PIFC: Key challenges in the implementation of PIFC

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Speech by

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1. INTRODUCTION

This year's seminar is on the implementation of Public Internal Financial Control (PIFC). DG Budget's experience shows that the introduction and development of PIFC is full of challenges and today I would like to focus on three of these:

- Managerial Accountability – Staying in control without controlling everything
- Making risk management better understood and more-widely used
- Making internal audit more effective at local level

2. MANAGERIAL ACCOUNTABILITY - STAYING IN CONTROL WITHOUT CONTROLLING EVERYTHING

Some top managers take accountability too literally. They think that if they are to be responsible for everything then they should control the minutiae of everything. This often means that other staff become alienated from the internal control processes.

It is correct that the top manager should be accountable. But some top managers take the notion of accountability to extremes, in that they believe that they can only be accountable for something if they personally take all decisions and see every transaction within their organisation.

The viewpoint of the senior management team (or the organisation as a whole), on risk, opportunity and governance is then nullified to that of the manager only. This situation is worsened where the appointment of the top manager had been based upon political consideration, rather than managerial competence.

Such a situation undoubtedly leads to poor delegation arrangements and reduced organisational efficiency; as well as little middle-management and other staff accountability; and sub-optimal staff development.

Concretely, this can often mean that lower level managers are not even fully sure of the budget they have to spend or the objectives they have to reach. The role or advice of the financial affairs department is insignificant or ignored, leading to ad-hoc and uncoordinated financial decision-making.

Improving managerial oversight of organisations

The challenge is to convince managers that being in control of the organisation does not mean that they have to control every single financial and operational decision and that a modern financial management and control (FMC) system can improve the governance of their organisation.

An FMC system provides for (inter alia): assignment of authority and responsibility; empowerment and accountability; and appropriate lines of reporting.

All staff, whether it be directors, managers or junior staff, should know their roles, responsibilities and limits of authority. Managers, in particular, need to understand the benefits, of delegation and that:

- they can remain in overall control through having a clearly defined delegation structure with job descriptions, performance objectives and indicators for all staff.
- more tasks can be done
- being freed up from routine administration allows them to have a clearer focus on the achievement of organisational objectives.

Accordingly, all managers should be aware of their operational objectives and should report on (a) their achievement of these objectives (b) on their use of resources in achieving their goals.

Sometimes there are legal barriers to have a comprehensive delegation framework, contained for example in the Civil Service law. This pleads for close cooperation between the central harmonisation unit (CHU) and the architects of Public Administration Reform.

Managers have a responsibility for the management of financial resources in the public interest, i.e. not only ensuring that funds are spent in accordance with the law, but also that they are spent well. In practice a great deal of attention is paid to compliance and very little to the latter. The organisational structure of an organisation should therefore take account of a facility for the provision of high quality financial information.

A financial affairs unit should exist to provide advice and support to the manager, as well as relevant accounting and costing information. Whilst the responsibility for financial management lies with top manager, the head of the financial affairs unit should have equal status with operational directors, in order to 'challenge' the top manager, in the search for economy, efficiency and effectiveness.

3. RISK MANAGEMENT IS NOT SUFFICIENTLY UNDERSTOOD OR USED

Overview

Risk management is a vital component of internal control and refers to the process of identifying and analysing risks to the achievement of the organisation's objectives and of determining the appropriate response to mitigate the risk.

It implies:

(1) Risk identification

(2) Risk evaluation and classification

(3) Assessment of the risk appetite of the organisation

(4) Development of risk response

As well, the management of risk should be reviewed and reported on in order to monitor whether or not the risk profile is changing, to gain assurance that risk management is effective and to identify when further action is necessary.

Typical problems relating to the introduction of risk management

The problems we have found are:

- Senior management are unaware of their responsibility to implement it and/or do not seem to wish to implement it.

- Middle management is afraid to apply risk management as they may not want to admit to risks/weaknesses in their current working arrangements.

- Where risk management does take place, it is often applied at the end of the internal control process, rather than the beginning.

What can be done to make risk analysis and management more accepted and widespread in your country?

Risk management will only become standard practice in line Ministries if there is a better understanding of what it involves and the benefits with which it can help to secure in terms of improved service delivery and achieving key objectives. The problem should be addressed at a central level and within each Ministry.

a) Central level

The CHU, backed by the Minister of Finance has a key responsibility in promoting and explaining risk analysis to management at all levels in line Ministries. Specifically, we believe that the CHU should:

- develop and propagate practical tools to assist in implementation of risk management (e.g. risk registers and effective internal control systems that incorporate risk techniques.)

- design and implement a training programme to enshrine risk management across the management community.

b) Within each Ministry

Managerial culture should be supportive of risk management in order to avoid that it is seen negatively or as something that may embarrass, or worse, punish, those middle managers who actively identify and discuss risks under their sphere of activity. Rather, the culture should be that proactive risk management shows a positive sign of control, whereby managers are making efforts to know what is going on and to stay in control.

Such a move to the free identification of organisational risk represents an opportunity to build an open governance culture within the organisation. Such a culture goes hand in hand with an improved ethical culture, where every person is to maintain and demonstrate personal and professional integrity and ethical values.

A Code of Ethics, whilst not having the same effect as a law, is nonetheless a serious document, because any breaches of the ethical code, even where no actual law is broken, can pose a significant risk to the reputation of the organisation.

Also within each Ministry, the internal audit function should increase audit focus on risk management issues to again promote its understanding and use.

When to apply risk management?

As risk management refers to the process of identifying and analysing risks to the achievement of objectives, it follows that organisations should establish their business objectives and then apply risk analysis to establish if it is possible, with reasonable assurance, to reach those objectives.

Risk management can be seen as a bridge between the control environment and the control activities, as it is on the basis of risk analysis that internal controls should be developed or fine-tuned. Should risk analysis come after the establishment of internal controls, it is unlikely that these will be adequate to address the risks. As a result, the internal control systems would no doubt resemble the traditional model of internal control that is based mainly upon legality and regularity of transactions.

4. AT LOCAL LEVEL, INTERNAL AUDIT IS UNDERVALUED AND TOO WEAK

No, or poor quality, internal audit means that internal control arrangements are unlikely to improve and the possibility for fraud increases. Yet some mayors may be reluctant to spend money to establish a fully-fledged internal audit function because they see no obvious short-term benefit. Where internal audit does exist, it is often too weak to add value, as the mayor is seen to have all of the power and any challenge would be seen as direct and personal criticism of the mayor. This is most commonly found in small municipalities and is a very tangible problem.

More and more the public are demanding higher quality public services and at a reduced cost. Local municipal administration is the closest and most regular point of interaction with the public. As such, the quality and cost-effectiveness of local municipal services will significantly colour public perception of the state of (good) governance. Whilst internal audit should be able to help municipalities in improving their overall service delivery, our impression is that internal audit is not particularly recognised or sought after at municipal level.

Everyone is well aware of the need for internal audit to be functionally independent. But there can be a problem when the internal auditor deals with the mayor only, at the exclusion of working with the whole senior management team. Take for example, the development of the annual internal audit plan. This should be driven by the (entire) managerial appreciation of risk. And where there is just one 'all-powerful' manager, this manager's appreciation of risk may unduly colour the judgement of the auditor.

Also, this restrictive interpretation of functional independence (interacting with the top manager only), often results in the auditor playing only a marginal role of checking system reliability and not engaging in fundamental audit activity such as reviewing

operational practice. Where the mayor is responsible for everything, then the internal auditor is especially vulnerable, because any findings can be seen as direct criticism of the boss.

It may be useful to include within the remit of the internal auditor, a responsibility for reviewing the governance arrangements and specifically to examine ways to ensure that top managers are not in a position to exert too much power in an organisation. However, alone, the internal auditor may find it hard to address this issue.

Ensuring high quality audit coverage at minimal (additional) cost

PIFC laws no doubt provide that all municipalities should have internal audit coverage. And firstly, of course, the law must be respected.

However given that in any country, there will be a mixture of small, middle-sized and large municipalities, it is difficult to have a one size fits all model in the PIFC law for the establishment of the internal audit unit/function at local level. No doubt, the CHU should play a key role in devising the optimal model for gaining internal audit coverage for municipal level. However, as well as direction from the CHU, municipalities should be encouraged to network and share experiences in order to discuss possible shared services.

Models such as a semi-centralised option, or 'geographically-centred' audit teams could reduce the financial burden on each municipality and at the same time, provide an appropriate degree of independence for the auditor and allow for greater flexibility and professional expertise.

Use of an Audit Committee as an expression of Good Governance

Another item linked to good governance is that of an audit committee - a body set up to provide management with an independent oversight of internal control, internal audit and financial reporting.

The role of the audit committee could typically be to advise management on:

- the strategic processes for risk, internal control and the Annual Declaration on Internal Control;
- the accounting policies, the accounts, and the annual report of the entity, including the process for review of the accounts prior to submission for audit, and levels of error identified;
- the planned activity and results of internal audit, and where appropriate, external audit;
- adequacy of management response to issues identified by audit activity;
- anti-fraud policies, whistle-blowing processes, and arrangements for special investigations.

Specifically in relation to internal audit, an audit committee would likely provide useful protection to safeguard the internal auditor's independence, as well as raising managerial awareness of the role and added value of the auditor.

Audit committee's at local level would of course be on the basis of a shared service and cover a number of municipalities, as it would be unrealistic to suggest an audit committee for each entity.

At the moment, audit committees are not common throughout the EU. We see that they exist in particular in the more northerly countries, but again, not everywhere. At the other end of the scale, we see considerable resistance, with some countries saying that they do not need this additional bureaucratic layer. We believe that the role and potential benefits of audit committees are pitifully misunderstood and deserve deeper discussion and reflection, both at this seminar, and back in your capitals.

We are of the opinion that the existence of a properly functioning audit committee could serve as a useful indicator of the level of good governance within an entity. The increased transparency and accountability generated by an effective audit committee will go a long way to increase public trust in the way that the municipality delivers services and uses public funds.

Even where a country would take a reasoned decision against having audit committees, I will have achieved my objective of stimulating the reflection on the matter. I challenge all participants to give me sound arguments why an audit committee would not add value in your country.