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Next Update
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► THE STATE AUDIT OFFICE OF LATVIA – CHANGES AND CHALLENGES

During the first half of 2005 the atmosphere in the State Audit Office (SAO) of Latvia has been one of ongoing improvement. Reorganisation of the audit departments, evaluation of auditors, and amendments to the Law of the State Audit Office have been carried out. The main objective of these dynamic, rapid and progressive changes has been to transform the SAO into a modern, effective and authoritative supreme audit institution (SAI) that enjoys confidence from audited entities, international organisations and the general public.

Reorganisation of the Structure — Significant Element of Performance Quality

Inguna Sudraba
Auditor General
State Audit Office
Latvia[1]

The reorganisation of SAO audit departments, which took effect in May 2005, aligned these departments according to the structure of national economic departments. This reorganisation was also necessary in order to put in place new, transparent wage schemes. One of the aims of this measure was to set an example for audited entities, since an auditing organisation cannot provide credible audit conclusions if it is not itself well structured and transparent.

Although the main priority of the SAO of Latvia is to serve as the financial auditor of all state and municipal bodies, as required by law, a secondary priority is to enable more efficient auditing. The SAO's unique position in the public sector provides us with an opportunity to evaluate and analyse systems at state and municipal administration levels across different institutions. The SAO's mandate is to identify weaknesses within systems and not only to detect errors in accounting documents. Shifting our focus from auditing transactions to systems should reveal that poorly drafted legislation is largely due to a weak foundation of financial mechanisms.

It was unacceptable, for example, that audits in the Ministry of Defense were carried out by a single auditor. After reorganisation, these audits will be carried out by up to seven auditors. More attention will thereby be given to the high expenditure sectors of national importance, which should result in improved auditor performance and more realistic audit opinions.

Amendments to the Law of the State Audit Office — Guarantee of Independence

Amendments to the Law of the State Audit Office took effect on 20 July 2005. Previously the law did not ensure the effective performance of the SAO in ascertaining that public money was spent in an appropriate, pleadable, and economically justifiable manner. At the beginning of 2005, auditors complained that several auditors' reports had been influenced by political pressure. Amendments to the law will ensure greater separation of powers from the executive, and consequently the performance of the SAO should substantially improve. There will be less bureaucracy, because decisions will be made only by persons who are involved in auditing the particular entity.

[1] Ms. Sudraba was elected as Auditor General of the State Audit Office on 22 December 2004.

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Future Challenges

The first test of the new, modernised SAO will be the parliamentary elections in 2006. We are aware that politicians might use administrative resources in their election campaigns, and accordingly greater attention will be paid to those spheres where misuse of public money can be found. The use of public money for selfish motives exceeds accepted standards of democracy and equal political involvement. By way of illustration, we can mention the frequent trips of well known politicians to various cities shortly before elections to hold meetings that apparently are not as professional or in the public interest as they should be.

The main function of the position of Auditor General is to increase public awareness of the efforts made by the SAO to put an end to the poor or improper use of public money, which in turn should increase trust in the SAO. This trust includes the confidence that we will carry out auditing tasks of the highest quality while maintaining close co-operation with the judiciary to ensure that fraudulent behaviour results in prosecution.

It is often assumed that if the auditors of the SAO have not detected and reported any offences or wasted expenditure of the state budget, their work must have been carried out in an unprofessional way. This public attitude needs to be changed so that the SAO is not considered at the outset to be as unprofessional as the entities that it is meant to be auditing. To influence this change, the public should be provided with a new meaning for the title of "auditor" so that auditors are perceived more as advisers rather than controllers or inspectors.

For many years staff in the State Audit Office had worked with a complete devotion to duty, but with the sole objective of finding mistakes and breaches of rules and procedures. To provide positive assurance to the taxpayer, SAO staff should adopt a more consultative approach, which could result in fewer attempts of tax evasion.

The main role of the auditor is to provide parliament and taxpayers with positive assurance as to how the state budget is being used. This in turn will indicate a certain level of managerial quality in the public administration and municipalities in Latvia. This assurance will never make the headlines in the media, but it constitutes a major part of the public sector auditor's role.

Another ambitious task of the SAO is the audit of European Union funds that finance expenditures in Latvia. Several inaccuracies and inadequate information occurred during the initial period of adopting the administration procedures for EU funding. The institutional framework for the administration of EU funds in Latvia is made up of managing and paying authorities, and first and second-level intermediate bodies. Evidence was found that sometimes criteria for projects were essentially different at the submitting stage and at the evaluating stage. As a result, many high-quality projects were rejected unnecessarily. The approval of poor schemes by public officials results in a lack of credibility on the part of the public and of applicants in the system.

In future, we hope to realise closer co-ordination between the SAO and a number of state and municipal institutions, as well as other partners, particularly from among international audit bodies. We are already working, for example, with the UK National Audit Office on an EU-funded project, and they are helping us implement some of the necessary reforms.

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► CHU: Its Role and Function[2]

Robert de Koning
Budget Directorate General
European Commission

Introduction

As an integral part of the EU-fostered PIFC (public internal financial control) concept, the Central Harmonisation Unit — 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 and for co-ordinating the implementation in all administrative bodies of the government of the new legislation on managerial accountability (financial management and control systems) and internal audit. Usually, this responsibility is given to the Ministry of Finance, although other solutions are possible[3]. CHUs have been established in conformity with the criteria set out in the EU accession negotiation chapter 28 on Financial Control. These criteria relate not only to the EU acquis for the new Member States' management and control of EU funds, but equally to best practice for the national control and audit systems applicable to national budgetary funds, for both revenues and expenditures.

The First Steps

Once a country has decided to upgrade its public control and audit systems by introducing modern, internationally accepted standards, then the best option is to make a central institution responsible for raising the awareness of all stakeholders (i.e. all management, control and audit levels) of the new concepts to be introduced. Ideally, such a central organisation would therefore start by developing a network for an adequate exchange of relevant information between its participants. At the same time, such an institution should define and explain to all stakeholders the advantages and challenges that are inherent in the introduction of PIFC. This networking and policy-making (including developing a written strategic vision paper known as a "PIFC Policy Paper") should provide for a steadily widening platform of understanding and involvement in the process, which is a condition for the success of the enterprise.

Self-Assessment

In a second stage, based on a commonly agreed self-assessment of the current financial management and control systems and their weaknesses as compared to modern international standards[4], the CHU should take responsibility for drafting framework or primary legislation to provide the government with a legal basis for introducing the various elements of PIFC. Such a self-assessment process in the context of accession to the EU is often provided with outside support, e.g. through a Sigma peer assistance review. This self-assessment may sometimes be a cumbersome exercise that needs to be carefully monitored and coached because traditional administrative values may be at stake. The results of such a self-assessment of current administrative capacities are then brought to the attention of the highest administrative levels for discussion and agreement on the recommendations.

2 This article was prepared for the Draft Report on Internal Control Systems in Candidate Countries of the PIFC Expert Group (Sub-group of the Working Group on Audit Manuals), in the framework of co-operation between Supreme Audit Institutions of Candidate Countries and the European Court of Auditors, 11 March 2004.

3 e.g. internal audit outside the Ministry of Finance or financial management and control in the Treasury and internal audit elsewhere in the Ministry of Finance

4 e.g. Institute of Internal Auditors' Attribute and Performance Standards and Code of Ethics for Internal Audit; see http://www.theiia.org/

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Introducing the New Laws and Regulations

Development and implementation of primary and secondary legislation follow next. On the basis of these laws, a start should be made with tertiary regulations, such as manuals for Financial Management and Control (FMC) and Internal Audit (IA) systems, templates like the Internal Audit Charter and the Code of Ethics, but also with directives relating to risk management and other methodologies, templates for audit trails, audit reporting, etc. — all to be used and refined by the relevant services within line ministries and other budget agencies.

From Development to Monitoring: Compliance Audit

Once these tasks have been performed in good order, the role of the CHU will gradually change from PIFC development to PIFC monitoring. It will be the task of the CHU to make compliance and quality assurance checks on whether its recommendations are being properly carried out and to find out how to overcome any bottlenecks in the implementation of adopted policies. This "compliance audit" — together with the results of analysing 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 PIFC throughout the public sector. Good vertical and horizontal networking — facilitated by the CHU — between financial managers and controllers and internal auditors will certainly contribute to the quality and impact of such reporting. The networking itself would be carried out, for example, through regularly organised meetings within the profession, use of a web site and/or regular newsletter to disseminate the latest information and discussions on common issues.

CHU as Centre of Excellence

The above-mentioned tasks explain why CHUs are called the "engines of propagation" of PIFC principles. This involves learning from, sharing and consolidating experience in implementing the adopted legislation and standards. Many government institutions wish and need to be continuously informed and updated about PIFC developments. They also may want to receive training on the further implementation of these new developments. They address their questions to the CHUs, which have thus become "centres of excellence". As a consequence, the CHU is facing extra responsibilities for improving governance[5]. One of the basic objectives of the CHU is to improve the quality of the staff responsible for financial control and internal audit and to thereby enhance the implementation of PIFC systems. In this respect, the CHU is the co-ordinator or supervisor of the establishment of sustainable training facilities for the professions concerned. Close co-ordination and co-operation with the State Audit Office, professional private organisations (such as the local IIA) and academic circles will facilitate this task.

A CHU is so fundamental a condition for the successful introduction and development of PIFC that in reality the CHU concept has become part of PIFC itself. Indeed, PIFC is defined as having three pillars: managerial accountability (FMC systems), functionally independent internal audit (IA systems), and central harmonisation for methodologies and standards (CHU).

[5] i.e. responsibility for managing and controlling the state budget

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Some Lessons from the Past

The establishment of CHUs in candidate countries has not always been an easy matter. In most countries the CHUs grew out of specialised services in the Ministry of Finance and had to struggle for taking the lead and for acknowledgement as leader by other ministries and budget agencies. In other countries the absence of strong commitment by the hierarchy and/or resistance by established traditional inspection forces proved to be blocking factors for the proper development of CHU functions. In many cases, this situation led to a waste of efforts and precious time in developing PIFC systems. There are some lessons to be learned in this respect. A CHU should from the outset be established under the inspiring leadership of a person who has proven qualities in management, knowledge of modern control and internal audit systems, easy access to Western professional literature, and who has been appointed in such a way that continuity of the project can be safeguarded. This means that the person is independent of political changes in the government. Since visibility is an important issue, the CHU Director should have the same status as the internal auditor of the institution, who reports directly to the highest level of the hierarchy. The relationship between the internal auditor of the ministry and the Minister of Finance should also apply to the CHU Director on the PIFC systems of the entire public sector. This status is of obvious interest to the Minister of Finance. The CHU Director should be regarded as the general internal auditor of the public internal audit function. In this capacity, the CHU Director should be able to resolve conflicts of interest between the internal auditor and its hierarchy on issues of professional integrity and even to provide an opinion (or visa) on the nomination and dismissal of financial control or internal audit staff.

The question often arises as to whether there should be one CHU or two, dealing separately with the issues of harmonisation and co-ordination of financial management and control systems and internal audit systems. It is thought that from the outset it might be beneficial to establish only one CHU, dealing with both aspects through separate sub-units. This arrangement has the advantage of placing the harmonisation of PIFC in one hand. Whether it would be necessary to later split such a CHU into two separate units — e.g. one for FMC systems in the Treasury of the Ministry of Finance (closer to proper budget management and control) and another for IA systems focusing on internal audit — is a matter for careful consideration at a later stage. This issue should normally be mentioned at the level of drafting the PIFC Policy Paper and reconsidered when an update of the PIFC Policy Paper might be appropriate, taking into account the special characteristics of already existing organisations in each country.

CHU Networking

CHUs have been established in nearly all of the acceding and candidate countries (13), more or less in accordance with the above-mentioned general functions, depending on national conditions and characteristics. Whereas adequate internal networking should be the highest priority for the optimal performance of a CHU, external networking is of equal importance. This external networking relates not only to co-operation with the State Audit Office, private internal audit organisations, professional audit and accountancy bodies, and relevant academic niches inside the country, but also to international contacts, e.g. in the framework of the annual meetings of the Contact Group for European Financial Control Organisations, the last of which was held in Vienna in December 2003. Since CHUs are recently established institutions, there is much benefit in learning from each other about common problems relating to the introduction and implementation of PIFC. This has been recognised by the Commission, and in June 2003 a first workshop was organised to bring together all existing CHUs in acceding and candidate countries. This workshop took place in Leuven, Belgium.

The conclusions of the Leuven workshop reflect the overall common concerns as expressed by the majority of CHU representatives. Six main areas of concern could be distinguished:

1. The low degree of awareness by management levels about the rationale for PIFC principles and an unsatisfactory level of hierarchical support for the work of the CHUs;

2. The highest priority should 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;

3. The networking role of the CHU and its visibility (organisational location and impact on ministries and budget agencies) need strengthening, together with improved salary systems and other compensation schemes in line, for example, with the external audit function;

4. Co-ordination with Supreme Audit Institutions should improve considerably in order to establish a common approach to general audit rules and methodologies and to the training of control and audit officials. Suggestions were made for administrative co-operation agreements, while fully taking into account each other's roles and independence;

5. CHUs should know best the training criteria for financial controllers and internal auditors; they have therefore a key role to play in defining training requirements and in organising training, which should be primarily focused on practical control and audit skills;

6. Finally, CHUs expressed their wish to have their voices heard in the international control and audit arena through the establishment of a permanent discussion forum. As CHUs are steadily changing the emphasis of their work from law-drafting to implementation, it would be necessary to further define the future roles and tasks of the CHU.

CHUs have only just begun; they are new and under development and thus subject to quite a number of challenges. In acceding countries they may well benefit from further administrative reform support under the EU Transition Facility (2004-2006) and from Sigma. During this period, DG-BUDG has organised (and is still organising) annual CHU workshops, bringing together established CHUs to discuss relevant political and organisational bottlenecks with which the young CHUs are struggling. These workshops provide a good insight into the tasks ahead. Hopefully this article has contributed to the development of CHUs into strong vehicles for supporting the central role of ministries of finance: ensuring sound financial management and control of national budgetary resources.

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► ROMANIA'S POLICY TO TACKLE FRAUD AFFECTING EU FUNDS

In late January of this year, following a change of government at the end of 2004, I was appointed as head of the **Prime Minister's Inspection Department and Follow-Up of the Transparent Use of Community Funds (PMID)**, the Romanian Anti-Fraud Co-ordination Service (AFCOS) — i.e. the contact point in Romania for the European Anti-Fraud Office (OLAF).

Tudor-Alexandru Chiuariu
State Secretary
Head of Fight Against Fraud Department
Romanian Government

The new government coalition, led by the "Justice and Truth" Alliance, had presented a comprehensive political programme for reforming the judiciary system and for fighting corruption and fraud, as a major step on the path to joining the European Union on 1 January 2007.

Protection of EU Financial Interests — Situation in January 2005

When I took over the mandate as head of PMID, the situation regarding the protection of EU financial interests was the following:

As PMID had to perform, at the same time, tasks concerning both administrative control over public bodies under the Prime Minister and control of the disbursement of EU funds, its efforts were divided and the results of its actions were limited.

The operational independence of the department was ambiguous, as its head could receive instructions for the performance of investigations from the Prime Minister.

The legal basis for inspections related to EU funds was weak. For example, in performing investigations, the department could request data and information, but no sanction was to be applied in the event that such a request was improperly answered.

A strategy for the protection of EU financial interests was to have been adopted at the latest by December 2004, but the strategy had not even been drafted when I took over the department at the end of January 2005.

Given that situation, I established the **objectives of my mandate** as follows:

- separating control activities carried out on behalf of the Prime Minister from control activities regarding EU funds;
- ensuring operational independence of investigations regarding EU funds;
- strengthening the legal framework for the anti-fraud fight;
- adopting the "National Anti-Fraud Strategy for the Protection of the European Union's Financial Interests in Romania"; and
- intensifying and ensuring the effectiveness of control actions.

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Creation of the Fight Against Fraud Department (DLAF)

By initiating and having approved **Emergency Ordinance No. 49** of 1 June 2005 *on setting up some reorganisation measures within the central public administration,* we have created a new department, the **Fight Against Fraud Department (DLAF).** DLAF has replaced PMID as the Romanian AFCOS and contact point with OLAF. Its competences are exclusively in the area of controlling the use of EU funds. Its main tasks are to co-ordinate the fight against fraud and to provide effective protection of the European Union's financial interests in Romania.

DLAF has complete operational autonomy. Under the new legislation, the control of EU funds has been established as the single activity area of DLAF. When exercising the department's competences of initiating or carrying out control activities or drawing up control reports, as the head of DLAF I am specifically prohibited from seeking or receiving instructions from any authority, institution or person.

Expansion of DLAF's Competences

Further evidence of the substantially improved legal framework are the expanded legal competences of DLAF and its personnel.

DLAF now has the right to carry out on-the-spot checks and to be given unconditional access to premises. Financial and fiscal control authorities, police and gendarmerie are legally obliged to provide operational support to control teams in performing their duties.

The department also now has the legal status of an ascertaining body with regard to crimes affecting EU financial interests. In practice, this means that control reports can be used as evidence in judicial procedures and that DLAF inspectors can seize objects and evaluate the prejudice involved.

Where elements of a criminal nature have been uncovered in the management of EU funds, the DLAF control report is forwarded to the National Anti-corruption Prosecutor's Office. This office is responsible for criminal investigations to block funds, recover and reimburse the prejudice, and bring the guilty parties to court.

A further competence of DLAF is in the normative area. The department has the legal right to initiate and approve legal acts that ensure appropriate legislative harmonisation.

In addition, in the area of intelligence, the department has the right to initiate intelligence-gathering, analysis and data translation for further assessment in the interests of protecting the European Union's financial interests in Romania.

Adoption of the National Anti-Fraud Strategy

Between end-January and June 2005, DLAF (and its predecessor, PMID) drafted the "National Anti-fraud Strategy for the Protection of the European Union's Financial Interests in Romania", which emphasized:

- the **necessity to harmonise Romanian legislation** with European regulations in the area of protecting EU financial interests and to prepare the institutional, legal and operational framework for EU accession;
- the need for **effective financial and fiscal control** regarding EU funds;
- strengthening **DLAF's role as operational and communications co-ordinator** for the institutions involved in the fight against fraud.

- The strategy is structured in eight chapters, covering: prevention measures, legal framework of public financial control, legal framework of fiscal control, criminal investigation procedures, prosecution procedures, recovery activities, co-ordination of the anti-fraud fight, and finally monitoring and evaluation of the implementation of measures set down in the strategy.

An **Action Plan** — containing objectives, measures, responsible institutions, deadlines and evaluation indicators — is also part of the strategy.

The **overall objectives** of the strategy are the development of an integrated system for co-ordination of the anti-fraud fight and the strengthening of administrative capacity of those institutions involved in preventing, identifying, investigating, and sanctioning fraud and in the recovery of the prejudice.

The National Anti-Fraud Strategy was **adopted by Government Decision on 14 July 2005**, and implementation of its measures will begin following its promulgation in the *Official Journal*.

Improvement of Anti-Fraud Results in 2005

Following the intensification of investigative actions during the first six months of this year, the PMID (and its successor, DLAF) sent to the National Anti-corruption Prosecutor's Office twice as many fraud cases as during the whole year 2004.

Next Steps

The measures described above are an important step forward towards the objective of ensuring the effective protection of EU financial interests in Romania. But we do not intend to stop here. The effectiveness of the new legal framework will be subject to further assessment. We will also try to find additional means for improving DLAF's independence, and the National Anti-Fraud Strategy will be reviewed and updated in July 2006.

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► NEW SIGMA PAPER: *ACHIEVING HIGH QUALITY IN THE WORK OF SUPREME AUDIT INSTITUTIONS*

Nick Treen
Senior Advisor
External Audit & Financial Control
Sigma

Sigma Paper No. 34 — *Achieving High Quality in the Work of Supreme Audit Institutions* — focuses primarily on the issue of how to achieve high quality in the audit process and organisation. In addition to describing the types of procedures needed to achieve quality, however, it discusses basic principles and those matters of institutional management that create an environment that encourages high quality in an SAI's work.

Audit quality is obtained by a process of identifying and administering the activities needed to achieve the quality objectives of an SAI. All types of SAIs need to understand the benefits that can be realised once audit quality is made a priority. Improving audit quality requires a systematic SAI-wide approach. Piecemeal efforts by individuals and individual audit teams are not enough and will not work. There are no quick fixes to be obtained where audit quality is concerned. SAIs need to proceed methodically in an organised way to fix each quality issue and problem in turn. As new problems will always emerge, this should be a continuous process for the SAI. It is also evident that most audit quality-related problems are mainly the result of poor management of the audit process or of the SAI itself.

Ensuring high levels of quality in an audit organisation and in the audit process involves a succession of steps that must be taken over a period of time. In fact, it is a never-ending process of continual improvement. The first requirement is to define the standards of quality and then to put quality control procedures in place that will ensure that these standards are met. These procedures need not — and should not — suppress the initiative and good judgement of the auditor in adapting to particular circumstances. However, if the auditor judges that it is necessary to depart from the usual audit techniques, it is incumbent upon the auditor to demonstrate the necessity of doing so, and to show that the approach chosen is capable of satisfying audit assertions and objectives.

The next stage in the evolution of an SAI's quality management involves the assurance that quality control procedures are working effectively together with the identification of ways of improving the effectiveness and/or efficiency of these procedures. The best technique for accomplishing this is the use of various types of post-audit quality assurance reviews and making appropriate use of peer review concepts for institutional issues.

Achieving true excellence also requires going even further. It requires building an institutional culture in which high quality is a fundamental value that is reflected in the management of the SAI and in its relations with other institutions.

The Sigma Paper is set out in four main sections:

- **Chapter 1** sets out the basic concepts, principles and requisites that must underlie an effective approach to ensuring the high quality of an SAI's audit work and reports.
- **Chapter 2** draws on international experience to set out a number of "good practices" involved in the audit process.
- **Chapter 3** discusses ways of ensuring that the quality control processes that an SAI has put in place are operating effectively.
- **Chapter 4** describes ways in which the overall management of an SAI can contribute to the quality and effectiveness of its work.

Different **Annexes** in the paper set out, *inter alia*: quality assurance practices in selected audit courts; comparable descriptions for selected audit offices; the functions of direction, supervision and review and how these can be performed effectively in various types of SAIs; several checklists that may be helpful for those reviewing the quality of an SAI's work; and some of the issues involved in conducting post-audit quality reviews.

While it is obvious that all SAIs should actively and conscientiously seek to ensure high quality in their audit work, considerably more attention needs to be given to this issue on the part of many SAIs in transition and developing countries. This new Sigma Paper suggests some useful and helpful ways of going about that task.

Sigma Paper No. 34 can be accessed by clicking here

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Public Internal Control and Audit

*Public Internal Financial Control (PIFC)**
by
Alain-Gérard Cohen

Modernising the administration by taking as a model the best practices of private sector management is the latest trend. This creative adaptation gives new meaning to such concepts as financial control or audit, and introduces new terminology: audit trail, risk management, management and control system. Acronyms abound as well: PIFC, LOLF, CHU, FMCs, COSO, etc.).

How can you find your way among all these new concepts and tools that, according to the author, mask a real administrative and mental revolution, the move to a result-oriented culture?

For the first time, a book (in French) approaches in a practical way these new management methods imposed by the European Commission on all EU Members under the term PIFC, *Public Internal Financial Control*.

Based on the author's experience, both in the private sector and in the public administration, as well as on his work as an expert in more than a dozen European countries, the book answers the questions being posed, in France and elsewhere in Europe, by civil service managers, department heads, controllers, inspectors and auditors, international experts and consultants, schools, institutes and trainers in public management, and private auditors interested in extending their competencies to the public sphere.

The book is also targeted to all citizens, politicians, elected officials, local administrators, academics and students interested in this modern approach to public management and wishing to understand its significance, concepts, norms and best practices.

These concepts will respond to the needs — beyond the frontiers of the European Union — of all organisations or countries, donors or recipients of international support, concerned with managing public funds with greater efficiency, transparency and security.

The author: Former Inspector-General of Finance, ***Alain-Gérard Cohen*** *was from 1993 to 2001 the President of the Inter-ministerial Commission for the Co-ordination of Control (CICC), the national audit body for control systems related to operations co-financed by European structural funds in France. He is currently a consultant in public and private financial control and internal audit.*

* ***Contrôle interne et audit publics — Le Public Internal Financial Control (PIFC)****, Librairie LGDJ, Paris, May 2005*

► REVIEW OF *PUBLIC INTERNAL CONTROL AND AUDIT*

Robert de Koning[6]
Budget Directorate General
European Commission

Sigma asked me to review the recently published (May 2005) book written by Alain-Gerard COHEN, former Inspector-General of Finance in France, entitled *Public Internal Control and Audit*[7]. The book is published as the first in a series on public governance, launched by ADETEF[8], the agency for international co-operation attached to the French Ministry of Economy, Finance and Industry, whose mission is to improve the function of public organisations[9]. As the book covers many aspects of internal control, internal audit and inspection, it would be impossible to provide a full analysis. I would therefore like to focus on a few issues that reflect the main messages of this important work.

The book initiates the discussion in France of a concept that had been developed by the European Commission in the early years of accession negotiations with applicant countries (1996-1999). That concept was coined PIFC (or Public Internal Financial Control) for the first time in December 1999[10]. PIFC is the acronym chosen by the European Commission to refer to a comprehensive, well defined and — on first sight — rather simple system of public internal control, based on international standards like the COSO[11]-model; the IIA[12], and the Guidance on Internal Control standards established by INTOSAI[13]. Since no comprehensive European concept existed prior to the end of the 20th century to assist the Commission in guiding applicant countries, the EC had to develop a set of standards that could serve as a vehicle for introducing the principle of sound financial management in the public sectors of new Member States[14].

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6 Mr. de Koning is senior administrator in DG BUDG.B.3 of the European Commission. He has been involved in the development of PIFC since 1996, and is currently the team leader responsible for chapter 28 on PIFC in accession negotiations. Mr. de Koning has contributed this book review to *Update* on a personal basis.

7 *Contrôle interne et audit publics — Le Public Internal Financial Control (PIFC)*, Librairie LGDJ, Paris, May 2005.

8 *Assistance au développement des échanges en technologies économiques et financières.*

9 Mr. Cohen has already been awarded for his efforts with the 2004 prize by the French branch of the IIA, the Institute of Internal Audit.

10 Robert de Koning, "PIFC in the Context of European Union Enlargement: December 1999", *Public Management Forum*, Vol. VI, Nov./Dec. 1999, Sigma, Paris (available on the Sigma web site).

11 Committee of Sponsoring Organizations of the Treadway Commission (www.coso.org).

12 Institute of Internal Auditors.

13 See INTOSAI Guidelines for Internal Control in the Public Sector (December 2004).

14 EU Glossary of Definitions used by the Commission in the framework of Public Internal Financial Control (PIFC), September 2002.

The PIFC concept was also born out of the need to provide applicant countries with a unified approach, taking into account the most recent standards and principles of internal control and audit and avoiding the confusing multitude of possible national systems promoted by a large number of consultants and twinning partners as being the "*nec plus ultra*" on the market. I am happy to record that among this plethora of possible models, the Sigma Programme has consistently and successfully supported the unique PIFC concept and the sensible use of modern control techniques and ideas in a helpful and effective way in its work with applicant countries, twinning partners and the Commission. Applicant countries asked the Commission for guidance, while the European Council, Parliament and Court of Audit asked the Commission to support the mainly ex-communist applicant countries in transforming their centralised, repressive control systems into state-of-the-art internal control and external audit systems in the shortest feasible period.

Mr. Cohen's book describes in two parts the principles of PIFC and its implementation, not only in new Member States, but — interestingly — also in France., It covers in particular internal control and internal audit systems, inspection functions (which he considers a vital ingredient in the French-style PIFC recipe), and the specific issues of audit trail and risk analysis/risk management. The book is a welcome contribution to the discussion on — and acceptance of — the EC's PIFC concept.

PIFC focuses basically on what is called the "internal control sequence" in the string of budget preparation, approval, implementation, internal control, fight against fraud, political discharge by the country's budgetary authorities, and assessment of the Supreme Audit Institution. The internal control sequence comprises: 1) managerial accountability, implemented through adequate financial management and control (FMC) systems; and 2) functionally independent internal audit (IA) as a management tool. In this sequence, both elements should be developed and harmonised by a central government harmonisation unit (CHU), so that PIFC = FMC+IA+CHU. PIFC is thus a coherent and integrated system delivering organised internal control systems for the public sector. PIFC provides income and spending authorities with a reasonable and cost effective assurance that those systems perform adequately and efficiently.

Mr. Cohen shows himself to be an ardent advocate of PIFC. He calls the concept of PIFC truly an administrative and mental revolution, even the backbone of the technically most advanced and philosophically most coherent variety of an entirely new public policy to change the civil servant into a responsible and accountable manager and the controller into a competent consultant. He goes the extra mile in stating that, whereas the Commission has developed PIFC only for new Member States and for those candidates that might follow, the PIFC concept should be taken up by those "old" Member States that also need to modernise and upgrade their own financial and administrative systems and policies to make their budget implementation better managed and result and quality-oriented.

The author elaborates extensively on the "French version" of PIFC, i.e. the inclusion of the financial inspection (FI) service into the equation, so that PIFC = FMC + IA + CHU + FI. This modified version of PIFC of course reflects Mr. Cohen's professional background and the strong position that the Inspection in France traditionally holds in the area of financial control. This may work well for France, but in other countries (e.g. Bulgaria) such an approach may prove to entail considerable risks. Nevertheless, the reader should be reminded here of the original reason why PIFC was diverted away from inspection in candidate countries. Most new Member States and the current candidate countries had a strong inspection (police) service that focused on complaints, individual transactions and penalties only. Systems of internal control did not function or were not assessed for adequacy.

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The repressive element of inspection is brought into line through the inclusion in PIFC of the managerial responsibilities for (ex post) financial control, which should not be part of the functions of internal audit. Complaints, fraud and serious irregularities of course remain within the competency of inspection services. Where the internal auditor suspects fraud or serious irregularities, he reports to the manager and to the judicial authorities, who will instruct inspection services to investigate. This explains why the specific investigation and prosecution elements of the fight against fraud or the Supreme Audit Institution fall outside the scope of PIFC, without denying the links that obviously exist. I would like to add that combining internal audit, which is a typical advisory function, with inspection, which focuses on correction and deterrence but does not address the inadequacies of systems and procedures, risks jeopardising — under certain conditions — the effectiveness of both concepts. The adviser may become a part-time police officer, while the police officer may choose to advise instead of stopping unlawful behaviour.

It was therefore necessary to develop an internal audit that was separate and distinct from inspection and to focus on the differences between the two functions rather than giving the impression that both functions could integrate. This was the purpose of the "Tallinn paper"[15] to which Mr. Cohen refers in his book. It will come as no surprise then that the author's theory of "PIFC Russian dolls"[16] — in which both internal audit and internal control are covered by the mantle of inspection — does not do justice to the EC's PIFC concept.

Clearly, the book touches upon many control and audit issues that cannot be discussed in this brief review. However, the book is of interest to all those who are involved in one way or another with the development and implementation of PIFC in an ever-widening circle of countries that want to upgrade their internal control systems. Indeed, the echo of PIFC goes well beyond EU borders: to countries in the Western Balkans and in the group of the European Neighbourhood Policy[17]. Even the World Bank has expressed its interest in the (EC's) PIFC concept, because a sound and transparent public internal control system is also valid outside the context of EU accession.

There is a final remark to be made. Clearly, the book has been written with the French public service in mind. During an IFACI[18] colloquium on the public sector held in Paris in November 2004, Mr. Cohen stated that in the past there was some truth in the recommendation to perhaps think twice before selecting the French (for PIFC twinning or TA projects) because they would not understand internal audit or the COSO framework. But things are obviously changing for the better in France. At present the French authorities are in the process of implementing a new Public Finance Law (the LOLF), which comprises internal audit; it should be fully operational as of January 2006. Internal audit experience and capacity are slow and hard to build. It is therefore good to see that France has taken the opportunity to rethink its internal control systems and integrate the sound principles of PIFC into its new legislation, which is indeed quite an accomplishment.

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15 A discussion paper issued at the 4th meeting of the Contact Group for European Financial Control Organisations held in Tallinn, Estonia, in October 2001.

16 See Table 4 on page 37 of Mr. Cohen's book.

17 *Inter alia* the Ukraine, Moldova, Maghreb, Mashrak, Caucasus.

18 Institut de l'Audit interne.

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