparency and accountability should start by analysing its internal control systems and benchmarking them against the latest relevant INTOSAI and IIA standards as well as the IFAC accounting and CIPFA standards with the resulting gap-assessment leading to new ideas, legislation and measures.

A Minister of Finance who is convinced of the need to improve the internal control of his national and international budget resources may wish to consider the **ten "easy" steps** to introducing **PI*f*C** in the public sector as printed in the box on the next page.

Of course these steps are not all that "easy". In fact, experience has shown that steps 2-10 can be hard to materialise; however, they guarantee a level of success in bringing benefits to the public sector in the longer term. On top of that, they are reasonable, logical and realistic. In addition, the new Member States have proved that it can be done.

"Ten Easy Steps"

1. Get this book, read it or have it read by your staff;
2. Select motivated and capable staff with knowledge of developments in the area of public internal control; persons who pair good management with communication and negotiation skills and who are skilled at conceiving, drafting and implementing long-term views;
3. Establish a Central Harmonisation Unit to analyse the weaknesses and hurdles in your present internal control systems (PI*f*C gap analysis) and to prepare a broadly-supported policy to introduce and implement PI*f*C (the PI*f*C Policy Paper);
4. Obtain technical assistance or twinning partners who have a long and proven track record in developing internal control and internal audit in the public sector, while you keep the ownership of reform;
5. Develop a realistic Action Plan with deadlines (attached to the Policy Paper) and Key Performance Indicators;
6. Start drafting the relevant PI*f*C legislation and regulations, while linking them to budget implementation, accounting procedures and fraud-investigation departments;
7. Strengthen the relevant internal control organisations (Central Harmonisation Unit(s), decentralised financial departments, decentralised internal audit units, training facilities, etc.);
8. Start training schemes for managers, financial departments and internal auditors at an early stage;
9. Exercise patience, overcome pockets of resistance and take out any obstacles;
10. Provide strong and continuing support for the process of developing PI*f*C and make sure you inspire the relevant staff in all public-sector organisations that will be affected by the envisaged changes.

Performing a PI*f*C gap analysis

The European Commission established a **set of logical steps** that lead the way to a final closure of the accession negotiation chapter or to a successful outcome of the ENP Action Plan. The steps start with a **PI*f*C** gap analysis that needs to be as objective as possible and carried out with good knowledge of both the existing internal control systems and international standards. This analysis therefore needs to be a co-production of civil servants from the Ministry of Finance and external expertise. The gap analysis needs to provide an honest evaluation of the current internal control systems in the country, giving a critical description and an objective assessment of its strengths and weaknesses as compared with current international standards for managerial accountability and functionally-independent internal audit, including public sector accounting standards.

The findings and conclusions of the **PI*f*C** gap analysis then need to form the basis of a draft discussion paper, prepared by the Ministry of Finance. The paper should be the basis for discussions with all the relevant partners (inter alia, all control or inspection bodies, the main spending ministries, the Ministry of European Integration where applicable and the Supreme Audit Institution). The paper needs to explain and define the new concepts and shed light on the measures that the national authorities need to take to comply with the requirements of the accession negotiation chapter or with the commitments in the ENP Action Plan.

To support this **conceptualisation** phase, DG Financial Control developed in co-operation with DG ELARG in November 1998, a glossary of definitions relating to public control and audit. This glossary (see appendix 12) relies on a large number of definitions in the existing INTOSAI and IIA glossaries. There is, after all, no need to reinvent the wheel. Many of the definitions, though, have been adapted to take account of the special character of public services, because back in 1998 the INTOSAI glossary related primarily to external audit while that of the IIA focused on audit in the private sector.

Developing a PI*f*C policy paper

The next step, still under the guidance of the Ministry of Finance, is to transform the discussion paper into a **PI*f*C** policy paper reflecting on the entire control environment in the public sector covering not only internal control, but also external audit, parliamentary control, the management and control of European Funds, the protection of European financial interests, the fight against fraud and irregularities. Furthermore, the paper should reflect the results and recommendations of the gap analysis.

Drafting a policy paper on **PI*f*C** should not be seen as a quick job done primarily to please the European Commission. Experience with former and current applicant countries teaches that this process can easily take up two years. This is because the policy paper needs to be “owned” by the relevant authorities. A central authority, the Ministry of Finance is suggested above, should take ownership of the whole process and initiate in-depth discussions with stakeholders in the government to make sure that all the parties involved understand the changes to be made and support their implementation. In recent times, especially in the western Balkan countries, there has been a tendency for consultants or twinning partners to provide a ready made **PI*f*C** policy paper, which is decided upon by the government on a single Friday afternoon. Although there can be much to be said for expediency, it certainly is not the best way to seek broad involvement and approval.

The policy paper needs to reach conclusions and make recommendations for future policies, set out in an action plan complete with planned dates for achievements. This action plan should be part of the **PI*f*C** policy paper. The paper’s recommendations are the rationale for legislative changes or new legislation. The paper needs to be endorsed by the Minister of Finance and sent to the Cabinet of Ministers for approval. Then it should be distributed to all management levels in the public service through (a series of) public relations events to inform all concerned about the changes to come.

The policy paper must formulate a comprehensive and consolidated national vision on the future quality of the public internal control systems as well as the quality of its external audit performance and should aim to create a broad consensus on the direction for **PI*f*C** development. This document will after all establish the path for many years of reform to come. DG Budget has developed a check-list for assessing the scope and quality of the contents of these policy papers; the general outline is attached in appendix 3.

It is important that the paper addresses responsibility for implementing and monitoring the progress of the **PI*f*C** policies in the short and longer terms and that its contents are relevant, accessible and concise and focus attention on the main issues. It should also cover the new principles of managerial accountability, reflected in the financial management and control (FMC) systems of the organisation, functionally-independent internal audit and central harmonisation (all to be explained in chapter 3), while providing estimates as to the resources needed to implement the paper’s conclusions and of course how and when they are to be allocated.

Today, all the EUR-12 and current applicant countries have adopted **PI*f*C** policy papers; all can be found on the FccWebsite (see page 118) and the relevant national websites. It is true that some EUR-12 countries have undergone substantial delays in developing adequate **PI*f*C** policies for a number of reasons. Among them was an entire lack of tradition in developing policy in this area, as well as resistance from established institutions fearful of their future positions. Nowadays it has become standard practice not just during the accession negotiations but well before they start, to demand the development of general government policies for public internal control. Developing **PI*f*C** is a dynamic process and as with many policy issues, regular updates and/or refinements of the policy may become necessary as further insights into the matter develop. A **PI*f*C** policy paper should therefore remain a living document to be updated if the existing one does not fully respond to new developments.

Drafting PI*f*C Legislation and Regulations

Necessary legislation will need to be prepared on the basis of the **PI*f*C** policy paper's conclusions and recommendations. Whereas the legal practice of the country must of course be respected, it cannot be allowed to become an impediment to including clear and unambiguous definitions of the new concepts and responsibilities. Experience shows that government legal advisers tend to protect the national legal traditions rather than accommodating themselves to new terms and standards relating to such things as internal control and, especially, to internal audit. Tough discussions are the rule.

There are several options for the format of legislation. To avoid difficult and lengthy deliberations both at inter-departmental levels and later in Parliament, it is suggested that developing the framework laws (primary legislation) containing the most basic principles relating to **PI*f*C** be tried first. A framework **PI*f*C** Act can stand alone, being treated as a comprehensive policy on its own, but it can also be part of a wider legal context, for example in a Public Finance Act or in an Organic Budget Law (for an outline see appendix 4). Countries opting for framework laws will need to adopt secondary or implementing legislation to explain in more detail the general principles in the framework act. However, some countries have preferred to put most of the details into their primary legislation, based on the notion that "everything permitted should be authorised by legal texts". Experience so far shows that this approach usually results in the need for quick revisions to redress vague stipulations. Changing laws through parliament is more time-consuming than changing decrees or regulations. Nevertheless, with the experience of the latest **PI*f*C** legislations being drafted there would seem to be a tendency to start directly with internal control and internal audit laws. It is important to remember that technical material should not be entrenched in laws because this may remove the essential flexibility that keeps technical material relevant. As there is a need for constant refreshing of technical manuals, entranching details too strongly in legislation is a mistake.

The implementing legislation may call for further regulations to be issued by the Ministry of Finance. These regulations may cover (templates for) manuals relating to internal audit or financial management and control, as well as to templates for audit trails or templates for an Internal Audit Charter (see appendix 21) and the Code of Ethics (see appendix 22) for auditors. The experience is that it may take between 2 and 4 years to achieve a complete set of the FC Chapter-compliant legislation and regulation. Examples of a financial management and control law (appendix 5); an internal audit law (appendix 6) and of an inspection law (appendix 7) are attached to the book for easy reference. The examples reflect the basic but relevant structure of the latest state of the art in this field resulting from close co-operation between SIGMA, DG Budget and a new Member State.

The wisdom of imposing a legal and regulatory framework update as a condition for **PI*f*C** has been questioned (Cohen: 2005) the stage of legislation in developing **PI*f*C** would not have taken into account the empiric and evolutionary nature of changing systems and the outcome would often have resulted in doubtful and irreversible texts. However, it is difficult to argue in favour of depriving a country from using the latest control and audit standards. The applicant countries themselves were eager to achieve international internal control standards, even if this meant some form of shock therapy and painful modifications to existing structures. Furthermore, there was no need to start from scratch as the standards for internal audit had already been fully developed. Finally, in the context of the accession negotiations, it would have been rather difficult to satisfy Europe (Council, Parliament) if the implementation of the accession negotiation requirements had been spread over a period considerably delaying the date of accession.

The CHU, Financial Departments and Internal Audit Units

Once the **PI*f*C** legal instruments have been adopted, the government needs to establish an organisational set-up to implement **PI*f*C** in line ministries and other budget-using public agencies. CHUs have been called the engines of propagation of **PI*f*C** principles, especially in relation to the introduction of managerial accountability and functionally-independent internal audit. The CHUs should become "centres of excellence", acting as a continuous source of information and education for interested parties - whether managers, controllers, auditors or inspectors, or even the public at large. As a consequence, CHUs share extra responsibilities for improving stewardship in government and the Head of the CHU should remain free of political influences. A change of government may bring a change in senior staff in the belief that a civil service friendly to the government will facilitate that government's business (the process of patronage). This approach can affect senior positions in internal audit and even in external audit. However, this is quite wrong as the key objective of internal and external audit is precisely to prevent manipulation in the interests of the government because such manipulation can easily be construed as a form of corruption. The role and functions of the CHU will be further explained in chapter 3.

Charts 1 and 2 will show in a graphical way the organisation charts for the suggested schemes with one or with two CHUs (see pages 170 and 171).

Government will need to ensure that existing Financial Departments (in-house financial services) in line ministries cover not only budget preparation and accounting, but also ex-ante and ex-post financial control functions and support management in all financial decisions to be taken. Financial Departments will need to operate in accordance with clear function descriptions and internal control manuals. They will need to develop audit trails and perform self-assessments.

The FC Chapter focuses on frontline budget agencies, like ministries, rather than describing how internal control should be developed at regional and/or municipal levels. It is obvious that in principle the internal control standards at central level should be mirrored in the lower administrative levels (Baltici and Yılmaz: 2006). The authors state that local governments have been affected adversely by decentralisation policies because they have not been provided with the necessary instruments to enhance the monitoring of local government performance and accountability checks. Effective decentralisation strategies require that sub-national government strengthen its internal control and audit instruments while devolving more power to local governments. The government (or CHU) should assess the need for establishing internal audit units based on considerations of efficiency and economy. If, for example, financial transactions are too few to make an internal audit unit acceptable on cost grounds then internal audit can be organised in other ways. Possible solutions are to make permanent or ad hoc combinations of other internal audit units closely related to the areas to be audited or to use a central department in the Ministry of Finance, e.g., a sub-directorate of the CHU for IA or of the Internal Audit unit in the Ministry of Finance.

Sustainable training facilities

Considering the eligibility requirements for obtaining qualifications like Certified Internal Auditor (CIA©) and Certified Government Auditing Professional (CGAP©) as established by the IIA (www.theiia.org), it is clear that obtaining one of these designations requires great effort. The IIA's Certified Internal Auditor qualification is a leading globally-accepted certification for internal auditors and the standard by which individuals demonstrate their competence and professionalism in the internal auditing field. The title has been developed for the private sector. The IIA's Certified Government Auditing Professional is a specialty certification designed for and by public sector internal auditing practitioners. The exam tests a candidate's knowledge of the unique features of public-sector internal auditing - fund accounting, grants, legislative oversights, confidentiality rights, and more. The programme's broad scope emphasizes the internal auditor's role in strengthening accountability to the public and improving government services. The CGAP is, however, not the only certification in this field and may have some drawbacks as to the appropriateness for European public sector internal auditors; the culture and approach of European public sector institutions will be different from those of North America. An excellent alternative to explore is the certification offered by the Chartered Institute of Public Finance and Accountancy (CIPFA) (www.cipfa.org.uk): the European oriented public sector audit qualification that has been introduced in Slovenia as a co-operation between CIPFA and the Centre for Excellence in Finance (CEF) (www.cef-see.org) and which is to be expanded to other Member States. Finding good internal audit trainers is a prevailing problem and using the private sector may not be adequate enough in the public sector context which is of crucial importance to public internal auditors. For this qualification CIPFA provides the initial trainers and the training materials.

With reference to the CGAP, in order to become a CGAP candidate, one must have a bachelor's (three-year) degree or equivalent; or a minimum of two years of post-secondary education with an accredited organisation plus five years of work experience in a government environment. The candidate must exhibit a high moral and professional character and submit a character reference signed by a CGAP. The candidate should have or obtain two years of auditing experience in a government environment, verified by a CGAP. The candidate agrees to abide by the Code of Ethics (signature) established by the IIA and, upon certification, will be required to acquire 40 hours of continuing professional education every two years. The CGAP exam covers areas like Standard and Control/risk Models (5-10%), Government Auditing Practice (35-45%), Government Auditing Methodologies and Skills (20-25%) and Government Auditing Environment (25-35%). From November 2004, the CGAP exam has taken into account the INTOSAI Guidelines for Internal Audit in the Public Sector; those following these courses should have knowledge of the guidelines. The IIA-Europe is presently developing a similar CGAP exam for the European environment, including PI*f*C principles.

With reference to the CIPFA curriculum, students will be trained in nine modules (syllabuses): internal auditing fundamentals, governance and control, public sector accounting and financial reporting, advanced internal auditing, managing the internal audit function, auditing management performance, local laws and taxes, external audit and building local professional institutions. For a brief overview of the syllabuses involved (see appendix 24). Students too have to agree to abide by the international accountancy profession's code of ethics.

The question arises as to whether such heavy criteria should be required of the first generations of internal auditors in applicant countries. Perhaps they should, but it does not seem realistic that they will be in the early stages of introducing internal audit into the public sector. In most applicant countries there were no "chapters" or local branches of private audit institutions, but they are now appearing everywhere. However, most applicant countries still do not have a real pool of certified public internal auditors to draw upon. PI*f*C requires the establishment and development by the applicant country of sustainable training facilities to provide professional hands-on development of internal auditors (but also managers and financial officers) ensuring sustainability after the departure of the foreign consultants or twinning partners. This can be done in a variety of ways: in-house training in the Ministry of Finance or the development of curricula in Public Administration Schools. It is strongly recommended that the procedures be flexible so as to attract the best-qualified auditors. Also recommended is close co-operation with private and academic institutions specialising in the certification of internal auditors. The internal audit profession is new in most of the applicant countries and salaries are generally low. There is also relatively low esteem for the public control business (traditional systems, language barriers, low management motivation, no exposure to international standards etc.). This means that, for a certain period at least, in-house human resources like controllers and inspectors might wish to enter a new job through adequate (re-)training in internal audit. But the award of internationally recognised qualifications to internal auditors could do a great deal to establish recognition and raise the status of internal auditors.

The government may therefore not necessarily aim at fully-fledged CIA's or CGAP's for the first generation of internal auditors. On the other hand, the title of Public Internal Auditor should not be given on the basis of a two-week crash course, as is sometimes thought to be adequate enough. Training public internal auditors should be based on a balanced combination of practice and theory; on knowledge of hands-on audit tools and on-the-job experience. Many good solutions have been found and are being developed in the EUR-12 with the help of twinning partners and/or technical assistance. The following training strategy was developed for internal auditors in Croatia and is a good example.

The Certification Scheme for Public Internal Auditors is a fundamental part of the overall Government strategy to develop a professional, wide-ranging and effective internal audit in the public sector and competent, confident and productive individual auditors. The training helps promote the career and personal development through the provision of a structured, integrated and accessible programme. It is managed by the CHU in the Ministry of Finance; with initial assistance of the team of the CARDS 2002 ***PIfC*** *project. The training consists of two levels: a* ***certificate*** *after 3 modules relating to Best Practice in Government Internal Audit, Applied Auditing and Communication and Interpersonal Skills and a* ***diploma*** *after another four modules: Governance, Risk Management and Control, Advanced Auditing, Accounting and finances and using IT in Auditing. Both stages (certificate and diploma) should be completed within* ***18 months****. Eligible are all those who have been nominated by the senior management in line ministries and other agencies as "nominated internal auditors". Applications are independently assessed for eligibility to be followed by interviews, thus providing additional credibility and transparency to the training programme.*

The solution described above has the benefit of providing well-trained internal auditors in a relatively short period of time. However, in the longer run, the development of, for example, a Certified Government Auditing Professional that focuses on European best practice could create a unified and highly visible public audit profession, without which it would be difficult for a government to claim its seriousness about strengthening its accountability to the public.

2. Internal control in the Public Sector

The variety of internal control systems in EU Member States; the Commission's analysis of existing public control systems in applicant countries; the lack of a common concept relating to internal control, internal as well as external audit; developing a strategy for supporting applicant countries in accordance with guidelines developed by SIGMA, the IIA COSO-model and INTOSAI.

Internal control systems in Europe

Analysing the overall situation in the early 1990s

The first analysis of public internal control systems in Europe was probably made by SIGMA (Support for Improvement in Governance and Management: a subsidiary of the OECD). SIGMA started mapping (SIGMA: 1996) the widely different approaches in OECD Member Countries to "implementing Management Control (MC)" in 1996 and demonstrated many weaknesses and mistakes relating to this concept. The paper defined MC as:

> "*the organisation, policies and procedures used to help ensure that government programmes achieve their intended results, that the resources used … are consistent with the stated aims and objectives…, that programmes are protected from waste, fraud, management and that reliable and timely information is (available) for decision-making.*
>
> *Even the most carefully designed MC systems have their limitations, partly because, while they allow top managers to control the organisation, they do not control the very top managers*[1]*. The various European models that were investigated in the paper (Sweden, Netherlands, Germany, Denmark and the UK) all revealed that most of the INTOSAI standards were applied explicitly or implicitly, but in very different ways, depending on national characteristics. There was no one specific model of MC to apply to all countries, nor was there a single pattern for how such control systems are likely to evolve over time…. This is likely to be as true for the new applicant countries as it is for the countries reviewed*".

How true and yet, how different the outcome of the accession negotiations would turn out to be!

1 ("But who will guard the guardians?"): this phenomenon was already referred to by the Roman satirist Decimus Junius Juvenal (60-140 AD), who criticised the reign of Emperor Domitian when asking "sed quis custodiet ipsos custodes?"

The SIGMA paper categorises the main differences mentioned above as follows:

1. The definition and role of internal audit;
2. The extent of centralisation or decentralisation of management and control;
3. The extent to which control systems are promulgated through primary legislation, regulations or administrative procedures and
4. The extent to which management controls form an integral part of an organisation's management and decision-making structure or are carried out by independent units outside the direct management line.

These differences are perhaps best shown by examining the French and Swedish public management and control models in the mid-1990s. The differences particularly relate to the degree of decentralisation and the role of internal audit.

France[2]

Prior to the fundamental changes in the internal audit functions of the Treasury (1996 to 2001) the public internal control system in France was characterised by a high degree of centralisation and internal complexity due to long term historical tradition; managerial decisions were subject to what were known as 'delegated' ex-ante financial controllers, who though in-house, were actually employees of the Treasury in the Ministry of Budget under the Ministry of Finance, Economy and Industry. Managerial decisions were also subject to the Accountants ('Comptables') who were usually in-house, but also delegated, and functionally independent from the authorising officer. The General Financial Inspectorate was the inspection body of the Ministry of Finance, Economy and Industry. The accountants were responsible administratively to the Minister of Budget and legally to the Court of Accounts. The Court of Accounts performed, as usual, "external" audits of the government accounts.

Since 1811 the system of ex-ante financial control has consisted of prior approval or disapproval of draft managerial financial decisions relating to appropriations, commitments, disbursements etc. These controls only covered **legality** and **regularity** aspects. The French system therefore lacked managerial accountability, relied heavily on central instructions for control and focused on regularity, compliance and transactions rather than on the performance of public activities.

This system was changed with the introduction of the new Budget Law of 2001 (implemented as of January 2006). The new Law aims at **management by performance** in all spending units. With the introduction of global programme-oriented budgets, spending departments are accountable to Parliament for their management decisions, their actual expenditure, their management of human resources and the levels of performance they achieve according to the resources they have

2 Based on discussions with Ms Françoise GUILLARME, Advisor to SIGMA, and others

been allocated (**efficiency**). These points are included in an annual performance report attached to the budget review act (**accountability**).

Furthermore, the Law makes the traditional ex-ante financial control focus on budgetary sustainability and risk levels: only for amounts above a certain threshold (oscillating between €90,000 and €150,000) is there need for an ex-ante financial controller's visa.

The Law also introduced a new public accounting system incorporating the existing cash-basis methods for budget, the accrual accounting model for general accounting and management accounting for programme-cost analysis purposes. Public accountants are responsible for implementing the new accounting standards and procedures in line ministries and will guarantee the quality of the annual financial statements made by the State and presented to the Court of Accounts for certification.

Finally, the Law establishes at central governmental level an **organisation for audit, evaluation and control** that focuses on the performance of the administration and on the quality of the State accounts. In chapter 4 and in appendix 14 a more detailed description is given of the French reform and its consequences.

Sweden

Following its accession to the EU in 1995, Sweden became a kind of role model for the development of internal audit in the Commission. The Swedish constitution determines that public administration and internal control are performed through fully independent government agencies. Internal control is integrated in management and is thus part of the delegation of authority and management's responsibility. This high degree of decentralisation is paired with a high degree of transparency; each individual in Sweden has access to the official records including internal control and audit reports.

Internal audit (introduced in 1995) is the monitoring aspect of internal control and therefore follows the COSO model (see appendices 9 and 9A). Internal auditors function under the Board of Directors of each government agency. The Swedish system does not provide for central supervision for either internal control or internal audit. However, there is the Swedish National Financial Management Authority (ESV) that carries out analyses, gives advice and 'networks' just as **PI*f*C** promotes a Central Harmonisation Unit to undertake such functions. Internal auditors in the Swedish public sector feel that they are suffering from a degree of isolation and would welcome a networking function to promote their profession within the framework of public-wide acknowledgement. The ESV is currently planning to establish a unit or department to co-ordinate internal audit in the public sector.

For its part, the external audit in Sweden was until 2003 not independent in the sense recommended by the INTOSAI Lima Declaration (see appendix 8). The Swedish National Audit Office was under the responsibility of the Minister of Finance. This inconsistency was put right in 2003: the Audit Office was changed into an independent Supreme Audit Institution reporting to Parliament.

Another SIGMA study was presented in 1997 (Pratley 1997: 145). SIGMA believed that pooling the replies of several Member States (this time Austria, Denmark, Finland, France, Portugal, Sweden and the UK) on the budgetary and financial control requirements of membership could be instructive for the applicant countries in central and eastern Europe (CeeC). The exercise could also indicate issues for future examination in the context of the Commission's ongoing programme of financial management reform. Quite rightly the conclusion was drawn that, especially for some recent adherents to the EU, accession itself had been an important element in the process which led to fundamental reform of national internal control systems. The reform processes at EU and national levels would be mutually supportive. Another important conclusion from the information provided by Member States was how essential it would be for the applicant countries to develop not just formal contacts with the Commission and Member States but also close and ongoing informal contacts at technical, senior official and political levels.

In this SIGMA study, DG Financial Control confirmed – based on its analysis of the replies to the 1996 Questionnaire – that there was no common concept of internal control, internal audit or external audit in the CeeCs). It is interesting to note how DG Financial Control itself had difficulties in this article in correctly defining internal audit, as it explains that it performs "audits" itself by ex-ante checking of receipts and expenditure on a sampling basis and by the internal audit of management and control systems[3]. The word audit, which is inherently ex-post, is also used here for the function of ex-ante control, which is nowadays thought of as a managerial responsibility and not the responsibility of the auditor. After all the auditor should not be tempted to perform tasks that he may later audit as this would create a case of conflict of interest.

The SIGMA study continues that "*the ongoing objective must be to encourage the applicant countries to develop effective internal control within ministries at all levels to provide for proper accountability for the management of funds and the execution of projects. Internal audit is to be developed from scratch with a clear remit to "ensure" that the internal controls are in place and function effectively. The key requirement for both internal and external audit is independence. The EU can contribute to this process, not*

3 The function of internal audit was added to the tasks of DG XX in the early 1990s. This led to a crisis in the late 1990s when it became clear that ex-ante financial control and internal audit could not walk comfortably together under the same umbrella. The 2000 Commission reform decided on a full organisational split between control and audit.

only by providing technical assistance and example, but also by offering clear models for public service institutions."

In 2003 a further attempt was made by the **PI*f*C** Expert Group of the SAIs in CeeCs to analyse Member States' internal control systems. Quite a few "old" Member States are presently in the process of reforming internal control or are engaged in preliminary discussions to prepare such reforms. Some examples will be given in chapter 4.

Two schools of internal control systems

Public internal control in Member States reflects many different realities, linked to the history of administrative structures and their evolution, to the strength of the position of the Ministry of Finance in the government, to the existence of a public Treasury, to a given control structure and as to whether certain financial activities are centralised or not (Simmony: 2002).

In the middle of the 1990s, it was customary (and still is) to distinguish between two broadly differing schools of internal control in Member States. The first and more traditional one was characterised by delegated but centralised control functions focusing on various modalities of *a priori* or ex-ante controls. Specifically designated organisations or a network of financial controllers under the guidance of a central body like the Ministry of Finance - e.g., a directorate for Budget or a General Finance Inspectorate would do the job of control. Managers would rely on the centralised control services to approve financial decisions; the concept of managerial accountability was thus not at all developed. Decentralised internal audit had no role as financial audit was performed by ex-post financial controllers or inspectors and independent systems-based audit did not exist. This is known as the Latin (or Napoleonic) approach, the Mediterranean approach or Third Party ex-ante control. This is (in some cases was) the approach in countries like Belgium, France, Italy, Greece, Portugal and Spain and was also used by the Commission up to 2000. The Latin approach is losing ground as it is no longer seen as compliant with present international standards. A number of Member States using it have already made or are planning reforms developing managerial accountability and internal audit, separating internal audit from inspection and bringing ex-ante financial control under managers' responsibility.

These reforms have been facilitated by three separate developments. At first the example of best practice arrived from private sector management. Second came the EU requirements demanding that specific internal control and audit rules for the management of EU-funds be implemented by the national control authorities. And third, there was an intensifying exchange of ideas (both multilaterally and bilaterally) between twinning partners (civil servants) and consultants in the private sector both coming from the Member States on the one hand and parties in the applicant countries on the other. These developments will be discussed later.

The **second school** had developed various forms of government governance (the systems by which government organisations are directed and controlled) over the past decades whereby the manager was made accountable for his (financial) decisions and management results and therefore made responsible for developing and improving his internal control systems. To enable the manager to accept such responsibilities, he would have need of and benefit from the support of an internal auditor. The internal auditor would assess whether the manager's financial management and control systems complied with the highest standards, report properly to management and make recommendations for improvement. This approach, based on the pillars of full managerial accountability and independent internal audit, would be called the North-European approach or the Managerial Accountability approach. This was the approach introduced by the Commission during its 2000 Reform.

The Commission's involvement

Whereas the Commission has responsibilities for defining the control and audit standards against which the adequacy of national internal control systems for the implementation of EU funds are controlled and audited, the Commission does not have a legal basis to intervene in the area of national control systems for national funds. The Commission cannot therefore prescribe any solutions for weaknesses in Member States' national public internal control systems. Since this specific area is not in the remit of the Commission, it cannot even assume a facilitator or advisory role without the unanimous consent of all Member States. This is not to say that the Commission and the Member States do not share a common interest in sound financial management of national funds.

In fact, **Article 10** of the EU Treaty on the Principle of Loyal Co-operation states that "Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks." And **Article 274** on budget implementation states: "The Commission shall implement the budget, in accordance with the provisions of the regulations made pursuant to **Article 279**, on its own responsibility and within the limits of the appropriations, having regard to the principles of sound financial management. Member States shall co-operate with the Commission to ensure that the appropriations are used in accordance with the principles of sound financial management. (…)"

Article 280 of the consolidated version of the Treaty establishing the European Community (Official Journal C 325 of 24 December 2002) explains:

> *1. The Community and the Member States shall counter fraud and any other illegal activities affecting the financial interests of the Community through measures to be taken in accordance with this Article, which shall act as a deterrent and be such as to afford effective protection in the Member States.*
>
> *2. Member States shall take the same measures to counter fraud affecting the financial interests of the Community as they take to counter fraud affecting their own financial interests….*
>
> *3. Without prejudice to other provisions of this Treaty, the Member States shall coordinate their action aimed at protecting the financial interests of the Community against fraud. To this end they shall organise, together with the Commission, close and regular cooperation between the competent authorities.*
>
> *4. The Council, acting in accordance with the procedure referred to in Article 251, after consulting the Court of Auditors, shall adopt the necessary measures in the fields of the prevention of and fight against fraud affecting the financial interests of the Community with a view to affording effective and equivalent protection in the Member States. These measures shall not concern the application of national criminal law or the national administration of justice.*
>
> *5. The Commission, in cooperation with Member States, shall each year submit to the European Parliament and to the Council a report on the measures taken for the implementation of this Article.*

When the protection of national and Community financial interests are compared in paragraph 2, it is in terms of fraud and not public internal control systems. However, measures against fraud or corruption should not be seen as being exclusively after-the-event punishment as we saw in chapter 1. When taking a broader stance, such measures should indeed include **preventive** processes; this certainly would not stretch the meaning of this paragraph and should be regarded as a first line of defence against the occurrence of corruption, fraud and irregularities. Transparency is the first requirement for reducing the likelihood of fraud. Some Member States (e.g., the UK supported by others during the Malta 2002 Contact Group meeting of European Financial Control Organisations) have tried to draw a direct parallel, saying that Article 280 might well be interpreted as also applying to *national* control systems (*"to be able to deal effectively with the EU requirements and aid schemes after accession")* but this was not supported by all Member States. Hesitancy mixed with apprehension that the Commission would interfere with traditional areas of national power, was expressed especially by Member States who follow the Latin-based approach.

Paragraph 2 of Art. 280 is the reason why the FC Chapter contains a specific sub-chapter relating to the protection of EU financial interests. But Article 280 does not provide a cross-over from EU funds to purely national budgetary means. Indeed, in several Member States there are two parallel systems, one for the national budget and another for EU-funds. The Commission cannot thus impose a specific system of management and control on a Member State for its national budget. The various regulations on management and control remind us that they are to be applied in conformity with the subsidiarity principle and without prejudice to the institutional, judicial and financial institutions of Member States (EC Regulation 1260/99 Article 8.3) (Simmony 2002: 152). Of course, the accession negotiations refer to changes to be made in applicant countries and not in Member States; furthermore, Regulation 1260/99 relates to the control of EU funds and not to national funds (apart from where joint financing might play a role). Thus, the Commission can neither impose a template for a national internal control system nor even suggest Member States to consider or discuss a number of templates if not explicitly relating to European Funds.

"Appropriate" Financial Control

When the PHARE (Poland and Hungary Assistance to the Restructuring of their Economies) programmes started around 1990, Commission Headquarters in Brussels had direct responsibility for implementing and controlling the programmes and projects. Soon, however, direct implementation became increasingly difficult to organise and maintain from a distance. In the mid-1990s, there was a trend towards decentralisation (or devolvement) resulting in the transfer of responsibilities and control from EC Headquarters to the newly-established EC delegations in beneficiary countries. In the years 1998/1999 the Decentralised Implementation System (DIS) was developed for PHARE programmes (later extended to the pre-accession funds SAPARD and ISPA). Implementation and control of these programmes was given to various Project Monitoring or Implementation Units established (in close co-operation with the EU Delegations) within the national PHARE implementing authorities.

In February 1999 the Commission adopted criteria for extended decentralisation; the resulting system was conveniently called EDIS (Extended Decentralised Implementation System). Further decentralisation was in line with the planned transfer of EU control responsibilities towards full recipient-state responsibility when a country becomes a Member State. Extended decentralised implementation involves complete decentralisation of the implementation and control of EU funds to national organisations that operate adequately and are ready to take up the responsibility. The basic feature of this system is to pass responsibility for ex-ante financial control in matters of tendering and contracting from the EU delegations to the national authorising officer (NAO). The applicant country must provide stable administrative structures as well as sufficient and adequate human resources.

The Memoranda of Understanding - agreements between the Commission and each of the applicant countries - on the establishment of National Funds speak of "*Appropriate Financial Control*" and "*The National Financial Control Authority*" (Articles 3 § 2 and 8 § 1). Many questions were raised as to what exactly these terms might mean.

The Commission replied that Financial Control would be "appropriate" if an "effective internal and external control scheme linked to the activities of the implementing agency, including an appropriate functionally-independent audit function and effective accounting and financial reporting system" could be demonstrated. Under ideal circumstances the external (but still internal to the government) control body would be located in the Ministry of Finance. This body was to be independent of any programming or implementing authority and responsible directly to the Minister or the Government. It would issue rules to harmonise internal audit and control so as to avoid different standards being used throughout the public sector. Applicant countries are recommended to follow these suggestions when setting up new organisations; especially in the context of the Public Administration Reform Programmes. These organisations might deal not only with the National Fund responsible for the management of EU funds, but also with income to and expenditure from the national budget. The reader notes the link between "appropriate financial control" and the "accounting and financial reporting systems"…

The emergence of the concept of PI*f*C

The concept of "appropriate financial control" was further developed in an article in the SIGMA Public Management Forum (de Koning: 1999). The abbreviation "**PI*f*C**" was used here for the first time in an effort to capture or consolidate several related elements at once. Nowadays, a case could be made for the more simple term "Public Internal Control", but the term **PI*f*C** has now stuck in the minds of those who are closely involved in the development of public internal control systems throughout the EUR-12 and in the remaining and future applicant countries. It has also gained a kind of brand status, so that it would be difficult to try to change it. Furthermore, the concept of **PI*f*C** covers some specific aspects that are not found in other systems of national internal control and therefore might be thought to merit a distinctive name. **PI*f*C** may do for some time to come.

The article explained the **PI*f*C** system as follows:

> ***Public*** *- meaning covering all activities in the public sector as opposed to controls and audits in the private sector;* ***Internal*** *– covering controls exercised by central and de-centralised government agencies as opposed to external control exercised by a body outside the government, e.g. the National Court of*

*Auditors, Courts of Accounts, other high level control bodies or the Parliament; **Financial** stressing the character (whether administrative, managerial or budgetary) of the activities to be checked and **Control** – meaning all activities to oversee the entire field of financial management, enabling the government to be "in control" of its finances (therefore, covering all control tools like ex-ante control and audits) and. last but not least, **system** – covering institutions, staff, training, procedures, methodology, reporting, responsibilities, sanctions and penalties.*

It is therefore possible to make the following refinements in the terminology of the various aspects of "financial control":

Public internal financial control refers to the government's internal control systems aimed at protecting the financial interests of the government at large, while external control refers to financial control activities by external bodies (here the Courts of Auditors and the Parliament, exercising democratic control functions) whose task it is to scrutinise and assess the financial control systems of the government.

Third party ex-ante approval is the procedure whereby a functionally independent financial control organisation (whether centralised or decentralised) checks and approves management decisions with financial repercussions before such decisions can be implemented. This procedure provides for the possibility of refusal by the controller, which can, however, be overruled under certain strict conditions (in French the "passer-outre" procedure). It is important to check with the Treasury function of the Ministry of Finance whether certain functions of the ex-ante approval system are not already automatically taken into account (e.g. checking the availability of committed funds before approving a contract or of contracted funds before making disbursements).

Internal audit is the total sphere of activities of ex-post verification by an organisation (located within the organisation to be audited but independent of the management functions of that organisation) of whether management and control systems comply with budget specifications, objectives, rules and standards, more in general to the principles of sound financial management. These internal audits include compliance and substantive tests, systems audits, performance audits, information technology audits and any other kind of ex-post verification that the independent internal organisation deems fit to ensure the compliance of management with financial rules and regulations. An important aspect is the establishment of an adequate feed back mechanism of the internal audit findings and recommendations into these rules and regulations."

This text (which relies heavily on the definition of financial control and emphasises the importance of the ex-ante visa) is very much influenced by DG Financial

Control's experience up to the mid -1990s. The definitions of internal control and internal audit should have been broader: internal control covers more than just financial control. Internal audit is more than just ex-post verification and is rather different from managerial inspection or ex-post financial control.

There are many guidelines in the fields of internal control and internal audit, but the international standards developed by the INTOSAI and the IIA have now become the authoritative norms for the definition of internal control. The term "internationally agreed standards and definitions and EU best practice" is a standard phrase used in the context of the FC Chapter and refers to these standards and definitions. The latest state of the art is to be found in the standards as emulated in the INTOSAI Guidelines for Internal Control in the Public Sector, November 2004 and in the ECIIA Position Paper of April 2005. The definition of Internal Control by the IIA has been broadened in 2004 with enterprise risk management (COSO Frameworks I and II). For the role of the internal auditor in these documents, (see appendices 9 and 9A). These standards should be consulted and understood by applicant countries wishing to upgrade and benchmark their internal control systems.

Before going into more details about the standards and definitions it may be interesting to provide some historical background to the term "audit". In 1285 King Edward II of England decided that servants "*found in arrears upon the account could be sent to prison by the testimony of the auditor*" (Littleton: 1966). A further notion of the concept of auditing is to be found around 1300 when it was stipulated that the records of the chamberlains of the City of London should be audited by a committee of "*six good men of the city, elected in the presence of the whole commonalty*". The practice of "*hearing the accounts*" is therefore rather old and it continued for a long time. In the early fourteenth century the following advice was given in a book on estate management by Walter of Henley (Lamond: 1890) to auditors of manorial accounts:

> "*The auditors ought to be faithful and prudent … and the accounts ought to be heard at each manor, and then one can know the profit and loss, the doings and improvements of seneschal, bailiff, provost and others…*"

In 1494 Fra' Paciolo, a Franciscan monk and Italian professor of mathematics (who has been given the title of the "*Father of Accounting*"), was the first to have printed the principles of double-entry bookkeeping as they were practised in Northern Italy in those days: his work "Summa" on algebra contains the tractate "*De Computis et Scripturiis*". Chapter 32 of this tractate considers how ledgers were closed and new ones opened. Journal entries were read out loud by an assistant, and were then ticked off by the owner (the listener) in the ledger. At the end of the calling and auditing exercise the books would reveal any items that did not figure in both of them.

The audits of the City of Aberdeen dating back to the 1580s use the term "Heard, seen, considerate, calculate and allowit by the auditors", the precursor of the modern audit certificate. In the same century the auditor of manorial accounts would give an oral report upon the accounts in the presence of the lord of the manor and his various officers. In 1882 reference is made in the British magazine The Accountant to an "old Encyclopaedia" that says that "*to audit is to hear whatever may be said on the subject in hand with a view of passing a judgment, generally applied to the examination and passing of accounts by persons denominated auditors, but who are, perhaps, in these transactions more properly inspectors*" (sic!).

Those who have a keen interest in the history of one of the oldest professions in the world may be referred to works of best practices in the Chaldaean and Mesopotamian (Gupta: 1991), Chinese and Indian (Sihag: 2004), Greek and Roman civilisations (Stone: 1969).

Audit has since developed substantially, but it would appear from the above that the relevant characteristics of (internal) audit are still listening, mutual trust, reporting and recommending in an independent manner. Clearly, mutual trust can only exist if audit is performed in an objective, professional and transparent way. During an audit the fear of punishment is not exactly the right condition for open discussions and for inspiring confidence. Internal audit is based on trust between partners and not on fear.

One can only listen to verify something that has happened in the past. By definition therefore audit is an ex-post activity. The auditor listens to what a manager has to say (e.g. in his accounts) about the structures and patterns of his management and control systems and then verifies whether the statements conform to the rules and whether the systems comply with the principles of economy, efficiency and effectiveness. Therefore, the term "ex-post audit" states the obvious, but ex-ante audit is impossible per definition.

Nevertheless, the term "**ex-ante audit**" is used (e.g. by DG Enlargement and DG Regio within the framework of the fourth stage of the EDIS roadmap: the verification audit to grant EDIS status to a recipient country). This is an audit that tries to assess management and control systems before any transactions have taken place, in fact it is a **dry run** to see whether the system is transparent, coherent and logical and provides the information that will be needed when the system will start running. France has a similar kind of classification: "**initial audits**" are performed by a centralised body consisting of General Finance Inspectors (the CIAP) to assess the adequacy of the formulation of objectives relating to the ministerial programmes proposed to the Budget Minister. In these audits the quality criteria relate to programme coherence, objectives and indicators, information systems, action plans, etc. but not to any transactions since they have not passed through the system yet.

Section 1 of the Lima Declaration (see appendix 8) is careful not to mention ex-ante audit, instead it refers to **pre-audit** as an activity or review before-the-fact of administrative or financial activities, which is indispensable for the sound management of public funds entrusted to the State. Pre-audit by a SAI has the advantage of being able to prevent damage before it occurs, but can have the disadvantages of creating an excessive amount of work and of blurring responsibilities under public law.

Defining Internal Control in the framework of the FC Chapter

In the context of the accession negotiations, the Commission defined Internal Control in 2000 as follows:

An **internal control system** encompasses the policies, processes, tasks, behaviours and other aspects of an organisation that, taken together:

1. *Facilitate its effective and efficient operation by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the safeguarding of assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed;*
2. *Help ensure the quality of internal and external reporting. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and outside the organisation;*
3. *Help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business and*
4. *Perform control on the basis of risk analysis and risk management.*

An organisation's system of internal control will reflect its **control environment** which encompasses its organisational structure. The system will include:

1. *Control activities (ex-ante, ex-post, inspection, revision, monitoring etc.);*
2. *Information and communications processes and*
3. *Processes for monitoring the continuing effectiveness of the system of internal control.*

External elements to the control environment are the Supreme Audit Institution and the Parliamentary Budget Committee.

Internal audit should be defined as an **objective assurance and consulting activity** that is independently managed within an organisation and guided by a philosophy of adding value to improve the operations of the organisation and achieve its objectives.

It assists an organisation in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organisation's risk management, control and governance processes.

Thus, in the context of the accession negotiations, the Commission's task is to review whether a country's control environment includes:

1. *A culture, code and other systems that support the overall objectives, risk management and internal control system;*
2. *Demonstration of the necessary commitment to competence, integrity and fostering a climate of trust;*
3. *Clear definitions of authority, responsibility and accountability such that decisions are made and actions taken by the appropriate level;*
4. *Communication to all relevant staff levels of what is expected of them and the scope of their freedom to act;*
5. *Clear strategies for dealing with the identified significant risks together with a policy for risk management, supported by adequate knowledge, skills and tools and attention for the need to adjust the processes and controls reflecting new or changing risks or operational deficiencies and*
6. *An independent internal audit;*

PI*f*C takes all these aspects into account. It combines internal control and internal audit into one concept as in the COSO model while adding a new element; a centralised organisation that is responsible for harmonising and co-ordinating both the internal control and the internal audit standards and rules for the entire body of public and/or semi-public service. The introduction of the new principles without some sort of central guidance would result in many different solutions within the national administration, adding to the confusion about how best to implement the principles and opening the door to differentiated treatment of those using the public services. In one new Member State, the introduction and nomination of internal auditors was left to the management of individual ministries which had as a consequence a large variety of functions, responsibilities, status and salary levels for each of the public internal auditors.

The notion of **PI*f*C** can be expressed as follows:

PI*f*C = IC + CHU, where IC stands for (FMC + IA)

Inspection by management is not excluded from this equation, but is considered to be part of the FMC-system (see chapter 3) and often called decentralised ex-post financial control. Centralised inspection at government level on the other hand would be confined to investigating complaints, fraud and irregularities and would not deal with standard control activities, like ex-ante and ongoing financial control. This structure provides an appropriate link with the fight against fraud, one of the other elements in the FC Chapter. When FMC and IA officers discover cases of fraud and irregularities, they do not investigate these cases themselves but bring them to the attention of the relevant judicial authorities, who use the centralised inspection department to perform technical investigations (see also appendix 16 on the Anti-fraud and Co-ordination Service AFCOS).

This expression of the **PI*f*C** concept has been and will continue to be used by DG Budget in accession negotiations in the framework of the FC Chapter. It has become the yard-stick for measuring the progress of applicant countries in the area of public internal control.

3. The three elements of PI*f*C

The need for a strong and lasting political commitment from the government to support the PIfC project; audit trails; self-assessments; risk analysis and risk management; the three elements of PIfC and the relationship between (traditional) inspection and modern audit, the organisation and functioning of internal audit units; Central Harmonisation Units; national audit boards or audit committees.

In countries that do not embrace the managerial accountability approach as described previously, governments will find, having made the **PI*f*C** gap analysis, that their current internal control systems are principally based on inspection activities dealing with third-party complaints, ad hoc transactions and penalising mistakes, and serious errors including fraud. Compared to more up-to-date systems of public internal control, a number of relevant elements which determine whether or not internal control of public funds complies with the criteria of economy, efficiency and effectiveness will be lacking. **Reasonable assurance, performance and transparency** are the key words here, especially in terms of the democratic principle that the government is held accountable to the public who have elected it to raise income and spend it on their behalf.

Managers of public income and spending centres should be held accountable for achieving the objectives defined in their budgets and other relevant laws, not only in income and spending policies, but also in financial management terms. The first level of control should be at the spender level (allocation of resources). This means that each public sector manager is responsible for establishing and maintaining adequate financial management and control (FMC) departments to carry out tasks like preparing and controlling transactions, accounting, monitoring, reporting, analysing and archiving. In short, the manager should have a financial directorate or department performing these actions under his responsibility.

The internal auditor is attached to the top manager, but independent in planning and carrying out his activities and in providing advice to him. The auditor's work is governed by a set of rules and ethics that derive from the profession and not from the management. The auditor should never involve himself in managerial tasks, for which he can assume no responsibility. The auditor assesses and recommends; the manager decides how to follow-up the auditor's recommendations and remains ultimately responsible for such decisions. The auditor will not correct or punish cases of human or systemic errors he finds, because this is left to the manager. In instances of fraud and irregularities the auditor will report to the manager who will contact/inform the anti-fraud departments/judicial authorities. It is interesting to note that there does not seem to be a specific universal description of a public internal auditor: the ECIIA Position Paper is written from a private sector point of view, while the INTOSAI Guidelines tend to see the internal auditor as a possible instrument for its own external audit work. The issue is further elaborated in appendix 9.

An internal control system based on these two elements (FMC and IA) should provide an answer to the call for modernisation of the budgetary management anywhere in the public sector. Managerial accountability and independent internal audit will in the end (that is, after successful implementation) provide for sound financial management and transparency. However, the road to modernisation is full of challenges, as the experience of the first wave of accession negotiations on **PI*f*C** has shown.

The first important challenge arises from the time needed to create a well-empowered central platform in the government to start developing the **PI*f*C** system in four phases (the CLOT-sequence). The phases include Conceptualisation (C): broad discussions and understanding of the new concepts needed to develop **PI*f*C** strategies for future implementation, Legislation (L): drafting and adopting relevant framework laws and by-laws, Organisation (O): developing the organisational framework for the implementation of **PI*f*C** and Training (T) sufficient managers/financial controllers and internal auditors. On average this process, from the earliest discussions to the start of full implementation may well take a period of 5 to 6 years, which under most circumstances is already optimistic. The CLOT phases should in theory be consecutive. A law should only be made when the reason for it and the wider context of the subject is well understood; the organisation of **PI*f*C** should follow the relevant law; and training should be in accordance with the needs assessed by the CHU. However, in practice there is no reason why some of the CLOT phases cannot overlap. Training, for example, could start very early in the process to create a body of internal auditors or prepare management to introduce managerial accountability. The precise CLOT sequence will depend on the specific characteristics of the current internal control systems in a country. It is important to consider it in the **PI*f*C** Policy Paper and should be reflected in the Action Plan attached thereto.

The second important challenge is, as with all changes in the public sector, how to effectively overcome resistance/opposition by vested interests. Opposition is often evidenced by a refusal to embark on changes resulting in a lack of commitment that may cause serious delays in the progress and implementation of the **PI*f*C**-project.

Experience has shown the need to fulfil at least three highly important pre-conditions before a government can embark on the change process:

> *Firstly, from the beginning, an* ***unequivocal political commitment*** *by the Minister of Finance (to be endorsed by the government) is needed to fully support the* PI*f*C *reform exercise. Subsequent governments should continue the commitments made by previous governments. A piecemeal approach risks internal inconsistencies causing the project to fail because of misunderstandings or lack of confidence on the part of both staff and public to provide support for the new systems, with the possibility of serious loss of funds and energy;*
>
> *Secondly, the* ***main stakeholders should be involved*** *in the deliberations on developing internal control systems, including those who are likely to resist the envisaged changes that may run counter to their own interests. Excluding stakeholders from the discussions may result in misunderstandings and refusals to underwrite the purpose of and the route to the new internal control systems;*
>
> *Thirdly, good* ***Public Relations*** *should be established by the Ministry of Finance to explain to a wider audience of stakeholders, including the public, the advantages of* PI*f*C *(institutions and management) and why it will be better than the current systems.*

It is therefore recommended that three **practical decisions** be taken before any serious attempt is made to pursue the road to **PI*f*C**:

Firstly, create a central directorate in the Ministry of Finance as a steering force; **secondly,** appoint a head of this central directorate who has experience in up-to-date financial management systems and internal audit matters. This head should be independent, i.e. be free from managerial responsibilities (other than managing his/her own directorate) and free from political pressure and **thirdly**, unless much experience with modern internal audit is to hand (which would seem unlikely in an early phase), the CHU should be supported from the beginning by external advisors with ample experience in public internal control particularly in developing the functions of managerial accountability and internal audit in the public sector.

The basic structure described above should allow the government to create the momentum necessary to develop **PI*f*C**. Failure to do this from the outset risks delays, frustration and disappointment. A successful outcome is in the interests of the Government, the Ministry of Finance and public sector at large. Sound financial management of public funds should be a major objective for any government, irrespective of whether or not it has aspirations to become a member of the European Union.

Based on the expression "**PI*f*C** = IC + CHU, where IC stands for (FMC + IA)", the country should focus on developing the following three elements:

1. The financial management and control (FMC) systems;
2. A functionally independent internal audit (IA) and
3. A centralised organisation responsible for harmonising and co-ordinating the establishment, implementation and improvement of FMC and IA, usually called a Central Harmonisation Unit (CHU).

The following sections deal in more detail with these elements plus the relationship with Inspection and the establishment of Internal Audit Boards.

Financial Management and Control systems

FMC is a term defined for the **PI*f*C** concept, but basically coincides with the notion and scope of Public Finance Management (PFM: see appendix 20) that covers budget preparation, budget allocation and rectifications, accounting, reimbursements, electronic payment systems, treasury cash management, public debt policies, control, etc. However, as part of **PI*f*C**, the focus is more laid on those management and control aspects that deal with the (financial) handling of income, expenditure, assets and liabilities. For example, all budgeting and accounting systems and procedures fall outside the scope of FMC. This is not to say that these areas are not important by themselves, on the contrary, but these topics are just not part of the FC Chapter. Budgeting and accounting is usually developed by the Treasury and/or the Budget Directory in the Ministry of Finance. Indeed, applicant countries get financial support from the EC to develop these areas, but not in the framework of **PI*f*C**. SIGMA, for example, includes the issues of budgeting and accounting into their base line reports on Public Finance Management. As a matter of fact, at the time of determining the scope of the accession negotiation chapters, it was hoped for that the issues of budgeting and accounting could have been taken care of in the negotiation chapter on Budgetary and Financial Provisions (chapter 29, now 33), but it was later (in 2005) decided to only cover the hard acquis in this area: the Own Resources (see appendix 23). Some acquis relating to Public Finance Management is also partially covered by EUROSTAT (the ESA95 rules on public finance accounting). Finally DG ECFIN may report in their annual assessment in the Progress Reports of the first Copenhagen economic criterion, i.e. the existence of a functioning market economy (one of the sub-criteria being macro economic stability). This would be the case if public finance management in an applicant country would be in such a bad state as to endanger budget sustainability and thus macro-economic stability. However, so far there have been no precedents of such reporting.

Value for money and Accounting

Audit, whether internal or external, can only reach the highest quality levels in the company of quality accounting systems. Good accounting systems need to provide management with cost identification and performance information. This means that management need to be enabled and trained to go beyond "public administration" to "actively managing the public activities". It is not good enough for public administration to be satisfied with the status quo of administrative systems (like the "jobs for life" concept in country X for tax inspectors, while there is a much greater need for VAT inspectors). Instead management should make sure it is informed - through good accounting information – of the need to redirect redundant resources towards areas in need of improvement or expansion and then take action. This process is called "value for money": value for money is not equal to spending in accordance with the budget; it is management challenging established practices and unwillingness and/or inability to change inadequate and costly administrative practices. Value for money through good management is unlikely to be obtained without frictions. An extreme example was the decision in country Y to abolish all inspection services in line ministries under the motto: better to have no inspection then corrupt inspection. In most applicant and third party countries accounting is still seen to have a rather limited objective (ensure information for budget control purposes), but it should be seen as having a much broader scope: it is a facilitator for reforms in economic financial management and should provide support to develop more dynamical service delivery systems for public service consumers. These objectives are still not well understood in many of the EUR-12 and applicant countries, so there is a constant risk of misunderstandings that can have serious consequences.

Managerial accountability

Managerial accountability is a concept in government policy highlighting the need for public officials to respond periodically to questions concerning their activities and to be held responsible (answerable) for exercising the authority given to them. The term managerial accountability is often used in the context of ensuring adequate Corporate Governance - i.e., the business of managing and controlling the organisation's activities. The same applies of course to Government Governance relating to the different levels of the national budget (at central/regional/local levels).

Managerial accountability stands for making management responsible not only for making financial decisions, but also for making sure that these decisions are adequately made and implemented in the best interest of the public. They should be monitored according to well-publicised rules and top quality norms capable of preventing mismanagement, fraud and irregularities. A key issue for clear lines of responsibility is that they must be firmly established, transparent, codified and consistently maintained.

Any manager of any organisation should have the responsibility for establishing, maintaining and improving the systems for financial management and control in his organisation. Normally this task is delegated to a Finance Directorate or Financial Department attached to the organisation (e.g. financial officers responsible for preparing financial decision documents like commitments from budget lines, payment orders, ex ante control, accounting, and ex-post control. All these tasks fall under the managerial responsibility.

Managerial accountability thus covers the whole area of Public Finance Management, but in the context of **PI*f*C**, the focus is more in particular on the FMC-systems. FMC systems should be based upon the principle of separation or segregation of duties (four-eye principle). The work of each official (authorising officer, financial controller and accountant/paymaster respectively) should be overseen by a second official. All transactions in the financial circuit (whether they cover income, commitments, tender procedures, contracts, disbursements, recovery of unduly paid amounts and/or the management of assets and liabilities) should be subject to the scrutiny of these officers. The risk level attached to each of the transactions may be the decisive factor in determining whether there is scope for introducing sample checking.

Prior to the 2000 administrative reform the centralised (ex-ante) financial controller in the EC was independent of the authorising officer, in that the financial controller could withhold his approval of a financial decision if he considered that the decision was not valid in terms of legality and regularity. The file would return to the financial department for correction and be resubmitted to the financial controller for approval. In case the authorising officer would stick to its original decision, he would have to state in writing his reasons for overruling the financial controller ("passer-outre" in French). This was a complicated and seldom used procedure that involved decision-making on the level of the Commission. The authorising officer would have to assume personal liability for his decision, after which the financial controller would sign the visa and pass it to the accountant/pay-master. However, with the 2000 Reform this practice was abolished.

Some countries still have the centralised ex-ante (or preventive) financial control function. However, in the concept of managerial responsibility for FMC systems, the ex ante financial controller is part of the Financial Department (although in a rather independent function) and reports directly to the manager. Whether or not to give the decentralised ex ante financial controller a special status (semi-independent from the manager and semi-attached to the financial department) with an overruling procedure depends very much on the well functioning of the internal control systems and on whether the control authorities of a country estimate that the internal control system can do without the extra assurance that the ex ante financial control can provide to increase the transparency of the system.

The manager and his financial department in any ministry are expected to develop sound FMC systems with the help of advice from a central organisation in the Ministry of Finance. That could well be the CHU specialising in harmonising and co-ordinating FMC systems. For example, financial departments might be given general support (templates and guidelines) for drafting FMC-system manuals, in which all procedures for financial management and controls are described in detail. The financial departments would then prepare audit trails explaining the minute steps of financial and information flows upstream and downstream. These audit trails will be of great value for the promotion of transparency, for performing self-assessment and for the internal auditor.

The concept of audit trails was brought into the FC Chapter because it is a powerful tool for both the manager and the internal auditor in understanding and analysing an organisation's financial management and control systems. Audit trails outline the structure of the existing internal control system and identify areas of risk, which may require additional attention in order to ensure the soundness of the management systems in place. Management is responsible for establishing the audit trail. A copy should be given to the internal auditor.

Audit trails

A specific audit trail approach has been applied to all Member States for the EU Structural Funds. It translates basic information into two fundamental flows – Monetary and Documentary – broken down into eight basic work processes in order to identify important procedures, thus providing a navigation road map through the various levels making up the national managerial and control systems.

The trail concentrates on:
i) the identification of the essential levels of information and management required to identify the form and the content of information available;
ii) the recording and evaluation of managerial requirements and procedures;
iii) the existence of the minimal information necessary to ensure compliance with the managerial requirements and, in the case of the Structural Funds and
iv) the requirements of the relevant Regulations.

A distinction is made between the presentation of: i) general facts and information, identifying the key organisations involved and ii) the description of specific organisations at government level.

The following eight processes are distinguished:

1. *Submission;*
2. *Selection;*

3. *Approval of programmes or projects;*
4. *Payments with the sub-headings accounts and data-processing;*
5. *Management (or management/control);*
6. *Controls and/or audits;*
7. *Reporting and*
8. *Evaluation (in the sense of assessment and/or validation).*

The Audit Trail instrument for Structural Funds had been developed by DG AUDIT prior to 1998. Within the framework of the accession negotiations it was decided to use the same technology to develop audit trails for the pre-accession funds (PHARE, ISPA, and SAPARD). However, the instrument developed by DG AUDIT proved to be too sophisticated and complex, having been designed for fully-developed management and control organisations in the existing Member States. A more straightforward system was made for the applicant countries and a first trial to help develop an Audit Trail (for pre-accession funds) took place in Poland in 1999.

During the accession negotiations DG Budget insisted that the CHU provide managers with templates on how to develop specific audit trails which can then be given to the internal auditor of the organisations concerned. The internal auditor will also have his own audit trail, which describes step-by-step how to carry out his audit and the way his conclusions should be arrived at. Audit trails are skeleton outlines of the internal control structure (Simmony, 2002:162). Internal auditors can also help financial departments draft such audit trails. Organisations that had developed audit trails for the management and control of EU funds can then provide their experience to the CHU and to other public organisations that receive funds.

Most CHUs have embarked on developing template audit trails, but because there are so many different national organisations, it is clear that the process of drafting specific audit trails in the public sector can only be achieved in the longer run.

Financial control consists not only of performing checks on the legality and regularity of financial decisions. Financial departments should also apply the principles of economy, effectiveness and efficiency in the full scope of their activities. However, the final assessment of the quality of the three "E's", as applied by and in the organisation, should be left to the internal auditor. Financial departments should organise regular self-assessment exercises (see box below) to establish whether management and control staff consider the existing rules and quality of their work adequate or due for improvement.

Self-assessment

Self-assessment is an essential part of the change taking place in the internal control culture in the public sector. The tool requires management and staff with financial management responsibilities to assess their own actions and procedures and benchmark the effectiveness thereof in terms of the objectives of the adopted internal control standards. This is a sophisticated exercise for organisations which have just begun to understand the current concepts of managerial accountability and transparent management and control. However, it is very constructive to make (senior) management aware of the usefulness of such an exercise, especially where (in the eyes of the CHU) there is a lack of motivation and commitment from management to making full use of the newly adopted internal control rules. The instrument is extremely useful in helping to combine management's understanding and the purpose of modern internal control.

The tool is based on the COSO-model definitions and was first introduced by the Commission in the framework of ***PIfC*** *and accession during a presentation in the Contact Group meeting in Berlin (Working document 14A/00, FccWebsite). The Commission White Paper on the 2000 Reform required each Directorate General to review the adequacy of its internal controls, to produce an action plan, to address areas identified as needing improvement and to include an internal control statement in its Annual Activity Report. The presentation was based on the experience gained by the Commission and described the procedure for self-assessment. The CHU responsible for developing and harmonising FMC systems should develop a template methodology for self-assessment that can then be further tailored by directorates for financial departments in ministries for application in their own organisations. The CHU could even provide support for pilot tests in order to gain experience useful for other organisations, but an important principle is that Directorates remain the owners of their own exercise, because self-assessment is not an audit and the success of the exercise depends on openness and self-criticism.*

The template should be developed as follows: draft a questionnaire (the replies should be anonymous to ensure full participation and frankness), consolidate and analyse the results, organise a management workshop to discuss the results, draw conclusions and draft a report as the basis for an action plan on areas identified for improvement. The questionnaire should review all the financially related processes: expenditure authorisation and payments, planning/budgeting/ accounting/financial management, information systems, human resources, capital assets/liabilities, cash management and revenues. The questionnaire should also involve the various elements mentioned in the COSO model:

1. ***control environment*** *(integrity/ethics, human resources, management philosophy, organisational structure and accountability);*
2. ***risk assessment*** *(objectives such as definitions, communication, consistency, performance measurement and priorities/resources, implementation and risk identification);*
3. ***information*** *(accuracy, timeliness) and* ***communication*** *(internal and external);*
4. ***control activities*** *(segregation of duties, supervision, procedures manuals, help desk, recording of exceptions and a checklist on financial procedures (audit trail) and*
5. ***monitoring*** *(role of audit, frequency of self-assessment exercises, update of methodology and reporting deficiencies).*

When analysing the replies to the questionnaire, the Directorate could make use of the Internal Control Scorecards and Chart, tools that can also be found on the FccWebsite. The results of the analysis should be consolidated in a stratified way, i.e. one relating to management and the other to staff, while it is important to report only overall results, so that individual statements are not traceable. The analysis should especially focus on deviations from the average norms established by the analysis. The preliminary results are then open for discussion in a management workshop, during which major root causes can be analysed and an action plan produced including priority-setting plus developing time schedules for improvements, for adoption by senior management.

The conclusions from the CHU workshop showed that self-analysis by management and financial departments had not been widely used in the EUR-12. This is certainly an area where there is a need for well-tailored support to help introduce into the new control culture and environment a deeper definition of managerial accountability. This message is especially directed to those organisations that plan further assistance to the EUR-12 after expiry of the Transition Facility period!

The classical approach of Financial Control was supposed to cover activities pertaining to **ex-ante financial control** (ex-ante approval of any financially related decision), **ongoing financial control** (monitoring throughout the project) and **ex-post financial control.** Ex-post financial control is understood to cover tasks normally performed by controllers or inspectors on transaction-related events (e.g. compliance with rules after the transfer of funds, goods or services, and investigations of third party complaints). The definitions thus stipulate that all forms of financial control, including inspection, are part of the FMC systems and therefore constitute managerial responsibilities. Centralised inspection, e.g. a separate General

Inspection department in the Ministry of Finance, is therefore considered to belong to the sphere of managerial accountability (at MoF level), as it controls/investigates individual transactions and not the underlying strengths or weaknesses of systems. If it does, then there might well be a problem of incompatibility in functions.

However, the various concepts of ex-ante, ongoing, ex-post financial control and inspection are confusing to say the least and there is great merit in the views of SIGMA to consider internal control in a more holistic approach as used in the COSO model that talks about processes, people, reasonable assurance and achieving objectives. This makes internal control a dynamic integral process. For a deeper understanding of this holistic approach, the reader may wish to consult the SIGMA Audit Newsletter of August 2006, issue n° 14 (http://www.oecd.org). SIGMA categorises three types of control:

Preventive control: designed to prevent the occurrence of inefficiencies, errors or irregularities, the break-down of processes, incorrect authorisation, payments or use of assets. These controls cannot guarantee that the controlled factor will not occur, but they do reduce the chance of it occurring. Examples include division of duties and authorisation controls.

Detective control: designed to detect and correct errors, inefficiencies or irregularities. They may not give absolute assurance since they operate after an event has occurred or an output has been produced but they should reduce the risk of undesirable consequences as they enable remedial action to be taken. Detective controls are most effective when they form part of a feedback loop in which their results are monitored and used to improve procedures or preventive controls. Examples include post payment confirmation, stock verification and bank reconciliations.

Directive control: designed to cause or encourage actions and events necessary to the achievement of objectives. Examples include clear definition of policies, the setting of targets, and adequate training and staffing.

SIGMA acknowledges that in practice these categories may not be clearly distinguished and that a single control may operate to cover two or more functions. Supervision, for example, covers all three types. Well organised and managed corrective actions and processes are, obviously and logically, also necessary when control weaknesses and failures occur.

Holistic approaches, however, demand a high degree of sophistication in the areas to be covered and as long as that has not been achieved the route to changing practice will be long and will need to cater for gradual steps.

As said before, the Commission has abolished the (centralised and independent) **ex-ante financial control** in its own internal control systems. However, there are arguments for not discarding this facility on a decentralised basis because of the weak performance of public control in general (i.e. at the level of budget managers in organisations that do not yet have sophisticated internal control systems). Under these circumstances, it may be advisable to keep or even to introduce the ex-ante financial control function as described above for some time and reconsider the need for the function at a later stage when the concept of managerial accountability is fully introduced and operational. Indeed: "ex-ante control should be taken seriously since it is not as archaic as internal audit would be modern (Simmony 2002:158)".

A further important aspect of internal control is the use of **risk analysis and risk management**. Effective risk management should cover both longer term strategic planning by government organisations as well as shorter term more limited financial risks; indeed, the internal auditor should be able to assess whether the highest levels of objectives and performance targets are being threatened by substantive risks. Management and internal control staff should be trained in these modern tools. Financial departments should develop methodologies to identify risk areas and focus on risk mitigation in close co-operation with the CHU and with the internal auditor. Units from financial departments should regularly (at least annually) report to management about the state and adequacy of the FMC systems from the point of view of implementation and quality assurance. This could then be compared with the opinions and assessment of the internal and external auditor.

Risk Analysis and Risk Management in the public sector[1]

In terms of providing value for tax payers and citizens alike, there should not be much difference between private risk management (responsible for adding value to stockholders) and public risk management. Amending a quotation from an authoritative document in this field (COSO 2004) one could define the challenge for public sector management as to determining how much uncertainty it is willing to accept in securing the trust and appreciation of the taxpayer/citizen in the sound financial management of the government. Public risk management enables the administration to deal effectively with uncertainty and the associated risks and opportunities. In the public sector this translates to a need to focus control and audit mostly on the riskier operations, involving high levels of financial input and human resources, and less on the areas, where a particular level of risk could be acceptable, because it is considered atypical or minimal in terms of the funds involved. In other words, when introducing economy, efficiency and effectiveness into financial decisions made by management, the internal control systems themselves should also become economic, efficient and cost-effective.

Risk Management acts as an awareness-raising exercise and as a forum for sharing views at all levels in organisations; it informs and trains management and staff and

1 For effective and coherent risk management in the Commission Services (SEC(2005) 1327 of 20 October 2005) see: http://ec.europa.eu/budget/library/documents/implement_control/intg_int_control/sec_2005_1327_en.pdf

can – if adequately managed - increase the likelihood of success in the achievement of the organisations' objectives (Conference document 06/01, Tallinn October 2001, see FccWebsite page 118).

Managing organisations involves achieving objectives. In the public sector the objective is generally the delivery of service or the delivery of a beneficial outcome in the public interest. Organisations confront all types of risks, which may affect achievement of their objectives. The challenge to management therefore is to determine how to identify such risks, assess their likelihood, the potential impact or exposure, and to decide what course of action to take to reduce those risks to an acceptable level.

Risk management is the overall process of identifying, assessing, treating and monitoring risks and implementing the necessary controls in order to keep exposure to an acceptable level. Best practice suggests that this should be an inherent part of the management process rather than something which is added at a later stage. In this way the conditions are created for management to evaluate, prioritise and decide before undertaking the activity. The internal control system put in place by management ought to ensure that management protects itself from unacceptable risks that would prevent it delivering the organisation's objectives.

Tools and skills are therefore needed to allow managers to obtain a reasonable assurance of achieving their objectives with sound value for money. Processes need to be developed to identify risks and then conceive and implement a system to control the most significant ones.

Standard risk management models must be customised to meet the specific requirements of each organisation, as the circumstances and risks they are confronted with are different and particular to each organisation. However, a universal success factor for implementing the risk management system throughout the organisation is management's general interest in the exercise. It is most important therefore that management puts risk management on the agenda in order to be able to develop its own system for risk assessing.

The question of whether the risk based approach to internal audit is appropriate for developing countries (Hepworth 2006:3) is pertinent. The concept of risk assessment and risk management has been one of the last to be developed under PIfC and still figures high on the shopping list of CHUs. The risk approach works well in modern systems where management understands and participates in the process and where there are technical capacities to identify and assess comparative risks. The approach presupposes also that internal control systems work appropriately and are regularly assessed by the internal auditor and audit recommendations are systematically followed up by management. Whereas all these and other conditions are part of the PIfC model, it is understandable that adequate risk assessment and management can only be one of the last elements to be developed in the progress towards modern public internal control.

The reports received on the state of the FMC systems should enable top management to make an **annual declaration providing reasonable assurance** that the organisation's resources have been used for their intended purpose, that the control procedures give the necessary guarantees, that the report gives a true account, that the principles of sound financial management have been followed, etc. In this way the manager shows himself responsible (answerable/ accountable) for exercising the authority given to him. The accession negotiation chapter for financial control did not elaborate on this issue, but applicant countries are strongly advised to consider introducing measures to provide reasonable assurance as it is part of international standards and best practice (see appendix 10 for a model Management Declaration).

Where the financial department is confronted with suspicions of fraud or irregularities, the relevant staff should report to the manager with a copy to the internal auditor. The manager should report subsequently to the judicial or relevant investigation authorities. Precise internal rules harmonised by the CHU should be part of the FMC manual.

Civil servants (whether managers, financial officers or internal auditors) carry responsibilities and may therefore become involved in legal proceedings or formal inquiries as a consequence of the positions they hold. The legal costs of these proceedings may be covered by departments and agencies if it is in the interest of these institutions and if the act in question was committed within the scope of the civil servant's employment. A good example of legal representation at public expense is the UK Civil Service Management Code, chapter 12.2[2]. The government may even accept responsibility for civil liabilities incurred by a civil servant in connection with his/her work, unless the liability arises from any "wilful default or bad faith on the part of the civil servant".

Internal Audit

To help the manager bear his newly-allocated responsibilities in the area of FMC, he should have the support of an internal auditor. The internal auditor assesses whether the manager's FMC systems function adequately and, if not, what measures should be taken to improve them. The definition of internal audit given in chapter 2 is clear enough: the internal auditor is not an extra control layer; on the contrary, he is a consulting service inside the manager's organisation. Internal audit is therefore a management tool. The manager is responsible for creating an internal audit department in agreement with the relevant national legislation. The auditor is to build a relationship of expert confidence with management and provide advice

2 http://www.civilservice.gov.uk/management/code/

in matters of sound financial management with the highest degree of integrity and professionalism.

Management should have a thorough understanding of the function of internal audit and especially of its independent character. This can only be fully achieved if the CHU for IA and the internal auditor work together on well-focused awareness campaigns aimed at managers and financial officers. Since it may happen that management and the internal auditor could have different views on past events as well as on what is material (essential) and what is not, the CHU for internal audit should establish general communication lines and procedures (contradictory procedures) for discussing audit findings with the auditee, for reporting to management and for following-up audit recommendations. It is good practice to let management set up a plan to implement accepted recommendations, with the (sub)-manager being responsible for preparing, within a specified time-frame, a report on implementation for the internal auditor. It is then up to the internal auditor, in accordance with his own risk analysis/management to decide when and how to assess the improved systems. Where material audit recommendations have not been given due attention by the manager and are not implemented, the internal auditor, after discussions with management, should be free to contact the CHU for IA or the Internal Audit Board (see the end of this chapter) and present his case for discussion. This procedure is elementary, should be well understood and established and never lead to fear of any repercussions.

Functional or operational independence from the day-to-day operations of the organisation means that the internal auditor is not to be involved in any management and financial control activities. This will give the internal auditor the possibility of developing an objective view of the management and control systems in the organisation and creating and maintaining an impartial and effective professional judgment of the operations within the organisation to be audited (the auditee). The auditor cannot therefore perform any tasks that are part of management responsibility. For example, the auditor should not perform tasks belonging to FMC, inspection or investigations. The point here is that the auditor should not perform tasks that he will, at a later stage, be assessing as this would create a conflict of interest[3]. The internal auditor may be functionally independent from management, but administratively he is not independent; he reports to the highest level of management and this makes him different from the external auditor (SAI) who reports to

3 A conflict of interest (or a conflict of roles) can be described as a situation in which someone in a position of trust, like a civil servant or politician has competing professional and personal interests. Even if there is no evidence of improper actions, a conflict of interest can create an appearance of impropriety that can undermine confidence in the ability of the person to act properly in his/her position. In and of itself, having a conflict of interest is not evidence of wrongdoing, but it may become a legal matter if an individual tries to influence the outcome of decisions for personal benefit; having two roles is not illegal, but the differing roles may provide an incentive for improper acts. If the internal auditor is involved in a conflict of interest, he should declare such conflict.

Parliament and the public. In the final end, it is the top manager who decides the scope and nature of the added value to be given by the internal auditor. This will be the normal situation in discussion and follow-up of the audit recommendations.

Although the auditor is a public official (who can be nominated, transferred or dismissed by the head of his organisation); the internal auditor, as far as his profession is concerned, does not take orders from management, but follows the rules of the profession as embodied in the Internal Audit Charter and Code of Ethics. Functional independence also means being free from interference in determining the scope of internal audit, the performance of audit work and communicating results. It goes without saying that the audit findings and recommendations should be of the highest professional quality, so that it is difficult for the manager to maintain any resistance to improving financial management and control systems. Therefore the quality of audit work and its reporting goes hand in hand with the claim for independence.

In performing his duties, the auditor should follow the rules of the **Internal Audit Charte**r (an agreement between manager and auditor) and live up to the **Code of Ethics** for Internal Auditors (a promise by the auditor to live up to the requirements of the audit profession). These documents should be attached to Internal Audit legislation or manuals as appendices or be promulgated as regulations by the CHU for Internal Audit. It is of great importance that these documents be actively used, i.e. the Internal Audit Charter should be signed between the Head of Management and the Internal Auditor and the Code of Ethics should be signed by each individual internal auditor upon his certification; copies of both documents might well be sent to the CHU for IA. It would not be helpful if both documents (templates) were merely attached to regulations and left there unused.

The functional independence aspect and the **auditor's status** should be embodied in legislation explicitly covering issues such as freedom in audit planning, audit performance (covering classical financial audits, systems-based audits, performance audits, IT-audits etc.) and audit reporting, within the limits of professional integrity. The government has to decide whether public internal auditors are nominated, transferred and/or dismissed by the manager (minister) independently or after consultation with (or even with the approval of) the CHU for Internal Audit. Another solution is that the government creates a pool of professional and certified public auditors from which managers can choose to nominate individuals to any place in the public sector for a certain period of time (with e.g. rotation after 5 years). That way management still retains the overall responsibility for establishing internal audit facilities and internal audit will still be part of the manager's accountability.

Reporting to and assisting management makes internal audit a part of the organisations' governance process. When considering the relationship between internal auditor and management as well as the meaning of functional independence, it is clear that the internal auditor should report on the quality and status of the FMC systems to the highest management level. He should report directly to the minister or head of public agency and should have an advisory role towards the highest management meetings when the agenda contain questions of implementation, finance and control. However, in cases of disagreement, e.g. when a manager disregards, refuses or forbids the disclosure of the auditor's opinion and recommendations - e.g., because he has a stake in the continuation of a situation despite the auditor's professional opinion to the contrary - the auditor is expected to discuss his findings with the relevant central audit organisations - e.g., the CHU for Internal Audit in the Ministry of Finance or the existing Internal Audit Board. In this context it might be recommended that an open register of national level audit recommendations be developed and maintained by the CHU. Such a register should only contain material or substantial audit recommendations ranked to order of importance.

The internal auditor is free to choose what kind of audit he wishes to perform in order to provide the opinions he is asked to deliver. There are many (up-to-date) audit tools and methodologies, ranging from classic financial and compliance audits to modern systems-based, performance or IT audits, all of which the internal auditor should be trained in or have knowledge of. There is a danger, however, in respect of the existing tendency to start with performance audit as quickly as possible. Performance audit is a sophisticated way of auditing and should be undertaken only when the auditor has full knowledge of how effectively to undertake compliance and systems-based audits. Even in the EUR-15, performance audit is not an easy matter. A serious warning is therefore issued not to emulate audit developments in the EUR-15 too rapidly before the basic audit practice is thoroughly entrenched: better be able to walk before starting to run!

The auditor will establish strategic **multi-annual audit plans** to enable him to cover as many areas in the organisation as possible, taking into account his objective risk assessments. He is also fully free to establish the **annual audit plans** and to perform ad hoc audits in case of perceived high-risk emergences. The auditor will discuss with top management his audit plans or with the audit committee where it exists and may, and normally will, take into account any suggestions for specific audit activities by management, but could refuse if there were well-founded arguments. The manager should **endorse** the audit plans but not refuse or otherwise hinder the correct functioning of the internal audit. In national legislation quite often the term "approve" is used instead of "endorse". The issue of which term is used may be merely semantic, but the point is that the manager should not be able to **disapprove** of the auditor's audit plan. Disapproval in fact should be brought to the attention of the CHU for Internal Audit. The important concern is that the manager should understand the professional choices of which areas are in most need of being audited and "endorse" the annual plan to show the organisation that he supports the auditor and authorises him to perform his tasks.

Inspection and Internal Audit

> "As our neighbour China says, it does not matter whether the cat is black or grey, as long as it catches the mouse"
>
> A Russian inspector overheard in the 2006 PEM-PAL meeting when considering the advantages/disadvantages of establishing modern internal audit.

During the Tallinn Contact Group of 2001 a discussion paper was distributed (Conference Document 05/01) on the "concept of **PI*f*C** versus Financial Inspection in Public Administration". The paper was presented because a large majority of the applicant countries relied exclusively on the traditional inspection function. They were indiscriminately using the terms auditor and inspector as if these terms were interchangeable. Indeed, in a number of applicant countries the names of their inspection departments were changed overnight into audit departments, with bad consequences for the longer-term development of the internal audit profession in the public sector. Experts from the EUR-15 that had not yet introduced internal audit and who were providing advice to applicant countries sometimes had difficulties in making this distinction, inexperienced as they were with the concept of internal audit. The fact that inspectors could be called internal auditors without any accompanying changes in function, tasks and re-education, only added to the general confusion as to how the two professions should relate to each other. The Tallinn discussion paper was presented by DG Budget to make these concerns explicit and aimed to properly define the responsibilities of both professions. In the early days of the accession negotiations the differences between the traditional role of the inspector and the new role of the internal auditor had to be explained in terms of what both of them **should do** as well as in terms of what they **should not do**.

The Tallinn paper states that an internal auditor cannot and should not assume managerial accountability. The auditor…

1. does not ensure compliance with the law and regulations;
2. is not responsible for financial management (whether good or bad);
3. is not responsible for an efficient and effective financial control environment and management and
4. does not ensure the absence of fraud and irregularities.

Inspection can be either internal or external to a budgetary organisation like a ministry. If the inspector is attached to the management and performs investigations on behalf of the manager, he is internal; basically he will then perform ex-post financial control or administrative investigation based on third- party complaints or following an investigation programme of its own - e.g., controlling the use made by beneficiaries of goods received (as with tractors that should not be sold within a certain time-frame after the transfer to farmers). Then the inspection role is a part of managerial responsibility.

Investigations (third-party complaints or suspicions/indications coming from management, controllers, auditors or the public) into fraud and irregularities can also be performed by an independent centralised body e.g. the General Finance Inspection, usually attached to the Ministry of Finance or to the Prime Minister.

Since in this scenario inspection is either part of managerial responsibility or involved in central investigations, it should not be involved in the independent assessment of financial management and control systems. This is the task of the internal auditor. Mixing the responsibilities of (centralised) inspection and internal audit may cause a failure of the manager's trust in the independence of the internal audit. The purpose of the Tallinn discussion paper was therefore not to abolish (financial) inspection or to take away its *raison d'être* (as some may have feared), but to explain the two functions in relation. Indeed, the discussion paper poses the question of whether the tendency in applicant countries to focus on and further develop financial inspection would be a deterrent to adequately developing sound internal control and internal audit. Another question was, to what extent the applicant countries should be encouraged or discouraged to let the two concepts to co-exist for a period of familiarisation with the concept of IC/IA before making changes to their internal control approach.

The ECIIA Position Paper on Internal Audit in Europe mentions that in cases where fraud is suspected, the internal audit activity may undertake investigations, provided that the specialist procedural skills for investigation analysis and evidence-gathering are present in the audit department. However, the ECIIA Position Paper relates to the private sector and the question should be asked whether this widening of audit scope should also apply to the public sector, which most likely already has centralised or decentralised inspection departments.

In Malta, the 2002 Internal Audit and Investigations Act provides for internal audit and investigations to sit together under the Internal Audit and Investigations Directorate, but the two functions are separate and distinct. Because of its relatively small size, Malta did not wish to create two separate bodies. Slovenia also has one central body: the Budgetary Supervising Service (BSS), in which both inspection and audit are housed, although functionally separate. The Director of the BSS, while advising fYRoM (former Yugoslav Republic of Macedonia is at present the official EU name for the Republic of Macedonia: hereafter called Macedonia) on **PI*f*C**, recently stated however that it would be better to separate conceptually the two functions from the beginning. Even Bulgaria, a long-time staunch defender of combining inspection with internal audit, has decided to rigorously split the internal audit and inspection functions. In early 2006 Bulgaria adopted three new laws, (on managerial accountability, on independent internal audit and on a financial inspection department) causing the preponderantly inspection-oriented **PI*f*C** Agency to become redundant and create a new reformed inspectorate. This set of new laws is the result of a long and painful negotiation process in which many players were involved; the outcome can be considered, for the time being, to be the latest state-of-**PI*f*C**-art.

Internal Audit Units/Departments

In the early years of the accession negotiations, the concept of **PI*f*C** aimed at developing internal audit only in national governments - i.e., in all ministries and other main budgetary agencies. It was not thought necessary to develop regional and local government levels at the same rate or at least not immediately. Where European funds are involved, the detailed relevant EU regulations cover control and audit all the way down to beneficiaries. However, as internal audit in most of the applicant countries did not exist, the early idea was to develop this function top-down and then, gradually roll it out to the lower echelons of public administration. Many local entities could well do without internal audit departments and would benefit from other innovative solutions to make their budget implementation subject to the benefits of internal audit.

An Internal Audit Unit should be a regular feature/establishment in a national budget organisation and be responsible for performing internal audit in the organisation under which it has been established. (It might perform audit in combination with units in other budget organisations where financial activities cover more than one institution. The number of auditors in a unit has been the subject of considerable debate. In order to be effective, an audit unit should at least have two or more auditors depending on the size and financial nature of the organisation, which allows team working, replacing one another in time of illness and developing the function of internal audit. The unit should have a Director or Head as well as internal staff, the number of whom should be determined by considerations of economy, efficiency, effectiveness and risk analysis.

In a number of countries though, laws were adopted stipulating the need to create internal audit units throughout national, regional and local structures. In Romania for example, the Internal Audit Law 672/2002 covers more than 3,000 local public entities that had to create - overnight, so to speak - internal audit departments. Perhaps this was the largest single addition to the world-body of public internal auditors ever! However, the creation of all these departments did not mean that there were as many internal auditors being nominated. A study carried out by the Romanian CHU for Internal Audit assessed the situation in 2004 and found that most of the positions had not been occupied: 75% of 2,300 local entities did not have internal audit departments and 8% outsourced their internal audit needs. Only 7% of the 2,050 local entities, with a budget of up to €400,000, had in-house internal audit staff and only 31% of the 1,000 local entities with budgets over that amount had established internal audit structures. It was also found that most such departments had only one or two auditors, not exactly the ideal number of staff needed to perform internal audit adequately. The danger of isolation (both in terms of geographic spread and of developing a public internal audit profession) is not entirely imaginary.

Romania does not stand alone in this example. Many other applicant countries have given their inspectors or financial controllers the title "internal auditor" overnight without the re-education, training and tools that should come with the creation of the public internal audit function. Pressed by the requirements of the EU accession negotiations, it was often thought that just a number of weeks' training by foreign advisors would be enough for a start.

However, the shortcomings of such decisions are clear and solutions are being sought to resolve the situation. In Romania for example, several potential solutions have been proposed. One would be to create internal audit structures in the General Directorate for Internal Audit in the Ministry of Finance to make compliance audits of small local public institutions. Another might be the creation of audit partnerships or public **audit associations** following similar developments in UK local government. Such bodies bundle their resources and offer their services to small separate local public organisations that have only limited budgets for internal audit. In this way the difficulties in recruiting and retaining staff are limited, while the internal auditors can work in adequately staffed groups and may ensure a proper back-up with the audit profession. Individual sickness is much less disruptive and the whole exercise becomes much more cost-effective. Audit associations may also foster good sharing of audit best practices and specialisation in certain types of auditee. The audit association formula is likely to raise the number of audits per auditor, allow for decreasing cost per audit, raise quality and consistency, use fewer staff overall, offer the prospect of better salaries and better qualifications (Gerry COX and others during the 2005 Public Internal Audit Conference in Sinaia, Romania).

The internal audit unit should report directly to the highest management level, giving the internal auditor direct access to the minister, making him free from the opinions or influence of other management layers. If the Minister is not responsible for its management, then it should be a Deputy-Minister, Under-Secretary, Secretary General or Director General. However, the reporting level should not be delegated to still lower levels. The need for direct reporting is obvious as the auditor has to report the conclusions of his assessments directly to the highest management levels to obtain a positive response on implementing audit recommendations. Success can only be guaranteed if the order for implementation is given at the highest management level. It is obvious that the Head of Audit should have a thorough knowledge of the audit profession and good management skills. These requirements should be laid down in primary legislation. Most of the time, however, it will not be easy in the early stages of developing internal audit to find such persons. This is an impediment that has to be acknowledged and solved with intermediate and temporary measures.

All audit staff in the unit should regularly follow internal audit training and adhere to the Internal Audit Charter and the Code of Ethics.

The Central Harmonisation Unit

The Central Harmonisation Unit is the lintel spanning the two pillars of FMC and Internal audit and is an integral part of the **PI*f*C** concept (de Koning 2005). The CHU stands for a central government organisation responsible for developing and promoting internal control and internal audit methodologies on the basis of internationally accepted standards and best practices. The CHU co-ordinates the implementation and further development of the principles of managerial accountability and internal audit in all the administrative bodies of the government. Usually, this task is given to the Ministry of Finance. The Ministries of Finance in the central European applicant countries tended to be accounting institutions rather than policymakers. In the administrative reform of the public finance sector; these institutions were usually weaker than their counterparts in the EUR-15. In 2000 for example, Poland decided to have the Ministry of Interior draft an internal audit law, rather than giving the job to the Ministry of Finance. This had disturbing consequences, nearly leading to a reopening of the FC Chapter negotiations in 2002. A decisive intervention by the Commission returned the initiative to the Minister of Finance. Similar situations have occurred in a number of the western Balkan countries where under the communist regime the position of the Ministry of Finance had been reduced to the function of a redistribution office. However, understanding of the need to establish modern internal control systems has grown considerably recently and the challenges are well taken up by most, if not all, Ministries of Finance.

The first action of the CHU is to raise the awareness of all stakeholders (i.e., all management, control and audit levels) about the new concepts to be introduced and develop a network for the adequate exchange of information amongst its participants. At the same time it should define and explain to all stakeholders the advantages and challenges that are inherent in the introduction of **PI*f*C**. This networking and policy-making should provide a steadily-widening **platform** of understanding and involvement in the process. This is a prerequisite for the success of the enterprise.

Based on a detailed **gap analysis** of the current internal control systems and its strengths/weaknesses as compared to new international standards, the CHU should take responsibility for drafting the **PI*f*C Policy Paper**. In the context of accession this gap analysis is often performed by outside support – e.g., technical assistance by private companies or twinning partners from Member States or through the help of a SIGMA peer review. The gap analysis or self-assessment can sometimes be a cumbersome exercise which needs to be carefully monitored and the participants coached because traditional administrative values may be at stake. The results of the analysis are then to be brought to the attention of the highest administrative levels for discussion and agreement on the recommendations to be made and acted upon by the Government.

Drafting, discussion and approval of **primary and secondary laws** is next to follow. The CHU should - on the basis of these laws - draft **regulations** such as **manuals** for Financial Management and Control and Internal Audit systems, **templates** like the Internal Audit Charter and the Code of Ethics, as well as **directives** relating to risk management and other methodologies, templates for audit trails, audit reporting, etc. all to be adapted for use in their specific circumstances by the relevant departments inside line ministries and other budget agencies.

Once these tasks have been performed – preferably in the right order – the role of the CHU will gradually change from **PI*f*C** development into **PI*f*C** monitoring. It will be the CHU's task to make compliance and quality assurance checks on whether its recommendations are being properly carried out and to find out how to overcome persistent bottlenecks in implementing the policies adopted. These evaluations/assessments together with analyses of the annual audit reports of each of the budgetary income or spending centres will facilitate the CHU's role of reporting to the Ministry of Finance on the progress of **PI*f*C** throughout the public sector. The CHU must therefore establish good vertical and horizontal **networking** between the professions of managers and financial officers and of internal auditors. This is also likely to raise the quality and impact of reporting. The networking itself can be carried out, for example, by regularly-organised meetings within the profession and by using a website and/or of a regular magazine to disseminate the latest information and discussions on common issues.

The foregoing explains why CHUs are called the "**engines of propagation**" of the **PI*f*C** principles. This involves learning from, sharing and consolidating experience in implementing the legislation and standards adopted. Many government institutions have a need to be regularly informed and updated about **PI*f*C** developments. They also may want to receive training on further new developments. They address their questions to the CHUs, who have thus become "**centres of excellence**". As a consequence, a CHU faces extra responsibilities for improving government governance. One of the basic objectives of the CHU is to improve the quality of the staff responsible for financial control and internal audit and thereby enhance the successful implementation of **PI*f*C** systems. In this respect the CHU is the co-ordinator or supervisor of the establishment of **training** facilities for the professions involved. Close co-ordination and co-operation with the Supreme Audit Institution, professional private organisations (like the local chapter of IIA) and academic circles will facilitate this task. The training facilities should be sustainable, i.e. able to continue supporting professional discussions and enhancing the systems even when the foreign consultants have left.

The establishment of CHUs in applicant countries is not always a simple matter. In most countries they spawned from specialised departments in the Ministry of Finance and had to struggle to take charge and be acknowledged by other ministries and budget agencies as the leader in the field. In some countries the absence of a strong commitment from the hierarchy and/or resistance by established traditional control/inspection forces proved to be impediments to the proper development of a CHU. In many cases this situation led to a waste of effort and precious time in developing **PI*f*C**-systems. There are some lessons to be learned in this respect. For example, a CHU, should from the outset, be established under the motivating leadership of a person who has proven qualities in management, knowledge of modern control and internal audit systems, and easy access to western professional literature. He should be appointed in such a way that the continuity of the project can be safeguarded. This means for example that political changes in the government or changes in management should not be allowed to affect his position. After the initial stages of developing and implementing **PI*f*C**, a government may think that there is no further need for the services of the CHU. This would be, however, a mistake. Institutions should of course be subject to regular shake-ups when needed, but there are always new managers, financial officers and internal auditors to be trained. There is usually also no shortage of differing "opinions" that want to diverge from the principles of accountability and transparency for reasons that need not be mentioned here.

Furthermore, since visibility is such an important issue, the Head of the CHU should have similar rights of access and reporting to the highest level as that of the Internal Auditor of the institution. What the internal auditor is to the Minister of a line ministry, the CHU Director is to the Minister of Finance. This is of obvious interest to the Minister of Finance. The CHU Director could be regarded as the General Internal Auditor of the public internal audit function. In this capacity, the CHU director could resolve conflicts of interest between the internal audit and its hierarchy anywhere in the public sector on issues of professional integrity. He should even be able to provide an opinion on (or approval of) the nomination, transfer and dismissal of internal auditors.

Should there be one or two CHUs?

(See Charts 1 and 2 on page 170 and 171)

The question often arises of whether there should be one CHU or two CHUs, one of them dealing with the issues of harmonising and co-ordinating Financial Management and Control systems and the other with the Internal Audit systems.

From the outset there might be a preference for establishing only one CHU, dealing with both aspects through separate units. This has the advantage that the harmonisation of **PI*f*C** is in the same hands. Since the start of **PI*f*C** implementation is characterised by a limited number of knowledgeable people, the practical argument for one CHU is quite understandable. On the other hand, the establishment of two different CHUs might be a better option: one for FMC systems – e.g., in the Budget section or the Treasury of the Ministry (as close to proper budget management and control as possible) – and the other focussing on internal audit only. This would have the advantage that the development of the two sub-systems is subject to a split of responsibilities, thus avoiding possible conflicts of interest later. This issue should normally be discussed and resolved during the drafting of the **PI*f*C** Policy Paper or in one of its later updates.

By May 2006, CHUs had been established in all the EUR-12 and applicant countries, more or less in accordance with the above-mentioned general functions depending on national conditions and characteristics. Whereas adequate internal networking should have the highest priority for the CHU's optimal performance, external networking is also of importance. This relates to co-operation with the Supreme Audit Institution, private internal audit organisations, professional audit and accountancy bodies, and relevant academic niches inside the country, as well as to international contacts.

CHUs are recently-established institutions, so there is much benefit in learning from one another about common issues relating to the introduction and implementation of **PI*f*C**. This was recognised by the Commission prior to the accession wave in May 2004 and over the period June 2003 – March 2006, during which DG Budget organised three CHU-workshops to bring together all existing CHUs in the EUR-12 and applicant countries. More on these workshops and their importance can be found in chapter 7.

Audit Boards or Audit Committees

Audit Committees come in many forms and in a variety of functions, both in the private and public sector. In the **private sector**, audit committees develop as an intermediate step in the relations between the company and its shareholders. They supervise internal risk management and control systems, the flow of financial information, the follow-up of audit recommendations from both internal and external auditors and accountants as well as the role of the internal audit department. Audit Boards aim at providing additional assurance that the conclusions and recommendations from internal audit are being taken seriously.

In the **public sector** the function of the AB/AC is as a platform for discussing issues of management, control and audit. The checks and balances in the public sector are guaranteed by the control and audit powers of Parliament and the SAI respectively. The success of an AB/AC in the public sector depends on the commitment of top and decentralised management to deal with management issues and to make adequate use of the audit and control functions to improve their management systems.

The UK National Audit Office (NAO) has made a questionnaire/checklist for AB/AC self-assessment with good practice questions (NAO 2006). When reading question 3 on the Roles and Remit of AB/ACs it would appear that an audit committee's role should include the review of administrative risk and internal control, the independence and effectiveness of internal audit, the maintenance of proper accounting records and quality of financial statements, the policies against fraud, the implementation of new systems, compliance with laws and regulations and obtaining assurances relating to corporate governance requirements.

The AB/AC should therefore be regarded as a body close to top management in a Ministry and to the internal audit of that ministry with a view to making sure that the internal control standards of the organisation remain in top condition. Therefore, the main purpose of AB/AC would seem to solve one of the most persistent bottlenecks in adequately developing **PI*f*C** – namely, the lack of management commitment and motivation to keep striving for efficient **PI*f*C** systems. The roles mentioned above involve the AB/AC in a host of activities, most of which are already taken up in the framework of **PI*f*C** by the CHUs for Internal Audit and for the FMC-systems. This is the main reason why the establishment of an AB/AC was not further pursued in the FC Chapter negotiations. Perhaps this was an omission. An audit board of the right mix of management representatives and high-level independent audit experts from the private and education sectors (always good for a fresh look at Byzantine administration practice) at the level of higher management should be an important incentive for overall management to strengthen internal control, recognise its added value to the organisation and raise the awareness of top, middle and lower management regarding matters of public internal control. This would especially be so where a CHU might not have strong support from the highest political levels.

Audit Committees have been established in the EUR-12 quite recently. In Cyprus an independent Internal Audit Board was established in 2002 as the guardian of the independence of the centralised Internal Audit Department. In Malta a similar body was established in 2003, the Internal Audit and Investigations Board is directly responsible to the Prime Minister. It oversees the work of the Internal Audit and Investigations Directorate and safeguards that organisation's functional independence. Both these Boards have at least one independent outside senior expert (in private and public audit matters) as a member. Hungary established a Consultative Inter-Ministerial Committee for **PI*f*C** in 2004. This Committee advises the Minister of Finance on **PI*f*C** policies. Both Latvia and Lithuania have established audit boards (the Internal Audit Council and the Standing Inter-departmental

Commission respectively) that advise the Ministers of Finance on measures to further develop public internal audit. Romania, Bulgaria and Turkey have also established internal audit boards. In Romania it is the Committee for Public Internal Audit (CPIA) (2003), in Bulgaria it is the **PI*f*C** Council (established in 2002) and in Turkey the Internal Audit Co-ordination Board (established by law in 2003). In Romania the Committee is advisory, whereas in Bulgaria the **PI*f*C** Council can decide on **PI*f*C** reform, while in Turkey the Board is very much integrated within the Ministry of Finance and DG Budget and Financial Control.

As of 2006, out of fourteen countries reviewed, eight have some sort of AB/AC, six of which include representatives from the private and/or university sectors.

All these Audit Boards and Committees function separately from their CHUs. CHUs have the technical capacities and responsibility for developing internal audit, while the audit boards are high-level political sounding-boards for providing advice to the government and the CHU about future developments in public internal audit. Thus, audit boards, provided they have a proper and balanced composition, should be well capable of adding to the quality of the overall control environment. This certainly could be the case where a CHU might find that it did not have adequate access to the highest levels of management and policy-making to promote the added values of **PI*f*C**.

The next table provides an overview of the various tasks performed by CHUs and AB/ACs. It shows that there is a considerable overlap of functions, which should not be a problem if the task of the internal audit boards is purely advising or mediating. If its tasks cover more than that, conflicts of interest may arise and this should be avoided. The future will show how the co-existence between these institutions will develop.

Table 1: Comparison between the tasks of a CHU and of an AB/AC

Tasks	CHU	AB/AC
Policy making	Full range of activities for PI*f*C	Elaborating PI*f*C policies Opinion on CHU policies Opinion on strategic IA and annual IA plans Safeguarding Independence
Legislation	Drafting primary and secondary legislation, templates, manuals etc.	Opinions on the legislation improvements and amendments
Networking	Development for all stakeholders Public relations inside/outside	Opinion on co-operation between IA and EA
PI*f*C monitoring	Compliance tests on the spot only relating to the follow-up of CHU guidelines	
Reporting	Analysing (annual) IA reports Reporting to MoF on PI*f*C status	Deliver opinions on strategic and annual audit plans etc.
Mediating role	Opinion on nomination and dismissal of IA staff Resolving conflicts of interest IA versus management	Assess rotation needs and staff policies Resolving conflicts of interest IA versus management Assessing role of CHU Director
Quality assurance of IA	Co-ordinating and supervising training of auditors Raising IA professionalism	Opinion on MoF Peer Reviews (assign experts) Common professional training for IA Assessing the role of Head CHU
EU funds control	Full range of activities	Consider IA tasks for EU-funds and prevention of fraud and irregularities

4. Financial Control Reform in the EU

Developments in the area of public internal control outside the scope of the accession negotiations; SEM 2000 and the 2000 White Paper on Commission Reform; the restructuring of the internal control systems in the Commission; recent discussions on the Commission roadmap to an integrated internal control framework; internal control developments in a number of EUR-15 Member States.

Reform in the European Commission

Understanding why and how the Commission spent so much effort in reforming its own administrative culture may well serve as an illustration for the purpose of this book.

In 1995 the Commission launched a far-reaching initiative to improve the management of its human and financial resources. SEM 2000 was born, a programme to modernise the Commission's administration and human resources policies. Sound and Efficient Management was to become an integral part of its administrative culture by the year 2000. The programme aimed at showing the real cost of making policy decisions, improving the management of its human resources and finances, upgrading its evaluation and control techniques and better preventing fraud. The first two phases of SEM 2000 aimed at improving financial management within the Commission, but the third phase related to the strengthening of the financial management and control partnership with Member States for the simple reason that 80% of the Commission's budget is spent in and by the Member States.

In March 1999 the Commission resigned collectively following the report of a Committee of Independent Experts' investigation into fraud, corruption and nepotism. The report highlighted the need to make the internal procedures of the institutions more democratic, and to improve its practices in the areas of financial control, staff appointments, transparency and efficiency.

The European Council meeting in Berlin on 24-25 March 1999 called on the future Commission to:

> *"… speedily put into effect the necessary reforms, in particular for the improvement of its organisation, management and financial control. In order to do this, the next Commission ought to give urgent priority to launching a programme of far-reaching modernisation and reform. In particular, all means should be used in order to ensure that whenever Community funds, programmes or projects are managed by the Commission, its services are suitably structured to ensure highest standards of management integrity and efficiency."*

More particularly, the criticisms were aimed at a basic flaw in the control system. The existing centralised ex ante financial control function or ex ante visa procedure had proved inadequate as a way of comprehensively assessing the added value and correctness of financial transactions. As a result, the system gave decision-makers a false sense of security (based on an outside approval of their decisions), leading to a culture of "de-responsibilisation" of management. At the same time the system was considered cumbersome and procedurally complex, which made the efficient execution of the budget harder. In addition, the Commission's Financial Regulation had given responsibility for both ex ante visa and ex-post evaluation systems (internal audit) to the Commission's Financial Controller, which was due to give rise to as significant potential for conflicts of interest within DG Financial Control.

The new Commission reacted by presenting the 2000 "White Paper on Reforming the Commission (Commission 2000)". This paper principally aimed at creating an administrative culture encouraging officials to **take** responsibility for the activities over which they have control – and **give** them control over the activities for which they are responsible. Improving and modernising financial management is desirable on its own merits and can make a direct and practical contribution to raising the operational performance of the institution. For this to happen, the White Paper suggested that procedures need to be made simpler and faster, more transparent and decentralised. All participants in the process should have clearly allocated tasks and responsibilities, while organisational rules and structures need to be made more adequate.

The White Paper pointed to four important elements:

1. Allocating resources to match priorities (in other words Activity-Based Management (see page 79);
2. Overhauling the financial management, control and audit systems;
3. Authorising officers (managers) must take responsibility for the quality, correctness and efficiency of their actions;
4. The Community's financial interests should be better protected.

The paper therefore proposed the following changes:

Financial management and control systems

1. Make Directors General directly answerable for maintaining adequate internal controls in their departments and make managers wholly responsible for the financial decisions they take. This responsibility would be acknowledged in a declaration made by each Director-General in his Annual Activity Report. The centralised ex-ante visa should be abandoned.

2. Each Directorate General was to have a Finance Unit to provide advice and assistance to the operational units. Each DG was to define the appropriate financial processes to be followed in its department within the framework of a set of minimum standards for all departments, including the principle of segregation of duties to ensure that each financial operation is seen from the operational and financial viewpoints by at least two persons.

3. A Central Financial Department was to be created to provide advice to the operational departments in the Commission. This department was to be the responsibility of the Commissioner for Budget and would define financial rules and procedures and common minimum standards or internal controls for DGs as well as advising on their application.

Internal audit systems

1. A new Directorate General for Internal Audit Service (IAS) under the authority of the Vice-President for Reform was to be set up to assist management within the Commission to (1) control risks, (2) monitor compliance, (3) provide an independent opinion about the quality of management and control systems, and (4) make recommendations for improving the efficiency and effectiveness of operations and ensuring that Commission resources are used cost-effectively ('security of money and value for money').

2. Each DG was to set up a specialised internal audit capability or IAC (this might range from one single individual relying largely on the work of the Internal Audit Service or be a fully-fledged unit), reporting directly to the Director-General, to carry out reviews of the internal control system of the DG plus reviews of management and the use made of Commission funds paid to external beneficiaries.

3. Finally, an Audit Progress Committee (APC) was to be set up. Its job was to monitor (1) the control processes of the Commission through the results of audits by the Internal Audit Service and the Court of Auditors, (2) to monitor the implementation of audit recommendations, including those of the Court of Auditors accepted by the Commission, and (3) to monitor the quality of audit work. The Committee was to be chaired by the Commissioner for Budget (actually the Commissioner for Internal Audit in the Barroso Commission) and was to be further composed of the Vice-President for Reform, two other Commissioners and two external members. The latter were to have relevant knowledge and experience of corporate governance and controls. All these new Departments and the Audit Progress Committee were set up by 1 May, 2000 and in October the European Commission approved the Charter for this Committee which is an advisory body without operational powers.

The White Paper concluded that once the key principles of independence, accountability, responsibility, efficiency and transparency were embedded in working practices; further change would be incremental and led by staff themselves. The process of encouraging a control culture throughout the Commission was also supported by the adoption of a set of 24 internal control standards based on COSO (see appendix 11), providing a framework for the control environment and internal control systems.

Key elements of the reform are the annual activity reports and the declaration from Directors-General including a self-assessment of the implementation of the internal control standards. Internal Control standard 24 on the Annual Review of Internal Control stipulates that each DG shall conduct an annual review of its internal control arrangements to act as a basis for the DG's management declaration. A template for this assurance statement is given in appendix 10. These elements are meant to provide **reasonable (thus not absolute) assurance** that the control procedures put in place give the necessary guarantees concerning legality, regularity and the use of resources in accordance with the objectives set.

In the three charts (see page 172/174) overviews are given of how the control and audit systems of the Commission have been changed. Chart 3 (page 172) provides the overview of how the Commission has currently organised its control systems after the implementation of the 2000 White Paper. Chart 4 (page 173) shows how the new financial management and control systems work and Chart 5 (page 174) shows how the internal audit functions.

Chart 3 refers, inter alia, to Activity-based Budget and Management. An explanation is given here:

Activity-based Budget and Management

As explained in Chapter 2.6.1 of the 2000 White Paper on Reforming the Commission, one of the four important actions was to allocate resources to match the political and management priorities. This is called Activity-based Budget and Management. Enterprises (including the public sector) should embrace the concept of ABM if they are genuinely keen to embody the principles of transparency, accountability and benchmarking of results.

ABM is part of a wider strategic decision-making process that starts with the setting of political priorities through management planning and performance and takes into account the objectives and available resources of the organisation - right through to the benchmarking of programme achievements.

Translated to the public sector, the Government adopts an annual Strategic Planning and Programming cycle (SPP), setting its political priorities, which are translated into operational objectives and resources allocated. The cycle starts with an orientation debate that gives rise to Annual Policy Strategy (to be discussed with Parliament) leading to a detailed Work Programme, *detailing key initiatives and resource allocation. Implementation is monitored (a management responsibility) and audited, resulting in an Annual Activity Report.*

The ABM fits into the SPP cycle, because it leads management to focus attention on activities rather than on budget or administrative structures. ABM points to the need to develop operational objectives or "results". This is done through Annual Management Planning (AMP), setting out strategic objectives, operational objectives, responsibilities and timelines, budgetary and human resources. AMP should provide for performance indicators, so that these can be benchmarked against achievements in the Annual Activity Report. That report also contains the Management Declaration in which the manager (minister) accepts responsibility for the correctness of the statements in the report. In its turn this Management Declaration is used by the Supreme Audit Institution when issuing what is known as the DAS or Declaration of Assurance.

It is obvious that this process would indeed benefit from a properly-functioning internal control system including independent auditor assessments of the systems. The manager's financial departments (controllers, inspectors and accountants) are the first source of information for the manager when monitoring progress on the objectives, while the internal auditor should provide relevant information on the quality of the financial departments and systems in use.

As noted before, SEM 2000 and the Committee of Independent Experts advocated the strengthening of the management and control of EU-funds to be spent in and by the Member States. Although the European Commission carries the ultimate responsibility of the control of Sound Efficient Management of those funds, it has to rely on and control the measures of the Member States to implement the large variety of EU programmes.

In 2005, the European Court of Auditors refused for the tenth (!) consecutive time to provide the Commission with a positive statement of assurance (DAS or *déclaration d'assurance*) for payments made under the Community budget, with the exception of administrative expenditure. In its June 2005 communication (COM(2005) 252 final) the Commission suggested a number of measures for obtaining a positive DAS for the entire Community budget.

The main problems cited in the Court's reports, relate to funds jointly managed with Member States. Obtaining a positive DAS is one of the Commission's strategic objectives (COM(2005) 12 of 26 January 2005). The Commission seeks the co-operation of all Member States to ensure proper implementation of the Community budget and hence effective protection of the Community's financial interests. The Commission has requested every Member State to provide information on their existing national certification systems (or statements of assurance) for the accounts used for national expenditure. This request should be seen in the light of the principle of equivalent protection laid down in Article 280 of the Treaty.

On 30 April, 2004 the Court issued an opinion (ECA 2004) No. 2/2004 in doc. 2004/C 107/01) on the single audit model containing a proposal for a Community-wide Integrated Internal Control Framework (IICF). The Court acknowledged significant progress in improving the internal control systems through the implementation of the 2000 reforms. However, it also noted the absence of an overall vision or co-ordination of the many varied control systems in the Commission. The Commission was therefore to establish a clear overall strategy leading to overall and specific objectives of what the control systems should achieve. The strategy would provide a baseline, allowing external audit to benchmark the quality of internal control. The Court also noted that there was no agreed definition of single audit. The concept seemed to be relatively restrictive in scope in those countries where it was being applied, i.e. in the USA and the Netherlands[1]. Therefore, the Court's opinion approaches the issue from the wider perspective of the whole process of internal control and external audit over the EU budget and proposes the development of a Community internal control framework for developing new and upgrading existing internal control systems.

The Court of Auditors can only give a positive Declaration of Assurance if it has reasonable assurance that transactions down to the level of the individual beneficiary – i.e. payments made by Member States to the final beneficiary such as a farmer, a student, an enterprise or a public body – are legal and regular. Therefore the supervisory systems and controls must provide reasonable assurance that the risk of error at this level is properly managed, and must include an appropriate level of on-the-spot checks at the premises of claimants.

Since more than 80% of the budget is implemented in what is known as "shared management" with the Member States, the Court recommended the development of a coherent and comprehensive internal control system over the entire EU budget, based on common concepts and standards applicable throughout the Commission and Member States.

Within the framework of the 2003 discharge, the Council, Parliament and Commission agreed that the creation of a comprehensive control and audit framework should be given priority and political momentum. One of the Commission's[2] strategic objectives for 2005-2009 is to obtain a positive Declaration of Assurance. The Commission has started to identify a number of actions to reach that objective and is currently analysing gaps between the current control framework and the

1 See Annex I to the Opinion 2/2004

2 COM(2005) 12 of January 26th, 2005

general principles defined by the Court in its 2004 Opinion. The Commission is seeking to improve internal control at all levels, whether they are centralised or decentralised. Member States have been asked, within the framework of the annual report mentioned in Article 208.5 of the Amsterdam Treaty, to co-operate with the Commission by providing information not only on their control systems for EU funds, but also on those for their own national expenditure.

Roadmap to an integrated internal control framework

In June 2005 the Commission sent a communication[3] to the European parliament, the Council and the Court of Auditors concerning a "**roadmap**" for achieving IICF. This communication started a dynamic discussion building on the Commission reforms, and on the positive assurance already given regularly by the European Court of Auditors for the Commission's management of the accounts for commitments, for revenues, for the European Development Fund and for administrative expenditure. Its aim is to encourage the institutions and Member States to work more closely together to make an internal control framework from beginning to end. This would provide the European Court of Auditors with sufficient and reasonable assurance to grant a positive statement of assurance on the regularity and reliability of the underlying transactions.

The Court has pointed out the need to balance the control costs in proportion to the benefits in both monetary and political terms and that the system should be built around a logical chain structure where controls are undertaken, recorded and reported following common standards. Only then will all participants in the chain (from the taxpayer through internal control and external audit to the beneficiary) be able to place reasonable reliance on them.

The existence of an efficient and effective IC system would facilitate the Court in fulfilling its role of external auditor. The more the Court can rely on the quality of internal control systems, the better it can use its own resources and improve the accomplishment of its tasks. More important, however, is the fact that the more the Court can rely on the quality of public internal control, the better it can acknowledge that the Commission and governments have done well in the areas of accountability and transparency, and in fighting fraud.

In January 2006[4] the Commission sent a communication to the Council, the EP and the ECA following-up its Action Plan for the IICF. For the period 2006-7 the following concrete actions were proposed: 1) to simplify and define common control principles; 2) to make use of management declarations and audit assurance;

3 EU Press release IP/05/732 (http://europa.eu/rapid)

4 EU Press release IP/06/47 (http://europa.eu/rapid)

3) to further develop the single audit approach: sharing results and prioritising cost-benefit of controls and audit, and 4) to define and fill sector-specific gaps.

Single Approach for EU Audit

The Commission reform in the areas of internal control and internal audit set the stage for building a single approach to the audit structure in the European Union. The approach focuses on minimising duplication of audit work and maximising the level of control achieved with a given level of resource. In the single audit concept, **sharing audit results** is the key to improving the targeting of audit and control efforts (Commission Action Plan towards an Integrated Control Framework in COM(2006 9 final of 17 January 2006)). Sharing well-defined and well-documented audit information can permit reliance on controls at each level of the chain and a formalised assessment of costs and benefits at each level should demonstrate that the controls in place have optimised the residual risk of error in underlying transactions.

When meeting with the Presidents of the SAIs of CEEC countries in Limassol in November 2001, Mr Engwirda, member of the European Court of Auditors emphasised that reliance on internal control and audit is an essential element for the work of the external auditor. He presented three conditions for good co-operation between the ECA and the national SAIs:

The legal competence of the SAIs should be in line with that of the ECA (meaning, inter alia, that SAIs should have the competence to audit the management and control of EU funds); common audit standards are a prerequisite (meaning that SAIs should adhere to INTOSAI guidelines and EUROSAI implementing guidelines) and common audit standards should be transposed into a common comprehensive audit methodology (laid down in audit manuals) to make results fully interchangeable.

These criteria were already applied implicitly in the accession negotiations, but have now found explicit wording in the criteria for the provisional closure of the FC Chapter. In 2002, the Commission (DG Internal Audit Service) organised a second conference in Brussels called “VERSTEHEN” to discuss the single audit approach. There was wide acknowledgement of the preconditions for and barriers to the introduction of the single audit approach, although SAIs questioned the need and rationale for their involvement in the assurance process for European funds beyond their present national remit. Conference participants formulated the following characteristics for the single audit approach: an efficient and effective use of audit resources; a reduction of duplication in audit work and the introduction of process simplification; more uniform audit requirements leading to quality improvements in public financial management and control systems; increased transparency and accountability as well as better identification of systematic problems. The single audit approach may also move the Commission closer to obtaining a positive assurance statement on the use of EU funds, the final benchmark for the Commission's performance.

In April 2002 the European Parliament took up the single audit approach issue in its discharge procedure in the framework of the implementation of the general budget of the European Union for the financial year 2000. The Commission was asked to prepare a report on the feasibility of introducing a single audit approach applicable to the European Union budget in which each level of audit builds on that preceding, with a view to reducing the burden on the auditee and enhancing the quality of audit activity, without undermining the independence of the audit bodies concerned. The Court was asked to provide an opinion, which it did.

Conclusion

Internal control systems are not irreversible schemes carved in tablets of stone. On the contrary, internal control systems are subject to an ever-changing environment and will need to be upgraded continuously; this certainly applies where a country's administration has only started the early phases of a change in control culture. Concepts like audit boards, risk analysis/management, logical chain structures, annual activity reports and self-assessment may have entered the minds of those who are responsible for developing internal control in the EUR-12 and applicant countries, but they are still far from being a widespread part of those countries' control culture, let alone tried and tested tools. This was indeed one of the general conclusions from the CHU workshops held since 2003. This Chapter, covering the Commission's long-term efforts to make its control and audit systems more efficient and effective and to place them appropriately into the entire control and audit chain of ECA and Member States is witness to the need for continuous and arduous work when upgrading public internal control systems. The increasing complexity of government governance requires constant re-thinking and reinforcement of the ways to obtain reasonable assurance that objectives are met.

Decentralised Implementation for EU Funds

When the PHARE programmes started in 1989 implementation was in the hands of the Brussels EU Headquarters. As the programmes unfolded the distance between headquarters and action on-the-spot became wider and caused increasing delays. As a result, the system of implementation had to be decentralised to the EU delegations in the beneficiary countries; the rules were spelt out in the DIS-Manual in 1998.

In June 1999 the Council adopted a Coordination Regulation (CR)[5] to provide a legal basis to “waive the Commission’s ex-ante approval for project selection, tendering and contracting by applicant countries” and opened the way to extended decentralised implementation (DG Financial Control introduced the acronym EDIS, nowadays the term “full DIS” is also used). Not only the PHARE, but also ISPA programmes/projects would be subject to much the same implementation rules as provided for in the Council Regulation 1267/99 (Article 9 and Annex III). Article 12.3 stipulates that “the Commission shall adopt rules governing inspection and evaluation” for the process and Section 4 provides for “minimum criteria and conditions” necessary for introducing EDIS.

In January 2001 the Commission services produced a “Working Document on the preparation of the PHARE and ISPA Programmes for EDIS” that was sent to all applicant countries. It sets out general guidelines for supporting the applicant countries’ preparations to obtain EDIS-status. The country’s control and evaluation systems need to meet the “minimum criteria and conditions regarding the National Fund, the implementing agencies and the procurement procedures”. Checklists are included as annexes to the working document to help the relevant national authorities ensure that their systems meet these “minimum criteria and conditions”. The fourth annex is the EU Glossary of control and audit definitions, prepared by DG Budget with the help of other DGs. An updated version of this glossary is attached in appendix 12 of this book.

The working document states that the Commission will apply the general **PI*f*C** principles as summarised in the annexes to the Co-ordination Regulation 1266/99, as covered in the annual Regular Reports on the FC Chapter for the individual applicant countries. In June 2001 the Commission produced a Roadmap to EDIS for ISPA and PHARE. It is complementary to the Working Document and describes the procedural stages that lead to a Commission decision to grant EDIS-status. There are four stages. The first is a gap assessment to determine to what extent EDIS conditions are currently met and what specific actions, changes and improvements are needed. The second stage is gap-plugging; making the necessary changes and improvements by following the recommendations of the Gap Assessment Report. The third stage covers the drafting of a Compliance Assessment Report by an external independent auditor on behalf of the national authorities. This should give a positive assurance that the first stage requirements have been met. Stage four finally prepares all the elements necessary to enable the Commission to decide whether or not EDIS can be granted under Article 12.2 of the Co-ordination Regulation. Important elements in this decision will be an analysis of the Compliance Assessment

5 Council Regulation (EC) No 1266/1999 of 21 June 1999 on coordinating aid to the applicant countries in the framework of the pre-accession strategy and amending Regulation (EEC) No 3906/89, OJ L161 vol. 42 of 26 June 1999.

Report, verification audits to check compliance with the key conditions for EDIS and a verification of the fulfilment of the FC Chapter requirements. All these activities are performed by the Commission Services.

In February 2005, DG ELARG/REGIO organised a seminar to discuss the findings of the "stage four" verification audits and the general lessons that might be learned from the results. These findings illustrate the practical difficulties encountered by national administrations with the transfer of responsibilities under EDIS. It is obvious that CHUs in applicant countries as promoters for good FMC and IA in the national budget area have an interest in the proper introduction of EDIS.

The FMC and Internal Audit systems referred to in the FC Chapter should apply to both national and EU funds. Since each Ministry or government agency should fulfil the conditions of managerial accountability and functionally independent internal audit, all agencies implementing EU programmes/projects should ipso facto have introduced or be introducing these systems. This should have been an important task for CHUs, but the Commission verification audits revealed a large number of weaknesses:

"The separation of duties in implementing agencies (initiation of and verification for each transaction) is often seen as an additional administrative burden rather than a tool to ensure the regularity of an operation. The internal control systems are often not based on objective risk analysis and do not involve management. Internal audit often reveals a lack of staff in the organisation and inadequate reporting to the appropriate level. The role of ex-ante control activities is often not clearly defined and relevant ex-ante control units may not be operational. Audit trails and procedures to report are lacking as well as procedure manuals relating to FMC systems especially those covering tendering, contracting, disbursements and monitoring. There is also a lack of adequate supervision over the deliverables to be produced by line ministries. Line ministries may not always have a clear understanding of their own role and the role of every actor in the process especially not their day-to-day activities; the scope and delimitation of each (sub-) delegation is not always clearly defined. There is no clear definition of an irregularity. Systematic reporting is a problem; no whistle-blowing rights for staff have been defined and there is no clear definition of the Financial Control department, while rules on precautionary and corrective measures for fraud and irregularities are lacking."

Both the CHU and the management of the implementing agencies share the responsibility for remedying these weaknesses. It is more than likely that the findings in the area of EU funds will also be valid in the management of national funds.

PI*f*C and EU internal control systems

During and after the accession negotiations, the national control institutions in the new Member States would often complain that, despite insisting on the same standards and methodologies for national and EU funds, the Commission did not exhibit the same diligence when explaining how to manage and control the various EU programmes. Certainly, there are differences in the set-up of the control systems for PHARE, SAPARD (EAGGF), ISPA, (Structural Funds) and **PI*f*C**. What exactly are these differences and how can we explain them? The answers to these questions are relevant, as from January 2007 the Commission will use a new instrument for promoting modernisation, reform and alignment with the acquis. This Instrument of Pre-accession Assistance (IPA) will replace previous assistance instruments such as PHARE, CARDS, ISPA and SAPARD and is a single set of rules and procedures with more flexibility providing greater impact and value for money in the allocation of EU funds (Council Reg. (EC) 1085/2006). The western Balkans and Turkey will benefit from around € 11.5 billion over the next 7 years. The Commission will develop a multi-annual financial framework, which sets out indicative amounts for the allocation of the IPA funds for each country and for each major component.

In comparing **PI*f*C** (see appendix 13) with the Commission's Financial Regulation (FR) and the systems for PHARE, SAPARD and ISPA, **PI*f*C** and FR relate to single management authority systems, the others relate to "shared" management systems, in which both the Commission and the national authorities co-operate. The importance of this is clear given that the present and future applicant countries will not only be subject to establishing IPA structures, but also to establishing **PI*f*C** structures.

Article 164 of the EC Financial Regulation[6] states that the Commission may decide to entrust management of certain actions (relating to Community funds) to the authorities of beneficiary third countries, but first the Commission must establish whether the country is in a position, to apply in whole or in part a number of criteria. Criterion b) requires the existence of an effective system for the internal control of management operations and criterion d) the existence of a national institution for independent external auditing. Criterion d) is clearly searching for a Supreme Audit Institution or similar organisation. It is almost inconceivable to imagine that such a body would exist only for Community funds and not for all other public sector income and expenditure. Similarly with criterion b) it would seem nonsensical to interpret this as suggesting that it is in any way desirable that an effective internal control system should not be in existence for all other national income and expenditure. This is of relevance in discussions with those countries that

6 Council Regulation (EC, Euratom) No 1605/2002 of 25 June 2002

focus on developing effective internal control systems for Community funds only and tend to neglect or regress on earlier attempts to create modern public internal control systems for the national budget. Indeed, during the accession negotiations the Commission insists that the national internal control systems be brought to the level of quality of the internal control systems for the Community funds.

The benchmarks are arranged in three categories of questions as follows:

1. Who is the competent managing authority (at both programming and implementation levels) and is there managerial accountability at implementation level? Who is responsible for the "accreditation" of the management and control systems?
2. Are all management verifications of transactions carried out at implementation level? Is financial control (ex-ante or ex-post) part of managerial accountability?
3. Who is responsible for internal audit and to whom does the internal auditor report? Is there adequate functional independence? What is covered by internal audit? Who is responsible for the overall harmonisation of internal audit and who is performing the external audit?

Similarities

The answers to the first group of questions (1-3) show little differences; managerial accountability or responsibilities are well defined in all systems. Any minor differences seem likely to be ironed out by the new draft IPA implementation. The issues of functional independence of Internal Audit (7), the presence of harmonisation (9) and of External Audit (10) are also not subject to basic differences.

Differences

However, the answers to the second group of questions, those relating to the certification of transactions (4) show two major differences: first, under the ISPA rules, it is not management, but the Winding-up Body (an internal audit department) that performs substantive transaction checks (5 to 15% checks). The second difference is in the treatment of ex-post control (4b), which is a mandatory part of managerial accountability in **PI*f*C** (it cannot be part of internal audit) and in SAPARD, but is mandatory neither under the PHARE and ISPA rules, nor under the new draft IPA implementation Regulation. It is also not mandatory in the Commission, although it appears to be quite commonly used.

Under question 5 (who performs Internal Audit?) the close link between the **PI*f*C**-IA units and the national audit bodies specifically established for EU funds becomes clear. Where PHARE would accept as a minimum the **PI*f*C**-IA units, the mandatory audit strata for SAPARD and ISPA might need three levels and even four if external audit is included. As far as reporting is concerned (6) the **PI*f*C**-IA unit is reporting to the highest level of the managing authority at implementation level. However, the Winding-up Body under ISPA sends its reports to the political level and to the Commission but not to the Managing Authority at implementation level for ISPA (National Authorising Officer). The draft IPA implementation Regulation tries to resolve this by requiring the Audit Authority to report to both the National Authorising Officer and the Commission.

Finally, in the draft IPA Regulation and in all other cases internal audit relates primarily to systems-based audit and not to transaction-related substantive tests. Only in the case of ISPA does the Winding-up Body not only perform systems-based audits, but the 5 to 15% substantive testing checks as well.

Conclusions

The concept of the Audit Authority in the draft Implementation Regulation for the new Instrument for Pre-Accession aims to square the circle of differences between the present pre-accession instruments into one global control and audit system that is very close to the **PI*f*C** and EC internal control concepts.

The main conclusion, however, is that the Commission in the area of "shared or split" management with Member States is seeking to get the highest level of assurance that the EU-funds are being used for the agreed objectives in the most economic, efficient and effective way. Further harmonisation of the IPA components may well take place in the future, when the quality of the **PI*f*C**-IA units has become fully compliant with international standards, so that the Commission can place confidence in them.

Recent reforms in "old" Member States

In recent years quite a number of reform efforts have taken place in the public internal control systems in the "old" Member States. The idea of making a complete overview of all internal control systems in the EUR-15 – as was done within the framework of the accession negotiations for EUR-12 – has been suggested more than once, but it requires considerable resources and close co-operation with the relevant authorities; so far, it has not been realised.

Mr Cohen calls the concept of **PI*f*C** the backbone of a technically advanced and philosophically coherent variety of an entirely new public policy changing the civil servant into a responsible manager and the controller into a competent consultant (Cohen: 2005). He states that whereas the Commission has developed **PI*f*C** only for the new Member States and for those candidates that might follow, the **PI*f*C** concept should also be taken up by the old Member States, which are in need of modernising and upgrading their own financial and administrative policies to make budget implementation result- and quality-oriented. Many of the EUR-12 support this suggestion.

Having country-assessments that benchmark Member States' internal control systems against the COSO II model, for example, would add much to the understanding of all involved in the development of sound financial management in the European Union's members. There is an important tendency in the public sector to shift from compliance to performance audit (see page 64) and to introduce internal audit to support management in becoming more result-oriented and accountable. Hereafter we will take a closer look at what is going on in France, Austria, Belgium and the Netherlands. The choice of these countries is based on the specific developments they have been making in internal control and internal audit. France has been chosen not only because of the significant role played by its twinning partners and private consultants in the area of developing **PI*f*C** in applicant and other countries, but also because of its major reforms in the implementation of the national budget.

FRANCE

The situation of internal audit in the French public sector is complicated. During a transition phase from 1998 to 2001 the French government worked on the introduction of internal control standards and internal audit standards based on internationally-recognised standards (IIA) and tools to be used by the Treasury. In 2001 the Mission for Audit, Evaluation and Control (MAEC) was created in the General Directorate for Public Accounting (GDPA) in the Ministry of the Economy, Finance and Industry. MAEC is the Internal Audit structure at the Treasury and is responsible for the policies and system requirements of audit and control; it performs internal audit within the Treasury departments (also called the Treasury network) and GDPA's central departments. Thanks to the important French principle of separation between management and the public accountant, the Treasury departments audit line ministries' accounting, but they do not have the right to audit the ministries' operational activities. Ministries can appoint internal auditors under their own responsibility – it is in their interest to do so –, but this is not obligatory; it is not stipulated by law. Ministers or managers have thus three options; either ask the Treasury to perform an internal audit of their operational activities, or request the support of a private audit company or nominate their own internal auditor. The accountants or financial controllers perform only regularity and legality accounting checks and the general inspectors of ministries perform only technical inspections.

The gradual introduction of the new 2001 State budget reform in recent years has been an admirable effort to bring increased ministerial accountability and improved result and performance-oriented control to the French public sector. The implementation of this reform started in January 2006 and it may therefore be too early to evaluate whether the reform has been entirely successful. The State Public Finance Reform is mainly a budget and accounting reform with strong impact on public internal control. In terms of introducing internal control and internal audit as defined by the international standards (COSO), there is certainly a convergence of opinion or, as the French would say, a "*rapprochement des idées*". One of the relevant audit elements has been the creation of a super-audit structure, the CIAP, an inter-ministerial committee that controls the quality of the ministerial programmes and audits the annual performance reports of ministries.

Appendix 14 gives a detailed overview of the French reform in relation to control and audit. Compared with the principle of decentralised internal audit attached to management, it is perhaps not possible to speak of full managerial accountability because the manager is still subject to the Treasury auditor (MAEC) as far as his financial accounting is concerned. However, a decentralised internal audit administrative reporting to management is an option to the manager – and in fact this is encouraged. France is aiming to achieve the best possible public sector performance and optimal budgetary results, albeit in ways not always easy to understand for the outsider. Nevertheless the new French budgetary, accounting and auditing systems are an exceptional and remarkable paradigm of recent developments in the public internal control systems in the "old" Member States.

BELGIUM[7]

In November 2000, Belgium decided to modernise the regulatory framework of its federal public departments. The reform principles cover "government governance" based on internal control systems in accordance with the COSO model and an internal audit function as defined by the IIA. Management is to be made more responsible for the results of their actions that can be benchmarked against objectives that have been decided upon prior to the implementation of the agreed actions. The objectives are based on economy, efficiency and effectiveness.

The reform also includes amending the rules for administrative and budgetary control. Measures within the framework of internal control are directed towards providing reasonable assurance about objectives relating to the reliability of financial and management information and of compliance with laws and regulations. The ex-ante control function will be partly transformed to sampling-based ex-post control, based on risk analysis and risk management procedures. Decisions have also been made to modernise the accounting systems in compliance with international standards. The federal accounting system will be transaction-based and provide a better analytical insight in the cost and income components of the public services.

7 Based on material received from Mr REYNDERS in the Federal Financial Inspectorate in Belgium.

These modernisation projects are so far best developed in the public organisations for social security. Since 2002 these institutions' relationships with the federal government have been characterised by management agreements that provide the institutions with more responsibility, but also make them accountable for the quality of the results of their actions. The agreements contain objectives, progress against which is benchmarked via indicators every six months. For the period 2006-2008 new agreements have been negotiated, based on experience gained, and they now include stipulations relating to the implementation of the internal audit function and the introduction of analytical accounting.

Other initiatives have been taken in the federal public sector. For example, new managers will be appointed with mandates of limited duration; they will be expected to follow specific management and annual operational plans. Human Resources management is to be modernised, evolving from seniority to merit- and competency-based developments of civil servants. To support the development of these and other related measures, Business Re-engineering Processes are being implemented to allow for a consolidated and coherent system of strategic and operational management planning. Internal Control is thus steadily being implemented in the federal administration.

Some important initiatives have also been taken in the areas of internal control and internal audit. The Federal Ministry of Finance has established internal audit for the fiscal administration and for the Treasury. The Ministry of Defence has also developed internal control measures and the Federal Ministry of Mobility is implementing the COSO model. The full realisation of these reform processes will of course take time. The Ministry of Budget and Management Control is the co-ordinating organisation, charged with the implementation of the new internal control systems, the internal audit departments and the audit committees.

AUSTRIA[8]

In Austria the *Bundesrechnungshof* (Court of Accounts) reported in May 2003 that the internal audit or "Interne Revision" in the public service would benefit from a substantial reform. The 'Internal Revision' may have an excellent knowledge of the organisation to which they are attached and have a special relationship of trust with the minister, but strengthening the internal audit and giving it greater (higher) status would be an important instrument in obtaining the control targets of the federal government. The Court suggests an interesting array of recommendations that are very close to the specific requirements in the framework of the FC Chapter negotiations for Applicant Countries:

1. Develop a strategic plan for revamping the internal audit function;

8 Based on discussions with Mr SCHUH of the Ministry of Finance in Vienna

2. Regulate the organisation, status and functions of the internal audit through new and comprehensive legislation; the existing audit regulations should be standardised;
3. Internal audit should report directly to the hierarchy responsible for the management of the ministry and perform the function of an objective information- and assessment-instrument, lessening conflicts of interest and promoting direct contact with the head of the organisation;
4. Provide an adequate input of staff and the creation of facilities for education and training;
5. A re-orientation of audit tasks: towards more ex-post, management-independent assessment and less towards participation by audit in organisational and administrative reform planning or even involvement in managerial decision-making;
6. Establishing a central organisation for harmonising internal audit in the public service.

In November 2003, the Federal Ministry of Finance established a new Internal Audit Unit, based on the IIA standards and directly reporting to the Minister. Its main audit goals are risk management, control and governance processes. IAU staff is following intensive training courses to meet the new requirements. In September 2005 the Ministry informed all other ministries about the new concept of the internal audit, but it is too early for the initiation of change processes. There is no intention to establish a CHU as in the **PI*f*C** model; however, there is a special unit in the MoF observing how the various public internal control bodies function together. Also in September 2005, the Council of Ministers decided that all internal auditors should participate in the Master of Business Administration qualification for auditors of the *Bundesrechnungshof* in the Executive Academy of the Vienna University of Economics and Business Administration that was to start in February 2006.

THE NETHERLANDS

In 2001 the Netherlands adopted a Government Accounts Act that makes ministers responsible for sound and verifiable financial management within their organisations, in respect of the budget in his or her charge. Operational controls (including ex-ante financial controls) are incorporated into the budget implementation process. Each ministry has an internal audit department responsible for assessing whether the principles of sound financial management have been applied and for verifying whether the annual accounts are reliable and transactions have been realised in a legitimate way. Audit findings are sent to the auditee (ministers), to the Ministry of Finance and to the Court of Audit.

All internal audit departments follow the same approach which has been harmonised by the Minister of Finance, particularly by the Government Audit Policy Directorate (DG Budget). Its director is the President of the inter-departmental Council of Directors of the Internal Audit Departments which meets once a month to discuss audit policy issues. This Council has issued an Audit Manual describing the scope of the audit opinions to be issued and stating the materiality (significance) criteria to be used. These criteria are confirmed by the Dutch Cabinet of Ministers. The Audit Manual has been agreed with the Court of Audit.

Heads of internal audit departments must have the rank of either Director or Deputy Director. The Director of the Internal Audit Department has the duty to certify the annual report of the department to which he is attached. He or she has a general appointment to the State at large and has no direct employment contract or employment relationship with the minister concerned. The internal audit department is not allowed to become involved in performing any managing or controlling activity. The tasks and positions of the internal audit departments are embodied in a special decree by the Minister of Finance.

Co-operation between the Court of Audit (*Algemene Rekenkamer* (AR)) and the audit departments follows two lines of communication, the first is with the Central Audit Department about audit policy issues (to be implemented by the Ministerial Audit Departments) so that these departments support the objectives set by the AR relating to the audits of financial management and the annual departmental reporting. This audit policy is laid down in the government Audit Manual. The second line of communication runs with the ministerial audit departments, whose audit work is reviewed by the AR, the conclusions of which are used as the basis for policy-making and recommendations by the AR.

PIƒC

The common thread running through the countries quoted, and indeed most other EU countries as well, is the need to improve the quality of public sector management (PSM). PSM is not only about improved efficiency and effectiveness, but also about making sure that public services meet the needs and interests of the public and do not just serve the interests of the public service provider. Thus, the traditional paternalistic approach to the provision of public services has changed radically in many countries. "Value for money" has become the main (or a major) determinant in the arrangements for delivering public services. Value for money not only means that those services have to be delivered efficiently, but they have to meet the needs of the consumer of the service and to a standard and style that the consumer actually wants.

This has significant implications for the way in which public services are organised and managed. The traditional concern has been for the administration of public services. Delivery of public services has not been seen as dynamic and the deliverer has set the standards, style and pattern of service delivery. In practice value for money has tended to be defined as either simply securing spending in compliance with the budget, or at best as ensuring that services are delivered as economically as possible. The internal control system as a consequence would ensure that the rules were being complied with and that for procurement the cheapest article or service, albeit at the quality required, was acquired. However, there is little point in providing a service that is either not wanted or does not otherwise meet the needs of the consumer; no matter how efficiently and economically it is provided. In most, if not all EUR-15 Member States, this traditional approach has changed and with it the definition of 'value for money'. The consequence is that services need to be managed rather than administered and this has profound effects upon managers' information needs and upon the internal control and hence internal audit arrangements. However, achieving value for money is difficult. It requires change and change disturbs existing interests.

Managers have a responsibility for achieving value for money. The role of the auditors (internal and external) is then, inter alia, to satisfy themselves that the management has due regard to value for money in its arrangements for delivering public services. The auditor should not aim to substitute for the manager, and performance audit activity should be designed to test the manager's success in achieving value for money. Managers need information about the detailed costs of service delivery; they need information about performance, that is, the outputs of the service. These outputs can be both qualitative and quantitative. PIFC structures play an important role in these circumstances in ensuring that these information systems are robust and that appropriate measures of performance are being chosen. The role of internal audit here is to assess whether or not these systems are delivering the information required.

These changes in service delivery have led some countries to make changes to their accounting systems, moving from cash to accrual accounting. Making this change is costly and carries risks; an accruals system ought to provide information of value to management, because a primary purpose of accrual accounting is to provide better quality information to the users of general purpose financial reports, but implicit in this is all other users having the capability to rely on the same information, especially the managers. So the managers need to understand how they can use the information provided. If the public services are still being delivered in the traditional manner, that is "administered", then the scope for 'management' is severely limited and therefore the benefits of accrual accounting will be hard to obtain.

Changing to accrual accounting also has profound effects for the internal control and internal audit system. Cash is no longer the dominant concern. If the budget remains cash-based, then how is compliance with the budget to be maintained if the accounting is on an accrual basis? If, to deal with this problem, two parallel accounting systems are operated then how does the organisation ensure that the two are compatible? Which accounting standards are to be used in developing the accrual system and how will the underpinning accounting policies be developed? How will manipulation of these standards and policies be prevented when unfavourable results emerge? To what extent is the internal auditor involved and does he have the training needed to understand both the accrual accounting standards and the underpinning policies, to provide a meaningful opinion on the accounts? (Hepworth: 2003).

These are some of the issues that the "old" countries have been addressing as they respond to the economic and political environment that now exists with its relentless pressure to keep public expenditure down and ensuring that tax rates remain at acceptable levels. Countries joining the EU or wishing to do so should not 'rush' at needed reforms as displayed by the EUR-15. They need to recognise the very significant meaning of 'value for money' and all the difficulties that exist in achieving it, that 'management' is far more than public administration and that as a result there are profound implications for information systems, not least for accounting and performance, and in turn for the arrangements for PIFC. Inadequately thinking through and learning lessons from those who have gone through the processes can add seriously to the risks that such countries face.

Conclusion

The examples discussed above show that in the countries concerned public internal control systems are all being reformed (although at different speeds) towards higher degrees of compliance with the principles of managerial accountability and functionally independent internal audit, while centralised organisations are set up to guide these processes.

Traditional management styles are changing to managing service delivering in accordance with consumer's demand. These changes have an important impact on the concepts of value for money, cost accounting and information reporting. They demand rethinking the accounting standards as well as the tasks of internal control and internal and external audit. These changes are not without risks; emulating the examples given by the majority of the EUR-15 in the areas mentioned-above requires careful analysis and thorough understanding of the underlying issues and perils.

5. The Accession Negotiations[1]

What happens; DG Budget's role in the negotiations, the Europe Association Agreements, Agenda 2000 and the Accession Partnerships; the purpose and structure of the accession negotiation chapter on Financial Control; co-operation with applicant countries; conceptualisation of the* PI*f*C *elements, drafting a* PI*f*C *Policy Paper, drafting and adopting* PI*f*C*-related framework and implementation legislation, establishing* PI*f*C*-related organisations; training needs for management, controllers and auditors.

Preparing for Accession Negotiations

In June 1993, the European Council of Copenhagen found itself confronted with the prospect of massively enlarging the European Union eastwards and adopted the following criteria for EU membership:

"Membership requires that the applicant country:

- has achieved stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities (also called the **Political Criteria**),
- the existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union (also called the **Economic Criteria**),
- and[has] the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union (the **Other Obligations**). "

These criteria are rather broad and go beyond what is known as the 'acquis communautaires', which can be defined as the entire set of laws and rules applicable to all EU Member States. These criteria should be accepted and implemented by applicant countries before accession. The 'acquis' include, for example, an assessment of administrative and judicial capacities, interpreted later as including, amongst other things, **PI*f*C** systems. In December 1995, the European Council of Madrid asked the Commission to submit opinions on a number of individual national applications to accede to the European Union and to start preparing a paper on Enlargement. The Commission's opinions appeared in the Agenda 2000 Commission communication of July 1997. This communication became the basis

1 This chapter contains operational aspects of value to the ENP Countries

for the European Council's decision of December of that year launching accession negotiations with Cyprus, the Czech Republic, Estonia, Hungary, Poland and Slovenia in March 1998.

Europe Association Agreements

The issue of financial control was not explicitly mentioned in Agenda 2000; this was first done in the Europe Association Agreements. Individual EAAs were concluded with the 10 applicant countries over a period of 4 years (1994-1998). They related to issues of commerce, political dialogue etc., as well as to a number of co-operation areas, including "audit and financial control": Article 88 under Title VI: Economic Co-operation reads as follows:

> *"The parties shall co-operate with the aim of developing efficient financial control and audit systems in the (national) administration following standard Community methods and proceedings. Co-operation shall focus on: the exchange of relevant information on audit systems; the uniformity of audit documentation and training and advisory operations. To this end, technical assistance shall be provided by the Community as appropriate".*

The general part of the Agenda 2000 communication therefore only made an indirect reference to the issue of "Financial Control". In its third chapter, entitled "Other obligations", the report mentions the importance of modernising applicants' administrations so that they can implement and enforce the *acquis*. It was noted that this will often require new administrative structures as well as properly trained and remunerated administrators. The individual opinions attached to the Agenda 2000 communication note that the Europe Association Agreement is the legal basis for relations between the country concerned and the Union. Its institutional framework provides a mechanism for implementation, management and monitoring of all areas of co-operation.

The **Agenda 2000** communication took into account:

- the Copenhagen criteria;
- the applicant countries' replies to the 1996 Commission Questionnaire;
- the multilateral and bilateral screening meetings (1996/1997) that had taken place between the Commission and individual applicant countries and
- the progress made under the European Association Agreements.

The Madrid Council also referred to the need to create the conditions for a gradual and harmonious integration of the applicant countries into the European Union, particularly through the development of market economies, the adjustment of their administrative structures and the creation of a stable economic and monetary environment.

The 1996 Commission's Questionnaire

The Commission had not included a Chapter on Financial Control issues during any of the previous accession negotiations. Specific elements about control of EU funds were dealt with in the chapters covered by those DGs responsible for the relevant funds. But since many ex-communist countries were still relying on their traditional control systems, the challenges they were facing pointed to the need to give the issue of "financial control" attention in its own right.

Although DG Financial Control was responsible for the technical negotiations for this Chapter, it had not been earlier involved in accession negotiations of this kind. But it had started, in 1992, to set up a network of contacts with national control organisations and Project Implementation Units in the applicant countries within the framework of managing and controlling PHARE funds. This network of contacts would prove to be most helpful in further developing **PIƒC** in the new applicant countries.

In April 1996, the Commission issued a long list of questions to each of the applicant countries about a number of areas (chapters) that would be part of the accession negotiations. One of the areas touched upon in this questionnaire was the Chapter on Financial Control. This designation followed the practice of naming chapters after the Directorate General responsible for the technical negotiations with applicants, but in the case of the Chapter on Financial Control, this was obviously not best practice – firstly because DG Financial Control was about to be renamed several times and secondly, the term *financial control* followed the rather narrow definition of ex-ante visa as explained earlier. Nowadays the title "Financial Control" for this Chapter is outdated and rather confusing, as the FC Chapter also includes external audit, the fight against fraud and the protection of the Euro against counterfeiting.

DG Financial Control started formulating the first series of questions, based on its experience in applicant countries. The questions for the FC Chapter were divided into two main categories: the first relating to general control issues and the second to the more specific control areas relating to Traditional Own Resources, Structural Funds and Agricultural Guarantee Funds. This sub-division reflected the various departments within DG Financial Control, jointly responsible for analysing the Questionnaire replies. The general questions required information on what reforms had taken place in the Public Administration of the applicant countries. Finally, the questions also related to the legal definitions, the capacities and efficiency of the existing national control authorities and the further development and improvements thereto. By July 1996 thousands of pages of replies to the numerous questions in each Chapter had arrived and DG Financial Control started to analyse the replies for the FC Chapter.

The main finding was that none of the applicant countries had a horizontal approach for dealing with the issues of internal control at governmental level. Already in August 1996, DG IA ("One-A"), then responsible for the co-ordination of the Commission's Opinion on the Enlargement exercise, was asked by DG Financial Control to provide an assessment of the progress of PHARE-financed programmes in developing internal control mechanisms in the applicant countries. DG Financial Control suggested that a platform should be built where the Commission and applicant countries could discuss needs and develop adequate contacts to examine the Enlargement requirements.

In November 1996, the EC's Forward Studies Unit proposed a reinforced Pre-Accession Strategy; to focus PHARE funds on institution-building and to develop co-operation between applicant countries and Member States, at the level of their respective administrations. This proposal would later be incorporated into the Twinning covenants, since 2004 called Twinning contracts, between applicant countries and the administrations of Member States. The Commission was asked to promote such co-operation and DG Financial Control took up the challenge. The already-existing ties with the national control bodies in the applicant countries were strengthened. The idea for a Contact Group for European Financial Control Organisations was born (see chapter 7).

Substantial Evaluation

In October 1996, DG Financial Control produced a substantial evaluation of the ten applicant countries for the preparation of the Commission Opinions. In the introduction to the evaluation, DG Financial Control noted two particular concerns:

> *1. The administrative structures of most applicant countries, in terms of modern public administration with highly qualified staff, was quite under-developed and would not be able to provide the necessary operational daily input in order to match the political objectives of the Pre-accession programmes. The* ***internal control function*** *implicitly activated within a modern system of diversified and decentralised administration was* ***largely absent*** *in the majority of the applicant countries.*

The prevailing weaknesses in the applicant countries' administrative structures had to be understood and addressed against the background of the lack of functional independence of the control bodies during communist times. Public administration had had little to say on economic issues and policy-making. PHARE had tried to circumvent this major weakness by establishing Project Monitoring or Implementing Units for the implementation of EU funds, implanted into or attached to existing administrative structures. It was hoped that these would contribute towards the realisation of a wide-ranging institution-building process. However, this policy did not meet with overall success. This was partly because some foreign experts and consultancy firms convinced their hosts that their staying on was a *conditio sine qua non* for further financing and the success of the projects and that any phasing out of foreign expertise would jeopardise all PHARE activities as a whole. Another important factor was that qualified national staff operating in the PMU/PIUs very often left public service for considerably higher salaries in the private sector. To remedy the situation, the Commission started to use its own payroll (through PHARE) to keep these staff. This led in turn – e.g., in Poland – to the creation of a privileged class of public officials only sustainable with ongoing Community financing. Other countries did not introduce special salary conditions, but they often suffered from understaffing, which had to be filled, again, by expensive foreign experts. Finally, this situation determined the need for more support for the reform process, including large-scale training and upgrading programmes for fully-fledged and modern-style public services.

> *2. Internal and external control bodies had not yet reached the* ***level of maturity and efficiency*** *which would make them compatible with generally-accepted European standards, both at Member State and Community levels.*

The analysis showed further that the control concepts and methods in the applicant countries were far from standardised. The concept of "*a priori*" controls or "ex-ante visa approval" was largely alien and the role of "ex-post financial control" was often translated to mean either centralised "inspection" by the government or "external audit" as performed by a Supreme Audit Institution. An important conclusion was that many of the control bodies set up after the fall of the Berlin Wall lacked sufficient independence from management. The evaluation underlined the importance of having sufficient reliable control facilities available.

The evaluation cleared the path for the development of **PI*f*C** in the ensuing years by the following:

> *"As Member States are committed to apply the same degree of diligence when spending Community money as they would normally apply to their own budgetary resources (a general principle that is mentioned in the Regulation concerning Structural Funds) this shall include,* mutatis mutandis*, the financial control of the use of these resources. This concept is clearly conditional upon the general agreement to the principle of sound financial management of public funds. The issue is that only sufficiently reliable "national" manage-*

> *ment and control systems can qualify for the decentralised use of European tax payers' money. It is in this respect that the need to upgrade the control facilities and institutions of the applicant countries to an acceptable level, to take place during the pre-accession period, should be understood."*

Finally, it was suggested that co-operation agreements be concluded between the EC Financial Controller and the corresponding control authorities in applicant countries. These agreements were to mirror the "protocols" already existing between DG Financial Control and the Member States' control authorities for structural funds. Co-operating would make the national control institutions more familiar with the standards and procedures of management and control of Community funds. Additionally public local audit bodies could gradually replace the audits of PMUs performed by private audit firms - and paid for by PHARE - with their own audits.

Agenda 2000 for a Stronger and Wider Europe

Enlargement Opinions and Accession Partnerships

In July 1997 the Commission adopted a report containing its opinions on the individual applications for EU membership[2]. The report proposed a reinforced pre-accession strategy with two main objectives. First, the different forms of support provided by the Union should be brought together within a single framework, the Accession Partnerships, on the basis of a well-defined programme to prepare for membership and be backed up by commitments from the applicant countries to particular priorities and a calendar for carrying them out. Regulation 622/98[3] states that the Council is to decide on the principles, priorities, intermediate objectives and conditions contained in the individual Accession Partnerships submitted to each applicant country, as well as on subsequent significant adjustments applicable thereto.

The purpose of the Accession Partnership was to set out in a single framework the priority areas for further work identified in the Commission's Regular Report on the progress made by the applicant countries towards EU membership, the financial means available to help the countries to implement these priorities and the conditions which would apply to that assistance. The Accession Partnership provided the basis for a number of policy instruments which would be used to help applicant Countries in their preparations for membership. These included, inter alia, the revised National Programme for the Adoption of the *Acquis*, the Joint Assessment of

2 Agenda 2000 for a Stronger and Wider Union, Com(97) 2000 (final) of July 15th, 1997

3 Council Regulation (EC) No 622/98 of 16 March on assistance to the applicant States in the framework of the pre-accession strategy, and in particular on the establishment of Accession Partnerships, OJ L85 vol. 41 of 20 March 1998

Medium-Term Economic Policy Priorities, the Pact against organised crime as well as the National Development Plans and other sector plans necessary for participation in Structural Funds after membership and for the implementation of ISPA and SAPARD before accession. Each of these instruments is different in nature and was prepared and implemented according to specific procedures. They are not an integral part of the Partnership but the priorities they contain are compatible with it.

The Commission would regularly report on progress to the European Council, highlighting the extent of the efforts still needing to be made in certain areas by countries preparing for accession. The outputs required in an action area are broken down into intermediate stages, these are ranked in priority terms and each is accompanied by precise objectives set in collaboration with the countries concerned. Achievements determine the degree of assistance granted and progress in the negotiations under way with some countries and the opening of new negotiations (chapters) with others. The first report was to be submitted by the end of 1998 and thereafter on an annual basis until the date of accession. Once the necessary conditions to enter accession negotiations had been fulfilled, the Commission would forward a recommendation to the Council that accession negotiations should be launched. The preparations for the Accession Partnerships started in the second half of 1997.

The Commission opinions on individual chapters, called "Criteria for membership", contained a special Chapter 3.9 (the 3 in "3.9" refers to the "Other obligations" in the Copenhagen criteria) on Financial Questions. With hindsight one can say that these opinions were rather vague. Terms like "internal and external control" and "efficient systems for public expenditure" were not adequately specified and could easily have led to confusion. The first term referred more particularly to the framework of national control systems, whereas the second term should be seen in the framework of Community policies only. However, the general structure of the first FC Chapter was a fact.

The early Accession Partnerships (starting in 1998) were not very specific as far as the issue of Financial Control was concerned. The recommendations and priority areas were spread under various headings in a rather fragmented way, reflecting the lack of coherence in this area. However, by 2002 the updated Accession Partnerships included a more comprehensive chapter on financial control. One example from one of the applicant countries is given here and shows the pains taken by DG Financial Control to arrive at a harmonised approach on all issues relating to **PI*f*C**:

Financial Control:

- Complete the legislative framework for public internal financial control;
- Implement the concept of managerial accountability;

- Set up an internal audit department with adequate functional independence directly under the highest management level in spending centres;
- Set up a central unit in the Ministry of Finance to deal with co-ordination and harmonisation of the methodology for financial management and control and internal audit throughout the government and
- Strengthen the fight against fraud and adopt the appropriate legislative framework to this effect.

DG Financial Control strategy for the follow-up

Since there was no pre-determined policy for providing support to the applicant countries, and no previous experience from earlier enlargement exercises, DG Financial Control had first to establish a strategy. Based on the comments given in the Substantial Evaluation and on its prior activities in the PHARE countries (missions and seminars), the main direction was clear: upgrading the old-fashioned control systems to current internationally-accepted control and audit standards. It would nevertheless take several years before DG Financial Control could claim to have developed a comprehensive policy for supporting applicant countries in developing adequate internal control systems. The most important reasons for this were that the Commission could not pronounce itself to be in favour of one or the other (best) control practices in the Member States and that the Commission itself was in the process of developing its own Financial Control reform.

Aware of the consequences of its input to the Commission's Substantial Evaluation, DG Financial Control started reflecting on a strategy to deal with the challenges of Enlargement in the area of Financial Control. In January 1998 DG Financial Control noted the importance of establishing a **pro-active policy** for grasping a unique opportunity: to transform the hitherto poorly-developed contacts between the Commission and the national control institutions into a well-functioning network, while developing a coherent approach in all matters related to the FC Chapter. In March 1998 an Action Plan was approved by the Director General to work on the following points:

1. Develop and conclude Administrative Co-operation Agreements (see chapter 6) with national control bodies; follow-up on the commitments;
2. Establish a Contact Group Task Force and instigate general meetings with control bodies during the London Seminar of June that year; organise the first so-called Contact Group meeting in Tallinn in 1999;
3. Organise Training Seminars in applicant countries ;
4. Draft country-specific synopses to keep track of progress in applicant countries and
5. Gather and consolidate information (mapping the counterparts' IC organisations); fact-finding missions by DG Financial Control led by high-level delega-

tions from DG Financial Control to capitals, starting an exchange of ideas on how to develop control bodies, etc.; analysing ongoing programmes relating to Financial Control in applicant countries performed by third parties.

During the early stages of implementing the Action Plan, the need to prepare an adequate blueprint for the development and organisational set-up of financial control organisations became obvious. DG Financial Control started to prepare a systematic presentation and methodological explanation of the principles and rules governing financial control and the ensuing initial requirements.

In May 1998 ten synopses were prepared for distribution during the London Seminar on Methods of Internal Control and Audit of European Structural Funds. The synopses provided detailed country-specific information in relation to the FC Chapter and gave an overview of the next steps to be taken. On the basis of information obtained from various sources such as the newly established counterparts, etc., these synopses would be regularly updated and fed into the newly-developed Financial Control Contact Database on the Web (the FccWebsite; see page 118). At the same time, DG Financial Control announced that it would launch training seminars in PHARE applicant countries aimed at the national control bodies.

During the remainder of 1998 DG Financial Control analysed the various National Programmes for the Adoption of the Acquis (NPAA). The information collected from these and other sources (EC Delegations and SIGMA); all pointed to the troubling absence of a common language and understanding of the basic requirements relating to internal control concepts and institutions and to the total lack of an overall integrated and co-ordinated approach.

Consultants from the EUR-15 were not always successful in providing guidance to applicant countries in their quest for optimal internal control solutions. Some of them came and went at short intervals. They put as many different approaches on the table (reflecting of course their national views on how to organise internal control) as there were Member States. Confusion grew to the extent that applicant countries started looking for the best offer to pick from the many different systems in Member States - and even beyond - hoping to find the right answers. Frustration was growing and the Commission found itself increasingly confronted with demands for guidance. It was high time to develop a co-ordinated approach in replying to requests for financial support from PHARE and from technical assistance.

The first Regular Reports on progress in the negotiations confirmed the absence of a common approach in the area of Financial Control, both overall and country-specific. The concepts used and texts written were often contradictory and confusing to say the least. DG Financial Control was hard-pressed to start providing support to its new clientele: the control bodies in the applicant countries – mostly located in the Ministries of Finance – who were seeking a clear direction and an authoritative voice in the multitude of solutions offered.

Structure and nature of the FC Chapter

The FC Chapter has been used as a basket for various control-related items and the elements covered have changed over the years as can be seen in the following table:

Table 2. Evolution of the contents of the FC Chapter

Chapter 18	Chapter 28	Chapter 32
—	Public Internal Financial Control	Public Internal Financial Control
External control systems	External Audit	External Audit
Measures against fraud	Protection of EU financial interests	Protection of EU financial interests
Own Resources system	—	Protection of the Euro against counterfeiting (non penal aspects)
The establishment of adequate internal control systems for EU financing	Control of EU pre-accession and structural funds expenditure	EDIS systems

Until 2000, DG Financial Control co-ordinated the various sub-chapters in-house, but after the transfer of the relevant unit to DG Budget, this task became increasingly difficult. The original sub-chapter 4): Own Resources control was transferred to Chapter 29 (now 33): "Budgetary matters" to be dealt with by another service in DG Budget. In March 2002, DG Budget informed DG ELARG and other relevant DGs that the Unit in the Central Financial Service (DG Budget D.6) responsible for the assistance to applicant countries in the field of financial control, would focus only on **PI*f*C** and External Audit, whereas the other DGs would have primary responsibility for the other sub-chapters; DG ELARG for PHARE, DG REGIO for ISPA, DG AGRI for SAPARD and DG OLAF for the Protection of EU financial interests (see appendix 16 for the Anti-Fraud Co-ordination Service).

The political process and FC Chapter criteria

DG ELARG (formerly DG IA) is responsible for the official negotiations and reports to the European Council in the EU working group on enlargement. Communications between the Council and the Commission are formalised in the EU Common Position Papers. DG Budget provides input and technical information during the meetings with the working group.

In December 2001 the working group discussed a request from the EU Presidency to assess progress in some applicant countries so that the FC Chapter could be provisionally closed for these countries. Not convinced of the information provided that these countries were ready for the closure of the FC Chapter, the President of the working group invited the Commission to initiate Peer Reviews covering **PI*f*C** baselines for a number of applicant countries. Bulgaria and Romania were mentioned, but also Poland, Hungary, the Czech Republic, Lithuania and Slovenia would be benefiting from such Peer Reviews. Peer Reviews are in-depth independent assessments of the internal control systems in an individual country that aim at arriving at solid recommendations for further improvements and have been carried out by SIGMA and its peers in the national administrations. SIGMA has unique experience in this field and the reviews were indeed most helpful to applicant countries on the road to **PI*f*C** implementation.

The working group also asked the Commission for information about its **criteria** for opening and closing the accession negotiations on the FC Chapter. As there was and is no written or hard "acquis" for this Chapter, providing objective and measurable yardsticks is not easy. There are only references to "internationally accepted standards in control and audit" and to "EU best practice". The final proof is in the degree of satisfaction that the EU can draw from the efforts of applicant countries to establish overall sound financial management and control systems for both national and EU spending and to start using them.

The first batch of countries to provisionally close their chapters comprised Poland, Hungary, Slovenia and the Czech Republic; their achievements in the FC Chapter had not at that stage been measured against well-defined criteria. With hindsight this early closure was an unfortunate error, as subsequently all these countries faced substantial problems with the implementation of **PI*f*C**. The Commission produced a list of criteria that had already been used for some period of time to ensure that applicant countries would be progressively subject to the same degree of benchmarking. This list of criteria was presented to the working group and accepted without debate.

To <u>open the FC Chapter</u> the criteria were:

- Sufficient progress in primary and secondary legislation based on a coherent strategy for the entire government income and expenditure;
- Adequate guarantees for the "functional independence" of internal audit;
- Sufficient progress on the establishment of efficient ex-ante financial control mechanisms, internal audit departments in spending centres and a Central Harmonisation Unit for control and audit methodology (e.g., at the level of the Ministry of Finance);
- Adequate staffing and training of staff in such organisations;

For the <u>provisional closure of the FC Chapter</u> the criteria were:

- Adoption by Parliament of primary **PI*f*C** legislation;
- Adoption by Government of secondary **PI*f*C** legislation;
- A satisfactory level of functioning of ex-ante financial control mechanisms, internal audit departments in spending centres and of the central harmonisation unit;
- A training programme in operation for staff (for example, under PHARE Twinning or otherwise).

At anytime up to the date of accession, by when all the major criteria would have been met and no important commitments would be left open, the Council could decide to close the FC Chapter. Nevertheless, the Council report could still recommend monitoring remaining minor commitments, so the monitoring missions could continue until the date of accession. The FC Chapter was closed for all ten acceding countries in December 2002.

The criteria for opening and provisionally closing the FC Chapter have been revised and brought to the attention of the new applicant countries. The new 2006 criteria take into account, inter alia, the comments of the European Court of Auditors made in its analysis of the way the Commission carried out the accession negotiations up to May 2004. The **new criteria** also cover External Audit. For the post-2006 negotiations they are as follows:

To open:

<u>PI*f*C</u>

- The country has developed a coherent strategy for public internal financial control based on international standards and EU best practice, and a gap analysis of its existing systems and organisations. In particular, the principles of managerial responsibility and accountability for its Financial Management and Control (FMC) systems, an independent and decentralised internal audit function and central harmonisation for FMC as well as for Internal Audit are reflected in a policy paper, adopted by government, including an action plan with realistic deadlines;
- The principles of managerial accountability are set out in an Organic Budget Law;
- Development of **PI*f*C** legislation is to be based on the recommendations of the policy paper.

External Audit

- The country has a Supreme Audit Institution (SAI) with a solid base in the Constitution[4] and in a specific SAI law;
- The SAI has developed a coherent strategy for itself, based on a gap analysis of the existing audit operations and its organisation benchmarked against the Lima Declaration and the INTOSAI standards, reflected in an adopted policy paper, including an action plan with realistic deadlines.

To provisionally close:

PI*f*C

- Adoption and full implementation of primary and secondary legislation;
- Adoption of regulation, including control and audit manuals, Audit Charter, Code of Ethics and audit trail templates;
- Establishment and effective implementation of managerial accountability arrangements; delivery of cost effective FMC-systems and effective decentralised functionally independent internal audit;
- Adequately resourced and competent central harmonisation arrangements for FMC systems and the internal audit function are in place and have been located in the Ministry of Finance;
- Establishment of sustainable training arrangements for all managers and staff involved in FMC and internal audit systems.

External Audit

- Fulfilment of the SAI's audit mandate and scope, including a formal mechanism for the consideration of SAI's audit reports by Parliament;
- Adoption and full implementation of the constitutional and legal framework in line with the recommendations of the Policy Paper for External Audit;
- Legal competence to cover all public foreign (including European) Funds;
- Audit standards adhere to INTOSAI Standards and guidelines; and the EU implementing guidelines for the adoption of the INTOSAI Standards;
- Audit standards have been translated into a detailed set of audit methodology and laid down in an audit manual and guidelines as appropriate.

The Council Opinions on the negotiation status of the FC Chapter are discussed with the applicant country in the Association Committee, a high level meeting between representatives of the Ministry for European Integration and of the European Commission. The technical details will have been delegated to a Sub-Committee, which meets once or twice a year to deal with a number of issues, of which the FC Chapter is one. Most of the technical negotiations, however, were conducted directly

4 or a declared intention to provide for such a basis during the negotiations

between DG Budget and the responsible organisations in the Ministries of Finance. The Sub-Committee meetings were often used to report progress established during fact-finding/monitoring missions held immediately prior to the meetings. Only seldom is an FC Chapter issue discussed by the Accession Committee itself.

Public External Audit

Public External Audit is usually referred to as the audit performed by the national Supreme Audit Institution, thus audit from the outside government management. Its sphere of activities will be wider, but generally this audit is concerned with financial auditing (certifying the accounts) or assessing the internal control systems of public bodies and, more generally, the internal control system of the government as a global system. External audit is sometimes also defined as an audit performed by outside private organisations on behalf of government institutions. In the framework of this book such an audit is to be considered as an "internal audit" since the government remains responsible for the assignment of such an audit and for the recommendations and follow-up thereof. This kind of audit can be performed by the public bodies themselves, which in fact is preferable. Thus, even if a public body (e.g., a museum) is audited by an audit unit coming from the Ministry of Finance or a team of auditors consisting of audit resources from the ministries of culture, finance and economic affairs, this audit will still be considered "internal", also taking into account that management of the entity is the addressee of the audit report.

Since the Commission and not the ECA is responsible for the accession negotiations, the deliberations on how to develop public external audit are guided by the Commission. However, much reliance is put on the SIGMA baseline-papers (annual progress reports prepared by SIGMA on the developments in the public external audit sector of a country). A baseline paper assesses existing weaknesses and reports on the measures taken over time to overcome them. During the accession negotiations with the EUR-12, the requirements of the FC Chapter were mainly restricted to the need to develop the SAI in line with the LIMA-declaration principles (see appendix 8); namely as an independent external audit body obtaining its mandate from, and reporting to, Parliament. It also needs to be financially independent – i.e., its budget must be approved by Parliament and not by the Government (although its financial management would have to follow the normal budgetary prudence applicable to all State institutions). The scope of the activities of the SAI should include all budgetary and non-budgetary public funds as well as foreign funds, such as financing from EU-programmes and projects. Finally, the SAI should develop systems-based and performance audits in addition to its traditional task of compliance and accounts audits. Its ex-ante financial control tasks should be abolished as they could lead to conflicts of interest.

The European Court of Auditors has an important stake in the way SAIs are developing. It organises workshops with the SAIs (see page 136) and aims at close co-operation in the area of external audit of EU funds. It is therefore a good practice to link the activities in the area of co-operation between SAIs and the ECA with the accession negotiations in the FC Chapter. This is why the criteria for external audit under the FC Chapter have now been formulated more explicitly.

Infringements

What would happen if a new Member State decided – for whatever reason – to renege on its commitments to rebuild its public internal control systems? These commitments would have been made by the government in the framework of the accession negotiations and usually substantial sums of EU funds would have been paid by the European tax-payer to help the country concerned to rebuild its administration in order to make internal control adequate and compliant with international standards.

The possibility of a new government deciding to deviate substantially from or undo the work done to introduce the accepted **PI*f*C** model after the date of accession is not entirely unthinkable. Newly elected governments may consider reintroducing powerful inspection departments and abolishing **PI*f*C**-related institutions for a number of reasons. These might be that the new government is desperately looking for funds, is unaware of the advantages of the concept of **PI*f*C** or that the implementers of the **PI*f*C** model are not to their political liking. Maybe the new government wishes to nominate its own allies to important control or audit posts. The sheer fact that the Commission is promoting the establishment of the Audit Authority under the new IPA instrument for EU-funds and has fallen silent about the need for continuing efforts to strengthen the **PI*f*C** system for the national funds seems to be inducing some Member States to dismantle the internal control system for national funds and abolish the CHUs for internal audit.

The European Treaty (see appendix 17) provides legal procedures to be used in the case of infringements. Infringements are breaches of law. The **general rules are** laid down in Article 226, under which the Commission may deliver a reasoned opinion if it considers that a Member State has failed to fulfil an obligation under the Treaty, covering primary and secondary EU law (including the Accession Treaty), and that Member State refuses to change its practice. If the Member State does not comply with the opinion, the Commission may bring the matter before the Court of Justice. Of course this may not be the most appropriate means of convincing a Member State to change. Discussion and persuasion would still be the best solution, but these presuppose the existence of some platform for continuous dialogue after the accession negotiations! Article 227 provides for the possibility that another Member State may take the initiative of bringing the matter to the Court.

An **exception** to this general **rule** applies only to "new" Member States and is laid down in Article 38 of the 2003 Accession Treaty which says that if

> *"a new Member State fails to implement its commitments undertaken in the context of the accession negotiations causing a serious breach of the functioning of the internal market, including any commitments in all sectorial policies which concern economic activities with cross-border effects, or an imminent risk of such breach, the Commission may, until the end of a period of up to three years after the date of entry into force of this Act, at the reasoned request of a Member State or at its own initiative, take appropriate measures."*

At first sight one would think that it might be difficult for the Commission to take measures based on this article since **PI*f*C** does not relate to the internal market or to economic activities with cross-border effects, but Art. 39 provides for a solution:

"If there are serious shortcomings or any imminent risks of such shortcomings in the … state of implementation, …or any other relevant commitments, … the Commission may, until the end of a period of up to three years after the date of entry into force of this Act, at the reasoned request of a Member State or at its own initiative and after consulting the Member States, take appropriate measures and specify the conditions and modalities under which these measures are put into effect."

These articles call for specific measures of an urgent nature and refer to a three-year period. The conclusion is therefore that the Commission can do quite a lot to prevent a Member State weakening its **PI*f*C** systems and therefore the management and control of EU funds as well. Whether these articles are sufficient for the Commission to have a decisive impact on any government decision to diverge substantially from what had been agreed upon during the accession negotiations, is a matter of testing. However, it should not go that far. The government ought to realise that such a course may, in the longer term, run counter to its own interests. The "*confiance légitime*" to be provided by the new Member State should be based on its understanding and willingness to adopt **PI*f*C** – made explicit during the accession negotiations and in the many contracts between that country and the twinning partners/consultants, financed by the Commission.

The internal control system should be so strong as to be able to withstand undue political pressures thanks to several safeguards built into the systems. **PI*f*C** is embedded into law that aims to bring benefits from a transparent and sound internal control system to a large number of stakeholders, with the government in the first place. Changes of the **PI*f*C** system can then only occur after making proposals to change the legislation, on which the Supreme Audit Institution and the Parliament will have to deliver their opinions. It would be highly unlikely that both institutions would go along with initiatives that would go against the overall interests of transparency and accountability.

6. DG Budget's Toolbox

Administrative co-operation agreements (ACAs) with applicant countries; multilateral and bilateral screening meetings to inform applicant countries of the obligations and opportunities of introducing adequate internal control systems; fact-finding and monitoring missions to Ministries of Finance and Supreme Audit Institutions; training seminars for national civil servants; contributions to Commission Reports and Council Opinions; CHU meetings, Joint Audit Arrangements and the FccWebsite.

In its capacity as ex-ante and ex-post financial controller (and since 1990 as the Commission's internal auditor), DG Financial Control had already developed a number of activities in the PHARE aid-receiving countries. Based on this experience, new instruments were developed to strengthen co-operation with the countries concerned.

Administrative Co-operation Agreements

Following the example of the Protocols (agreements on co-operation between DG Financial Control and the organisations in the Member States responsible for the management and control of EU-funds), DG Financial Control concluded ACAs on **PI*f*C** with its counterparts in applicant countries. For a template (see appendix 15). The counterparts were national organisations the Government had designated to co-ordinate with the Commission – usually this was the Ministry of Finance. The ACA specifies the department in the Ministry that will be responsible for co-operation. Following advice from the Commission's Legal Department, the ACA format is not that of an agreement subject to international law, but rather a declaration of intent to co-operate. Once the text is agreed between the organisation and the Commission, it becomes part of an exchange of letters between the parties. DG Budget is considering concluding ACAs with all the western Balkan Countries and with interested ENP countries, as the ACAs have proved helpful in strengthening co-operation between the national authorities and the Commission and in supporting the national authorities in continuing their internal reforms.

The first ACA was concluded with the President of the Hungarian Government Control Office (GCO) in Brussels, in December, 1997. By 2000, agreements had been concluded with the remaining 11 applicant countries. When DG Budget took over the responsibility for **PI*f*C** from DG Financial Control in 2000, new ACA's were concluded with all the applicant countries, including Turkey. More recently, ACAs were concluded with Croatia in September 2004 and with Macedonia in July 2006.

Table 3. List of ACAs concluded between DG Financial Control and applicant countries, after 2000 renewed with DG Budget:

Country	Organisation	Concluded on
Hungary	Government Control Office	3/12/1997
Czech Republic	Ministry of Finance	1/6/1998
Slovenia	Ministry of Finance	21/9/1998
Poland	Ministry of Finance	30/9/1998
Estonia	Ministry of Finance	11/12/1998
Cyprus	Ministry of Finance	15/3/1999
Lithuania	Ministry of Finance	25/3/1999
Slovak Republic	Ministry of Finance	22/4/1999
Latvia	Ministry of Finance	21/5/1999
Bulgaria	PIFCA, Ministry of Finance	12/10/1999
Malta	Office of the Prime Minister	16/11/1999
Romania	Ministry of Finance	16/3/2000
Turkey	Ministry of Finance	16/9/2001
Croatia	Ministry of Finance	13/9/2004
Macedonia	Ministry of Finance	31/7/2006

In the Hungarian ACA the emphasis was on performing on-the-spot audits of the management of PHARE Programmes and Projects in Hungary. The agreement also contained some basic rules about selecting Programmes and Projects and the relevant Project Management Unit; the annual audit programme; the conduct and results of audits and the exchange of general information relating to audit and financial control within the framework of the pre-accession strategy. However, after the Commission Reform in 2000, most of these responsibilities were transferred to DG ELARG and DG REGIO. As a result, the new ACAs had to be revised.

Currently, an ACA covers co-operation in the field of **PI*f*C** at national level, in particular through strengthening **PI*f*C** legislation and supporting institution-building. It covers co-ordination between the parties regarding the Commission's fact-finding and monitoring missions to the country's institutions and departments and discussions on **PI*f*C**-related draft legislation and regulations. The Ministry of Finance is responsible for drafting the **PI*f*C** law and under the ACA seeing that due account is taken of the Commission's comments before the legislation is sent to Parliament for approval. This is to ensure that draft legislation does not deviate from the principles of **PI*f*C** as agreed on in the Accession Negotiation process. In between the endorsement of the **PI*f*C** Policy Paper and Parliament's final adoption of **PI*f*C**-related legislation, many bottlenecks may need to be sorted out; support from the Commission can be of great value to the government in coaxing the reforms through. It is therefore of great importance that the authorities in the applicant countries provide the Commission with timely and official translations of draft strategies, legislation and regulations, showing version numbers and ownership.

Multilateral and bilateral screening meetings

Following the Council's 1998 Enlargement Opinions, all applicant countries were invited to visit the Commission Headquarters in Brussels to participate in a Multilateral Screening exercise for the FC Chapter discussing how the gaps between existing public internal control systems and the international standards could be plugged. This meeting led to more detailed bilateral meetings, these started in May 1999. Altogether DG Financial Control met with more than 400 representatives of the national control organisations from 12 applicant countries. The main conclusion from these meetings was that further bilateral contacts (fact-finding missions) were necessary to explain in greater detail the Commission's views on public internal control. DG Financial Control consolidated all the country-related information into individual synopses and rose to the challenge of starting to develop urgently a strategy for responding to the many expectations expressed. The synopses were the technical forerunners of the Regular Reports.

Fact-finding and monitoring missions

The fact-finding missions aimed at presenting the role and responsibilities of DG Financial Control for the FC Chapter and permit an initial exchange of opinions on the state of control and auditing in the country concerned. These missions were headed by the Director General and meetings were arranged with the Minister of Finance, the President of the Supreme Audit Institution, financial control inspection departments and with the ministries responsible for implementing EU funds. These meetings served foremost to explain the concept of "sound financial management" and to ensure the minister's support for the necessary administrative reforms. A mission was dubbed "fact-finding" when it took place prior to the provisional closure of the FC Chapter and "monitoring" after that event.

Monitoring (or evaluation) missions assess progress on commitments made by applicant countries and recorded in EU Common Position Papers, the Regular Reports and the Monitoring Tables. Between mid-1998 and early 2004 some 70 to 80 missions were made to applicant countries, an average of between 5 and 6 per country until the provisional closure of the FC Chapter. Visits to the Commission in Brussels from the authorities of applicant countries were frequent.

Regular or progress reports and monitoring tables

Every year during the negotiation process, the Commission issues a Regular Report (RR) for each applicant country covering all the negotiation chapters. A RR gives an overview of the extent to which a country fulfils the "acquis" requirements. Progress towards meeting each criterion is assessed on the basis of a standard checklist to ensure the exercise is transparent. The reports are drafted in July and are subject to intensive informal inter-departmental consultations, in which many sources play a role: EU delegations, the National Programmes for the Adoption of the Acquis, SIGMA baseline papers and of course DG Budget's own findings. The final text is decided upon between DG ELARG and DG Budget following a formal inter-departmental consultation in September and is benchmarked against previous commitments and their level of implementation.

When an applicant country approaches the stage where the FC Chapter might be provisionally closed, DG ELARG updates the Monitoring tables regularly using input from DG Budget. These tables provide a full overview of the remaining commitments and/or requirements. Six months before the planned date of accession, the Commission presents the Council with a Comprehensive Monitoring Report on the country. This report is the last Commission Opinion before the accession date and analyses both the progress made and the remaining commitments.

Training seminars for national civil servants

Until 1998 DG Financial Control organised training seminars for officials in PHARE Project Monitoring Units responsible for the management and control of EU funds in each of the applicant countries. Thereafter until 2002 DG Financial Control organised training seminars for the national financial control organisations. The first seminar of this kind was organised in Brussels in 1998 for Hungary, the Czech Republic and Slovenia. Speakers at the seminars included representatives from the European Parliament (COCOBU), the European Court of Auditors and some of the Member States. A panoply of topics would be discussed; usually covering financial control instruments, internal audit in the Commission, PHARE audit trails, controls for the Cohesion Fund and ISPA, Regional Funds, Traditional Own Resources and Customs. The EAGGF Guarantee audit trail was used as an example for national control systems use. Later, more attention was given to the concept of **PI*f*C**, audit methodology, risk assessment, DIS and EDIS for controlling EU Structural Funds as well as parliamentary control systems. The training seminars were primarily organised to make their audience acquainted with control and audit in the Commission and other European institutions and to allow them to meet with colleagues from these institutions and from other countries. Of course the seminars could not fulfil or replace the detailed day-to-day work the applicant countries needed to undertake to move to compliance with the EU requirements. This had to be left to external private-sector consultants and later to SIGMA and to Twinning Partners from Member States.

Further seminars were organised in Brussels for Poland and the Baltic countries (April 1999), for Bulgaria, Romania and the Slovak Republic (March 2000), for Cyprus and Malta (March 2001) and for Turkey in Ankara (March 2002). In 2003 the organisation of these seminars was transferred to TAIEX.

TAIEX is the Technical Assistance and Information Exchange Instrument of the Institution Building unit of DG Enlargement of the European Commission. Since 1996, TAIEX has provided centrally-managed short-term technical assistance in the field of approximation, application and enforcement of EU legislation. Its services are complementary to several European Commission assistance programmes offered to the EUR-12, new applicant countries and the western Balkan countries. Since 2006, TAIEX is also available to the European Neighbourhood Policy Countries and Russia. The twin roles of TAIEX are a catalyst, channelling requests for assistance as well as a facilitator; acting as a broker for the delivery of appropriate tailor-made expertise to address problems at short notice.

Its main tasks are providing:

1. Technical assistance and advice on the transposition of the "acquis communautaires" into the national legislation of beneficiary countries and on the subsequent administration, implementation and enforcement of such legislation (information brokerage by gathering and making available information on the Community acquis);
2. Technical training and peer assistance to the acceding countries;
3. Technical assistance to the officials of the administrations of Bulgaria, Romania, Croatia and Turkey, the western Balkans, the Turkish Cypriot Community, the European Neighbourhood Policy Countries and Russia;
4. Database tools for facilitating and monitoring the approximation progress as well as to identify further technical assistance needs

Its services comprise: expert visits, study visits, seminars and workshops, training, monitoring, database and information products and translation; TAIEX supports the Commission services and DG Budget in organising seminars for civil servants in national, regional or municipal public administrations and associations of local authorities in the area of **PI*f*C**. In 2000, in co-operation with DG Budget, TAIEX organised several Seminars on "Community own resources" in the new Member States and applicant countries. In 2003 a meeting for Turkish, Romanian and Bulgarian nationals responsible for financial control in their administrations and in October 2004 a seminar for officials of the Croatian Ministry of Finance took place in Brussels.

The FccWebsite

The link to website: https://forum.europa.eu.int/Public/irc/budg/Home/main

You need a user-id and password for this site, which can be obtained through a simple email to budg-fccweb@ec.europa.eu.

The acronym "FccWebsite" stands for "Financial control contact Website". DG Financial Control started developing it in 1996. It provides a platform for **PI*f*C**-related exchange of information and is based on the Communication Information Resource Centre Administrator (**CIRCA**) technology which is located in Luxembourg. DG Budget has inherited the FccWebsite. The most important service provided by the website is the vast database of **PI*f*C**-related policy and legal texts. Over the years the database has been fed with policy documents and primary and secondary legislation as well as regulations relating to **PI*f*C**-matters in all applicant countries and can be consulted by anyone who has a specific interest (whether officials or non-officials) in understanding and/or developing **PI*f*C**. Basically, the database is split into two categories: one is horizontal and contains documents on horizontal issues like training seminars, Contact Group meetings, CHU-workshops etc. and the other category is vertical: it provides all **PI*f*C**-related documents for each Member State and applicant country, including progress in western Balkan and ENP countries. Many of the documents mentioned in this book are available on the FccWebsite.

Joint audit arrangements[1]

When talking about internal control, most people have expenditure in mind. However, for **PI*f*C** internal control relate to both income and expenditure. The internal control rules for income (and for assets and liabilities!) should follow the same standards and be of the same quality as those for expenditure. During the first discussions in the European Council Working Group on Enlargement, the Austrian Delegation drew attention to the system known as "Joint audit arrangements" in the Traditional Own Resources (TOR) area. This completely separate initiative dealing with only one aspect of a Member State's control system grew independently in DG Budget but of course intersects with **PI*f*C** thinking. The topic is described here only as an illustration. As the Joint audit arrangements are based on voluntary initiatives, they are not part of the *acquis*. Although as we shall see should the newly-joined States wish to take part then thanks to **PI*f*C** they could.

TOR are customs and other duties and levies collected by Member States (in 2004 the total amount was €12.3 billion or about 13% of the total income components of the European Union of €95 billion). Each month Member States transfer 75% of the amounts they have collected to the EC; the remainder they keep as com-

1 Based on discussions with Ms Westley, DG BUDG.B.3

pensation for the collection costs. The Commission makes inspections in Member States (under Regulation 1150/2000) checking that the correct amount of TOR has being made available to the Commission on time and that Member States have an appropriate infrastructure to collect and account for TOR in conformity with the relevant community legislation.

The joint audit arrangement grew from concerns of the Heads of Internal Audit in the Danish, Dutch, Portuguese and UK customs departments. They were using or were experimenting with using systems-based audit techniques. They considered that the Commission's inspection approach did not take any account of the internal control framework in the organisations being inspected and so the Commission might not properly evaluate the risks relating to the reliable collection of TOR. They presented the Commission with a prototype of an audit tool based on their joint analysis of the TOR collection systems in their States. It identified the key points and testing markers in those internal control systems.

The tool became known as an **audit module** (it is a combination of identification and evaluation of system objectives, an internal control questionnaire and a test programme). The tool particularly highlighted the need for strategic audit planning, for establishing key risks and controls and for including the quality and coverage of internal controls performed by the Member States in any assessments made for assurance purposes. Used by experienced auditors it could be an effective roadmap for establishing how far objectives had been fulfilled and to evaluate the adequacy of internal control.

The Commission acknowledged the advantages of the techniques used in the audit module and started to adapt its inspection methods moving towards using systems-based techniques to evaluate internal controls and reflecting in the resulting reports the audit trail that had been followed.

Originally the Heads of Internal Audit had envisaged that staff from the Member States might make up multi-national teams of 'their internal auditors' to conduct evaluations of other Member States rather than the Commission making inspections. This approach raised confidentiality problems but the Commission concluded that once it was satisfied that a Member State's internal audit systems for customs were sound and sufficiently comprehensive, then, should the Member State wish, the Commission could rely on the findings and conclusions of the national audit services to gain assurance about TOR collection systems. An important prerequisite for this procedure was that the national audit department should be independent from management. It is at this point that the link with **PI*f*C** becomes clearest as this is also an essential for **PI*f*C**. So far, bilateral agreements have been concluded between DG Budget and three national audit departments (the Netherlands, Denmark and Austria). Under these agreements the Commission and each of the Member States concerned agrees a topic in the TOR field which the internal audit department in that Member State will audit during the coming year. The starting point for the coverage and content of the audit is the audit module (there are now six such modules covering the most frequently examined areas) but this is then modulated by the Member State's own audit strategies and risk assessment. The Commission receives a copy of the report sent to management, plus a summary of the areas tested and evaluated and found satisfactory where "exception reporting" is the norm.

Under these circumstances the internal audit responsible for counselling management about the quality of its control systems recycles some of its activity to provide assurance to an external inspection department. One could argue that such a function deviates from the definitions given earlier in the book about the separation between inspection and internal audit, but also one can recognise an opportune symbiosis between the responsibilities of two different institutions for a task they have in common: namely, ensuring that Member State's systems for collecting TOR are in good order and therefore increase the likelihood that the Member State pays what is due in an appropriate and timely manner.

The Commission evaluates the internal audit report and evaluates the work done in the Member State. It discusses the methodology developed, findings and examines some of the working papers in meetings with the national audit team. The Commission reports on the evaluation findings and adopts the findings of the national audit where relevant. The Member States' response to these findings is followed up through the normal processes but implementation is quicker and easier because the process in the Member State will already have been triggered by the initial report from internal audit. Any adjustments required to TOR payments are made in exactly the same manner as they would be if they had been found by a Commission inspection.

Since the first full use of the joint audit arrangement in the Netherlands in 2000, the Commission and the Member States mentioned before have all found merits in the change in inspection strategy. The Commission obtains greater assurance regarding the suitability and reliability of the procedures used by Member States, though at some cost in terms of "hands-on" reviews of specific classes of underlying transactions. For the Member States concerned, they have been able to harness their own systems for internal control assessment and evaluation to provide assurance to an outside organisation by giving wider distribution to the advice they are delivering to their own management client. There may be extra cost involved to the extent that some additional auditing might be necessary.

Since in all EUR-12 countries independent internal audit departments have been established, the road to joint audit arrangements between the Commission and the EUR-12 had been opened up. The first new Member State to join the Commission in this initiative was Hungary. In November 2005 the first bi-lateral agreement was signed in Budapest, providing another positive spin-off from the **PI*f*C** negotiations.

7. Networking and Technical Assistance

Networking with the Contact Group for European Financial Control Organisations; the Central Harmonisation Units, Ministries of Finance, the Supreme Audit Institutions; technical assistance and national twinning partners from Member States; the DGs concerned (DGs ELARG, RELEX, AIDCO, ECFIN, OLAF); the CHU workshops; the European Parliament (COCOBU); the European Court of Auditors, SIGMA of OECD, the World Bank, PEFA and other institutions like the INTOSAI, the IIA, the ECIIA and the IIA country chapters, PEM-PAL

The EFCO Contact Group

In February 1998, DG Financial Control established a secretariat to organise a series of annual gatherings of Member States and applicant countries which would allow networking between the participants and the Commission in the area of public internal control. Other organisations with an interest were also invited, including the European Court of Audit and SIGMA. The grouping was referred to as the Contact Group for European Financial Control Organisations (in short the Contact Group). In the opinion of its participants the Contact Group provided an excellent and much needed forum in which to discuss applicant countries' progress with **PI*f*C**. First let's shed some light on the Group's history.

On 3 December, 1997, the President of the Hungarian Government Control Office (GCO), Mr RUBICSEK, informed DG Financial Control that he planned to establish an "Association of European Government Control Organisations" (following the examples of the EUROSAI and INTOSAI), combining the members of the EU and the former Warsaw Pact. This association was intended to become DG Financial Control's formal correspondent (counterpart) and would be a self-financing, non-profit-making civil organisation and a permanent forum for national government control organisations to exchange experience and the use of methodologies. To organise the first Association Conference the GCO suggested the EU contribute ECU 144,000 via the PHARE programme.

However, the Commission decided that establishing a network of national auditors outside the fold of the European Union would overlap considerably with its planned June 1998 London Seminar for Member States and Applicant Countries. This was being organised by DG Financial Control within the framework of its bilateral administrative arrangements with these countries – the "protocols". So no

PHARE contribution was forthcoming. Instead DG Financial Control proposed establishing a contact group to support networking by the internal financial control authorities in the applicant countries. The rationale was explained by DG Financial Control as follows:

> *"The objective is to create a forum for the development and exchange of ideas and methods in the field of government control of finances* ***not only for European Union funds, but the whole range of government expenditure****. Since there is already a rich fund of knowledge and expertise in the PHARE countries and in the Member States, it is essential to harness and develop that expertise through a flexible network. The idea of the Association with an elaborate legal framework of rules and procedures and the fees needed to set up a headquarters organisation would be time-consuming and distract from the more immediate purpose of developing a common methodology and taking the best out of our different control and audit systems and traditions."*

In July 1998, DG Financial Control and the GCO sent a letter to Member States and applicant countries announcing the establishment of the EFCO CG. Invitations were sent to Member States, applicant countries, the European Court of Auditors and SIGMA.

The **Contact Group** was established by an exchange of letters between DG Financial Control and those who volunteered to be members. Third-party countries could be invited and the Chair was to be occupied in rotation by a representative from either an applicant country or a Member State with DG Financial Control as the co-chairman. DG Financial Control was to provide the financing and secretarial assistance to organise the Contact Group and for maintaining contacts with the European Court of Auditors and the Commission services.

The objectives of the Contact Group were the following:

1. Sharing experience in matters of government control of public finances;
2. Exchanging and disseminating information on control methodology;
3. Encouraging relevant research and studies by members;
4. Illuminating relevant concepts used by members and
5. Supporting PHARE countries in consolidating and adapting their control and audit structures to deal with the flow and use of PHARE funds and later, Agricultural Guarantee and Structural funds.

The annual work programme consisted of updating country-related synopses (prepared by DG Financial Control); providing support for producing audit trails and audit manuals and exploring the role of information technology in audits and controls.

Until the Berlin Contact Group in 2000, the annual meetings were organised back-to-back with the meetings of control organisations in Member States responsible for control of Structural Funds. But as a result of the Commission Reform in 2000 responsibility for the FC Chapter was transferred from DG Financial Control to DG Budget and the responsibility for co-ordinating control of Structural Funds passed to DG REGIO, so the two meetings were split. The Contact Group started its own life at the Tallinn meeting of October 2001, organised by DG Budget.

The then Commissioner for Budgetary Affairs and Financial Control, Ms Schreyer, showed a high degree of interest and participated actively in nearly all the Contact Group meetings. She strongly supported the development of up-to-date internal control and audit systems in applicant countries as a sound basis for the management and control of EU funds. But in the deliberations on whether or not to continue the Contact Group beyond the date of accession of 1 May 2004, the Commissioner confirmed that in the absence of a legal basis for the Commission to express opinions on the reform of the Member States' national control systems the Commission would stop financing and providing secretarial support to the Contact Group. The last Contact Group meeting took place in Vienna, October 2003, during which the Commission tried to combine **PI*f*C** discussion issues with those pertaining to control of Traditional Own Resources. That agenda was not successful as the usual Contact Group members found "their" discussions on the wider issue of developing national internal control systems hijacked or overshadowed by the more narrowly-defined issues relating to the inspection of EU revenues.

Assessing the Contact Group meetings

The annual meetings of the Contact Group had focused especially on the progress applicant countries were making with **PI*f*C** within the framework of the accession negotiations. The meetings provided an opportunity to share opinions and experience in realising **PI*f*C** criteria. Applicant countries could discuss with Member States their experience in developing various new concepts of public internal control and how to best establish new organisations to deal with these concepts. The Group meetings were a platform for discussion amongst equals in the applicant countries and Member States analysing the bottlenecks found as traditional inspection systems were being replaced by public internal control systems based on international standards and methods.

From the beginning in 2000 the Group suffered from a mismatch in the composition of delegations. The EUR-15 mostly sent representatives from specialised EU fund-control bodies rather than the policy bodies responsible for developing national internal control concepts. On the other hand, applicant countries sent representatives from their Central Harmonisation Units responsible for developing overall internal control policies. As a result, the discussions were mainly between CHUs and the Commission with material contributions from just a few Member States (UK, the Netherlands, France and Germany).

Surveying all the agenda for the meetings shows these areas of common concern: how to assess **PI*f*C** progress in applicant countries and progress in the field of management and control of EU funds. Other specific themes included: the true meaning of 'having a functionally independent internal auditor', the difference between 'inspection' and 'internal audit'; institution-building, trends in public administration management and control systems, risk assessment/risk management, performance audit, internal control self-assessment, and the role and localisation of OLAF-like institutions in applicant countries.

All of the applicant countries and most of the Member States highly valued the co-ordinating role the Commission played in the Group discussions and the working of the CG. A large majority of the members of the Contact Group were in favour of continuing the work; they asked the Commission to consider broadening and consolidating the Group's approach in order to continue the successful co-operation already achieved. They wanted the Commission to remain the driving force and play a proactive and facilitative role by ensuring that the network would be able after accession to continue exchanging and sharing experience of good practice, current common policies, and issues and methodologies. This opinion was fully shared by the representatives of the European Court of Auditors and of SIGMA.

The Commissioner's decision to end the Contact Group stopped discussions on public internal control systems at the level of the enlarged group of 25 Member States. In fact, the initiative to build a permanent association of European Internal Control Authorities (as advocated by Hungary back in 1997) was placed back in the hands of Member States.

Efforts to revive a regular discussion platform

There have been several efforts to revive the Contact Group since. In the framework of the SEM 2000 project, in 1996, the Commission had established a group of personal representatives (PRG) from the Ministries of Finance in Member States to provide advice on improving co-operation between the Commission and Member States on financial management issues. Over 80% of EU expenditure is managed and controlled by Member States. The PRG group first reported to ECOFIN and the European Councils in 1996 and was planning to meet twice or three times a year to follow up its recommendations. The reforms (both in substance and procedure) were to cover creating a network in Member States on budgetary questions as well as a number of measures and procedures for dealing with the rules for control of Structural Funds. The experience of the PRG members was to be drawn upon particularly to the Agenda 2000 reforms. The Group was expected to write progress reports on the implementation of Administrative Co-operation Agreements with applicant countries and to serve as a forum to discuss the redrafting of the European Union's Financial Regulation. In July 2000 DG Budget suggested including the issue of "Financial control in applicant countries" for discussion in the Group's meeting in December 2000. However, the PRG group stopped convening.

In a discussion paper of 22 October 2003, circulated during the Vienna Contact Group meeting, DG Budget suggested to:

1. Redirect the current CG activities towards a new helpdesk function in the Commission that would preserve the know-how and support new policies;
2. Establish and maintain a database on Member States' laws and regulations relating to the national internal control systems;
3. Provide expertise and support to the new MS, DG ELARG and twinning-operations covering the implementation of the EU Transition Facility (see next page) and
4. Maintain the current **PI*f*C** activities with regard to the three remaining applicant countries RO/BG/TR and to potential new applicant countries, strengthen the CHU platform by organising further annual meetings to share experience, determine best practice, solve bottlenecks and allow feedback to further evaluate measures and improve the performance of CHUs (initially for a period of three years).

Since the Commission could not advise Member States on how to organise their national control and audit systems, any discussion of **PI*f*C** between the Commission and Member States was to be on a voluntary case-by-case basis. It would be free of course for, any Member State to suggest the European Council to recommend to the Commission that a platform be re-created for discussing internal control issues amongst peers. In the same spirit it would be welcome were Member States to inform the Commission about any further (progressive) changes in the development of their public internal control systems.

In May 2004, the Dutch Ministry of Finance and the Dutch chapter of the Institute of Internal Auditors organised an International Conference entitled "Meeting your Colleagues", aimed at key players in the area of public and private internal audit and discussing public auditing experiences and developments. The Dutch Minister of Finance, in his keynote speech, referred to the need to establish a Contact Forum for Public Internal Audit. He expressed his hope that initiatives would be forthcoming from Member States and the Commission and said that he would raise the issue in the Council during the Dutch EU Presidency in the second half of

2004. This was welcomed by i.a. the representative of the European Court of Audit who circulated draft terms of reference for a contact forum of directors of (central) internal audit departments in EU Member States. Objectives as well as institutional and financing proposals were included. However, the issue was never raised in the Council and no further initiatives were taken. The next big European event in the area of internal audit will be the hosting of the Netherlands of the IIA World Conference in Amsterdam between 8 -11 July 2007 catering for internal auditors in both the private and public sectors. In this context, the PEM-PAL initiative of the World Bank to host platform meetings for internal audit institutions of European and central Asian countries is also worth mentioning (see page 144).

The CHU workshops

After May 2004, DG Budget took the initiative of replacing the high-level official CG meetings by informal hands-on workshops for the newly-established Central Harmonisation Units in the EUR-12 and for those already established in the remaining applicant countries. CHUs had only just begun functioning in the new Member States and were looking for their proper places in the framework of **PIƒC** implementation. They faced considerable challenges (and still do). The Transition Facility (Act of Accession 2003, article 34) (TF) provides further support in this area. The TF assists the new MS in their efforts to strengthen their administrative capacity to implement Community legislation. It is a temporary instrument designed to cover the period from accession 2004 till the end of 2006. National programmes will be drawn up to address the need for consolidating administrative processes and institutional structures, guided by the shortcomings as identified in the Comprehensive Monitoring Reports. Financial Control is one of the areas covered by the TF.

DG Budget organised three such workshops (see appendix 18 for the main conclusions of the three workshops). The first took place in Leuven (Belgium) in June 2003; the second in Balatonösződ (Hungary) in December 2004 and the third in Bled (Slovenia) in March 2006. The workshops aimed to consolidate the CHUs' achievements and to share information on the bottlenecks encountered in each of the countries in further implementing **PIƒC**.

The general conclusions of the **Leuven workshop** reflected the common concerns expressed by the majority of the CHU representatives. These could be grouped into 5 main areas:

First was management's low degree of awareness of the rationale underlying **PIƒC** principles and the unsatisfactory level of hierarchical support for CHUs' work.

The second was the high priority that needed to be given to raising the quality of internal audit – failing to achieve this was thought to be a determining factor in the deterioration of the role and status of functionally-independent internal auditors. The third was CHUs' visibility (organisational location, and impact on ministries and budget agencies), which needed strengthening as did their networking role. The fourth was the need to improve co-ordination with Supreme Audit Institutions so as to establish a common approach to general audit rules and methodologies. The fifth concerned CHU responsibility for determining the training criteria for financial controllers and internal auditors.

The **second CHU-workshop in Balatonösződ** confirmed that, despite progress in the area, management still needed to be more alert to the advantages that internal control and internal audit are supposed to deliver. To improve this it was proposed that each CHU should develop tailor-made information and training programmes. Thus far, CHUs' had been concentrating on developing internal audit, but now they perceived a need to pay more attention to the FMC-pillar and the concept of managerial accountability through a better understanding of the international standards for internal control systems. Finally, without periodic upgrading **PI*f*C** Policy Papers could not play an important role in re-assessing the national and international developments relating to public internal control.

Management respect for **PI*f*C**'s role can only be won through high-quality delivery by the FMC and internal audit departments and through positive assessments of **PI*f*C** in operation by both the CHU and the SAI (especially in their respective annual reports). Once the post-accession Transition Facility programmes over, the European Commission will not, at least not for the foreseeable future, perform any further **PI*f*C**-quality assessments itself; the assessments should increasingly come from SAIs (this is not to say that the SAI should be the only source of **PI*f*C** quality-assessment; in chapter 8 other ways of performing assessments will be discussed). Also, closer co-operation with the national branches of the IIA will enhance the perception of the public audit approach at national level and contribute to higher levels of professionalism.

An important tangible result of the second CHU workshop was DG Budget's introduction of a new **template for CHU annual reporting** (see appendix 19). It was expected that it would be used by CHUs for **PI*f*C** Annual Reporting starting with the reports for the year 2004. Indeed, many new Member States are already benefiting from its use. The report template aims to provide concise and relevant information about progress over years in the quality of the **PI*f*C** system. The reports should permit benchmarking over time and between countries with the overall objective of continuously raising the quality of systems and reporting.

The **third CHU workshop in Bled** concentrated on the concerns the CHUs had expressed in the first two workshops. Representatives of INTOSAI were invited to explain in detail how implementation of the INTOSAI Guidelines for Internal Control Standards for the Public Sector developed by the Internal Control Standards Committee of INTOSAI (and approved by the 18th INCOSAI in Budapest, November 2004) was progressing. DG Budget had issued a questionnaire to CHUs in August 2005 on co-operation with INTOSAI asking them to assess implementation of the standards for FMC systems. The results were interesting:

Whereas most CHUs confirmed that they were actively involved in the process of internal control assessment as consolidators and facilitators (guiding and advising top management about following-up internal audit recommendations), they saw a further need to develop management supervision, management monitoring and management information systems. The majority of CHUs thought that financial departments in public administrations complied with internal control standards such as organisational structure, competence, segregation of duties, procedures, ethics and planning. However, CHUs generally assessed the overall quality and effectiveness of their FMC systems at a rather meagre and unconvincing 6 out of 10. They noted a lack of political commitment and managerial interest in the effective use of FMC as management tool plus insufficient training in the tools of risk analysis and management, self-assessment, the development of audit trails, supervision, monitoring and reporting.

So at Bled activity also focused on risk assessment, managerial supervision and relations between CHUs and SAIs. For the first time, DG Budget invited representatives from national SAIs to the workshop to discuss with CHUs opportunities for co-operation.

The CHU workshop initiatives were highly valued by all **PI*f*C** stakeholders as they brought together a large number of European public control and audit institutions on a regular basis. However, in the longer term they could not deliver the same benefits as an institutionalised forum for public internal control and they were organised only for the new Member States. The EUR-15 were not invited. These workshops too were to terminate. Unsurprisingly CHU representatives in Bled strongly voiced their concerns about this. They opined that, as CHUs steadily changed the emphasis of their work from **PI*f*C** law-drafting to implementation, it would be necessary to further define their future roles and tasks. They therefore decided to use 2006 to explore ways of re-establishing a regular discussion forum for the European public control and audit area. This forum should be open to all EU Member States and to applicant countries. At the time of writing a meeting of

CHUs is being organised by the Hungarian Ministry of Finance to discuss the issue in December 2006.

In addition, the link with the Commission developments within the framework of Integrated internal control (see page 82) may also provide in one way or another for an impetus to bring together EUR-15 and EUR-12 public control and audit bodies. The SAIs' initiative to establish a network for SAIs in the applicant and near-applicant countries together with the ECA and SIGMA could be an example for the CHUs in those countries to seek a regular discussion platform.

Finally, in its report discharging the EU budget for 2004, the European Parliament invited the Commission to restart a network for European Financial Control Organisations to discuss general EU internal control systems and foster co-operation between Member States, at the same time pleading for specific resources from the EU budget for such a network.

Co-operation with experts

The Commission could not have achieved its objectives under the FC Chapter without help from SIGMA, the ECA and the numerous consultancy firms and twinning partners from Member States. Whereas DG Budget guides and assesses the early developments in national internal control systems at a fairly high theoretical level, the detailed day-to-day and specialised work has to be left to short and long-term expert support on the spot. Before the twinning instrument was created in 1998, technical support was mainly provided to applicant countries through two channels: SIGMA and a large number of technical advisers from private consulting firms in Member States. From 1998, civil servants from Member-State governments gradually replaced consultants in Twinning Programmes.

SIGMA

SIGMA's role in the area of public administrative reform – and more particularly on the issue of public internal control since 1996 – has already been highlighted in Chapter 2. SIGMA is located in the OECD and mainly financed by the European Commission. SIGMA assists the reform and modernisation of public institutions, the design and implementation of EU programmes. It also assesses country reform progress in partnership with the governments of the former, present and future applicant countries. It is likely that the geographical scope of SIGMA's role may be extended to countries benefiting from ENP resources.

In March 1999 the Commission discussed with SIGMA representatives how best to co-operate in the area of the FC Chapter. It was decided that SIGMA would provide what are known as "Baseline papers" to support the Commission in its task of advising the Council. SIGMA was particularly well placed to cover those areas where the Commission would not have the resources to perform in-depth analytical work. "Baselines" are minimum institutional requirements for key areas like **PI*f*C** and External Audit. Five basic criteria were identified for **PI*f*C**: a **coherent and comprehensive statutory base** defining the principles, systems and functioning of FMC systems, **relevant management control systems** and procedures, a **functionally-independent internal audit** mechanism with relevant remit and scope, and systems to **prevent and take action against fraud and irregularities** and to **recover any amounts lost** because of fraud, irregularities or neglect. The first baseline papers for internal control were produced in the summer of 1999 and continued up to 2004 for the EUR-10 (the exercise is still ongoing for the remaining candidate countries). Baseline reports provide the Commission with benchmarking tools for assessing progress in the applicant countries, these assessments being included in the Regular Reports. SIGMA has also started producing baseline papers for external audit and other related areas.

Co-operating with SIGMA has proved to be a highly successful investment, beneficial both to the applicant countries and the Commission. The Commission considered that the knowledge SIGMA obtained while preparing the baseline documents made it the best-placed organisation to perform Peer Assistance Reviews (PARs) with the responsible national bodies. PARs are self-assessment exercises, carried out by the relevant control organisations of a country supported by independent SIGMA peers often drawn from old Member States' public services. The PAR concept is based on SIGMA's experience gained from similar exercises in applicant countries' SAIs. The Commission's role is to assess the risk to **PI*f*C** implementation in each country and suggest a timetable prioritising PARs for those applicant countries that would benefit most.

The initiative for a review must come from the government or the Ministry of Finance writing to SIGMA to formulate an agreement as to the purpose and scope of the review. Both the country's and SIGMA's experts are "peers" discussing issues and problems as equals, and the results of the review are owned by both. A key advantage of Peer Reviews is that they allow Ministries of Finance to demonstrate confidence in and commitment to developing public internal control systems in accordance with international standards and to show the progress they have made in achieving this. The review should enhance the government's understanding of the **PI*f*C** principles, help solve technical and organisational challenges, mobilise support and guide the change process through well-planned and well-organised steps. The overall purpose of the PAR is to help the country meet its commitments in the area of **PI*f*C** up to and beyond the date of accession.

The peers finalise the PAR Report after detailed discussions of the draft conclusions. SIGMA then makes detailed presentations of the agreed results to the Ministry and other Government officials, to the Commission and the EU Delegation, and if necessary to the national Parliament.

Co-operation between DG Budget and SIGMA has developed into a close joint venture with a common mission: i.e. helping the applicant countries understand the need for internal control reforms and taking the steps to prepare those countries to comply with the requirements set by the Commission. SIGMA and DG Budget have become closely involved in one another's networking and training activities.

Technical Assistance and Twinning Arrangements

Some reflections on Technical Assistance

Most technical assistance with **PI*f*C** and External Audit is delivered by consultants (either individuals or private consultancy firms) or twinning partners (in various national combinations) in short or long-term assignments. Although the need for good technical assistance is beyond doubt, it is still important to assess its value in more detail.

An interesting and pertinent self-assessment of the value of technical assistance in post-communist countries can be found in a recent Carnegie paper called "Lessons not learned" (Channel: 2005). The paper recognises *mistaken assumptions* about the role of law, government and culture in the development process as one of the main causes for failure to learn. It also believes that *incentive structures* (read benefits to consultants) in the TA industry do not really encourage learning.

The paper mentions three common and persistent problems when beneficiary authorities move from legislation to implementation. These problems are:

1. **Lack of ownership** (hasty transplants from foreign systems to local legal cultures):

The overall law reform processes have not permitted users to participate in adapting the draft law to local conditions. This can be the result of adopting too quickly the products of small, elite working groups or of the desire to put concepts into law prematurely usually because of the need to satisfy the overseeing authorities (internal or foreign). This may cause users who feel excluded from the process, and who were not consulted for their knowledge and consent beforehand, to resist fundamental changes. Few beneficiary governments have developed adequate mechanisms of political transparency and accountability, so wider participation, input and feedback, which are all essential for the success of the project, have been blocked. This has also to be seen in the wider framework of internal resistance to further empowering the State, and in the case of **PI*f*C**, the Ministry of Finance.

2. **Insufficient resources** to permit sufficient absorption through discussion and sustained participation in the process of reform:

The difficulty is finding a balance between paying TA staff to draft a law and funding a wide-ranging programme of public education and institutional reform. Time is an important factor. Whereas the legal procedure for important reforms from inception to law may take anywhere between 5 to 10 years in a democracy; legal reform in post-communist countries was expected to move much faster. Indeed, in the case of **PI*f*C**, some laws were adopted with sometimes mind-boggling speed without much regard for the consequences.

3. **Excessive segmentation**: narrow diagnoses and responses to legal shortcomings ignore systematic problems and fail to provide for an integrated and effective approach.

The paper draws conclusions that will be helpful when benchmarking the performance of twinning projects in general and those of **PI*f*C** in particular. It seems that project design and selection processes reward repetition rather than innovation; incentives (salaries, etc.) encourage storage of knowledge rather than publication. Motivated consultants should participate in ongoing education and learning, and a competitive market should make TAs stay ahead of developments so that they can provide better services to clients. These requirements, however, do not seem to apply in the present business of TA or Twinning. Published papers and reports on lessons learned are read by very few people. Active and critical analyses on this theme should be available in a structured and accessible system, although too often they are not.

The incentives mentioned earlier suggest that admitting past mistakes is not good for obtaining the next contract. Analysing and commenting on tender proposals cost money. Improving the overall project proposal may be self-defeating for the contractor and thus reduce his competitive edge. Much of what is available in the literature is not worth the effort of reading and many of the better documents are not available at all for a variety of reasons, mainly political sensitivity. Reporting on unsuccessful aspects of the project may reduce the flow of funding and contractors know how to make mistakes and failures look like successes. The paper states *"that there is an unintended but natural "conspiracy" perceived as inherent in telling the truth to characterise weakness as strength and failure as success to avoid any sanctions"*. In one of the western Balkan countries for example, a follow-up TA project is meeting with continuing failure by the beneficiary government to take an interest in the project. Rather than persuading the beneficiary to take responsibility - or, should that not be successful, ultimately stopping the project - piecemeal solutions are sought that in the end risk jeopardising the objectives of the entire project and wasting money and efforts for a second time.

Finally, the paper concludes that supply and demand are not sufficiently connected. Although the paper is primarily about the legal reform market, the same pretty much applies to the public internal control reform market where monopolies also exist. Both markets are principally driven by suppliers. Donor nations and TA firms compete to provide assistance based on their own needs to influence the beneficiary for a number of reasons: altruism in improving socio-economic conditions, self-interest in improving markets, or foreign policy concerns of rewarding collaboration. Recipient countries are not generally shopping for services in a competitive market, but are offered free or subsidised assistance on a take-it-or-leave-it basis. Who would say no to a donor or to a contractor, especially if he seemed to be the only one available? Since the support is for free, beneficiaries do not determine success or failure; donors do this job. Therefore, the lessons learned by contractors relate primarily to pleasing donors to ensure further contracts, which do not require significant performance adjustments.

The conclusions to be drawn from the foregoing are that twinning in the **PI*f*C** sector should be directed towards a longer-term framework or master-plan for a period of, say, 7-10 years and not towards piecemeal solutions like training some auditors or just drafting a **PI*f*C** Policy Paper. The process of support should be well-planned and co-ordinated at the highest possible level avoiding overlap with other donors. In this respect we should mention here the new initiative of the SAIs' Joint Audit Working Group developing a "twinning practical guide" based on earlier experience with twinning partners. This initiative is a welcome step and should be emulated by CHUs for their own twinning experiences.

Twinning

Twinning is a form of technical assistance, where government officials from donor and beneficiary countries co-operate to achieve public administrative reforms. Twinning was launched by the Commission in 1998 as a major instrument to assist applicant countries in strengthening their administrative capacities. Twinning transfers knowledge and experience from the public sector in Member States to an applicant country, for a period of twelve months or longer, to assist them in acquiring the capacity to adopt, implement and enforce the *acquis communautaires*. For shorter periods, there is "Twinning Light". In the words of Commissioner Verheugen (Twinning in Action, October 2001), "Twinning is a unique instrument to pool the expertise of Member States' administrations for the benefit of the applicant countries and provides a unique learning experience and exposure for both sides". This means that not only the beneficiary countries benefit. Indeed, some civil servants from the main donor countries have said that their early **PI*f*C** experience in applicant countries helped to unlock or stimulate public internal control discussions in their own administrations.

Twinning contracts are concluded directly between the recipient applicant country and the tender-winning Member State. The Commission pays under the relevant programme. The European Court of Auditors has commented in one of its sector reports[1] that twinning partners have not always been aware of the precise requirements regarding **PI*f*C** systems and in some cases simply tried to "promote" their own national control systems. This phenomenon, widespread in the early days of twinning, caused considerable confusion in applicant countries searching for the best mix of standards and methods in public internal control.

The "markets" for twinning in public internal control and in external audit are concentrated in the hands of a few players (Member States). The statistics[2] show that between 1998 and 2005 a total of over €37 million was spent in these two areas. This is about 6.8% of the overall spend of €471m on twinning across all areas of administrative reform during the same period. The €37m can be divided into €25m for PI*f*C-related activities and €12m related to external audit activities. The average contract value for both a PI*f*C and External Audit development project is around €1m. Nearly 72% of the PI*f*C-related twinning is provided by one Member State: France, while about 67% of external audit-related twinning is provided by another: the UK. These figures should of course be seen in the broader context of the overall twinning exercise, including many other sectors, aiming to provide support to a large range of administrative reforms. However, the purpose of this chapter is to assess the impact and effectiveness of the twinning experience relating to the area of public internal control.

High geographical concentration does not necessarily bring the highest possible benefits. Certainly the shortcomings in consultancy identified in the Carnegie-paper (see above) on "Lessons not learned" apply to Twinning projects. Applicant countries are strongly advised to shop around (using their networking capacities or those of the Commission) in those Member States which have civil servants with considerable experience in developing and implementing public internal control. A

1 European Court of Audit, Special Report no. 6/2003, concerning twinning as the main instrument to support institution- building in candidate countries, 10 April 2003, OJ C 167, 17.7.2003

2 EuropeAid Co-operation Office: Institutional Twinning Thesaurus PHARE-CARDS-Transition Facility-TACIS-MEDA: Version 3 of 2006

number of Member States are familiar with the public internal audit profession and have established transparent internal control systems. Because of the low degree of competition in both internal control and external audit markets, shopping around may not always be easy, but it is important for both parties to avoid potential disappointments that might damage efforts to establish good administrative structures for establishing **PI*f*C**. Applicant or third-party countries would be well advised to "shop" around in Europe for possible partners and not always rely on the immediately available offers. In this respect, both the applicant countries and the Member States should be more proactive in matching with the right twinning partners to secure satisfactory results.

There is another recent development to consider here. Whereas in the past TA firms were always chosen for their experience in the subject area, nowadays there is a tendency to select "brokers" rather than expert firms. These brokers bring together experts and contracts. The broker maintains a panel of experts that will often be the same as panels maintained by other similar brokers in the market. The broker has someone experienced in writing bid proposals but less so (or not at all) in the subject matter. The broker also knows not much more of the experts than what their CVs tell him and it is common knowledge that CVs are massaged to the extent that aid agencies will consider the person concerned to be the more or less perfect match. Job winning comes first, to be followed by the final composition of the team of experts to be dispatched. The problems of this procedure surface when teams are composed of individuals coming from various national backgrounds (especially in the case of Francophone and Anglophone backgrounds in the framework of PIFC) and when tensions arise for technical or personality reasons. This problem is compounded by the habit of aid agencies of becoming too specific in their contractual requirements. There is an increasingly important role here for the contractor (the relevant authorities in the beneficiary country), who should ask the TA provider (the firm or broker) for ideas about how a particular objective should be achieved in a particular country with the best deployment of staff, over what period and at what cost. This would sort out those who know from those who do not.

DG Budget provides advice to DG Enlargement and the Ministries of Finance of applicant countries on drafting the Terms of Reference for twinning contracts. Once the twinning partners have won a contract and are on their way to the applicant country to take up their posts, advice is given individually to the twinning partners on their roles in promoting the **PI*f*C** concept. Despite the monopolistic tendencies in both twinning markets, the overall impression is that twinning projects have increasingly substantial benefits as long as the partners chosen have ample experience in the fields they are going to develop.

In the case of the western Balkan countries, support is still provided mainly through technical assistance from private companies, including non-European agencies, like USAID, but twinning with Member States' administrations is gaining ground. In most cases the technical advisors in the western Balkan countries have a fair knowledge of the comprehensive nature of the **PI*f*C** concept. Nonetheless, it remains difficult to convince national authorities to take the lead in transforming their control environments and become the owners of change. Too often a strategy is being developed by the advisors without the active participation of all stakeholders in the government. It then risks being adopted by the Ministry or Council of Ministers without a clear view of the far-reaching consequences for managerial and control behaviour and for the requirements in terms of reorganisation and staff training. This is a complicated process that requires careful attention to fully understand all the implications.

The IIA

The contacts between DG Budget and the Institute for Internal Audit, the European Confederation of Institutes of Internal Auditing and the national branches of the IIA have been intensive in the area of training and certifying internal auditors. Senior representatives of the two institutions were invited to several Contact Group and CHU meetings. DG Budget of course used the IIA/ECIIA standards in appendices 9 and 9A as the basis for **PI*f*C** development. In addition it strongly supports the creation of local branches of IIA in all **PI*f*C**-developing countries plus the participation of its national counterparts therein as a way to promote the status and development of a public internal audit function. A strengthening of relations between all the relevant partners (ECIIA, national IIA chapters, CHUs, SIGMA, SAIs, INTOSAI, DG Budget – e.g., in organising international meetings, seminars and even certification programmes) – will add to the status of public internal auditors. The ECIIA, for example, is presently considering widening its exam papers to include questions on **PI*f*C** to provide its Certified Government Auditing Professional (CGAP) with an extra European dimension to test candidate graduates from Europe.

The European Court of Auditors and the SAIs

In 1993 the European Court of Auditors and the Supreme Audit Institutions of the central and eastern European Countries met to establish closer relations for exchanging experience and practice in the field of External Audit. SIGMA too was closely involved. A number of working groups were created to discuss and then report on topics of common interest to the Annual Meetings of SAIs. One such group was the Working Group on Audit Manuals. In December 2002 a sub-group on internal control systems was created, called the "**PI*f*C** Expert Group". This group presented a report on its activities to the SAI meeting in Riga on March 31st, 2004.

The Expert Group concluded with the following recommendations for a well-functioning **PI*f*C** system:

- Clear management responsibilities;
- Creation of an effective internal audit function;
- Competent staff and adequate training programmes;
- Clear legal framework defining **PI*f*C**;
- Positive attitude of the management towards **PI*f*C**;
- Adequate and effective reporting system;
- Reliable and secure IT management information systems;
- Sound accounting practices and application of relevant international accounting standards;
- Cost-effective control resources and the use of risk-assessment/management and
- Cost-effectiveness of the **PI*f*C** system.

These recommendations cover many of the concerns that were expressed by CHUs during their Leuven 2003 workshop. The need to persuade and encourage management to understand and appreciate the role and functions of the internal auditor stands high on the agenda as does the need to adequately define and consistently apply the definitions of internal control and internal audit. Other recommendations were the need to establish good working relations between internal audit units (and between the IAUs and CHUs) and to focus on training practice (organising pilot audits in weak areas).

The recommendations of the Expert Group were timely and relevant. Timely, because external monitoring and assessment of **PI*f*C** progress – previously the responsibility of the Commission within the framework of the accession negotiations – were to become the responsibility of SAIs. Relevant, because these recommendations provided the framework within which the SAIs would be assessing and guiding governments in their continuous efforts to promote sound financial management and control.

When visiting applicant countries, DG Budget usually has meetings with the Supreme Audit Institution. These meetings are to inform the SAI of the progress the government has made in the negotiations on the FC chapter as seen by the Commission and to obtain information on the measures taken by the SAI to follow up on its own commitments. With a view to future developments in **PI*f*C**, the SAI will need to be involved as an external assessor of the entire public internal control system of the country. Conveniently, there is a useful recommendation already adopted by the Presidents of the SAIs and the ECA during their meeting in Prague of 26 October 1999: **Recommendation 11** concerning the functioning of SAIs in the context of European Integration:

> *"Supreme Audit Institutions should focus on the development of high-quality, effective internal (management) control systems in audited entities"*

This means that SAIs should be commenting on the effectiveness of a government's efforts to develop and implement **PI*f*C** in public services and so will become the external assessor of the public internal control systems. Their assessments will need to cover the entire sequence from conceptualisation in the **PI*f*C** Policy Paper, via the resulting new **PI*f*C** legislation, through implementation and finally to the operation of the new control and audit systems, including Central Harmonisation Unit(s). If a government was to decide, for whatever political reasons, to deviate from its previously chosen **PI*f*C** path, the SAI could, as assessor and as commenter on legal changes, provide advice to the government whether to move or not in particular directions. This provides the SAI with an important responsibility (see also Infringements on page 111)

During accession negotiations, however, an SAI is much focussed on its own reform processes. Much of its attention is focused on developing and reforming in line with the LIMA Declaration (see appendix 8). Only later, when it has developed in compliance with the international standards for public external audit, should the SAI become more and more "involved" in **PI*f*C** developments. It may wish to develop a thorough understanding of the internal control systems in the public administration and to make assessments and recommendations on a regular basis. The Dutch example is a good illustration of this co-operation (see page 93).

Relations between CHUs and SAIs can be set down in written agreements. As of June 2006, only Poland and Bulgaria had written co-operation agreements between their CHUs and SAIs. Although the relationships between CHUs and SAIs are usually formulated in the **PI*f*C**-related laws and in the SAI laws a number of other EUR-12 countries are considering specific agreements. Some difficulties must be overcome before a strong relationship can exist between external and internal audit in the public sector. First, the two functions of internal and external audit need to be in place and work effectively; they need to overcome old rivalries and overlapping working habits; then, the SAI should regard Recommendation 11 not as a dead letter, but as an instrument for assessing the overall healthiness of the public internal control function. There are many benefits in good co-operation. It will strengthen the common audit culture in the public sector and add to the professional exchange of ideas and experience; secondly, the economy, efficiency and effectiveness of the total audit activity is likely to increase; overlaps and duplications which are signs of inefficiency may be prevented, while the demands on the auditee's staff may be reduced. Co-operation should also focus on common training and qualification schemes and offer wider career prospects as well as job mobility and job opportunities.

In 2004, the co-operation network between the SAIs of CEEC, Cyprus, Malta, Turkey, the European Court of Auditors and SIGMA met in Riga and recommended continuing the promotion of audit activities with and among current and future applicant countries. As a result, a network of SAIs from Albania, Bulgaria, Croatia, Romania and Turkey with the ECA was established. Other SAIs may join in the future. To identify common problems and needs, a questionnaire was sent to all SAIs in the network. The replies showed the subjects of interest were: the most appropriate forms of co-operation, the preferred types and frequency of meetings and the continuation of the Joint Audit Activities Working Group. An interesting initiative is being developed in the framework of the European SAI networking, by the Twinning Expert Group. This group is charged with preparing a Twinning Practical Guide, focusing on good practices identified by all SAIS who were beneficiaries of twinning. This initiative could be a good example for similar action by CHUs that receive funds for developing **PI*f*C**.

The World Bank

The first contacts in the framework of **PI*f*C** with the World Bank were in Turkey in 2001 during discussions with the Ministry of Finance in Ankara on the drafting of the **PI*f*C** Policy Paper and the Public Financial Management and Control Act. There were subsequent contacts in Kiev in 2004, where DG Budget was explaining, at the invitation of the Ukrainian Minister of Finance, the essentials of **PI*f*C** as a possible template for administrative reform in the Ukraine government. The World Bank had made country assessments on financial accountability within the framework of budgetary support to the government in both countries. Both governments chose, with the explicit support of the World Bank, to adopt **PI*f*C** principles for further development.

The World Bank prepares **Country Financial Accountability Assessments (CFAAs) -** in-depth reviews of a country's financial accountability framework, financial management systems and practice. The CFAA identifies priorities for action, which usually lead to capacity-building delivered and financed by the World Bank. A country's financial management risks are assessed on a four-point scale (low, moderate, significant and high risk). The information obtained is also used to meet the Bank's fiduciary[3] objectives by identifying risks that may have a negative impact on its loans. The Bank may decide to provide direct budget support to countries whose level of fiduciary risk is assessed as significant or high, provided that there is a strong government commitment to reform and a positive track record. In its **Public Expenditure Reviews (PER)** the World Bank also assesses a country's expenditure policy and practice, including the underlying Public Financial Management (PFM) issues *(see below)*. PERs typically evaluate public expenditure priorities and the links between inputs and outcomes; they also analyse public sector and budgetary institutional arrangements. These documents have proved useful for DG Budget, first in Turkey and the Ukraine and later in other western Balkan and ENP countries.

The World Bank does not proffer an integrated or harmonised approach for developing public internal control in beneficiary countries. It does not have a specific "doctrine" or template for developing a comprehensive policy in this area. Influenced by the background and nationality of its experts, varying potential solutions may be recommended. For example, in some of the ENP countries suggestions have been made that internal audit be developed within the prevailing inspection departments or as part of the treasury function. Elsewhere a decentralised functionally-independent internal audit, as in the new EU Member States has been preferred. In still other cases, tranches of budget support have been made conditional on the adoption of specific internal audit laws, which in itself is good, but of uncertain benefit if there is no overall **PI*f*C** policy. The situation is often comparable with that which confronted the Commission in the early days of accession negotiations in the second half of the 1990s, when a harmonised approach towards the field of public internal control did not yet exist.

It would be helpful if the World Bank were to take the first steps towards developing an internal control "doctrine" based on the best international standards; contacts with the World Bank indicate that there is an interest in further exploring the template of the **PI*f*C** model. At least in the western Balkans and the ENP countries in northern Africa and eastern Europe, where the interests of the World Bank Public Finance Management programmes and the European **PI*f*C**-acquis meet, much benefit could be gained from a co-ordinated approach in responding to the needs of recipient countries. Contacts between the World Bank and DG Budget have been initiated to avoid the two bodies giving conflicting advice and to ensure delivery of a harmonised **PI*f*C** approach to interested beneficiary countries.

However, the World Bank is not alone in diagnosing or assessing public internal control systems in countries receiving large amounts of international financial aid or in need of administrative reform. There are many international organisations

3 "Fiduciary" is a person (or institution) who manages money or property for another entity and who must exercise a standard care imposed by law, i.e., personal representative or executor of an estate, a trustee, etc.

(including the IMF) and national aid agencies that do the same, based on a well-understood concern for the proper use of their financial aid. An important development is the PEFA initiative.

Public Expenditure and Financial Accountability (PEFA)

PEFA is a partnership between the World Bank, the IMF, the EC and several aid agencies in donor countries. PEFA aims to support integrated and harmonised approaches to assessing and - ultimately - reforming the field of public expenditure and financial accountability. PEFA is concerned that beneficiary governments and donors both make assessments before committing funds to implementing projects and programmes in accordance with their own criteria, to prevent overlap and waste of resources. The partnership therefore developed the "Strengthened approach to supporting PFM Reform" in order to encourage government leadership, harmonisation of PFM assessment and co-ordination of donor support to reform programmes. As part of this approach PEFA has developed a tool for performance measurement, which was adopted in June 2005. It is called the Public Financial Management Performance Measurement Framework (Framework for short) and covers systems of fiscal and debt management, budget formulation, budget execution, internal controls, procurement, accounting and reporting, internal auditing, transparency and external audit (PEFA 2005). The purpose of the Framework is to provide a common information pool for dialogue between government and donors on reform measures and for monitoring the impact on PFM performance of the agreed measures. The Framework consists of a PFM Performance Report and a **standard set of high level indicators** enabling the performance of a country's public financial management systems to be regularly assessed or monitored by domestic and international stakeholders in a consistent and objective manner. In the language of PEFA, the "standard set would have wide international acceptability so as to facilitate harmonisation and have a clearly defined system of calibration to ensure consistency over time and across countries".

The Framework seeks to assess the processes, systems and institutions of Public Financial Management against a set of six critical dimensions:

1. Budget credibility;
2. Comprehensiveness and transparency;
3. Policy-based budgeting
4. Predictability and control in budget execution
5. Accounting, recording and reporting
6. External scrutiny and audit.

These six dimensions are worked out in 28 standard indicators (see appendix 20) of which indicators 20 and 21 relate to the effectiveness of internal controls and internal audit whereas indicators 26 and 28 relate to external audit. So, when compared to the Framework, **PI*f*C** covers just a few indicators. However, where the Framework provides a high-level performance rating (but does not go deep enough to reveal the underlying problems in many of the PFM areas), **PI*f*C** suggests recommendations to comprehensively overcome identified weaknesses.

Closer examination reveals that indicators 20 and 21 do not assess whether there is any centralised harmonisation of internal control and of internal audit systems. This, as we have seen before, is essential to achieving consistency in those systems across central (and lower-level) government. In addition, the Framework does not differentiate between internal audit (an assessment function) and systems-monitoring which is considered to be a managerial responsibility. Moreover, indicator 21 permits internal audit to be undertaken by the government's central inspection departments, which does not seem to be compliant with international standards. The PEFA indicator is concerned with internal audit's coverage, nature, frequency and reporting, and the action taken on the basis of audit reports. It is not concerned with how internal audit is organised in order to achieve that output/impact. While this does not conflict with the IIA COSO model standards and although the indicator provides a detailed assessment of the underlying system characteristics it does not directly address the dangers lurking in combining inspection with the independent assessment functions of the internal audit.

The European Court of Audit in a special report (2/2005, its appendix 2) pointed out that the Framework does not lead to recommendations and that any diagnosis made would probably require a more thorough investigation into the causes of the problems identified. PEFA recognises that the surge in reform of public administration in beneficiary countries is highly donor-driven. It has therefore decided to provide the results of the diagnosis to governments, which may then consider their own priorities and political actions, choosing their own time for reform in accordance with their priorities. PEFA has not yet developed a platform for discussing priorities at a more detailed technical level with governments.

The Framework is the result of the legitimate concerns of donor countries and institutions about the quality of public expenditure and financial accountability and how to avoid double work and overlapping diagnoses in developing countries (for the EU more in particular the Asian, Caribbean and Pacific countries as well as TACIS). Nevertheless, the Framework can be applied very well in other types of country, in fact in all countries, existing Member States included. After one year of operation the Framework has been applied by more than 25 countries, 40%

of them Sub-Saharan countries the remainder from throughout the world. The Framework is applied with the agreement of the country concerned. On average, from tendering to final report may take from between 6-9 to about 15 months, depending upon whether the Framework is being looked at in the larger context of World Bank diagnostic work. The costs for a typical Framework diagnosis vary, depending on, for example, whether regional or local governments need to be covered, but at its simplest it will typically involve 2-4 team members for a total of 3-4 person-months. Whereas the World Bank and IMF make assessments mostly using their own staff, the EC and bilateral donors rely on contracted consultants.

The Framework is intended to measure progress over time. It is often performed annually, but it is obvious that any improvements resulting from diagnosis, will take considerable time to implement and are unlikely to show up in the indicators after just one or two years.

Both the PEFA Framework and **PI*f*C** have been sharing common geographic areas (mainly those countries covered by the European Neighbourhood Policy and the western Balkan countries) since June 2005. But they come from different directions. PEFA originates from a wider global donor interest in sound financial management in beneficiary countries and the aid harmonisation agenda, while **PI*f*C** comes from support to applicant countries working on admission to the European Union. When seen from the angle of complementarity, both tools can be used to achieve common objectives. Where the Framework covers all aspects of public finance management, **PI*f*C** deepens the indicators' diagnosis in the areas of public internal control and internal audit and provides a roadmap for reform.

As said before, the World Bank and DG Budget are discussing how to align the relevant recommendations in the CFAA assessments with the development and implementation of **PI*f*C**. The **PI*f*C** gap analysis recommended in the conceptual stage of developing can be considered a sub-set of the Framework diagnosis. The outcome of attempts to quantify how much the benefits of one activity can support the other varies much with the timing of the two activities. In the case of Framework diagnoses already made (as in the cases of Moldova, Serbia or the Ukraine), it is obvious that **PI*f*C** development can use the results as part of the **PI*f*C** gap-analysis. If a **PI*f*C** gap-analysis has already been made, the Framework diagnosis can rely on the findings of such an analysis. There may even be common exercises to achieve the same results.

The implementation of the next stages (**PI*f*C** legislation, re-organisation and training) will gradually contribute over years to the relevant Framework indicators showing improved levels of performance.

Public Expenditure Management – Peer Assisted Learning (PEM-PAL)

The World Bank, co-sponsored by DFID, OECD, InWEnt and others, started in 2006 a highly remarkable and welcome initiative by creating a network of public expenditure management professionals in various governments in the Europe and central Asia regions[4]. The initiative is called PEM-PAL or Public expenditure Management Peer Assisted Learning and aims to bring together in workshops leading government officials in Treasury and Internal Audit. The national officials will be able to benchmark their PEM systems against one another and against international standards. In December 2006 PEM-PAL organised such a workshop for internal audit officials housed in the Ministries of Finance from 19 countries (eastern European and central Asian) in Ljubljana at the “Center for Excellence in Public Finance. The objective of this workshop was to share experiences in the implementation of internal audit development or improvement projects in the region and to facilitate interaction between internal auditors in order to establish a Community of Practice for long term collaboration. For the purpose of this workshop PEM-PAL developed a wide-ranging framework for analysing and evaluating the development of internal audit in transition countries. The highly interesting results and recommendations can be found at the CEF’s website (www.cef-see.org).

4 www.worldbank.org/pempal

8. Assessing PI*f*C Implementation

Assessing achievements; the drive to find a common terminology and vocabulary; culture and age barriers; external assessments made by the Council and Commission, the European Parliament and the European Court of Auditors; **PI*f*C** ***in algorithms***

The **PI*f*C** initiative has had a remarkable impact on the public internal control systems in the new Member States. The EUR-12 countries have rebuilt their administrative systems following the **PI*f*C** model. **PI*f*C** has now become a norm if not ***the*** norm for governments who wish to follow the example of the new Member States. The new applicant countries are aware that they are subject to the same, if not more stringent, requirements for accession. This chapter will focus on achievements and their sustainability. It also explains why the progress made needs to be closely monitored and above all consolidated.

Assessments can be made in many ways and, in good audit tradition, they should be as objective as possible. **PI*f*C** has been subject to a number of internal and external assessments and should certainly continue to be so in the future. But before looking at assessments it will be worthwhile giving some thought to the "shock" the **PI*f*C** initiative has been for the beneficiaries and especially the administrations in the EUR-12 who had to take the brunt of dealing with the requirements for administrative reform.

One of the earliest and most persistent problems in contacts with applicant countries was **terminology**. It is a continuing concern. In the planned economies of the ex-Soviet bloc the concepts of managerial accountability and internal audit did not exist. Audit, inspection, investigation were all captured in one word: *control*, but this is not a specific ex-Soviet phenomenon. During international seminars on public internal control it is commonplace to hear the terms *auditing*, *controlling* and *inspecting* being used indiscriminately, as if they are synonyms for the same activity. Or take the terms *accountant* and *internal audit*; how often are they used as different names for the same function?

Where the term "audit" had to be included in legal texts, there was considerable resistance from legal experts. According to one, the term internal auditor could not be used in the law on public audit because in another law it had already been defined as being a private sector term. Or, the same word could have different meanings, depending on how it was defined in the job-descriptions of control, audit and inspection departments in the administration. The overlap of functions made it difficult to obtain a clear picture of the role and responsibilities of staff involved in public internal control.

An old word for a State controller, in all European languages, except curiously in English, is the word “Revisor”[1]. This word carries connotations of “sacking” management or worse, severe punishment – not things to look forward to with trust and confidence if you happen to be the manager! A manager’s position might not only depend on merit and/or honesty, but it could also be conditional on favouritism on the part of the revisor or his powerful organisation. It is therefore regrettable that many applicant countries have opted to keep the term in their new legislation as calling an “internal auditor” a “revisor” does not promote the real characteristics of the modern internal audit function, which are advisory rather than punitive. It was also difficult to translate terms like “sound financial management”, “risk analysis” and “risk management”. The international standards in the area of internal control were not sufficiently known and had to be discussed and subsumed into the local languages. In fact, a **new vocabulary** had to be developed: the EU Glossary for **PI*f*C** (appendix 12) was developed on the basis of INTOSAI and IIA standards while taking into account the specific aspects of the public sector. The Glossary is a tool to help applicant countries in absorbing the new terminology and definitions. When the Commission asked for Policy or Strategy Papers, there appeared to be no departments that could deliver them; in many cases there was no tradition of drafting such policies or strategies and in the early days of reform a common understanding of international terms and definitions was totally absent.

In planned economies, Ministries of Finance were generally weak and not much more than windows for money transfers with little or no role in developing financial management policies. For example, at the start of **PI*f*C** development in Poland, the government decided that the Ministry of the Interior should draft a new Internal Audit Law rather than the Ministry of Finance. Only after this failed to produce viable legislation was the task subsequently given to the Ministry of Finance. Ministries of Finance in applicant countries usually had to fight to really achieve their newly granted positions as guardians of the national budget. This new involvement and responsibility was not always easily accepted by the administration outside the Ministry of Finance.

There were **cultural and age barriers** as well: comprehensive systematic thinking about the control requirements in a market economy was non-existent and had to be developed. Internal control functions were seen as less important activities in the administration and left to staff in part-time professions (often women with other jobs) or to staff nearing retirement. It was difficult to mobilise these categories, let alone convince them to develop new systems that might have a negative impact on their own positions. Gap assessments only work if the practitioners have a good

1 In 1836 Gogol wrote a comedy called “The Revisor”, about a State controller trying to uncover local mismanagement, but who succumbs, as was often the case, to bribery and even elopes with the local chief’s daughter.

understanding of both the old systems as well as of new standards/insights and practice in modern administration. Therefore the identification of links missing in the country's internal control systems and good examples elsewhere took a long time.

Another important hurdle was the **legislative drafting** process. Even if the CHU did understand the modern concepts of internal control and internal audit; this did not mean that traditionalist lawyers would accept the new views and new definitions. Somewhat twisted and imprecise language often resulted; form being preferred over content. However, it was better to have such laws adopted than having no law at all. Indeed, in many new Member States a wave of amendments can now be seen refining the initial laws. The first shock is over and there is now enough knowledge about international standards to be able to get rid of imperfections in the internal control laws.

In some applicant countries there was **resistance** not only from (middle) management (which was inclined to put developing **PI*f*C** on a side track that only led as far as the end of the provisional closing of the negotiation chapter), but also from inspection departments, which were afraid of being left out of the new developments or of losing out on jobs. In one country all activity to develop **PI*f*C** was consistently boycotted with the result that new staff had to be assigned to pick up the threads; another country thought that with provisional closure of the chapter no further action was needed and the new commitments were not implemented for a long period; in still another country, the Director of the CHU was sidelined so that his superior could continue the old boy networks and take control decisions that would favour the traditional inspection departments irrespective of the new legal stipulations and the consequences of the accession negotiations. However, it must also be admitted that it was not easy in the early years to find national staff with an adequate internal control background who had the clout and stamina to introduce new standards of control and audit, and to guide a small group of people with a high degree of self-assertiveness, motivation and independence.

Very often responsibility for control and audit development was given to staff with experience in the control of European Funds as a result of which **PI*f*C** was thought to be a particular phenomenon relating only to EU funds. In some countries it took quite some time before these departments could develop into CHUs with a remit that went beyond the control of EU funds. The Central Financial and Contracts Units managing and controlling EU funds would, however, provide good examples of sound financial management to the CHU and other budgetary control and audit bodies.

Most of these problems were primarily teething problems and were by no means insurmountable. With hindsight they should have been expected and were perhaps even necessary to better understand the processes of change. Thanks to the work of those national civil servants who were motivated enough to play important roles in re-building the administrations in which they worked, there was a successful outcome; today's achievements must be credited to them.

Three important external assessments

There have been three major external assessments of the results of the **PI*f*C**-initiative: the Council assessment of 2002 based on the Commission's Comprehensive Monitoring Report, the European Parliament's discharge procedures for 2003 and a review by the European Court of Auditors in 2004.

1. Council and Commission assessments

On 13 December 2002 the Copenhagen European Council formally closed negotiations with the ten applicant countries and adopted the European Commission's Comprehensive Monitoring Report on their state of preparedness for EU Membership. This document dealt with all 31 chapters for each of the ten countries. Its sheer volume perhaps explains why the Summary of Findings devotes only a few words to progress on Financial Control. Rather laconically, the following message was delivered:

> *"As regards financial control, external audit is well developed, and half of the acceding countries can be considered to already have optimally functioning public internal financial control in place. … Further efforts are required in the Czech Republic, Cyprus, Hungary and Poland to optimise* **PI*f*C**. In Latvia external audit should be strengthened".

However, in the same text, without making specific references, the Council notes that

> *"… for most acquis areas the administrative structures may be in place, but most countries would need strengthening in terms of human resources, training (including language training) and budget. Better results could be achieved if priorities were clearly identified and targeted on areas that are critical to function properly within the EU."*

In January 2003 in the Report on the results of the negotiations on the accession of Cyprus, the Czech and Slovak Republics, Estonia, Hungary, Latvia, Lithuania, Malta, Poland and Slovenia, the comment on the FC Chapter was even shorter:

> *"All acceding countries will take over and implement the acquis under this chapter as from the date of accession."*

To understand what is behind these terse statements a brief analysis of current **PI*f*C** progress in the new Member States is given below.

PI*f*C Concept and legislation

All EUR-12 countries except Cyprus, Malta, and Latvia have approved a comprehensive **PI*f*C** Policy Paper at government level. The Czech government adopted its policy paper in November 2005. The internal audit systems in Malta and Cyprus are based on the existing audit structures inherited from the past while Latvia bases its internal control system on a collection of policy documents.

In terms of legislation, all EUR-12 countries except Cyprus and Latvia have **PI*f*C** framework laws. Cyprus, Hungary, Lithuania, Malta, Latvia and Slovenia adopted separate internal audit laws prior to May 2004. Secondary legislation and/or regulations relating to **PI*f*C** have been developed and approved in all countries. Experience shows that both policies and legislation are in constant development and updated where the need for a substantial overhaul or fine-tuning is found justified.

Internal Audit

Today all the EUR-12 countries have put the concept of decentralised functionally independent internal audit attached to the national budget income and spending centres into their legislation. Malta and Cyprus opted, from the beginning, for centralised internal audit because of the relatively small size of their administrations. Internal audit regulations and manuals, including templates for internal audit charters and codes of ethics, have been issued in all countries. However, the extent to which internal audit is still being used for activities that are managerial responsibilities is considerable. The notion of functional independence will take time to fully develop. Old habits die hard. It shows upgrading internal audit to international standards is a long-term activity.

Financial Management and Control

The available information does not indicate the same degree of success in establishing adequate FMC systems in the new Member States. The CHU annual reports available, the CHU-3 workshop analyses and the results of the Commission verification audits in the framework of EDIS all point to important residual weaknesses in FMC-systems. There is still much to be done in this area and CHUs must work together with the Supreme Audit Institutions to further strengthen financial management and control systems.

CHUs

All countries have established Central Harmonisation Units. The majority of these CHUs cover both Financial Management and Control and Internal Audit; although some countries have opted for two CHUs so as to cover each area separately. A number of the EUR-12 have also established centralised Internal Audit Boards or

PI*f*C Committees to discuss general developments in public internal audit and to provide advice to the CHUs.

Sustainable training for FMC and IA training

All countries have developed sustainable FMC and IA training facilities. This was a requirement for the successful closure of the FC Chapter negotiations. In the beginning most countries relied on foreign technical assistants, who left the country at the end of a programme. The departure of foreign consultants could disrupt training programmes and other measures were necessary to make training available to managers, financial officers and internal auditors on a permanent basis. A good indicator of the long term commitment of a government towards further **PI*f*C** development is the continuing activity of national training schemes. Another indicator is the development of co-operation between the public sector and IIA local branches to achieve (gradually) higher quality levels of certification.

2. The European Parliament (CBC)

During the accession negotiations the Chairman of the European Parliament Committee of Budgetary Control (CBC) took part in training seminars to express the European Parliament's interest in the Commission's activities on the FC Chapter. The seminars were organised by DG Financial Control to benefit civil servants in applicant countries who had responsibility for introducing **PI*f*C**. The seminars explained the control and audit institutions in the European Union. In November 2001, the CBC also took part in the annual meeting of the European Court of Auditors with the SAIs from applicant countries and expressed a keen interest in a report on the relations between the SAIs and national Parliamentary Budget Committees. SIGMA had prepared a document (SIGMA 2002) on this issue, presenting two **sets of recognised good practice**.

The **first set** concerned SAIs enhancing their overall effectiveness and ensuring that the SAIs are fully co-operating with the relevant parliamentary committees. Good practice is the setting and adopting of audit policies and standards as well as of ethical standards; writing audit reports in a clear and concise, fair and factual manner and being selective in deciding which audit reports should be submitted to parliament. Appropriate consideration was given to a number of concerns: fixing audit priorities; establishing a separate unit to co-ordinate contacts with parliament; active and methodical follow-up of previous audit findings and informing parliament on any patterns of inertia.

The **second set** was aimed at parliaments and suggested ensuring via national legislation that the SAI be independent of both Government and Parliament, that the SAI President be appointed in such a way as to ensure broad confidence and support in parliament, that a parliamentary committee oversee SAI finances (which should be independent from government) and inform the SAI of specific parliamentary interests, but would leave to the SAI final decisions on audit priorities. All SAI audit reports should be timely and made public. Parliament should establish rules for the operation of parliamentary committees and provide them with adequate staff support. Parliamentary committees should discuss SAI audit reports promptly and the discussions should be open to the public and media to enhance the transparency of the way government manages and controls public funds.

A **symbiotic relationship** between the SAI and Parliament is clearly of great importance in ensuring effective governance in government. The report engendered an initiative by the CBC to organise a discussion as part of the procedures to discharge the 2001 General Budget of the European Commission on 29 April 2003 (SP(2003) 1624 of 30 April 2003). The then Commissioner for Budget and representatives from the ECA, SAIs (Malta and Poland) and SIGMA took part.

The Commission explained that it had gone beyond merely providing a vision of control and audit only for pre-adhesion funds. It had succeeded in putting into place in the applicant countries comprehensive control systems at national level, based on the principles of managerial accountability and functionally-independent internal audit, thereby creating an environment for a move from inspection to accountability and a firm audit system. The Commission had played a large part in this transfer and the concomitant cultural change; its involvement had resulted in new legislation coupled with new control and audit structures in applicant countries. Both the European Court of Auditors and the CBC expressed their appreciation for the Commission's development of a comprehensive internal control scheme for the public finance sector going well beyond the scope of EU funds.

3. The European Court of Auditors

In 2004 the European Court of Auditors reviewed the way the Commission had managed negotiations on the FC Chapter during 2000-2004. The report was sent to the Commission but was not published. During the CHU-2 workshops in Balatonösződ the Court's representative discussed (in a personal capacity) a few elements of this review (Lingen 2004).

Because in 1998 the Commission had not yet developed a clear strategy on what exactly should be achieved by the FC Chapter; it was confronted by three major difficulties:

- The Commission could not fall back on experience from former accession negotiations as the issue of financial control had not played any role in former negotiations. Member States who had previously acceded were never subjected to the same scrutiny of their domestic financial control systems;

- A clear written description of the *acquis* in terms of relevant European legislation did not exist, nor did explicit criteria or standards relating to implementing capacity. Prior to May 2004, the EUR-15 applied and still continue to apply different approaches in the area of financial control;
- With the stepping-down of the SANTER Commission in 1999, the Commission's own credibility was at stake and its own internal control systems were subject to substantial reform proposals in the 2000 White Book and to a complete reorganisation thereafter.

Regarding the first element of the FC Chapter, the Public Internal Financial Control (**PI*f*C**) systems, the Court found that the Commission had successfully developed a new concept based on internationally-accepted standards of control and audit and on "best practice" in the Member States. The Commission had never previously set out Union-wide principles for **PI*f*C** systems, because it did not wish to discriminate between the various **PI*f*C** systems established in the existing Member States. Given the development and learning process needed for the Commission itself, it was clear that especially during 1998-2000 clear guidance and direction for applicant countries was lacking. It was only from 2001 onwards that the applicant countries progressively understood the complete set of requirements to be fulfilled under the FC Chapter.

Despite the uncertainty in 1998-2000, the FC Chapters for Hungary, Poland and Slovenia were provisionally closed in the first half of 2000 after a negotiation phase of only some months. The closures for these countries were premature as the requirements of the FC Chapter were neither fully defined nor clear. Furthermore, provisional closure did not give the applicant countries any political incentive to improve their financial control systems further. The slowness with which some applicant countries proceeded after provisional closure confirmed this. The Court therefore advised that closure of accession negotiations should not be based on commitment and promises, but on the actual capability to implement and enforce all criteria and conditions set.

Other ways of assessing the new IC systems

It is important that the newly created administrative facilities in the new MS remain under **regular scrutiny** so that further progress can be measured and benchmarked. This can be done in a variety of ways. Internal assessments can be made by CHUs through good use of annual reports and evaluations. These reports should be based on increasing experience in the field (compliance tests on the spot) and on reports from FMC and IA organisations. Creating a **national internal audit register** of material findings and recommendations would be a useful tool as would a central register for Internal Audit Charters. Charters should be benchmarked against the template issued by the CHU and should be considered during any mediation by the CHU in conflicts between management and internal audit.

Evaluating quality levels in FMC and IA can be done through self-assessment exercises in each of the income and spending centres. These exercises could initially be prepared and organised by the CHU through pilot studies and thereafter organised by the individual FMC and IA organisations themselves. The Tallinn Contact Group meeting of October 2001 discussed these techniques at length. A somewhat sophisticated method available to national organisations is presented on the FccWebsite. It would not be helpful to explain this method in detail here, but the material available on the FccWebsite is highly recommended to CHUs and control/audit organisations. Further reference can be found in chapter 3, in the section on self-assessment by management and financial departments[2].

Another method of assessing the quality of the work performed by the **PIƒC** institutions is certification along the lines of compliance with **ISO standards**. This may yet be too ambitious for the systems recently developed in the EUR-12, but it should certainly be considered in the future. On 17 October 2005 the International Standards Organisation published a new edition (see http://www.iso.org/iso/en) of the standard in the ISO 9000:2005 family, defining the vocabulary and description of the fundamentals of Quality Management Systems (QMS), including auditor, audit team, audit plan and audit scope. ISO 9000:2005 will be useful for all users of standards in the ISO 9000 family, in particular for people who assess QMS, or audit them for conformity to ISO 9001:2000 – such as internal auditors, external auditors of certification bodies, regulators, and for providers of consultancy or training on QMS.

Furthermore, the independent assessment of efficiency and effectiveness made by the **Supreme Audit Institution** of the entire **PIƒC** administrative structure and its operational elements is highly relevant. The need for good relationships between CHUs, individual internal audit bodies and the SAI has already been mentioned. The SAI can provide an assurance to the CHU as well as to the government and Parliament as to whether the quality of public internal control in the country's administration is adequate and following the right track.

Finally, another interesting initiative/study deserves to be mentioned here. The study is under development by the Centre for Financial and Monetary Research (Dinga 2006) which is part of the National Institute of Economic Research in Bucharest.

2 MERCHAN Francisco, Risk Management at the European Commission, see FccWebsite

The study tries to measure and evaluate through an algorithm the **institutional gap** between progress in introducing **PI*f*C** in Romania and the relevant EU *acquis communautaires*. The procedure can be used for any country. The objective of the study is to allow decision-makers to take corrective action if the institutional gap does not lessen or even seems to be widening.

To measure the difference between the institutional gap and the European benchmarks the study takes three criteria (status, trend and capacity) these lead into three gap-marker classes (position, process and resources). The position markers relate to economy, efficiency and effectiveness and the process markers are particularly interesting: they are direction, speed, irreversibility and self-evaluation of the **PI*f*C** process. For example, the irreversibility marker aims to quantify the qualitative aspect that general institutional reforms may have on ensuring the absorption and implementation of the relevant *acquis communautaires*. It could show the changing risks should the country (read government or ministry of finance) abandon the process, be lukewarm about its progress or was to support the process wholeheartedly. This process marker would measure, for example, whether changes considered by government to the Civil Service Law might endanger the status of internal auditors or whether the abolishment of the CHU for Internal Audit would be advantageous or unfavourable for the sustainability of the internal audit profession. Such steps have recently been taken in the Polish administration. The resource markers relate to the build-up of relevant legislation, to institutional aspects and to the cultural component. The value of this study still needs to be tested. The first measurements are still being made and it remains to be seen whether it will be possible to bring the results together as useful information for decision-makers, but it would seem to have potential for keeping the **PI*f*C** project on course.

There is thus great merit in regularly assessing the achievements made in the field of **PI*f*C** in individual countries, especially after accession, when the driving force of the European Commission will become less obvious and visible and may even vanish or worse, when the function of the SAI has not yet matured enough to take over the Commission's role to monitor the further development of internal control and internal audit.

9. PI*f*C's Future role

A brief overview of the latest* PI*f*C *developments in applicant countries; building public internal control systems in the western Balkans and European Neighbourhood Policy countries: applying the* PI*f*C *concept and drawing benefits from experience elsewhere; a matter of taking a long breath.

The latest PI*f*C developments in applicant countries

After the wave of accessions in May 2004, three applicant countries remained (Romania, Bulgaria and Turkey), with Romania and Bulgaria entering the EU as Member States as of January 2007. Both countries have made considerable progress in the **PI*f*C** legislative and implementation sphere. **Romania** has been introducing managerial accountability since 2006, while decentralised internal audit systems were already established. **Bulgaria** had initially opted for centralised internal audit, built into the inspection framework of the old State Control Office. The result was a **PI*f*C** Agency that combined inspection with internal audit with audit being delegated to major public spending centres. However, it was not possible to develop a free and independent internal audit under the inspection umbrella. Bulgaria has therefore opted for a strict separation between FMC, internal audit and inspection systems and in 2006 adopted three separate laws, one on each of the systems, underlining the principles of separation between internal audit and inspection, and of decentralised internal audit to strengthen managerial accountability. Both Romania and Bulgaria will benefit from a three-year Transition Facility to continue support in strengthening their public administrations.

Turkey has been an applicant country since 2000, although official negotiations only started in November 2005. DG Budget has had contacts with Turkey since 1999, resulting in a **PI*f*C** Policy Paper having been adopted, and a Framework Public Financial Management and Control Act. The concepts of managerial accountability and independent internal audit have been accepted, but implementation so far has been partial and slow. In early 2006 the Ministry of Finance drafted secondary legislation to implement the Public Financial Management and Control Act and to establish the relevant control and audit organisations. In June 2006 the FC Chapter was officially screened with Turkey, a pre-condition for opening of negotiations on the FC Chapter. Currently the **PI*f*C** Policy Paper as well as the framework and implementation laws are under scrutiny.

In June 2004, the European Council of Copenhagen decided that **Croatia** should be considered an applicant country although negotiations were only to be opened in November 2005. In June 2005 the Croatian Government adopted a **PI*f*C** Policy

Paper with a timetable for implementing its measures and has adopted a **PI*f*C** law in December 2006. In June 2006 the FC Chapter was officially screened and in November the Council decided that Croatia was ready to open the FC Chapter.

In 2004 the government of **Macedonia** requested applicant country status. A wide-ranging questionnaire was sent to the government and its replies analysed. In November 2005 the Commission published its analytical report for the Opinion on Macedonia's application. The European Council decided in February 2006 that Macedonia would receive the status of applicant country but that the negotiations were to be suspended to a later date.

With the accession of the EUR-10 in May 2004 things changed for **PI*f*C**. Whereas the new Member States considered that the "old Member States" should also implement **PI*f*C**, the attention of both the Commission and the army of consultants and twinning partners shifted towards the countries in the western Balkans and to the neighbours of Europe Enlarged: the south and south-east Mediterranean, the Caucasus and eastern Europe (Ukraine and Moldova).

In these new geographic areas, there are two trends that are noteworthy. Firstly, the support the EU has given to western Balkan countries in the area of public internal control is the same as was given in the early days of the EUR-10 accession negotiations – i.e., public internal control systems have been suggested to beneficiary countries from a supply-driven rather than demand-driven perspective. A race to harvest contracts again took precedence over planned careful steps taking into account the long-term needs of a country to prepare well for possible accession negotiations. Secondly, in a number of western Balkan countries, the eyes and ears of the relevant authorities have already been opened, learning from the experiences of neighbouring countries that have already undergone structural changes in the area of **PI*f*C** and external audit. Even consultants and twinning partners (as monopolised as ever) have become more **PI*f*C**-aware; they are now well-informed about what is required in the framework of the accession negotiations. Nevertheless, their Terms of Reference are often such that **PI*f*C** Policy papers and relevant **PI*f*C** legislation have to be produced within very short deadlines – and that increases the danger of failure as explained in the section on "Lessons not learned" (see chapter 7).

On the other hand, there is no need to reinvent the wheel over and over again. If, as well as being a criterion for accession, the **PI*f*C** concept is useful, and is supported by major international organisations, then there is only benefit to be derived from the use of the templates offered and the experience gained in adjacent countries as well as the knowledge accumulated in consultancy. The important thing is to strike a pragmatic balance between the swiftness of copy-pasting as opposed to long-term understanding and intellectual and institutional absorption of the principles and terminology to start changing age-old control concepts so fundamentally.

The western Balkan countries

The promotion of stability and peace in the western Balkans is a key priority for the external relations of the EU. The EU-western Balkans Summit of Thessalonica, June 21, 2003 said the following:

"The EU reiterates its unequivocal support to the European perspective of the western Balkan countries. The future of the Balkans is within the European Union. The ongoing enlargement and the signing of the Treaty of Athens in April 2003 inspire and encourage the countries of the western Balkans to follow the same successful path. Preparation for integration into European structures and ultimate membership into the European Union, through adoption of European standards, is now the big challenge ahead. The speed of movement ahead lies in the hands of the countries of the region."

In 2000 aid to the region was streamlined through a new programme called CARDS[1]. The programme's wider objective is to support the participation of the western Balkan[2] countries in the Stabilisation and Association Process (SAP), which is the cornerstone of the European Union's policy towards the region. The SAP is designed to help each country progress at its own pace towards greater European integration. One of the main objectives of the programme is institutional and legislative development, including harmonisation with European Union norms and approaches. A key element of the SAP for those countries that make sufficient progress in terms of political and economic reform and administrative capacity is a formal contractual relationship with the EU in the form of a Stabilisation and Association Agreement (SAA).

Transparency International

For the western Balkan countries as a group, the Corruption Perception Indicator in the public sector is illustrative. It amounts to ***2.28*** *as compared to* ***6.20*** *for the EURO-25 group and* ***3.07*** *for the ENP group in 2005 (See appendix 2). Accountability and the fight against corruption could be major elements in raising investment in the countries concerned and therewith job opportunities. The average unemployment rate in the western Balkan countries is high. It is therefore extremely important that corruption be fought by raising accountability and transparency in public life.*

1 Community Assistance for Reconstruction, Development and Stabilisation adopted with the Council Regulation (EC) No. 2666/2000 of 5 December 2000, OJ L306 vol. 43 of 7 December 2000

2 Albania, Bosnia and Herzegovina, the provisional government of Kosovo, Serbia, Macedonia and Montenegro

The Regional Strategy Paper for 2002-2006 and the CARDS Country Strategy Papers covered budgetary reform, financial control, and internal and external audit as priority areas of institution-building. SIGMA and foreign consultants have been asked to provide support in these areas. At present, technical expertise is provided by foreign consultancy firms, but in 2006 twinning arrangements will be introduced. It is interesting to note that in most of the western Balkan countries Ministry of Finance officials have already acquired good knowledge of the **PI*f*C** negotiations in neighbouring countries. Most of them have attended **PI*f*C** seminars organised by the Centre of Excellence for Finance (CEF) in the Slovenian Ministry of Finance together with SIGMA and most of the information imparted in those seminars will have reached the relevant policy levels. In any event, the exchange of ideas about modern internal control standards has made most of these countries receptive to the principles of **PI*f*C**.

The European Agency for Reconstruction started financing EU programmes in the western Balkan countries before 2002. One of its programme sectors relates to administrative reform and in particular to public internal control. However, rather than starting from a comprehensive public internal control programme concept, activities were undertaken and contracts tendered for on a case-by-case basis answering to general country demands (often on the basis of World Bank studies and recommendations) rather than taking advantage of the lessons learned in the EUR-12 and applicant countries. The first series of EAR projects was therefore not very successful, because of the absence of a comprehensive PI*f*C-approach. As of mid-2004 DG Budget started fact-finding missions to all of the western Balkan countries. The EAR and most of the Technical Assistance personnel involved are now well informed about the Commission's PI*f*C requirements. Tendering for the second generation of follow-up projects for developing PI*f*C will be monitored by DG Budget in close co-operation with DG Enlargement, and coaching Technical Assistance providers has become standard practice as was the case for the support to the EUR-12.

In mid-2004 DG Budget started fact-finding missions to all of the western Balkan countries. The EAR and most of the Technical Assistance personnel involved are now well informed about the Commission's **PI*f*C** requirements. Tendering for the second generation of follow-up projects for developing **PI*f*C** will be monitored by DG Budget in close co-operation with DG Enlargement, and coaching Technical Assistance providers will be standard practice. Currently, Albania and Kosovo are in the process of drafting or updating their **PI*f*C** Policy Papers and of adjusting their legal bases for **PI*f*C**. Similar initiatives will be developed in Serbia, Montenegro and Bosnia-Herzegovina.

As a result of these interventions the PIFC situation in the western Balkan countries has improved considerably. Croatia, Macedonia, Albania and Kosovo have produced PIFC policy papers and internal audit legislation; Montenegro, Bosnia

& Herzegovina and Serbia have introduced internal audit departments and are considering comprehensive PI*f*C strategies. There is a good chance that some (if not all) of these countries will have developed and implemented PI*f*C even before the opening of the FC Chapter negotiations or, even more strikingly, before lodging an application for membership of the European Union.

Clearly, the nature of DG Budget's intervention will need to shift from initiating and coaching to monitoring and ensuring that the achievements gained comply to the requirements of the FC Chapter and that the SAIs are well prepared to oversee further development of public internal control. This means that the PI*f*C concept is generally well accepted as the model to be followed by prospective applicant countries, the donor community, and the twinning and consultancy professions. It finally shows that PI*f*C can find its way without the intervention of DG Budget.

The western Balkan countries will eventually start their accession negotiations and thus be subject to the same criteria relating to PI*f*C and external audit as were the EUR-12, if not to yet more stringent ones. This is because of the learning curve of both the Commission and applicant countries and the positive criticisms expressed by the European Court of Audit. The most important conclusion is that the western Balkan countries can and will reap the benefits of the experience gained by the EUR-12 in implementing PI*f*C over the last 6-8 years.

In July 2006 the Council approved the Instrument for Pre-accession Assistance (IPA) with the objective to help the beneficiaries (Albania, Bosnia & Herzegovina, Croatia, Macedonia, Kosovo, Montenegro, Serbia and Turkey) to face the challenges of European integration, to implement the reforms needed to fulfil EU requirements and progress in the Stabilisation and Association Process and to lay the foundations for fulfilling the Copenhagen criteria for EU membership. The Multi-Annual Indicative Planning Document (MIPD) is the strategic document for IPA and is established for a three-year rolling period, with annual reviews. It follows the Multi Annual Indicative Financial Framework (MIFF) which indicatively allocates funds per beneficiary and per component. The purpose of this Multi-Beneficiary MIPD is to provide the strategic framework for the Multi-Beneficiary envelope of IPA to candidate and potential candidate countries.

The IPA budget for the period 2007-2009 is €4,119.5 million. The bulk of this IPA support to the beneficiaries will be delivered through national programmes. However, around 10% of available funds will be allocated through the Multi-Beneficiary programmes to support beneficiaries in their efforts towards EU accession. In the period 2007-2009, this will total €401.4 million. One of the areas of intervention of MIPD having been identified is Public Administration Reform. This area contains inter alia the support to develop Public Internal Control and External Audit.

The European Neighbourhood Policy

Whereas western Balkan countries are in the pipeline to become Member States and therefore subject to accession negotiations, the countries covered by the European Neighbourhood Policy (ENP) programmes are not. However, they can benefit from EU financial support, provided that they agree a programme with the EU to increase their accountability and transparency by developing and upgrading their national internal control systems and bringing these up to level with international standards.

In March 2003 the Commission presented its Communication on "Wider Europe – Neighbourhood: a new framework for relations with our eastern and southern Neighbours", which outlined the basic principles of the European Neighbourhood Policy. In October 2003, the European Council welcomed this initiative and urged the Commission and the Council to push it forward.

The Council conclusions of 16 June 2003 listed the Ukraine, Moldova, Belarus, Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestine Authority, Syria and Tunisia. On 14 June 2004 the Council conclusions on European Neighbourhood Policy offered Georgia, Armenia and Azerbaijan the opportunity to participate in the European Neighbourhood Policy, *inter alia* stating:

'*The objective of the ENP is to share the benefits of the EU's 2004 enlargement with neighbouring countries in terms of stability, security and well-being – in a way that is distinct from EU membership. It is designed to prevent the emergence of new dividing lines between the enlarged Union and its neighbours and to offer them the chance to participate in various EU activities through close political, security, economic and cultural co-operation*.'

The ENP offers privileged relationships with neighbours, which will build on mutual commitment to common values principally within the fields of the rule of law, *good governance*, the respect for human rights, the promotion of good neighbourly relations, and the principles of a market economy and sustainable development.

Since October 2003, the Commission has held explanatory talks with partners in eastern Europe and the southern Mediterranean who have Partnership and Co-operation Agreements or Association Agreements in force.

The ENP is addressed to the EU's neighbours and, in particular, to those who have been drawn closer to the EU as a result of the recent enlargement. In Europe, this applies to Ukraine, Belarus and Moldova. In the Mediterranean region, the ENP applies to all the non-EU participants in the Euro-Mediterranean Partnership (also called the Barcelona process) with the exception of Turkey, which is pursuing its relations with the EU in a pre-accession framework.

Jointly-agreed Action Plans will set priorities with a view to bringing these countries as close as possible to the European Union. The Action Plans will be differentiated, i.e. tailor-made to reflect the existing state of relations with each country, its needs and capacities as well as common interests and define the way ahead over the next three to five years. They will be put forward by the Commission and approved by the respective Co-operation or Association Councils.

Transparency International

*For the ENP countries as a group, the Corruption Perception Indicator in the public sector is revealing. It amounts to **3.07** as compared to **6.36** for the EURO-25 group and **2.87** for the western Balkan group in 2005[3]. Again accountability and fighting corruption are major elements in raising investment in the countries concerned and therewith job opportunities. The average unemployment rate in the ENP countries as a group can be estimated at 30%.*

The Action plans include **PI*f*C** and External Audit issues as part of administrative reform in the framework of government governance. This is why Chapter 7 of the draft Action Plans contains the following text:

'Financial Control and related matters

7. Sound management and control of public finances

Public Internal Financial Control

- Development of a strategy and policy paper for the public internal financial control system (managerial accountability and internal audit).

- Establish a legislative framework for public internal financial control.

- Gradual harmonisation with the internationally-agreed standards (IFAC, IIA, INTOSAI) and methodologies, as well as with EU best practices for the control and audit of public income, expenditure, assets and liabilities.

External Audit

- Ensure the establishment and adequate functioning of an independent Supreme Audit Institution in line with the internationally-accepted and EU best practice external audit standards (INTOSAI standards – International Organisation of Supreme Audit Institutions)'

3 See appendix 2

This standard text is negotiable with partner countries and therefore is likely to be amended in accordance with the interests of both the partner country concerned and the Commission. At the time of writing it is not possible to assess what consequences these negotiations might have. Partner countries' commitments to embark on **PI*f*C** development are voluntary and are therefore different from the **PI*f*C** developments in the (former) applicant countries. Nevertheless, it is highly important that the government – and more particularly, the Ministry of Finance – develop projects and programmes that follow the consolidated picture of **PI*f*C** and refrain from partial and marginal projects that will not, in the end, give hope of upgrading the entire public internal control systems in the country. Audit pilot projects in line ministries not matched by ideas of how to develop managerial accountability or worse, without any central ownership by the Ministry of Finance, will certainly lead to frustration for all involved and to a waste and/or loss of public funds. Such projects can ultimately do more harm than good and therefore the pros and cons should be carefully weighed before they are embarked upon.

The ENP beneficiary countries can be split into two broadly-defined groups: The southern and south-eastern Mediterranean countries from Morocco to Lebanon/Syria, and the countries that belonged to the ex-Soviet Union (Ukraine, Moldova and the Caucasus). Many countries in the first group follow the inspectorate system practised in France before its LOLF-reform. Although there are indications that a number of countries in this category understand the benefits of upgrading their national internal control systems, there is strong hesitancy to do this outside the present power structures. Looking at the average corruption levels in these countries, the prospects for substantial real changes in the public internal control systems in the short or mid-term do not appear very high. Nevertheless, if within these countries there is a platform of interest for introducing sound financial management and control, than it fully deserves strong support. With the agreement of the relevant governments, a good first step would be to perform a PEFA Framework Diagnosis to monitor the pace of progress in the longer-term and take measures to support a more accountable administration.

Countries in the second category, however, already have outspoken aspirations to closer ties with the European Union and watch with interest developments in **PI*f*C** and External Audit in their neighbouring countries. Their current position is similar to that of many of the new Member States before their accession and they have expressed specific interest in the concept of **PI*f*C**. In fact, in Moldova, the Ukraine and in the three Caucasian countries developments are ongoing in co-operation with the World Bank and the European Commission to start public administration reform, including internal control.

A matter of taking a long breath and looking beyond

Countries in the western Balkans and others who consider it worthwhile to upgrade their public internal control systems to international standards and EU best practices should realise that this is a matter for long-term policies and long-term commitment. It is therefore important to choose a realistic time-frame within which to take the various steps. **PI*f*C** cannot be established overnight, or even within one or two years. Although it is true that many mistakes can be avoided by understanding how other countries have gone through the unavoidable pitfalls and related problems, experience also shows that it takes a long time before the real meaning and consequences of managerial accountability and independent internal audit are absorbed and understood. This understanding can only be achieved after intensive, broadly-based and result-oriented discussions by all stakeholders who deal with public management and control, directed by a centrally-placed organisation that should take ownership of the developments that lead to the introduction of **PI*f*C**.

The question of whether the **PI*f*C** concept - particularly the establishment of risk-based internal audit - is appropriate for developing countries depends on a number of crucial conditions in the administration of those countries: is there a real desire at the highest political level to achieve progress?; is there local ownership of reform?; is there management capability? Of equal importance is the need to have robust budgetary and effective accounting systems. Success can only be expected if the answers to all these questions are positive and if it is well understood that effective reform can only follow realistic long term planning.

Nevertheless, the latest developments in countries like Macedonia, Bosnia and Herzegovina, Azerbaijan, Moldova and even in Tajikistan (where efforts are being made to introduce **PI*f*C**) show that the adoption of the **PI*f*C** concept could become successful and convincing enough to lead governments to commit themselves to the necessary change processes. Whether these commitments can be sustained in the longer term is another matter and, indeed, a matter of concern. If some new Member States are already considering dismantling **PI*f*C** structures for reasons of politics or of economy, then it will certainly be easier for countries that have no accession obligations to follow different paths suiting the local political and traditional circumstances that may not be **PI*f*C**-compliant. Only the future will show whether the relatively sophisticated **PI*f*C** template can flourish in countries that still have highly centralised control or inspection systems and where transparency remains a concept at best.

10. Conclusions

The **PI*f*C** concept grew gradually in reaction to various inter-related developments. Since public internal control systems in the EUR-15 Member States were and are not harmonised, the applicant countries were at a loss as to which system would be considered *good practice*. They asked the Commission to provide **advice as to best practice** and to make recommendations. The Substantial Evaluation of the applicant countries' replies to the "Grand Questionnaire" of 1996 gave clues of the necessary ingredients of **PI*f*C**. Furthermore, international events (like ENRON and the happenings that led to the European Commission's own administrative and finance reforms in 2000) raised public interest in sound financial management in both private and public sectors, and created an acute awareness of the consequences of corruption, fraud and creative accounting.

PI*f*C developed into a strategy to answer the strong concerns felt by Member States about corruption in the ex-communist countries. The validity of these concerns was confirmed by Transparency International. The Member States and European institutions both insisted the issue be raised in the accession negotiations and asked that transparency and accountability be developed. **PI*f*C** could only be (and is indeed) based on the principles of **democracy and the rule of law**. The Commission, in the meantime, had a difficult choice to make. Earlier accession negotiations had not included a chapter on financial control. The Commission could not fall back on precedent. The promotion of one model for **PI*f*C** as best European practice would implicitly mean that other European models were not considered best practice, a hard statement to make. Nevertheless the Commission decided, at an early stage and in the interests of the applicant countries, to use modern international good practice and proven effective techniques from both public and private sectors as examples to offer applicant countries. This approach allowed the use of the latest control and audit standards as recommended by institutions like the International Organisation for Supreme Audit Institutions (INTOSAI) and the Institute of Internal Auditors (IIA), notably managerial accountability and decentralised, functionally-independent internal audit. Throughout the accession negotiations, this choice was not contested by any of the Member States and actively supported by most. Many, including the Commission, were at the same time applying these practices and techniques to improve their own systems. Had there not been the unprecedented wave of negotiations leading to the 2004 accessions, the **PI*f*C** concept would, in all likelihood, not exist. Most likely, the prediction (see page 33) that applicant countries (like the old Member States) would not benefit from a specific and harmonised internal control model, might have come true, were it not for the introduction of **PI*f*C**.

One of the most difficult issues in dealing with public internal control functions and responsibilities is the **vocabulary** used. **PI*f*C** may not be as rich in words as vocabularies in sectors like fisheries or nuclear co-operation, but the many national interpretations of concepts like Managerial Accountability, Audit, ex-ante and ex-post Financial Control, Accounting, Independence, Inspection etc. did not make it easy to find a common terminology. The key issue is often not so much to explain what a concept means but rather what it does not. In other words, defining the roles and responsibilities of each actor was a primary need for ensuring efficient co-operation without overlap or conflicts of interest.

In the international field of public internal control there is persistent **confusion about concepts** (inspectors performing audits; accountants and controllers being auditors, etc.). As a result the intricate but often misleading interrelationships between "control" bodies had to be untangled. Operational management responsibilities (ex-ante financial control) had to be taken away from supreme audit institutions, internal audit had to be developed outside inspection and "control", operational management had to be separated from assessing management, ex-post financial control and internal audit had to be differentiated; and systems-based audits had to become the key activities of internal auditors. Such developments touch upon long-established traditions and altering them involves a cultural change in administrative procedures and understanding. In this context finding new roles for those that fear losing out in the reform is of great importance, for example inspectors could be retrained in anti-fraud activities or could be converted to become "quality" inspectors.

PI*f*C and the EU Administrative Reform of 2000 developed more or less in parallel and it is therefore not surprising that there was cross-fertilisation. For both the adagio is the same as for democracy: they are dynamic processes that seek continuously for the best next phase achievable in a rapidly-changing environment. The EU reforms continue developing the single audit/control chain approach and the integrated internal control framework with the objective of obtaining a positive statement of assurance on the Commission accounts from the European Court of Auditors. **PI*f*C** still needs further rooting and deepening in those countries that have embraced it. The concept's use is spreading geographically, with each country that takes up the concept needing to be committed to going through all the phases identified. If **PI*f*C** is about harmonising standards and procedures and about making public internal control for national and EU funds follow the appropriate international standards, it is not surprising that applicant countries complained about inconsistencies in terminology and organisation in the management and control mechanisms for the Common Agricultural Policy and EU Structural funds. Chapter 4 has commented on this issue and concluded that harmonising concepts and ways of organisation would be logical and beneficial and is to a large extent reflected in the new Instrument for Pre-Accession Aid.

PI*f*C aims to bring the latest developments in the field of internal control and audit from the private to the public sector, while taking account of the particular characteristics of the latter. Reforms took place in the applicant countries, but at a cost. Nevertheless, the accession negotiations helped the applicant countries to make policy decisions and adopt international standards faster than could reasonably have been expected in the absence of these negotiations. Even if in some countries certain decisions may have been taken too hastily or without a full understanding of the issues and needs involved; the basic understanding of and ingredients for implementing international standards are now embedded in minds and laws, so that the structural elements of public internal control can be refined in the future. This is not to say that there are no **dangers**. Minds may change in newly-elected governments whose officials might have a different kind of interest in the nature of transparency and accountability and want important financial management and audit posts occupied by their friends. Old habits have a tendency to die hard. So it is important that **PI*f*C** Policy Papers provide for a strategic framework that is regularly reviewed and updated, accessible and endorsed by the highest control authorities. The Supreme Audit Institution will need to comment strongly on legislative and other initiatives that break away from the **PI*f*C** Policy direction. This is obviously a matter of concern and for continuous vigilance.

Networking and looking forward

PI*f*C could never have become a successful standard for public internal control reform were it not for the **strong partnerships** established between applicant countries, SIGMA, TAIEX, technical assistants and Twinning partners, the SAIs, the European Court of Auditors and the European Commission. It is undoubtedly the result of both **official and informal networking** between all partners.

The most prominent networking tool for public internal control issues was without any doubt **the Contact Group for European Financial Control Organisations**. Although from the point of view of the Commission the decision to stop organising and financing these meetings was defensible, it left the new Member States (as well as the old ones) bereft of a central platform to discuss their problems in implementing the new **PI*f*C** systems regularly. It also left them bereft of a sounding-board to help them stand more strongly against harmful influences coming from, for example, new but old-style political management. For some time the Contact Group fulfilled the need for a group that could discuss the particular problems of introducing modern control and audit standards in the environment of the public sector.

Effective though they are international professional bodies like IFAC and the IIA cannot compensate for this networking loss. Neither can the INTOSAI organisation, specifically created for public external audit bodies, cover this area. It is unfortunate that there is now no intergovernmental body left in Europe that can discuss, share experiences and harmonise the standards for public internal control or public internal audit. The frustration of the ten new Member States, having adopted **PI*f*C** and then finding themselves confronted with the need to continually consolidate the far-reaching changes started during the negotiations to ensure their sustainability, but without a forum to meet, is understandable. Even though the "old" Member States had never been involved in a similar process initiated by the Commission, many of them also felt the lack of a focal point for discussions.

The arrangements for a Transition Period (2004-2006), during which the new Member States received further support for strengthening their new administrative structures allowed DG Budget to take the initiative to organise **workshops** for the Central Harmonisation Units in the EUR-12 to discuss their progress (and lack of it) and consolidate their achievements. This was highly valued by all participants, but in the last CHU meeting in Bled (Slovenia), 2006, they once again expressed (as they had in Vienna) their widespread regret that the Commission would not organise such meetings for the new Member States any longer. One delegate explained that the workshop reports were powerful documents in defending the CHU's position in national governments, that local attitudes were slowly changing but needed further boosts from international platform discussions which could benefit from Commission participation, authority and expertise.

The Commission considers it cannot take any action itself to organise such a platform since it has no remit to discuss the national internal control systems of its Member States. There indeed is no unanimous EUR-27 desire, at least not one that has been brought to the attention of, for example, ECOFIN to ask the Commission to organise discussions on the topic. The best option for establishing a **new intergovernmental platform** to discuss public internal control issues would seem to be an initiative from the new Member States supported by those in the EUR-15 that share their interest. It could return ownership of the co-operation to the countries concerned and could be similar to the 1996 proposal where Hungary suggested the "Association of European Government Control Organisations". An association of Member States could of course invite other interested members from any or all Member States and applicant countries as well as delegates from the Commission and other interested organisations to discuss and share experience and good practice, to benchmark achievements over time amongst peers, and compare/discuss progress and make suggestions to remove obstacles that hinder progress.

The European Parliament made reference to the networking function for financial control organisations in its 2004 discharge report on the general budget. It invited the Commission "to set up a **network for financial control organisations and bodies** (including an annual meeting in the presence of the Parliament's Budget Committee) to discuss and exchange experiences as regards general internal control systems (including internal audit) in the EU, and accountability issues and so foster more effective cooperation between Member States and the European Union and invite its competent committee to provide specific resources from the EU budget for such a network." In the light of the foregoing this invitation is most welcome and needed and deserves to be taken up by all stakeholders who are considering reviving European FCO networking.

Consultants and Twinning partners are indispensable elements in developing **PI*f*C** in applicant countries. Without them it would not be possible to go through the various stages of introducing **PI*f*C**. Consultants, twinning partners and particularly SIGMA of OECD have delivered valuable work in this area. However, the negative phenomenon of monopoly-building in this sector should not be overlooked nor should the equally negative tendencies of not learning from previous experience. This book hopes to contribute to overcoming these dangers. CHUs should combine their forces and establish rules for tendering technical assistance taking into account their experience in the field.

Recent years have seen many assessments of progress by the new Member States in implementing **PI*f*C**. There are a number of initiatives to further develop and refine assessment techniques. CHUs should develop and promote self-assessment exercises by the departments involved in control and audit and should report annually on the status of **PI*f*C** to the government, benchmarking progress. The Supreme Audit Institution should provide an opinion on the overall development and direction of **PI*f*C,** but there is a risk that they are not yet strong enough to do so. It might be worthwhile organising a general appraisal of **PI*f*C** implementation in all of the new Member States in, say, a period of four years after their accession, to be performed by, for example, a working group possibly established under a revived European FCO or CHU Platform. This would be particularly welcome since there are signals that **PI*f*C** may not hold in some of the new Member States (especially those whose FC-Chapters had been closed prematurely). Newly elected governments may be (or prefer to be) ignorant of the FC-Chapter negotiation commitments and may show a tendency to undo the efforts for making a strong public internal control system. This would be unfortunate for the national taxpayer who has a right to accountable and transparent government and for the EU-taxpayer as much effort and EU-funds went into the re-engineering of the public internal control sector of those countries.

In conclusion, the **PI*f*C** concept was developed during the accession negotiations with the EUR-12 and further polished in the process. In the EUR-15 one can see indications of an emerging convergence in thinking about how to upgrade old public internal control systems. The **PI*f*C** concept is being adopted by the new applicant countries in the western Balkans. Thanks to its successful formula and its aim of strengthening the position of ministers of finance who are concerned with adequate budget implementation, modern management and internal control, the concept has already found followers in a number of governments participating in the European Neighbourhood Programme (the concept is now even being tested in central Asia!). The success of **PI*f*C** is not dependent on the prospect of accession, but is based on its inherent consistency and relative straightforwardness. It has become a living concept with a practical purpose; it is not a dogma, but continues developing as a tool by incorporating the latest relevant good practices. **PI*f*C** can promote transparency and accountability in those countries that are ready for far-reaching changes in public administration. The fact that this Commission formula has been accepted as a useful concept and reference by international organisations such as SIGMA, INTOSAI and the World Bank, and uses the guidance and standards of international professional bodies such as INTOSAI, IIA and ECIIA, and the PEFA initiative is indicative of its usefulness. **PI*f*C** has made a big impact in public internal control's international arena and is likely to continue to do so in the foreseeable future.

Chart 1. Schematic Overview of PIFC with one CHU in Government

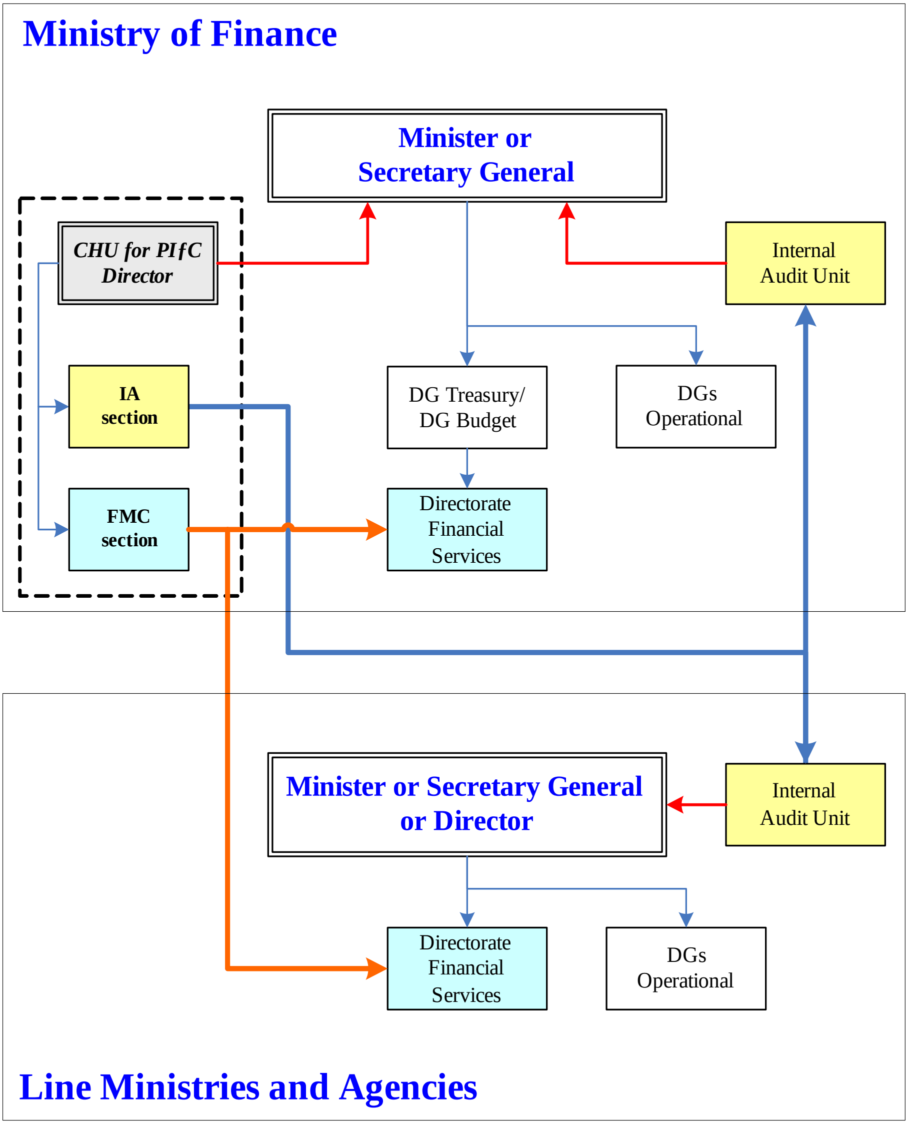


Chart 2. Schematic Overview of PIFC with two CHUs in Government

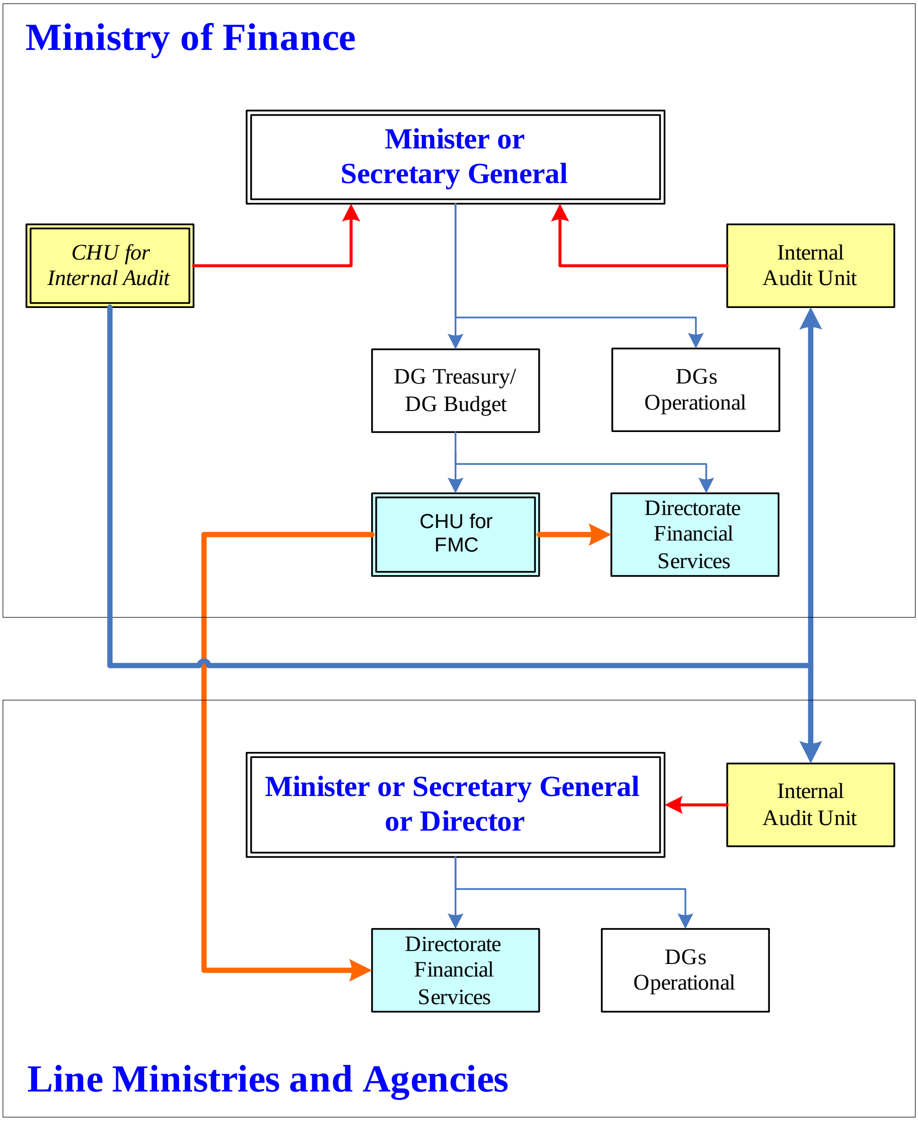


Chart 3. Overview of Management, Control and Audit Structures in the Commission

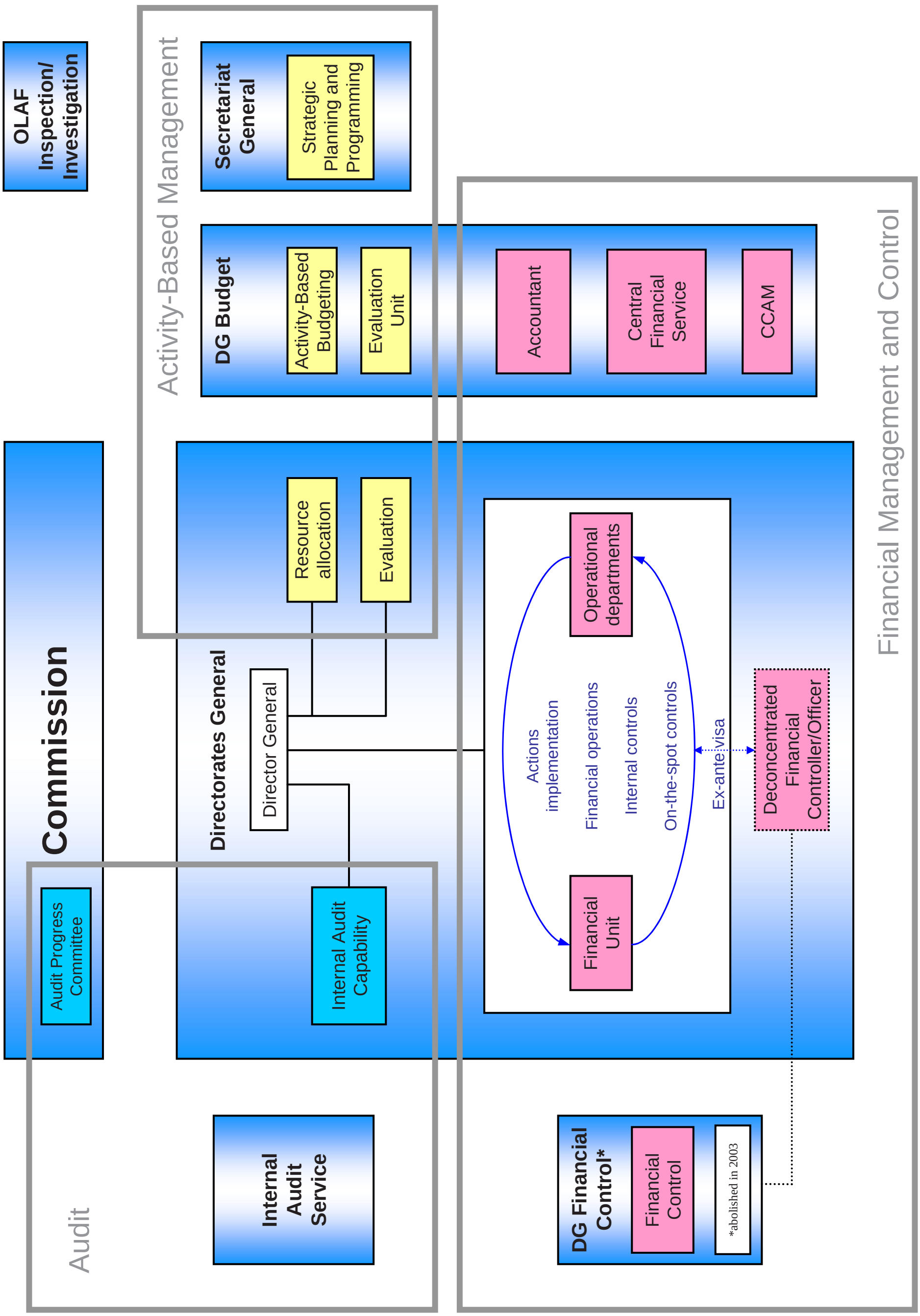
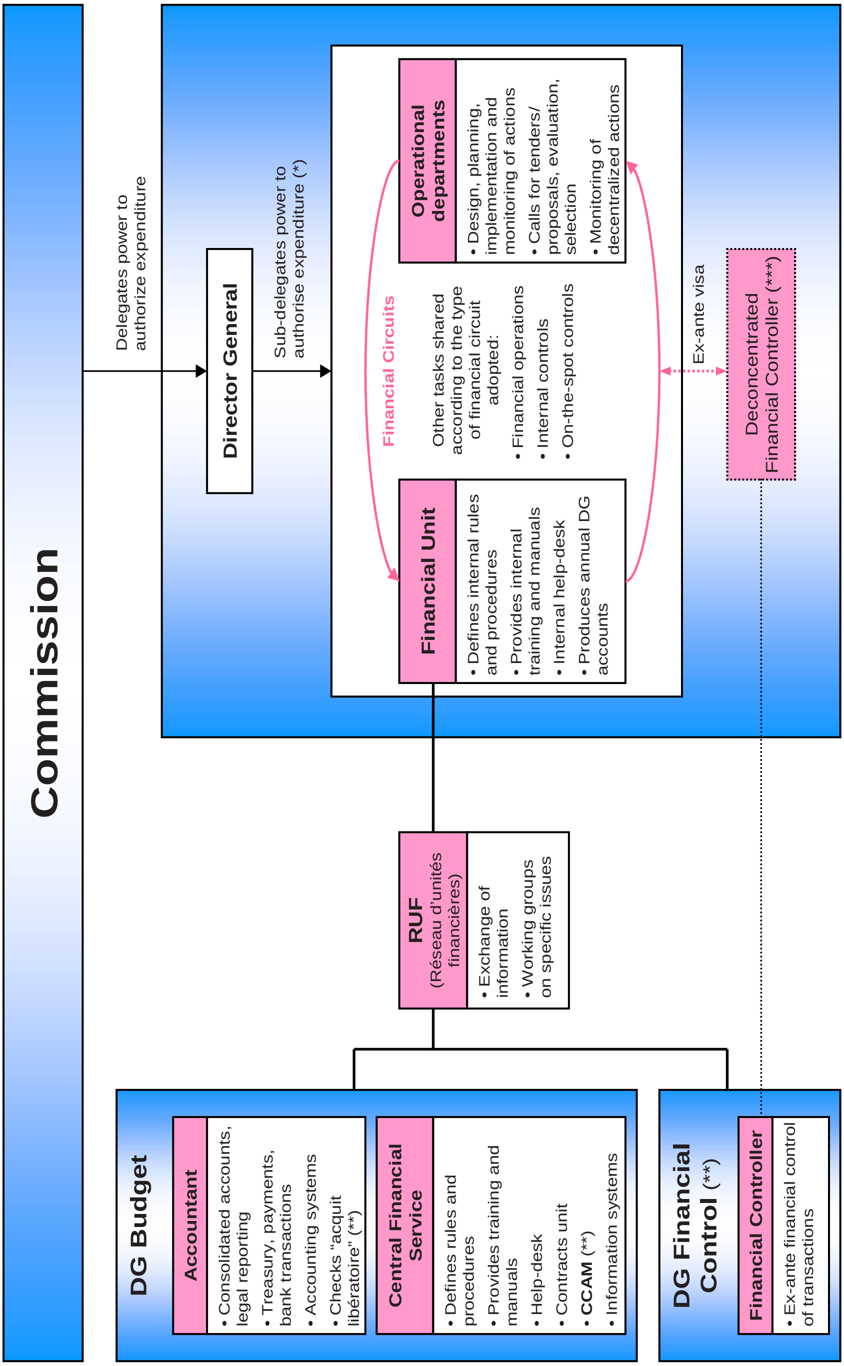
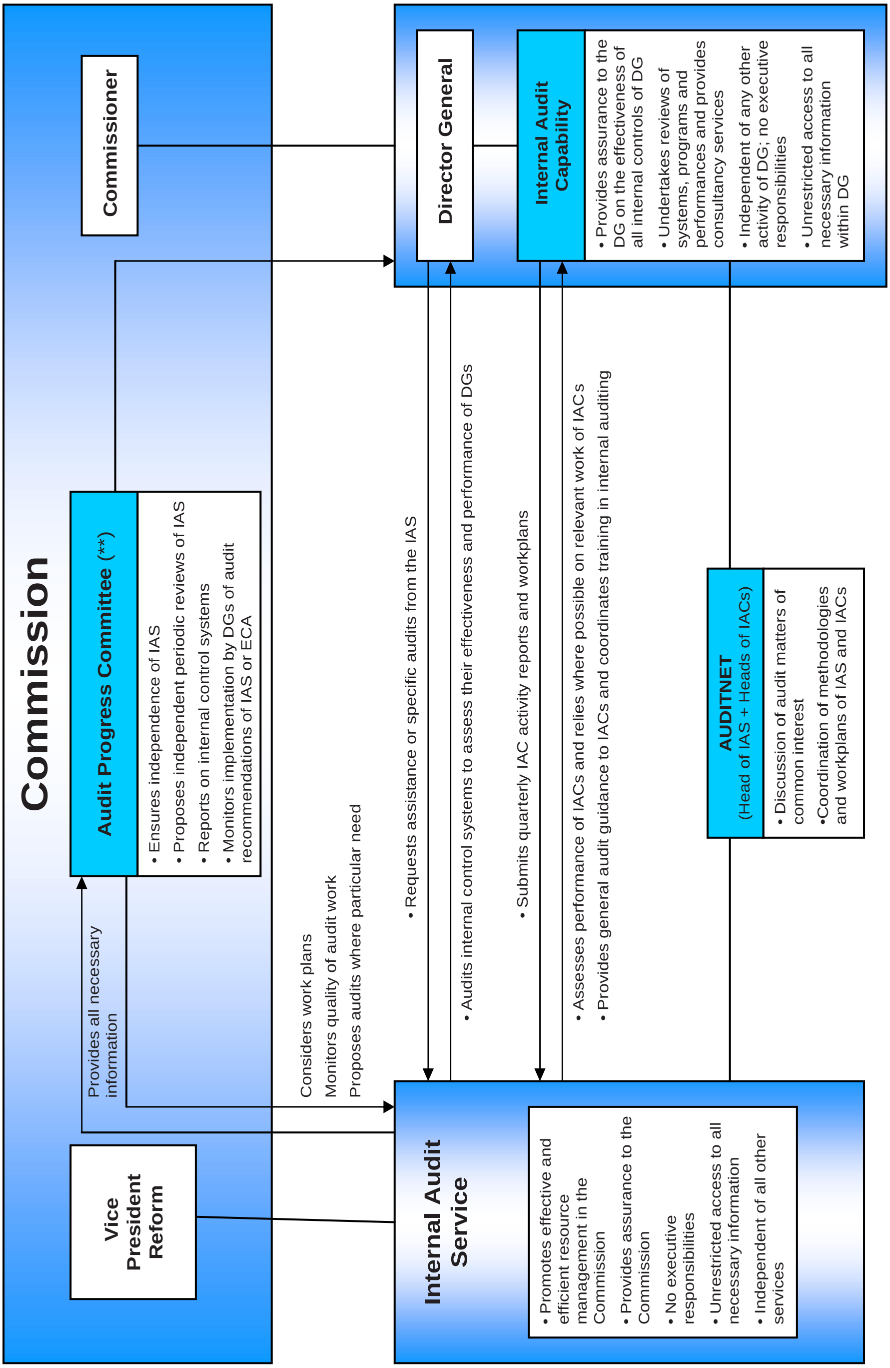


Chart 4. Overview of the Commission's Financial Management and Control System



(*) The type of financial circuit adopted determines to whom the sub-delegation is given (to the operational department in most cases).
(**) Transitional arrangement pending the adoption of the new Financial Regulation, which proposes the abolition of centralised ex-ante controls.
(***) Where feasible.

Chart 5. Overview of the Commission's Audit System (*)



(*) After adoption of the "fast-track" proposal to modify article 24 of the Financial Regulation in order to separate the internal audit from the Financial Controller.

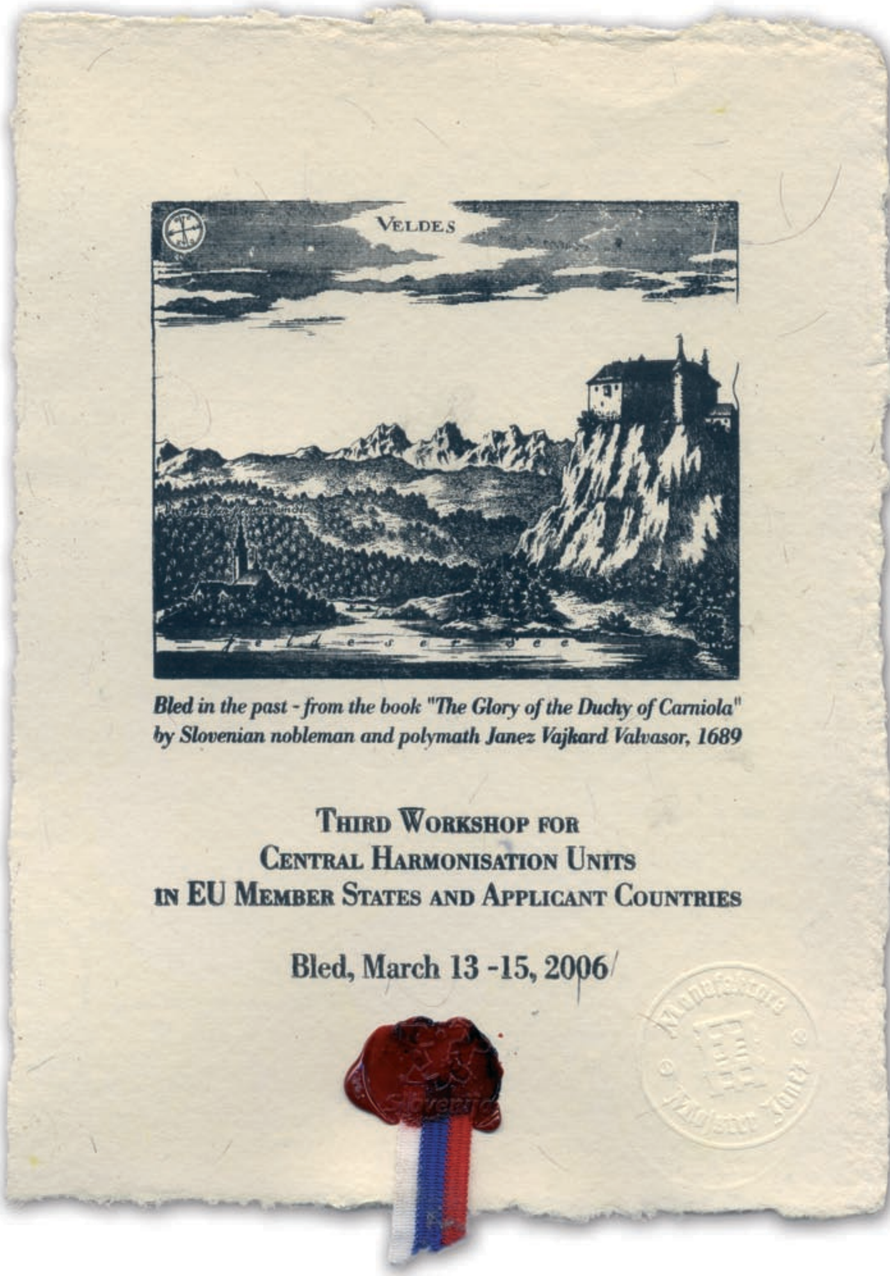
(**) Budget Commissioner, VP Reform, two other Commissioners, one external member.

Picture 1. CHU1 workshop participants in Leuven, Begijnhof, June 2003

Picture 2. CHU1 workshop participants in Leuven, City Hall, June 2003

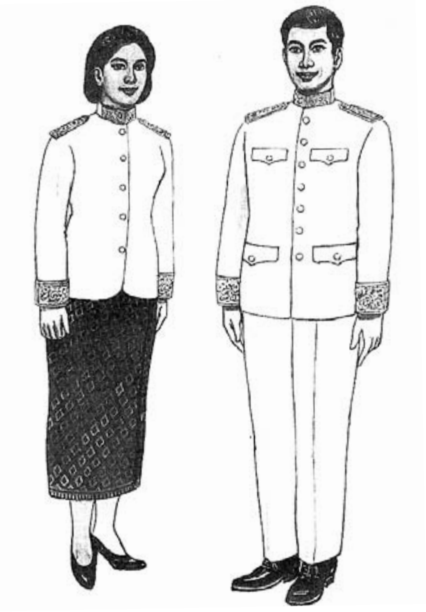
Picture 3. CHU2 workshop participants in Balatonösződ, Hungary, November 2004

Picture 4. CHU3 workshop in Bled, Slovenia, March 2006



Picture 5. Progress in the Cambodian National Audit Authority

An article in the Phnom Penh Post of December 6, 2002 heralded the celebration of the first anniversary of the start of the operations of the National Audit Authority (SAI) in Cambodia. Donors toasted the event as a great step forward in bringing good governance to the State's opaque finances. Apart from political nominations of senior staff, the most noteworthy development was the adoption of a regulation governing insignia and official uniforms – smart white or blue pants, and white jackets with gold braid. The National Audit Authority may be ready for work, but the question is: is it Lima-compliant?



Picture 6. The stellar future of PIFC (Prague, 2004)

Picture 7. Waiting for reform?

Picture 8. PIFC: "spending" control, not "spelling" control.

Appendix 1. List of PI*f*C Builders

Each of the individuals mentioned below provided, in one way or another, contributions to the development and implementation of **PI*f*C**, both inside and outside the Commission. The author apologises for any omissions or errors.

Name			Organisation
Albania			
Mr	Gjon	NDREJA	MoF
Bulgaria			
Mr	Ljubomir	DATSOV	MoF
Mr	Atanas	DOBREV	MoF
Ms	Ginka	DRAGANOVA	PIFC Agency
Mr	Nicolai	GEORGIEV	MoF
Ms	Tatiana	HOUBENOVA	PIFC Agency
Ms	Mariana	HRISTCHEVA	Mission
Mr	Toma	JEKOV	SCO
Ms	Dobrinka	MIHAYLOVA	MoF
Mr	Georgi	NIKOLOV	NAO
Ms	Nadeja	SANDALOVA	NAO
Ms	Svilena	SIMEONOVA	PIFC Agency
Ms	Mariyana	TOUHTCHIEVA	SCO
Mr	Tzvetan	TZVETKOV	PIFC Agency
Mr	Milen	VELCHEV	MoF
Mr	Nahit	ZIYA	MoF
Commission			
Mr	Juergen	ANDERMANN	DG BUDG
Mr	Jean-Pierre	BACHE	DG BUDG
Mr	Martin	BECK	DG FC
Mr	Michael	BERRISFORD	DG ELARG
Mr	Bernd	BIERVERT	DG ELARG
Mr	Edwin	CROONEN	DG IAS
Mr	David	DALY	DG RELEX
Mr	Lucien	DE MOOR	DG FC
Mr	Rainer	EMSCHERMANN	Cabinet
Ms	Maria	FIRICI	DG BUDG
Ms	Karin	FOGG	DG RELEX
Mr	Peter	GALLAGHER	DG ELARG
Mr	Robert	GIELISSE	DG BUDG
Mr	Domenico	GIGLIOTTI	DG ELARG
Mr	Enrico	GRILLO PASQUARELLI	DG ELARG
Ms	Anca	GRIU	DG RELEX
Mr	Borko	HANDZISKI	DG RELEX

	Name		Organisation
Ms	Hilde	HARDEMAN	DG ELARG
Ms	Noora	HAYRINNEN	DG ELARG
Mr	Johannes	HEEREN	DG REGIO
Mr	Raymond	HILL	DG BUDG
Mr	Antonio	IZQUIERDO	DG RELEX
Mr	Peder	JAKOBSSON	DG BUDG
Ms	Lubomira	KACALJAKOVA	DG BUDG
Ms	Marianne	KAREPOVA	DG ELARG
Ms	Una	KELLY	DG RELEX
Mr	Martin	KERN	DG RELEX
Ms	Ulrika	KLINGENSTIERNA	DG FC
Mr	Jose	LEANDRO	DG ECFIN
Ms	Caroline	LEFFLER-ROTH	DG ELARG
Mr	Jerome	LEGRAND	DG ELARG
Mr	Andre	LYS	DG RELEX
Mr	Peter	MAHER	DG ELARG
Mr	Nicholas	MARTYN	DG REGIO
Ms	Michela	MATUELLA	DG ELARG
Mr	Patrick	McCLAY	DG ELARG
Mr	Dirk	MEGANCK	DG ELARG
Mr	Jean-Paul	MINGASSON	DG BUDG
Mr	James	MORAN	DG BUDG
Ms	Simona	NANESCU	DG RELEX
Mr	Carlo	NATALE	DG ELARG
Mr	John	O'ROURKE	DG ELARG
Ms	Umut	ÖZDEMIR	DG RELEX
Mr	Ioannis	PANTALIS	DG AIDCO
Mr	John	PEARSON	DG FC
Mr	Alan	PRATLEY	DG FC
Mr	David	RINGROSE	DG ELARG
Mr	Luis	ROMERO REQUENA	DG BUDG
Mr	Philip	ROSE	DG ELARG
Mr	Jose	SANCHEZ-ALEGRE	DG ELARG
Mr	Luc	SCHAERLAEKENS	DG OLAF
Mr	Danny	SCHEERLINCK	DG BUDG
Ms	Michele	SCHREYER	Commissioner
Mr	Duncan	SPARKES	DG ELARG
Ms	Paulina	STANOEVA	DG ELARG
Mr	Philippe	TAVERNE	DG BUDG
Mr	Alain	VAN HAMME	DG ELARG
Ms	Marie	VAN RUYMBEKE	DG BUDG
Mr	Jean Pierre	VANDERSTEEN	DG BUDG
Ms	Isabella	VENTURA	DG FC

	Name		Organisation
Mr	Rutger	WISSELS	DG ELARG
Ms	Sylvie	ZAITRA	EAR
Mr	Huseyin	ZENGIN	DG RELEX
Ms	Ritva	HAIKINNEN	EU Delegation
Croatia			
Ms	Ljerka	LINZBAUER	MoF
Ms	Lidija	PERNAR	SAI
Mr	Mičetić	TOMISLAV	MoF
Cyprus			
Mr	Andrea	ANTONIADIS	Treasury
Mr	Lakis	DEMETRIOU	IAS
Mr	Lazarou	LAZAROS	Treasury
Mr	Andreas	ZACHARIADES	Treasury
Czech Republic			
Mr	Zdenek	CHALUS	Expert
Ms	Milada	FRITZOVA	MoF
Mr	Jiri	KUCHYNA	MoF
Mr	Karel	MARIK	MoF
Ms	Vera	MARTINU	MoF
Mr	Petr	MIKESTIK	MoF
Mr	Vaclav	PERICH	SAI
Mr	Josef	SVOBODA	MoF
Estonia			
Mr	Andres	KAROTAMM	MoF
Mr	Apo	OJA	MoF
Mr	Mart	OPMANN	MoF
Mr	Mati	PALJASMA	MoF
Mr	Raivo	SULG	MoF
Mr	Guido	VIIK	MoF
European Union – European Court of Auditors			
Mr	Dieter	BOECKEM	ECA
Mr	Chris	KOK	ECA
Mr	Maarten	ENGWIRDA	ECA
Mr	Jan Pieter	LINGEN	ECA
Finland			
Mr	Tuomas	PÖYSTI	MoF
France			
Mr	Jean-Marc	CASSAM CHENAI	Twinning Partner
Mr	Hervé	CHAZEAU	Twinning Partner
Mr	Frédéric	CHETCUTI	Consultant
Mr	Alain Gérard	COHEN	Consultant
Ms	Des	FERGUSON	Consultant
Ms	Gisèle	GROUX	Twinning Partner

	Name		Organisation
Ms	Gisèle	NADALIN	Twinning Partner
Mr	Pierre	PELAN	Twinning Partner
Mr	Tayeb-Alexandre	S'HIEH	Twinning Partner
Mr	Albert	SOUCHON	Twinning Partner
Ms	Martine	THOUET	Consultant
Germany			
MS	Karin	HOCHHAUS	MoF
Mr	Hans	SCHLIEF	MoF
Mr	Walter	SCHMIDT-BENS	RTA
Hungary			
Mr	Deszo	IHASZ	GCO
Mr	Peter	JANZA	GCO
Mr	Andras	TOTH	GCO
Ms	Krisztina	KOVACS	MoF
Mr	Jozsef	THUMA	MoF
Ms	Edit	WEIDLICH	MoF
Mr	Geija	HALASZ	SAO
Mr	Arpad	KOVACS	SAO
Ireland			
Mr	Gareth	EVANS	Consultant
Mr	Sean	O'SULLIVAN	Consultant
Mr	Sean	O'CEALLAIGH	Consultant
Kosovo			
Mr	Fehmi	MEHMETI	MoF
Latvia			
Ms	Dace	NULLE	MoF
Ms	Inguna	SUDRABA	MoF
Mr	Roberts	ZILE	MoF
Ms	Inguna	ZVANE	MoF
Lithuania			
Mr	Aleksandras	GRODZENSKIS	MoF
Ms	Dalia	GRYBAUSKITE	MoF
Mr	Darius	MATUSEVICIUS	MoF
Mr	Sigitas	MITKUS	MoF
Mr	Andrius	STULPINAS	MoF
Mr	Edmundas	ZILEVICIUS	MoF
Macedonia			
Ms	Ljubika	GERASIMOVA	Gov
Mr	Trajko	SPASOVSKI	MoF
Malta			
Mr	Alfred	FIORINI LOWELL	Cabinet Office
Mr	Joseph	GALEA	NAO
Mr	Pierre	PACE	IAID

Name			Organisation
Moldova			
Mr	Oleg	HIRBU	MoF
Netherlands			
Mr	Ron	BRINKS	MoF
Ms	Suzanne	BROM	MoF
Ms	Suzan	VAN DER HEIJDEN	MoF
Mr	Harry	VAN LANKVELD	MoF
Mr	Pieter	VAN NES	MoF
Mr	Sander	WINCKEL	MoF
OECD			
Ms	Francoise	GUILLARME	SIGMA
Mr	Bob	BONWITT	SIGMA
Mr	Francois-Roger	CAZALA	SIGMA
Mr	Kjell	LARSSON	SIGMA
Mr	Niels	OLOFSSON	SIGMA
Mr	Bo	SANDBERG	SIGMA
Mr	Johannes	STENBAEK MADSEN	SIGMA
Mr	Nick	TREEN	SIGMA
Mr	Rudy	VOET	SIGMA
Mr	Joop	VROLIJK	SIGMA
Poland			
Ms	Agnieszka	KAZMIERCZAK	MoF
Mr	Konrad	KNEDLER	MoF
Ms	Monika	KOS	MoF
Ms	Ewa	KRZYZEWSKY-KURAN	MoF
Mr	Augustyn	KUBIK	MoF
Ms	Maria	ZACHARCZUK-KAKIETEK	SAI
Romania			
Mr	Camil	BOJIN	MoF
Mr	Vasile	CABULEA	MoF
Mr	Alexandru	DIMA	MoF
Mr	Emil	DINGA	MoF
Ms	Niculina	MATEI	MoF
Ms	Ioana	MUNTEANU	MoF
Mr	Viorel	SERBANESCU	MoF
Mr	Mihai	SPRANCEANA	MoF
Mr	Dragos	BUDALAC	RCoA
Mr	Dan	SAGUNA	RCoA
Slovakia			
Ms	Denisa	AMBROVA	MoF
Ms	Dana	DYCKOVA	MoF
Mr	Jiri	EICHLER	MoF
Ms	Dagmar	HUPKOVA	MoF

	Name		Organisation
Mr	Viliam	KACERIAK	MoF
Ms	Maria	KOMPISOVA	MoF
Mr	Boleslav	NEJEZCHLEB	MoF
Ms	Anna	STAVINOVA	MoF
Mr	Viliam	VASKOVIC	MoF
Slovenia			
Mr	Miran	GOSTICA	MoF
Mr	Jurij	MILATOVIC	MoF
Sweden			
Ms	Ulrika	BARKLUND-LARSSON	MoFA
Turkey			
Ms	Pinar	ACAR	MoF
Mr	Ibrahim	BERBEROGLU	MoF
Mr	Abdulkadir	GÖKTAS	MoF
Mr	Huseyin	GÖSTERICI	MoF
Mr	Hasan	GÜL	MoF
Mr	Cevad	GÜRER	TCA
Mr	Abdullah	KAYA	MoF
Mr	Ahmet	KESIK	MoF
Mr	Vedat	ÖZDAN	MoF
United Kingdom			
Mr	Bill	FRASER	Consultant
Mr	Chris	BUTLER	Treasury
Mr	Gareth	EVANS	Consultant
Ms	Sharon	HANSEN COOPER	Consultant
Mr	Noel	HEPWORTH	Consultant
Mr	Phil	TARLING	Consultant
Mr	Julian	WATTS	Consultant
World Bank			
Mr	Peter	DEAN	staff
Mr	Jim	PARKS	staff
Mr	Ranjan	GANGULI	staff
Mr	John	HEGARTY	staff

Appendix 2. Corruption Perception Indicators[1]

Based on Transparency International, Annual reports of 2005 and 2006, modified: the higher the figure, the less corruption in the public sector

EUR-15	1998	2005
Finland	9.6	9.6
Denmark	10.0	9.5
Sweden	9.5	9.2
Netherlands	9.0	8.6
United Kingdom	8.7	8.6
Luxemburg	8.7	8.5
Austria	7.5	8.7
Germany	7.9	8.2
Ireland	8.2	7.4
Belgium	5.4	7.4
France	6.7	7.5
Spain	6.1	7.0
Portugal	6.5	6.5
Italy	4.6	5.5
Greece	4.9	4.3
Averages	**7.55**	**7.77**

EUR-10	1998	2005
Malta	n.a.	6.6
Slovenia	6.0	6.1
Estonia	5.7	6.4
Cyprus	n.a.	5.7
Hungary	5.0	5.0
Lithuania	3,8	4.8
Czech Rep.	4.8	4.3
Slovakia	3.9	4.3
Latvia	2.7	4.2
Poland	4.6	3.4
Averages	**3.65**	**4.23**

n.a. = not available

1 Transparency International Corruption Perception Index 2005, http://www.transparency.org. The data are based on various sources measuring perception of the overall extent of corruption (frequency and/or amount of corruption) in the public and political sectors.

Candidates	2005
Romania	3.0
Bulgaria	4.0
Turkey	3.5
Croatia	3.4
Averages	**3.5**

CARDS	2005
Albania	2,5
BiH	3,1
Macedonia	2,7
Kosovo	n.a.
Montenegro	2,7
Serbia	2,7
Averages	**2.3**

ENP	2005
Armenia	3.1
Azerbaijan	1.9
Egypt	3.2
Georgia	2.0
Jordan	5.3
Lebanon	3.1
Moldova	2.3
Morocco	3.2
Palestine	2.5
Syria	3.4
Tunisia	5.0
Ukraine	2.2
Averages	**3.1**

Appendix 3.
Checklist for a draft PI*f*C Policy Paper[1]

I. Format

1. Suggested components: Executive Summary, Introduction, Contents, Recommendations and Endorsement and Action Plan;
2. Mention the framework of the EC requirements in the FC Chapter;
3. Describe briefly the national control environment and all existing relevant institutions;
4. Provide for a gap analysis and benchmarking with international standards;
5. Make recommendations for policies, legislation, reorganisation and training;
6. Provide for an Action Plan with time horizons and
7. Prepare for explicit endorsement by Minister of Finance and Cabinet of Ministers

II. Contents

Executive Summary

This section wishes to state the purpose and background of the paper and provide the reader with the most relevant operational conclusions and recommendations. This section should aim at all management levels, the public audit profession as well as to Parliament and the public at large.

Introduction

1. Statement of who is responsible for the drafting and co-ordination of the Policy Paper
2. Clear statement of the purpose of the Policy Paper
3. Recall the recommendations of the EC and other bodies where applicable (SIGMA, World Bank) in relation to **PI*f*C** and EA
4. Define the national stakeholders in the discussions
5. Explain the gap analysis and who performed it
6. Provide for the conclusions of the gap analysis
7. Describe the resources that will be needed to implement and run the recommendations and new systems
8. Mention those who will be responsible for the implementation of the paper's recommendations within the set deadlines?

National Control environment:

1. Provide an overview/analysis of all existing external control bodies dealing with public internal control:
   - Parliamentary Control;
   - State Audit Institution with its relations to both Parliament and government (financial independence); preferably written by the SAI and
   - Other centralised control bodies
2. Description of specific public internal control organisation:

1 DG BUDG may use a more extensive check-list.

A. FMC:

1. How are the Financial Management and control systems functioning?
2. Is there a notion of managerial accountability or to what extent are managers accountable for their actions to implement the budget and do so in terms of economy, efficiency and effectiveness?
3. Describe the organisation and functions of the financial departments in income and spending centres; director, ex-ante financial controller, ongoing financial control, ex-post financial control and/or decentralised inspection, accountant, reporting
4. Does financial control cover all steps of the budgetary decision cycle: appropriations/commitments, tendering and contracting procedures, income, disbursements, management of assets and liabilities, recovery of unduly paid amounts?

B. Internal Audit

1. Is there an internal audit function? How is it organised on central, regional and local levels?
2. What kinds of audits are performed by the internal audit departments: financial or classical audits, systems-based audits, performance audits, IT or other audits?
3. Describe the objectives of internal audit, explain how the functional independence concept works, provide information on the status and contents of the Internal Audit Charter and Code of Ethics (could be added in annexes);
4. Provide information on the internal audit tools, audit planning and reporting procedures.
5. Do public internal auditors receive a private or public training and certification? Is the certification accompanied by the signing of a Code of Ethics for the internal auditor in accordance with international standards? Are internal auditors regularly assessed for their compliance with quality standards?
6. Are there harmonised internal audit manuals?

C. CHU:

1. Will a centralised organisation be established that is responsible for the harmonisation of Financial Management and Control systems in the entire public sector based on the principle of managerial accountability?
2. Will a centralised organisation be established that is responsible for the harmonisation in the entire public sector for decentralised functionally independent internal audit?
3. Is the status of these CHUs such that they report directly to the highest management level and that they have adequate power to reach ministries and public agencies for the implementation of relevant guidelines?
4. Do the CHUs take responsibility for determining training needs in the **PI*f*C** areas covered?
5. Will the status of the head of the CHU be such that it is a civil servant rather than a contract agent and that his or her nomination and dismissal will not be subject to political coalition changes?

D. External Audit

1. Has the SAI provided for a chapter on External Audit to explain the latest developments in the public external audit area and relevant strategies and on how the SAI positions itself in view of the latest **PI*f*C** policy developments?
2. Does the SAI enjoy functional and financial independence?
3. Is the SAI a member of INTOSAI and does it adhere to its recommendations?
4. Does the SAI provide training to auditors that can be shared with CHUs?

Parliamentary control

1. Does the MoF report to Parliament on the status of IC and IA in the public sector?
2. Is Parliament responsible for the nomination of the external auditor and for the SAI Budget?
3. Are there procedures and committees to discuss the findings and recommendations of the SAI?

Other public control or inspection bodies

1. Are there other public control or inspection bodies that may have an impact on the entire **PI*f*C** structure?
2. Are the objectives and tasks of General Inspectorates on centralised and decentralised levels or of Technical Inspection departments in ministries well defined?

Gap analysis

Is a description given of the strengths and weaknesses in the present control environment as compared with international control and audit standards (IIA and INTOSAI) and EU best practice? The analysis should focus for both **PI*f*C** and External Audit on issues like: changes to the present legal framework; Institutional changes; qualification and staffing of senior management; staffing and training needs.

Conclusions

1. Does the **PI*f*C** Policy Paper contain a separate section on conclusions?
2. Do the conclusions provide for a description of the main actions to be undertaken?
3. Do the conclusions provide for a description on project organisation, management and monitoring?
4. Do the conclusions stipulate the needed resources allocations?
5. Is support foreseen from the EU?
6. Will the Policy Paper be sent by the Minister of Finance to the government (Cabinet of Ministers) for approval?
7. Will the approved PP be sent to all stakeholders after approval by the Cabinet - PR programme for distribution - ?

Action plan

1. Is an action plan for the short/medium/long term attached to the Policy Paper for the implementation of the conclusions?
2. Are the action plan items related to the gaps/recommendations identified?
3. Is indicated who is responsible for implementing the action plan items?
4. Is the time-table for the delivery of the action plan items realistic

Appendix 4. Example of a PI*f*C Framework Law

This example shows how the* PI*f*C *framework could be embedded into a Public Finance Act or an Organic Budget Act. Only the principles are mentioned and further detailed elaboration is to be regulated in separate laws.

Chapter on Public Internal Control and Financial Inspection

Article 1. Public Internal Control

Public internal control covers the entire system of managerial, financial and other controls, including the organisational structure, methods, procedures as well as internal audit, established by management within its governance objectives. The primary objectives of internal control are to ensure:

- The reliability and integrity of information,
- Compliance with policies, plans, procedures, laws, and regulations,
- The safeguarding of assets and liabilities.

The internal control systems shall function in compliance with the principles of legality and regularity, transparency, economy, efficiency and effectiveness. Each organisation shall design its own system of internal control to meet the needs and environment of the organisation taking into account the advice of the public central harmonisation organisation based on international standards and best EU practice.

Article 2. Financial Management and Control systems

1. Financial management and control refers to the management accountability for budget planning, implementing and controlling of financial plans, accounting and reporting in order to achieve the established objectives and to assure safeguarding of assets and liabilities from waste, misuse and fraud. FMC shall be based on the segregation of tasks and covers all budgetary commitments, disbursements, income, tender procedures, contracting and the recovery of unduly paid amounts. FMC is subject to internal and external audit.

2. The Financial Management and Control system shall be harmonised throughout the public sector by a centralised organisation under the directorate general for budget in the Ministry of Finance;

3. The Ministry of Finance shall regulate the Financial Management and Control system based on managerial accountability by a separate law.

Article 3. Public internal audit

1. Internal audit is an independent, objective assurance and consulting activity designed to add value and improve the operations of the budget user. It helps the budget user to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

2. Internal auditing shall be performed by decentralised internal auditors attached to the highest level of management in budget users. The internal auditor shall perform audits in compliance with the Internal Audit Charter signed by management and the internal auditor and taking into account the Code of Ethics for Internal Auditors to be adhered to by the auditor upon his/her certification after training as defined by the CHU for Internal Audit.
3. In performing his/her work, the internal auditor shall be functionally independent from management and shall not perform any other operational tasks nor perform auditing of any procedures in which he/she has participated before. The independence shall relate in particular to strategic and annual audit planning, to the selection of audit methods, to reporting and to making recommendations. The internal auditor will assess the management's implementation of his recommendations. In performing his/her audits, the internal auditor shall have free access to all related premises, documents and persons.
4. The internal auditor must acquire the title of Public Internal Auditor after having successfully concluded a certification training programme organised by the CHU for Internal Audit.
5. The Ministry of Finance shall regulate the Internal Audit system by a separate law on public internal audit.

Article 4. Financial Inspection

{It would be useful to insert an article on the nature of financial inspection as the organisation that is responsible for the fight against fraud and carries out investigations on behalf of the government or the judicial authorities in case of suspicions of fraud. In this article the complementary nature of internal audit and inspection would have to be explained while avoiding any overlap in the responsibilities between the two functions. In that case it would also be necessary to indicate what organisation is responsible for financial inspection under what criteria as well as the stipulation that the Ministry of Finance will regulate the Financial Inspection by a separate law.}

Article 5. Reporting

The Ministry of Finance shall annually report on the implementation and status of public internal control and on the material findings of internal audit services to the Government and the Court of Auditors

Appendix 5. Example of a Public Sector FMC Act

Financial Management and Control Act

Chapter One

GENERAL PROVISIONS

Article 1 This Act regulates the scope and implementation of financial management and control as well as the principles and requirements to the financial management and control systems within the public sector organisations.

Article 2 (1) The provisions of this Act shall apply to public sector organisations.

(2) For the purpose of this Act public sector organisations are:

1. Organisations managing funds from the State Budget;
2. Organisations and/or structures managing extra-budgetary funds;
3. Organisations managing municipal budgets and funds;
4. Organisations managing separate and/or autonomous budgets,;
5. Organisations and/or structures managing funds guaranteed by the (name of the country), including resources under European Union Funds and Programs;
6. Commercial companies under Art 61 of the Commercial Code and state enterprises under Art 62, par.3 of the Commercial Code;
7. Other organisations and/or structures managing public funds under legal act.

Article 3 (1) The Managers of the organisations under Art.2 shall be responsible for implementation of the financial management and control in all the structures, programs, operations and processes managed by them, observing the principles of legality, sound financial management and transparency.

(2) The managers at each level in the organisations under Art.2 shall be responsible and accountable to their senior manager for their financial management and control activities in the structures and units they manage.

Article 4 (1) The Managers of the organisations under Art.2 shall be responsible for setting the objectives of the organisations, identification of the risks for their attaining and for the introduction of adequate and effective financial management and control systems in compliance with the requirements of this Act, international internal control standards, and European Union best practices.

(2) The managers of structures and units, performing the functions of paying, managing or intermediary bodies under European Union Funds shall be responsible for ensuring adequate and effective financial management and control systems in compliance with the requirements of this Act and the applicable European Union regulations.

Article 5 (1) Public financial management and control is a comprehensive process, integrated in the organisations' operations and exercised by their management and employees.

(2) Public financial management and control is exercised via a system of policies, procedures and activities, designed by the management of the organisations under Art 2 with the aim to provide reasonable assurance that the objectives of the organisations shall be achieved through:

1. Compliance with the legislation, internal acts and contracts;
2. Reliability and integrity of financial and operational reporting;
3. Effectiveness and efficiency of operations;
4. Safeguarding of assets and information.

Chapter Two
MANAGERIAL ACCOUNTABILITY

Article 6 (1) The Managers of the organisations under Art 2 shall be accountable for achieving the objectives of the organisations by managing public funds in a legal, economical, efficient and effective manner.

(2) When implementing programmes and projects, involving more than one public sector organisation and/or structure, the Managers concerned shall agree in writing on the scope of managerial accountability that each of them shall bear.

Article 7 (1) The Managers of the organisations under Art 2 shall be responsible for:

1. Setting the objectives of the organisations they manage, elaboration and implementation of strategic plans, action plans and programmes for achievement of the objectives set;
2. Identification, assessment and management of the risks jeopardizing the achievement of the organisations' objectives;
3. Planning, management and accounting of public funds with a view to achieve the objectives of the organisation;
4. Observance of the principles for legality, sound financial management and transparency of public funds;
5. Effective management of the staff and maintaining its level of competence;
6. safekeeping and safeguarding assets and information against loss, theft, unauthorised access and misuse;
7. Establishing an appropriate organisational structure to effectively carry out their responsibilities;
8. Segregation of the responsibilities on decision making, control and implementation;
9. Full, correct, precise and prompt accounting of all transactions;
10. Ensuring an internal audit function in accordance with the legislation in force;
11. Monitoring and updating the financial management and control systems and undertaking measures to improve the systems in response to internal audit recommendations, and other evaluations and assessments;
12. Documentation of all transactions and actions and ensuring traceability of the processes within the organisation;
13. Introduction of anti-corruption procedures;

14. Accounting and reporting on financial management and control systems' status;
15. Introduction of internal financial management and control rules via an administrative act or a system of acts;
16. Establishment of conditions for legitimate and expedient management, adequate and ethical behaviour of staff within the organisation.

(2) The Managers of organisations, spending units under the state and municipal budgets, as well as spending units of extra-budgetary resources and under European Union Funds and Programs, shall be responsible for the application of all guidelines under paragraph 1, issued by the Minister of Finance as well as for the application of the guidelines, issued by their senior manager.

(3) The Managers of organisations, secondary and lower level spending units shall account to their senior managers on the implementation of the guidelines under §graph 1 and paragraph 2.

Article 8 (1) The Managers of organisations, spending units under the state and municipal budgets, spending units of extra budgetary resources and under European Union Funds and Programs shall report to the Minister of Finance on the functioning, adequacy, efficiency and effectiveness of financial management and control systems in place within the organisations**.**

(2) The format, contents, procedure and deadlines for reporting under paragraph 1 shall be set out by an ordinance of the Minister of Finance.

Article 9 (1) In the performance of their duties as defined under this Act the Managers shall have the right to delegate tasks to their subordinates, specifying the requirements for reporting on the fulfilment of the tasks.

(2) The delegation of rights and duties shall not prejudice the rights of, nor shall it discharge the delegating Manager from accountability for the fulfilment of the respective task or for the choice of subordinate to whom rights and duties have been delegated.

Chapter Three
COMPONENTS OF FINANCIAL MANAGEMENT AND CONTROL

Article 10 (1) The Managers of the organisations referred to under Art 2 shall implement financial management and control through the following interrelated components:

1. Control environment,
2. Risk management,
3. Controls,
4. Information and communication,
5. Monitoring.

(2) The Managers at all levels in the organisations referred to under Art 2 shall ensure the setting up, development and functioning of the financial management and control components in compliance with the specificity of their organisation and the methodological guidelines, issued by the Minister of Finance.

Article 11 (1) The Managers of the organisations under Art 2 shall be responsible for the control environment establishment, status and improvement.

(2) The control environment shall cover:

1. Personal and professional integrity of the management and the staff of the organisation;
2. Management philosophy and style of work;
3. Organisational structure, ensuring segregation of responsibilities, hierarchy and clear rules, rights, obligations and levels of reporting;
4. Policies and practices of human resource management;
5. Competence of staff.

Article 12 (1) The Managers of the organisations under Art 2 shall be responsible for risk management.

(2) Risk management covers identification, assessment of and control over potential events or situations that might have an adverse effect on the achievement of the organisation's objectives and it is designed to give reasonable assurance that the objectives will be attained.

(3) To implement the activities under paragraphs 1 and 2 the Managers shall adopt a Strategy which shall be updated every three years or in the event the risk environment changes significantly. The controls aimed at minimizing the risk should be analysed and updated at least once a year.

(4) In order to minimise the risk of fraud and irregularities, the Managers of the organisations under Art 2 shall record and report to the competent authorities the measures undertaken to prevent any fraud and irregularities.

Article 13 (1) The Managers of the organisations under Art 2 shall introduce controls, including written policies and procedures, established to give reasonable assurance that risks have been confined within the admissible limits, defined in the risk management process.

(2) The controls should be adequate and the costs for their implementation should not exceed the benefits expected thereof.

(3) The Managers shall establish and implement controls that shall include at least:

1. Procedures for authorization and approval;
2. Segregation of duties in a manner not allowing an official to have at the same time responsibility for authorisation, execution, accounting and control;
3. Double signature system under which no financial liability can be assumed or payment made without the signatures of the Manager of the organisation under Art 2 and the chief accountant or any other person, responsible for accounting entries;
4. Rules for access to assets and information;
5. Ex-ante control on the legality that can be exercised by appointed for the purpose financial controllers or other persons nominated by the Manager of the organisation;
6. Procedures of full, correct, precise and prompt accounting of all transactions;
7. Reporting and review of the activities – assessment of transactions' efficiency and effectiveness;

8. Monitoring procedures;
9. Procedures of human resources management;
10. Rules on the documentation of all transactions and actions related to the organisation's activity.

Article 14 The Managers of the organisations under Art 2 shall develop and deploy reliable information and communication systems, ensuring:

1. The identification, collection and dissemination, in appropriate form and timeframe, of reliable and trustworthy information which enables any official to take certain responsibility;

2. The effective communication, both horizontal and vertical, to all hierarchical levels of the organisation;

3. The building of an appropriate information system for management of the organisation in view of bringing to all employees' knowledge of clear and precise guidelines and instructions on their role and responsibilities in connection with the financial management and control;

4. The application of a documentation and document flowchart system containing rules for drafting, execution, movement, use and archiving of documents;

5. The documentation of all operations processes and transactions with a view to ensure an adequate audit trail for tractability and monitoring;

6. The development of an effective, timely and reliable reporting system, including: levels and deadlines for reporting; types of reports presented to managers; forms of reporting upon detection of errors, irregularities, misuse, frauds or misappropriations.

Article 15 (1) The Managers of the organisations under Art 2 shall develop a system for monitoring of the financial management and control in view of evaluating its adequate functioning and guaranteeing its timely updating upon any change in the conditions.

(2) Monitoring in organisations shall be mainly accomplished through current monitoring, self-assessments and internal audits.

Chapter Four
COORDINATION AND HARMONISATION OF FINANCIAL MANAGEMENT AND CONTROL

Article 16 (1) The Minister of Finance shall be responsible for the coordination and harmonisation of financial management and control in the organisations under Art 2.

(2) The Minister of Finance in fulfilment of his/her tasks under the present Act shall be supported by the "Internal Control" Directorate under Ministry of Finance, which exercises the functions of a Central Harmonisation Unit for Financial Management and Control and is directly subordinated to the Minister of Finance.

(3) The Central Harmonisation Unit for Financial Management and Control shall comprise persons who meet the requirements for the respective position and have minimum 2 years of experience in the field of internal control, internal and/ or external audit.

Article 17 (1) The Minister of Finance shall be responsible for the development, dissemination and updating of strategies and methodological guidelines on public financial management and control in compliance with the internationally accepted standards on internal control, the applicable regulations and the good practices in the European Union.

(2) The Minister of Finance shall issue guidelines, instructions, standards, manuals and methodology papers for the implementation of this Act;

(3) The Minister of Finance shall coordinate and support the professional training in the field of financial management and control and managerial accountability in the organisations under Article 2.

Article 18 (1) The Minister of Finance shall ensure the systematic monitoring of the application of the provisions of this Act as well as of the implementation of the acts issued under Art 17, § 2, in the spending units under the Republican and the municipal budgets as well as in the spending units of extra budgetary resources and under European Union Funds and Programs.

(2) Following a written notification by the Minister of Finance the Managers of the organisations under § 1 shall ensure to the staff of the Internal Control Directorate of the Ministry of Finance access to any documents, records and other information necessary for the monitoring of the financial management and control.

Article 19 (1) The Minister of Finance shall establish an Advisory Board for financial management and control, which shall include persons with relevant qualification and experience in the field of financial management and control, managerial accountability, internal and external audit, and shall be chaired by the Minister of Finance.

(2) The Advisory Board shall support the Minister of Finance in the field of financial management and control and managerial accountability.

(3) The Advisory Board shall meet at least twice a year. Its meetings shall be convened by the Minister of Finance.

(4) The activities of the Board shall be serviced by the Internal Control Directorate of the Ministry of Finance.

(5) The Managers of the organisations under Art 2 may establish Advisory Boards for financial management and control in their organisations.

Article 20 (1) The Minister of Finance shall prepare an annual report on the status of the public financial management and control which summarizes the information obtained in accordance with the provisions of Art 8.

(2) The Minister of Finance shall prepare and submit, not later than (date), to the Council of Ministers a Consolidated Annual Report on internal control in the public sector which summarizes the annual reports on financial management and control and internal audit in the public sector. Following its approval by the Council of Ministers the report shall be presented to the Parliament and the Supreme Audit Institution.

(3) The Supreme Audit Institution, (the Supreme Judicial Council and the Financial Supervision Commission) shall present, not later than (date), to the Parliament reports on the status of financial management and control and internal audit in the respective organisation.

ADDITIONAL PROVISIONS

§ 1. For the purpose of this Act:

1. "**Public funds**" are all funds, which are collected, received, kept, allocated and spent by the organisations from the public sector, including budget revenues, credits, expenditures and subsidies.
2. **"Adequate financial management and control systems"** are present where the management plans and organizes the processes in such a way that gives reasonable assurance that the risks to the organisation are effectively managed and that the objectives and tasks of the organisation will be efficiently and economically achieved;
3. **"Managerial accountability"** is the obligation of the managers of organisations under Art. 2 to observe and apply the principles of sound financial management and legitimacy in administering public funds and any other activity related thereto;
4. **"Sound financial management"** is the requirement the public funds to be spent and administered in compliance with the principles of economy, effectiveness and efficiency;
5. **"Financial management and control elements"** – these are introduced in compliance with the COSO (The Committee of Sponsoring Organisations of the Treadway Commission) integrated framework of internal control;
6. **"Reasonable assurance"** is a satisfactory level of confidence on an issue under given considerations of costs, benefits, and risks;
7. **"Internal Audit"** is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations;
8. **"Risk"** is the probability that a certain event, which would have an impact on the achievement of organisation's objectives, may occur. The risk is measured by its effect and the degree of probability for its occurrence;
9. **"Information management systems"** include automated and manual processing of data, procedure plans, controls, hardware, software and personnel dedicated to the operation and support of system functions;
10. **"Fraud** affecting the European Communities' financial interests" is every intentional act or omission:
    a. in respect of expenditures relating to the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the misappropriation or wrongful retention of funds from the general budget of the European Communities or budgets managed by or on behalf of the European Communities, concealment of

information in violation of a specific obligation, with the same effect; the application of such funds for purposes other than those for which they were originally granted;

b. in respect of revenues relating to the use or presentation of false, incorrect or incomplete statements or documents, which has as its effect the illegal diminution of the resources of the general budget of the European Communities or budgets managed by or on behalf of the European Communities; non-disclosure of information in violation of a specific obligation, with the same effect; the misapplication of a legally obtained benefit, with the same effect.

11. **"Irregularity affecting the European Communities' financial interests"** means any infringement of a provision of Community law resulting from an act or omission by an economic operator, which has, or would have, the effect of prejudicing the general budget of the Communities or budgets managed by them, either by reducing or losing revenue accruing from own resources collected directly on behalf of the Communities, or by an unjustified item of expenditure;

12. **"Managers"** are the persons who head the organisations under Art. 2, exercising managerial functions and bearing managerial accountability.

§2. The order and procedure of exercising ex-ante control are a component of the internal control procedures and shall be approved by the Managers of the organisations under Article 2 in compliance with the instructions of the Minister of Finance.

Appendix 6. Example of a public sector Internal Audit Act

Chapter One
GENERAL PROVISIONS

Art 1 This Act shall regulate the nature, principles and scope of internal audit in public sector organisations, referred to hereafter "the organisations", the statute and functions of the structures and persons implementing it, as well as the specific activities related to the audit of European Union funds and programmes.

Art 2 The manager shall be responsible for the setting up and functioning of adequate and effective financial management and control systems and for this purpose he/she is supported by the internal audit.

Art 3 (1) Internal audit shall be an independent and objective activity for providing assurance and consulting services designed to add value and improve the activities of the organisation.

(2) Internal audit shall assist the organisation in the achievement of its goals by applying a systematic and disciplined approach to evaluate and improve effectiveness of risk management, control and management processes.

Art 4 Internal audit shall be performed in accordance with the International Standards for Internal Auditing, the Code of Ethics of internal auditors and in compliance with the following principles:

1. Independence and objectivity;
2. Competence and due professional care;
3. Integrity and confidentiality.

Chapter Two
INTERNAL AUDIT SCOPE AND ORGANISATION

Art 5 Internal audit under this Act shall be performed at:

1. Organisations managing funds from the State Budget;
2. Organisations and/or structures managing extra-budgetary accounts;
3. Organisations managing funds under municipal budgets and funds;
4. Organisations managing public separated and/or autonomous budgets (including the National Social Security Institute and the National Health Insurance Fund);
5. Organisations and/or structures managing funds guaranteed by the (the country concerned), including the European Union funds and programmes;
6. State-owned enterprises (and other companies under the Commercial Act).

7. Organisations and/or structures managing public funds assigned to them by legal act;

Art 6 (1) The manager shall be responsible for the implementation and guarantee of the adequate functioning of the internal audit in compliance with the requirements under this Act.

(2) The scope of internal audit shall cover all structures, programmes, activities and processes in an organisation.

Art 7 (1) Internal audit shall be performed by:

1. An Internal Audit Unit, which shall consist of a head of unit and internal auditors, and shall report directly to the head of the respective organisation;
2. Internal auditor/s from the audit unit of another organisation, on the basis of an agreement between the managers of the respective organisations;
3. Auditor/s listed in the internal auditors register referred to in Art. 50.

(2) The internal audit in cases under § 1, subparagraphs 2 and 3 shall be performed in compliance with the requirements of this Act and Guidelines issued by the Minister of Finance.

Art 8 (1) An Internal Audit Unit shall be set up at:

1. The administrations of the President, the Parliament, the Council of Ministers, and at the Supreme Audit Institution, the Supreme Judiciary Council, Ministries, the National Social Security Institute and the National Health Insurance Fund;
2. The administrations of the first-level spenders of budget appropriations under the national and municipal budgets other than those referred to in sub§ 1, whose budget for the previous year exceeds (minimum level in national currency);
3. Second-level spenders of budget appropriations under the republican budget and spenders of extra-budgetary funds.

(2) Upon the decision by the Minister of Finance after risk assessment, the Internal Audit Unit shall be established at other organisations, spenders of budget appropriations under the republican budget.

Art 9 (1) The Internal Audit Unit shall perform internal auditing of all structures, programmes, activities and processes, including those of spenders of European Union resources and lower-level spending units within the organisation.

(2) The Internal Audit Unit of organisation, responsible for the management of interdepartmental programmes/projects, shall co-ordinate the work of the Internal Audit Units of the organisations participating in these programmes/projects.

(3) The Internal Audit Unit of a first-level spender of budget appropriations shall not audit the activities of second-level spenders in which an independent Internal Audit Unit has been set up, or those of their lower-level spending units.

(4) The Internal Audit Unit of the first level spenders of budget appropriations shall monitor and co-ordinate the activities of the Internal Audit Unites at the second level spenders of budget appropriations.

Art 10 (1) The managers referred to in Art 8 shall comply with the following requirements for a minimum number of Internal Audit Unit personnel:

1. Where the budget of the respective organisation for the previous year, is up to (minimum level in national currency) including the management of funds under the European Union funds and programmes, not less than two internal auditors, including the head of internal audit;
2. Where the budget of the respective organisation for the previous year ranges from over (level in national currency to be determined), including the management of funds under the European Union funds and programmes, not less than four internal auditors, including the head of internal audit;
3. Where the budget of the respective organisation for the previous year ranges from over (levels in national currency to be determined), including the management of funds under the European Union funds and programmes, not less than six internal auditors, including the head of internal audit;
4. Where the budget of the respective organisation for the previous year exceeds (levels in national currency to be determined), including the management of funds under the European Union funds and programmes, not less than ten internal auditors, including the head of internal audit.

(2) For the purposes of determining the minimum number of personnel for the Internal Audit Unit, the budgets of first-level spenders shall be netted of the budgets of lower-level spending units in which independent Internal Audit Units are set up.

(3) The minimum number of Internal Audit Unit personnel referred to in § 1 shall not include trainee auditors.

Art 11 (1) State-owned enterprises (and other companies under the Commercial Act) with total balance sheet assets for the previous year exceeding (level in national currency) shall set up an Internal Audit Unit.

(2) The number of personnel in units referred to in § 1 shall be established upon a decision of their governing bodies but should not be less than two internal auditors, including the head of internal audit.

(3) In cases other than those referred to in § 1, State-owned enterprises (and other companies under the Commercial Act) may set up Internal Audit Units upon a decision of their governing bodies.

Art 12 (1) The manager shall ensure the independence of internal auditors in internal audit planning, performance and reporting and cannot assign the performance of any functions and activities other than the activities involved in internal audit to the head of internal audit and internal auditors.

(2) In order to ensure the functional and organisational independence of the internal audit, the head of the Internal Audit Unit shall report directly to the manager.

Art 13 The manager and other officials in the organisation shall be obliged to cooperate with internal auditors in the performance of their activity and shall not have the right to refer to a commercial or official secret of their organisation or of another as a reason for non-disclosure or denying access.

Art 14 (1) The manager can set up a consulting audit committee which shall support the internal audit in the organisation.

(2) The statute, the staff number and the functions of the audit committee shall be defined in compliance with the Guidelines of the Minister of Finance and in compliance with the International Standards for Internal Auditing.

(3) On the basis of risk assessment the Minister of Finance can require from the managers to set up audit committees.

Chapter Three
NATURE OF INTERNAL AUDIT

Art 15 Internal audit shall support the organisation in the achievement of its goals by:

1. Identifying and assessing the risks in the organisation;
2. Evaluating the adequacy and effectiveness of financial management and control systems in relation to:
   a) Risk identification, risk assessment and risk management by the management of the organisation;
   b) Their compliance with primary and secondary legislation and internal acts and contracts;
   c) Reliability and comprehensiveness of financial and operating information;
   d) Efficiency, effectiveness and economy of operations;
   e) Safeguarding of assets and information;
   f) Performance of tasks and achievement of goals.
3. Providing recommendations for improving activities in the organisation.

Art 16 Internal audit shall be implemented through the performance of specific audit engagements for the provision of assurance services or consulting services.

Art 17 (1) An audit engagement for assurance services shall consists in the provision of an objective evaluation of evidence by the internal auditor in order to provide an independent opinion or conclusion concerning a process, a system or another item covered by the audit.

(2) The objective and the scope of each audit engagement for assurance services shall be defined by the head of internal audit. An audit engagement shall have the following stages: planning, performance of actual checks, reporting, and follow-up activities to monitor the implementation of recommendations made.

(3) An audit engagement for assurance services shall be performed through: systems-based audits, compliance audits, performance audits, financial audits, IT-audits, and due diligence.

Art 18 (1) An audit engagement for consulting services shall consists in the provision of an advice, opinion, training and other services designed to improve the processes of risk management and control, without the internal auditor assuming any managerial accountability therefore. Audit engagements for consulting services shall be initiated by the manager.

(2) The objective and the scope of each audit engagement for consulting services shall be agreed with the manager.

Chapter Four
RIGHTS AND RESPONSIBILITIES OF THE HEAD OF INTERNAL AUDIT AND INTERNAL AUDITORS

Section I

Rights of the Head of Internal Audit and Internal Auditors

Art 19 (1) The head of internal audit and internal auditors shall have the right to unrestricted access to the management, all members of staff and all assets of the organisation in connection with performing the audit.

(2) The head of internal audit and internal auditors shall have the right of access to all information, including classified, as per their respective level of clearance, and to all records, including electronic, available at the organisation and necessary for the performance of the audit.

(3) The head of internal audit and internal auditors shall have the right to request from the responsible officials any data, summary statements, opinions, documents and other information necessary in connection with the audit.

(4) The head of internal audit and internal auditors shall obtain the necessary support from the management and all members of staff of the structures of the organisation where an audit is being performed.

Art 20 (1) The internal auditors shall, upon the endorsement of the head of internal audit and the manager, have the right to carry out checks at structures and parties outside the organisation, where this is necessary for the purposes for carrying out the audit engagement.

(2) Checks referred to in § 1 shall be carried out after a prior notification and in coordination with the management of structures and parties where such check is to be carried out.

Art 21 In addition to the rights referred to in Art. 19, the head of internal audit shall have the following rights:

1. To report to the manager on all matters relating to the performance of audit;
2. To propose to the manager to appoint an expert, where special knowledge and skills related to the performance of internal audit are needed;
3. To have access to the chairman and the members of the audit committee referred to in Art 14 and to take part in its meetings, if such audit committee is established.
4. To determine the audit engagement's objectives, scope, frequency, the audit techniques and the resources, required for the implementation of each audit engagement.

Section II

Responsibilities of the Head of Internal Audit and Internal Auditors

Art 22 The head of internal audit and internal auditors must comply with the International Standards on Internal Auditing, the internal auditors' Code of Ethics, the Internal Audit Charter and the methodology for internal audit in the public sector approved by the Minister of Finance.

Art 23 The head of internal audit and internal auditors shall be obliged not to disclose and not to provide any information they have become aware of in the course of or on the occasion of the performance of their activity, with the exception of cases provided for by law.

Art 24 The head of internal audit shall be responsible for the overall activity of the Internal Audit Unit, including: He/she shall:

1. Prepare and submit for co-ordination to the manager and to the audit committee, referred to in Art 14, if such audit committee is established, a draft Internal Audit Charter, a strategic and an annual plan for internal audit,
2. Organise, coordinate and distribute tasks among internal auditors for implementation, in accordance with their knowledge and skills;
3. Approve specific audit engagement plans;
4. Monitor implementation of the annual plan for internal audit and implementation of methodology of internal audit in the public sector at the unit he/she manages;
5. Prepare and present for approval by the manager a plan for the professional training and development of internal auditors and makes best efforts to retain audit personnel with sufficient knowledge, skills, experience and professional qualifications;
6. Develop specific methodology where needed for the activities of the Internal Audit Unit;
7. Organise the assessment of all new financial management and control systems, as well as of all changes in the structures and functions of the organisation.

Art 25 The head of internal audit shall be accountable to the manager, and to the audit committee, if such audit is established, referred to in Art. 14 for:

1. Presenting the annual internal audit activity report and an assessment of the adequacy and effectiveness of financial management and control systems;
2. Reporting the results of audit engagements and all significant issues brought up in them, recommendations made and actions undertaken to improve the organisation's activity;
3. Reporting periodically on progress made in implementing the annual internal audit activity plan;
4. Reporting on the adequacy of internal audit resources;
5. Reporting on all cases where the activity of the head of internal audit and internal auditors had encountered restrictions;
6. Coordinating the interaction with the external audit and preparing information for the Minister of Finance.

Art 26 (1) The head of internal audit shall develop and implement an audit quality assurance programme including internal and external evaluations.

(2) Internal evaluations shall include progress reviews of the Internal Audit Unit performance and periodic reviews through self-assessment or through peer review by others who are familiar with internal audit practices and International Standards on Internal Auditing.

(3) External evaluations shall be made at least once every five years by parties external to the organisation, who are familiar with internal audit practices and the International Standards on Internal Auditing.

Art 27 (1) The head of internal audit and internal auditors should have relevant knowledge to be able to recognize fraud indications and the presence of any conditions for enabling fraud.

(2) When indications of fraud have been identified the internal auditors notify immediately the head of internal audit, who shall immediately notify the manager making a proposal to notify the competent authorities and any other action which needs to be taken.

(3) In case the manager fails to undertake follow-up action after the reporting referred to in § 2, the head of internal audit shall notify the audit committee, if such audit committee is established, referred to in Art. 14.

Art 28 Internal auditors cannot perform audit engagement for providing assurance, relating to activities and structures on which he/she has provided consulting services or in which he/she had been employed over the past one - year period. They shall disclose to the head of internal audit any existence of such circumstances.

(2) The head of internal audit and the internal auditors shall not have the right to perform functions and activities in the organisation other than the internal audit activities.

Chapter Five

REQUIREMENTS FOR THE HEAD OF INTERNAL AUDIT AND INTERNAL AUDITORS

Art 29 (1) Internal auditors shall be appointed by the manager in an employment arrangement regulated by the (Labour Code or the Civil Servant Act).

(2) Individuals who meet the following requirements shall be eligible for employment as internal auditors:

1. To be a legally capable (national) citizen;
2. Not to have been convicted for any premeditated crime of a public nature and not been deprived of the right to hold the respective position by a court ruling;
3. To have completed a programme of higher education and hold a master's or bachelor's degree;
4. To have taken successfully the examination for internal auditors in the public sector referred to in Art. 53 of this Act or hold an internationally recognized audit certificate.

Art 30 (1) Individuals who do not meet the requirements specified under Art. 29, § 2, subparagraph 4, may be appointed as trainee auditors for a period of two years.

(2) Within the time period specified in § 1, a trainee auditor should meet the requirements of Art. 29, § 2, sub§ 4, and can then be appointed as internal auditor.

Art 31 (1) The head of internal audit shall be appointed in an employment arrangement regulated by the (Labour Code or the Civil Servant Act) and must meet the requirements referred to in Art. 29, § 2, sub§s 1, 2 and 4, and the following additional requirements:

1. To have completed a programme of higher education and hold a master's degree;
2. To have at least 3 years of service experience in the field of internal or external audit.

(2) The appointment and the dismissal of the head of the internal audit at the organisations spenders of budget appropriations under the republican and municipal budgets, as well as spenders of funds under extra-budgetary funds and under EU funds and programmes, shall be made after receiving written approval by the Minister of Finance.

(3) The following cannot be appointed as head of internal audit:

1. A person who has been employed in a position within the management authorities or over the past 2 years in an employment arrangement regulated by the (Labour Code or the Civil Servants Act);
2. A person who has been employed by the organisation over the past one-year period in an employment arrangement regulated by the (Labour Code or the Civil Servant Act) excluding the officials, which were occupied as internal auditor or as a member of the Inspectorate of the organisation under Art. 46 of the (Administration Law);

3. A person whose spouse, relative in a direct line without limitation, in a collateral line up to the fourth degree, or by marriage up to the fourth degree are or have been employed in a managerial position in the organisation over the past 2 years.

(4) The circumstances defined in § 3 shall be declared in writing by any applicant for the position of head of internal audit before the manager at the time of appointment.

Chapter Six
INTERNAL AUDIT PLANNING, PERFORMANCE AND REPORTING

Art 32 Internal audit planning shall be done on the basis of risk assessment and shall be set in a three-year strategic plan, on the basis of which an annual internal audit activity plan shall be developed.

Art 33 (1) The strategic plan shall be developed by the head of internal audit following a discussion with the manager and other persons in managerial positions; it shall be guided by the long-term goals of the organisation and set strategic development objectives in the field of internal audit.

(2) The strategic plan shall be endorsed by the manager and by the audit committee, referred to in Art. 14, if such audit committee is established.

Art 34 (1) The annual plan containing specific audit engagements shall be developed by the head of internal audit following a discussion with the manager and the other persons in managerial positions.

(2) In a situation of planned audit engagements, relating to interdepartmental programmes/projects, the annual plan shall be co-ordinated with the internal audit units of the organisations participating in these programmes/projects.

(3) The annual plan of the Internal Audit Unit of second-level spenders of budget appropriations shall be co-ordinated with the annual plan of Internal Audit Units of the first-level spender.

(4) The annual plan shall be endorsed by the manager and by the audit committee, referred to in Art. 14, if such audit committee is established.

Art 35 Any modifications to the strategic and the annual plans shall be made on the basis of risk assessment, upon a proposal by the head of internal audit and shall be endorsed by the manager and by the audit committee, referred to in Art. 14, if such audit committee is established.

Art 36 For each audit engagement, an audit plan shall be developed, indicating the scope, objectives, duration and allocation of resources for implementing the engagement, the audit approach and techniques, type and volume of checks.

Art 37 An audit engagement shall be performed by identifying, analysing, evaluating and documenting sufficient information to issue an opinion as to the set objectives.

Art 38 (1) Results from an audit engagement shall be reported and discussed with the manager and with the head of the structure the activity of which is being audited.

(2) For every audit engagement performed, an audit report shall be prepared which shall contain an executive summary, objectives and scope of the engagement, findings, conclusions and recommendations, as well as the comments of the manager or of the manger the structure, the activity of which has been audited.

Art 39 (1) The manager shall make provisions for the fulfilment of recommendations by developing an action plan, which he/she shall submit to the head of internal audit.

(2) Follow-up activities on monitoring the fulfilment of recommendations made in audit engagements shall be included in the annual plan referred to in Art. 34 and shall be reflected in an evaluation of the adequacy, effectiveness and timeliness of follow-up measures undertaken.

Art 40 (1) The head of internal audit shall prepare an annual internal audit activity report, to cover:

1. Audit engagements performed, any restrictions in scope of the audit engagement when performing the audit and other reasons for failures to fulfil the plan;
2. The main conclusions regarding the functioning of financial management and control systems within the organisation, and recommendations made to improve the activity of the organisation;
3. Actions undertaken to implement recommendations, and any recommendations not fulfilled;
4. Any cases of violation of laws and regulations and any indications of fraud;
5. Proposals for the development of internal audit.

(2) The annual report shall be submitted to the manager and the audit committee, referred to in Art. 14, if such audit committee is established.

(3) The managers of second-level spenders with budget appropriations, which have set up internal audit units, shall send the annual reports referred to in § 1 to the first-level spenders by 31 January of the following year.

(4) The head of the internal audit unit at the first-level spender with budget appropriations shall prepare a summary annual report and shall send it through the manager of the organisation to the Minister of Finance till 28 February next year.

Chapter Seven
SPECIFIC AUDIT ACTIVITIES RELATED TO THE AUDIT OF EU FUNDS AND PROGRAMMES

Art 41 Activities under this Chapter shall include:

1. Checks of operations, selected by appropriate sample from the eligible costs under the Structural Funds and the Cohesion Fund, as well as the performance of such checks under the pre-accession funds of the European Union
2. Issuance of a certificate or declaration of winding up a project or programme under European Union funds and programmes.

Art 42 Such certificate or declaration, as the case may be, shall be based on an evaluation of the management and control systems, results of previous checks and, where necessary, additional checks of transactions.

Art 43 Activities referred to in Art. 41 shall be performed in compliance with Internationally Recognized Standards on Auditing, International Agreements for the provision of European Union funds, and the respective European Union regulations dealing with the management and control of funds provided from the EU Structural Funds, the EU Cohesion Fund, and EU pre-accession funds.

Art 44 (1) The Minister of Finance shall determine the authority/persons which shall perform the activities referred to in Art. 41.

(2) The Minister of Finance shall issue a regulation on the implementation, coordination, harmonisation and the procedures and methods of performing the activities referred to in Art. 41.

Art 45 (1) Auditors performing activities under this Chapter must meet the requirements of Art. 29, § 2, subparas 1-4 and have 2 years of experience in the field of internal or external audit.

(2) Audit team leaders must meet the requirements of Art. 29, § 2, subparas 1, 2, and 4, have a master's degree and have at least 2 years of experience in the field of auditing European Union funds.

Art 46 Auditors performing the activity under this Chapter shall have the rights specified in Art. 19 and can, where necessary, perform checks at structures and parties outside the audited organisation, where so needed for the purposes of implementing the activities referred to in Art. 41.

Chapter Eight
COORDINATION AND HARMONISATION OF THE INTERNAL AUDIT

Art 47 (1) The Minister of Finance shall be responsible for the co-ordination and harmonisation of the internal audit at the organisations under Art. 5.

(2) The Minister of Finance in fulfilment of his/her tasks under the present Act shall be supported by the "Internal Control" Directorate under the Ministry of Finance, which shall perform the function of a Central Harmonisation Unit for internal audit and is directly subordinated to the Minister of Finance.

(3) Persons, who meet the requirements referred to in Art.31, § 1, shall be appointed in the Central Harmonisation Unit for internal audit.

Art 48 (1) The Minister of Finance shall be responsible for developing and updating a strategy and a uniform methodology for internal audit in the public sector and auditing EU funds and EU programmes.

(2) For the implementation of this Act, the Minister of Finance shall issue guidelines, manuals, methods, instructions, procedures, guidelines for elaboration of a Charter in accordance with the International Standards on Internal Auditing.

Art 49 (1) The Minister of Finance shall monitor the application of the methodology referred to in Art. 48, the implementation of the International Standards for Internal Auditing and the Internal Auditors' Code of Ethics at the budget and municipal spenders of budget appropriations as well as spenders of extra-budgetary funds and under EU funds and programmes.

(2) After being notified by the Minister of Finance in writing, the managers of the organisations, referred to in § 1 shall grant to the staff of the Central Harmonisation Unit an access to documents, records and other information necessary for monitoring.

Art. 50. The Minister of Finance shall make provisions for setting up and keeping a database of Internal Audit Units and a register of the certified auditors and the auditors who have successfully taken the examination for internal auditors in the public sector referred to in Art. 53, as well as a register of charters of Internal Audit Units.

Art 51 The Minister of Finance shall provide, co-ordinate and support the professional training of the heads of internal audit and the internal auditors in the public sector and shall organise regular meetings on and discussions of common issues related to the strategy, the application of the methodology and the execution of internal audit in the public sector.

Art 52 The Minister of Finance shall issue an annual report on the status of the internal audit in the public sector as part of the consolidated annual report on the status of internal control, in compliance with the requirements of Art. 20, § 2 under the Financial Management and Control Act.

Art 53 The Minister of Finance shall issue a Regulation for the terms and references of the conduct and organisation of examinations to acquire an "internal auditor in the public sector" certificate, certifying a required minimum proficiency level in internal audit.

Art 54 The Minister of Finance shall cooperate with institutions and parties in the field of internal and external audit from this country and from other countries and exchange information on internal audit developments.

ADDITIONAL PROVISIONS

§1 For the purpose of this Act:

1. **"Financial Management and Control Systems"** shall be a system of policies, procedures and activities established by the management of the organisations under Art.2 aiming at to provide a reasonable assurance that the objectives of the organisations have been achieved through:
    1. compliance with the legislation, internal acts and contracts;
    2. reliability and comprehensiveness of the financial and operational information;
    3. effectiveness and efficiency of the operations;
    4. safeguarding of assets and information
2. **"Risk"** shall refer to the probability of an event to occur that would affect the achievement of the organisation's goals. Risk is measured in terms of its impact and likelihood of occurrence.
3. **"Risk management"** shall refer to the process of identification, assessment and control of risks in order to provide reasonable assurance that the goals of the organisation will be met;
4. **"Control"** shall refer to all actions by management aimed at avoiding or reducing risks that have a negative impact on the achievement of the organisation's goals;
5. **"Independence"** shall refer to the lack of conditions which jeopardize the objectivity of internal audit. The set-up of the internal audit should not allow any interference in the work of internal auditors in determining the scope of an internal audit in planning, performance of assignments and reporting;
6. **"Objectivity"** shall refer to a bias-free attitude, which is not based on the judgement of another;
7. **"Audit engagement"** shall refer to a specific auditing assignment, task or review, which includes assurance or consulting service activity. An engagement can include various tasks, processes and activities;
8. **"Competence"** shall refer to the possession by internal auditors of the relevant knowledge, skills and other competencies necessary for the performance of their individual responsibilities, and for internal auditing as a whole to possess or procure the relevant knowledge, skills and other competencies necessary for the performance of its responsibilities;
9. **"Due professional care"** shall refer to the exercise by internal auditors of care and skills that can be expected from a reasonably prudent and competent internal auditor;
10. **"Integrity"** shall mean that the internal auditors should not knowingly take part in any illegal activity and commit themselves with activities which are discrediting for the internal auditor profession or for the organisation;

11. "Confidentiality" shall refer to respecting the value and ownership of information which internal auditors receive in the course of their work, and which they should not disclose without authorization, except in cases where they are legally or professionally obliged to do so;

12. "Management and control authorities" shall refer to managers of public sector organisations, including all heads of subordinate spending units and the heads of the units performing ex-post control over activities within the organisations.

13. "Fraud Indications" are actions or inactions from which a justified conclusion for a deliberate or incorrect presenting of material or financial facts.

14. "Code of Ethics" shall refer to the Code of Ethics of the Institute of Internal Auditors. This is a document which includes principles which apply to the internal audit profession and practice, and rules of conduct describing the behaviour expected from internal auditors. The Code of Ethics shall apply both to individual internal auditors and to organisations providing internal audit departments;

15. "Internal Audit Charter" is an internal act signed between the head of internal audit and the manager of the respective organisation which establishes the goal, authority and responsibilities of internal audit. The Charter shall:

(a) indicate the position of internal audit within the organisation;

(b) regulate the access of internal auditors to records, personnel and property necessary for the performance of engagements;

(c) define the scope of internal audit.

16. "International Standards on Internal Auditing" shall refer to *International Standards for the Professional Practice of Internal Auditing*" of the Institute of Internal Auditors, USA /IIA, Inc./;

17. "Internationally Recognised Standards on Auditing" shall refer to the standards of the International Federation of Accountants /IFAC/;

18. "Internationally recognised audit certificate" shall refer to the following certificates: CIA, CGAP, CPA, CFSA, CISA, ACCA.

Appendix 7. Example of a public sector Inspection Act

Chapter one

GENERAL PROVISIONS

Article 1

This Law shall define the objectives, the tasks, the principles and the scope of the public financial inspection activity, as well as the statute and the functions of the Public Financial Inspection Agency, hereinafter referred to as the "FIA".

Article 2

(1) The main purpose of the FIA shall be to protect the public financial interests by supporting the activities of the persons and organisations, specified in Article 4 to be performed in compliance with the principles of legitimacy and transparency.

(2) For accomplishing of the purpose under § 1 the authorities of the FIA shall implement the following main tasks:

1. Performance of financial inspections for the observance of normative acts regulating the budget, finance-economic or accounting activities of the organisation and persons under article 4.
2. Establishment of violations of the normative acts that regulate the budget, finance-economic or accounting activities, as well as of indicators for committed frauds.
3. Detection of damages of the property of the persons and the organisations according article 4, § 1
4. Implementation of the administrative penal and property liability of the perpetrators when the legal prerequisites are present.

Article 3

The FIA shall observe the principles of legality, objectivity, ex-officio principle and confidentiality.

Article 4

(1) Financial Inspection shall be performed in:

1. Budget organisations including the authorities of the Judiciary;
2. State owned enterprises under article [of the Commercial Code];
3. Commercial companies in which capital the state or municipal posses a blocking quota equity;
4. Commercial companies in which capital a person under item 2 and 3 participates with a blocking quota;
5. Legal entities that have obligations, guaranteed with state or municipal property;

6. Legal entities under the Law for legal entities with non-commercial purpose and non-personified associations under the Law of Obligations and Contracts in which the state or the municipality participate directly or indirectly in their property;
7. Persons financed by the republican or municipal budgets, extra-budgetary accounts or funds, or under international agreements, as well as persons funded by state owned enterprises funds under article [of the Commercial Code] only as regards those funds;

(2) With the exception of cases under § 1, item 3 at the commercial companies in which the state or the municipality participate in the capital nevertheless the scope of the participation, Financial Inspection can be performed upon the request of the authority, exercising the property rights of the state or municipality.

Article 5

(1) Financial Inspections shall be performed:

1. upon received requests, complaints and signals for the violations of the budget, financial-economic or accounting activities of the organisations and persons under article 4, submitted by the state authorities, civil and legal entities;
2. for checking the assigning and implementation of the public procurement procedures on the basis of information from the [Public Procurement Register, the Public Procurement Agency and the Supreme Audit Institution];
3. for checking the disbursement of target subsidies, provided under the State Budget Act of the (name of the country) for the respective year and Decrees issued by the Council of Ministers;
4. upon request by the Council of Ministers or the Minister of Finance;
5. upon assigning by the authorities of the Prosecutor's Office under the terms of articles ….[Judiciary Law].

(2) The financial inspections under § 1, item 1-3 shall be performed after preliminary judgement for effectiveness and public interest. The term for performance and the judgement criteria shall be defined in the Regulation on the Implementation of this Law.

(3) In cases when the signals are received from the Supreme Audit Institution, the financial inspections shall be assigned without judgement under § 2.

Chapter two

FINANCIAL INSPECTION AGENCY

Section I

Structure and functions of the Financial Inspection Agency

Article 6

(1) The FIA, shall be an Agency attached to the Minister of Finance and shall be a legal entity funded by the public budget.

(2) The structure, the staff and the organisation of the activities of the Agency, shall be defined in a Regulation on the Structure adopted by the Council of Ministers.

Article 7

Authorities of the FIA shall be the Director, the Deputy Director and the financial inspectors.

Article 8

(1) The FIA shall perform the following functions:

1. Manage, conduct and supervise the performance of the inspection activities;
2. Exercise control for the legitimacy of the assignment and the implementation of the public procurement;
3. Analyse the reasons and the conditions for the violations of the financial discipline and propose corrective measures to the competent authorities;
4. Provide methodical guidance and elaborate manuals for performance of the inspection activities under this Law;
5. Organise primary professional training for newly appointed officers, periodic training for maintaining and increasing the qualification and training for gaining new professional knowledge and skills of the officers of the Agency;
6. Co-operating and exchanging information with other public authorities;
7. Co-operate with the financial control authorities and organisations of other states and international organisations.

(2) The FIA shall present an annual report on the results of its activities to the Council of Ministers via the Minister of Finance. The Report shall be submitted for information to the relevant Parliamentary Committee(s) having competence in the field of the public budget and finance activities.

(3) The authorities of the Public Prosecutor's Office and the Ministry of Interior shall co-operate with the authorities of the FIA during the performance of financial inspections.

(4) The FIA and the Supreme Audit Institution shall co-operate, aiming at the protection of the public financial interests.

Article 9

(1) The FIA shall be represented and managed by a Director appointed by the Minister of Finance, with the approval of the Prime Minister, under an employment contract with a term of 4 years, without restriction to the number of re-appointments.

(2) An individual who meets the following requirements, shall be eligible for employment as Director:

1. To be a legally capable,
2. Possess a (national) citizenship,
3. To have university "Master" degree in Economics or university degree in Law with acquired legal capability,

4. To have at least ten years professional experience, at least two of which as a manager;
5. To have not been sentenced for imprisonment for a deliberate crime irrespective of his/her being rehabilitated;
6. To possess the necessary moral and professional qualities.

(3) The Director shall be dismissed by the Minister of Finance with the approval of the Prime Minister, prior to expiry of the term under § 1:

1. Upon his/her written request;
2. Upon permanent actual inability to fulfil his/her obligation in the period of 6 months;
3. Enactment of a sentence imposing a punishment of imprisonment for deliberate crime;
4. Upon severe violation or systematic negligence of his/her duties.

(4) The Deputy Director shall be employed under an employment contract and shall be appointed and dismissed by the Director with the approval of the Minister of Finance.

(5) The Director shall appoint and discharge the other authorities and officers, who must meet the requirements of article 11.

Section II

The powers of the authorities of the Public Financial Inspection Agency

Article 10

(1) The Director shall:

1. Manage and supervise the activities of the FIA;
2. Approve methodology for performing the inspection activities;
3. Assign by means of an order the performance of financial inspections and cross-checks;
4. Be responsible for the professional qualification and training of the officers of the FIA in accordance with article 8, § 1, item 5 and for the quality of the inspection activities;
5. Represent the FIA and organise its international relations;
6. Conclude agreements for co-operation with public authorities in relation to the implementation of the activities of the FIA.
7. Perform also other functions assigned to him/her with a Law or with a Decree of the Council of Ministers.

(2) The Director or officials authorised by him/her can appoint external experts, to the expense of the FIA, under terms and procedures as specified in the Regulation on the Implementation of this Law.

(3) Pursuant to a written request by the Director or officials authorised by him/her, the banks and the bank registers shall be obligated to provide information on the quantity of the accounts and the numbers of any existing and closed accounts held by organisations and persons subject to check and by the persons referred to in (article 50 of the Banking Act and under the terms of article 52, § 5, item 3 of the Banking Act - to provide information on the transactions in these accounts as well).

(4) The Director or officials authorised by him/her can provide information related to performed financial inspections, only after the finalisation of the inspections.

(5) The Director can authorise other officials to perform his/her functions under § 1. The authorisation shall not discharge the Director from the responsibility for the overall activity of the FIA.

Article 11

(1) The FIA shall employ only legally able (national) citizens, after a competition, who have not been convicted of any deliberate crime of a public nature and have not been deprived, through court proceedings, of the right to hold the respective position.

(2) The financial inspectors shall perform their powers under an official relationship and shall meet the following requirements:

1. To have university "Master" degree in Economics or university degree in Law with acquired legal capability,
2. To have professional experience as specified by the Regulation on the Structure of the FIA.

Article 12

The FIA must obtain insurance cover for its authorities and officers as specified by the Regulation on the Implementation of this Law by means of life insurance policies and insurance against accidents at the expense of the FIA's budget.

Article 13

In performing their official duties the authorities of the FIA shall have the right to:

1. An unrestricted access to the whole information, including classified, according to their level of access, while observing the principle "necessity to know", as well as to all documents, including in electronic format, which are stored at the organisation or person subject to check;
2. An unrestricted access to the business premises and to all officers of the organisation or person subject to check;
3. Check the assets and liabilities, the established accounting system, and all documents, electronic documents inclusive;
4. Demand from the officials of the organisations and persons subject to check documents, certified copies of documents, information and references and other documents relevant to the performed financial inspections within specified deadlines;
5. Demand from officials of the organisations and persons subject to check declarations of all bank accounts both in the country and abroad within specified deadlines;

6. Demand from officials of organisations and persons subject to check written explanations in relation to the performance of the financial inspections within specified deadlines;
7. Require and acquaint with the reports of the internal auditors, the reports of the National Audit Office and other control authorities, which are kept at the organisation or person subject to check, within the specified deadlines.
8. Demand certified copies of documents, information and references from legal entities and sole proprietorships outside the organisation or person subject to checks in relation to the performance of the financial inspection;
9. Perform cross-checks at legal entities and sole proprietorships outside the organisation or person subject to check when it is necessary during the performance of financial inspection;
10. Acquaint themselves with the permission of court or of the authorities of pre-trial proceedings with the investigation and other materials relevant to the financial inspection activities;
11. Acquaint themselves with materials gathered in trial proceedings and as well as decisions of the court, which have significance for the inspection activities;
12. Prevent the access of the liable persons to the safes, warehouses and other items subject to check, by their sealing in the presence of an official from the organisation subject to check;

Article 14

(1) In performing their official duties, the authorities of the FIA shall be obliged:

1. To identify themselves by an official ID card and an order for assigning financial inspection;
2. To report objectively and precisely the results established from the implemented inspection activity, the established irregularities and damages, the causes for their occurrence and the perpetrators on the basis of the facts and circumstances checked officially by them;
3. Not to disclose any facts and circumstances, obtained in the course of or during the performance of their duties with the exception of the cases provided by a law.

(2) The financial inspectors and the external experts appointed by the Director or by officials authorised by him/her shall be obligated to recall themselves when over the last three years:

1. They have worked at the organisation or for the person subject to check;
2. They have participated in the management or the supervision authorities of the organisations and/or persons under item 1;
3. They have personal interest in the activities subject to check;
4. Their spouse, a direct relative without any limitation and relatives up to the fourth degree laterally have been employed as reporting officers or have worked in the management or the supervision authorities of the organisation or the person subject to check.

(3) The circumstances under § 2, after their establishment, shall be immediately reported in written form to the Director or to persons authorized by him/her by the financial inspector or by the external expert.

(4) The Director or by the persons authorized by him/her shall assess the justification of the recall under § 2, item 3.

Article 15

(1) Each person from the organisations or persons subject to check under article 4 shall be obliged to:

1. Co-operate with and not to impede the financial inspectors in the process of execution of their duties;
2. Provide an unrestricted access of the financial inspectors to the official premises and the whole documentation;
3. Submit within specified deadlines by the financial inspectors documents, certified copies of documents, information, references and declarations for any bank accounts and written explanations, as well as the reports under article 13, item 7.
4. Submit within specified deadlines by the financial inspectors accurate data, references and declarations, documents and certified copies of documents.
5. Each person under § 1 shall not have the right to refuse access to information by referring before the financial inspectors to his/her own or other bodies commercial, bank secret, as well as to information classified as state or professional secret, observing the provisions of the Law for the Protection of the Classified Information.
6. The persons under article 13, item 8 shall be obliged to submit, within specified deadlines, certified copies of documents, data and references to the authorities of the FIA in case they are required.

Section III

Performance of financial inspection

Article 16

(1) The financial inspections shall be performed by the financial inspectors of the FIA based on an order issued by the Director or by officials authorised by him/her.

(2) The order under § 1 shall not be subject to appeal.

Article 17

(1) For the results of the performed financial inspection a report shall be drawn up, containing findings made on all checked issues. The findings in the report shall be supported by the respective evidence.

(2) The report shall be submitted to the Manager of the organisation or the person subject to check for a written statement, which shall be provided within 7 days after its submission.

(3) Under the terms of § 2, copies of the respective findings of the report and the supporting evidence shall be also submitted for a statement to the persons, whose activities have been subject to financial inspection by the financial inspectors and whose violations have been established.

(4) The financial inspector, who has performed the financial inspection shall provide a justified written conclusion within 7 working days on the received statements under § 2 and 3. This term shall start after the expiry of the term under § 2. The justified written conclusion shall be presented to the Manager of the organisation or person subject to check, as well as to the persons under § 3.

(5) The report, its conclusion and the statements under § 2 and 3 shall be presented to the authority, which has issued the order under article 16, § 1.

Section IV

Follow-up measures

Article 18

(1) As a result of the performed inspection activities, the Director or officials authorised by him/her can:

1. Provide written instructions to the Manager of the organisation or person subject to check to discontinue perpetrating irregularities and/or to remove the harmful consequences of these activities;
2. Make proposals to the competent authorities to stop the activities leading to irregularities or causing damages to the organisations and persons subject to check;
3. Make proposals to the competent authorities for repealing any illegal acts of the Managers of the organisations and persons subject to check;
4. Propose to the competent authorities to seek property and/or disciplinary liability according to the relevant procedures;
5. Propose to the Minister of Finance to discontinue the transfer of the subsidies determined with the annual State Budget Act or to blockade the accounts of the budget organisations until the removal of the irregularities.

(2) The managers of the organisations and persons subject to check in cases under § 1, item 1, within the period of 2 months after the submission of the guidelines, are obliged to notify in a written form the Director for the undertaken activities.

Article 19

When data indicating the commitment of a crime exists, a copy of the report under article 17, together with the evidences attached to the report and the statements under article 17, § 2 and 3, shall be sent to the authorities of the Public Prosecutor's office.

Article 20

(1) Information on the results of the financial inspection performed as regards organisations under Article 4, §.1, item1, shall be provided to the higher spending level organisation when irregularities are established.

(2) In case of the financial inspection of municipalities and spenders of funds under municipal budgets, information shall also be sent to the respective Municipal Council, when irregularities are established.

(3) Information on the results of the financial inspection as regards persons under Article 4, §1, item 2 and item 3, when irregularities are established, shall be provided to the authority exercising the property rights of the state or the municipalities at the person subject to check.

(4) Information on the results of the financial inspection as regards trade companies under Article 4, §.1 item 4, when irregularities are established, shall be provided to the legal entity holding a blocking quota in the capital.

(5) When financial inspection has been performed at a trade company in the insolvency proceeding or in liquidation, when irregularities are established, the information shall be submitted to the authority exercising the ownership rights of the state or municipality.

(6) For entities, funded under republican budget, municipal budgets, extra-budgetary accounts and funds or under international agreements, as well as for persons funded by the state owned enterprises under article [of the Commercial Code], when irregularities are established, information shall be sent to the financing authority.

Chapter three

Property Liability

Article 21

(1) For any illegal damages caused to the organisations or persons under Art. 4, §1, item 1 - 3, established during financial inspection under this Law, that are direct or indirect consequence of the behaviour of the perpetrators, they shall bear complete property liability, when:

1. The damage has been deliberately caused, or
2. The damage is a result from a deficit, or
3. The damage has been caused otherwise than in the course of or in relation to the execution of official duties.

(2) In case several persons cause the damage, they shall be jointly held liable.

(3) The persons, who have received anything in the absence of legal reason or as a donation as a result of the perpetrator's actions shall be obliged to return it and they shall be jointly held liable with the perpetrator of the damage.

(4) Any persons who have ordered or allowed illegal payments shall jointly bear a complete property liability with the persons under § 3.

Article 22

(1) When the prerequisites for seeking complete property liability under this Law are present, the financial inspectors shall draw up a deficit deed.

(2) The factual findings in the deficit deed shall be supported by evidence.

(3) The persons charged with deficit deed shall provide written objections to the deficit deed issued within a deadline set by the financial inspector, which cannot be earlier than 14 days after the submission of the deed.

(4) On the justification of the objections thus provided, the financial inspectors shall submit a motivated written conclusion within 14 days after receiving the objections under § 2.

(5) When after an additional check it is established that the raised objections are justified and they significantly change the findings in the deficit deed, the initiated deficit deed proceeding shall be ceased according to the rules provided in the Regulation for the Implementation of this Law.

Article 23

The following persons may be held property liable under this Law:

1. Those who receive, collect, store, spend or account property;
2. Those who supervise the persons under item 1;
3. Those who exercise control over the budget, financial-economic and accounting activities of the organisation or person subject to check;
4. Those who manage and dispose with property;
5. Those defined in article 21, § 4.

The amount of the damage shall be determined at market or book value, whichever is higher, as of the date on which the damage was incurred, and if that date cannot be identified, as of the date it was discovered

Article 25

A damage caused in foreign currency shall be recovered in the same foreign currency or in local currency, using the highest central rate of the National Bank as of the date of the incurring, discovery or recovery.

Article 26

The persons responsible for the damage shall be charged the interest stipulated by law as of the date of incurring the damage and, if such a date cannot be identified, since the date of discovery until the day of recovery of damage.

Article 27

(1) Property liability including interest shall expire with the expiry of a period of prescription of 5 years as of the date the damage was incurred, and if this cannot be identified, as of the date of discovery of such damage.

(2) Except for cases subject to the provisions of the Obligations and Contracts Act, the duration of the period of prescription under § 1 shall be interrupted also by the issuance of a deficit deed.

(3) Regardless of any suspension and discontinuation of the period of prescription, the property liability under this Law shall expire with the elapse of ten years following the incurring of the damage.

(4) The deficit deeds issued shall be examined by the Court under the terms of the[Code of Civil Procedure].

(5) The organisations and persons under article 4, § 1, item 1-3 shall not make a waiver of deficit deed, including of the interest rates.

Chapter four

Administrative penal provisions

(…)

ADDITIONAL PROVISIONS

§ 1. In the meaning of this Law:

1. "Budget organisations" are the state and municipal authorities, their structural units and all economically differentiated persons, applying budgets, budget accounts, extra-budgetary accounts and funds under the Organic Budget Law and the Municipal Budgets Act, as well as the state funds and institutions under the obligatory public, health and other kind of insurance, the state institutions for higher education and other persons and structural units, whose accounts and operations are within the consolidated fiscal programme, including the spenders of funds under EU programmes.
2. "Blocking quota" is the equity participation of the State or municipality in the capital of a trade company which amounts to no less than [34%], or a participation which enables them to prevent taking decisions, concerning: the increase or decrease of capital; transformation or termination of the company, amendments and supplements to its statute or articles of association.
3. "Guaranteed by state or municipal property" obligations are all obligations of the legal entities in favour of which guarantees with funds under state and/or municipal budget have been undertaken, including with funds from centralised funds, as well as with funds and property of legal entities with more than [34%] state or municipal equity participation.
4. "Legality" – is a principle, according to which, the officials of the FIA during the implementation of their powers must observe the Constitution, the normative acts and the international treaties, in which the [country name] as a part, which are ratified, promulgated and have entered into force for the [country name].

5. "Confidentiality" – prohibition for the authorities of the FIA to disclose and provide any information to third persons obtained in the course of conducting their official duties unless otherwise provided for by a law.
6. "Objectivity" – is a principle that requires impartial, full and exact establishment of all facts and circumstances, subject to the performed financial inspection.
7. Ex-officio principle – is a principle for establishing upon the initiative of the financial inspectors of all facts and circumstances related to the financial and economic activities of the organisation or person subject to check.
8. "Damage" according chapter 3 is any reduction of the property, without the missed benefits.
9. "Funded under the Republican or Municipal budgets as well as under EU programmes" are the natural and the legal entities that have received free funds with general or targeted purpose under the State Budget, Municipal Budgets and EU programmes.
10. "Fraud indicators" are actions or inactions from which can be made a reasonable conclusion for intentional incorrect or false presentation of material or financial facts.

Appendix 8. The INTOSAI Lima Declaration

The Lima Declaration of Guidelines on Auditing Precepts

Foreword

When the Lima Declaration of Guidelines on Auditing Precepts was adopted by acclamation of the delegates more than two decades ago in October 1977 at the IX INCOSAI in Lima (Peru) there were great hopes, but no certainty, that it would achieve world-wide success.

The experiences made with the Lima Declaration since that time have exceeded even the highest expectations and proven how decisively they influence the development of government auditing in the given context of each individual country. The Lima Declaration is equally significant for all Supreme Audit Institutions grouped in INTOSAI, no matter to what region they belong, what development they have undergone, how they are integrated into the system of government or how they are organized.

The success of the declaration is above all due to the fact that it contains a comprehensive list of all goals and issues relating to government auditing, while simultaneously remaining remarkably significant and concise, making it easy to use, with its clear language ensuring that focus does not wander away from the main elements,.

The chief aim of the Lima Declaration is to call for independent government auditing. A Supreme Audit Institution which cannot live up to this demand does not come up to standard. It is not surprising, therefore, that the issue of the independence of Supreme Audit Institutions continues to be a theme repeatedly discussed within the INTOSAI community. However, the demands of the Lima Declaration are not satisfied by a SAI just achieving independence; this independence is also required to be anchored in the legislation. For this, however, well-functioning institutions of legal security must exist, and these are only to be found in a democracy based on the rule of law.

Rule of law and democracy are, therefore, essential premises for really independent government auditing and are the pillars on which the Declaration of Lima is founded. The precepts contained in the Declaration are timeless and essential values which have maintained their topicality since the years they were first adopted. The fact that it has been decided to re-publish the Declaration more than 20 years later indeed witnesses the quality and farsighted spirit of their authors.

We extend our thanks to the International Journal of Government Auditing for their effort in publishing the new edition of the Lima Declaration, realizing the great importance of this fundamental paper which quite rightly is held to be the Magna Carta of government auditing. We now know that the Lima Declaration will continue to be disseminated in future. Living up to its high ideals remains an ongoing task for us all.

Vienna, in the autumn of 1998
Dr Franz Fiedler
Secretary General of INTOSAI

The Lima Declaration of Guidelines on Auditing Precepts

Preamble

The IXth Congress of the International Organisation of Supreme Audit Institutions (INTOSAI), meeting in Lima:

- Whereas the orderly and efficient use of public funds constitutes one of the essential prerequisites for the proper handling of public finances and the effectiveness of the decisions of the responsible authorities;
- whereas, to achieve this objective, it is indispensable that each country have a Supreme Audit Institution whose independence is guaranteed by law;
- whereas such institutions become even more necessary because the state has expanded its activities into the social and economic sectors and thus operates beyond the limits of the traditional financial framework;
- whereas the specific objectives of auditing, namely, the proper and effective use of public funds; the development of sound financial management; the proper execution of administrative activities; and the communication of information to public authorities and the general public through the publication of objective reports, are necessary for the stability and the development of states in keeping with the goals of the United Nations;
- whereas at previous INTOSAI congresses, plenary assemblies adopted resolutions whose distribution was approved by all member countries;

RESOLVES:

- To publish and distribute the document entitled "The Lima Declaration of Guidelines on Auditing Precepts."

I. General

Section 1. Purpose of audit

The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent--or at least render more difficult--such breaches.

Section 2. Pre-audit and post-audit

1. Pre-audit represents a before the fact type of review of administrative or financial activities; post-audit is audit after the fact.
2. Effective pre-audit is indispensable for the sound management of public funds entrusted to the state. It may be carried out by a Supreme Audit Institution or by other audit institutions.

3. Pre-audit by a Supreme Audit Institution has the advantage of being able to prevent damage before it occurs, but has the disadvantage of creating an excessive amount of work and of blurring responsibilities under public law. Post-audit by a Supreme Audit Institution highlights the responsibility of those accountable; it may lead to compensation for the damage caused and may prevent breaches from recurring.
4. The legal situation and the conditions and requirements of each country determine whether a Supreme Audit Institution carries out pre-audit. Post-audit is an indispensable task of every Supreme Audit Institution regardless of whether or not it also carries out pre-audits.

Section 3. Internal audit and external audit

1. Internal audit departments are established within government departments and institutions, whereas external audit departments are not part of the organisational structure of the institutions to be audited. Supreme Audit Institutions are external audit departments.
2. Internal audit departments necessarily are subordinate to the head of the department within which they have been established. Nevertheless, they shall be functionally and organisationally independent as far as possible within their respective constitutional framework.
3. As the external auditor, the Supreme Audit Institution has the task of examining the effectiveness of internal audit. If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and internal audit.

Section 4. Legality audit, regularity audit and performance audit

1. The traditional task of Supreme Audit Institutions is to audit the legality and regularity of financial management and of accounting.
2. In addition to this type of audit, which retains its significance, there is another equally important type of audit--performance audit--which is oriented towards examining the performance, economy, efficiency and effectiveness of public administration. Performance audit covers not only specific financial operations, but the full range of government activity including both organisational and administrative systems.
3. The Supreme Audit Institution's audit objectives--legality, regularity, economy, efficiency and effectiveness of financial management--basically are of equal importance. However, it is for each Supreme Audit Institution to determine its priorities on a case-by-case basis.

II. Independence

Section 5. Independence of Supreme Audit Institutions

1. Supreme Audit Institutions can accomplish their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.

2. Although state institutions cannot be absolutely independent because they are part of the state as a whole, Supreme Audit Institutions shall have the functional and organisational independence required to accomplish their tasks.
3. The establishment of Supreme Audit Institutions and the necessary degree of their independence shall be laid down in the Constitution; details may be set out in legislation. In particular, adequate legal protection by a supreme court against any interference with a Supreme Audit Institution's independence and audit mandate shall be guaranteed.

Section 6. Independence of the members and officials of Supreme Audit Institutions

1. The independence of Supreme Audit Institutions is inseparably linked to the independence of its members. Members are defined as those persons who have to make the decisions for the Supreme Audit Institution and are answerable for these decisions to third parties, that is, the members of a decision-making collegiate body or the head of a monocratically organised Supreme Audit Institution.
2. The independence of the members shall be guaranteed by the Constitution. In particular, the procedures for removal from office also shall be embodied in the Constitution and may not impair the independence of the members. The method of appointment and removal of members depends on the constitutional structure of each country.
3. In their professional careers, audit staff of Supreme Audit Institutions must not be influenced by the audited organisations and must not be dependent on such organisations.

Section 7. Financial independence of Supreme Audit Institutions

1. Supreme Audit Institutions shall be provided with the financial means to enable them to accomplish their tasks.
2. If required, Supreme Audit Institutions shall be entitled to apply directly for the necessary financial means to the public body deciding on the national budget.
3. Supreme Audit Institutions shall be entitled to use the funds allotted to them under a separate budget heading as they see fit.

III. Relationship to Parliament, government and the administration

Section 8. Relationship to Parliament

The independence of Supreme Audit Institutions provided under the Constitution and law also guarantees a very high degree of initiative and autonomy, even when they act as an agent of Parliament and perform audits on its instructions. The relationship between the Supreme Audit Institution and Parliament shall be laid down in the Constitution according to the conditions and requirements of each country.

Section 9. Relationship to government and the administration

Supreme Audit Institutions audit the activities of the government, its administrative authorities and other subordinate institutions. This does not mean, however, that the government is subordinate to the Supreme Audit Institution. In particular, the government is fully and solely responsible for its acts and omissions and cannot absolve itself by referring to the audit findings--unless such findings were delivered as legally valid and enforceable judgments--and on expert opinions of the Supreme Audit Institution.

IV. Powers of Supreme Audit Institutions

Section 10. Powers of Investigation

1. Supreme Audit Institutions shall have access to all records and documents relating to financial management and shall be empowered to request, orally or in writing, any information deemed necessary by the SAI.

2. For each audit, the Supreme Audit Institution shall decide whether it is more expedient to carry out the audit at the institution to be audited, or at the Supreme Audit Institution itself.

3. Either the law or the Supreme Audit Institution (for individual cases) shall set time limits for furnishing information or submitting documents and other records including the financial statements to the Supreme Audit Institution.

Section 11. Enforcement of Supreme Audit Institution findings

1. The audited organisations shall comment on the findings of the Supreme Audit Institution within a period of time established generally by law, or specifically by the Supreme Audit Institution, and shall indicate the measures taken as a result of the audit findings.
2. To the extent the findings of the Supreme Audit Institution's findings are not delivered as legally valid and enforceable judgments, the Supreme Audit Institution shall be empowered to approach the authority which is responsible for taking the necessary measures and require the accountable party to accept responsibility.

Section 12. Expert opinions and rights of consultation

1. When necessary, Supreme Audit Institutions may provide Parliament and the administration with their professional knowledge in the form of expert opinions, including comments on draft laws and other financial regulations. The administrative authorities shall bear the sole responsibility for accepting or rejecting such expert opinions; moreover, this additional task must not anticipate the future audit findings of the Supreme Audit Institution and must not interfere with the effectiveness of its audit.
2. Regulations for appropriate and as uniform as possible accounting procedures shall be adopted only after agreement with the Supreme Audit Institution.

V. Audit methods, audit staff, international exchange of experiences

Section 13. Audit methods and procedures

1. Supreme Audit Institutions shall audit in accordance with a self-determined programme. The rights of certain public bodies to request a specific audit shall remain unaffected.
2. Since an audit can rarely be all-inclusive, Supreme Audit Institutions as a rule will find it necessary to use a sampling approach. The samples, however, shall be selected on the basis of a given model and shall be sufficiently numerous to make it possible to judge the quality and regularity of financial management.
3. Audit methods shall always be adapted to the progress of the sciences and techniques relating to financial management.

4. It is appropriate for the Supreme Audit Institution to prepare audit manuals as an aid for its auditors.

Section 14. Audit staff

1. The members and the audit staff of Supreme Audit Institutions shall have the qualifications and moral integrity required to completely carry out their tasks.
2. In recruiting staff for Supreme Audit Institutions, appropriate recognition shall be given to above-average knowledge and skills and adequate professional experience.
3. Special attention shall be given to improving the theoretical and practical professional development of all members and audit staff of SAIs, through internal, university and international programmes. Such development shall be encouraged by all possible financial and organisational means. Professional development shall go beyond the traditional framework of legal, economic and accounting knowledge, and include other business management techniques, such as electronic data processing.
4. To ensure auditing staff of excellent quality, salaries shall be commensurate with the special requirements of such employment.
5. If special skills are not available among the audit staff, the Supreme Audit Institution may call on external experts as necessary.

Section 15. International exchange of experiences

1. The international exchange of ideas and experiences within the International Organisation of Supreme Audit Institutions is an effective means of helping Supreme Audit Institutions accomplish their tasks.
2. This purpose has so far been served by congresses, training seminars jointly organised with the United Nations and other institutions, by regional working groups and by the publication of a professional journal.
3. It is desirable to expand and intensify these efforts and activities. The development of a uniform terminology of government audit based on comparative law is of prime importance.

VI. Reporting

Section 16. Reporting to Parliament and to the general public

1. The Supreme Audit Institution shall be empowered and required by the Constitution to report its findings annually and independently to Parliament or any other responsible public body; this report shall be published. This will ensure extensive distribution and discussion, and enhance opportunities for enforcing the findings of the Supreme Audit Institution.
2. The Supreme Audit Institution shall also be empowered to report on particularly important and significant findings during the year.
3. Generally, the annual report shall cover all activities of the Supreme Audit Institution; only when interests worthy of protection or protected by law are involved shall the Supreme Audit Institution carefully weigh such interests against the benefits of disclosure.

Section 17. Method of reporting

1. The reports shall present the facts and their assessment in an objective, clear manner and be limited to essentials. The wording of the reports shall be precise and easy to understand.
2. The Supreme Audit Institution shall give due consideration to the points of view of the audited organisations on its findings.

VII. Audit powers of Supreme Audit Institutions

Section 18. Constitutional basis of audit powers; audit of public financial management

1. The basic audit powers of Supreme Audit Institutions shall be embodied in the Constitution; details may be laid down in legislation.
2. The actual terms of the Supreme Audit Institution's audit powers will depend on the conditions and requirements of each country.
3. All public financial operations, regardless of whether and how they are reflected in the national budget, shall be subject to audit by Supreme Audit Institutions. Excluding parts of financial management from the national budget shall not result in these parts being exempted from audit by the Supreme Audit Institution.
4. Supreme Audit Institutions should promote through their audits a clearly defined budget classification and accounting systems which are as simple and clear as possible.

Section 19. Audit of public authorities and other institutions abroad

As a general principle, public authorities and other institutions established abroad shall also be audited by the Supreme Audit Institution. When auditing these institutions, due consideration shall be given to the constraints laid down by international law; where justified these limitations shall be overcome as international law develops.

Section 20. Tax audits

1. Supreme Audit Institutions shall be empowered to audit the collection of taxes as extensively as possible and, in doing so, to examine individual tax files.
2. Tax audits are primarily legality and regularity audits; however, when auditing the application of tax laws, Supreme Audit Institutions shall also examine the system and efficiency of tax collection, the achievement of revenue targets and, if appropriate, shall propose improvements to the legislative body.

Section 21. Public contracts and public works

1. The considerable funds expended by public authorities on contracts and public works justify a particularly exhaustive audit of the funds used.
2. Public tendering is the most suitable procedure for obtaining the most favourable offer in terms of price and quality. Whenever public tenders are not invited, the Supreme Audit Institution shall determine the reasons.
3. When auditing public works, the Supreme Audit Institution shall promote the development of suitable standards for regulating the administration of such works.

4. Audits of public works shall cover not only the regularity of payments, but also the efficiency of construction management and the quality of construction work.

Section 22. Audit of electronic data processing facilities

The considerable funds spent on electronic data processing facilities also calls for appropriate auditing. Such audits shall be systems-based and cover aspects such as planning for requirements; economical use of data processing equipment; use of staff with appropriate expertise, preferably from within the administration of the audited organisation; prevention of misuse; and the usefulness of the information produced.

Section 23. Commercial enterprises with public participation

1. The expansion of the economic activities of government frequently results in the establishment of enterprises under private law. These enterprises shall also be subject to audit by the Supreme Audit Institution if the government has a substantial participation in them--particularly where this is majority participation--or exercises a dominating influence.
2. It is appropriate for such audits to be carried out as post-audits; they shall address issues of economy, efficiency and effectiveness.
3. Reports to Parliament and the general public on such enterprises shall observe the restrictions required for the protection of industrial and trade secrets.

Section 24. Audit of subsidised institutions

1. Supreme Audit Institutions shall be empowered to audit the use of subsidies granted from public funds.
2. When the subsidy is particularly high, either by itself or in relation to the revenues and capital of the subsidised organisation, the audit can, if required, be extended to include the entire financial management of the subsidised institution.
3. Misuse of subsidies shall lead to a requirement for repayment.

Section 25. Audit of international and supranational organisations

1. International and supranational organisations whose expenditures are covered by contributions from member countries shall be subject to external, independent audit like individual countries.
2. Although such audits shall take account of the level of resources used and the tasks of these organisations, they shall follow principles similar to those governing the audits carried out by Supreme Audit Institutions in member countries.
3. To ensure the independence of such audits, the members of the external audit body shall be appointed mainly from Supreme Audit Institutions.

Appendix 9. International control standards

The COSO[1] model and its interpretations for the public sector

The COSO model (in both its version I and II) is a framework that is designed to enable management to deal effectively with existing and future risks and to respond in such a way that the likelihood of risk is reduced. COSO was developed for the private sector and the standards it contains have become the most widely accepted in enterprise management and control/audit.

COSO version I contains five interrelated components: Control environment, risk assessment, control activities, information & communication and monitoring. In this appendix we will only focus on the fifth aspect "monitoring" so that we will not elaborate on the first four elements, which all belong to the managerial responsibility aura. COSO version II is an amendment of version I (without changing the basic message). The amendment was made in the wake of the corporate governance failings that shook the world of international accounting and auditing around 2000, and has split the risk assessment component into three more components: event identification, risk assessment and risk response, also belonging to the managerial sphere.

The two most influential documents at this moment (May 2006) are, in chronological order: The INTOSAI Guidelines for Internal Control Standards for the Public Sector, published in November 2004 and the ECIIA[2] Position Paper on Internal Auditing in Europe of February 2005.

It is interesting to note that the only existing standards and guidelines for how the **public** sector in general should organise its internal control systems come from two outside sources: the IIA with its roots in the private sector extending its message to the public sector and the INTOSAI, whose members are responsible for auditing the public sector from the outside. The INTOSAI is basically using the same COSO-model for its guidelines.

The INTOSAI Guidelines for Internal Control Standards

The first 1992 INTOSAI guidelines for internal control standards (hereafter "guidelines") were conceived as a living document reflecting the vision that standards should be promoted for the design, implementation, and evaluation of internal control. This vision involves a continuing effort to keep these guidelines up-to-date. The 17th INCOSAI (Seoul, 2001) recognized a strong need for updating the 1992 guidelines and agreed that the COSO integrated framework for internal control should be relied upon. Subsequent outreach efforts resulted in additional recommendations that the guidelines address ethical values and provide more information on the general principles of control activities related to

1 Committee on Sponsoring Organisations of the Treadway Commission

2 European Confederation of Institutes for Internal Audit

information processing. The revised guidelines of 2004 take these recommendations into account and should facilitate the understanding of new concepts with respect to internal control. They will be further developed over time and refined to embrace the impact of new developments such as COSO's Enterprise Risk Management Framework (COSO 2004). The update is the result of the joint effort of the members of the INTOSAI Internal Control Standards Committee.

The guidelines state that monitoring is accomplished through either routine activities, specific evaluations or both. The routine or ongoing monitoring is the responsibility of the manager, whereas the specific evaluations can be carried out by the following actions/entities: self-assessment, SAIs, external auditors and internal auditors (in that order!). It is not clear what might be the difference between the SAI and the external auditor. Audit is being defined as a specific task covering the evaluation of the effectiveness of the internal control system and <u>ensures</u> that internal control achieves the desired results based on predefined methods and procedures. Any deficiencies should be reported to the <u>appropriate</u> level of management.

The word "ensure" is somewhat enigmatic, because it might be interpreted as containing elements of being responsible for the well-functioning of the internal control system. This should obviously not be the case as internal audit cannot assume responsibility for managerial decisions. The auditor gives recommendations to the manager, but it is up to the manager to implement them. This is recognised in chapter 3 of the guidelines on the roles and responsibilities of the internal auditor where it says that although internal audit can be a valuable educational and advisory resource on internal control, the auditor should not be a substitute for a strong internal control system. The quintessence lies in the internal auditor being independent from management, working in an <u>unbiased, correct and honest</u> way, reporting to the <u>highest</u> level of authority within the organisation.

For professional guidance, the guidelines refer to the IIA's Professional Practices Framework (PPF) including the Definition, the Code of Ethics, the Standards ands the Practice Advisories. Additionally, the INTOSAI has also developed its own Code of Ethics to be followed by its auditors, which may be of use to internal auditors as well. Finally, the guidelines state that the internal audit staff can contribute to the efficiency of the external audit by providing direct assistance to the external auditor.

ECIIA Position Paper on Internal Auditing

The Position Paper provides the best detailed standards for internal audit in the private sector. Internal auditing is seen as a <u>separate profession</u> on a global basis, whose activities should be independent from the activities to be audited. It should also be free from any interference in determining the scope of its work, performing its duties and in communicating the results. To guarantee sustainable independence, the chief audit executive should report functionally to those responsible for governance and administratively to an appropriate senior level within the organisation. The Position Paper suggests the board of governors, an audit committee or another appropriate body as the responsible organisation for governance. The audit committee should safeguard internal audit independence by regularly reviewing and approving the internal audit charter and mandate; it should also be consulted for hiring and firing the chief audit executive. Regular reporting to executive management and the board on the effectiveness of internal control, on providing recommendations for improving internal controls and on distributing information on the latest techniques for fraud detection, can together make a significant contribution to fraud prevention. In cases where fraud is suspected, the internal audit activity may undertake investigations, provided the internal audit department has the necessary skills in specialist procedures, investigations, analysis and evidence gathering.

It would thus seem that the most important international standards relating to audit provide us with the following set of criteria for internal audit:

- Is it a distinct profession?
- Is there functional independence from management?
- Is it free from interference in the work scope, work performance and reporting?
- Is it reporting to management or audit board responsible for governance?
- Is the hiring/firing of the audit chief only after consultation of audit board?
- Does it perform investigations only if it has such skills and if there is no other body better skilled to do the job?
- Do internal auditors follow for professional guidance the Professional Practices Framework (PPF) of the IIA including the Definition, the Code of Ethics, the Standards and the Practice Advisories?

The question now is how to translate this set of criteria to the public sector internal audit. The government should be seen as one entity with one budget. The Minister of Finance has the responsibility to impose budgetary discipline and should therefore set the standards relating to both internal control and to internal audit down to all levels of budget implementation and control for reasons of transparency and consistency. The Ministry of Finance can establish a Central Harmonisation Unit for Internal Audit and/or an Audit Committee with the main tasks of developing and co-ordinating the professional guidance for public internal audit as a separate and independent profession, the assessor and developer of the audit quality. The Ministry of Finance should determine that not only the internal auditors are free from interference (apart from the standard-setting), but also that the hierarchy of the CHU should be free from any and thus also political interference. This element is important for how the CHU is being seen by those that depend on the CHU for their professional guidance (leading by example/tone at the top). The CHU should provide advice on the hiring/firing of internal auditors or have some other role in this process. Since centralised inspection bodies for investigations of fraud etc. normally exist, there is no need to let the internal audit perform investigations, making the conceptual split between audit and inspection easy.

This set of audit criteria has been further elaborated in the development of the **PI*f*C**-system. The standard expression is “international control and audit standards and EU best practice”. When we talk of EU best practice, we mean those national (internal control and) audit policies that have best translated and implemented the abovementioned criteria into the public sector.

Appendix 9A. International auditing standards

International Standards for the Professional Practice of Internal Auditing as published on http://www.theiia.org/?doc_id=1499, effective January 2007

The Attribute Standards address the characteristics of organisations and parties performing internal audit activities. The Performance Standards describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated.

Attribute Standards (1000-1340)

1000 – Purpose, Authority, and Responsibility
The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the board.

1000.A1 - The nature of assurance services provided to the organisation should be defined in the audit charter. If assurances are to be provided to parties outside the organisation, the nature of these assurances should also be defined in the charter.

1000.C1 - The nature of consulting services should be defined in the audit charter.

1100 – Independence and Objectivity
The internal audit activity should be independent, and internal auditors should be objective in performing their work.

1110 – Organisational Independence
The chief audit executive should report to a level within the organisation that allows the internal audit activity to fulfill its responsibilities.

1110.A1 - The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

1120 – Individual Objectivity
Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.

1130 – Impairments to Independence or Objectivity
If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

1130.A1 – Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

1130.A2 – Assurance engagements for functions over which the chief audit executive has responsibility should be overseen by a party outside the internal audit activity.

1130.C1 - Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130.C2 - If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement.

1200 – Proficiency and Due Professional Care
Engagements should be performed with proficiency and due professional care.

1210 – Proficiency
Internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

1210.A1 - The chief audit executive should obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2 – The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210.A3 – Internal auditors should have knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1 - The chief audit executive should decline the consulting engagement or obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220 - Due Professional Care
Internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1220.A1 - The internal auditor should exercise due professional care by considering the:

Extent of work needed to achieve the engagement's objectives.

Relative complexity, materiality, or significance of matters to which assurance procedures are applied.

Adequacy and effectiveness of risk management, control, and governance processes.

Probability of significant errors, irregularities, or non-compliance.

Cost of assurance in relation to potential benefits.

1220.A2 - In exercising due professional care the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques.

1220.A3 – The internal auditor should be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1 - The internal auditor should exercise due professional care during a consulting engagement by considering the:

Needs and expectations of clients, including the nature, timing, and communication of engagement results.

Relative complexity and extent of work needed to achieve the engagement's objectives.

Cost of the consulting engagement in relation to potential benefits.

1230 – Continuing Professional Development
Internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development.

1300 – Quality Assurance and Improvement Program
The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program should be designed to help the internal auditing activity add value and improve the organisation's operations and to provide assurance that the internal audit activity is in conformity with the *Standards* and the *Code of Ethics*.

1310 – Quality Program Assessments
The internal audit activity should adopt a process to monitor and assess the overall effectiveness of the quality program. The process should include both internal and external assessments.

1311 – Internal Assessments
Internal assessments should include:

Ongoing reviews of the performance of the internal audit activity; and

Periodic reviews performed through self-assessment or by other persons within the organisation, with knowledge of internal audit practices and the *Standards*.

1312 – External Assessments
External assessments should be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organisation. The potential need for more frequent external assessments as well as the qualifications and independence of the external reviewer or review team, including any potential conflict of interest, should be discussed by the CAE with the Board. Such discussions should also consider the size, complexity and industry of the organisation in relation to the experience of the reviewer or review team.

1320 – Reporting on the Quality Program
The chief audit executive should communicate the results of external assessments to the board.

1330 – Use of "Conducted in Accordance with the Standards"
Internal auditors are encouraged to report that their activities are "conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing.*" However, internal auditors may use the statement only if assessments of the quality improvement program demonstrate that the internal audit activity is in compliance with the *Standards*.

1340 – Disclosure of Non-compliance
Although the internal audit activity should achieve full compliance with the *Standards* and internal auditors with the *Code of Ethics*, there may be instances in which full compliance is not achieved. When non-compliance impacts the overall scope or operation of the internal audit activity, disclosure should be made to senior management and the board.

Performance Standards (2000-2600)

2000 – Managing the Internal Audit Activity
The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organisation.

2010 – Planning
The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organisation's goals.

> **2010.A1** - The internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. The input of senior management and the board should be considered in this process.
>
> **2010.C1** - The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organisation's operations. Those engagements that have been accepted should be included in the plan.

2020 – Communication and Approval
The chief audit executive should communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and to the board for review and approval. The chief audit executive should also communicate the impact of resource limitations.

2030 – Resource Management
The chief audit executive should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

2040 – Policies and Procedures
The chief audit executive should establish policies and procedures to guide the internal audit activity.

2050 – Coordination
The chief audit executive should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to the Board and Senior Management

The chief audit executive should report periodically to the board and senior management on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting should also include significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management.

2100 – Nature of Work

The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.

2110 – Risk Management

The internal audit activity should assist the organisation by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.

2110.A1 - The internal audit activity should monitor and evaluate the effectiveness of the organisation's risk management system.

2110.A2 - The internal audit activity should evaluate risk exposures relating to the organisation's governance, operations, and information systems regarding the Reliability and integrity of financial and operational information.
Effectiveness and efficiency of operations.
Safeguarding of assets.
Compliance with laws, regulations, and contracts.

2110.C1 - During consulting engagements, internal auditors should address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2110.C2 – Internal auditors should incorporate knowledge of risks gained from consulting engagements into the process of identifying and evaluating significant risk exposures of the organisation.

2120 – Control

The internal audit activity should assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2120.A1 - Based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organisation's governance, operations, and information systems. This should include:

Reliability and integrity of financial and operational information.
Effectiveness and efficiency of operations.
Safeguarding of assets.
Compliance with laws, regulations, and contracts.

2120.A2 - Internal auditors should ascertain the extent to which operating and program goals and objectives have been established and conform to those of the organisation.

2120.A3 - Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

2120.A4 - Adequate criteria are needed to evaluate controls. Internal auditors should ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors should use such criteria in their evaluation. If inadequate, internal auditors should work with management to develop appropriate evaluation criteria.

2120.C1 - During consulting engagements, internal auditors should address controls consistent with the engagement's objectives and be alert to the existence of any significant control weaknesses.

2120.C2 – Internal auditors should incorporate knowledge of controls gained from consulting engagements into the process of identifying and evaluating significant risk exposures of the organisation.

2130 – Governance
The internal audit activity should assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

Promoting appropriate ethics and values within the organisation.

Ensuring effective organisational performance management and accountability.

Effectively communicating risk and control information to appropriate areas of the organisation.

Effectively coordinating the activities of and communicating information among the board, external and internal auditors and management.

2130.A1 – The internal audit activity should evaluate the design, implementation, and effectiveness of the organisation's ethics-related objectives, programs and activities.

2130.C1 – Consulting engagement objectives should be consistent with the overall values and goals of the organisation.

2200 – Engagement Planning
Internal auditors should develop and record a plan for each engagement, including the scope, objectives, timing and resource allocations.

2201 - Planning Considerations
In planning the engagement, internal auditors should consider:

The objectives of the activity being reviewed and the means by which the activity controls its performance.

The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.

The adequacy and effectiveness of the activity's risk management and control systems compared to a relevant control framework or model.

The opportunities for making significant improvements to the activity's risk management and control systems.

2201.A1 – When planning an engagement for parties outside the organisation, internal auditors should establish a written understanding with them about objectives, scope, respective responsibilities and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1 - Internal auditors should establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding should be documented.

2210 – Engagement Objectives
Objectives should be established for each engagement.

2210.A1 – Internal auditors should conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives should reflect the results of this assessment.

2210.A2 - The internal auditor should consider the probability of significant errors, irregularities, non-compliance, and other exposures when developing the engagement objectives.

2210.C1 – Consulting engagement objectives should address risks, controls, and governance processes to the extent agreed upon with the client.

2220 – Engagement Scope
The established scope should be sufficient to satisfy the objectives of the engagement.

2220.A1 - The scope of the engagement should include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

2220.A2 - If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

2220.C1 – In performing consulting engagements, internal auditors should ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations should be discussed with the client to determine whether to continue with the engagement.

2230 – Engagement Resource Allocation
Internal auditors should determine appropriate resources to achieve engagement objectives. Staffing should be based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.

2240 – Engagement Work Program

Internal auditors should develop work programs that achieve the engagement objectives. These work programs should be recorded.

2240.A1 - Work programs should establish the procedures for identifying, analyzing, evaluating, and recording information during the engagement. The work program should be approved prior to its implementation, and any adjustments approved promptly.

2240.C1 - Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement

Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

2310 – Identifying Information

Internal auditors should identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

2320 – Analysis and Evaluation

Internal auditors should base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Recording Information

Internal auditors should record relevant information to support the conclusions and engagement results.

2330.A1 - The chief audit executive should control access to engagement records. The chief audit executive should obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2 - The chief audit executive should develop retention requirements for engagement records. These retention requirements should be consistent with the organisation's guidelines and any pertinent regulatory or other requirements.

2330.C1 - The chief audit executive should develop policies governing the custody and retention of engagement records, as well as their release to internal and external parties. These policies should be consistent with the organisation's guidelines and any pertinent regulatory or other requirements.

2340 – Engagement Supervision

Engagements should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

2400 – Communicating Results

Internal auditors should communicate the engagement results.

2410 – Criteria for Communicating

Communications should include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410.A1 – Final communication of engagement results should, where appropriate, contain the internal auditor's overall opinion and or conclusions.

2410.A2 – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3 – When releasing engagement results to parties outside the organisation, the communication should include limitations on distribution and use of the results.

2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420 – Quality of Communications
Communications should be accurate, objective, clear, concise, constructive, complete, and timely.

2421 – Errors and Omissions
If a final communication contains a significant error or omission, the chief audit executive should communicate corrected information to all parties who received the original communication.

2430 – Engagement Disclosure of Non-compliance with the *Standards*
When non-compliance with the *Standards* impacts a specific engagement, communication of the results should disclose the:

Standard(s) with which full compliance was not achieved,

Reason(s) for non-compliance, and

Impact of non-compliance on the engagement.

2440 – Disseminating Results
The chief audit executive should communicate results to the appropriate parties.

2440.A1 - The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2 - If not otherwise mandated by legal, statutory or regulatory requirements, prior to releasing results to parties outside the organisation, the chief audit executive should:

Assess the potential risk to the organisation.
Consult with senior management and/or legal counsel as appropriate
Control dissemination by restricting the use of the results.

2440.C1 - The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2 – During consulting engagements, risk management, control, and governance issues may be identified. Whenever these issues are significant to the organisation, they should be communicated to senior management and the board.

2500 – Monitoring Progress

The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.

> **2500.A1** - The chief audit executive should establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.
>
> **2500.C1** – The internal audit activity should monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Resolution of Management's Acceptance of Risks

When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organisation, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

Appendix 10. Model of Management Declaration

A Model Declaration by the authorising officer by delegation relating to the annual activity report for [year]

I, the undersigned,
Director-General of
Head of Department of

In my capacity as authorising officer by delegation
Declare that the information contained in this report gives a true and fair view[1].

State that I have a reasonable assurance that the resources assigned to the activities described in this report have been used for their intended purpose and in accordance with the principle of sound financial management, and that the control procedures put in place give the necessary guarantees concerning the legality and regularity of the underlying transactions.

This reasonable assurance is based on my own judgement and on the information at my disposal, such as the results of the self-assessment, the *ex-post* controls, the work of the internal audit capability, the observations of the Internal Audit Department5 and Financial Control and the lessons learnt from the reports of the Court of Auditors for years prior to the year of this declaration.

Confirm that I am not aware of anything not reported which could harm the interests of the institution.
However the following reservations should be noted:

[where appropriate]

[The authorising officer by delegation could, by way of reservations, note, for example, any particular risks which may have been run in using appropriations, or report any malfunctions; in this case, an indication must be given of remedial measures taken or planned by the authorising officer by delegation].

Place ……………., date ……………..

Signature

1 True and fair view in this context means a reliable, complete and correct picture of the state of affairs in the service

Appendix 11. Internal control standards in the EC

Typical roles and responsibilities as regards the Internal Control Standards as applied in the European Commission[1]

This table sets out the typical responsibilities as regards the ICS. "Management" refers to all management levels (Director General, Director, Unit Head, etc). "Staff" refers to all other personnel in all areas (finance and contracts, operations, support functions, etc).

Control Standard	How are staff and management concerned?
1. Ethics and Integrity: Each DG shall ensure that staff are fully aware of the rules governing staff conduct and prevention and reporting of fraud and irregularities.	**Management:** ▪ Communicate relevant rules and documents to all staff ▪ Raise awareness by organising workshops, etc ▪ Be aware of and adhere to applicable rules **Staff** ▪ Be aware of and comply with applicable rules
2. Mission, Roles and Tasks: Each DG shall communicate to all staff on an up-to-date and written basis: ▪ the mission statement of their department (unit, directorate and directorate general); ▪ their role in their department (job description); ▪ their tasks assignment (individual objective) and expected results	**Management:** ▪ Communicate mission statements, roles and tasks **Staff** ▪ Be aware of mission statements ▪ Carry out work in line with job-descriptions and individual objectives
3. Staff Competence: Each DG shall ensure on a permanent basis the adequacy between staff competence and their tasks	**Management:** ▪ Define the knowledge and skills required by each job ▪ Conduct recruitment interviews ▪ Review training needs with staff by discussing individual Training Maps at a minimum on the occasion of the CDR dialogue and at other career milestones as appropriate (change of job, function, new tasks, etc.) ▪ Monitor completion of Training Maps. ▪ Ensure that – where relevant - your staff have completed compulsory or conditional training courses (see Commission and DG-specific Strategic Training Frameworks) ▪ Ensure that DG-specific training needs (training to be organised locally) are notified in good time to HR unit.

1 European Commission, DG Budget, Standards for internal control within the Commission's services, of 11 December 2000, http://ec.europa.eu/budget/library

Control Standard	How are staff and management concerned?
	▪ Guide staff in choice of appropriate training courses and bear targets in mind (average of 8.5 days' training activities in 2004; 10 days in 2005). Be aware of implications of approving training requests (e.g. time needed for language training) and ensure that choices are relevant. ▪ Encourage staff development by protecting learning time: once enrolled staff must participate in training; where possible, ensure backup/cover for absences due to training. ▪ Encourage application of new learning in the workplace. ▪ Organise work-specific on-the-job training for staff (target of 1.5 days in 2004) ▪ Participate in management training. ▪ Invite job applicants (internal mobility) to provide a copy of their Training Passport. ▪ Provide feedback on training to Training Manager (COFO). **HR Unit:** ▪ Keep records of interviews and potential candidates ▪ Identify immediate training plan for new recruits ▪ Review training needs with management and staff ▪ Develop internal training capacity for training courses not provided by Commission-wide training ▪ Define training and mobility policy **Staff** ▪ Manage your career: draw up a career plan and consider where you want to be 5 years from now. Choose relevant training based on current and future needs. ▪ Review training needs with line manager, at a minimum on the occasion of the CDR dialogue, and at other career milestones (new post, new tasks, etc.). ▪ Notify any DG-specific training needs to line manager and Training Manager (COFO). ▪ Draw up annual Training Map bearing in mind the targets (average 8.5 days' training activities per person in 2004, 10 days in 2005). ▪ Enrol for Training Map courses and ensure that you complete your Training Map within the deadlines (including those courses designated as compulsory or conditional for your role or function (see Commission and your DG-specific Strategic Training Frameworks). ▪ Once enrolled, ensure that you participate fully in training courses. ▪ Apply new learning in the workplace. ▪ Your Training Passport can be attached to internal job applications. ▪ Make the most of other learning opportunities (conferences, lunchtime and evening video sessions, lunchtime debates, language learning materials, etc.)

Control Standard	How are staff and management concerned?
4. Staff Performance: Each DG shall review the performance of its entire staff at least annually. All staff shall have the opportunity to discuss their individual performance with their reporting officer at least once a year. Where specific performance issues are identified these shall be addressed by managers as early as possible.	**Management:** ▪ Discuss and agree with staff on how to measure the individual performance (performance should be measured against the individual objectives) ▪ Review and discuss the performance of all staff once a year **Staff** ▪ Discuss and agree with management on how to measure the performance (performance should be measured against the individual objectives) ▪ Discuss the performance with management at least once a year
5. Sensitive Functions: Each DG shall draw up an inventory of sensitive functions in its department and define an appropriate rotation policy. A person holding a function classified as sensitive should move to another function after a maximum period of 5 years.	**Management:** ▪ Draw up inventory of sensitive functions taking into account mitigating controls ▪ Define appropriate rotation policy **Staff** ▪ Understand the concept of sensitive posts and be aware of the rotation policy
6. Delegation: Responsibilities and authority limits shall be clearly defined, assigned and communicated in writing. Delegation shall be appropriate to the importance of the decisions to be taken and the risks involved;	**Management:** ▪ Define responsibilities and authority limits in function of the decisions to be taken and the risks involved ▪ Ensure the delegations meet formal requirements **Staff** ▪ Act within the limits of assigned delegations (+ check that formal requirements are met) ▪ Inform management of any issues related to delegated responsibility levels and authority limits (too high, too low, other issues?)
7. Objective Setting: Each DG shall communicate to its staff general objectives and expected results established by the Commission by policy area and activity. Each DG shall translate general objectives into specific objectives and expected results for each activity and communicate them to its staff. Specific objectives shall be verifiable and include meaningful and practical measurement criteria	See ICS 9 (Annual Management Plan)

Control Standard	How are staff and management concerned?
8. Multiannual Programming: (Standard applicable only to activities with multiannual budget requirements). At the time of the adoption of a decision or legal base establishing an activity and its multiannual financial programming, the DG shall establish a "road-map" of measures to be set in hand to achieve this programming.	**Management:** ▪ Establish "road-map" to achieve the programming ▪ Adopt multiannual programming **Staff** ▪ Be aware of "road-map" and multiannual programming (and in some cases participate in the establishment of the road-map)
9. Annual Management Plan: Each DG shall prepare an annual management plan which incorporates appropriate objectives and indicators and the resources (financial and human) necessary to achieve them	**Management:** ▪ Establish annual output/impact objectives and indicators, and assign necessary resources to achieve the objectives ▪ In a process involving .both top-down steer and bottom-up feedback, objectives and indicators of the management plan must be discussed and validated. Once adopted, the management plan should be communicated to all staff ▪ Explain how the overall objectives are broken down to a unit level/sub-unit level/individual level **Staff** ▪ In the process (top-down, bottom-up), staff have an active role in the objective setting process ▪ Be aware of the objectives and understand how the Unit's objectives and the individual objectives fit with the overall DG objectives
10. Monitoring Against Objectives and Indicators: Key performance indicators, including indicators for economy, efficiency and effectiveness, shall be established and monitored for each Policy Area and Activity. Management should regularly receive reports on each Activity which compare the output and impact achieved with the objectives set. Management shall take action to address any identified shortfall against objectives.	**Management:** ▪ Establish suitable performance indicators ▪ Review and take action on regular reports on performance **Staff** ▪ Support management in the identification of suitable performance indicators (depending on the management model) ▪ Participate in the performance monitoring (depending on the management model) ▪ Be aware of performance indicators and the performance evolution for activities linked to unit/individual responsibilities

Control Standard	How are staff and management concerned?
11. Risk Analysis and Management: Each DG shall systematically analyse risks in relation to its main activities at least once a year, develop appropriate action plans to address them and assign staff responsible for implementing those plans.	**Management:** ▪ Perform a strategic (high-level) risk assessment for key activities and establish a suitable risk management plan (to be done once a year + whenever there is an important change to the activities or control environment). ▪ Perform process risk assessments (detailed risk assessments) together with relevant staff ▪ Perform on-going risk management by acting on risks identified by staff and management in the day-to-day work **Staff** ▪ Depending on the risk management model, staff are more or less involved in the strategic risk management exercise ▪ Support management by performing detailed risk assessments of key processes (for example financial processes or operational processes) ▪ Be aware of key risks associated with the day-to-day work. Report on any identified risks to management. Help management to reduce/control identified risks.
12. Adequate Management Information: Managers and other staff shall receive regular, reliable and easily accessible management information on budget execution, use of resources and progress of their management plan.	**Management:** ▪ Establish adequate systems for collecting and analysing relevant management information ▪ Perform ongoing/regular reviews of management information. Take actions to address any issues identified. **Staff** ▪ Perform ongoing/regular reviews of management information related to individual job-assignments. Take action/inform management of any issues identified.
13. Mail Registration and Filing Systems: Each DG shall systematically register incoming and outgoing mail to enable efficient monitoring of deadlines and maintain a comprehensive and up to date filing system which is accessible to all appropriate staff.	**Management:** ▪ Ensure that there are systems in place that adequately support mail registration and filing ▪ Ensure staff and management are aware of mail registration and filing requirements **Staff** ▪ Be aware of and adhere to mail registration and filing policy

Control Standard	How are staff and management concerned?
14. Reporting Improprieties: Appropriate procedures, in addition to reporting to the direct superior, shall be established and communicated to staff covering the reporting of suspected improprieties. Persons complying with the above obligations must not suffer inequitable or discriminatory treatment as a result of communicating such information.	**Management:** ▪ Ensure that there are procedures in place to cover reporting of suspected improprieties ▪ Ensure staff is regularly made aware of and fully understand the policy and procedures **Staff** ▪ Be aware of and adhere to policy and procedures for reporting of suspected improprieties
15. Documentation of Procedures: The procedures used in the DG for its main processes shall be fully documented, kept up to date and available to all relevant staff and shall be compliant with the Financial Regulation and all relevant Commission decisions.	**Management:** ▪ Overall responsibility for ensuring that main processes are adequately documented and updated ▪ Ensure that staff has necessary time and resources to document the procedures. Provide training/guidance/methods for documenting procedures ▪ Ensure that updated documented procedures for the main processes are easily available (via website, etc) **Staff** ▪ Prepare the documentation of procedures ▪ Ensure any updates are documented and communicated to management ▪ Be aware of and comply with existing procedures
16. Segregation of Duties: The operational and financial aspects of each transaction shall be checked by two people who are independent of each other [i.e. not subordinate to each other]. The functions of initiation and verification of each transaction shall be kept se§te.	**Management:** ▪ Ensure that the rules regarding segregation of duties are complied with ▪ Inform staff about applicable rules and the reasons behind them **Staff** ▪ Be aware of and adhere to applicable rules

Control Standard	How are staff and management concerned?
17. Supervision: Each DG shall establish appropriate supervision arrangements including, where appropriate, ex-post control of a sample of transactions to ensure that the procedures set up by management are carried out effectively.	**Management:** ▪ Establish a supervisory structure, guidelines and checklists (by activity, or by entity) ▪ Carry out supervisory activities ▪ Be able to demonstrate that supervisory activities have been carried out (supervisory activities should be documented), that the results are analysed, and that any issues identified are escalated to the appropriate management level **Staff** ▪ Supervision is mainly a management responsibility, but staff might also be responsible for supervisory activities
18. Recording Exceptions: Each DG shall establish appropriate arrangements to ensure that all instances of overriding of controls or deviations from established policies and procedures under exceptional circumstances are documented, justified and approved at an appropriate level before action is taken.	**Management:** ▪ Ensure that adequate systems and procedures for recording exceptions are in place ▪ Inform staff of applicable policy and procedures ▪ Regularly analyse exception reporting in order to identify recurrent issues. Take actions to address any issues identified. **Staff** ▪ Be aware of and comply with applicable policy and procedures for accepting and recording exceptions. Understand the rationale for this policy.
19. Continuity of Operations: Each DG shall establish appropriate arrangements to ensure the continuity of operations at any moment [i.e. absence of an official, substitution of an official, migration to new information systems, change of procedures, mobility, retirement, etc.]	**Management:** ▪ Establish appropriate arrangements to ensure the continuity of operations at any moment (for example handover files, disaster scenarios) ▪ Regularly test that the arrangement work in practice (notably as regards system recovery plans, etc) ▪ Ensure staff is aware of applicable policy and procedures. **Staff** ▪ Be aware of and adhere to applicable policy and procedures
20. Recording and Correction of Internal Control Weaknesses: A clearly defined procedure shall be established for the proper reporting and subsequent correction of internal control weaknesses and for any related updating of procedures.	**Management:** ▪ Define clear procedures for reporting and correction of internal control weaknesses ▪ Ensure staff is aware of applicable procedures. Encourage staff to report on important internal control weaknesses **Staff** ▪ Be aware of and comply with applicable procedures

Control Standard	How are staff and management concerned?
21. Audit Reports: Each DG shall review annually the recommendations made and action taken in response to audit reports by the Internal Audit Department, its own internal audit capability and the European Court of Auditors, define appropriate action plans to remedy weaknesses and monitor the implementation of those plans.	**Management:** ▪ Review (at least) annually the recommendations made by auditors and define appropriate action plans to address the issues (for example establishing a risk based summary of audit recommendations and related action plans) ▪ Inform staff of audit recommendations and action plans **Staff** ▪ Be aware of audit recommendations and action plans concerning areas related to the individual job responsibilities ▪ Support management in identifying and establishing adequate and realistic action plans
22. Internal Audit Capability: Each DG shall establish or have access to a competent and properly staffed internal audit capability with an annual work programme based on risk assessment.	**Management:** ▪ Ensure that the DG has a competent and properly staffed internal audit capability with an annual and risk based work programme ▪ Inform staff about the role and functions of the IAC ▪ Provide support to IAC **Staff** ▪ Understand the role and function of the Internal Audit Capability ▪ Provide support to IAC
23. Evaluation: Each DG shall establish or have access to a properly staffed evaluation function responsible for carrying out or commissioning ex-ante and ex-post evaluation of all its activities. It shall prepare an evaluation plan which sets out the timing of the planned evaluations and against which progress is regularly reviewed. It shall ensure the systematic follow up of the conclusions of evaluation reports.	**Management:** ▪ Ensure that the DG has a properly staffed Evaluation Function responsible for carrying out or commissioning ex-ante and ex-post evaluation of all its activities ▪ Inform staff about the role and functions of the Evaluation Function ▪ Provide support to the Evaluation Function **Staff** ▪ Understand the role and function of the Evaluation Function ▪ Provide support to the Evaluation Function
24. Annual Review of Internal Control: Each DG shall conduct an annual review of its internal control arrangements to act as a basis for the DG's statement on internal control in the annual activity report.	**Management:** ▪ Conduct an annual review of the DGs internal control arrangements (for example carry out self-assessments; review audit reports; review results of supervisory activities, ex-ante and ex-post controls, etc) **Staff** ▪ Support management in its evaluation of the IC arrangements (provide information, etc)

Appendix 12. Glossary of PI*f*C Definitions

Glossary of Definitions in the framework of **PI*f*C**

Version of October 2006[1]

Term	Definition
Accounting Control System	A series of actions, which are part of the total internal control system concerned with realising the accounting goals of the entity. This includes compliance with accounting and financial policies and procedures, safeguarding the entity's resources and preparing reliable financial reports.
Activity Based Management (ABM)	ABM is part of a wider strategic decision-making process that starts with the setting of political priorities through management planning and performance - taking into account the objectives and available resources of the organisation – right to the benchmarking of the programme achievements.
Administrative Control System	A series of actions, which are part of the internal control system, concerned with administrative procedures needed to make managerial decisions; realise the highest possible economic and administrative efficiency and ensure the implementation of administrative policies, whether related to financial affairs or otherwise.
Audit Evidence	Information, which supports the opinions, conclusions or reports of the auditor. ***It should be:*** **Competent:** information that is quantitatively sufficient and appropriate to achieve the auditing results; and is qualitatively impartial such as to inspire confidence and reliability. **Relevant:** information that is pertinent to the audit objectives. Reasonable: information that is economical in that the cost of gathering it is commensurate with the result, which the auditor is trying to achieve.
Audit Mandate	The auditing responsibilities, powers, discretion and duties conferred on any audit body under the constitution or other lawful authority of a country (as set out in primary or secondary national legislation).
Audit Objective	A precise statement of what the audit intends to accomplish and/or the question the audit will answer. This may include financial, regularity, systems based or performance issues.

1 This Glossary is a substantial update of the one in use by DG Budget which still mainly uses the 1999 definitions.

Term	Definition
Audit Procedures	Tests, instructions and details included in the audit programme to be carried out systematically and reasonably, contained in the audit manual
Audit Scope	The framework or coverage and subjects of the audit.
Audit Trail	Council Regulation 2064/97 appendix 1 provides for a specific detailed description of the requirements of 'a sufficient audit trail' for the purposes of the Structural Funds managed by the Member States on behalf of the Commission. In brief, it requires "the maintenance of records giving the full documentation and justification at all stages of the life of a transaction together with the ability to trace transactions from summarised totals down to the individual details and to trace all reporting stages ". The phrase 'audit trail' in the Regular Reports and the Accession Partnerships is to be understood in the light of the above definition. An audit trail should be developed by the Financial Directorate under management responsibility on the basis of support by the CHU for internal audit and the internal auditor.
Audited Entity (auditee)	The organisation, programme, activity or functions subject to audit.
Auditing Standards	Auditing standards provide minimum guidance for the auditor that helps determine the extent of audit steps and procedures that should be applied to fulfil the audit objective. They are the criteria or yardsticks against which the quality of the audit results is evaluated.
Central Harmonisation Unit	A policy unit attached and directly reporting to the Minister of Finance on the status of internal control in the entire public sector, responsible for redesigning, updating and maintaining the quality of the internal control systems, for harmonising and co-ordinating definitions, standards and methodologies, for networking between all actors (managers, financial officers, internal auditors), for the establishment and co-ordination of sustainable training facilities, including the setting of criteria for the certification of public internal auditors and for all other actions to improve public internal control systems. A CHU can cover both areas of Financial Management and Control systems and Internal Audit in one Directorate with each area to be developed independently (two sub-directorates). Alternatively a country may decide to establish a special CHU for the development of Internal Audit, directly reporting to the MoF and a special CHU for FMC-systems that could be attached to the Treasury or the Budget Department.

Term	Definition
Charter *(Internal Audit Charter)*	Also called Internal Audit Mission Statement. The Charter/Mission Statement of the internal audit activity is a formal document that defines the purpose, scope, and responsibility of internal audit. It aims to ensure that the internal audit is looked upon with trust, confidence and credibility. The charter should: ▸ Ensure the functional independence including specification of the position of the internal audit activity within the organisation; ▸ Permit unrestricted access to records, personnel, and physical properties relevant to the performance of engagements; ▸ Define the scope of internal audit activities; ▸ Define reporting requirements to auditees and, where necessary, to judiciary institutions and ▸ State the relationship with the State Audit Office.
Compliance tests	Tests to be carried out by control or audit on a sample basis that allow for extrapolated, generalised conclusions; see also regularity tests
Conflict of Interest *(Conflict of Roles)*	There is a conflict of interests where the impartial and objective exercise of the functions of a player in the implementation of the budget or an internal auditor is compromised for reasons involving family, emotional life, political or national affinity, economic interest or any other shared interest with the beneficiary.
Due Care	The appropriate element of care and skill which a trained auditor would be expected to apply having regard to the complexity of the audit task, including careful attention to planning, gathering and evaluating evidence, and forming opinions, conclusions and making recommendations.
Economy	Minimising the cost of resources used to achieve given planned outputs or outcomes of an activity (including having regard to the appropriate quality of such outputs or outcomes).
Effectiveness	The extent to which objectives of an activity are achieved i.e. the relationship between the planned impact and the actual impact of an activity.
Efficiency	Maximising the outputs or outcomes of an activity relative to the given inputs.

Term	Definition
Ethics	Ethics in the public sector cover four main areas: setting public department roles and values as well as responsibilities and levels of authority and accountability; measures to prevent conflicts of interest and ways of resolving them; setting the rules (standards) of conduct of public servants; setting rules for dealing with fraud and irregularities. Management responsible for the FMC system is expected to make use of tools promoting and raising awareness of ethical values in management and control. For internal auditors in particular, ethics imply the four principles of integrity, objectivity, confidentiality and competency.
Evaluation	Specific reviews designed to examine the overall performance of a programme or project. Its scope may vary. Its core should be setting out, obtaining or calculating the outcomes of the programme or project and considering their economy, effectiveness and efficiency, but it usually covers a much wider range of issues including the appropriateness and achievement of output objectives as well. It may be carried out before, during or after the programme or project has been completed (usually known as ex-ante, mid-term or ex-post). It shares many characteristics with performance audit
Ex-ante financial control	Ex-ante financial control is part of the FMC-systems, usually carried out by a financial officer with special powers; the set of control activities performed on draft financial decisions (appropriations, commitments, tender procedures, contracts (secondary commitments), and related disbursements and recovery of unduly paid amounts) that lead to either approval or refusal of the draft decision. In case of approval the draft decision becomes a final decision and is passed on to the accountant/pay master. In case of refusal the draft is returned to the Financial Department for corrections. Ex-ante financial control is sometimes called “preventive control”. The difference is that under preventive control the first refusal by the preventive controller is decided upon by the manager and not returned to the controller, but sent directly to the accountant; whereas the ex-ante financial controller must always approve (even under passer outre) before the accountant can execute the order.
Ex-post	When referring to audit, “ex-post” usually means an audit performed after the initial legal commitment of a transaction. When referring to evaluation, “ex-post” usually means an evaluation performed after the transaction has been fully completed.

Term	Definition
External audit	Any audit carried out by an auditor who is independent of the management being audited. In public finance, it means audit external to the Government public internal control systems and policies. This is carried out by the national Courts of Auditors or the Supreme Audit Institution and aims to objectively ensure that public internal control systems are compliant with the set objectives.
Financial Audits	Financial audits cover the examination and reporting on financial statements and examine the accounting statements upon which the financial statements are based
Financial controller	The person(s) who is (are) responsible for financial control.
Financial control	Financial Control should be understood as a sub-concept of Internal Control as defined by COSO. In the practical organisation of internal control PIƒC sees two important control levels or moments: ex-ante controls to ensure that draft management decisions comply to regularity and legality and ex-post controls that verify that such decisions have been carried out correctly. In PIƒC we refer to the ex-ante financial control and ex-post verification (e.g. monitoring of program implementation, inspection)
Financial Management and Control Systems (FMC)	In the framework of PIƒC the term is understood to be the set of responsibilities of the management (responsible for carrying out the tasks of government budget handling units) to establish and implement a set of rules aiming at a legal and regular, efficient, effective and economic use of public funds (comprising income, expenditure and assets and liabilities). It refers to planning, budgeting, accounting, reporting, ex-ante and ex-post financial controls. FMC is subject to internal and external audit.
Financial Systems	The procedures for preparing, recording and reporting reliable information concerning financial transactions.
Audit Findings, Conclusions and Recommend-ations	Findings are the specific evidence gathered by the auditor to satisfy the audit objectives; conclusions are statements deduced by the auditor from those findings; recommendations are courses of action suggested by the auditor relating to the audit objectives.

Term	Definition
Fraud	Fraud is, in the broadest sense, a deception made for personal and/or corporate gain, although it has a more specific legal meaning, the exact details varying between jurisdictions. In the broad legal sense a fraud is any crime or civil wrong for gain that utilises some deception practiced on the victim (a natural or legal person) as its principal method. Fraud in the EU is defined as any intentional act (also cases of organised crime) or omission related to the use or to the presentation of false, incorrect or incomplete declarations or documents or non-disclosure of information or to the misapplication of a legally obtained benefit.
Functional Independence (FI)	The special status of an internal auditor (whether central or decentralised), providing him/her with the power of maintaining a free professional judgement vis-à-vis the management of the organisation in matters of audit. This concept requires the maintenance of a balance between those who are responsible for managing the organisation and those who are auditing the organisation. FI should be embodied in relevant legislation. Another way to ensure FI is to have the central audit organisation nominate a delegate Internal Auditor into the organisation to be audited or to allow the Internal Auditor (in case of conflict of interests) to report his findings freely to the central audit body. It is also possible to talk of independence of the ex-ante financial controller, although this person is subject tomanagerial accountability. He can refuse draft authorising decisions, but may be overruled in accordance with a specific procedure.
Fundamental	A matter becomes fundamental (sufficiently material) rather than material when its impact on the financial statements is so great as to render them misleading as a whole. See also *Significant Control Weakness*
Independence	For external audit independence means the freedom of the national Courts of Auditors or similar institutions in auditing matters to act in accordance with its audit mandate without external direction or interference of any kind. From an internal audit viewpoint it means that the internal audit department should be organised directly under the top management. Nevertheless, the internal audit department should be free to audit any area that it considers to be an area of objective risk for material errors, even when management might have a different opinion. (see also functional independence)

Term	Definition
Internal audit	The IIA definition is: *Internal audit is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.* Objective assurance should be understood as the professional opinion of the auditor about the quality of the accounts or internal control (FMC) systems over the period of time during which the auditor carried out his audits. More concretely, it is the functional means by which the managers of an entity receive an assurance from internal sources (including internally subcontracted sources) that the internal controls are achieving their objectives. Internal audit can perform, inter alia, financial audits, system-based audits, performance audits, IT-audits, etc. It has most of the characteristics of external audit except that it finally reports internally to management and therefore cannot have the same level of independence as external audit. CIPFA defines internal audit as an assurance function that primarily provides an independent and objective opinion to the organisation on the degree to which the internal control environment supports and promotes the achievement of the organisation's objectives. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic, efficient and effective use of resources.
Centralised internal audit (CIA) **Decentralised internal audit (DIA)**	In PI*f*C a distinction is made between centralised internal audit and decentralised internal audit as follows: CIA is public internal audit performed by a centralised body (e.g. the Ministry of Finance or another body (like the Internal Audit Board in Malta)) on systems. In principle this form of organised public audit does not support the concept of managerial accountability. DIA is the internal audit performed by specialised internal audit units located inside ministries, budget agencies government or lower public budget implementation spending centres (Ministries or Agencies) and reporting to the highest level of management (the Minister or Secretary General).

Term	Definition
Internal Auditor	The Internal Auditor is the officer carrying out all relevant kinds of internal audit. He or she is subject to a special "statute" (preferably written in the Internal Audit Law governing the PI*f*C-system in a given country) or in the Audit Charter allowing him/her an adequate degree of functional independence. The IA reports to the highest level of management. Exceptions have been made for particularly small countries that have established a central Public Internal Audit Department, established for example in the Ministry of Finance or as an Internal Audit Board responsible to the Prime Minister or the Cabinet of Ministers. This option, however, is not strictly PI*f*C conform.
Internal Control	The whole system of managerial, financial and other controls, including the organisational structure, methods, procedures and internal audit, established by management within its governance objectives, to assist in conducting the activities of the audited entity in a regular, economic, efficient and effective manner. In the COSO definition internal control relates to the following categories: control environment; risk assessment; information and communication; control activities and monitoring of controls
Internal Control Objective	The primary objectives of internal control are to ensure: ▸ The reliability and integrity of information. ▸ Compliance with policies, plans, procedures, laws, and regulations. ▸ The safeguarding of assets and liabilities. ▸ The economical, efficient and effective use of resources. Each organisation should design its own system of internal control to meet the needs and environment of the organisation.
International Organisation of Supreme Audit Institutions (INTOSAI)	INTOSAI is an international and independent body which aims at promoting the exchange of ideas and experience between Supreme Audit Institutions in the sphere of public internal control.
Irregularity	Irregularity is any infringement of a provision of the financial regulations or of a provision relating to financial management or to the checking of operations resulting from an act or omission of an official or other servant. Irregularities include negligence, human errors, mistakes etc. Usually irregularities are divided in two categories, material or serious ones and those who are not. Although a mistake of 5 Euro is an irregularity, the consequences of this mistake should not be such that the mistake is to be treated as a major infringement or fraud. It will depend on the discretionary powers of the executive or the judiciary to what extent non-material irregularities are to be pursued or not.

Term	Definition
IT systems audit	Examines the sufficiency and adequacy of the protection of the security of the systems of IT applications in order to guarantee the confidentiality, integrity and availability of information and IT systems
Management Information System (MIS)	Centralised data base collecting and processing information that is to be given timely and accurately to managers at all levels for decision making, planning, programme implementation and control.
Managerial Accountability	Represents the liability to be called to account (answerable); obligation to be accountable to for example the government, parliament, public etc. for a given managerial task. In the PIƒC context accountability covers issues like separation of duties (authorising officer, accountant, ex-ante financial controller); development of FMC systems and manuals (powers, responsibilities, reporting and risk management), all financial transactions (commitments, contracts, disbursements, recovery of unduly paid amounts), links with the central harmonisation facilities, and evaluation and reporting on FMC systems
Managing Director	The Managing Director is defined as the highest level in an organisation carrying responsibility on operational level. He/she can be a Minister, Director General or appropriately designated delegates, responsible for the implementation of programmes - projects relating to national or lower budget income or expenditure. He/she is responsible for setting up adequate FMC systems and internal audit functions inside the organisation. The MD and the Accountant should create a double signature system to provide for the highest degree of transparency in financial management.
Materiality and Significance (Material)	In general terms, a matter may be judged material if knowledge of it would be likely to influence the user of the financial statements or the audit report. Materiality is often considered in terms of value but the inherent nature or characteristics of an item or group of items may also render a matter material - for example, where the law or some other regulation requires it to be disclosed separately regardless of the amount involved. In addition to materiality by value and by nature, a matter may be material because of the context in which it occurs. Audit evidence plays an important part in the auditor's decision concerning the selection of issues and areas for audit and the nature, timing and extent of audit tests and procedures.
Mission Statement	See Charter (Internal Audit Charter)

Term	Definition
Monitoring of IA recommendations	The manager is responsible for ensuring that audit recommendations are followed-up in compliance with the general rules established by the CHU for IA and by the internal auditor. The internal auditor establishes and maintains a system to monitor the follow-up by management of the audit recommendations communicated to management. This system may include periodic internal and external quality assessments. The internal auditor should also develop and maintain a quality assurance and improvement programme that covers all aspects of internal audit activity and continuously monitors its effectiveness.
Opinion	The auditor's written conclusions as the result of the findings of any kind of audit.
Organic Budget Law	A law specifying the schedule and procedures by which the budget should be prepared, approved, executed, accounted for and final accounts submitted for approval. Objectives of the organic budget law are: ▸ Creating a legal framework regulating the budget process ▸ Adjusting budget procedures legal, cultural and political conditions of the country ▸ Strengthening the transparency of budget information ▸ Clearly indicating division of responsibilities
Outcomes	The effects of a programme or project measured at the highest meaningful level in proportion to the programme or project objectives (e.g. jobs created). In practice there are always at least some external non-controllable elements, which influence whether outcomes are achieved or not.
Passer-outre	Passer-outre is the expression for a procedure whereby the opinion of the ex-ante financial controller (in the form of a refusal to approve) can be overruled by the body that is ultimately responsible for the management of government budget implementation (e.g. Council of Ministers, but also the highest authorising officer). A reasoned and written request or overruling by the highest management level should be the basis for such a decision, while the MD remains responsible for his acts. The financial controller will approve the decision on the basis of the request.

Term	Definition
Performance Audit	An objective and systematic examination of a public sector organisation's programme, activity, function or management systems and procedures to provide an assessment of whether the entity, in the pursuit of predetermined goals, has achieved economy, efficiency and effectiveness in the utilisation of its resources. In practice there can be difficulty distinguishing Performance Audit from Evaluation or from systems-based audit. Sometimes Performance Audits are limited to the examination of outputs but this considerably limits the value of the audit. Also, evaluation may create data, particularly on outcomes, whereas Performance Audit would usually be limited to a review of data available (and if necessary identification of missing data). Performance Audit is usually concerned with testing performance against some given standards.
Planning	Defining the objectives, setting policies and determining the nature, scope, extent and timing of the procedures and tests needed to achieve the objectives, based on objective risk assessment.
Probity	Complete and confirmed integrity
Public Accountability	The obligations of persons or entities, including public enterprises and corporations, entrusted with public resources to be answerable for the fiscal, managerial and programme responsibilities that have been conferred on the manager and to report to those that have conferred these responsibilities.
Public Internal Financial Control (PI*f*C)	PI*f*C is the overall and comprehensive internal control system performed by a Government or by its delegated organisations, aiming to ensure that the financial management and control of its national budget spending centres (including foreign funds) complies with the relevant legislation, budget descriptions, and the principles of sound financial management, transparency, efficiency, effectiveness and economy. PI*f*C comprises all measures to control all government income, expenditure, assets and liabilities. It represents the wide sense of internal control and thus includes decentralised functionally independent internal audit.

Term	Definition
Reasonable Assurance	Internal control, no matter how well designed and operated, can provide only reasonable assurance to management regarding the achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These limitations may include faulty decision-making with respect to the establishment or design of controls, the need to consider costs as well as benefits, management override, the defeat of controls through collusion and simple errors or mistakes. Additionally, controls can be circumvented by collusion of two or more people. Finally, management may be able to override elements of the internal control system. Reasonable assurance is provided when cost-effective actions are taken to restrict deviations to a tolerable level. This implies, for example, that material errors and improper or illegal acts will be prevented or detected and corrected within a timely period by employees in the normal course of performing their assigned duties. Management during the design of systems considers the cost-benefit relationship. The potential loss associated with any risk is weighed against the cost to control it.
Regularity Audit	Assessment (attestation) of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements; attestation of financial accountability of the government administration as a whole; audit of financial systems and transactions, including an evaluation of compliance with applicable statutes and regulations; audit of internal control and internal audit functions; audit of the probity and propriety of administrative decisions taken within the audited entity; and reporting of any other matters arising from or relating to the audit.
Report	The auditor's written opinion and other remarks on a set of financial statements as the result of the auditor's findings on completion of an audit.
Reporting Standards	The framework for the auditor to report the results of the audit, including guidance on the quality, form and content of the auditor's report.
Risk	An event which can result in an undesirable or negative outcome. It is characterised by the probability or likelihood of the event occurring and the resulting impact or consequence if it does occur. These two factors combine to result in a level of risk exposure.

Term	Definition
Risk Management	Risk management has to be performed by both management and the internal auditor independently. The auditor assesses the processes of risk management by management. Risk Management (RM) is the process of measuring, or assessing risk and developing strategies to manage it. Strategies include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk. Traditional risk management focuses on risks stemming from physical or legal causes (e.g. natural disasters or fires, accidents, death, and lawsuits). Financial risk management, on the other hand, focuses on risks that can be managed through improving the internal control system. The overall process of identifying, assessing and monitoring risks and implementing the necessary controls in order to keep the risk exposure to an acceptable level. Best practice suggests that it should be an embedded part of the management process rather than something, which is added at a later stage. RM acts as an awareness raising exercise and as a forum for sharing views at all levels in organisations; it informs and trains management and staff and increases the likelihood for success in the achievement of the objectives. Processes need to be developed to identify these risks and conceive and implement a system to control the most significant risks. A success factor for implementing the risk management system throughout the organisation is the management's general interest in the exercise. Risk management performed by the auditor helps in identifying audit projects offering the highest added value to the organisation. Risk assessment here is the identification of all local financial management and control (FMC) systems and of their associated risks according to a number of risk factors (IIA)
Significant or material control findings	Significant is the level of importance or magnitude assigned to an item, event, information, or problem by the internal auditor. Significant audit findings are those conditions that, in the judgement of the Head of Internal Audit Unit, could adversely affect the organisation. Significant audit findings (as well as weaknesses cited from other sources) may include conditions dealing with irregularities, illegal acts, fraud, errors, inefficiency, waste, ineffectiveness, conflicts of interest, and control weaknesses

Term	Definition
Supervision	By the Head of Internal Audit: an essential requirement in auditing which entails proper leadership, direction and control at all stages to ensure a competent, effective link between the activities, procedures and tests that are carried out and the aims to be achieved.
Supreme Audit Institution (SAI)	The public body of a State which, however designated, constituted or organised, exercises by virtue of law, the highest public auditing function of that State. The SAI should have a constitutional basis and is nominated by Parliament, to which it reports independently.
Systems-based Audit	Systems-based audit refers to an in-depth evaluation of the internal control system (more in particular the Financial Management and Control systems) with the objective to assess the extent to which the FMC systems are functioning effectively and contributing to the objectives of the auditee. In as far as it is also designed to assess the accuracy and completeness of financial statements, the legality and regularity of underlying transactions and the economy, efficiency and effectiveness of operations, it does not very much differ from performance audit, but the systems-based audit should primarily be based on assessing the FMC systems, which necessitates the Financial Directorate to draw up an audit trail on the basis of the internal control manual, that can be tested by the internal auditor.

Appendix 13.
Benchmarking PIfC against EU and EU funds.

Benchmarks	PIfC model[1]	European Commission[2]	PHARE	SAPARD (EAGGF)	ISPA (Structural Funds)	Instrument for Pre-Accession (IPA)[3] *Under discussion*
1. Who is the competent Managing Authority (MA)?						
1a. Political Level	Government, ministers appoint DGs	Commission appoints DGs	Government, ministers appoint NAC and NAO	Government, minister appoint CMA	Government, ministers appoint NIC and NAO	Government, ministers appoint NIPAC and NAO
1b. MA at Programming level	Directors General	Directors General	National Aid Co-ordinator (NAC)	Competent Managing Authority (CMA)	National ISPA Co-ordinator (NIC)	National IPA Co-ordinator (NIPAC)
1c. MA at Implementation Level	Directors General and sub-delegation to authorising officers	Directors General and sub-delegation to authorising officers	National Authorising Officer (NAO) with sub delegation to Programme Authorising Officer (PAO) or to CFCU[4]	National Authorising Officer (NAO) sub delegating to SAPARD Agency (or to Paying Agency under EAGGF)	National Authorising Officer (NAO) is responsible for financial management of funds, while Sectoral Authorising Officer (SAO), the head of a Project implementing Agency has MA at implementation level.	National Authorising Officer (NAO) is responsible for financial management of IPA funds. "Operating Structure" is MA for implementation.
3. Who accredits[5] the management and control systems[6]?						
	FMC[7] systems in line ministries etc. under ministerial responsibility	**Management and control services in DGs are under the responsibility of the DG**	**National Authorising Officer "accredits" after an assessment by an external auditor[8] and then subject to approval by the Commission**	**NAO "accredits", SAPARD/Paying Agency after an assessment by external auditor, e.g. the SAI**	**The beneficiary country "ensures" the set-up of the management and control systems**	**National Authorising Officer "accredits" on the basis of a positive opinion from an external auditor and then subject to approval by the Commission**

Benchmarks	PI*f*C model[1]	European Commission[2]	PHARE	SAPARD (EAGGF)	ISPA (Structural Funds)	Instrument for Pre-Accession (IPA)[3] *Under discussion*
4. Are all verifications of transactions undertaken by MA at implementation level?						
	Yes	Yes	Yes	Yes	<u>Ex ante checks</u> are performed by MA/ implementing agencies. <u>Ex post sample checks</u> (15% of total eligible expenditure) to be carried out by independent audit bodies, e.g. IAUs or winding-up bodies.	Yes
4a. Is ex ante financial control[9] part of managerial accountability?						
	Yes	yes	Yes	yes	Yes	Yes
4b. Is ex post financial control[10] part of managerial accountability?	Yes	Common, but not mandatory	Not mandatory	yes	Mandatory, Regulation imposes monitoring function on beneficiary country. As well as ex post sample checks.	Mandatory, Regulation imposes monitoring function on beneficiary country. Also requirement for ex-post controls (systems-based audits and sample checks) by the' audit authority.

Benchmarks	PI*f*C model[1]	European Commission[2]	PHARE	SAPARD (EAGGF)	ISPA (Structural Funds)	Instrument for Pre-Accession (IPA)[3] *Under discussion*
5. Who performs Internal Audit?	**Decentralised internal audit units (IAUs) nominated by ministries and CHU**	**DG Internal Audit Service (IAS) nominated by Commission** **Internal Audit Capabilities (IAC) nominated by DG**	1. PI*f*C-IAUs	1. Internal auditor of the Paying Agency nominated by PA Director **2. Certifying[11] Body** (CB)[12] nominated by the competent authority 3. PI*f*C-IAUs	**ISPA regulation requires independent competent national bodies performing audit.** **1. Winding-Up Body** (WUB) (nominated by the political level of the country) 2. PI*f*C-IAUs	1. Audit Authority nominated by the “country” in art. 23 (1): a single audit authority responsible for systems-based audits and sample chekcs 2. internal audit (art. 22 (j) (is this generic?) 3. PI*f*C-IAUs
6. Who reports to whom?	**IA: To highest level of management (and, under circumstances: to CHU)**	**DG IAS to Commission** **IACs to highest level of management and to Audit Committee**	**1. to highest level of ministry**	1. to Director PA 2. to NAO 3. to highest level of ministry	1. WUB reports to the Deputy Minister (above NAO) for approval, after which report is sent to the Commission 2. to highest level of ministry	1. to both the NAO and the Commission art 23. (b) 2. under debate 3. to highest level of ministry

Benchmarks	PI*f*C model[1]	European Commission[2]	PHARE	SAPARD (EAGGF)	ISPA (Structural Funds)	Instrument for Pre-Accession (IPA)[3] *Under discussion*
7. Can one speak of Functional Independence of the internal audit?	**Yes, IAUs are; they have no managerial (operational) responsibilities**	**Yes, IAS and IACs are, they have no managerial (operational) responsibilities**	1. yes	1. in principle yes 2. Certifying Body is independent of the NAO 3. yes	1. Winding-up Body is independent of the NAO 2. yes	1. Audit authority (AA) is independent of all actors in management and control systems. AA can be IAU or by (private) external auditors as long as independent from IPA structure 2. under debate 3. yes
8. What is performed by the Internal Auditor?	**Financial, systems-based, performance and IT audits, but no transactions-related substantive tests**	**Same as under PI*f*C, although substantive tests may be performed**	**Financial, systems-based, performance and IT audits, but no transactions-related substantive tests**	**Certifying Body (CB)** (performs systems-based audits and compliance checks[13] only)	**Winding-Up Body (WUB) performs 5/15 % sample checks[14] as well as systems-audit and gives assurance to the political level**	**Under debate**
9. Who is responsible for harmonisation?	**1. CHU for PI*f*C or 2. CHU for IA and CHU for FMC**	**IAS for internal audit and Central Financial Services in DG Budget for FMC**	**CHU for PI*f*C**	**CHU for PI*f*C**	**CHU for PI*f*C**	**CHU for PI*f*C**
10. Who performs External Audit?	**Supreme Audit Institution**	**European Court of Audit**	**SAI, Commission services and ECA**	**SAI, Commission services and ECA**	**SAI, Commission services and ECA**	**SAI, Commission services and ECA**

Endnotes

1 For national budgets in applicant countries: the model

2 For the EU budget only

3 Implementation Regulation of Council Regulation 1085/2006, Article 3.3 (still in draft)

4 Central Financial and Contracting Unit

5 Accreditation is the act of nominating an organisation for a specific purpose

6 Verification of individual transactions (legality and regularity)

7 Financial Management and Control services

8 Assessing in the sense of providing an opinion that the organisations performs with reasonable assurance

9 Ex-ante financial control defined as control that may lead to blocking a financial decision of the authorising manager

10 Ex-post financial control defined as control of all post-contract activities relating to that contract (after the financial decision usually by technical inspection)

11 Certifying defined as taking responsibility for providing 100% assurance to management. That is not the case here, so it should be understood as providing an opinion for "reasonable assurance"

12 Either public audit body or private audit firm

13 or walk-through tests, but no substantive testing

14 This activity is strictly speaking not an intern audit activity as defined in the PIfC mode

Appendix 14.
Public internal control in France[1]

1. Reforms in the French public internal control sector from 1998-2006

France has a long tradition in separating the authorising officer from the public accountant. Management is responsible for payment authorisation and the public accountant verifies whether the authorisations are correct and appropriately put into the accounting systems. The public internal control system in France is based on both deconcentration and decentralisation and characterised by a high degree of internal complexity. A description of the systems has to take into account deep rooted traditions and the fundamental reforms since 2001. This appendix focuses on the control and audit aspects of the public systems in France before and after the 2001 budget reform.

Since 1811 the traditional system of ex-ante financial control consisted (until 2001) of prior approval or disapproval of draft managerial financial decisions relating to appropriations, commitments, disbursements etc. These controls only covered the legality and regularity aspects, providing the manager with a "assurance" that his financial management was in good order. The French system lacked the characteristics of managerial accountability and relied heavily on central instructions for control. It focused on regularity, compliance and transactions rather than on the performance of the entire chain of public activities. Internal audit was not introduced until the 2001 Framework Law on Public Management with the establishment of the Mission for Audit, evaluation and control (MAEC).

In the French public administration the General Finance Inspectorate stands central and powerful. This body (called Inspecteurs Généraux de Finances (IGF)) is the inspectorate of the Ministry of Economy, Finance and Industry (MEFI). Line-ministries have their own general inspectorates (IG). These IGs do not report to the IGF; however, they can be inspected by the IGF in the perspective of fight against fraud. IGF number only about 70 individuals and inspecting several thousands of offices would not really make for good and timely coverage. IGF inspection missions are usually carried out jointly in co-operation with the various IG inspectorate bodies involved. Apart from the IGF main inspection assignments ("detection of fraud and major irregularities"), IGFs also perform as "public policy advisory bodies" to their relevant Ministers. IGFs may make surveys on behalf of line ministries and perform audits at inter-ministerial level (see the CIAP hereafter). IGs are also in charge of audits for the government (CIAP and "modernisation audits" for the Prime Minister; they report to the MEFI.

Until 2006 the authorising officer's decisions were subject to ex-ante financial control. On State **central level**, ex-ante financial controllers were appointed by the Directorate for Budget. Each of the 15 line ministries had an ex-ante financial controller. .There was only one public accountant for all ministries. On State **local level**, there were general paymasters (performing both accounting and ex-ante financial control) who were appointed jointly

1 The author is not able to claim a 100% certainty as to his understanding of the French way of public control and audit and to whether this appendix covers the entire practice and reality of public internal control in France.

by the General Directorate for Public Accounting and the Directorate for Budget; they are physically located in the Treasury offices. As an result of the implementation of the new Law on Public Management (LOLF), the general institutional framework has not changed, but there is now at **central level** a General Paymaster (accountant) for each Ministry whereas the functions of accountant and financial controller have merged in a single office (Budgetary and Accounting Ministerial Controller) the to serve the Ministry more efficiently. At **local level** there are the General Paymasters (one in each province) who are also public accountants and financial controllers. Therefore, both on state and deconcentrated provincial level there is a duality of functions with the public accountant function reporting to the GDPA and the financial controller function reporting to the Directorate for Budget. However, the contents of their assignments have been changed (see below).

Managerial decisions were also subject to the approval (verification only) of Public Accountants (Comptables publics), who are also delegated and attached to the Ministries and subject to inspections by the IGF. Internal audit did not exist until 1998, when IIA standards were gradually introduced into the Treasury network system. The IGs would perform compliance or regularity audits. External audit is performed by the Court of Accounts.

The General Director for Public Accounting (GDPA) under the Minister of Budget under the Ministry of Economy, Finance and Industry (MEFI) and has developed since 1998 public internal control and internal audit for the entire Treasury-system. The Treasury is a deconcentrated control and audit system, therefore not part of the managerial accountability of the line ministries. Treasury auditors will therefore audit the treasury systems in the line ministries but not audit operational management aspects. The minister has a choice of four options: either he asks the Treasury internal auditor to perform operational audits on his behalf or he asks the IG to do this for him or he nominates his own internal auditor or he requests a private audit organisation. The last option is not favoured because of the specificities of the public internal control environment, but the 2001 Reform Act does not provide for any harmonisation as to the profession of the "public internal auditor", nor does it suggest that ministries should nominate their own internal auditors.

Under the new LOLF, GDPA gives direction to a sub-organisation, called the Mission for Audit, Evaluation and Control (MAEC), which is independent vis-à-vis GDPA. MAEC is responsible for the general development of audit, evaluation and control in the Treasury network. MAEC also acts as the secretariat for the NAC or the National Audit Committee (that was established in September 2004), which is the Audit Board of the GDPA. The NAC is responsible for the development of the accounting internal control framework and methodology for the State accounts certification. A similar set-up exists on regional level: the Regional Audit Committee (RAC) with the Regional Training and Control Unit; these can be defined as local MAEC's attached to the highest manager of the local Public Treasury departments.

The MAEC unit could be compared to a CHU for Internal Audit, were it not for the fact that MAEC only relates to auditors in the Public Treasury network; it has no remit for the internal audit function in the line ministries' operational activities or for the "audit-activities" of the IGs. The MAEC is in charge of the following assignments:

- Steering the Public Treasury auditor pool at the central and local levels, providing vocational training and on-going training programmes, developing audit mission standards and benchmarks in compliance with international standards.
- Configuring and providing internal audit tools (Computer assisted audit techniques, quality control approach).
- Implementing the national audit programme by involving its own pool of auditors.

The General Payment Treasury or General Paymaster (GPT) used to be the accountant of all the State central administrations. On regional level, the Regional Audit Committee consists of regional and departmental payment treasuries and develops regional audit programming; it is the intermediary for the national internal control policies, supervises the regional auditors and performs quality audit control.

The Public Treasury network has four organisational levels: central (GDAP with 7 sub-directorates), regional (22 offices), departmental (104 offices) and local (3000 offices)

Furthermore, five specific General Treasuries can be distinguished: one for the external (foreign) networking, one for state debts, one for public support, one for general payments (to disappear under the LOLF) and one for central accounting (for managing the state's single account).

Finally, the Public Treasury network has three categories of staff: recovery agents (category C); controllers (contrôleurs, not to be confused with the financial controllers mentioned above) (category B) and technical inspectors (category A). These technical inspectors are either accountants, deputies or perform otherwise in the central administration departments. These inspectors therefore do not necessarily "inspect".

Other category A+ staff is either civil administrators or auditors, who have passed a specific internal exam and attended specific audit training

As said before, the GPT has been replaced by the "Budget and Accounting Ministerial Controller" as of January 2006. The Public Treasury auditors are only responsible for auditing State accounting functions. Therefore they are not in charge of the programme or operational audits in the line ministries, which should, in principle, be performed otherwise (see the four options mentioned above).

Where the accounting function is related to the performance of the programme implementation, Public Treasury auditors can be associated with the programme audit missions. Moreover, through the performance of the accounting functions in every public administration, Public Treasury internal audit units are in touch with the financial managers' internal control frameworks.

2. Other aspects of the 2001 Framework Law on Public Management

After an extensive period of discussions/adaptations to overcome the negative effects of the rigid control procedures in the French public sector, France adopted in 2001 a new Organic law on public management (LOLF: Loi Organique relative aux Lois de Finances) as part of a wide-ranging budget reform. The enforcement of the organic law followed gradually. On January, 1st 2006 the Organic Law has been enforced in all its provisions. The reform aims at result-oriented budgeting, co-ordinating ministries as far as their global strategies are concerned, improving financial transparency and establishing a new and more efficient accounting system.

In parallel developments, a series of experiments was led to assess the new budget presentations and benchmarks regarding the budgetary part of the State public finance reform, under the responsibility of the Directorate for Budget Reform and the Directorate for Budget in the Ministry of Finance.

The Organic law also introduces an accounting reform targeting two objectives, under the responsibility of the Directorate for Budget Reform and the General Directorate for Public Accounting:

- Introducing an accounting framework with three dimensions: cash accounting; accrual basis accounting and cost efficiency accounting, in order to provide an accurate image of the State assets and liabilities and
- Preparing the certification of State accounts by the Court of Accounts to assess the State accounting function and the State accounting quality.

The new budget presentation is organised in chapters (in French "missions"), programmes and actions. Parliament debates and votes on the chapters that are implemented by chapter managers (line ministers). Each chapter will have objectives, indicators and targets, so that the performance can be benchmarked and measured. The manager is responsible for his budget and the programme outputs and therefore responsible for establishing an efficient internal control system at all programme levels and should be able to draw on an independent internal audit capability to assess the internal control system. Prior to the establishment of the MAEC, internal audit was not more than compliance checks, performed by the IGs (delegated to the ministries through the Public Accounting).

Although the COSO model assumes that internal audit is an internal, but functionally independent service to the manager and thus internal audit should best be carried out by internal auditors directly attached to the managers, the LOLF does not provide for a legal obligation or a specific provision for the manager to create such function. Ministries follow a general trend in demanding performance audit as an aftermath of performance budgeting. In line ministries where there is no operational internal audit established the IGs can be asked to perform audit assignments.

(There would seem to be three alternatives: 1. turn the inspectorate body into modern audit bodies with the effect that the specific inspection assignments (fight against fraud) would have to be performed by outside bodies; 2. Combine internal audit and inspection in the same body which would not comply with international standards or 3. Establish new internal audit units in line ministries by severing the link between audit and inspection.)

3. Managerial Responsibility under the 2001 French reform

One of the main objectives of the State Public Finance reform was to provide more responsibility to the line ministries and the financial managers in charge of implementing the new budgetary programmes. This is to be achieved by giving the (financial) manager more discretion in allocating budgetary and human resources in such a way that the required performance can be optimally achieved. In the implementation of the budget programmes the financial manager will be able to choose the best mix of means that are at the disposal of the programme, provided that the limits set by the Parliament annually are respected. There are some general limitations to the managers' responsibility in this respect. One limit is that funds for human resources can be reallocated to other kinds of expenditure but not the other way around – this is called asymmetrical arbitration (fongibilité asymétrique). Another limit is that the organic separation between the authorising officer and the accountant (the Public Treasury) remains valid to ensure the security of the public funds and the quality and accuracy of the accounting function (four eyes principle).

One important aspect of the Budget Reform is that the traditional ex-ante financial control function would be abolished as of January 2006, reflecting a similar decision made by the European Commission in 2000. To avoid undue overlap in control and rigidity in the expenditure execution (by ex-ante financial control and accounting), a new relation between the MoF and the line ministries was established as follows:

- As of January 1st, 2006 there will be only one MoF representative physically located in the departments of each line ministry: the "Budget and Accounting Ministerial Controller" (contrôleur budgétaire et comptable ministériel).This controller is in charge of the ministerial budget control and accounting departments.
- The new <u>budget control</u> will guarantee the "asymmetrical arbitration" limitation set by the Organic Law and assess the financial sustainability of the expenditure (in fact check whether the financial impacts of an expenditure decision falls within the forecasts). Budget control does no perform compliance control with regard to legal provisions.
- The IGs will introduce risk assessment and risk management techniques, partnership control based on a common acknowledge of the financial management best practices and the internal control framework. This can be performed by joint audits led by the auditors from the Public Treasury and the IGs attached to the line ministries, invoice services, preparation of the accounting certification by enhancing the accounting information quality of the financial managers and the accounting departments.

Prior to 1998, the ex-ante financial control function was a straightforward 100% control of financial payment orders without regard to risk management. This changed through the introduction of thresholds below which there would be no longer a need for ex ant approvals and the introduction of risk management. This function is now to be replaced by a risk-based approach in the accounting function and by partnership-control involving the reorganised accounting function and the financial departments' improvements in the invoicing procedures. The risk-based approach should contribute to reasonable assurance in the field of payments.

At the end of the fiscal year, the GDPA is responsible for providing the consolidated accounts of the State budget execution to the Court of Accounts.

4. The CIAP: an Inspection body performing programme ex-ante and results audit on State level.

The new Budget Law created a new super-audit structure called the inter-ministerial audit committee under the name of CIAP (Comité Interministérielle d'Audit des Programmes). The CIAP is composed of 15 IGs: one from each of the 14 Ministries and a President, nominated by the Ministry of Economy, Finance and Industry and an IGF.

According to a circular distributed to all Ministries on July 4th, 2003 the CIAP will both "control" the quality of the ministerial programmes as proposed to the Budget Minister and "audit" the annual performance reports as drafted by the ministries in order to guarantee the trustworthiness of the results and the objectiveness of the comments attached. The audits aim to assess the adequacy of the formulation of objectives relating to the ministerial programmes as well as the adequacy and reliability of the performance indicators. The CIAP thus distinguishes two types of audit: the "initial audits" relating to the programme drafts and the "result audits" relating to the reporting of results. In the *initial audits* the quality criteria would relate to programme coherence, objectives and indicators, information systems, action plans, and the internal control systems. In the *result audits* the quality criteria focus on the reliability of the figures and on the objectiveness and completeness of the comments relating to the perceived gaps between objectives and results.

All departments involved in the programme preparation and performance reporting have received an audit guide for the purpose of self-control. Each audit team mandated by CIAP will be inter-ministerial in character and will consist of at least one inspector general that is member of the CIAP and one member of the inspection body of the ministry, the technical inspector general mentioned above. The CIAP is responsible for the recommendations based on the audit report's conclusions and the replies of the auditee. The report and recommendations will be sent to the minister concerned and the Minister of Finance. CIAP determines the selection criteria for the programme audits and informs the auditee ministries as well as the Court of Accounts thereof. The programme audits have started as of 2004, while the results audits will start as of early 2006. These audits are different from the audits performed by the internal auditor in each of the ministries.

5. Control in the area of the EU Common Agricultural Policy and Structural Funds

The EU Regulations in the area of the Common Agricultural Policy (CAP) and the Structural Funds (SF) require beneficiary Member States to establish specific ways of management and control/audit. Since about 1990 the CAP requires two organisations, a competent management authority and a paying agency, to be "audited" by independent audit, covering financial and operational activities. The Ministry of Agriculture in France is responsible for the accreditation of the Paying Agency, authorising it to carry out the payments under the aid schemes. The annual certification of the Agency's accounts is performed in France by a specific external certification authority (CCCOP), whose staff and president are delivered by the Court of Accounts. The Court as such retains the right to audit externally all organisations in its responsibility towards parliament. The IGF is not involved in the certification procedure.

Around 1995 the Structural Funds Regulation developed a different approach and does not require accreditation of the Paying Agency. Instead, the Regulation requires a certification of its accounts and, in the winding-up phase, a declaration on the quality of the finalised programmes. The declaration must cover both the managing and the paying authorities, hence the need for an independent audit of both authorities. However, in this case, "independent" was not considered to mean external. If for the Structural Funds the CAP system would have been followed in France, this would have meant that the Public Accountants who verify the competent managing authority and report to GDPA and the Directorate for Budget would have been subject to certification by the Court of Accounts (through a body similar to the CCCOP) or by an independent internal auditor. Instead, it was decided to appoint a new body (composed of a few IGF bodies that are inter alia concerned with the fight against fraud and irregularities) called the CICC (inter-institutional committee for the co-ordination of the Structural Funds) as the internal auditor for the Structural Funds. The CICC is responsible for systems-based audits and reports to the Prime Minister. Thus, under the CAP structure, "audit" is in the hands of the Court of Accounts, under the Structural Funds "control" is in the hands of the IGF. Establishing an independent internal auditor for the Structural Funds would have meant a certain competition with the IGF.

The CICC has also close links with ICLAF, which is the French counterpart of DG OLAF in the Commission (that is responsible for investigating cases of fraud and irregularities in the use of EU funds). The CICC is thus wholly a matter of the IGF and not of the Court of Accounts. The responsibilities for internal audit and for fraud investigation, that are so closely combined in the CICC, could be perceived as rather uncomfortable in the light of the **PI*f*C** concept of an independent internal auditor, who may not perform both assessment and management (including investigation) functions. The two different control systems for CAP and the Structural Funds in France may have had consequences for the differences between the CAP (SAPARD) and Structural Funds (ISPA) controls in the EU.

6. Conclusion

The gradual introduction of the new state budget reform in France has been a huge and marvellous effort to bring increased ministerial accountability and improved result and performance oriented control to the French public sector and testifies to the "rapprochement des idées" in the international developments in public internal control.

One important characteristic of the Reform has to be underlined; the French reform in terms of control and audit did not start with a legal framework development; the changes were sought in missions and capacities to better answer the government's expectations of a sound financial management. Missions, methods and procedures changed in the last ten years, but the framework and institutional presentation and image have remained the same. This may have worked well for France, but whether a similar approach is advisable for new Member States and applicant countries, where not much can be done without a legal basis and where the development of principles of democracy and transparency had been halted for some time, is another question altogether.

Most of the new elements are still to be tested as the full implementation started only as of January 2006. The State Public Finance Reform in France does not aim at creating a decentralised internal audit function attached to management, but chose for a centralised and deconcentrated internal audit function in the Treasury. This option differs from **PI*f*C** in the sense that internal audit is not performed by a decentralised auditor functionally independent from but administratively reporting to the highest level of management to which is it attached. In cases of serious disagreement with management, the internal auditor can turn to the CHU that does not audit itself, but harmonises the standards and general practice of the internal audit function and defends the professional status of the internal auditor. Whereas under **PI*f*C** there is basically one breed of public internal audit, in France there can be a plethora of internal auditors (Treasury, IGs, programme-related internal auditors and hired private internal auditors).

Since its establishment, MAEC has been developing the profession of internal auditor in the Treasury network through important programmes in methodology development as well as in certification of its organisations (ISO) and of its audit professional standards (IFACI, CIA and CGAP). Would the creation of a unique profession for public internal audit attached to management have introduced competition with the inspection departments? The Ministry of Finance, Economy and Industry has opted for a hybrid system of treasury auditors and general inspection departments to result and performance oriented management and to increase managerial accountability. The future experience of the LOLF-implementation will show whether this constitutes the best solution for the French control environment.

The new public internal control systems in France, especially to the extent that control, audit and inspection are so closely interwoven, is not easy to explain to outsiders like applicant countries that have chosen to introduce and develop decentralised internal audit outside (but not disconnected to) the sphere of traditional inspection as a new and independent profession, apart perhaps from those that have, for historical reasons, similar characteristics.

Appendix 15. Template for an ACA

Administrative Co-operation Agreement between
The Directorate General for Budget of the European Commission and the Minister of Finance of the (*country name*)

(*date*)

Concluded between Minister of Finance, … and
The Director General, DG BUDG, …

1. The Directorate General for Budget of the European Commission (henceforth called "DG BUDGET") and the Ministry of Finance of (country name) (henceforth called "the Ministry") shall co-operate on the issues described hereafter, without affecting the legal position of each party involved.

2. DG BUDGET shall support the Ministry in its efforts to establish and implement Public Internal Financial Control (**PI*f*C**) on national level, in particular by enhancing the level of **PI*f*C** legislation and institution building. To this end, the Ministry shall provide for co-ordination during the "assessment" and "monitoring" missions of DG BUDGET to the (country name) institutions and departments that are competent for **PI*f*C**. The Ministry shall see to it that all relevant information is provided for during these missions, or within a reasonable time-span following these missions.

3. Draft strategy planning and legislation relating to **PI*f*C**, on both primary and secondary level, shall be the subject of discussions between DG BUDGET and the Ministry. The Ministry will see to it that due account is taken of the comments made by DG BUDGET before finalising the before-mentioned legislation.

4. The Ministry shall send its delegates to Association Committees and relevant Sub-Committees, the agenda of which may include **PI*f*C**-related issues.

5. DG BUDGET shall, for the organisation of training seminars, take into account the suggestions of the Ministry concerning agenda issues and participants.

6. DG BUDGET and the Ministry will exchange regular information on issues relating to **PI*f*C**, particularly on aspects concerning legislation, methodology and institution building.

7. This Agreement will be concluded by way of exchange of letters between the Director General of DG BUDGET and the Minister of Finance of (country name).

Appendix 16. Anti-Fraud Co-ordination Service

Anti-Fraud Co-ordination Service (AFCOS)

1. One of the aims of the Commission's Action Plan 2001-2003 for the protection of the Communities' financial interests and the fight against fraud (Com(2001) 254 final) is to involve the applicant countries more closely in fraud prevention and the fight repression. Since 2000, the Commission has encouraged every applicant country to establish an operationally independent Anti-Fraud Co-ordination Service. These services should be responsible for the co-ordination of all legislative, administrative and operational aspects of the protection of the Communities' financial interests. Strictly speaking, the designation of an AFCOS is not an obligation under Community law but rather an institution building measure. However, by setting up such services, applicant countries demonstrate their capability to give effective and equivalent protection to the Communities' financial interests and to co-operate effectively in this respect with DG OLAF and Member States, as required by Article 280 of the EC Treaty. The Budgetary Control Committee of the European Parliament has, in its report of 29 November 2001, underlined the need for such a strategy, describing the effective protection of the Communities' financial interests in the Candidate Countries as one of the major challenges in the years ahead.
2. AFCOS has the following special functions:

a. Functions of a legislative and prospective nature

- taking the lead in formulating, disseminating, co-ordinating and implementing a comprehensive national anti-fraud strategy;
- identification of possible weaknesses in the national system for the management of Community funds, including pre-accession funds (ISPA, PHARE, SAPARD);
- initiation of the necessary legislative, regulatory and administrative adaptations, aimed at ensuring an effective protection of the Communities' financial interests, including the definition of relations with other institutions or bodies involved in the protection of the Communities' financial interests and the establishment of common co-ordination structures and mechanisms;
- dissemination of information to authorities responsible for the management of EU funds and revenues, concerning obligations and procedures to follow as regards the protection of the Communities' financial interests.

b. Operational functions, including the exchange of information

- facilitating and ensuring co-operation between the national administration, investigation authorities and prosecution authorities, as well as between these authorities and DG OLAF, in cases of suspected fraud or irregularities affecting the Communities' financial interests;

- ensuring and monitoring the exchange and provision of relevant information at all levels within the national administration and with DG OLAF as regards cases of suspected fraud and irregularities affecting Community funds (and after accession, Community resources), including reporting obligations foreseen under Community legislation and pre-accession instruments. This supposes the establishment of inter-departmental electronic information links as well as a well-functioning information exchange mechanism with DG OLAF, centrally managed by the AFCOS. This mechanism also includes monitoring the use and operation, by all national authorities concerned, of the EU Anti-Fraud Information System (AFIS).

c. Training-related functions

- definition of the training needs of the different institutions and bodies involved in the protection of the Communities' financial interests;
- development, in close collaboration with DG OLAF, of general and specific training programmes and training modules about the different (legislative, administrative and operational) aspects of the protection of the Communities' financial interests, including temporary exchange programmes with DG OLAF and Member States' administrations ;
- organisational support to training activities;
- provision of assistance and advice to other institutions and bodies involved in the protection of the Communities' financial interests, and liaison with the Commission (OLAF) in this respect.

3. The AFCOS' status and institutional framework should have the following characteristics:

a. Multi-disciplinary character:

The service to be composed of experts coming from the different national administrative control and law enforcement authorities, responsible or involved in investigations of presumed fraud and irregularities involving EU-funds or in the supervision of such investigations. The following types of authorities may second agents to the AFCOS:

- administrative control authorities (before accession: authorities responsible for the control of PHARE- SAPARD- ISPA Funds ; after accession: all authorities responsible for the control of EU resources and expenditure)
- treasury control authorities and **state auditors**[1]
- experts in VAT and Taxation matters
- Customs and Border Guards
- investigation authorities of Customs (Customs Police)
- specific Police or other investigative forces dealing with EU-related matters
- prosecuting authorities

1 Note that state auditors here could be asked to be involved in investigations of presumed irregularities and fraud.

In case it is not possible to establish a multi-disciplinary group from the beginning, the AFCOS should be able to request, when needed, adequate input from the remaining competent authorities with the objective of formulating an adequate assessment of cases of presumed fraud and irregularities.

b. Operational independence:

Even if, from an administrative point of view, the investigative part (or parts) of the AFCOS may be established as a service within an existing institution, it should have a **legal mandate** which **guarantees its independence in operational matters**. The AFCOS, having the mandate to ensure both co-ordination between the relevant services within the Applicant country and co-operation with DG OLAF in cases related to the EU budget, should be authorised to:

- request an administrative or law enforcement authority to analyse information related to cases of suspected fraud and irregularities , for the purpose of initiating an investigation;
- request the said authority to initiate an investigation, if necessary;
- request to be informed of the results of such an investigation.
- ensure effective exchange of relevant information with DG OLAF

c. Ability to foster inter-institutional co-operation

It is essential that the AFCOS can also count on the support of other institutions or bodies outside the AFCOS but directly or indirectly involved in the protection of the Communities' financial interests for its co-ordinating activities. Furthermore, the applicant country's legislative and administrative framework should facilitate these as much as possible. Where necessary, the AFCOS and the other institutions involved in the protection of the Communities' financial interests should conclude binding agreements.

Appendix 17. Safeguard clause and Infringement

CONSOLIDATED VERSION OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY

EN 24.12.2002 Official Journal of the European Communities C 325/33

Article 10

Member States shall take all appropriate measures, whether general or particular, to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community's tasks.

They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty.

Article 226

If the Commission considers that a Member State has failed to fulfil an obligation under this Treaty, it shall deliver a reasoned opinion on the matter after giving the State concerned the opportunity to submit its observations.

If the State concerned does not comply with the opinion within the period laid down by the Commission, the latter may bring the matter before the Court of Justice.

Article 227

A Member State which considers that another Member State has failed to fulfil an obligation under this Treaty may bring the matter before the Court of Justice.

Before a Member State brings an action against another Member State for an alleged infringement of an obligation under this Treaty, it shall bring the matter before the Commission.

The Commission shall deliver a reasoned opinion after each of the States concerned has been given the opportunity to submit its own case and its observations on the other party's case both orally and in writing.

If the Commission has not delivered an opinion within three months of the date on which the matter was brought before it, the absence of such opinion shall not prevent the matter from being brought before the Court of Justice.

Article 228

1. If the Court of Justice finds that a Member State has failed to fulfil an obligation under this Treaty, the State shall be required to take the necessary measures to comply with the judgment of the Court of Justice.

2. If the Commission considers that the Member State concerned has not taken such measures it shall, after giving that State the opportunity to submit its observations, issue

a reasoned opinion specifying the points on which the Member State concerned has not complied with the judgment of the Court of Justice.

If the Member State concerned fails to take the necessary measures to comply with the Court's judgment within the time‹limit laid down by the Commission, the latter may bring the case before the Court of Justice. In so doing it shall specify the amount of the lump sum or penalty payment to be paid by the Member State concerned which it considers appropriate in the circumstances.

If the Court of Justice finds that the Member State concerned has not complied with its judgment it may impose a lump sum or penalty payment on it.

This procedure shall be without prejudice to Article 227.

The Treaty of Accession 2003
16 April 2003

AA2003/ACT/en 49

Article 38

If a new Member State has failed to implement commitments undertaken in the context of the accession negotiations, causing a serious breach of the functioning of the internal market, including any commitments in all sectoral policies which concern economic activities with cross-border effect, or an imminent risk of such breach the Commission may, until the end of a period of up to three years after the date of entry into force of this Act, upon motivated request of a Member State or on its own initiative, take appropriate measures.

Measures shall be proportional and priority shall be given to measures, which disturb least the functioning of the internal market and, where appropriate, to the application of the existing sectoral safeguard mechanisms. Such safeguard measures shall not be invoked as a means of arbitrary discrimination or a disguised restriction on trade between Member States. The safeguard clause may be invoked even before accession on the basis of the monitoring findings and enter into force as of the date of accession. The measures shall be maintained no longer than strictly necessary, and, in any case, will be lifted when the relevant commitment is implemented. They may however be applied beyond the period specified in the first paragraph as long as the relevant commitments have not been fulfilled. In response to progress made by the new Member State concerned in fulfilling its commitments, the Commission may adapt the measures as appropriate.

The Commission will inform the Council in good time before revoking safeguard measures, and it will take duly into account any observations of the Council in this respect.

Article 39

If there are serious shortcomings or any imminent risks of such shortcomings in the transposition, state of implementation, or the application of the framework decisions or any other relevant commitments, instruments of cooperation and decisions relating to mutual recognition in the area of criminal law under Title VI of the EU Treaty and Directives and Regulations relating to mutual recognition in civil matters under Title IV of the EC Treaty in a new Member State, the Commission may, until the end of a period of up to three years after the date of entry into force of this Act, upon motivated request of a Member State or on its own initiative and after consulting the Member States, take appropriate measures and specify the conditions and modalities under which these measures are put into effect.

These measures may take the form of temporary suspension of the application of relevant provisions and decisions in the relations between a new Member State and any other Member State or Member States, without prejudice to the continuation of close judicial cooperation. The safeguard clause may be invoked even before accession on the basis of the monitoring findings and enter into force as of the date of accession. The measures shall be maintained no longer than strictly necessary, and, in any case, will be lifted when the shortcomings are remedied. They may however be applied beyond the period specified in the first paragraph as long as these shortcomings persist. In response to progress made by the new Member State concerned in rectifying the identified shortcomings, the Commission may adapt the measures as appropriate after consulting the Member States. The Commission will inform the Council in good time before revoking safeguard measures, and it will take duly into account any observations of the Council in this respect

Appendix 18. Conclusions of the three CHU-workshops

I. Leuven, June 2003

1. **Management awareness** about the rationale for **PI*f*C** principles (managerial accountability and functionally independent internal audit) and even pro-active support (promotion) is a pre-requisite for the success of the activities of CHUs, but in many cases this is absent or hardly developed. Management awareness- setting-up of courses should be organised, e.g. either through tailored courses or through horizontal coverage to all relevant acceding and applicant countries.

2. **Quality of internal audit** is of the highest priority. Without it the role and status of functionally independent internal auditors would quickly deteriorate. EU best practice and internationally agreed internal audit standards need to be channelled through the CHU to the individual income and spending centres in the government. The CHU should be given an advisory role in the appointments and dismissals of head of internal audit. CHUs should assess whether their guidelines are adequately followed up (on the spot compliance tests) and assess how internal audit reports stand in relation to set criteria. Risk assessment and self-assessment for both FMC-actors and IA-actors are important issues to develop.

3. The **networking role** of the CHUs covering control and audit authorities in the rest of the public sector is highly important and needs strengthening (more frequent meetings to discuss bottlenecks and impediments to the good development of control and audit schemes); the CHUs' roles of centres of excellence and experience needs to be expanded and deepened. CHUs should have the status and power (high visibility) in the Ministry of Finance to guide the other line ministries and public agencies in the areas of control and audit. Improved salary systems and compensation schemes should reflect the increased responsibilities of controllers and auditors;

4. **Co-ordination with the national Supreme Audit Institutions** (SAIs) should considerably improve. There is much need for a common approach to general audit rules, to advice managers on how to set up sound FMC-systems and to train internal auditors. Administrative co-operation agreements between CHUs and SAIs are a good suggestion with frequent meetings to discuss experience and suggestions for improvements.

5. CHUs know best the **training criteria for financial controllers and auditors** and they should aim at sustainability and quality of training. CHUs should therefore have a key role in the description of training requirements and in the organisation of training. The focus of such training should primarily be oriented towards practical control and audit skills.

6. The workshop was the first of its kind, where CHUs were brought together to discuss common problems and standards. Further meetings would be beneficial, especially if organised in a permanent discussion forum, e.g. the **Contact Group** for European Financial Control Organisations or otherwise, because many CHUs will need further support from each other in areas that are still relatively unknown, and they would wish to let their voices be heard in the international control and audit arena. As CHUs are presently changing the

emphasis of their work from law drafting to **PI*f*C** implementation through networking with the rest of the public sector, it will be necessary to define the future roles and tasks of CHUs.

II. Balatonösződ, December 2004

1. Despite progress, **management awareness** of the specific roles and responsibilities for internal control and internal audit and for the need to adequately harmonise these, still needs to be improved. Towards this end tailor-made information (or brief training) programmes must be developed;

2. So far, much of CHUs' attention went into the development of internal audit. In the upcoming period more attention should focus on the **adequate development of managerial accountability**, towards understanding the international standards for financial management and control systems. Further and periodical upgrading of the **PI*f*C** Policy Paper would play an important role.

3. The interest of high levels in administrations in **PI*f*C** should not be allowed to fade away gradually after the date of accession. In this respect it is understood that the **quality of national control and audit systems** should be assessed first by the CHUs and then (with a view to inform Parliament and the public) by the SAIs. Whereas the European Commission has, since the date of accession, no official remit to perform quality assessments (apart from the assessment of relevant Transition Facility programmes), such assessments should now increasingly come from the SAIs. This would become a win-win situation for all stakeholders involved.

4. **Closer co-operation with the IIA local chapters** is needed to enhance the national audit approach and to aim for higher levels of professional public internal audit.

5. An important tangible result of the CHU-2 seminar is the new **common template for CHU annual reporting**. The Commission anticipates that CHUs will use this template for the Annual Reporting on **PI*f*C** by CHUs starting with the reports on 2004. This annual report template could inspire CHUs to develop audit report templates to help improve the general quality level of audit reports. It is important to achieve higher degrees of standardisation (terminology) in the internal control and internal audit areas.

6. DG BUDG continues to have a large and pro-active interest in the further development of **PI*f*C** in Member States, Candidate and western Balkan Countries. DG BUDG also supports **PI*f*C** initiatives in the framework of the European Neighbourhood Policy. DG BUDG commits itself to go on providing input on a technical level, where necessary and appropriate.

III. Bled, March 2006

1. Introducing **risk analysis and risk management** will not work if management is not interested in establishing and implementing a risk management strategy. Other conditions for success are to regulate risk analysis and risk management in legislation; explaining the

objectives of implementation; have management take responsibility for strategic planning and outlining of risks; develop a toolkit: meetings, training, questionnaires, audit trail development, check lists, pilot implementation, manuals and guidelines; benchmarking compliance by management and have the CHU and SAI comment on the progress. These are important tasks for the CHU.

2. There is a need for **strengthening management awareness and accountability** to ensure a common understanding of the nature of managerial supervision. Suggested are training courses, provision of methodological tools like standards, guidelines including examples, manuals and publication of all relevant documents and to explore the possibilities for using EU-funds to finance training. The design of managerial supervision arrangements requires **operational strategy planning and the use of management declarations**. A specific task for the CHU would be to develop a standard template for such declarations and the **elaboration of self-assessment tools** for management.

3. The common understanding and terminology for financial management and control as well as for the function of internal audit by both SAI and CHU mean that optimum levels of co-operation can and should be reached. There is a strong demand for co-operation examples and good practice. Probably the best chances for good co-operation are in the field of methodology, standards and definitions, common training programmes and the planning and co-ordination of audit activities.

4. The last generation of CHU annual reports on the progress of **PI*f*C** shows that the 2004 template by DG Budget has been well received and provides for increased accessibility and transparency in reporting to government, management and the public. Further efforts in benchmarking would be a good next step.

5. In quite a number of cases the nature of **functional independence of the internal audit** is not well understood by management: a specific task for the CHU.

6. Internal Audit Charters and Codes of Ethics should be uniformly applied in the public sector: a specific task for the CHU-IA

Appendix 19. Template for a CHU Annual Report

TEMPLATE FOR THE CHU ANNUAL REPORTS on PI*f*C

This template was developed by DG Budget in 2004 after an analysis of the first CHUs' annual reports on the status of **PI*f*C** in their countries. The template is only a guideline for structure and content to ensure the highest degree of accessibility to relevant stakeholders and to allow for benchmarking progress over time. Report drafters may wish to include the following elements::

1. Executive summary (Maximum 2 pages) might contain[1]:

- Short overall assessment following the issues mentioned under Main findings (the scope of this assessment should follow the Coverage of the report mentioned under "Introduction");
- Three or four most important conclusions on the findings (those that block most seriously the **PI*f*C** progress and need most urgent dealing during the next period of reporting, so that progress can be facilitated and measured next year)
  - with reference to FMC-systems
  - with reference to Internal Audit performance
  - with reference to CHU harmonisation and co-ordination activities
- Recommendations that have an operational impact and have been covered in the above assessment and conclusions;
- Clear indication of who will be responsible for implementing the recommendations and in what timeframe and who will be responsible for monitoring the implementation.

2. Introduction (Maximum one page) might contain:

- Purpose of the report (Objectives): (thread with earlier similar annual reports) – purpose in general, period covered, date of final version of report, which is responsible organisation, who is responsible person for the report, for whom this report is meant and what channels of distribution will be used.
- Legal basis of the report (national law and regulations)
- Material basis of the report (**PI*f*C** Policy Paper, SIGMA Peer Review, etc.) as well as (CHUs audit reports, decentralised internal audit reports, FMC-systems reports)
- Coverage of the report: is the report assessing all **PI*f*C** aspects or only part(s) of it (FMC-systems or internal audit)? Is the CHU also assessed (self-assessment)?

1 Should be as short and operational as possible and refer to the main conclusions under Heading 4.

3. FINDINGS might contain:

3.1 Assessing the functions of Internal Audit Units[2]

- Are all sectors of public income and expenditure (assets and liabilities) satisfactorily covered by the principle of internal audit?
- **The status and staffing** of internal audit units (decentralised[3])
  - Status of the Internal Audit Units and auditors in the hierarchy
  - Direct access and reporting to the highest management levels by the IAU
  - General awareness of management of the added value role of the internal audit
  - Management and IAU understanding of and compliance with the Internal Audit Charter and the Code of Ethics for the auditors; (assessing the CHU-templates for these documents and their use.)
  - General experience and qualification of the internal audit staff
  - Systematic training of the internal audit staff
  - Staffing of IAUs (vacancies)
  - Adequacy of staffing in IAUs
  - Qualification level and experience of internal audit staff
  - Successfulness of tenders for internal auditors; (Suggestions to overcome the main impediments - in annex)
  - Adequacy of salary and remuneration levels; Suggestions for plans to improve;
  - Language courses (Are actions considered necessary to make the internal auditors acquainted with the English language, enabling them to obtain knowledge of the vast body of information on the latest developments in international standards relating to FMC-systems and internal audit?
  - Policy of job rotation
- Reporting of cases of conflict of interest by IAU's to CHU relating to infringement of principle of functional independence
- Internal audit units self-assessment exercises either independently or through the help (pilots) by the CHU; conclusions for further action
- Are there any problems reported in relation to non-access by the IAU to documents and/or premises of the auditee?

3.2. Assessing the Performance and Reporting of IAUs in budget income and spending centres on central, regional and local levels.

- **Performance**
  - **Statistical evidence:** In general, statistical evidence should be used sparsely, with clear and telling conclusions in the text and the underlying statistical data put into

2 It is necessary to define what should be written here and what under Chapter 3.5 to avoid overlapping
It might also be useful to consider giving score marks to the various assessments

3 Or centralised in the case of Malta or Cyprus, for example

the annexes. Statistics are useful if they can be measured over time. It would make sense to consider what statistics relating to FMC, IA and CHU performance could be usefully made, without annoying the reader and thus detracting from the presentational value of the report. Benchmarking should become possible.
- Self-assessment exercise organised in the IAUs on performance issues (see also 3.1.4)
- Multi-annual strategic plans for audit in an income/ spending centre considered satisfactory
- Quality of the annual audit plans
- Relation between audits requested by management and those planned by the IA in accordance to risk analysis
- Conflicts between management and IAUs in relation to establishing the annual audit plans
- An qualitative assessment on the rate of planned audits and ad hoc audits performed
- IAUs use of objective risk assessment methodologies to establish highest risk in areas subject to audit
- Important factors known or uncovered that hinder the implementation of internal audit
- IAU's balance on the classical financial internal audit / systems-based audits/ performance audits/ IT- (refer to detailed % figures in annex

- **Reporting**
  - IAU reporting follow report templates established by the CHU
  - General quality of the audit-reporting by IAUs. Suggestions for improvements to be made
  - Frequency of IAU reporting to the CHU about conflicts of interest with the management or about non-implementation of audit recommendations by management
  - Number of cases known where the IAU had to inform the legal authorities about assumptions of fraud, corruption and/or irregularities (details in annex)

3.3. Assessment of the findings and recommendations of the IAU in budget income and spending centres

Audit findings

Procedures and experience of discussing audit findings with the auditee on the basis of notes made by individual IAU's)

Audit recommendations

- IAU recommendations classified meaningfully
- General quality of audit recommendations
- Adequacy of follow-up procedures
- Deadline of follow-up procedures
- Does a database exist to register recommendations and does it function?
- Analysis of the (non-) implementation of recommendations (categories: not yet started, not yet finalised, refusals)

3.4. Assessment of the operations of the FMC system in budget income and spending centres

- **General**
  - Overall and integrated policy for managerial accountability with responsibilities for establishing and maintaining Financial Management and Control systems
  - Level of professional skills and experience of financial controllers
  - Quality of ex-ante and ongoing financial control systems
  - Management understanding of the role of the ex-ante financial controller
  - Functioning of the ex-post financial control in relation to the tasks and functions of internal audit. Suggestions to overcome overlap and problems (analyses in annex)
  - Quality of FMC-manuals and descriptions as a tool for internal auditors to assess the quality of the systems involved (analyses in annex)
  - Effectiveness of the FMC-systems in developing audit trails
  - Turnover of FMC-staff; Suggestions to overcome any problems in this area (analyses in annex) (to be co-ordinated with section 3.5 to avoid overlap)
- **Performance of FMC:**
  - Establishment and adequacy of the controls of assets and liabilities and of the policy of claim recoveries
  - Understanding by FMC-staff of their FMC standards and procedures: delegation of tasks
  - Management awareness of the internal control procedures and the effectiveness of established procedures
  - Double signature procedures
  - Risk assessment methodologies used by FMC-systems to remedy / reduce critical factors and areas of risk
  - Follow-up of audit recommendations?
- **Planning, reporting, and archiving:**
  - Procedures established and implementation for the annual plans, if any, by FMC-directors, including the main objectives of FMC-systems. An assessment on the growing experience in this field
  - Quality of the annual reports on FMC performance and results

4. Operations of the CHU for Internal Audit:

- Activities carried out regarding Internal Audit: General trends noted in IAUs, conclusions and recommendations
- Quality assurance processes regarding Internal Audit: General trends noted in IAUs, conclusions and recommendations
- Recruitment and retention of Internal Auditors: Problems (analysis of the reasons behind high / low staff turnover) Details to be put in an annex
- Conclusions and Recommendations

Training activities of internal auditors

- State of play of sustainable training programmes/individual training programmes of IA staff
- Short general experience and qualification/training of internal audit staff
- Training and development - % of days allocated to training by internal audit unit vs. actual outcome
- Professionalism – number of members of IIA as % of total numbers of internal auditors; number of qualified members as % of total no. of internal auditors;
- Conclusions and Recommendations

5. Operations of the CHU for Financial Management and Control:

- **Activities carried out regarding FMC:** General trends noted, conclusions and recommendations

- **Quality assurance processes**
  - General trends noted in financial control reporting
  - General trends noted in reporting on irregularities, fraud, etc.
  - Conclusions and Recommendations

- **Recruitment and retention of financial control staff**
  - Problems (analysis of the reasons behind high / low staff turnover) Details to be put in an annex
  - Conclusions and Recommendations

- **Training activities of financial control staff**
  - Training and development - % of days allocated to training by financial control staff vs. actual outcome
  - Turnover of FMC-staff. Suggestions to overcome any problems in this area (Analyses in annex) (ensure no overlap with section 3.4)
  - Conclusions and Recommendations

6. Independent or self-assessment of the CHU

- Background

- Findings

- Conclusions and Recommendations

7. Various issues

- Planning organisation of the CHU (presence and validity of a Multi-annual Work Plan or Annual Work Plan)

- Ongoing work of updating primary and secondary **PI*f*C** Legislation and Regulation in the light of general internal audit findings and experience

- Effectiveness of the role of the CHU in terms of its responsibility for networking between internal auditors (Regular meetings, website, publications, etc.)

- Effectiveness of the role of the CHU in terms of its responsibility for networking between financial controllers (Regular meetings, website, publications, etc.)
- An assessment by the CHU on the general issue of functional independence of the internal audit (Overlap with section 3.1?)
- Provision and conclusion of the self-assessment exercise or organise such exercises for internal audit units and/or management of FMC-systems (Briefing on background and method used and results in annex)
- Co-operation with external audit (Supreme Audit Institution (agreement framework), European Court of Audit, EC)
- Production of templates for FMC-manuals and of IA-manuals (charter, audit trail templates, code of ethics, etc.)
- An overview of the adequacy of establishing IA units and functions (this has to be co-ordinated with section 3.1 to avoid overlapping)
- The role of the Internal Audit Board or similar institution and on the actions and contributions of this Board in the area of **PI*f*C**; Suggestions on improving the scope of action and functioning of this board

8. Conclusions

This section should provide for a general assessment about the **PI*f*C** objectives achieved so far as well as mention the most important bottlenecks and provide for solutions in the foreseeable future.

The conclusions should be brief and operational, covering main concerns expressed under Heading 3 above and avoiding too much detail. Suggestions should be made explicitly on whether there is urgent need for improving **PI*f*C** legislation or for focussing on specific areas in the year to come.

9. Signature and date

The annual report should be signed by the one who takes explicit responsibility for the report (e.g., a Minister)

Appendix 20. Performance Management Framework

Performance indicators on internal control and external audit in the PEFA Framework

PI-20. Effectiveness of internal controls for non-salary expenditure

An effective internal control system is one that (a) is relevant (i.e. based on an assessment of risks and the controls required to manage the risks), (b) incorporates a comprehensive and cost effective set of controls (which address compliance with rules in procurement and other expenditure processes, prevention and detection of mistakes and fraud, safeguard of information and assets, and quality and timeliness of accounting and reporting), (c) is widely understood and complied with, and (d) is circumvented only for genuine emergency reasons. Evidence of the effectiveness of the internal control system should come from government financial controllers, regular internal and external audits or other surveys carried out by management. One type of information could be error or rejection rates in routine financial procedures.

Other indicators in this set cover controls in debt management, payroll management and management of advances. This indicator, therefore, covers only the control of expenditure commitments and payment for goods and services, casual labour wages and discretionary staff allowances. The effectiveness of expenditure commitment controls is singled out as a separate dimension of this indicator due the importance of such controls for ensuring that the government's payment obligations remain within the limits of projected cash availability, thereby avoiding creation of expenditure arrears (ref. indicator PI-4).

Dimensions to be assessed (Scoring Method M1):

(i) Effectiveness of expenditure commitment controls.

(ii) Comprehensiveness, relevance and understanding of other internal control rules/procedures.

(iii) Degree of compliance with rules for processing and recording transactions.

Score Minimum requirements (Scoring methodology: M1)

A (i) Comprehensive expenditure commitment controls are in place and effectively limit commitments to actual cash availability and approved budget allocations (as revised).

(ii) Other internal control rules and procedures are relevant, and incorporate a comprehensive and generally cost effective set of controls, which are widely understood.

(iii) Compliance with rules is very high and any misuse of simplified and emergency procedures is insignificant.

B (i) Expenditure commitment controls are in place and effectively limit commitments to actual cash availability and approved budget allocations for most types of expenditure, with minor areas of exception.

(ii) Other internal control rules and procedures incorporate a comprehensive set of controls, which are widely understood, but may in some areas be excessive (e.g. through duplication in approvals) and lead to inefficiency in staff use and unnecessary delays.

(iii) Compliance with rules is fairly high, but simplified/emergency procedures are used occasionally without adequate justification.

C (i) Expenditure commitment control procedures exist and are partially effective, but they may not comprehensively cover all expenditures or they may occasionally be violated.

(ii) Other internal control rules and procedures consist of a basic set of rules for processing and recording transactions, which are understood by those directly involved in their application. Some rules and procedures may be excessive, while controls may be deficient in areas of minor importance.

(iii) Rules are complied with in a significant majority of transactions, but use of simplified/emergency procedures in unjustified situations is an important concern.

D (i) Commitment control systems are generally lacking OR they are routinely violated.

(ii) Clear, comprehensive control rules/procedures are lacking in other important areas.

(iii) The core set of rules are not complied with on a routine and widespread basis due to direct breach of rules or unjustified routine use of simplified/emergency procedures.

PI-21. Effectiveness of internal audit

Regular and adequate feedback to management is required on the performance of the internal control systems, through an internal audit function (or equivalent systems monitoring function). Such a function should meet international standards such as the ISPPIA11, in terms of (a) appropriate structure particularly with regard to professional independence, (b) sufficient breadth of mandate, access to information and power to report, (c) use of professional audit methods, including risk assessment techniques. The function should be focused on reporting on significant systemic issues in relation to: reliability and integrity of financial and operational information; effectiveness and efficiency of operations; safeguarding of assets; and compliance with laws, regulations, and contracts. Internal audit functions are in some countries concerned only with pre-audit of transactions, which is here considered part of the internal control system and therefore assessed as part of indicator PI-20.

Specific evidence of an effective internal audit (or systems monitoring) function would also include a focus on high risk areas, use by the SAI of the internal audit reports, and action by management on internal audit findings. The latter is of critical importance since lack of action on findings completely undermines the rationale for the internal audit function.

The internal audit function may be undertaken by an organisation with a mandate across entities of the central government (such as government inspection general or IGF) or by separate internal audit functions for individual government entities. The combined effectiveness of all such audit organisations is the basis for this indicator.

Dimensions to be assessed (Scoring Method M1):

(i) Coverage and quality of the internal audit function.

(ii) Frequency and distribution of reports.

(iii) Extent of management response to internal audit findings.

Score Minimum requirements (Scoring methodology: M1)

A (i) Internal audit is operational for all central government entities, and generally meet professional standards. It is focused on systemic issues (at least 50% of staff time).

(ii) Reports adhere to a fixed schedule and are distributed to the audited entity, ministry of finance and the SAI.

(iii) Action by management on internal audit findings is prompt and comprehensive across central government entities.

B (i) Internal audit is operational for the majority of central government entities (measured by value of revenue/expenditure), and substantially meet professional standards. It is focused on systemic issues (at least 50% of staff time).

(ii) Reports are issued regularly for most audited entities and distributed to the audited entity, the ministry of finance and the SAI.

(iii) Prompt and comprehensive action is taken by many (but not all) managers.

C (i) The function is operational for at least the most important central government entities and undertakes some systems review (at least 20% of staff time), but may not meet recognized professional standards.

(ii) Reports are issued regularly for most government entities, but may not be submitted to the ministry of finance and the SAI.

(iii) A fair degree of action taken by many managers on major issues but often with delay

D (i) There is little or no internal audit focused on systems monitoring.

(ii) Reports are either non-existent or very irregular.

(iii) Internal audit recommendations are usually ignored (with few exceptions).

PI-26. Scope, nature and follow-up of external audit

A high quality external audit is an essential requirement for creating transparency in the use of public funds. Key elements of the quality of actual external audit comprise the scope/coverage of the audit, adherence to appropriate auditing standards including independence of the external audit institution (ref. INTOSAI and IFAC/IAASB), focus on significant and systemic PFM issues in its reports, and performance of the full range of financial audit such as reliability of financial statements, regularity of transactions and functioning of internal control and procurement systems.

Inclusion of some aspects of performance audit (such as e.g. value for money in major infrastructure contracts) would also be expected of a high quality audit function.

The scope of audit mandate should include extra-budgetary funds and autonomous agencies. The latter may not always be audited by the Supreme Audit Institution (SAI), as the use of other audit institutions may be foreseen. The scope indicates the entities and sources of funds that are audited in any given year. Where SAI capacity is limited, the audit program may be planned by the SAI in line with legal audit obligations on a multi-year basis in order to ensure that most important or risk prone entities and functions are covered annually, whereas other entities and functions may be covered less frequently.

While the exact process will depend to some degree on the system of government, in general the executive (the individual audited entities and/or the ministry of finance) would be expected to follow up of the audit findings through correction of errors and of system weaknesses identified by the auditors. Evidence of effective follow up of the audit findings includes the issuance by the executive or audited entity of a formal written response to the audit findings indicating how these will be or already have been addressed. The following year's external audit report may provide evidence of implementation by summing up the extent to which the audited entities have cleared audit queries and implemented audit recommendations.

Dimensions to be assessed (Scoring Method M1):

(i) Scope/nature of audit performed (incl. adherence to auditing standards).

(ii) Timeliness of submission of audit reports to legislature.

(iii) Evidence of follow up on audit recommendations.

Minimum Score requirements (Scoring methodology: M1)

A (i) All entities of central government are audited annually covering revenue, expenditure and assets/liabilities. A full range of financial audits and some aspects of performance audit are performed and generally adhere to auditing standards, focusing on significant and systemic issues.

(ii) Audit reports are submitted to the legislature within 4 months of the end of the period covered and in the case of financial statements from their receipt by the audit office.

(iii) There is clear evidence of effective and timely follow up.

B (i) Central government entities representing at least 75% of total expenditures12 are audited annually, at least covering revenue and expenditure. A wide range of financial audits are performed and generally adheres to auditing standards, focusing on significant and systemic issues.

(ii) Audit reports are submitted to the legislature within 8 months of the end of the period covered and in the case of financial statements from their receipt by the audit office.

(iii) A formal response is made in a timely manner, but there is little evidence of systematic follow up.

C (i) Central government entities representing at least 50% of total expenditures are audited annually. Audits predominantly comprise transaction level testing, but reports identify significant issues. Audit standards may be disclosed to a limited extent only.

(ii) Audit reports are submitted to the legislature within 12 months of the end of the period covered (for audit of financial statements from their receipt by the auditors).

(iii) A formal response is made, though delayed or not very thorough, but there is little evidence of any follow up.

D (i) Audits cover central government entities representing less than 50% of total expenditures or audits have higher coverage but do not highlight the significant issues.

(ii) Audit reports are submitted to the legislature more than 12 months from the end of the period covered (for audit of financial statements from their receipt by the auditors).

(iii) There is little evidence of response or follow up.

PI-27. Legislative scrutiny of the annual budget law

The power to give the government authority to spend rests with the legislature, and is exercised through the passing of the annual budget law. If the legislature does not rigorously examine and debate the law, that power is not being effectively exercised and will undermine the accountability of the government to the electorate. Assessing the legislative scrutiny and debate of the annual budget law will be informed by consideration of several factors, including the scope of the scrutiny, the internal procedures for scrutiny and debate and the time allowed for that process.

Adequacy of the budget documentation made available to the legislature is covered by PI-6. In-year budget amendments constitute a common feature of annual budget processes. In order not to undermine the significance of the original budget, the authorization of amendments that can be done by the executive must be clearly defined, including limits on extent to which expenditure budgets may be expanded and re-allocated and time limits for the executive's presentation of amendments for retro-active approval by the legislature. These rules must also be adhered to.

Dimensions to be assessed (Scoring Method M1):

(i) Scope of the legislature's scrutiny.

(ii) Extent to which the legislature's procedures are well-established and respected.

(iii) Adequacy of time for the legislature to provide a response to budget proposals both the detailed estimates and, where applicable, for proposals on macro-fiscal aggregates earlier in the budget preparation cycle (time allowed in practice for all stages combined).

(iv) Rules for in-year amendments to the budget without ex-ante approval by the legislature.

Minimum Score requirements (Scoring methodology: M1)

A (i) The legislature's review covers fiscal policies, medium term fiscal framework and medium term priorities as well as details of expenditure and revenue.

(ii) The legislature's procedures for budget review are firmly established and respected. They include internal organisational arrangements, such as specialized review committees, and negotiation procedures.

(iii) The legislature has at least two months to review the budget proposals.

(iv) Clear rules exist for in-year budget amendments by the executive, set strict limits on extent and nature of amendments and are consistently respected.

B (i) The legislature's review covers fiscal policies and aggregates for the coming year as well as detailed estimates of expenditure and revenue.

(ii) Simple procedures exist for the legislature's budget review and are respected.

(iii) The legislature has at least one month to review the budget roposals.

(iv) Clear rules exist for in-year budget amendments by the executive, and are usually respected, but they allow extensive administrative reallocations.

C (i) The legislature's review covers details of expenditure and revenue, but only at a stage where detailed proposals have been finalized.

(ii) Some procedures exist for the legislature's budget review, but they are not comprehensive and only partially respected.

(iii) The legislature has at least one month to review the budget proposals.

(iv) Clear rules exist, but they may not always be respected OR they may allow extensive administrative reallocation as well as expansion of total expenditure.

D (i) The legislature's review is non-existent or extremely limited, OR there is no functioning legislature.

(ii) Procedures for the legislature's review are non-existent or not respected.

(iii) The time allowed for the legislature's review is clearly insufficient for a meaningful debate (significantly less than one month).

(iv) Rules regarding in-year budget amendments may exist but are either very rudimentary and unclear OR they are usually not respected.

PI-28. Legislative scrutiny of external audit reports

The legislature has a key role in exercising scrutiny over the execution of the budget that it approved. A common way in which this is done is through a legislative committee(s) or commission(s), that examines the external audit reports and questions responsible parties about the findings of the reports. The operation of the committee(s) will depend on adequate financial and technical resources, and on adequate time being allocated to keep up-to-date on reviewing audit reports. The committee may also recommend actions and sanctions to be implemented by the executive, in addition to adopting the recommendations made by the external auditors (ref. PI-26).

The focus in this indicator is on central government entities, including autonomous agencies to the extent that either (a) they are required by law to submit audit reports to the legislative or (b) their parent or controlling ministry/department must answer questions and take action on the agencies' behalf.

Timeliness of the legislature's scrutiny can be affected by a surge in audit report submissions, where external auditors are catching up on a backlog. In such situations, the committee(s) may decide to give first priority to audit reports covering the most recent reporting periods and audited entities that have a history of poor compliance. The assessment should favourably consider such elements of good practice and not be based on the resulting delay in scrutinizing reports covering more distant periods.

Dimensions to be assessed (Scoring Method M1):

(i) Timeliness of examination of audit reports by the legislature (for reports received within the last three years).

(ii) Extent of hearings on key findings undertaken by the legislature.

(iii) Issuance of recommended actions by the legislature and implementation by the executive.

Minimum Score requirements (Scoring methodology: M1)

A (i) Scrutiny of audit reports is usually completed by the legislature within 3 months from receipt of the reports.

(ii) In-depth hearings on key findings take place consistently with responsible officers from all or most audited entities, which receive a qualified or adverse audit opinion.

(iii) The legislature usually issues recommendations on action to be implemented by the executive, and evidence exists that they are generally implemented.

B (i) Scrutiny of audit reports is usually completed by the legislature within 6 months from receipt of the reports.

(ii) In-depth hearings on key findings take place with responsible officers from the audited entities as a routine, but may cover only some of the entities, which received a qualified or adverse audit opinion.

(iii) Actions are recommended to the executive, some of which are implemented, according to existing evidence.

C (i) Scrutiny of audit reports is usually completed by the legislature within 12 months from receipt of the reports.

(ii) In-depth hearings on key findings take place occasionally, cover only a few audited entities or may include with ministry of finance officials only.

(iii) Actions are recommended, but are rarely acted upon by the executive.

D (i) Examination of audit reports by the legislature does not take place or usually takes more than 12 months to complete.

(ii) No in-depth hearings are conducted by the legislature.

(iii) No recommendations are being issued by the legislature.

Appendix 21. Template for an Internal Audit Charter

I. The Internal Audit Mission Statement

This document, to be known as the Internal Audit Charter or Mission Statement, should have the approval of the Council of Ministers (either as annex to relevant legislation or as part of regulation). This Statement sets out the frame within which Internal Audit will function to add value to the operations of the public sector. The Charter should be signed by both the (top) manager and the internal auditor.

II. Purpose

Internal Audit is an independent, objective assurance and consulting activity to take place in the public sector determining whether acceptable policies and procedures are followed, legislative requirements and established standards are met, resources are used efficiently and economically, planned missions are accomplished effectively and the objectives of public institutions are met.

III. Objective

The overall objective of Internal Audit is to provide additional assurance to the government, the relevant minister and head of department that the implementation of management and control mechanisms is adequate, economical and consistent with the generally recognised standards and national legislation. Internal Audit furnishes Heads of budget income and spending-centres with analyses, recommendations, counsel and information concerning the activities reviewed.

IV. Independence

1. The Internal Audit is independent of the activities it audits to ensure objective judgement essential to its proper conduct and impartial advice to Government.
2. No internal auditor shall have the authority over, or responsibility for, any of the activities reviewed. The involvement of the internal audit in developing or implementing departmental policies, systems and procedures shall be in an advisory capacity, in adherence to any past and/or present recommendations made by the Internal Audit Unit itself.

V. Authority

1. The Internal Audit Unit derives its authority from the [**PI*f*C** law / the Internal Audit Law].
2. The Internal Audit Unit is authorised to conduct regularity and financial audits, systems based audits, IT-audits, management audits as well as economy, efficiency and effectiveness audits and to direct a broad comprehensive program of internal auditing within the Government.

3. The Internal Audit Unit reports to the Head of budget income and spending-centre through its Head of Unit and submits reports to the auditee and the [Central Harmonisation Unit for Internal Audit].

4. In order to carry out his/her responsibilities, the Head of Internal Audit Unit and his/her representatives are authorised to have full, free and unrestricted access to all Government records, property, and staff relevant to the performance of internal audits. Head of budget income and spending-centres shall co-operate in providing information and/or explanations to the Head of Internal Audit or his/her staff as necessary for the effective and efficient performance of audits.

VI. Role and scope

1. The role of Internal Audit is to identify and understand potential risk in the activities of Government and to examine and evaluate the adequacy and effectiveness of the systems of internal control designed to control such risk.

2. The scope of internal audit is unrestricted and includes adherence to centrally prescribed policies, directives and procedures (including those emanating from any international commitments made by the [X-country] and/or any membership within international groupings), and the promotion of the economy, efficiency and effectiveness of budget income and spending-centre's activities, in the interest also of transparency in and, sustainability of, the public service.

3. The Internal Audit Unit has unrestricted access to all activities undertaken within Government in order to review, appraise and report on:
   a) the adequacy and effectiveness of the systems of financial, operational and management control and their operation in practice in relation to risks involved;
   b) the extent of compliance with relevance of, and financial effect of, policies, standards, plans and procedures established by Government, the minister of the corresponding area of the government and the head of the department;
   c) the extent of compliance with laws and regulations of the X-country and those emanating from its international commitments, including reporting requirements of regulatory bodies, both national and international;
   d) the extent to which resources are acquired economically, used efficiently, duly accounted for and safeguarded from losses of all kinds arising from waste, extravagance, inefficient administration, poor value for money, fraud or other causes;
   e) the suitability, accuracy, reliability and integrity of financial and other information and the means used to identify, measure, classify and report such information;
   f) the integrity of processes and systems, including those under development, to ensure that controls offer adequate protection against error, fraud and loss of all kinds and that the process aligns with the goals and objectives, of Budget Income and Spending-centre;
   g) the suitability of the organisation of Government Departments, and other units audited, for carrying out their functions, and to ensure that public services are provided in ways which are economical, efficient, effective, transparent and sustainable;

h) the follow-up actions taken by the Head of Budget Income and Spending-centres to remedy weaknesses identified by internal audit review ensuring that good practice is identified and communicated widely.

VII. Responsibilities

1. The Internal Auditor will function in compliance with the Standards for the Professional Practice of Public Internal Auditing (meant is here the Internal Audit Manual) and with professional standards as embodied in the Code of Ethics for public internal auditors.
2. The Head of Internal Audit unit shall be responsible for:
   a) Ensuring that all audits, falling within the scope of Internal Audit as set out in this charter, are effectively carried out;
   b) Effectively managing and developing the Budget Income and Spending-centre's Internal Audit by providing the necessary professional, technical and operational direction as emanating from international audit standards, guidelines and practices;
   c) Ensuring the efficient functionality of the Internal Audit Unit as an independent, internal Budget Income and Spending-centre's institution with no direct responsibility for, nor authority over any of the activities reviewed;
   d) Developing a strategic plan based on the objective and scope of Internal Audit and on an objective understanding of risks to which the Budget Income and Spending-centre is exposed, and referring the plan for endorsement to the Head of Budget Income and Spending-centre;
   e) Developing an annual operational plan to support the strategic plan. The plan will take into account the policies and directives of the Central Harmonisation Unit, concerns of the Head of Budget Income and Spending-centre and risk assessments of Budget Income and Spending-centre's activities carried out by the Internal Audit Unit from time to time. The annual audit plan will set out the critical areas to be reviewed, definition of tasks to be performed, target dates and allocation of resources;
   f) Implementing the plans submitted to, and approved by the budget income and spending-centre, and completion of other ad-hoc assignments as may be required to fulfil the role, and cover the scope of Budget Income and Spending-centre Internal Audit;
   g) Advising the Head of Budget Income and Spending-centre and the Central Harmonisation Unit of resources required to meet the approved audit plans;
   h) Maintaining a professional audit staff with sufficient knowledge, skills and experience to carry out the work of internal audit;
   i) Providing a continuous and timely internal audit service to the Head of Budget Income and Spending-centre respecting the total confidentiality of their affairs wherever possible.

VIII. Reporting

1. The Internal Audit Unit will report formally upon the results of its work to the Head of Budget Income and Spending-centre.
2. A draft report to the auditee and the Head of Budget Income and Spending-centre responsible for the areas audited shall be produced within one month of the conclusion of each audit assignment. The report shall set out the findings and recommendations arising there from and also express an assessment on the reliability and adequacy of that part of the system of internal control reviewed. The draft report will be discussed with the auditee and the factual accuracy agreed prior to the issue of the final report.
3. In case of fraud or financial irregularity, the report to the relevant judiciary capacity shall be made within two days of the definite conclusion of the investigation.
4. The Internal Audit shall report to the Head of Budget Income and Spending-centre throughout the year, at least on a quarterly basis, on achieved coverage against agreed audit plans and explain any variation from plan.
5. The internal audit unit shall issue an Annual Report on its activities during the year to the Head of Budget Income and Spending-centre. A copy of the report shall be submitted to the Central Harmonising Internal Audit Unit not later than April 1st of the following year. As a minimum, the report shall include:
   a) an executive summary of each internal audit;
   b) an analysis of common or significant weaknesses arising;
   c) a comparison of audit coverage achieved with that planned;
   d) details of any major audit and investigation findings where action is urgently required but has not been taken, including those identified in previous years' reports.

IX. Relationship with the Supreme Audit Institution (SAI)

The relationship between the Internal Audit Unit and the SAI shall be in accordance with the parameters set out below:

1. The points of communication between the SAI and the Internal Audit Unit shall invariably be the Auditor General him/herself and the Head of Internal Audit Unit him/herself;
2. The Head of Internal Audit Unit shall discuss with the Auditor General audit plans which solely relate to service-wide internal audit assignments, with the primary objective of ensuring that duplication of effort and resources is avoided;
3. Working papers of the Internal Audit Unit, because of the possibility of the sensitivity and restrictiveness of their contents, should only be made available to the SAI if the request is made specifically by the Auditor General him/herself;
4. Ownership of reports is issued by the Internal Audit Unit to Head of Budget Income and Spending-centre rests with Head of Budget Income and Spending-centre and requests by the SAI to obtain access to such reports should be directly addressed to Head of Budget Income and Spending-centre;

5. Both the SAI and the Head of Internal Audit Unit undertake to inform each other in a spirit of trust while maintaining their independence, should any of them discover, during an audit assignment, that there is a grave underlying suspicion of mismanagement and/or fraud;
6. Both the SAI and the head of internal audit undertake to inform each other and mutually participate in any training initiative that bears upon their respective responsibilities, including those EU initiatives that are targeted towards the control and protection of the financial interests of the EU.

X. Amendments to Mission Statement

This Mission Statement is subject to continuous monitoring and periodic updating (at least once a year). It shall be amended by the Central Harmonisation Internal Audit Unit if it is considered that the Statement does not adequately support the continuing effectiveness of the Internal Audit institution. In doing so, the Central Harmonisation Internal Audit Unit will consider any recommendations put forward by Head of Internal Audit Units.

Date:

Signature of Head of Organisation **Signature of Internal Auditor**

(Copy of the signed Audit Charter could be sent to the CHU for IA.)

Appendix 22. Template for an IA Code of Ethics

The Code of Ethics (Code) should be signed by each individual public internal auditor (usually following the certification of the internal auditor) is a comprehensive statement of the values and principles, which should guide the daily work of auditors. The Code considers the ethical requirements of civil servants in general and the particular requirements of the audit profession.

The conduct of auditors should be beyond reproach at all times and in all circumstances. Any deficiency in their professional conduct or any improper conduct in their personal life places the integrity of the government, the public audit function and of the auditors in an unfavourable light and may raise doubts about the reliability and competence of the audit function. The adoption and application of the Code promotes trust and confidence in the auditors and their work.

The Code applies to both individuals and entities providing internal audit services. Internal auditors are expected to apply and uphold the following principles:

INTEGRITY

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.

Rules of conduct:

Internal auditors:

- Shall perform their work with honesty, diligence and responsibility;
- Shall observe the law and make disclosures expected by the law and the profession;
- Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing;
- Shall respect and contribute to the legitimate and ethical objectives of the government;
- Shall make decisions with the public interest in mind.

INDEPENDENCE, OBJECTIVITY AND IMPARTIALITY

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about the activity or process being examined. Internal auditors shall be independent from the audited entity and other outside interest groups. Internal auditors make a balanced assessment of all relevant circumstances and are not unduly influenced by their own interests or by others in forming judgements.

Rules of Conduct:

Internal auditors:

- Shall be independent and objective in dealing with issues and topics under view;
- Shall protect their independence from any political influence;

- Shall sustain from personal or external interest or pressure (i.e. prejudices held by auditors about individuals, audited entities, projects or programmes, recent previous employment with the audited entity, personal or financial dealings which might cause conflict of loyalties or of interests);
- Shall make use of information and views brought forward by the audited entity and other parties but the internal auditors' own conclusion shall not be affected by such information and views;
- Shall provide accurate and objective audit reports (i.e. conclusions shall exclusively be based on evidence obtained and assembled in accordance with the auditing standards);
- Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the government;
- Shall not accept anything that may impair or be presumed to impair their professional judgement;
- Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

CONFIDENTIALITY

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Rules of Conduct:

Internal auditors:

- Shall be prudent in the use and protection of information acquired in the course of their duties;
- Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the government.

COMPETENCE

Internal auditors apply the knowledge, skills and experience needed in the performance of internal audit services

Rules of Conduct:

Internal auditors:

- Shall engage only in those services for which they have the necessary knowledge, skills and experience;.
- Shall perform internal audit services in accordance with the Internal Audit Charter and any other standards for internal auditing as developed by the Ministry of Finance;
- Shall continually improve their proficiency and the effectiveness and quality of their services.

CONDUCT AND RELATIONS

Internal auditors should conduct themselves in a manner, which promotes co-operation and good relations between auditors and within the profession.

Rules of Conduct:

Internal auditors:

- Shall support the profession by its members and their co-operation with one another;
- Shall deal with fellow auditors in a fair and balanced way.

CONFLICT OF INTEREST

If internal auditors provide advice or services other than audit to an audited entity, care shall be taken that these services do not lead to a conflict on interest.

Rules of Conduct:

Internal auditors:

- Shall ensure that such advice or services do not include management responsibilities or powers, which shall remain firmly with the management of the audited entity;
- Shall protect their independence and avoid any possible conflict of interest by refusing gifts or gratuities which could influence or be perceived as influencing their independence and integrity;
- Shall avoid all relationships with managers and staff in the audited entity and other parties which may influence, compromise or threaten the ability of auditors to act and be seen to be acting independently;
- Shall not use their official position for private purposes and shall avoid relationships which involve the risk of corruption or which may raise doubts about their objectivity and independence.

Date:

Signature of Internal Auditor

(Copy of signed Charter can be sent to the CHU for IA)

Appendix 23.

Chapter 33[1] on Financial and Budgetary Provisions

Chapter 33 covers the rules concerning the financial resources necessary for the funding of the EU budget (the Own Resources). These own resources are made up mainly from contributions from Member States based on 1) traditional own resources from customs, agricultural duties and sugar levies, 2) a resource based on value-added-tax (VAT) and 3) a resource based on the level of gross national income (GNI).

The acquis communautaires consists of Community legislation which is directly binding on the Member States and does not need to be transposed into national legislation. *However, all necessary steps should be taken so that full and correct application of the own resources rules can be assured.*

This includes:

- The creation of an appropriate **administrative capacity** and **institutional infrastructure** to adequately co-ordinate and ensure the correct calculation, collection, payment and control of own resources and reporting to the EU for implementation of Regulations 1150/00 and 1553/89. This is the ability to fulfil the administrative conditions in the area of Own Resources. BUDG will provide **technical assistance** to the building-up of administrative capacity.
- Setting up effective instruments to combat fraud in the areas of customs duty and VAT so that the financial interests of the EU can be protected.
- Giving particular consideration to the links between this Chapter and the Chapters having **indirect effects** on the application of the own resources system. The correct application of the own resources rules are to a large degree dependent on progress under other chapters, in particular as concerns taxation (Chapter 16), statistics (Chapter 18), Customs Union (Chapter 29), and financial control (Chapter 32).

DG Budget's responsibilities are thus twofold:

- Following-up the progress made in the application of the acquis related to Chapters on Taxation, Statistics, 29 (Customs Union) and assessing the effects that possible requests for derogations from the acquis may have on the Union's Budget;
- Assuring Candidate Countries' ability to fulfil the administrative conditions in the area of the European Communities' own resources as laid down in Council Regulations 1150/2000 and 1553/89 by the date of accession (technical and administrative capacity with regard to the operational management of own resources).

As regards the **operational management of the own resources system itself**, what matters most is the country's ability to put in place the human and administrative resources necessary to follow the Communities' operations and instructions concerning payments to the EU budget. For this, Member States must ensure the creation of appropriate administrative capacity to adequately **co-ordinate** and ensure the correct calculation, collection, payment

1 EU accession negotiations

and control of own resources and reporting to the EU for implementation of the own resources rules.

Implementation of the acquis in this regard implies the capacity to establish properly and make available the country's contribution to the own resources of the Communities, for each of the types of own resources.

For this reason, DG Budget provides the accession countries with a structured reference framework to guide them with their administrative preparations through technical assistance and a monitoring programme.

Roadmap for Technical assistance and monitoring programme

Main steps to assist candidate countries in their administrative preparations and how progress in these preparations will be monitored up to actual date of accession.

The technical assistance and the monitoring action should allow BUDG to have a sound opinion about progress in administrative preparations that serves as input for the country Progress Reports the Commission adopts on an annual basis.

Roadmap in chronological order	Remarks
Checklist on administrative conditions and overview of own resources acquis	Used in the framework of the screening
Two-day information seminar on EU financing	BUDG experts deal with all types of own resources. Seminar takes place in the country's capital.
Distribution of a questionnaire to start evaluating administrative capacity	Modified version of the checklist above
Launch of VAT simulation exercise	Reconstruction of a VAT statement for a given year. A 50 pages manual as support tool will be distributed
Two-day follow-up workshop, split-up in several parallel sessions: ▸ A one and a half day session on TOR ▸ A full day session on the VAT resource ▸ A half day session on the above questionnaire ▸ Two half day sessions (simulation of expected own resources payments, overview of various concepts to calculate budgetary imbalances, UK rebate…)	The workshop takes place in the candidate country's capital. The workshop has a dual function: providing technical assistance and assessing both the progress achieved and the future actions planned in building-up administrative capacity.
Project work aiming at improving quality/reliability and exhaustiveness of national accounts and GNI calculations following ESA95 standards.	The technical work is carried out under the auspices of EUROSTAT. BUDG has the financial responsibility. Eurostat has its own action plan.
TOR simulation exercises on A&B accounting for a given quarter.	Simulation exercises are requested ahead of the monitoring visits and possible shortcomings are discussed during the visits.
TOR monitoring visits (A&B accounts, OWNRES, certify improvements in areas earlier identified for improvement)	Kind of system audits based on a structured approach (questionnaire + evaluation checklist). Each visit takes one week including a visit to a local customs office.
Analysis of the VAT simulation exercise followed up through simulation control visits.	Visit of one week.
Info session on Web-based OWNRES application.	IT communication system for fraud and irregularities in the area of TOR. One-day seminar.
Seminar on payment of and reporting obligations on own resources after accession.	A one and a half day seminar.

Appendix 24.
Internal Audit training Curriculum and Syllabuses[1]

I. Internal auditing fundamentals

- The broad learning objectives are to provide the knowledge and skills to:
- Undertake a wide range of audits;
- Participate in the planning and management of the audit function;
- Prepare reports on audit assignments.

The more detailed learning objectives are to:

IAF1	Describe the role and mandate of both internal and external audit
IAF2	Explain the concept of control, including ex ante and ex post controls, describe how control may be achieved in a public sector organisation, and give examples of controls that may be applied in particular systems and circumstances
IAF3	Utilise and apply audit techniques, including analytical review, sampling, CAATs, and other appropriate techniques, and maintain documentation relating to the audit function
IAF4	Describe the process of planning and risk assessment in the auditing environment
IAF5	Discuss the application of systems auditing and the audit of financial systems and accounts
IAF6	Undertake an audit of compliance with legislation
IAF7	Discuss the role of value for money auditing and distinguish it from operational auditing
IAF8	Describe the auditor's role with regard to fraud
IAF9	Report audit findings to management
IAF10	Carry out audits of donor funded projects, including those funded from the EU

II. Governance and control

The broad learning objectives are to provide the knowledge and skills to:

- Describe the process of corporate governance, and the systems, structures, networks, policies and procedures by which it is achieved, both in the student's own organisation and internationally;
- Describe the framework of public internal financial control in a public sector organisation, its contribution to good governance, and its relationship with the internal audit function;
- Describe how risks are managed to achieve good governance;
- Describe the legal and quasi-legal framework, and the wider environment, in which the organisation operates;
- Critically compare that framework with best practice internationally;
- Describe in outline the macroeconomic planning process and how that is related to policy formulation and implementation, financial planning and budgeting;
- Critically appraise the budget preparation process, including the preparation of output and performance budgets, and the process of budgetary control within the organisation;
- Relate output budgets and performance budgets to traditional input-based financial budgets.

1 Example from CIPFA: Slovenia Internal Audit Training , May 2006

The more detailed learning objectives are:

GC1	Discuss the concepts of accountability, integrity, ethics, transparency and the public good, and how they are related to the concept of good governance
GC2	Describe the governance framework and its relationship with accounting and auditing, including the accountability cycle
GC3	State the characteristic features of management in the public sector, and the environment in which public sector entities operate, in the context of their own organisation and country
GC4	Give an overview of the business of government, including policy making, policy execution, planning, budgeting and budgetary control, and how risks are identified and managed
GC5	Describe the main provisions of the Constitution and the wider legal framework in the country, including Treasury regulations
GC6	Describe relevant elements of the law and explain their application to public sector accounting and auditing
GC7	Describe the nature of internal control, management's responsibilities for internal control and the role of other actors in the internal control process
GC8	Give an overview of the role and function of internal and external audit, and the role of audit committees

III. Public sector accounting and financial reporting

The broad learning objectives are to provide the knowledge and skills to:

- Describe the role of accounting in a public sector organisation, including its role with regard to poverty reduction, anti-corruption and other major policy objectives;
- Describe the role of the Chart of Accounts (CoA) and its relationship with systems of national accounts, including where appropriate the European System of National and Regional Accounts (1995 ESA) and the System of National Accounts (1993 SNA); and Government Finance Statistics (GFS); and describe the structure of the CoA in use in the student's own organisation;
- Describe in outline the role of accounting standards in public sector accounting and how those standards are applied in the country concerned.

The more detailed learning objectives are:

PSA1	Describe the role of accounting, including fund accounting, and financial reporting in a public sector organisation
PSA2	State the basic accounting concepts that underpin the production of accounting information
PSA3	Describe the accounting treatment of fixed assets and depreciation, and distinguish between capital and current expenditure and income
PSA4	Describe the use of journal entries, the use of suspense accounts and the correction of errors, the role of control accounts
PSA5	Describe the form and purpose of the primary financial statements
PSA6	Explain the role of the Chart of Accounts (CoA) in accounting systems, and the structure of an illustrative CoA
PSA7	Describe Systems of National Accounts (SNA) and General Finance Statistics (GFS) and their relationship with financial accounting
PSA8	Describe the role of accounting standards, and the standards setting bodies

IV. Advanced internal auditing

The broad learning objectives are to provide the knowledge and skills to:

- Lead and manage teams of internal auditors;
- Plan internal audit assignments;
- Review and control the work of the internal audit team;
- Critically appraise the role and use of internal auditing standards and international best practice, and interpret and apply the detailed requirements of those standards;
- Establish and maintain effective working relationships with the external audit function;
- Give assurance to management and donors relating to the proper use of funds provided by them;
- Manage, maintain and develop effective working relationships with client departments;
- Lead and manage specialised, sensitive and difficult audits e.g. audits of capital expenditure and contracts, auditing in an IT environment and forensic audits related to possible fraud or corruption;
- Contribute to the operation, management and development of the internal audit function within the wider corporate governance context;
- Identify and assess risks and evaluate the extent to which these are being appropriately managed;
- Undertake audits of performance.

The more detailed learning objectives are:

AIA1	Describe the role of internal audit, its relationship with management and its contribution to achieving effective public internal financial control
AIA2	Describe the role of internal auditing standards, including quality standards, and apply those standards to the work of internal audit in the public sector
AIA3	Describe current approaches to audit management, planning and completion, including risk based approaches to audit planning
AIA4	Undertake the audit of grants, donor funds and development funds
AIA5	Describe the importance of effective management of client relationships, and explain how to achieve that in the context of internal audit in the public sector
AIA6	Describe the roles of internal and external audit and the management of effective working relationships between the two
AIA7	Discuss the use of performance and Value For Money auditing in the public sector
AIA8	Describe how to approach the execution and management of fraud and other sensitive investigations
AIA9	Discuss the role of internal audit with regard to corporate governance
AIA10	Discuss the approach of audit to auditing in an IT environment

V. Managing the internal audit function

- The broad learning objectives are to provide the knowledge and skills to:
- Function as effective members of teams, units and departments;
- Manage teams and individual team members to achieve the team's purpose;
- Interact and communicate effectively with colleagues, using appropriate techniques to influence and manage conflict;
- Participate effectively in the recruitment process;
- Set objectives and appraise performance;
- Ensure the quality of the internal audit service;
- Make training and development plans.

The more detailed learning objectives are:

MIA1	Describe the role of management in the public services, including the relationship between elected representatives and paid officials
MIA2	Describe the particular issues that arise in the management of teams of professionals
MIA3	Describe what makes for effective groups in organisations, and discuss the role of individual differences and personality in managing people
MIA4	Discuss the role of programme and project management and describe typical approaches to programme and project management in the public sector, including Project Cycle Management and the Logical Framework Approach
MIA5	Describe the main schools of thought with regard to motivation, and explain how these ideas may be applied in the work place
MIA6	Describe the role of leadership and discuss current thinking on what makes for effective leaders in a public sector organisation
MIA7	Describe the role of delegation in getting work done, and explain how to delegate effectively
MIA8	Choose an appropriate influencing style, and describe how to manage conflict in the context of making audit recommendations
MIA9	Describe current approaches to the management of quality and how to measure and monitor the quality of the internal audit service
MIA10	Discuss the factors to be taken into account when introducing and managing change in a public sector organisation, and give examples of the application of these factors in a practical setting
MIA11	Describe modern approaches to objective setting, performance appraisal and staff development, including training and coaching
MIA12	List the processes involved in recruiting, retaining, redeploying and retraining staff

VI. Auditing management performance

The broad learning objectives are to provide the knowledge and skills to:

- Describe how systems are used to produce, analyse and interpret cost information;
- Critically appraise managers in their use of cost information;
- Describe the structure and operation of systems for accounting, financial and performance and reporting;
- Describe how managers prepare budgets, within the constraints and requirements of local policy and practice;
- Critically appraise systems for the production of budgetary control reports, and how those reports are communicated, analysed and interpreted by managers and other interested parties;
- Critically appraise the operation of systems to manage working capital;
- Critically appraise the operation of systems of Treasury Management;
- Critically appraise the operation of asset management systems.

The more detailed learning objectives are:

AMP1	Explain the role of management accounting and its relationship with financial accounting
AMP2	Explain the role of cost information in the management process
AMP3	Describe the conventional approaches to cost classification and apply these in a public sector context
AMP4	Describe the role of cost behaviour in management accounting, and analyse the behaviour of costs in specific situations
AMP5	Distinguish between direct costs and indirect costs, and apply that distinction in a practical setting
AMP6	Describe the characteristic features of absorption costing, marginal costing, standard costing and activity based costing and illustrate their use by reference to practical examples
AMP7	Describe the main consideration to take into account when designing and developing accounting systems, and explain the use of packaged software, including integrated financial and management information systems in the government accounting process
AMP8	Describe the role and purpose of budgeting and its relationship with macro-economic planning and medium term expenditure frameworks
AMP9	Explain the various forms of budgets, including input based budgets and output and performance based budgets, and critically appraise their use in public sector organisations
AMP10	Describe and critically appraise the budget process in a public sector organisation
AMP11	Describe the differences between cash based and accruals based systems of accounting
AMP12	Describe the management of working capital, the use of cash flow forecasting, and the role of treasury management in a public sector organisation
AMP13	Discuss the role of asset management in a public sector organisation
AMP14	Describe the main steps in the design and development of systems for budgeting, accounting, management information and control

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