Public Financial Management and Internal Control

The Importance of Managerial Capability for Successful Reform in Developing and Transition Economies

Noel Hepworth

CIPFA

OPEN ACCESS

palgrave macmillan

Public Financial Management and Internal Control

Noel Hepworth

Public Financial Management and Internal Control

The Importance of Managerial Capability for Successful Reform in Developing and Transition Economies

palgrave
macmillan

Noel Hepworth
Kenley, UK

ISBN 978-3-031-35065-8 ISBN 978-3-031-35066-5 (eBook)
https://doi.org/10.1007/978-3-031-35066-5

This Palgrave Macmillan imprint is published by the registered company Springer Nature Switzerland AG.
The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

Paper in this product is recyclable.

Foreword

Good public financial management is fundamental to a well-functioning public sector and is at the heart of Chartered Institute of Public Finance and Accountancy (CIPFA)'s work. The principles of financial management are internationally recognised and apply in all jurisdictions around the world, and include accountability, transparency, and long-term sustainability. When followed, these principles bring wider benefits as public money is handled carefully, promoting trust between government and its citizens and preventing corruption.

The shift from public financial administration to public financial management (PFM) is a vital step towards unlocking these social benefits. This book outlines how to successfully achieve this reform, highlighting the various aspects to consider and providing guidance for the implementation process. The particular focus of the book is on managerial capability as a driver for change and a key determinant of success. Strong leadership is a core component of effective PFM and this kind of transformation requires buy-in from the top alongside managers at all levels taking responsibility.

There are many different elements to PFM reform, and this book takes a comprehensive view, including setting the ground at the beginning of the process, risk management, the role of government ministers, and the impact on second-level organisations. The benefits of undertaking reform are set out alongside the potential costs, indicating what can be achieved as long as there is sufficient determination to make the most of the transformation opportunities.

As the only professional accountancy body in the world exclusively dedicated to public finance, CIPFA is committed to working for the public good both in the UK and internationally. Our aim, and one of our charitable objectives, is to advance the field of public financial management and promote best practice throughout the global public sector. We work closely with international bodies, government ministries, technical development partners, public accounting organisations and supreme audit institutions to further this aim and develop a global perspective on common issues.

In line with this work, CIPFA is proud to sponsor this book and support the implementation of public financial management and internal control to strengthen developing economies. If executed well, the benefits of this type of reform are clear, and this book will be a valuable tool to help reach that goal. Noel Hepworth's research and guidance provide a roadmap that will ultimately improve lives in communities around the world.

London, UK Rob Whiteman

Preface

I was moved to write this guide because, based upon my experience of working in many developing and transition economy countries, I felt that little substantial progress in reform to the public financial management and internal control (PFM/IC) arrangements was being achieved. This was because the focus was always on technical developments without regard to the cultural, political, and managerial context in which the reform was being applied. The main thrust of this guide is that to achieve successful reform that context is of overriding importance and simply focussing on the bureaucracy of reform processes, as mainly seemed to happen, was no signal of success. The change that is required can perhaps be best summarised in this remark by William Faulkner "You cannot swim for new horizons until you have courage to lose sight of the shore."

Having said that, the country officials I have worked with have almost all been enthusiastic about and supportive of the reform. Working with them and learning from their experiences has been very rewarding.

Improving the techniques included the adoption of the international best practice that is the standards of internal control advocated by the Committee of Sponsoring Organisations (COSO). This approach was complemented by an emphasis upon the development of internal audit, as in effect the 'guardians' of internal control. Financial management in this context was perceived of as being limited to financial and budgetary control. That limitation, however, is quite inadequate in a modern managerial environment. It says nothing about how to improve efficiency and effectiveness in public expenditure, or alternatively public sector productivity. It also says nothing about supporting a government to achieve its policy objectives towards the delivery of public services. Consequently, I concluded that this approach to the application of PFM/IC was inappropriate and a different approach was required.

Adopting international best practice or standards is not as simple as it might seem because individual countries have different historical and cultural backgrounds and international best practice may not be easily transferable. International best practice also incorporates a set of assumptions which, whilst they are not explicit, are very important and they do need to be taken into account. So far as PFM/IC is concerned any adopter should recognise these implicit assumptions. They focus around the idea of management. What has not been recognised by those responsible for supporting the implementation of PFM/IC, that is, donors, consultants, or governments, is that if the benefits of improving efficiency and effectiveness as well as assisting governments to deliver their objectives are to be achieved, this reform should be regarded as fundamentally a management reform.

As a management reform this means that it affects the relationships between politicians and civil and local government-appointed officials, budgeting and accounting systems, and personnel appointment and management arrangements. Therefore, these all need to be addressed with managerial reform being central to success. This includes the commitment and support of the top officials, both elected and appointed. They should recognise and appreciate the benefits that the reform can generate and should want to achieve them. This guide indicates where that commitment and support are of particular importance. Without that the reform will not achieve the benefits. Achieving control of public expenditure is relatively easy but doing so and achieving better value public services is much more difficult. This is why establishing high-quality public financial management and internal control is so important and why success demands management commitment.

Who should read this guide? Those who aspire to the position of minister of finance ought to do so but I recognise that this is unlikely to occur. The ministry of finance state secretary (or equivalent) and the head of the department of that ministry responsible for the implementation of the reform should read the whole text. Other heads of operational management in public organisations and their supporting staff also ought to do so because they have key managerial responsibilities. Equally, heads of finance ideally should read the whole guide, paying particular attention to those sections which specifically relate to their responsibilities. Internal and external auditors also should read the whole guide. Aid agency officials framing proposals for reform and consultants advising on this reform also should read this guide. It will affect the framing of proposals. Other readers should be those concerned with public administration reform, including human resources reform. Although this is a practitioner text, academics interested in public sector management should also read this guide, not least because they often will have training responsibilities.

In writing this guide I have had enormous assistance and advice from Dr. Stephen Peterson—retired lecturer and Faculty Chair of the Executive Program in Public Financial Management at the Harvard Kennedy School. He has not only given me technical advice but also been a source of encouragement and support during a very lengthy writing and research process. I am very grateful to him. He has been very generous with his time.

I am also very appreciative of the advice and support I have had from my daughter, Dr. Sarah Hepworth. She has a wide experience of working in developing countries and her research expertise as well as her critical appraisal of the text has proved invaluable to me.

I am also grateful to many former colleagues and friends who, based on their experiences, have given me wise advice and guidance. In particular, Joop Vrolijk, Alastair Swarbrick, and Brian Finn, former colleagues from Support for Improvement in Governance and Management (SIGMA), have shared their very considerable knowledge and have been very encouraging.

Kenley, UK — Noel Hepworth

Contents

List of Tables

1

Changing from Financial Control to Financial Management in the Public Sector: An Introduction to the Changes That Will Be Required

This chapter describes the key aspects of public financial management and internal control reform, viewed through a managerial lens. It describes how, without a thorough appreciation of the linkage with management, this reform will at best fail to meet the intended objectives and at worst could add to administrative bureaucracy and hence costs. These are recurrent themes throughout this guide. This chapter introduces some of the terms and facets of the reform that will be explored in more depth in later chapters. Overall, this should be regarded as a major reform and it will take several years to achieve. It affects the quality of policy making, the relationships between politicians and the civil (or local government) service officials, the operational managerial arrangements and the approach to internal control and budgetary and accounting information. To undertake the reform is not a simple task: it has wide-reaching effects including the arrangements for delegation, accountability and transparency. The requirements of the reform may be in conflict with traditional customs and practices and these may affect whether or not the reform can be effectively implemented.

1.1 The Aim of and Audience for This Guide

This guide is about the development and then the practical application of the public financial management and internal control (PFM/IC) reform. It aims to help countries seeking to adopt PFM/IC to undertake this successfully and to avoid common pitfalls experienced by many countries which have tried to adopt

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_1

PFM/IC, but ended up ultimately with only superficial reforms. The critical pitfall that this guide seeks to highlight and help countries avoid is the common assumption that focusing solely on the technical procedures and bureaucratic processes of introducing PFM/IC will achieve the substantive benefits of the reform. It will not! The technical aspects of the PFM/IC reform are important but to achieve a robust reform, managerial changes will almost certainly be required. Changes to governance arrangements and transparency are also likely to be needed. The nature of the necessary reforms may conflict with traditional custom and practice with the risk that such reforms may be difficult to embed.

Unfortunately, this failure to recognise the impact upon management and traditional custom and practice has been a typical feature of financial management reform activities, both of PFM/IC and other PFM reforms, such as programme budgeting and accrual accounting, leading to some being described as 'fake' reforms.[1] A key message of this guide is that countries should do their utmost to avoid this failure. To do that, countries should recognise that introducing PFM/IC requires a major managerial reform and it should be treated as such by senior politicians and senior appointed officials. This guide demonstrates the complexities of the reform.

Before PFM/IC is introduced, countries will have in place some form of public financial administration and internal control (PFA/IC). The principal difference between the two systems is that PFA/IC has a focus on the control of financial *inputs*, whereas the more advanced PFM/IC has a focus not only on control of financial *inputs* but also upon the efficient and effective delivery of the *outputs* of public services. This applies equally to revenue collection arrangements, including taxation. This change of focus is central to improving public sector productivity. With PFM/IC the operational management[2] of a public organisation has considerably more discretion over the detail of spending (and revenue collection arrangements), that is, the mix of inputs and levels of spending in order to achieve objectives (outputs) and to do so efficiently and effectively, than it would with PFA/IC. Discretion is also needed when circumstances require that economies have to be made so that minimum damage occurs to existing services and activities. PFM/IC

[1] See an article published by the Institute for State Effectiveness in a discussion about performance and policy-based budgeting—how to spot the fakes: Andrew Laing: https://effectivestates.org/publication/performance-and-policy-based-budgeting-how-to-spot-the-fakes/.

[2] Operational management is the day-to-day responsibility for the delivery of public services. In developed economy countries, operational management would be the responsibility of the civil or local government service. The policy and strategy on which operational management is based would be the responsibility of the political management. But that policy has to be operationally realistic and that requires cooperation between the politicians and senior civil servants. However, in many developing and transition economy countries, the political management aims to undertake both sets of responsibilities.

consequently has the potential benefit of making the financial system more resilient by being able, through a more effective management, to utilise whatever level of resources are available in an optimum manner.

The aim of PFM/IC is to provide the information and authority operational management requires to deliver the policies of the organisation making the best use of public resources. These policies will be expressed through the budget along with complementary objectives and performance standards. The operational manager's responsibility is to deliver those policies and objectives efficiently and effectively, to time and within the law and budget. Efficiency and effectiveness apply equally to the utilisation of current resources (i.e., employee costs, supplies and services costs, transport costs and property costs as well as overhead costs) and to the utilisation of assets. It also means ensuring that all resources are only used for public purposes.

Thus, the aim of reform is positive, that is, focussed on achieving the outputs of a public organisation. It is not 'defensive' or alternatively negative in concept, that is, simply to impose controls and reduce financial misconduct or misuse, which is how some appear to treat it.[3] If the objective of a government is solely to develop or strengthen defensive controls this does not require the extensive managerial reform that would be necessary with the implementation of PFM/IC. The techniques accompanying PFM/IC should be aimed to facilitate, not constrain, managerial discretion. Consequently, in considering this reform this guide advises that, contrary to much advice on the introduction of PFM/IC, countries should start by focussing on and addressing the managerial implications of this reform rather than considering only the technical bureaucratic features. Ultimately, no matter how 'clever' the techniques or the bureaucratic rules, without management the benefits of the reform will not be achieved.

The purpose of this guide therefore is to enhance understanding of what a PFM/IC reform is meant to achieve, how to then apply this type of reform and the consequences for managerial arrangements. The key argument is that PFM/IC should be seen as much a management reform, not just a technical audit or accounting reform nor just about improving financial and budgetary control, although if properly applied it will achieve such benefits. It will also facilitate improvements in policy development through the availability of additional information, not least about the causes of the costs of providing services (i.e., those factors that drive costs) or the costs of revenue collection and weaknesses in revenue collection policies.

The guide is predominantly directed at countries either planning or undergoing reform, that is, developing and transition economy countries. However,

[3] Institute of Internal Auditors: Lines of Defence IIA Exposure document June 2019.

because PFM/IC has been widely treated as simply a technical financial reform, rather than a management reform even by developed economy countries, such countries which have already been through a reform process would benefit from questioning whether or not they are in practice achieving the benefits of the reform. Not the least of which are improvements in efficiency and effectiveness in the delivery of public services and activities and in the utilisation of assets.

This guide is also aimed at development agencies who often advocate sophisticated reforms when there is little or no local managerial capacity to implement them, much less operate advanced systems. This author has argued elsewhere that "a financial reform must fit with how the state operates' and that financial reforms are not free standing."[4] Yet such reforms are regularly promoted as technical improvements with no recognition of the managerial impact. Where countries are not prepared to make the managerial changes that the PFM/IC reform requires, the reform should not be proceeded with and instead countries should focus upon improving public financial administration and internal control.

Countries considering, or are in the process of implementing, the PFM/IC reform should ask themselves a series of questions which will indicate whether they have recognised the full implications of the reform and not least the managerial impact of the reform? (Table 1.1).

If these types of question have not been addressed in planning the implementation of PFM/IC, then there is a real possibility that the resulting reform will not produce the benefits that countries should be looking for and will, in all probability, simply add to costs. Therefore, countries who answer 'no' to all or most of the self-assessment questions in figure 1, apart from those marked with a *, should consider revisiting the reform and use this guide to help rethink and adapt how they have implemented, or intend to implement the policy and apply it.

1.2 Why Is Management Relevant and Important?

Development agencies, multi- and bilateral, do often advocate advanced public financial management reforms because they represent 'international best practice'. Usually, they are treated as technical financial reforms even though

[4] Hepworth (2013, p. 3) cited in Public Finance and Economic Growth: S. Peterson, Routledge 2015 (p. 252).

Table 1.1 A self-assessment questionnaire to determine if the comprehensiveness and managerial aspect of PFM/IC reform has been sufficiently realised

Section 1: The manager and managerial responsibilities	Yes/ No
• Has thought been given to the separation of the development of policy and strategy from operational management and who should be responsible for which?	
• Has consideration been given to who the operational managers should be with PFM/IC?	
• Is there clarity about the objectives managers are to achieve along with the performance standards that are to be applied?	
• Have managerial structures been developed to secure the effective delivery of objectives and performance standards and in turn to support more senior managers?	
• Are those managerial structures organised to deliver the objectives of the organisation?	
• Has consideration been given to the degree of authority to be granted to individual managers at different managerial levels to make decisions, that is, delegation?	
• Consequently, has consideration been given to the accountability arrangements where delegation is agreed to?	
• Do operational managerial capacities exist that can take the reform forward and achieve concrete results?	
• Has any regard been had to the impact upon civil service management reform including motivation, training and the rethinking of the civil service sanction arrangements in order to recognise that if civil servants become managers and therefore decision makers that this involves taking risks which will be new to them?	
Section 2: The manager and efficiency and effectiveness	
• Is there an acceptance that the operational manager is the person primarily responsible for achieving improvements in efficiency and effectiveness within agreed policy parameters?	
• Is there any relationship between budgetary provision and the objectives and performance standards the management is expected to deliver?	
• Is there an acceptance that operational managers need to '*agree and commit*' to deliver objectives and performance standards and that they can do so within the agreed level of budgetary resources?	
• Has consideration been given to the impact upon budgeting and accounting systems if managers are to make better use of resources because managers can require significantly different financial information from that needed simply for budgetary and financial control purposes, although they need that as well?	
• Is it recognised that to enable managers to improve efficiency and effectiveness improvements in the extent of performance information and in the quality of financial information and financial analysis are necessary?	

(*continued*)

Table 1.1 (continued)

Section 1: The manager and managerial responsibilities	Yes/ No
• Has the focus of those officials responsible for the reform been simply upon building the bureaucracy of the reform assuming that somehow this alone will achieve the objectives of the reform? (The bureaucracy incorporates all those administrative arrangements required to demonstrate the application of the international best practice i.e., COSO requirements, such as risk registers, the control environment and the monitoring arrangements.)	*
• Is the view that if the bureaucracy associated with COSO is introduced, then PFM/IC itself will have been successfully introduced?	*
Section 3: External accountability and transparency	
• Has parliament been informed about and agreed to the policy proposals for the implementation of PFM/IC?	
• Has consideration been given to the provision of performance indicators and objectives to parliament in conjunction with the budget?	
• Is there an acceptance that the form of reporting to parliament about the utilisation of budgetary resources will need to include information about performance and the achievement of objectives?	
• Is there an acceptance that increased accountability and transparency will result in greater parliamentary scrutiny of the quality of management of public resources?	

Note: If the answer to most questions is 'No' apart from those marked with a * when the answer may be 'Yes', then the likelihood is that neither the comprehensiveness nor the managerial implications of the reform have been recognised

[a] COSO: International standards of internal control advocated by the Committee of Sponsoring Organisations (COSO). https://www.coso.org/Pages/default.aspx

they require a managerial capacity if advantage is to be taken of those reforms. Yet there may be limited or even no local managerial capacity to both sustain those reforms on an ongoing basis and achieve the benefits that those reforms make possible. Examples of such reforms include accrual accounting and programme and performance budgeting as well as PFM/IC. Any financial or management reform must also fit with how the state operates including its traditional customs and practices. Reforms are not free standing and will fail or become simply superficial if the promoters of the reform do not sufficiently recognise the context or the complexity of the managerial task in implementing and then delivering the reform into the future.

The reality is that most studies, advice and reform programmes appear to treat PFM/IC reform simply as a financial technique. The discussion contained in such documents makes no reference to the management implications for the utilisation of the technique. This fails to recognise that simply treating it as a financial technique completely overlooks that someone has to apply that technique if there are to be improvements in the utilisation of public resources and that better quality public services result. That 'someone' is the manager.

Taking a management perspective recognises that what may be construed initially as simply technical financial reforms actually have a significant managerial impact. For example, line ministry[5] managers have different information needs so far as budgeting and accounting is concerned from a ministry of finance; managers need clarity of objectives (both operational and performance) and performance standards to work to which can often be difficult to define with any precision, adding to the complexity of the managerial task. This complexity can produce conflicting objectives which in turn need to be managed. For example, what is the purpose of prison: is it retribution, incarceration, deterrence, rehabilitation or elements of all four and is it the same for all prisoners of both sexes? Managers also should be accountable, not just internally but also externally and in particular through parliamentary scrutiny. Accountability is the process that strengthens management through the consequential scrutiny activity. (Parliament may need to establish one or more specific committees to undertake the scrutiny process.)

A misunderstanding about PFM/IC reform, particularly at the political level, is that it is simply about reducing fraudulent or corrupt activity or introducing tighter budgetary and financial controls. The approach to implementation, especially in European influenced countries, has been through focussing on the technical elements of the reform and not least on the financial and budgetary control elements partly because the initial PFM/IC reform activity has been on the development of internal audit. The idea that the reform is also designed to support managers in achieving objectives efficiently and effectively does not appear to be appreciated. The management perspective has been almost entirely overlooked. Delegation and managerial accountability have been developed, at best, principally in the context of financial and budgetary control, not in the context of the delivery of objectives and the achievement of efficiency and effectiveness.

As a result, other features, which recognise the relevance of the reform to management, such as the responsibilities of the different levels of management for the delivery of objectives and for achieving efficiency and effectiveness have been overlooked. Consequently, the need for clarity of objectives (both operational and performance) and performance standards for managers to work to along with the specific financial and performance information that

[5] A line ministry is a government ministry responsible for implementing a program or group of programs as opposed to one responsible for general finance, economic management, planning and administration.

managers require have also been overlooked. Thus, managers should have available to them detailed budgetary information for the area of activity or service for which the manager is responsible; budgets should be consistent with the objectives and performance standards managers are expected to meet. Managers need authority and some degree of control over the utilisation of resources, even over what may be regarded as sensitive resources such as personnel and assets. This in turn requires delegated authority, that is, the ability to exercise discretion. PFM/IC requires strengthening managerial discretion. Management structures need to be so organised that they secure effective management of the different elements of a service or activity with mechanisms to enable managers to be held to account by more senior operational managers leading to accountability to the political management of an organisation. Those managerial accountability arrangements have to be effective and that means that those more senior managers must respond to accountability reports. Ultimately, reporting should be to parliament as part of the government responsibility to demonstrate how budgetary resources have been used. Two forms of parliamentary scrutiny could occur, one which responds to the report of the state auditor (sometimes by establishing a committee perhaps called a 'public accounts or public audit committee') and the other which investigates the quality of the management of public resources which again can be undertaken through a parliamentary committee arrangement.

1.2.1 Management

The question then is, who is the operational manager and what is the environment in which that manager is operating? The manager barely gets a mention in most reform strategies, because of the focus upon PFM/IC as a financial control technique. Neither does management training apart from the notion that somehow training in the technique will solve all problems. Yet success with this PFM/IC reform depends upon the information the manager has available and upon the capacity of the manager to use that information.

However, for public sector organisations a difficulty can be determining who is the manager? Is the manager the minister or mayor or other political head of the organisation, supported by their deputies or in Francophone countries by a politically appointed cabinet? Is such a person responsible for policy development, policy implementation and operational management in the delivery of public services? Or, is there a distinction between a minister or mayor responsible for policy and strategy and a civil or local government service responsible for policy implementation and operational service management, as occurs, or should occur, in Anglophone systems? In most systems the politically appointed head will have overall responsibility for the successes and failures of the organisation but may not have day-to-day responsibility for operational management (i.e., policy implementation). In such circumstances the political head is likely to have a responsibility to supervise the quality of the operational management ensuring that it delivers the policy objectives and maintains budgetary and other controls. In many countries adopting PFM/IC, the managerial situation is quite unclear and the law often refers to the responsibility for the implementation and quality of PFM/IC as that of the 'top manager' by which is meant the political head of the organisation. As is shown later in this guide, this is not a practical arrangement with the implementation of PFM/IC unless accompanied by operational management reform.

In Anglophone systems there is, in theory, usually a clear distinction between the responsibilities of the political head of the organisation and the administrative head. The latter should be responsible for policy delivery and operational management. The administrative head is very often known as a permanent secretary. Permanent secretaries are the 'accounting officers', meaning that they are responsible for ensuring that public funds allocated to the ministry through the budget process are appropriately spent. The permanent secretary is responsible for the application and quality of PFM/IC within the ministry. This official can be called to account by parliament as part of the parliamentary scrutiny process. However, a constitutional convention is that a cabinet minister bears the ultimate responsibility for the actions of their ministry or department. This means that if an administrative failure occurs within a ministry, the minister is responsible even if the minister had no knowledge of the actions which led to that failure. In other countries this distinctiveness in the allocation of responsibilities is not so clear and the political appointee may be responsible for both policy and day-to-day operational management and this results in some countries in the minister undertaking minor administrative tasks.

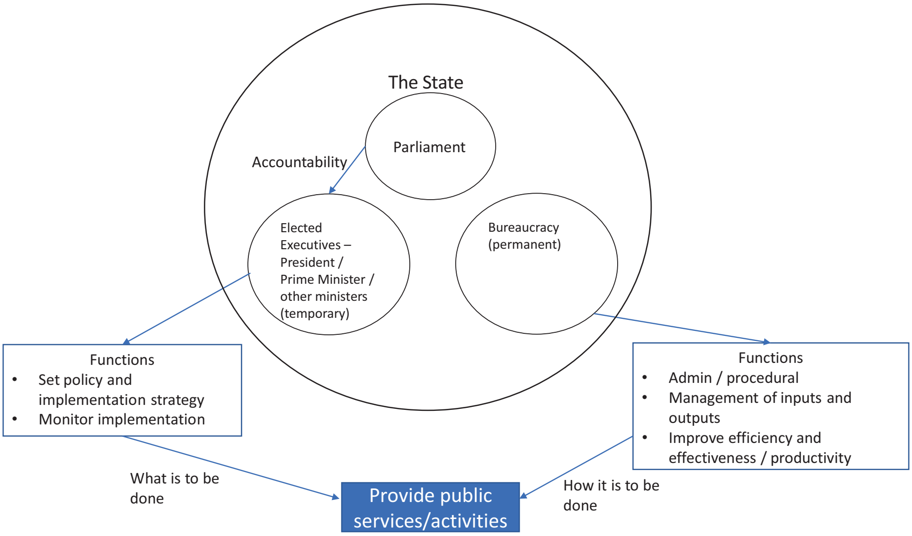
A feature of the implementation of the European Commission's version of PFM/IC which is called 'public internal financial control' (PIFC) and which is to be applied by countries wishing to join the European Union or benefitting from its funds as neighbourhood countries is the recognition of a need for delegation and the corresponding development of accountability. This ought to mean the delegation of operational management responsibility from the political to the civil service (or local government service) level. But in practice because the reform is treated as a financial technique, delegation is usually limited to aspects of financial control and relatively minor administrative matters.

A manager is defined as a person responsible for controlling or administering the whole or part of an organisation or group of staff.[6] Managers ought to exist at all levels in an organisation and a clear management structure should exist. Managers at different levels within an organisation should have different levels of responsibility and these will be, or ought to be, set out in delegation arrangements. Each level of management should be accountable to a higher level of management and ultimately to the top manager, whether a political figure or an official. Where operational management is the responsibility of the civil or local government service, a state secretary (or equivalent), or head of a local government service, would be the top operational manager and therefore responsible for the application of PFM/IC. That top operational manager should be responsible for the quality of operational management including the delivery of objectives and performance standards efficiently and effectively and to time and for the control of income and expenditure to within budgetary limits. In turn that top operational manager should be responsible for the quality of operational management to the political manager.

Success with the application of PFM/IC depends very heavily upon the quality of management but changing the role and responsibilities of civil servants and local government officials to incorporate managerial responsibilities does not somehow automatically make them effective managers. Good quality managers in most public sectors are in short supply, and therefore, countries embarking on the PFM/IC reform should recognise that a heavy investment in management training is likely to be required. (Who is the manager is also discussed in Chap. 2.)

[6] Oxford English Dictionary: https://www.lexico.com/definition/manager.

A schematic representation of the arrangements that ought to apply with the implementation of PFM/IC is set out below:



1.2.2 Leadership and Organisational Culture

The leadership responsibility in the development and application of PFM/IC would in most countries fall upon the minister of finance, and the responsibility of that ministry would extend to ensuring that the application of the PFM/IC policy in individual public organisations followed the specified policy guidance. There should be overall government support for the reform and head of government (prime minister or president) support as well as that of the cabinet of ministers is necessary. Parliamentary support for the reform is also essential, and this should include parliamentary approval to the reform itself and the process for implementing the reform. Parliament should also be informed periodically of implementation progress.

Overall responsibility for operational implementation leadership of PFM/IC for the public sector should lie with the head of the civil service in the ministry of finance (the state secretary or equivalent). Responsibility for the leadership of the operational application of the reform within each ministry or other public organisation should lie with its head of the civil or local government service under the guidance of the head of the civil service within the ministry of finance. (In some countries there is no single civil servant who has the role of 'head' within a ministry: where this is the situation with PFM/IC this arrangement will almost certainly require change as this guide demonstrates.)

Delegation of operational management and managerial accountability are not only key features of PFM/IC but they are essential to make PFM/IC work, as this guide will show. However, for some countries the introduction of delegation and managerial accountability will represent a radical cultural change. Politicians who have traditionally been responsible for operational decisions as well as policy development and the strategy for the application of that policy may find such a change difficult to accommodate because it runs against traditional cultural approaches. This will be a factor in the extent to which PFM/IC reform is possible, and certainly, it will affect the timetable for implementation.

This distinction between policy development and operational management must be addressed by the political and civil service leadership responsible for the implementation of PFM/IC. This is because, if properly applied, PFM/IC is about the professionalisation of operational management, and a minister or mayor will find it impossible to remain responsible for both operational decision making and policy and strategy development. This is because of the demands that PFM/IC will make upon the time and skills required for efficient and effective delivery of operational objectives and performance standards. (However, effective policy development and the strategy for its application depend very heavily upon cooperation between the politician and operational management for it is the latter who has, or should have, the experience and information necessary to turn political ideas into operationally effective public services.)

The features of PFM/IC affect the way in which an operational manager would carry out a particular task and therefore the operational manager must become familiar with them because they impact upon the achievement of objectives and improvements in efficiency and effectiveness. They have the potential to generate public service improvements, better quality policy making (because more information should become available) and more efficient resource utilisation. However, they will not do so unless they are accompanied by a managerial capacity to take advantage of them. Failing to recognise the importance of management and simply focussing on techniques (which usually are simply defined as the international standards[7] and the bureaucracy associated with those standards), which appears to be almost always how

[7] The techniques which are referred to here are the five elements of the international standards defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). However, to improve efficiency and effectiveness much more is required and not least a more analytical approach to finance which is demonstrated in this guide.

PFM/IC is developed, will not achieve the benefits that the reform can bring. It simply adds bureaucracy and hence costs and can have a negative effect on morale as well as upon the possibility of other future reforms if no benefits become apparent. Not recognising the managerial changes PFM/IC requires and simply focussing on these techniques will not cause public services and activities to be delivered more efficiently and effectively. Yet an important objective of all PFM/IC reform is to improve service delivery, the achievement of objectives along with improved operational efficiency and effectiveness and asset utilisation.

Another critical factor that is frequently overlooked in the introduction of PFM/IC reform is the extent of cultural change required within organisations. Such change is not simply about reforming the organisational structure but is also about changing human behaviour and the relationships between different organisations such as between a ministry of finance and spending (line!) ministries. With PFM/IC spending ministries should have more discretion to make decisions within a context set by a central ministry such as a ministry of finance. This in turn raises the question of 'trust', that is, will a central ministry 'trust' a spending ministry to utilise its resources efficiently and effectively? Similarly, the delegation of operational management to the civil service requires civil servants to make decisions and consequently to take risks. Will the political level 'trust' the civil service to do that? Another feature of the reform affecting culture and behaviour is leadership. How the leader performs and the attitudes of the leader can be significant in the successful implementation of the reform and in its subsequent operational application.

However, in many countries there is a problem with requiring the head of the civil service in a ministry or other public organisation, to undertake the leadership role in the implementation of PFM/IC. This is because in many countries the law provides that the organisation leader is the top political official who is directly responsible for all activity and therefore feels that he/she must make all decisions. This person should have ultimate oversight of the implementation of the reform but that is different from having responsibility for day-to-day implementation. In countries where the operational management leader is a permanent, rather than elected, official, such as a state secretary, whilst a politically appointed official can influence the culture and managerial approach of the organisation, there is a potential to maintain a continuum in the approach (although this may be 'good' or 'bad'). Political change may cause policy and strategy change, but where there is separation between responsibility for policy development and operational management, political change does not necessarily affect how operational management is conducted. Operational management needs to remain stable for successful sustainability of the reform. In addition, the requirements falling upon the top official with PFM/IC are such that an elected official would not have the time or the training to undertake all the managerial responsibilities that would flow from the reform.

The cultural change that introducing PFM/IC will cause requires the support of the political leadership. Because that cultural change will cause civil servants to make managerial decisions, they will need to be prepared to take risks: all decisions involve some element of risk. This is a factor which will affect the willingness of civil servants to take decisions because in many countries there exists a fear of personal penalty for error of judgement or mistake or even of making a potentially controversial decision. So, in introducing PFM/IC, consideration should be given as to how these penalty arrangements will impact upon the attitude and approaches of civil servants.

Almost inevitably change induces resistance amongst some and a feeling of 'this is not how we do things here'. Again, this impacts upon operational leadership, and the question then becomes how can the operational leadership arrangements have a positive impact on the changing culture of an organisation? Such issues are rarely, if ever, considered as important to the success of PFM/IC reform. The positive commitment of the head of operational management is essential as is management training for the different levels of management. Usually, any training that is provided is concerned simply with technique in terms of applying the bureaucratic requirements of PFM/IC and this is regarded as all that is necessary. The application of a sophisticated reform such as PFM/IC requires the application of sophisticated management and a thorough review of how organisations are managed and the training available to managers. This applies equally to the penalty and reward structures applying to management. Management training and the impact upon human relations (HR) policies are often overlooked in the reform process with the only staff management concern being expressed is through 'training in technique'.[8]

[8] For a more extensive discussion of managerial and cultural aspects of organisational arrangements, see, for example, Management and Organisational Behaviour by Laurie J. Mullins: Pearson Education Limited 2016.

1.3 Key Terms and Facets of PFM/IC Reform

The technical aspects of PFM reform are covered in many text books and handbooks on the subject (e.g., 'Financial Management and Control Manual'[9] and PIfC[10]). However, they rarely, if ever, describe the critical role the manager needs to play in each of the technical areas. They do not discuss the role of the leader or the distinction between policy and strategy development and operational management. This section highlights some of the key terms and facets of PFM/IC reform that will be explored in more detail later in the guide and highlights the managerial versus the technical aspect of the function.

1.3.1 The Budget

A precondition for PFM/IC reform is that the budget provides a clear and reliable basis on which management can build the policies, strategy and objectives that an organisation aims to achieve. The budget, as far as possible, should be consistent with the objectives (and performance standards) that an organisation is expected to achieve. The individual managers within an organisation should be involved in the budget preparation process and agree that the objectives (and performance standards) they are expected to achieve can be delivered within that budget. Where the overriding consideration is the level of the budget, if that is insufficient in the view of the manager to deliver the objectives and performance standards, then either the objectives or the performance standards or both should be modified to fit with budgetary availability or the budget should be adjusted to ensure that there is compatibility.

With PFM/IC the disciplines surrounding the budget should be such that manipulative activities to avoid budgetary and financial controls should be eliminated as far as possible. Budgetary discipline is particularly important because for managers to deliver objectives and performance standards within a specified budget efficiently and effectively adds significantly to the pressures upon them compared with simply ensuring that spending does not exceed a specified budget. This means that ideally there should be no scope for public organisations to avoid the budgetary limitations by, for example, transferring items of expenditure between revenue and capital (or investment) budgets or by using second-level bodies such as agencies or state-owned companies to

[9] Published by the Ministry of Finance of Albania—and similar manuals published by other countries.

[10] Published privately by Robert de Koning: information and orders from: www.pifc.eu. (This book is a major explanation of the technical aspects of the European Commission policy on the introduction of its application of PFM/IC including internal audit.)

incur expenditure as proxies for their controlling or owning first-level public organisations or by transferring payments between years. Again, there should be no scope for moving expenditure apparently into the private sector through 'off-balance sheet' arrangements, leasing and other similar devices[11] or for using extra-budgetary funds except within very clearly specified circumstances. This should extend to use of 'own funds' generated by either first- or second-level organisations. With PFM/IC a risk is that the added pressure on managers to deliver objectives efficiently and effectively may cause managers to try to avoid the impact of budgetary and financial controls. This imposes an added responsibility on ministries of finance to ensure that budgetary and financial controls are rigorously observed.

The budget also provides the key financial mechanism by which parliament exercises financial control. In addition, a question that will need to be considered is the extent to which the traditional budget, and in some countries the budget law, should be modified to include objectives and performance indicators. PFM/IC enhances the opportunities for parliamentary scrutiny. In other words, PFM/IC potentially increases transparency and public accountability.

1.3.2 Cash Management

Budgetary control rules will be complemented by cash management rules. A ministry of finance will want to ensure that it is not forced to borrow unnecessarily through unplanned or erratic expenditure patterns or revenue forecasts that cannot be fulfilled. With PFM/IC the flows of expenditure will affect the ability of the manager to deliver efficiency and effectiveness and therefore managers should be consulted about cash flow calculations and they should not simply be determined by the interests of the ministry of finance.

With PFM/IC the operational management will have much greater scope for decision making than they would with PFA/IC. This includes having automatic authority to spend (subject to any overriding or specific constraints) with only managerial approvals as necessary within their organisation but without further ministry of finance approval. Managers must also respond to changing circumstances especially as they will be expected to deliver objectives and this could affect the traditional arrangements for the approval of budgetary variations (virement). All of this should affect attitudes to cash management controls which in practice will mean that such controls should become more strategic rather than detailed.

[11] See, in particular, IMF Working Paper /15/238: Defining the Government's Debt and Deficit: Timothy Irwin.

1.3.3 Management Accounting

Managing the budget of a public organisation to deliver objectives to time, to standard, efficiently and effectively is no simple task and it requires highly trained and financially aware managers. The operational manager needs to understand what causes costs to be what they are, that is, what drives costs, and which parts of the organisation are operating efficiently and effectively and which are not. This is a contrast with administering a budget within the context of a PFA/IC regime where the administrator's task is much more limited to ensuring compliance with the ministry of finance external controls. What this also means is that both budgets and financial information need to be allocated in accordance with the needs of the manager, not solely in accordance with the needs of the ministry of finance.

The development of management accounting therefore should be a feature of this reform. Management accounting responds to a manager's requirement not only for different budgetary and financial information for effective management from that required by a ministry of finance, which has different interests from the manager. What are also required are systems which deliver performance information and which need to be linked to the management accounting system. This linkage should affect the construction of the budget as well as the type of financial analysis the manager should require. The form of analysis that suits a ministry of finance is rarely likely to meet the needs of the manager, especially where the manager is responsible for delivering efficiency and effectiveness and service quality. This involves a challenge to the traditional practices and controls exercised by a ministry of finance. It also requires the development within public organisations, other than a ministry of finance, of more sophisticated financial analytical systems and the capacity of organisational financial analysts and managers to utilise those systems. This in turn raises questions about the capacity of finance officers within organisations. Do they have the training to provide the information that managers require? These requirements are not simply those of financial controller and bookkeeper[12] but managers will require financial analytical information and that a capacity exists to provide advice and support including over the implementation of policy, the strategy for the implementation of that policy as well as over the development and implementation of investment projects. These are not skills that are readily available within governments and require the

[12] *A bookkeeper* records the financial transactions of an organisation, and the financial controller role in public organisations in transition and developing economy countries usually includes ensuring that such transactions are within budget and comply with the relevant financial regulations and meet legal requirements.

employment of professional, that is, more expensive, staff. A question then is how are such skilled persons to be recruited, used and integrated into existing career structures? Integration is important because such skilled professionals need to become 'part of the team' and not perceived as 'outsiders'.

1.3.4 Control

The term 'control' has a wide range of meanings. These can range from 'prohibit' to 'manipulate', and within this range there are two major themes. First, there is the idea of control as 'domination'. Secondly there is the idea of control as 'regulation'.[13] Both meanings can exist within the use of the term in the PFM/IC management arrangements.

Advisers and others promoting PFM/IC sometimes talk about 'control' in terms of 'lines of defence' focussing on ensuring that public resources and assets are not misused through fraud or corrupt activity.[14] This often occurs where internal audit has been developed before PFM/IC and the 'policy focus' is dominated by internal audit concerns. This is quite appropriate if the only concern is financial and budgetary control which leads to a robust public financial administration. But the result is not financial management. It also makes the mistake of focussing control on adherence to procedures and budgetary compliance not recognising that bringing together public financial management and internal control broadens the meaning of internal control to include the management controls necessary to secure the achievement of objectives and to do so to time, to standard, within budget, efficiently and effectively. The issue for management is how to 'control' (a better term might be 'steer') the organisation to ensure that it delivers its objectives and at the same time makes the best use of resources. This is not about defence. This is achieved by deciding upon the best strategy that will achieve success and that strategy will depend upon how best to utilise all the resources that a government has available for a specific purpose and how to do so efficiently and effectively. Delivery of that strategy depends upon the quality of management and that is why the focus of PFM/IC is upon 'management' and its ability to achieve its objectives. Merely thinking about control in terms of 'defence' will not achieve that.

[13] Accounting controls in perspective: Emmanuel and Otley: Explorations in financial control (p. 129). Editors Lapsley and Wilson 1997.

[14] See, for example, Institute of Internal Auditors (IIA) exposure document June 2019 and subsequent updates. https://global.theiia.org.

1.3.5 External and Internal Control

The development of PFM/IC has the consequence that detailed financial and budgetary control shifts from external control to internal control. This means that instead of an external organisation such as a ministry of finance or a state auditor or some other external body, that is, external to the ministry or other public organisation, approving expenditure and ensuring that spending does not exceed approved budgets or that personnel appointments and procurement arrangements conformed with externally set regulations, such controls would be exercised by the management of the public organisation itself. This is characteristic of moving from an administrative style of public service organisation to a managerial style. Thus, the organisation management would act as the controller, albeit exercising that control according to centrally agreed rules and it would be accountable for how it had applied those rules. The benefit of this is that it facilitates the exercise of discretion by the management of an organisation and therefore creates the opportunity to improve efficiency and effectiveness in the utilisation of public resources. This element of the reform is counterbalanced by enhanced arrangements for managerial accountability. Professor Allen Schick argued in 1978 in an article on Contemporary Problems in Financial Control[15] that the evolution from external to internal control was a 'sea change' in financial systems, that is, "Internal control is much more than a procedural matter. It represents a fundamental shift in attitude about government. In an era of big activist government, internal control signifies that public agencies can police themselves, that it is much more important to get on with the job than to worry about preventing the misuse of funds." Therefore, where a country wishes to implement PFM/IC it does need to ask itself this question: Given the growth in the scale of public services with the growing demand for more and better quality services can we continue to administer those services in the same manner that we have always done and still achieve the objectives of public expenditure, or do we need to rethink the administrative arrangements? The substantive introduction of PFM/IC, that is, with a managerial perspective, raises this question. It also adds to this question by asking, what is the purpose of the control? Is it simply budgetary and financial control to maintain a traditional and tight control to meet the particular needs of the ministry of finance (and other central ministries) or should the control reflect not just those needs but also those of the manager required to help the manager achieve objectives and performance

[15] Public Administration Review, Vol. 38, No. 6 (Nov.–Dec., 1978), pp. 513–519. Published by Wiley on behalf of the American Society for Public Administration.

standards? Managerial control needs are likely to be different from those of a ministry of finance because a line manager may require greater flexibility in the management of budgets in order to deliver objectives and to make improvements to efficiency and effectiveness: a ministry of finance is in no position to do either of these. To reconcile the 'control' interests of a ministry of finance and a manager, a necessary parallel reform should be to establish a different approach to the external control framework of regulations and guidance so that it focuses on strategic issues rather than on the detail. Reform also needs to occur to the budgeting and accounting arrangements. Such a reform would allow budgetary and accounting information to be analysed in a manner that suits two sets of needs, that is, those of the manager and the ministry of finance. No longer should a ministry of finance have a monopoly on how such information should be presented. This will require the development of more sophisticated data analytical arrangements.

Another feature of effective management is how well managers cope with austerity. Periods of austerity are almost inevitable and the challenge for managers in such circumstances is how then to continue with the highest possible level of service delivery. It is not simply a matter of 'cuts' but of prioritising services, seeking out inefficiencies, disposing of underused or surplus assets and rethinking how services can be delivered within a constrained financial envelope. Again, line ministry managers are more likely to be effective in managing austerity at the individual service level than the ministry of finance, emphasising again the significance of internal control being exercised by the organisation management.

Whether or not such a change from external to internal control could or should occur or be achieved depends upon the quality of the existing public administration arrangements. It also depends upon the level of trust that exists between the political and the official levels of the public administration and between a ministry of finance and other central ministries and line ministries and other public organisations. In some countries, such trust does not exist and results in the politicisation of the civil or local government administration with a reluctance to offer any concessions on control by central ministries. This lack of trust, in turn, encourages elected officials to see their role as including that of operational management, sometimes at a very detailed level.

'Trust', which needs to exist at all levels, is not just trust that 'inputs' are controlled but that the 'outputs' meet expectations compared with those 'inputs'. Those expectations though need to be explicit rather than implicit. 'Trust' is a product of the professionalism of the management.

Another factor is that central ministries may also be very reluctant to lose their powers to exercise detailed control. An example of central ministries wanting to maintain central control is that given by De Geyndt referring to devolution of responsibility to hospital management in low- and middle-income countries with the aim of making their hospitals more performing, that is:

> Policies granting autonomy to public hospitals have had limited success. In all cases Boards of Directors have been created. Governance of autonomized hospitals by Boards however is obstructed by the resistance of central level entities to have their authority diminished. The Ministry of Finance tends to maintain control over revenues and expenditures. The Public Service Commission resists abdicating its role to hire, promote, transfer and dismiss government employees. The Ministry of Health attempts to keep its authority to appoint hospital staff, procure medical supplies and equipment; it may do so directly or indirectly by selecting and appointing Board members. Management information systems continue to collect activity measures to be aggregated at the national level for statistical purposes and do not provide financial and clinical data useful for decision making by the Boards and by senior management.[16]

Also attempts to establish sophisticated systems of public financial management, including PFM/IC, when existing systems of public financial administration are weak, are mistaken. Examples of public financial management reform failures are given in a research study 'Evaluation of Public Financial Management Reform'.[17]

Weakness in public financial administration is identified by extensive levels of corruption and fraud, weak budgetary and financial controls or poor application of such controls, by lack of trained and experienced civil or local government staff and by instability in staffing arrangements, often demonstrated by political interference in operational management because of a lack of trust. This in turn prevents the development of the ideas of 'delegation' and 'managerial accountability', both of which are essential to the establishment of PFM/IC and management more generally. In such circumstances introducing sophisticated systems which, if they are to work, means giving more discretion to individuals without a strengthening of accountability. This will only exacerbate current problems, not lead to their solution. This point about building quality before switching from external to internal control has been made by Stephen Peterson in his book on the lessons from Ethiopia's 12-year reform[18]

---

[16] Social Science and Medicine 2017, Pgs. 74–80, De Geyndt: journal homepage: www.elsevier.com/locate/socscimed.

[17] OECD, published by Swedish International Development Agency (SIDA) 2012.

[18] Public Finance and Economic Growth: S. Peterson. Routledge, 2015, p. 254.

"A coherent financial reform requires an alignment of the *purpose* of the financial reform, building financial administration or management, with the operation of the state, administration or management. A principal and possibly key reason that financial reforms have failed in developing countries, especially Africa, has been the attempt to insert financial management into states that have weak administration." As Professor Peterson says, "How can you build a sophisticated financial management system onto a weak public administration system?"

1.4 Implementing Reform from a Management Perspective

Looking at the implementation of PFM/IC from a management perspective this raises a specific set of issues that need to be considered. These are discussed in the following sections.

These are questions that the top management (ministerial and state secretary or equivalent in local government) together ought to be asking and they involve cooperation between political and operational management. They apply equally to both expenditure and income.

1. How do we best deliver the policy and the objectives we are expected to deliver;
2. How do we deliver those objectives to time, to standard and within budget;
3. How do we deliver those objectives efficiently and effectively;
4. Is the present organisational structure appropriate for the purpose;
5. Do we have an appropriately skilled management and workforce;
6. Do we have the necessary resources and information, financial and performance;
7. How do we ensure that public resources, including assets, are only used for approved public purposes;
8. How do we ensure financial resilience for the organisation, not just for the current year but into the medium and longer term;
9. Are the accountability arrangements clear and effective, both internally and externally?

The order of the importance of each of these questions and which element of management has the most interest in them lies with the circumstances that prevail in each country seeking to introduce PFM/IC. Failure to approach this reform in this manner will affect its success. In answering these questions, the top management, both political and official, also need to ensure that the culture prevailing in the organisation is one that is focussed upon the interests of the user of public services; that those to whom authority is delegated are prepared to accept the conditions of delegation and accountability and that the operational environment enables them to do so. The public interest should be paramount.

These managerial elements of the reform process are not addressed just by the technicalities of PFM/IC. They need to be addressed as part of the processes of a public administration reform leading to a focus on management. (The relationship between the PFM/IC reform and public administration reform is discussed in Chap. 14.) That such a public administration reform should occur and ideally precede a PFM/IC reform is essential as part of the preparation for the introduction of PFM/IC. A PFM/IC reform cannot be used to drive managerial reform: managerial reform needs to come first. As the PFM/IC reform requires a high degree of managerial skill the reform should not be entered into without a full appreciation of what will be required in terms of managerial capability as well as the extent of the technical reforms that will be required.

If the argument is that the civil service/local government service does not have that capability, this in fact raises the whole question as to whether a PFM/IC reform is appropriate anyway. Introducing the PFM/IC reform without civil and local government service reform, unless it already has a managerial capacity, is a mistake. A consequence, if the reform is to go ahead, is that the reform will take much longer to implement with the risk, even likelihood, that the benefits will not be achieved. However, the reality is that this is what frequently occurs. (Personnel development is discussed in Chap. 14.)

Planning the implementation of PFM/IC, as is shown above and in later chapters of this guide, should recognise that there are a series of important strands that need to be addressed to accommodate both the managerial and financial changes that accompany the reform. These include

- an emphasis upon managerial decision making within the delegated parameters designated for each level of management, to achieve objectives efficiently and effectively and within budget;
- a reconsideration of the relationships between central and line ministries to facilitate decision making at the line ministry level whilst retaining overall financial and budgetary control;
- reform to the budgeting arrangements to provide the information managers require;

- development of the financial and performance information that managers will require including the development of cost and management accounting;
- reform to the information technology systems (IT), both to extend their use and to amend current systems to make them 'managerially friendly';
- the development of accountability and transparency arrangements and encouraging parliament, interest groups and users of public services in reviewing performance to bring together finance and outputs and for parliament to develop a capacity to consider budgets and reports not just in terms of financial inputs but also in terms of expected and actual outputs.

Because PFM/IC represents such a radical managerial change the cultural environment in which decisions are made also needs to change because this creates new risks. This is addressed in Chap. 6.

A crucial element of this reform should be to create a civil and local government service that has a capacity to advise ministers (and mayors) on policy issues based upon their experience of operational management and to deliver public services efficiently and effectively within budgetary and legal specifications and the politically determined policies.

Also, citizens want to see that public funds (their funds!) are well spent and that legal and regulatory rules are adhered to. Managers and policy makers do not have a monopoly of wisdom over decisions about service levels and there is an increasing trend to encourage public participation in decision making processes including in the budget process. The benefits have been summarised in this way:

> Good public participation practices can help governments be more accountable and responsive to their communities, and can also improve the public's perception of governmental performance and the value the public receives from their government. Transparency is a core value of governmental budgeting. Developing a transparent budget process will improve the government's credibility and trust within the community.[19]

The solution to public sector problems frequently requires reliance on several public organisations coordinating their activities. It may also require coordination with private organisations. A single organisation thinking that it can alone solve a social or other form of public problem (such as the alleviation of homelessness), that is, a silo mentality approach, can be mistaken. Yet very often individual ministries are allocated specific responsibility even

---

[19] https://www.gfoa.org/materials/public-engagement-in-the-budget-process.

though an effective solution depends very heavily upon utilising the resources and expertise of other organisations. A feature of PFM/IC is information and coordination and that just does not mean within an organisation but more widely. This again is a management responsibility and is not simply addressed by thinking only in terms of budgetary and financial control within a single organisation. Management needs to consider this wider dimension in preparing budgets and in the form of the accounting and performance arrangements that will be necessary to enable managers to maintain control and determine how well they are achieving their objectives and very often in cooperation with managers from other organisations. This again raises the question of how such operational service coordination that can be required over time can be best achieved. That coordination may be essential in considering how to achieve efficiency and effectiveness.

However, preventing the development of a 'silo mentality' can be extremely difficult. Programme budgeting is in theory a solution to this problem but programmes are frequently just focussed on individual ministries with line ministry managers reluctant to share budgets with other organisations.[20] A ministry of finance can exercise pressure to encourage budget sharing but, in practice, to be successful a cabinet decision led by the prime minister (or in some countries by a president) with parliamentary support may be essential.

1.4.1 Longer Term Public Financial Management

In many countries, whether operational management is the responsibility of political or civil service officials, public services and activities are not *managed* but are *administered* in accordance with traditional practice. This means that the focus of financially based control is on spending the items of the current year's line-item budget with little or no regard to the longer term even where medium term budgeting exists. Also, no practical regard is had to how to improve efficiency and effectiveness as part of the administrative arrangements even though often budgetary announcements may be coupled with expressions of intent to make such improvements in public service delivery. However, most public sector objectives along with improvements in efficiency and effectiveness cannot be achieved within a single year or even a medium-term time horizon of a three- or four-year budgetary period. Effective management of public services requires that regard should be had to the longer term time horizon over which objectives may be achieved along with

[20] A senior UK civil servant once informed this author that she would not be prepared to advise her minister to agree to any sharing of the budget.

improvements in efficiency and effectiveness. This is not about multi-year budgeting but is about establishing a longer term financial perspective of the costs of implementing public policy in providing particular services. That longer term financial perspective is necessary for a better quality of budgeting. That financial perspective is likely to reach beyond the conventional three- or four-year period of medium-term budgeting. Longer term budgeting is also not a simple projection forward of existing budgets and allowing for inflation. It needs much more extensive analysis. Effective management requires that an organisation has a capacity to prepare long-term financial forecasts reflecting all circumstances such as the ongoing future costs of current policies and investments as well as the factors that are likely to affect those future costs and the ongoing financial resilience of the organisation. These other factors would include the financial impacts of, for example, changes in the population, legislation, technology, in the environment, including climate change and so on. Only then can management prepare longer term service plans where the impact of potential ‘shocks’, such as budgetary limitations, on service delivery can be properly assessed. If such longer term analyses are not made, those responsible for service delivery can then be forced into short-term ‘service cuts’ to accommodate unforeseen events which are almost inevitably uneconomic and damaging to service delivery. Longer term financial forecasting, which may cover any period from three to ten years (depending upon the service concerned such as its capital intensiveness) is an important factor in achieving greater efficiency and effectiveness in service delivery and is an important element in the development of PFM/IC. Again, this is frequently overlooked in its implementation or if forecasting is attempted it is treated as a token type of exercise.

Another feature of longer term public financial management is the long-term financial resilience of a public organisation. Political management should be advised by the civil or local government service against making policy or investment decisions which are unlikely to be capable of being financed over the longer term. That way leads to a lack of financial resilience or an inability to continue with the present patterns and standards of service delivery or, for say a local government. an inability to remain solvent. (The financial perspective of a state secretary (or equivalent) is always likely to be longer than that of a politically appointed official and this should be reflected in how a state secretary considers the financial viability of an organisation.)

1.4.2 Ownership of the PFM/IC Reform and Stability in the Reform Process

Another factor which is frequently not considered is the ownership of the PFM/IC reform and stability within that ownership. This is also an element in the cultural issues that were referred to earlier. 'Ownership' raises the question, whose reform is it and that in turn affects its acceptability? Is it an externally imposed reform as part of a financial aid package (bearing in mind that the motives of the providers of financial aid packages are not necessarily the same as those of the recipient government)? Or, as for European countries, is adoption of the reform a condition of membership of the European Union? Is it a reform wholly embraced by the government itself or only by the ministry of finance? Within individual government organisations the question becomes, is it a reform that a ministry or local government itself wishes to see implemented or is it to be imposed by an external organisation such as the ministry of finance. And within that as the reform is applied who becomes the 'owner' within individual organisations?

There is also the question of the overall owner within a government. Usually this is the minister of finance but whether this is a sufficiently high level of ownership depends upon the status and experience of the minister of finance and of the ministry of finance. If that minister does not have a high status within the government, to be successful the overall owner might have to be the prime minister, whose support is essential anyway. High-level ownership is essential to successful implementation.

Externally imposed reforms have much less chance of being successful in the longer term, especially where the benefits cannot be perceived. This is because they are lost in the bureaucratic arrangements which often occur with such reforms (not least with public financial management reforms). Equally, even if reforms are externally imposed, there does need to be a 'local owner' and leader who is sponsor of the reform within the organisation. The question then is who is that to be? This in turn raises the question of consistency. If the 'owner' or leader changes frequently, as is possible when the owner or leader is a political appointee, can consistency of policy be maintained and maintained continuously? At the individual public organisation level, such as line ministries and local governments, ownership ought to lie jointly with the political leadership and the civil service or local government official leadership. Civil service or local government ownership is essential where operational management is their responsibility. The technical aspects of PFM/IC do require considerable technical knowledge and the owner must also have considerable persuasive powers to secure implementation within large and complex organisations (as ministries and larger local governments are).

Similarly, a minister of finance or the state secretary within that ministry will need to persuade key officials within the ministry to accept the implications of the reform for that ministry. For example, the head of the budget department will need to be persuaded that the budgetary arrangements should be redesigned to meet the needs of the manager as well as those of the ministry of finance and similarly with financial information. Again, persuading the department or ministry responsible for personnel to recognise the need to allocate personnel costs in a manner which promotes effective management may also prove difficult. Also, persuading those responsible for determining salary structures to recognise the enhanced role of the head of finance and finance department staff and hence to attract appropriately trained and skilled personnel may prove difficult. (Not the least of these reasons for difficulty will be that they upset traditional arrangements.)

Achieving 'ownership' and its continuity are among the most significant challenges to be faced by those responsible for the application of this reform, yet they are usually never considered where the reform is treated as a technical bureaucratic reform ignoring all these managerial and cultural implications. Or where the pressure for reform comes from external organisations such as providers of aid, the driver of implementation is likely to be the donor rather than an 'internal' owner. Neither of these approaches will lead to success in terms of achieving the benefits of the reform.

1.4.3 Corporate Governance (or 'Good Governance')

Corporate governance is rarely considered in the process of introducing PFM/IC. This is even though an essential feature of the reform is promoting good governance, including transparency and accountability. Corporate governance has been defined as being about the way in which public organisations are directed and controlled. The design of the structures of governance within organisations and not least between political and appointed officials and between first- and second-level organisations should have regard to the requirements of corporate governance. A failure in such relationships can lead to serious adverse consequences.[21]

[21] A recent example of such consequences was described in a report on the financial problems of Croydon Council, a UK local authority. The Penn report 2023 | Croydon Council, www.croydon.gov.uk.

Accountability is an important feature of corporate governance and associated with accountability is transparency. Transparency is a key factor in developing 'trust'. There are two elements to accountability. One is internal accountability. A need for operational management accountability as an essential element of the PFM/IC reform is widely accepted. It should demonstrate how efficiently and effectively objectives and performance standards have been delivered to the senior and top management of an organisation. A second is accountability to external interests, that is, external to organisations such as parliament, to the service user and taxpayer, that is to civil society. External accountability, particularly to parliament, has been referred to earlier in this chapter but is usually not considered in PFM/IC reform proposals. A fear appears to be that external accountability exposes governments to criticism and risk. Yet, transparency and accountability enhance the benefits from the implementation of PFM/IC as the following quotation demonstrates: "International experience, from research, … show(s) that there is a strong positive correlation between accountable and transparent political and economic institutions and the sustainability of the development outcomes."[22]

Corporate governance should be therefore a factor that the government, the minister of finance and ministers and mayors as well as senior civil service and local government officials should take into account and incorporate into guidance on the application of PFM/IC.

PFM/IC, if properly implemented, improves the quality of governance because it makes clearer who is responsible for what. It also causes the distribution of responsibilities through the introduction of delegation accompanied by managerial accountability arrangements, so that those responsibilities are no longer focussed wholly upon a single or very few senior, usually political, officials. Because PFM/IC encourages the separation of policy decision making and the strategy for implementing those policy decisions from the actual execution and operational decision making, it gives to top and senior management more time to focus on strategy and policy and hence potentially improve the quality. It also potentially allows operational decision making to occur at the level of an experienced operational management. This is because through delegation, operational decisions are more likely to be made by persons (civil or local government officials) who should have longer operational experience of a service or activity than elected officials whose tenure in office can be limited and often they will have no practical experience in the delivery

[22] Keynote Address: Transparency and Public Accountability is at the Core of Good Corporate Governance: Dr. Idah Pswarayi-Riddihough, World Bank Country Director for Sri Lanka and the Maldives: April 2018: https://www.worldbank.org/en/news/speech/2018/04/10/keynote-address-transparency.

of the service or activity for which they are responsible. Separation of operational decision making also allows operational decision makers to focus on the operational considerations rather than being influenced by political considerations, although such considerations may influence operational decisions.

Governance also includes the arrangements put in place to ensure that the intended outcomes for stakeholders, who could include service users, taxpayers and other interested parties (i.e., civil society), are defined and achieved.

An international framework[23] describes the fundamental function of good governance in the public sector as being to ensure that public organisations achieve their intended outcomes while always acting in the public interest. This framework further defines what acting in the public interest means, that is:

> Acting in the public interest requires:
>
> A. Behaving with integrity, demonstrating strong commitment to ethical values, and respecting the rule of law.
>
> B. Ensuring openness and comprehensive stakeholder engagement.
>
> In addition to the overarching requirements for acting in the public interest in principles A and B, achieving good governance in the public sector also requires effective arrangements for:
>
> C. Defining outcomes in terms of sustainable economic, social and environmental benefits.
>
> D. Determining the interventions necessary to optimise the achievement of the intended outcomes.
>
> E. Developing the entity's capacity, including the capability of its leadership and the individuals within it.
>
> F. Managing risks and performance through robust internal control and strong public financial management.
>
> G. Implementing good practices in transparency, reporting and audit, to deliver effective accountability.

1.4.4 The Timing of the Reform

Because introducing PFM/IC is a major reform, there is no 'quick fix' such as simply introducing a law specifying what is to be done coupled with the introduction of a series of additional bureaucratic procedures. The introduction of PFM/IC will take a considerable period of time to implement across a public

[23] International Framework: Good Governance in the Public Sector: IFAC: CIPFA (2014).

sector, maybe 10–15 years[24] or more, although where there is a decentralised state each with a regional government implementation is likely to take longer. Not only within this period will the techniques associated with PFM/IC need to be implemented, including the extended financial and performance information systems, but also and fundamentally the managerial changes that will be required, including the inculcation of managerial skills. This will require the development and/or employment of skilled managers and in some countries a refocusing of elected official interests away from day-to-day administrative and operational arrangements towards the development of policy and strategy together with an oversight responsibility for operational management activity.

Indeed, introducing PFM/IC is really an ongoing reform as experience is gained and new ideas emerge. What is important in the first stage in the implementation of PFM/IC is to put in place the basic elements of this reform, that is:

- The sponsors of the reform having a clear appreciation of what the reform is essentially about with its managerial implications and promulgating widely that appreciation;
- Ensuring that a robust and skilled financial administration exists;
- That service delivery objectives, performance objectives and performance standards are established;
- Trust is built between the political level and the civil and local government service officials facilitating the delegation of operational responsibility and between central and line ministries;
- Establishing managerial structures accompanied by delegation and managerial accountability for operational management;
- Reorganising budgetary and financial accounting arrangements so that they not only provide the information and budgetary control that the ministry of finance requires but also provide the managerial information the managers require to enable them to deliver the objectives efficiently and effectively, to standard, to time and within budget;

[24] Comprehensive reform programmes usually have a time perspective of 10–15 years. This will allow capacity development measures to start at the earliest stage of reform planning without necessarily delaying the reform work. However, in practice, there may be a conflict between this view and the desire of certain donors and government to start implementation at the earliest possible date without providing scope for capacity development. The result may be the early production of reform plans that can be characterised as shopping lists rather than reform efforts. There will be a need for a strategy on when and how to use technical assistance and also to liaise with and incorporate ongoing reform efforts in order not to waste knowledge and lose momentum. Public Finance Management in Development Co-operation—A Handbook for SIDA Staff 2007 para 6.3.1.

- Developing a financial analytical and a long-term financial forecasting capability;
- Ensuring that managers, and policy makers, have the statistical data they require to accompany financial data;
- Ensuring that the objectives and activities of second-level organisations (such as agencies and state-owned enterprises) are consistent with those of the owning first-level organisation and that second-level organisations operate to the same standards as those expected of first-level organisations;
- The development of a parliamentary capacity to scrutinise managerial performance (this would go beyond that required to address the reports of the state auditor).

Only towards the end of this schedule of activity would it be appropriate to seek to introduce the bureaucratic elements associated with the reform such as the five elements of international best practice bureaucratic (i.e., COSO) requirements (see Chap. 11). What PFM/IC is *NOT* about is simply introducing those five elements. Yet this has been the focus of much reform activity, especially in countries joining or aiming to join the European Union and then seeing this as the starting point for the reform. These practices are important but they are only facilitators and what matters is the quality of leadership and management and how management utilises the information becoming available from those practices. In other words, these are techniques for management to utilise.

Because of the length of time that the reform will take to implement, there is a risk of 'reform fatigue'. Therefore, a staging process should be developed where key milestones are established with progress measured against those milestones.

1.5 Applying This Reform

Applying this reform will be complex as well as requiring a long-term time horizon. Set out below is a summary of the key practical issues that need to be taken into account.

1.5.1 The Practical Consequences of the PFM/IC Reform

This section brings together issues that have been referred to earlier in this chapter. As has been shown the consequences of applying the reform extend well beyond introducing the various bureaucratic requirements because of the significant managerial implications and the impact upon budgeting and accounting arrangements. (A detailed summary of the impacts of the reform, which are very wide-ranging, is given in the annex to this chapter.) However, a key preliminary condition before countries should adopt PFM/IC is that their present public financial administration/financial control arrangements are robust. This means that fraud and corruption have limited effects; that very importantly a robust system of financial control exists and consequently that budgets are well managed. If this is not the situation, then a preliminary reform should be to ensure that the present arrangements for public financial administration are reformed to make them robust and that manipulation of the public finances does not occur through any systematic abuse of the control system. Examples of the latter have been given earlier in this chapter. Why the existence of a robust control is so essential is that a key feature of PFM/IC is the development of managerial discretion and delegation with the transfer of control responsibility from an external control by a ministry of finance to an internal control by an organisation itself. The quality of internal control then becomes primarily the responsibility of the management of each public organisation.

Another key practical, and in some countries controversial, consequence of the reform is the delegation of operational management from the political level of management to the official civil service or local government service level. For some countries this will be a significant change of approach and will require change to organisational structures. These will, in effect, be demanded by the practicalities of establishing a professionalised approach to the management of the delivery of public services. This will have major consequences for how civil and local government service officials are trained as well as how accountability arrangements evolve between the official and political levels of management. However, the reality is that not all operational management decisions need to be delegated and there will be some circumstances where delegation is inappropriate. (In Chap. 14 a discussion is included about where and where not delegation is appropriate.) A major advantage of delegation is that it creates a more informed civil (and local government) service. This is potentially to the significant advantage of the politician in the formulation of policy where cooperation between the political and operational managerial levels is highly desirable.

Because managers will require different budgetary and financial information for effective management from a ministry of finance, this will potentially expose differences between a ministry of finance budget department and line ministry managers. This could be a source of resistance and tension. The manager also requires performance information. Finance and performance need to be linked and this linkage should affect the construction of the budget as well as the type of financial analysis the manager should require. Again, this is a potential source of tension between the manager and the ministry of finance budget and financial accounting (sometimes called treasury) departments. As has been pointed out earlier, the form of analysis that suits a ministry of finance is rarely likely to meet the needs of the manager, especially where the manager is responsible for delivering objectives and performance standards efficiently and effectively as well as service quality. This involves a challenge to the traditional practices and controls exercised by a ministry of finance. It also requires the development within public organisations, other than a ministry of finance, of more sophisticated financial analytical systems (i.e., management accounting) with the development of the capacity of managers to utilise those systems. This also raises questions about the capacity of finance officers within organisations. Do they have the training to provide the information that managers require including advice about the development and strategy for the implementation of policy? They also need the analytical skills to identify those factors which impact upon efficiency and effectiveness. The question then is how are such skilled persons to be trained, recruited, used, retained and integrated into existing career structures? These are not skills that are readily available within governments and require the employment of professional, that is, more expensive, staff. Those responsible for implementing PFM/IC need to address such questions.

Also required will be performance information systems. These must be robust, relevant to the needs of the manager but subject to independent control so that the manager is not able to manipulate the information flowing from those systems and in that way demonstrate a better performance than is actually occurring.

A managerial responsibility with PFM/IC is to deliver an objective to time, to standard, within budget, efficiently and effectively. This is a far more difficult task than a simple requirement to ensure that expenditure does not exceed a prescribed budgetary limit. This demands a skill and expertise that requires development, and this in itself will mean that PFM/IC cannot be introduced without managerial change and then over a period of time as experience is gained. PFM/IC establishes a need for a high quality of managerial skill. Consequently, the reform should not be entered into without a full appreciation of what will be required in terms of managerial capability as well as the extent of the technical reforms that will be required. This therefore means thinking about how such managerial staff will be trained and/or recruited and retained. Are there, for example, to be negotiations with a university to provide appropriate managerial courses, and if there is not a capability to provide such courses, then how are they to be developed?

1.5.2 How Will the Existing Political and Operational Management React in Practice to Advanced Public Financial Management Reforms?

Where advanced public financial management reforms are to be introduced, reformers need to address how operational management is likely to respond to such reforms. This determines how effective they are likely to be. Mellett et al. (2007) have pointed out that in the example of the application of accrual accounting in the United Kingdom's National Health Service, which has a sophisticated management, managers did not in fact utilise accrual accounting information.[25] Similarly, in a review of three decades of public sector reform in the United Kingdom, Christopher Hood and Ruth Dixon concluded: "As to reform making the Government Work Better and Cost Less there has been No Change."[26]

Again, with the introduction of another technical reform, programme budgeting, although there are different approaches (analytic and managerial), a study in 2012 by the Korea Institute of Public Finance and the World Bank pointed out that even though "experience in some … countries have shown that programs need to have clearly designated 'owners' with responsibility for the performance of each program. In practice, more than one 'owner' for a program means that resource allocation usually remains unresolved among the different owners, which defies one of the most important rationales for program budgeting. Furthermore, in such cases, it has proven extremely difficult to assess the individual performance of the 'owners' involved." This study also identified that "a program inherently is a broader category of expenditure than an activity; hence, switching to a program structure inevitably enlarges the capacity of managers to decide how operating resources are used."[27] The questions that this raises include is there the managerial capacity to support a programme approach and are the budgetary and accounting systems capable of adapting to the managerial requirements of a programmatic approach?

---

[25] NHS Resource Accounting in Wales: Problems of Implementation: Mellet et al. (2007).

[26] A Government that Worked Better and Costs Less? Evaluating Three Decades of Reform and Change in UK Central Government. Oxford University Press. Hood and Dixon (2015, Table 9.2, p. 182).

[27] From Line-item to Program Budgeting Global Lessons and the Korean Case 2012. Edited by John M. Kim: Korea Institute of Public Finance and the World Bank: pages 21/22.

Another example illustrating the reaction to advanced financial management reforms where either strong coordination/support with local management did not occur or was inadequate or the purpose of the reforms was not fully understood has been described in a study investigating the implementation of public sector accounting reforms in Egypt, Nepal and Sri Lanka. This study described the factors that affected implementation resulting in "resistance, internal conflicts and unintended consequences, including the fabrication of results, in all three countries without any evidence of yielding better results for public sector and accountability."[28]

These examples emphasise the need for much greater consideration to be given by advocates of PFM reforms to the impact upon organisational cultures, management and leadership arrangements. How are managers to be encouraged to support the reform and to make use of the reform information for practical managerial purposes? From a PFM/IC perspective, unless this occurs the benefits will not materialise. For example, whilst the opportunity will emerge to improve efficiency and effectiveness it will only happen if the manager wants to do so and utilises the information that becomes available. The role of the leadership of the organisation (political and senior official) is to encourage the operational manager in this approach and to create the environment that accepts this as 'normal and expected' behaviour.

1.6 Individual Governments and This Reform

Each government wishing to introduce PFM/IC will need to make some adaptations to what is described in this guide in order to reflect their own administrative, legal and cultural backgrounds. However, in making any such adaptations those responsible for the reform should not move away from the principle that this reform must require a management capability to be effective. Financial management and internal control *are* a managerial responsibility. In other words, governments should not treat this reform as simply a reform designed to further tighten financial and budgetary controls. Though there are exceptions—some glaringly so—most countries already have tight budgetary and financial controls. These controls are often achieved in theory by systems/techniques (e.g., IT-based treasury financial accounting systems). Where weaknesses exist, the source of those

[28] Unintended Consequences in Implementing Public Sector Accounting Reforms in Emerging Economies: Evidence from Egypt, Nepal and Sri Lanka: Adhikari, Kuruppu, Ouda, Grossi, Ambalangodage: International Review of Administrative Sciences October 2019.

weaknesses is usually a management failure in one form or another. What are also frequently lacking in countries adopting PFM/IC reform are objectives and performance standards along with those controls designed to achieve those objectives and performance standards. This is firmly a managerial responsibility, and this reform is designed to remedy that. Another deficiency is a lack of substantive measures to improve efficiency and effectiveness. Another commentator on management, Peter Drucker, defined effectiveness as 'doing the right thing' and efficiency as 'doing the right thing right': this is succinct and illuminating.[29] Whilst the terms efficiency and effectiveness are used frequently, in many countries they are not supported by substantive measures to identify how efficiency and effectiveness can actually be improved. The PFM/IC reform, if properly defined and applied, will address this and make such improvements possible, providing managers are prepared to take the necessary actions, that is, again a management issue.

PFM/IC adds significantly to the day-to-day responsibilities of operational managers. This is because there are several features that improve the quality of operational management. These include the setting of and accountability for the achievement of objectives and performance standards, strategic and business planning and financial analysis to achieve efficiency and effectiveness and the emphasis upon risk identification and management. These are all factors which are designed to facilitate the achievement of objectives efficiently and effectively and hence for managers to be engaged in. These features alone may require the significant organisational change as well as budgetary and accounting change referred to earlier. Not to recognise these will simply mean that the reform is just a cosmetic and is not worth the effort and cost because it will not produce the benefits that could otherwise accrue. How quickly the reform can be introduced will depend upon the administrative, cultural and legal background. Therefore, the timescales and approaches are likely to differ between countries.

Countries should also recognise that this reform is a continuing process as experience is gained and circumstances change. There is effectively no 'end date'.

The long timescales—years if not a decade or more—will create a challenge to the ability to apply the PFM/IC reform. The officials driving the reform will change. Importantly, if the reform relies on foreign aid funding, the patience of the funder and/or availability of funds is rarely long term. A critical policy question for governments is whether they should even rely on

[29] "Efficiency is doing things right; Effectiveness is doing the right thing." Peter F. Drucker.

external funding for the reform of core government systems. The term dates for such funding are generally relatively short and do not reflect the complexity and timescales for the reform of such systems including PFM/IC. In such circumstances governments should consider whether to fund this reform directly treating any aid funding as a 'bonus'. The argument in this guide is that this reform is so important, with its managerial implications, that it is desirable in any event. A country's financial system is at the core of its sovereignty and that makes it desirable for a government to be determined in its ownership and hence its willingness to secure the reform over time with its own funds as far as possible.

1.7 Structure of This Guide

The initial chapters of this guide provide an overview of PFM/IC. A detailed explanation is also provided of the differences between public financial management and internal control and public financial administration and internal control. Following this different chapters explain the responsibilities of the key officials who will be involved in implementing this reform. This is then followed by chapters explaining different aspects of the reform including the benefits and costs, the international standards of internal control, the impact upon the management of second-level organisations, the significance of transparency about the quality of the internal control arrangements and the relationships with public administration reform.

1.8 Summary

This chapter emphasises the nature of this reform and, in particular, that it is not just some form of financial technique but requires a management reform. What is also necessary is that there is clarity of understanding by parliament and particularly at the higher levels of government, and of their commitment to the reform. With that commitment they need to recognise what this reform is really about, namely, that the reform is principally about the more effective achievement of the government's policy objectives and making better use of public money. This consequently affects attitudes to external accountability, not least to parliament including the information available to parliament and also to civil society.

This reform cannot be successful unless it is linked to public administration or civil service reform. Such reforms ought to change the role of political leaders as well as appointed officials with, in principle, policy execution including operational management becoming the responsibility of the civil or local government service officials and with the political level focussing on the development of policy, the strategy for the implementation of that policy and the supervision of the operational management. However, to be successful the reform must have regard to the local culture, the support of the local leadership and the present quality of the public administrative arrangements. Trying to build an advanced form of public financial management onto a weak administrative structure will not work and a first step in such circumstances has to be to improve the quality of the present administrative arrangements. Merely regarding this reform as desirable because it represents international best practice is a mistake because international best practice has no regard for the local culture and it contains assumptions that do need to be considered in its application.

Other factors affecting success with this reform are ownership, leadership of the reform process and a willingness to change established practices so that managers can have the information that they need, not least financial and performance information, and this information may be different from that required by a ministry of finance.

In undertaking this reform regard should be had to the impact on the corporate governance arrangements and that applying the reform will take a long period of time. Consequently, consistent political support will be needed.

This introductory chapter deals only briefly with many aspects of the reform. Later chapters will address individual issues in considerably more detail.

Annex 1

Likely Consequences of the Reform

There are many consequences of the adoption and application of the PFM/IC reform. Some are referred to in detail in Chap. 1 and others are discussed in more detail in later chapters in this guide. These consequences are summarised below.

The Managerial Consequences of the PFM/IC Reform

- A separation should exist between responsibility for policy making and strategy development (i.e., these should lie with politically appointed officials) and responsibility for policy execution including all aspects of implementation (i.e., these should lie with appointed civil and local government officials), although where the boundary is drawn will vary and depend upon circumstances and policies. (In practice in many countries this separation does not exist.) However, effective policy making does depend upon the building of cooperation between the policy maker and those responsible for implementation. Without that policy is being developed in a vacuum. Effective policy making depends upon quality analysis of information including, for example, information about what drives costs and political decisions about cost drivers (examples would be pupil/teacher ratios and penal policy) will determine the costs of providing a service.
- Objectives and performance standards should be set by the political level of management and linked with budgetary availability (frequently none of this is clearly defined).
- Operational objectives should be based upon reliable statistical analyses where appropriate (this very often does not occur).
- The head of operational management such as a state secretary (or equivalent in local government) should have a specific responsibility for the quality of operational management and the delivery of policy objectives and performance standards efficiently and effectively. In some countries no such position exists or where it does the official has relatively little authority.
- Operational management structures should exist designed by the head of operational management to deliver the objectives of the organisation (however, because objectives are not clear neither are managerial structures).
- The head of operational management should have a specific and personal responsibility to ensure that systems exist to secure effective control and utilisation of the resources of the organisation, even though a political appointee (such as a minister) may have an overall responsibility. Often the allocation of responsibilities is not clear.
- The head of operational management should ensure that assets are used efficiently and effectively and if that is not possible disposed of. In practice, assets are frequently not well managed because no such personal responsibility exists, and in effect under, or improper, use can represent a significant waste of public resources.

- The effective application of the international PFM/IC standards should be a responsibility of the head of operational management: that head should then be responsible to the political head for the quality of their application. This responsibility can only be exercised once an operational management has been established and has received management training: the international standards are not ends in themselves, they are designed to facilitate effective management and their mere legal application does not make for effective management.
- The head of operational management should ensure that new services or activities or new investments are not entered into without a full financial appraisal of the financial and investment consequences for both the current year and future years. This often does not occur because no longer run forward financial forecasting exists or effective long-term financial planning.
- The head of operational management should ensure that all risks to the achievement of the organisation's objectives and the delivery of its services and activities are identified, evaluated and monitored. Risk management is often not well developed and at best is focused upon systems rather than also encompassing managerial objectives, not least because managerial objectives do not exist or if they do exist, they do so only in a generalised form.
- The head of operational management should ensure that no new risks are taken which would impact upon the delivery of the objectives, services and activities without a full financial appraisal of their impacts: this includes all fiscal risks and not least those that may arise from any 'off-balance sheet' financing arrangements such as public/private partnerships and leasing. The identification, proper authorisation and management of fiscal risks are usually not a feature of developing and transition economy financial management arrangements.
- The head of operational management should have a concern for the quality of public expenditure. This means that simply adhering to spending limits is not enough. Each ministry and other public organisation should focus on what was achieved with the allocated resources and how well resources were used, that is, how efficiently and effectively and for some activities equitably. An increased focus on outputs should improve the ability of political decision makers to prioritise objectives as well as improving the quality of the services that are being provided. (See also accountability and transparency below.)
- The head of operational management should ensure that annual financial reports are prepared in accordance with the appropriate standards: where international financial reporting standards are adopted, this is likely to

require the employment of skilled and qualified accountants even though such skills are usually not readily available in the public sector.
- The head of operational management should ensure that the organisation has the prospect of long-term financial resilience taking into account the long-term impact of those external and internal factors likely to affect it such as demographic change, climate change, environmental and regulatory changes, as well as the long-term impacts of policies and new and proposed investments. Long-term financial planning is essential to secure the long-run financial resilience of an organisation, but this is rarely if ever undertaken in developing and transition economy countries and it involves much more than medium-term budgeting.
- PFM/IC requires that corporate governance arrangements are enhanced which means a greater focus upon the stakeholder interest (effectiveness) coupled with increased transparency. This is primarily a responsibility of the political head of the organisation supported though by the head of operational management. This would largely be a new aspect of public organisation management in most developing and transition economy countries.
- The head of operational management should ensure that second-level organisations, whether non-market agencies or companies controlled or owned by the first-level organisation, are managed efficiently and effectively and not used to avoid budgetary and other controls. Usually, second-level organisations are subject to very loose, if any, controls and often agencies and state-owned enterprises pursue their own agendas. This adds to the problems of effective coordination. State-owned enterprises frequently appear to be inefficient and do not meet financial targets, which are often not set anyway. All second-level bodies are a potential source of inefficient and even corrupt activity unless effectively supervised by first-level organisations.
- The head of operational management should ensure that no officials are put in any position where that official can be subject to a conflict of interests. For example, in some countries the practice is to appoint officials to be members of the boards of second-level organisations. In this example where does that employee's loyalty lie?

The Control and Budgetary Consequences of the Reform

- The structures of control change. External control should move from a detailed control to a strategic form of control. Detailed control becomes an internal organisational responsibility, albeit so far as financial controls are concerned within parameters set by the ministry of finance. Other controls need to be developed by internal management to secure the delivery of objectives and performance standards, to time, within budget, efficiently and effectively. This would represent a radical change in control arrangements compared with traditional controls.

- Budgets should be organised in such a manner that they meet the needs of both the ministry of finance and those of the line ministry, or local government or second-level organisation management. Budgets generally do not display these characteristics with their format being wholly determined by the ministry of finance.
- Budgetary and financial controls should be adapted to respond to the needs of a managerial environment. Also, personnel controls may need to change. Such controls should have regard to the existence of a managerial environment.
- Whilst expenditure may occur only in accordance with agreed cash flow arrangements, cash flow controls may require modification to reflect the managerial environment. This also would be a major change from traditional cash flow control practice and would give to managers more influence over the timing of cash allocations.
- Expenditure planning should be undertaken in a manner which is appropriate to the needs of the organisation rather than simply the needs of the ministry of finance. Budgetary and cash flow considerations can prevent effective expenditure planning.
- The head of finance should ensure that unplanned arrears of expenditure do not arise and that managers do not incur liabilities which are to be funded from future year's budgets except in accordance with planned and agreed arrangements. This problem arises because expenditure planning tends to be annual even where medium-term budgetary frameworks exist, and because budgetary control is focussed upon expenditure limits, inadequate consideration is given to the linkage between physical activity and expenditure flows.
- The head of operational management should ensure that all procurement is undertaken according to agreed procurement rules. Procurement rules also need to be sensitive to operational circumstances and to have regard to efficiency and effectiveness rather than simply to least cost, which is the situation in some countries.
- Policies affecting taxation, charges for services and other income-raising activities should have clear objectives including that they result in equitable charges amongst those affected by the policies and that they facilitate effi-

cient and effective levy and collection arrangements. (Taxation policies will have more complex objectives than simply revenue raising. They will include, e.g., income redistribution, improving the operation of the economy, discouragement of imports to reduce an adverse balance of payments, promote stability in the economy, discouragement of the consumption of certain products such as tobacco and alcohol, and as a support to the promotion of government policies such as combating climate change. Taxation policies can be affected by international agreements, especially those affecting the taxation of companies.)

- The head of finance should ensure that all income due from the activities of an organisation, whether for charges, fees or other activities, is promptly invoiced and collected and that costs and losses on collection are kept to a minimum. This does not necessarily occur and pressure may exist which discourages promptness. Inadequate administrative arrangements and statistical data may also prevent the efficient and effective collection of income.
- The head of finance should ensure that operational managers have the relevant performance and accounting information to enable them to take responsibility for budgetary and financial control and for the achievement of objectives. This rarely occurs because budgets are usually simply designed to meet the needs of the ministry of finance. Also, individual managers may not know what their budgets actually are and they may have no performance information.
- Because services and activities are to be delivered efficiently and effectively, this means that operational managers need to be provided with the necessary financial analytical information linked to performance. This rarely occurs because the analysis necessary to achieve this does not exist nor the skills to undertake the analysis.
- To provide the financial and analytical information that managers will need with the application of PFM/IC, the head of operational management should ensure that a significant upgrading of the responsibilities and role of the head of finance will be required from bookkeeper/financial controller. The aim should be to ensure that this official is able to raise financial awareness throughout the organisation and to act as a financial adviser to management at all levels as well as providing the financial information and advisory support that a head of operational management would require to enable that person to properly exercise the responsibilities of the position.

The Accountability and Transparency Consequences of the Reform

- The linkage of financial inputs with envisaged outputs creates greater pressures upon managers at all levels to achieve performance, that is, the achievement of objectives and performance standards. This in turn enhances accountability at different levels. This includes providing an opportunity for parliament, perhaps through the establishment of a special committee, to assess the quality of the performance of the organisation and also at the budgetary stage enables parliament to have a specific, rather than a generalised, focus upon the objectives that are expected to be delivered for the resources to be made available. It also provides an opportunity for taxpayers, service user groups and other special interest groups (i.e., civil society) to have a clearer indication of what was expected to be achieved, not just what money was spent. Internally, it also provides the ministry of finance with better information about the quality of public expenditure.
- Transparency will be improved through the publication of reports about what has been achieved or not achieved rather than simply about expenditure compared with budgets.
- The budget is the critical document for parliamentary control and PFM/IC creates the opportunity to provide more information to parliament about objectives and performance indicators. Decisions need to be made about the extent to which such information should be provided and this should be following discussions between the ministry of finance and parliament. PFM/IC creates the opportunity for greater parliamentary scrutiny, transparency and accountability.

This is a significant list of managerial, technical and accountability consequences of the reform. However, it does illustrate that this reform is a significant reform with important impacts upon the managerial arrangements within ministries, local governments and other public organisations. As a consequence, this is a reform that is likely to take a considerable period to implement.

2

Implementing Public Financial Management and Internal Control (PFM/IC)

This chapter explains what is necessary to implement public financial management and internal control (PFM/IC). It discusses the role of parliament, how the different elements of PFM/IC can be achieved including what sound financial management means, what are cost drivers and cost centres and why such information is required by managers. It explains why there is a need to 'professionalise' management and the difficulties with doing so. It discusses briefly the role of the head of finance and the arrangements for the control of second-level organisations. It also considers how to achieve the benefits of the reform. This chapter expands on the argument introduced in Chap. 1 that the reform is not simply achieved by introducing a series of bureaucratic reforms based upon international standards. Management is of the essence and without good quality management the benefits will not be achieved. However, achieving the reform will not be easy and potential difficulties are identified and discussed.

2.1 The Context for Public Financial Management and Internal Control (PFM/IC)

The regulatory framework governing PFM/IC should be specified in a law or set of laws and other regulations approved by a country's parliament. The powers and duties of the different bodies involved in the processes of PFM/IC should prescribe how income is to be raised through taxation and other means and how public organisations are to utilise the resources made available to them. The law and the complementary regulations should be transparent and their application

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_2

predictable. This is so that those involved in the processes are clear in their responsibilities, that there is a consistency of approach and that civil society can comment on the political and managerial decisions that are made in the utilisation of public resources. The budget, which is the core financial document, will be developed by the ministry of finance and approved by the cabinet of ministers. It will represent government policy. Parliament should want to approve the allocation of resources and decisions about the raising of taxation and other revenues. It would do this through the approval of the budget which will then be enacted in a budget law. Parliament may establish a committee (e.g. a budget committee) to undertake detailed scrutiny of the budget proposals. At the end of the financial year, the parliament should also approve or not how resources have actually been spent during the year and in addition should have a view about how well that money has been spent. It may do this in three ways, one through the consideration of periodic expenditure statements submitted by the minister of finance including proposals for variations to the budget ('virement'), secondly through consideration of the report of the state auditor via the establishment of a public accounts/audit committee (or equivalent) and thirdly through scrutiny of the quality of public expenditure in some detail via the establishment of a special committee. Exactly how parliament would undertake these specific responsibilities would depend upon the arrangements applying in a particular country. For example, it may wish to approve all changes to the budgetary allocations or only the more significant ones. In some countries parliament may establish committees with the specific responsibility of reviewing public expenditure by different ministries.

In principle, this is no different from the traditional budgetary framework. However, with PFM/IC the content will be different.

PFM/IC creates the opportunity for greater parliamentary scrutiny and accountability because the budgetary arrangements ought to have a focus upon outputs as well as inputs. Traditionally the scrutiny role of parliament has been to review what has been spent against the approved budget and to approve or not any variations. PFM/IC adds to that scrutiny role by making it possible, because of the additional focus on outputs, for parliament to consider not only how public resources have been spent, but also how well they have been spent and whether objectives have been achieved and performance standards maintained. Parliament may be advised in this process of review by the state auditor. Parliament could do this by holding either the government itself or individual ministers to account on whether they have achieved the objectives and performance standards set out in the budget or indirectly through its use of the type of committee referred to above. An indicator of the strength of the parliamentary processes should be the existence of specific arrangements within parliament to review the effectiveness of the PFM/IC arrangements. A key figure in this review process should be the state auditor. The state auditor role should include ensuring that governmental activities are carried out in a manner consistent with parliament's intentions, and are effective, efficient and economical. The existence of a budget focussed upon outputs as well as inputs facilitates the development of this role.

Consequently, parliament should approve the laws and regulations relating to the introduction and development of this reform. Parliament should be consulted by the government about the policy of implementation and on progress during the application of the reform. As PFM/IC creates new opportunities for parliament to assess the quality of public expenditure, parliament should be concerned about the arrangements for the reporting of the activities of government and the quality of its performance. With PFM/IC as parliament is able to move from a simplistic concern for spending to a more complex concern for what public resources have achieved or not achieved, that is, both 'inputs' and 'outputs'. This provides greater opportunity to hold government to account and also individual ministries. (Chap. 13 discusses the form of reporting and the information that the report should contain.)

The ministry of finance will be the key ministry that parliament should relate to over the establishment of PFM/IC. This ministry should provide reports to parliament on the development of the PFM/IC policy and on its application within government organisations. Parliament should hold the ministry of finance to account for progress (or lack of it). This accountability process should act as a driver of the reform. The effectiveness of the PFM/IC reform should be reflected in the achievement by the government and, by extension, by individual ministries, of the approved policies, and objectives. Therefore, the focus of accountability is extended. Parliament should also be in a better position to ask questions about the efficiency and effectiveness of public expenditure and the economical use of public resources. Traditional public financial administration arrangements would not achieve these accountability benefits.

The conclusion is that PFM/IC can only be applied effectively if a functioning parliament exists. Parliament has an important role in the processes of implementing PFM/IC and in the complementary accountability processes. A functioning parliament is one that gives the public voice, ensures transparency, and has the capacity to effectively challenge the government through an accountability process. Political stability in the country should also be an important feature prior to the implementation of PFM/IC. Political stability is about the integrity and durability of the government structures. It does not mean that there can be no change of government rather that a change of government does not result in such an inconsistency of policy that long-term reform (such as

PFM/IC) cannot be implemented, that political consensus about the significance of the reform cannot be achieved and, in the example of PFM/IC, that the ministry of finance and its political leadership is unable to consistently focus upon the reform. Political instability may also be evidenced by social unrest which distracts policy makers from effective consideration of managerial issues.

2.2 Implementing PFM/IC Reform

Public financial management as a discipline consists of two main areas of activity covering all the components of a country's budget process. One is 'upstream' (including strategic economic planning, the development of medium-term expenditure frameworks, and annual budgeting): the other is 'downstream' including expenditure management to deliver services and activities efficiently and effectively, to ensure that assets are fully and properly utilised, that all resources are only used for approved public purposes, that revenues due to public organisations are managed efficiently and that procurement, control, accounting, reporting, monitoring and evaluation, audit and oversight are effective.[1] This guide focusses on the 'downstream' element of public financial management recognising that there is an overlap with the budget making process. (The quality of annual and medium-term budgeting arrangements significantly affects the quality of the 'downstream' activities.)

Public financial management covering both upstream and downstream activity has become by far the most common theme of public sector finance related reforms. A reason for this lies in the increasing use of budget support funding by aid agencies with their corresponding concern to ensure that such funding is not abused. As noted in Chap. 1, whilst countries may themselves initiate their own reform to implement PFM/IC, very often the initiative comes from third parties such as multi- and bilateral organisations as a condition for the granting of budget support funding. Budget support funding involves the transfer of funds directly to a country's own treasury and therefore relies on the strength and capacity of a country's own systems to ensure that funds are used for the agreed purposes and that they are used efficiently and effectively. Budget support funding, despite its advantages, does expose donor countries to greater risks of waste, fraud, and corruption and, as a result, there is a greater emphasis on countries to address these problems.

[1] See also OECD (2009) quoted by Bietenhader and Bergmann principles for sequencing public financial reforms in developing countries: *International Public Management Review* · electronic journal at http://www.ipmr.net, Volume 11 Issue 1, 2010, International Public Management Network.

When countries make the decision to adopt the PFM/IC reform unfortunately much of the advice that they receive from bi-and multilateral agencies is driven by the conditions attached to budget support. Very often this is based upon 'form' not 'substance', with short time-scales. Also, such advice may not be suited to the local bureaucratic and cultural context. Consequently, the focus in such circumstances is on developing and implementing the laws, systems, and accompanying bureaucracy that needs to be in place rather than considering the broader issues such as the human or managerial consequences. Those laws and systems are usually defined to represent international best practice which as was pointed out in Chap. 1 may be completely irrelevant to local needs. This is because a country may not have the governance, managerial capabilities, information or disciplinary structures, and skills that are necessary to ensure that international best practice provides a workable solution. There also may be inconsistencies with local cultural traditions. (The experience of this author is that, despite these problems, aid agency pressure tends to be to encourage countries to adopt advanced practice such as PFM/IC, based upon the idea that 'international best practice' represents the most appropriate solution rather than recognising that, as in this example, ensuring initially that PFA/IC is robust and that a managerial capability exists before proceeding with the more advanced reform.)

2.3 Who Is the Manager?

Because PFM/IC is as much a management reform as a technical financial reform, the question that then arises is 'who is the manager' and what are his/her responsibilities. This was discussed in Chap. 1 where the point was made that in some countries all management responsibilities covering policy and strategy development, policy execution and all other aspects of operational management[2] are the responsibility of politicians or politically appointed officials. In other countries, with more developed arrangements, a distinction is drawn between the responsibilities of politicians including other politically appointed officials, who are responsible for policy and strategy development and oversight of policy execution, with operational management including policy execution, being the responsibility of civil servants and local government officials.

[2] In this guide, policy execution and all other aspects of operational management are collectively called 'operational management'.

As has been explained previously, with PFM/IC in each public organisation there should be an official appointed with overall responsibility for the quality of operational management. This would include responsibility for the development of the organisational structure with managers appointed at different levels in the organisation. In some countries a state secretary (or equivalent) would have the authority to make the decisions about the management structure whilst in others agreement with the minister or other politically appointed official may be necessary. With the introduction of PFM/IC the state secretary (or equivalent) has a central role because he/she should also be responsible for the practical application of the PFM/IC policy and its ongoing quality, including the efficiency and effectiveness with which public resources are utilised.

It was also pointed out in Chap. 1 that 'management' requires the making of judgements and all judgements require the acceptance by the decision maker of some degree of risk. Accepting the need for risk taking will be new to many civil servants and local government officials where operational management responsibility is to be delegated to them from politically appointed officials as part of the PFM/IC reform. This could well cause them to resist the changes that the reform entails. Yet central to the reform is delegation and managerial accountability. The 'upside' to this for these officials is a more effective operational role coupled with better quality decision making. For elected officials this removes from them many administrative responsibilities, some of which can be quite trivial, and gives them time to focus on their primary responsibilities of policy development, strategy, and monitoring. However, in many countries with traditional legally based public financial administration and internal control arrangements (PFA/IC) civil service rules or laws can inhibit initiative and threaten civil servants with penalties if they make mistakes or errors of judgement. Financial inspection arrangements can also discourage risk taking. In many developing and transition economy countries even the most senior officials in line ministries have limited authority to make decisions, not because of political constraints but because approval has to be sought from central ministries. And in those central ministries the responsibility for approving a line ministry decision often lies with a lower level official. So in effect who is the manager? Is it the official in the line ministry or the official in a central ministry giving the approval?

Before the introduction of PFM/IC, as explained in Chap. 1, the ministry of finance should satisfy itself that a robust PFA/IC exists (see Chap. 3 for a detailed explanation of the differences between PFM/IC and PFA/IC). The focus with PFA/IC is upon control and compliance, rather than on the achievement of objectives efficiently and effectively, to time and to standard as well as within budget. Control and compliance are critical attributes which all countries ought to strive to attain and they should be maintained with the introduction of PFM/IC. If control and compliance do not exist, a sophisticated system is being introduced without the underpinning basic financial stability and without recognition and acceptance of the structures necessary to achieve and maintain that stability. This is the equivalent to building a physical structure on sand, that is, without appropriate foundations: a structure which will be unable to withstand the buffeting of events.

2.4 Efficiency and Effectiveness and PFM/IC Reform—Why Countries Should Want to Introduce the Reform

2.4.1 Securing Efficiency and Effectiveness

Most governments, taxpayers, service users and external development partners (i.e. bilateral and multilateral agencies) want efficient and effective arrangements for the raising of public revenues and for the utilisation of public financial resources. Introducing PFM/IC is a core strategy to help achieve this aim. 'Efficiency and effectiveness' were defined in Chap. 1 by referring to a definition attributed to Peter Drucker, that is, efficiency is doing things right; effectiveness is doing the right thing. Doing the right thing depends upon the quality of the policy determining what services are to be delivered and how they are to be delivered. However, achieving efficiency and effectiveness in practice is not at all easy and whether it can be achieved depends very heavily upon the quality of the policy operational management is required to implement. The changes required to achieve efficiency and effectiveness, for most, if not all, developing and transition economy countries will require significant management and financial reform, a reform to the control framework exercised by bodies external to a ministry or local government such as the ministry of finance and the ministry responsible for personnel management, as well as to budgetary and financial information arrangements. It will also require the existence of focussed pressure to achieve improved utilisation of resources and that pressure may be generated by the ministry of finance through the budgetary process, or directly by the political and/or operational leadership of a ministry or other public organisation. Once that pressure is established the leadership of the operational management (the state secretary or equivalent) and the head of finance should have a specific responsibility to identify inefficient and ineffective operational activity whether it be in the raising of revenues or in public expenditure. Each individual manager should also have a responsibility to achieve efficiency and effectiveness in delivering the services or activities for which they are responsible.

To develop a policy that will facilitate efficiency and effectiveness both the political officials and the operational manager (i.e. the civil servant or local government official) need to be involved. The former should set the policy based upon the political agenda of the government which should be developed in consultation with the operational management. (The operational manager should be able to advise, based upon experience, on the practicalities of implementing policy.) Efficiency and effectiveness are not simply about compliance with laws, regulations and policies and budgets or just spending less money, although they can include all of these attributes. Efficiency is about producing the results intended (i.e. the objectives and performance standards) and doing so in a manner which maximises those results for the least input of resources, both current resources, such as personnel and supplies, and services and investment resources, such as assets. Effectiveness is about results being those that the user of the service or activity requires or which meets their needs and does so to time and standard, rather than the results that the supplier wishes to produce. Effectiveness can only be established by identifying the impact of the activity, including asking the user. The user may be external to the organisation or internal. However, consultation with the user is an important dimension in improving the quality of public service provision. Sometimes, however, the results can be perverse and managers need to be alive to such a risk. For example, a drug prevention scheme in the USA probably increased marijuana use.[3]

To achieve efficiency and effectiveness, the manager needs discretion and that is why the traditional framework of external controls needs to change.

However, not all countries want a focus on efficiency and effectiveness with policy being more concerned with maximising public sector employment. Where this is the situation, such countries should concentrate on improving the quality of PFA/IC rather than seeking to adopt PFM/IC.

2.4.2 The Role of the Operational Manager in Achieving Efficiency and Effectiveness

Although the terms 'efficiency and effectiveness' have become widely used in the processes of public financial management reform there is no 'automatic' driver as in the private sector, where the market ultimately forces in efficient and effective management of resources. In the public sector the driver has to be political coupled with managerial initiative, ultimately driven by political debate and end user reaction (i.e. through accountability).

[3] Quoted in a paper by David Ainsworth and referring to an example quoted by Caroline Fiennes: https://charityawards.co.uk/article/made-to-measure-how-should-charities-assess-effectiveness/.

To deliver operational efficiency and effectiveness as the manager needs discretion this requires the delegation of authority from the politician. Another factor affecting discretion is the extent to which the manager is subject to detailed control by an external organisation. Where that occurs (e.g. by a ministry of finance or the organisation responsible for personnel management), achieving operational efficiency and effectiveness can become impossible.

Compared with the private sector achieving efficiency and effectiveness in the public sector context is much more complex. In the private sector products and services are relatively easily identifiable and a supplier, for example, does not have to supply every potential customer. In the public sector products and services can be less easy to define. Thus, what are the specific objectives of 'education' or 'security'? Also, very often the public sector supplier cannot choose who to supply or not supply. Again, in the public sector if the terms efficiency and effectiveness are to have any real meaning, managers need not only discretion but require operational objectives and providing clarity of objectives can be difficult. Changes are also required to traditional methods of public sector working. For example, a manager requires different financial information than a ministry of finance requires for budgetary and financial control purposes, although a manager needs that as well for the manager's specific area of responsibility. To facilitate effective management the finance made available through the budget should be linked to objectives and performance standards including performance objectives. This then makes it possible for the operational manager, provided that manager has agreed that the budget and objectives and performance standards and objectives are compatible, to deliver objectives and performance within budgetary constraints and to be held accountable for doing so. To achieve management discipline in this context the operational manager needs to be under systematic pressure from his/her superior manager, who ultimately may be a politician.

2.5 Defining 'Sound Financial Management'

2.5.1 Sound Financial Management

An aim of the PFM/IC reform is to give 'reasonable assurance' that a public organisation's transactions comply with the principles of 'sound financial management', that is, 'transparency, efficiency, effectiveness, and economy, as well as with relevant legislation and budget descriptions'.[4] Sound financial management therefore means much more than a traditional approach to

[4] Welcome to the World of Public Internal Financial Control, European Commission, 2006.

internal control which is focussed on legality and financial and budgetary control. Financial management encompasses all the activities within an organisation that are concerned with the raising and use of resources designed to achieve the objectives of the organisation efficiently and effectively:

> Financial management is a core part of successful management, central to each organisation's decision-making process and an essential part of the overall performance management. It is essential to the effective corporate governance of an organisation and fundamental to achieving objectives. High performing organisations and those with a track record of improving services consistently demonstrate strengths in leadership, performance management and financial management.
>
> Financial management encompasses all the activities within an organisation that are concerned with the use of resources and that have a financial impact. CIPFA has defined financial management for public bodies as the system by which the financial aspects of a public body's business are directed and controlled to support the delivery of the organisation's goals.
>
> The financial management arrangements within public sector organisations provide information that management use to:
>
> - Direct the activities of the organisation
> - Control the activities of the organisation
> - Report and discharge accountability
> - Utilise resources efficiently and effectively.[5]

Therefore, in the context of financial management, 'internal control' has a much wider application than simply the traditional transactional approach to financial and budgetary control envisaged in the context of PFA/IC. It includes those controls that are necessary to ensure that the management delivers the objectives and performance within the law and any budgetary constraints, efficiently and effectively. Those controls need to be defined and made operationally effective.

The idea of the discharge of accountability is not one that is confined to internal accountability but incorporates external accountability to the user of services and their representative groups, to parliament and to the taxpayer. In other words, PFM/IC also involves a greater degree of transparency and accountability than traditional administrative systems.

[5] Financial management as defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) Technical Information Service Volume: Financial Management and Corporate Governance. Introduction to Financial Management (cipfa.org) Introduction to Financial Management and Corporate Governance updated Nov. 2017.

2.5.2 Financial Control

Financial management incorporates 'financial control'. Financial control is designed to ensure that the operational managers of the organisation, at all levels, follow in practice the rules and regulations about all financial matters (usually set out in 'financial regulations') including the safeguarding of assets. Financial management also incorporates 'budgetary control' which requires that the operational managers ensure that budgets are not overspent or over-committed and are only used for the purposes for which those budgets are intended, or that where income is to be generated that income forecasts are achieved.

Financial management within a particular area is the responsibility of the manager for that area although the organisation's head of finance should be involved in this as a provider of key information and as an adviser to the manager.

2.5.3 Cost Drivers and Cost Centres

To achieve 'sound financial management', as has been indicated above, operational objectives and performance standards need to be defined and linked to the policy and budgetary objectives a manager is expected to achieve. This means that the traditional process of developing a budget by taking the previous year, adding for inflation, and then adjusting the total to reflect economic forecasts, will no longer be appropriate. If a budget is to have any meaning in managerial terms it must be linked to policy objectives and to performance standards. This is what a change to PFM/IC ultimately requires. Those policy objectives in many circumstances will also be 'cost drivers'. A cost driver is a factor that affects the level of costs that an organisation is likely to incur and therefore how policy impacts on the budget. Examples of cost drivers can be quite simple such as the policy towards the numbers of children to be educated, or elderly persons to be cared for by the state or total numbers of persons held in prisons or the number of children to be vaccinated. But they can be more complex and may depend heavily upon the complexity of the policy being pursued or they could be a combination of both simple and complex cost drivers. For example, the number of crimes, depending upon their type, can affect the demand for police resources but how the police and the judicial system address the consequences of criminal activity will affect the total budget that is needed. In effect a cost driver can be a particular political or management policy or it can be a numerical factor such as the pupil/teacher ratio.

Changing the cost driver can significantly affect costs. Another example would be penal policy, where the policy approach to sentencing affecting the length of prison sentences for different types of crime can have a material impact on costs. Or again it could be the age at which children are vaccinated and the range of vaccinations to be provided. If costs are to be kept under control regard should be had to such cost drivers.

Identification of cost drivers and associated costs is an important factor in the establishing quality in the policy making process.

The operational manager needs to be able to allocate costs over different areas of activity, that is, over cost centres. A cost centre could be a regional office or prison, or police unit or operating theatre, or university course and so on. The manager will also need to know the level of the operational performance of each cost centre. Some cost centres will operate more efficiently than others and the manager must know this. Only then is the manager able to take any necessary corrective action. That action may include changing the cost centre manager or its staffing or reorganising the cost centre organisational arrangements to reflect changes in demand for its services. To make such a detailed allocation of costs possible more elaborate coding of costs and more detailed information about performance will be required.

Making operational decisions based upon cost driver and cost centre information should be the responsibility of the operational manager. To support the manager the head of finance should be able to provide the information the manager needs to identify which cost drivers to address, and which cost centres require his attention if costs are to be kept under control and efficiency improved. The operational manager should inform the policy maker where the cost driver is having effects upon budgetary limitations, and the policy maker should then decide on any action to be taken. Cost drivers are highly significant in translating policy ideas into practical and operationally effective public services. There is a legitimate question about whether particular policies, or the methods of delivering those policies, result in the efficient and effective utilisation of public resources. (Poor policy formulation can be a cause of inefficient and ineffective public services.) Cost centre analysis is about efficiency and effectiveness and whilst operational management should be the responsibility of the civil service or local government manager the reorganisation or sometimes closure of cost centres may require political authority.

Overall, with 'sound financial management' developed through the adoption of PFM/IC objectives and performance standards will be more likely to be achieved than would occur with traditional systems of financial and budgetary control which focus simply upon financial parameters.

2.6 Appreciating the 'Management' in Public Financial Management

2.6.1 The Professionalisation of 'Management'

Public financial management when considered from a 'downstream' perspective is based, as the name implies, upon the idea of management. Public financial management is not simply a collection of technical tools (i.e. application of international standards, laws, and systems with associated training) that if implemented will, of themselves achieve a range of benefits leading ultimately to economic improvement. Much more is required. In particular 'managerial professionalism' is needed. Professionalism refers to the behaviour, attitude, competence, accountability, and integrity standards expected of managers and impacts upon how they undertake their responsibilities, including the exercise of leadership within their organisation and accountability for their organisation's performance. 'A state that promotes management promotes professionalism—discretion, performance and stewardship.'[6]

The European Union in its advocacy of public financial management reform has recognised this. A key feature of the public financial management reform it requires to be undertaken includes the development of managerial structures accompanied by appropriate delegation and managerial accountability. This means:

- First, the delegation from the political level of management of the responsibility for most operational management decisions for the delivery of public services and activities, to the civil or local government service but within the approved policy and strategic political context; and
- Second, the establishment of operational managerial accountability ultimately back to the political level of management.

In other words what is required in practice is that to achieve effective PFM/IC there does need to be a separation of responsibility for policy and strategy development from operational management, the former being a political responsibility and the latter a civil or local government service responsibility. However, effective policy making does depend upon close cooperation between the operational manager and the policy maker with the former advising the latter on the feasibility and cost of policy. This also has an impact upon

[6] Public Finance and Economic Growth in Developing Countries: Lessons from Ethiopia's Reforms by Stephen B. Peterson (New York: Routledge, 2015), page 285.

budgetary, financial and performance information arrangements (these are discussed in Chaps. 5 and 8) as well as upon decision making processes and how the responsibilities for control are exercised.

The introduction of PFM/IC with the professionalisation of management also imposes significant additional technical responsibilities upon the manager which would make very difficult the combination of policy and strategy development with operational management. In that event the likelihood would be that one or other would not be properly undertaken.

However, as has been commented upon previously, in some transitional and developing economy countries, even though they may nominally be introducing PFM/IC, operational management effectively remains a responsibility of the political level which therefore undertakes the two roles of defining policy and the strategy for its delivery and the operation management of service or activity delivery. Consequently, delegation and managerial accountability between the civil or local government service and the political level are not being achieved. This does not encourage the development of an effective and responsible civil and local government service management or the opportunity for the provision of independent informed advice to political policy makers. It also casts doubt on the quality of both policy development and operational management.

Countries wishing to join the European Union are expected to absorb a managerial dimension into public financial reform from the outset of the reform process. Other countries may not be required, or wish, to undertake the same comprehensive reform as those European influenced countries and therefore may only wish to address the internal controls that lead to an improved quality of public financial administration.[7]

[7] With the European Union reform different terms are often used to describe the same thing. One term that is commonly used is 'financial control'. This though is often used as a generic term covering external audit, internal audit and public financial management, and internal control. 'Public internal financial control', another term used by the European Commission, is a derivative of 'financial control' and includes three elements, internal audit, financial management and internal control, and the establishment of what is called a central harmonisation unit whose function is to introduce and manage the other two elements of public financial management and internal control. (The public internal control reform is specified in the 'Conditions of Membership' for countries wishing to join the EU. Chapter 32 of the Conditions of Membership [the *acquis communautaire*] specifies the criteria that apply to applicant countries in the field of 'Financial Control'. These conditions require the development of public financial management and internal control.)

2.6.2 Challenges to Professionalising Management

One problem with developing a professional management is resistance both by the political level and by the official level to this management element of the reform. Also, the public administrative culture may not be compatible with the introduction of advanced PFM reforms as the following report on a regional workshop sponsored by the IMF on the challenges of developing MTEFs and PBB (a similar advanced PFM reform to PFM/IC) in East Africa indicates[8]:

> Participants concluded that regional MTEF and PBB reform objectives are not fully reconciled with the structure, processes, laws, regulations, procedures, practices and capacity in place, hence failing to reap the benefits of these reforms. They also noted that the prevailing public service management culture does not encourage the delegation of responsibility for managing programmes and budgets at the ministry and agency level, or the development of improved decision making within government on the prioritisation and allocation of budgetary resources. The incentives for civil servants to improve performance are quite weak. In addition, improved macro-fiscal forecasting is hampered by weak national statistical databases.
>
> The workshop further concluded that:
>
> 'existing reforms of MTEF and PBB focus too much on the formal technicalities (e.g. developing new reporting templates and elaborate systems of performance indicators) without much consideration of how these techniques and data should be used to improve decision making on the prioritisation and allocation of resources. Ministries and agencies often lack the capacities to analyse performance information, and the new reporting formats and performance data are not fully integrated into existing platforms (IFMIS) for managing financial information. Finally, the Cabinet debate is not informed by the need for improved performance, while parliamentary interest in holding the executive accountable for performance is limited.'
>
> 'Above all, countries should invest in changing the culture and 'mindset' of public officials so as to support improvements in the efficiency and effectiveness with which public services are delivered. Key stakeholders should be sensitised to encourage a common understanding and ownership of the MTEF and PBB reforms, and to reduce their resistance to these reforms. Such a programme of change management is not a simple matter and will require leadership and commitment over a sustained period. Borrowing from experiences in more advanced countries, and taking account of the magnitude of the reforms, participants

[8] Public Financial Management Blog: Making Public Money Count—Fiscal Affairs Department—IMF March 2016.

proposed therefore that a phased approach to adopting MTEFs and PBB was more sustainable.'

A second problem is that civil servants and local government officials do not somehow automatically become managers once the title of 'manager' is bestowed upon them. Management is a skill which is in short supply, especially in the public sector and particularly in developing and transition economy countries. This means that success with this reform is likely to require a heavy investment in management training, which in turn may require the making of special arrangements with an appropriate training institution such as a university. It will also affect human relations (personnel) policy, the quality of the work that civil servants and local government officials are engaged in, how they are to be incentivised and rewarded (and this is not just about pay) and the training that is to be provided. Political management also needs to show evidence that the skills are valued and that staff are encouraged to develop their skills within government through promotion and other career development opportunities. The same circumstances apply to financial managers. Theirs too is a skill in short supply in the public sector and specific skill training is likely to be required with the same problems as for managers, that is, skill retention, incentives, and rewards. (These topics are discussed more extensively in Chap. 14.)

Bearing in mind the potential for increased accountability, resistance to a reform involving delegation could also exist for other reasons. For example, at the political level it affects opportunities for patronage (including rent seeking), perceived status and requires that a significant degree of trust exists between politically appointed and civil service and local government officials. For the official level, taking decisions involves risk and the possibility of penalties. The civil or local government service may lack trust in the willingness of the politically appointed officials to take their share of the blame if something goes wrong. Given that the ideal civil or local government service should be non-political establishing 'trust' can be difficult for both sets of parties.

To achieve the gains from the PFM/IC reform countries need to recognise that managerial reform is essential as a prior condition and that reform should start at the top of organisations, usually at the political level, that is, with the minister or mayor, as the report quoted above demonstrates. This is even though reform at this level can be the hardest to achieve, especially where organisational and management structures are highly hierarchical, where challenge to authority can be very difficult to sustain without adverse consequences, and where a need for delegation of operational management is not recognised.

However, having applied the PFM/IC reform and developed the managerial and financial capacity to support the management the further problem is how to sustain the reform. This depends very heavily upon an ability to retain those skilled managers and financial managers. A political policy that relies on political appointees only to fill senior civil and local government management positions does not help.

2.6.3 Management Structures and Delegation

Exactly what the management structure should be for each organisation will depend upon various factors, including:

- The size and complexity of the organisation and its objectives.
- The type(s) of service or activity being delivered.
- The political sensitivity of the organisation or activity.
- The confidence of the organisation leadership in the more junior officials (which can involve the relationship between politically appointed officials and the civil or local government service officials).
- The extent to which an organisation can manage the delivery of its objectives or whether success in delivery depends upon cooperation with other organisations.[9]
- The financial and other resources which are available.

The effectiveness of a management structure depends upon the clarity of its objectives, performance standards and performance objectives, the powers, the resources (including the information available to the managers at different levels in the organisation), the spans of control[10] of different managers, that is, are they relevant for the responsibilities that the manager has? In other words, is the degree of delegation and are the corresponding accountability arrangements for that manager appropriate?

[9] This is a feature for many public sector objectives because for many of them the solution lies not just in a single organisation but in cooperation between one or more public organisations including between central and local government and possibly cooperation with private organisations such as charities. However, in practice, this is very difficult to achieve because as has been pointed out previously public organisations are notoriously reluctant to share budgets and whole of government planning is also very difficult to achieve.

[10] 'Span of control' refers to the number of subordinates that a manager or supervisor can directly control.

2.7 Internal Control and Management

Internal control has been defined by INTOSAI as follows:

> Internal control is an integral process that is effected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that in pursuit of the entity's mission, the following general objectives are being achieved:
>
> - Executing orderly, ethical, economical, efficient, and effective operations.
> - Fulfilling accountability obligations.
> - Complying with applicable laws and regulations.
> - Safeguarding resources against loss, misuse, and damage.
>
> *Internal control is a dynamic integral process that is continuously adapting to the changes an organisation is facing. Management and personnel at all levels have to be involved in this process to address risks and to provide reasonable assurance of the achievement of the entity's mission and general objectives.[11]

This definition of internal control emphasises the role of management (note: at all levels, not just at a top and senior level) and that of the mission of the organisation which is about the achievement of the organisation's objectives (i.e. corporate objectives). A mission cannot be left vague: it must be defined and this means that its objectives need to be clearly identified and as far as possible measurable.[12] Those objectives also need to be cascaded down to the different levels of management. (In practice to achieve the overall objectives of an organisation, the political objectives may have to be divided over sub-objectives, and sometimes sub-sub-objectives, with a manager being responsible for the delivery of each sub-objective or very often, more than one sub-objective.) Organisational budgets should be linked to those objectives and in practice organisational policy objectives should be supplemented by performance standards, and performance objectives (such as waiting times for accident and emergency patients or the utilisation rates for operating theatres or school examination success rates for pupils, or reduced reoffending rates for prisoners).

Internal control when used in a management context incorporates the INTOSAI definition but should be developed to include not only the

[11] The Guidelines for Internal Control Standards for the Public Sector (INTOSAI GOV 9100), INTOSAI, http://www.intosai.org/issai-executive-summaries/intosai-guidance-for-good-governance--intosai-gov.html.

[12] They should have the characteristics of SMART objectives—SMART is an acronym for Specific, Measurable, Achievable, Relevant, Time bound.

controls necessary to secure budgetary compliance and adherence with the law and financial regulations, but also, and very importantly those controls necessary to:

- Secure the delivery by public service managers of the objectives, performance standards and performance objectives that they are or ought to be expected to deliver.
- Ensure that public resources, including assets, are used efficiently and effectively.
- Ensure that public revenues are raised and managed efficiently and effectively.
- Ensure that the financial resilience of the organisation is maintained over time. (This is not about medium-term budgetary planning, although that is important in this context but is about ensuring that decisions are not made which are likely to be unfinanceable into the future. Considering the financial impacts only over a single year or even a 3-year period in the delivery of public services is, for most such services and the associated activities, far too short a time horizon and does not recognise the level of capital investment usually required to deliver such services or the long lead times necessary to achieve objectives.)

One feature of those controls would be an effective system of risk management. A second would be systems of managerial accountability and how managerial accountability reports are responded to by higher-level management. A third would be the systematic assessment of the effectiveness of public services and activities in achieving their objectives.

Introducing PFM/IC requires that a manager considers a range of issues that would not be considered with a more traditional public administration structure. With PFM/IC each manager should have an appreciation of the financial implications of decisions and all that this entails in terms of delivering objectives and performance standards efficiently and effectively. This involves a consideration of risk. What are the risks that could prevent a manager achieving the objectives efficiently and effectively? This should be a main concern of management. Without the existence of objectives, risk cannot be properly assessed. This goes beyond risk to systems although that is frequently how this is interpreted in practice and often emphasised by auditors.

The experience of this author in reviewing the implementation of PFM/IC in many of the countries of central, eastern, and southern Europe and some neighbourhood countries shows no practical recognition of this broader concept of internal control which should be associated with the idea of 'management'. Similarly, there can also be a reference to the idea of 'achieving efficiency and effectiveness' but without the managerial arrangements, clarity of objectives and the financial and performance information systems and skills necessary to achieve it. Consequently, delivering efficiency and effectiveness remains a 'nominal concept'.

2.8 The Ministry of Finance and Its Controls

Financial and budgetary controls are the controls with which the ministry of finance is primarily concerned not least because the traditional parliamentary concern is just about financial and budgetary control. They are also usually the only controls that are considered by those responsible for implementing public financial management reforms. However, both sets of controls are usually designed to meet the needs of the ministry of finance. They will require modification with the introduction of PFM/IC and particularly if the impact of the introduction of PFM/IC is to encourage parliament to widen its control interest to consider 'outputs' as well as 'inputs'.

Whilst a ministry of finance should require that all non-market public organisations such as ministries, their second-level organisations and local governments implement financial controls, how successfully they are implemented depends upon several factors, including the following:

- Is there any consultation by the ministry of finance with other public organisations about their content?
- Is any attempt made to explain the controls to the top and senior management of line organisations and to convince them of their relevance and necessity: or is the attitude of the ministry of finance that these are requirements which have to be accepted, whatever the circumstances or costs?
- Are the controls relevant to current needs and are they regularly updated?
- Are they too bureaucratic and detailed?
- Do the ministries and other line organisations responsible for service delivery see them as relevant to their needs as well as the needs of the ministry of finance?
- Is the real aim of the controls to enable the ministry of finance to influence the policies and operational actions of the line organisations, even though the controls are ostensibly only for the purposes of financial (and budgetary) control?

- Does any systematic consultation occur with ministries and other line organisations about the costs of implementing those controls and their relevance?

An example of a financial control activity that is frequently imposed upon senior officials in line organisations and in some countries upon politicians, but which is undesirable except for exceptional transactions, is a need for them to sign all invoices and payment schedules before payments are actually made.

So far as budgetary controls are concerned, those required by a ministry of finance should be those that are central to overall economic management and to the maintenance of parliamentary authority over the budget. Because with PFM/IC the budgetary analysis which suits a ministry of finance is most unlikely to be appropriate for managerial purposes an alternative, probably additional form of analysis will be required so that financial inputs can be linked to the achievement of outputs. Those controls may need to be extended should parliament broaden its interest to incorporate performance.

A question therefore is, do the budgetary control regulations issued by the ministry of finance recognise the change of circumstances generated by the introduction of PFM/IC, or indeed by any extension of parliamentary interest? Or are traditional controls being maintained because they enable a ministry of finance to effectively determine the policy of the spending or line ministry (as De Geyndt pointed out in the quotation in Chap. 1). In that circumstance, the reality will be that relatively junior ministry of finance officials will probably be responsible for the controlling or authorising decisions made by senior spending ministry officials. This is not conducive to the development of PFM/IC within spending ministries and other organisations and in particular to achieving efficiency and effectiveness.

Usually, ministries of finance impose controls without consultation and as a result top and senior officials of ministries and other public organisations may not see the need for such controls or may resent them. This can be especially true where senior managers are politically appointed and therefore have no civil or local government service backgrounds or experience. An important lesson for ministries of finance therefore is that with PFM/IC they should do their utmost through consultation and agreement to encourage spending ministries and other public organisations to 'take ownership' of these controls as far as possible rather than just seek to impose them without any consultation or recognition of their relevance to those organisation's needs.

With PFM/IC a consequence of the shift from external to internal control will be that the ministry of finance should not be required to approve every variation to budgets or cash flow calculations because that in effect puts the ministry of finance in the position of the actual service manager even though the nominal service manager is located within a spending ministry or local government. The ministry of finance control should therefore change from a detailed form of control to a more strategic form of control. Consequently, instead of being required to approve every variation, the ministry of finance should focus only on the key or main changes proposed by line ministries or local governments whilst maintaining control of ceilings.

Even though a ministry of finance will need to recognise and accept that managerial requirements for budgetary and financial information are likely to be different from the requirements of the ministry of finance this does not mean in any way weakening or changing the information available to a ministry of finance but of recognising that managerial needs within a line ministry are, or can be, very different from the budgetary and financial management control needs of the ministry of finance. The core financial information should remain the same, that is, line ministry managerial information should be derived from the ministry of finance information systems and be capable of being reconciled with the ministry of finance information. (Further discussion about this is included in Chap. 5.)

2.9 Second-Level Organisations

Governments and local governments sometimes provide public services through agencies and state owned enterprises, that is, second-level organisations. Very often neither agencies nor public enterprises (sometimes called 'public corporations') are well managed or controlled by the relevant ministries or local governments. Controlling/owning ministries or local governments often lack an adequate policy capacity able to set objectives for second-level organisations and to effectively supervise their performance. As a result, there is a tendency for second-level organisations to dominate the relationships with the first-level organisation because the management of the second-level organisation has greater knowledge not just about the detail of the second-level organisation's activities but also about its policy objectives and performance. This indicates a weakness in the accountability arrangements. As a result, decisions are likely to be made in the interests of the agency or enterprise rather than in the interests of the controlling/owning ministry or local government. Consequently, second-level organisations can be a significant source of inappropriate utilisation of funds and /or the development of activities which are inconsistent with the interests and objectives of the first-level body.

OECD evidence[13] suggests that inefficient or poorly managed public corporations can impose substantial economic and fiscal costs.[14] The mere fact that public services or activities are provided on behalf of a ministry or local government by a second-level organisation should not exempt the controlling ministry or local government from incorporating them into the PFM/IC arrangements that apply elsewhere in the ministry or local government. The precise administrative arrangements may be different from those of the controlling/owning organisation, but the controlling ministry or local government should define what it expects of the agency or public enterprise. There is a responsibility upon controlling ministries and local governments to ensure that the agencies and enterprises they are responsible for deliver their objectives, meet performance standards and operate efficiently and effectively. This responsibility should be set down in some form of formal document which can change annually with an annual budget settlement or preferably over a longer period where the budget settlement is for a longer period. Such formal documents are often referred to as 'service-level' or 'performance' agreements. (A full discussion about the control of second-level organisations is included in Chap. 12.) The controlling ministry or local government should also systematically monitor the performance of the agency or enterprise against such an agreement.

What this consequently means is that the objectives, management, performance standards and governance arrangements of second-level organisations should be consistent with those of the first-level organisation and be subject to regular review. The management of second-level organisations should have clear objectives set for them by the first-level organisation, the resources and discretionary authority to make decisions about the delivery of those objectives should be defined in the agreement and they must be accountable for their successes and failures. This should require a change of managerial approach by first-level organisations which should follow from the introduction of PFM/IC.

[13] See 'How to note—November 2016 "FISCAL POLICY How to Improve the Financial Oversight of Public Corporations"'.

[14] Extract from the 'How to Note': in the absence of strong performance incentives, public corporations also often produce at high costs, overcharge customers, and under-provide often essential services such as power, water, and telecommunications' 'loss-making public corporations can be a persistent drag on public finances in the form of government guarantees, subsidies, loans, or capital injections' 'many public corporations are pressured or mandated to fulfil political objectives and engage in quasi-fiscal activities that bear little relationship to their core commercial operations and for which the companies are not compensated from the budget' 'such quasi-fiscal activities include, for example, public service obligations that are below cost-recovery, price regulations that imply cross-subsidies, ancillary operations outside the public corporation's core mandate, or excessive employment levels' 'public corporations can be used as a mechanism for circumventing traditional fiscal controls, and as a conduit for financial corruption' (p. 2).

2.10 The Head of Finance

With PFM/IC to be effective the role of the head of finance in an organisation becomes more significant. Managers at all levels, that is, including the political level, must be supported by a strengthened financial management capability. That capability requires the upgrading of the traditional finance officer role from that of bookkeeper/financial controller[15] to become the equivalent of a finance director in a private sector company. That would mean ensuring that the head of finance and the department he/she is responsible for has a financial analytical capability, a financial planning and forecasting capability and an ability to act as adviser at all managerial levels in the organisation. The head of finance should be concerned about the efficient and effective utilisation of all the resources of the organisation including the available assets. The aim with the latter should be to encourage either more effective utilisation or, alternatively, disposal if assets cannot be demonstrably efficiently and effectively utilised.

The head of finance should have the status and ability to advise top and senior-level political as well as operational managers on the costs and financial viability of their plans and the objectives they wish to meet. They should also support both levels of management in the development of forward operational planning and have a capacity to prepare long-term forward financial plans. He/she should advise the managers (political and operational) about the long-run financial resilience of the organisation and therefore how it can be managed.

Overall, the head of finance should be responsible for securing the financial discipline processes that are essential with the development of PFM/IC. Ideally, he/she should work in partnership with the head of operational management. (A full description of the role of the head of finance is included in Chap. 8.)

2.11 The Time Horizon for Decision Making Under PFM/IC

A feature of PFM/IC relates to the time horizon for the delivery of public policy objectives. This is usually long term and rarely coincides with the time horizon envisaged in budgets even medium term (or 3 yearly) budgets or with the electoral cycle. Consequently, an important feature of PFM/IC should be

[15] For a definition of bookkeeper/financial controller responsibilities see footnote 11, Chap. 1.

an assessment of the longer-run consequences of public policy. Without that longer-run assessment managers (both policy makers and operational managers) cannot be sure that an organisation will be able to deliver its objectives or to remain financially viable over time. Financial viability over both the short and the long term should be a very important political consideration. If such viability is not a factor in policy making there is the possibility that at the extreme the organisation, if a body such as a local government or agency or state owned enterprise, may become bankrupt or incapable of continuing to operate without further cash injections which would be likely to be accompanied by stringent conditions. Or if the body is a ministry, it may require additional financial support which could have been avoided with more careful financial management and which in some circumstances may not be available. In a ministry, a lack of attention to the longer-run financial viability of the organisation may mean that it will have to make forced budgetary savings that can both be extremely wasteful and cause considerable discomfort to the users of the services provided by the organisation. Added to that, the reputational risk is substantial, which is likely to be of major concern to elected representatives. Consequently, those responsible for a public organisation should always consider the long-run financial strategy for the organisation and its long-run financial resilience. Politicians who have the ultimate responsibility for an organisation have a primary responsibility to ensure that adverse financial circumstances do not arise or, if they are likely to arise, for example, because of changes to government policy that the organisation is fully prepared. Financial viability and the achievement of objectives are intertwined.

Most public policy decisions made in one year have long-run implications which can extend well beyond the usual budgetary horizon. Although many countries have adopted a medium-term budget process, in practice those budgets are either based upon the current-year budget and spending plus an allowance for inflation or reflect the allocation of budgetary resources envisaged as available through the macro-economic planning process and government assessment of its priorities. This is not the same as organisation financial planning and neither do such arrangements form the basis for the development of a financial strategy. Public organisations will have to abide by any limits that are imposed but those responsible for the financial health of an organisation need to have a clear idea of what an organisation is committed to financially in the longer term and therefore of the consequences that restrictions on future finances may generate.

Where a long-run financial assessment has been made those responsible for an organisation are better placed to:

- Negotiate with the ministry of finance about the level of financing that will be required, whether for investment or current funding.
- Produce arguments to substantiate claims about the required level of financing.
- Manage the process of changing a service to accommodate pressures for service cuts.
- Develop plans to secure improvements in the efficiency and effectiveness of the services which are provided as part of a cost management process.
- Develop awareness amongst service users of the likelihood of change and hence reduce the risk of a disruptive reaction to policy and service changes.

There are also the longer-run consequences of demographic change, the impacts of technology, the consequences of a better educated and wealthier population, environmental and climate change and other factors that cannot yet be properly foreseen. However, as far as possible, assessments should be made about their potential financial impact even if these can be only vaguely forecast. Attempts at spurious precision are not helpful. The questions that then arise are these:

- Do policy changes need to be made now because current policies are financially unsustainable?
- Does the management of the organisation envisage the possibility of longer-run changes to the operational environment, or other factors that could affect the future financial and operational viability of the organisation?
- Are the present management arrangements capable of responding to those changes?
- Do current policies need rethinking in any event to respond to these changes?

A specific example would be over the application of technology to a particular service or activity which is likely to require substantial investment, but which also may have a dramatic effect upon ongoing costs. Another example would be environmental changes, especially given the effects of climate change.

Financial management and internal control if properly implemented asks the types of question set out above. Take financial resilience: does anyone at present with traditional financial control and budgetary arrangements ask the question, can this organisation afford, within likely budgetary constraints and given the demographic and environmental changes which are occurring, to continue with its present policies over the next 5–10 years? Of course, to answer such a question does require speculative judgements to be made but it is either this or doing nothing and then suddenly finding that an existing policy cannot be pursued because the finance is not available, or it is not sustainable for other operational reasons. Trying to answer such a question at the very least encourages policy makers to consider the options that are available. Political time horizons will be shorter than those of appointed officials but asking this question does require the 'official' part of the organisation to prepare a strategy to take such possibilities into account and this will ultimately benefit political decision making. (Longer-run planning is also discussed in Chap. 8 on the role of the head of finance.)

2.12 Effective Public Financial Management and the Information Requirements

Effective public financial management introduces a demand by managers for a wide range of new information. That demand can also extend to parliament depending upon how it approaches its role given the introduction of PFM/IC. Information is central to effective management. If information needs are not fully considered, the management dimension to the PFM/IC reform is effectively being ignored. Managers will also require information to enable them to advise effectively on the development of policy and if policy is poorly defined it becomes difficult in turn to define objectives and to prepare budgets. However, information in itself is of little value unless the manager has the authority and capacity to use that information, that is, unless accompanied by appropriate delegation and managerial accountability arrangements. A manager requires information. That requirement must go beyond the limits of budgetary and financial controls because the responsibility of the manager is to deliver improvements in efficiency and effectiveness. That information requirement also extends to decisions made elsewhere in government because decisions made in one part of government can have an impact on other parts of government. The information required needs to include information that can affect both finance and performance such as changes to national or international standards. This does add to the cost and complexity of introducing the PFM/IC reform but without this additional information the manager will not be able to control costs or achieve improvements in efficiency and effectiveness or even deliver objectives (see above about the development of cost driver and cost centre analyses). Exactly what a manager's information needs are will depend upon the manager's specific responsibilities.

2.13 Achieving the Benefits of PFM/IC

2.13.1 Management and the Benefits of the Reform

The benefits from introducing PFM/IC derive from the impact that it has upon the management arrangements. The system itself does not deliver the benefits. The system creates opportunities for a manager that a traditional system does not and therefore what matters is the quality of the management if those benefits are to be achieved.

Evidence from other countries[16] of the impact of public financial management reforms has shown that, firstly, many years[17] and in some cases many decades are required to implement substantive and sustainable changes. Secondly, political economy issues, together with the history and culture of a country, are enormously important factors in determining the success of a reform strategy. Strong public financial management systems are not created out of weak institutions and therefore an initial action should be to strengthen existing institutions as necessary (by, e.g., ensuring that the arrangements for PFA/IC are both sound and effective) and by encouraging parliament to take that broader interest in public finance referred to above (which may require support from the state auditor). Thirdly, prioritisation and the correct sequencing of the implementation of the reform are essential for the success of any reform strategy. Fourthly, capability constraints in the public administration play an important role. Strengthening capability is not about training alone. Capability is a wider concept. Capability includes the ability to mobilise and direct all resources to achieve an objective (finance, assets, personnel, IT systems and so on depending upon the organisation) in an efficient and effective way.[18] A further (fifth) factor that should under no circumstances be ignored is that financial management and internal control require a capacity to think and plan strategically. This is not a simple matter of the forward forecasting of the impact of events but also of how those events, together with cultural and environmental changes, are likely to affect how management should react and how the changing expectations of the electorate, the service user and the

---

[16] IMF Director for Africa quoted by Richard Allen, IMF Blog 2 December 2013: https://blog-pfm.imf.org/pfmblog/2013/12/is-there-a-new-consensus-on-pfmreform.html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+pfmblog+%28PFM+blog%29reform.html?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+pfmblog+%28PFM+blog%29.

[17] See the assessment of SIDA referred to in Chap. 1—footnote 22.

[18] For a full discussion see *Building State Capability: Evidence, Analysis Action*: Andrews, Pritchett, Woolcock: Oxford University Press 2017.

taxpayer will affect attitudes to public services and those responsible for their delivery in the future.

As experience of managing within a PFM/IC environment is gained further changes are likely to be required particularly to the definition of objectives, performance measures or indicators and the analysis arrangements designed to assist managers improve efficiency and effectiveness. Changes in technology will also impact upon the processes of financial management and internal control. Given the complexity and length of time that implementing PFM/IC will take, as was pointed out in Chap. 1, political consensus about the desirability of the reform is highly desirable. This will be particularly important where a consequential management change is to move responsibility for operational management from elected officials to appointed civil service and local government officials. This will mean that officials will need to be trained in management techniques and that the managerial ethos facilitates decision making and the making of operational service delivery judgements.

In summary the benefits of the reform are derived from a better quality of management with more efficient public services, an increased focus on achieving objectives and with greater regard for the needs and interests of the user of public services (effectiveness) usually expressed through civil society. (The benefits that can be obtained from this reform are discussed in Chap. 10.)

2.13.2 Integrating PFM/IC Reform with Managerial Reform

Given that the introduction of PFM/IC should be regarded essentially as a management reform the introduction of PFM/IC should be coordinated with civil service or public administration reform, although it rarely is. As has been pointed out a central feature of PFM/IC is the separation of responsibility for policy and strategy development from policy execution and all aspects of operational management with the delegation of operational management to civil service and local government officials. (The extent of delegation will depend upon the particular operational circumstances and where delegation is appropriate and where not is discussed in Chap. 14.) This means that a management structure should be developed which is appropriate to the needs of the organisation. However, the development of a management oriented organisation cannot simply be driven by the needs of PFM/IC. The development of a managerially oriented public administration, because of its far-reaching implications for policy development, the relationships between politicians and officials and staff management go well beyond the remit of a ministry of finance. However, the development of PFM/IC does mean that managers, at all levels, need to be financially aware. Financial awareness is not simply about knowing what budget is available and securing budgetary control. Financial awareness also means that managers know what the total costs are of the services or activities for which they are responsible and how any changes of whatever type will affect those costs (e.g. of those factors which drive costs). Where managers are responsible for the development and management of income sources, including taxation they need information on the effectiveness of the policies in achieving the objectives as well as information about the costs and losses on collection. They also need to be aware of the total resources, current and capital (investment), that they are using and of the commitments that they are proposing to enter into. This too may represent a significant change because very often administrators, such as heads of departments, in developing and transition economy countries are not aware of the total costs of the department for which they are responsible because some costs may not be allocated over services and activities and in some countries, particularly lower-level administrators, may not know at all of either the budget they have available or the actual costs that are being incurred. The only financial information that it is often deemed necessary for an administrator to know is that necessary to maintain budgetary control over those expenditure lines for which the administrator has a direct responsibility. With PFM/IC this nowhere near enough! Neither is it enough for only the finance department to be responsible for the effectiveness of the financial and budgetary control arrangements: this should be primarily the responsibility of the manager. A particular responsibility of the head of finance is to promote financial awareness in all its aspects amongst managers (see next section).

2.13.3 Promoting Financial Literacy and Awareness

Managers need budgetary and financial information which meets their needs and as has been explained above these needs will be different from those of the ministry of finance. Whilst budgetary control must be maintained in accordance with the requirements of the ministry of finance that budgetary information needs to be reanalysed in a manner which supports the manager and as far as possible linked to performance information. Only by this occurring can a manager assess how efficiently and effectively services are being provided and through that the development of financial awareness. This also supports the development of managerial accountability. That will mean providing individual managers with the specific budgetary and accounting information they require to enable them to manage their part of the business of the organisation. To meet these different requirements more sophisticated financial analytical processes will be necessary. A single coding structure for the whole of government will be most unlikely to have the capability to achieve this. In developed economy countries the problem has been addressed by allowing public organisations to develop their own coding structures but in accordance with conditions specified by the ministry of finance that allow the ministry of finance to maintain the control and financial information it requires. A specific example is provided in Chap. 5.

Reluctance often exists in many developing and transition economy countries to provide budgetary and financial accounting information to managers other than to the top level of management and in any form other than that required by a ministry of finance. This will need to change.

2.13.4 Engaging a Wider Set of Actors in Financial Decision Making

Rather than confining debate about budgetary allocations to senior officials, line ministry and local government managers at all levels ought to be involved in decisions affecting the level of budgetary allocations (within any overall ceilings) given the objectives and performance standards they are expected to meet. They should also be involved in decisions about budgetary variations required during the year and cash flow calculations. In summary, if those managers are to be responsible for the delivery of objectives, performance standards and levels of operational performance they need to agree the resources necessary to do so and if resource availability is not at the level to achieve them, then changes will need to be made to objectives, performance standards or performance levels to match the available resources. Only the manager is in a position to give advice on that.

2.14 Learning Lessons from the Experience of Countries Aiming to Introduce PFM/IC

Where countries have not had regard to the managerial dimension to the PFM/IC reform the impression is that they have not asked themselves these questions:

- Who is to use the information derived from those bureaucratic procedures[19] that are associated with the implementation of PFM/IC, how is it to be used and is it reliable?
- Does an appropriate management structure exist reflecting the objectives of the organisation with experienced managers in place?
- Do those managers have clear objectives and have performance standards been set for them, with both linked to their budgets, and is performance information available?
- Do managers have the appropriate financial and budgetary information along with performance information to enable them to make judgements about the efficiency and effectiveness of the operations for which they are responsible?
- Do managers have the delegated authority to act in order to deliver those objectives?
- Do appropriate arrangements exist to hold managers to account, including by parliament and by civil society?

Unless these questions can be answered positively the main point of the reform is being missed and the potential benefits will not be achieved.

Also, the linkages between this reform and public administration reform or civil and local government service reform have not been recognised. In most countries, public administration reform and PFM/IC reform operate as it were, on parallel lines, not recognising the significant relationships between the two. What has also been missing is a recognition that budgeting and financial accounting systems also need to meet the needs of line ministry managers as well as those of the ministry of finance. Some budget headings which may be currently centralised in some countries (such as personnel and premises costs) may need to be allocated over individual management areas of responsibility to provide managers with the information that they require if they are to deliver services efficiently and effectively.

These weaknesses in the approach to the financial management and internal control reform appear to have partly come about, at least in countries with a legalistic tradition of public administration, because of the traditional focus upon adherence to that legalistic approach exemplified by bureaucratic rules and procedures. The legal approach has a focus on structure and functions allowing the exercise of power. It emphasises formality, the powers available and the limitations of power. It affects the discretionary authority of

[19] The main procedural requirements are included in the guidelines for internal control standards for the public sector published by INTOSAI—see footnote 11.

administrators. This contrasts with the approach exemplified in PFM/IC where the focus is more upon the public service user, the outputs, efficiency, and effectiveness in delivering those outputs. The legalistic approach in these countries also reflects concerns about the misuse of funds leading to a focus upon 'financial and budgetary control'. The reform approach that has been adopted in many countries has been to strengthen public financial administration, not 'management'. However, that also reflects a limited view of the meaning of 'control'. An internal audit based approach, which is the point from which many developing and transition economy countries start the reform, with a focus on compliance with procedures and systems to ensure that they are properly implemented has been usually the approach adopted. Whilst such controls are very important, thought has not been given to the outputs of those procedures and systems. This is not the end outcome that PFM/IC is aiming for. It ignores the point set out above in this chapter that 'control' is also about ensuring that the organisation delivers its objectives and does so efficiently and effectively and without risk to the financial resilience of the organisation. In other words, 'control' is also about where the organisation is heading and how well it is using its resources. That is a management responsibility. To use a motoring analogy, control is about more than just the accelerator and brake (i.e. the systems and procedures), it is also about steering towards the objective (i.e. where is the organisation trying to get to). Consequently, implementing PFM/IC in countries with a legal tradition does mean a significant cultural change and cultural change in all circumstances is very difficult requiring careful preparation.

The lesson from this is that whilst the experience of other countries can be valuable it does need to be treated with great care recognising that many (perhaps most) other countries have had a very narrow perception of what this reform is mainly about in that they have not recognised the managerial impact of the reform.

2.15 PFM/IC and Delegation

Countries with highly centralised power structures may have difficulty with the concept of delegation. There are two aspects to delegation, one is from politicians to the civil or local government service officials and the other is from central organisations to line organisations such as individual ministries.

The first aspect from political appointees to officials tends to occur because of a lack of 'trust' in the civil or local government service officials and concerns about competence. This can be accentuated where the civil and local government service has been politicised and has no reputation for independence. Power also provides important benefits to those who hold it, such as patronage and in some countries, as has been said earlier, opportunities for rent seeking. This is unlike in those developed economy countries, such as the Netherlands and other western European countries which have a long history of implementing PFM/IC. Here responsibility for delivering operational activities lies with the civil and local government officials and policy and strategy development and monitoring lies with politicians, that is, the elected officials. Exactly where the boundary lies between policy and strategy and operational activity varies considerably from country to country, as do the reporting arrangements, but either the civil and local government service is not politicised or politicisation is strictly limited.

The second factor is that in many developing and transitional economy countries power may be concentrated in a limited number of central ministries such as the ministry of finance (or there may be a separate ministry responsible for investment control) which may have to approve spending decisions where they do not conform with traditional practice, or cause variations to existing budgets. Or again a central ministry may be responsible for all employment levels and arrangements and this central ministry may have to approve personnel changes or appointments. This limits the discretion of line ministries to make decisions about the way in which services are delivered and how they can be made more operationally efficient. In practice, such controls are not related to the efficient and effective delivery of a service or the achievement of objectives but are simply about budgetary or policy control and sometimes a perceived need to avoid creating precedents. Such arrangements conflict with the managerial responsibility to improve efficiency and effectiveness and where authority must be sought from another organisation, decisions are likely to be made in the interests of the organisation exercising the power. Therefore, for example, where a line ministry may require a change to budget structures or change the personnel structure to facilitate improvements in efficiency and effectiveness meaning that a different form of budgetary analysis is necessary or different personnel arrangements, a central ministry can effectively prevent this if it will not agree to those reforms that a line ministry may require. A legitimate question then is who in fact is the manager of that service or activity?

2.16 PFM/IC and Decentralisation

Decentralisation transfers authority and responsibility from central government to regional and local government of certain government functions. This responsibility may include all aspects of service delivery from policy formulation, the strategy for implementing that policy to the detailed arrangements for service delivery. Exactly what the arrangements will be depends upon individual country arrangements. An important factor affecting decentralisation will be the level of financial resources available to each level of government. Some subordinate governments may have local taxation resources but usually these are insufficient to finance the costs of the more major public services such as education or poverty relief or security. In such circumstances local revenues sources are usually supplemented through grants from central governments which can attach conditions to the provision of grant aid including conditions about how such funds are to be managed, for example, by the adoption of PFM/IC.

With the introduction of PFM/IC at the central government level a decision will need to be made about its implementation by these different levels of government. How far a central government can impose a requirement for a subordinate government to adopt particular managerial or administrative arrangements will depend very much upon the local constitutional arrangements. Whilst a central government can use the lever of the provision of financial resources to encourage or cause subordinate governments to undertake reform, there may also be other reasons why central governments should require subordinate governments to undertake reform. An example is of governments wishing to join the European Union where the equivalent of PFM/IC is expected to be adopted by both central and local government as well as any intermediate levels of government.

The ideal position though is that all levels of government within a country should be encouraged or required to adopt PFM/IC recognising that the timetable and the specific arrangements may well be different from those applying to central government.

2.17 Summary

The PFM/IC reform is likely to challenge the traditional cultural approach to the delivery of public services. It also affects the distribution of power within and between organisations and affects how some organisations have traditionally operated as well as the roles that they have traditionally undertaken, including the parliament. This can make the reform difficult to implement. However, as a key component of PFM/IC, namely management with the responsibility to deliver objectives efficiently and effectively, this inevitably will lead to challenge to existing power structures particularly with the development of a delegated but much more disciplined managerial approach to the delivery of public services and activities. It will also require a more flexible attitude to budgeting and financial accounting compared with traditional arrangements.

Some civil and local government officials will appreciate the benefits of this, but others could object especially as their 'comfort zones' will be challenged with them being expected to accept new responsibilities that could be potentially frightening and risky.

The possibility is that together these concerns will generate resistance to the reform and may cause those responsible for the reform to argue that either it is not really relevant to the needs of the country or it so runs against the grain of the culture of the country that at least some aspects of the reform are inappropriate. In some countries the result has been that the PFM/IC reform has been quite superficial and limited to legal changes and requirements but with no substantive management or budgetary or accountability changes. Delegation often has been limited and largely restricted to relatively minor administrative matters. Because delegation has been so minor, the accountability arrangements have also been of superficial impact. Therefore, there is little or no prospect of achieving the benefits of the reform.

Another important lesson from those countries that have sought to implement a PFM/IC reform is that to be effective it must be complemented by a public administration/civil service reform. (That too has not always been appreciated.)

Given the difficulties with implementing and sustaining a full PFM/IC reform, what the reform may only in practice result in is improvements to public financial administration. This in itself could well be an important step forward, as well as a necessary step as a precursor to the much more substantive managerial PFM/IC reform. The important point is that those with the ultimate responsibility for reform should recognise this.

Overall, the objectives of PFM/IC are to ensure:

- Public services are managed and delivered efficiently and effectively and that a focus exists upon the user and the delivery of objectives and performance standards, not just financial and budgetary control.

- No commitments are entered into which risk the short-, medium-, or long-term financial resilience of the organisation.
- Full and effective accountability exists to the parliament, to the user of public services, to the taxpayer and to the population, showing how public resources have been raised and used, how effective internal controls (defined more broadly than simply budgetary and financial control), have been.
- The extent to which government objectives have been achieved and whether they have been achieved efficiently and effectively.

3

The Distinction Between Public Financial Management and Internal Control (PFM/IC) and Public Financial Administration and Internal Control (PFA/IC)

The previous chapters explained PFM/IC and the implementation arrangements. This chapter distinguishes between public financial administration and internal control (PFA/IC), with a detailed explanation of what is meant by PFA/IC and compares it with public financial management and internal control (PFM/IC). The main difference lies in the role of 'management' and the greater discretion that management has in the decisions about the delivery of services with PFM/IC, including responsibility for achieving greater efficiency and effectiveness in service delivery. In the previous chapter the statement was made that PFM/IC should not be introduced until a robust PFA/IC exists, and this chapter explains what a robust PFA/IC involves. It also highlights deficiencies in the PFA/IC arrangements when compared with PFM/IC.

3.1 Public Financial Administration and Internal Control (PFA/IC)

3.1.1 Control Prior to the Adoption of PFM/IC

Before the introduction of PFM/IC should be attempted a robust PFA/IC should exist. The focus with PFA/IC is upon control and compliance. Control and compliance are critical attributes which all countries ought to strive to attain. They mean that spending conforms with budgetary limits, that all spending is in accordance with the relevant laws and regulations, and that such expenditure is only for public policy purposes. If control and compliance do

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_3

not exist, the sophisticated system which is PFM/IC, with the increased discretion available to managers, is being introduced without the underpinning basic financial control stability and without recognition and acceptance of the structures necessary to achieve and maintain that stability and propriety. With their present PFA/IC arrangements, many governments have *potentially* good-quality financial and budgetary control systems. These 'good-quality' financial and budgetary control systems, often known as integrated financial management information systems (IFMIS), will be electronic information (IT) systems. They may be local 'custom-built' systems or 'off-the-shelf' commercial systems. They are designed to help governments and ministries of finance maintain control and compliance whilst operating within a PFA/IC framework. The accompanying financial, budgetary, and procurement regulations should complement the PFA/IC arrangements and be designed to prevent inappropriate actions.

However, such systems have their weaknesses often caused by poor security or by non observance of the accompanying rules and procedures. IT security in some countries can be limited and IT systems can be subject to hacking or made vulnerable by a lack of IT discipline. A further problem is that countries using advanced commercial 'off-the-shelf' IT systems need to adapt their processes and arrangements to meet the requirements of the IT system, rather than the other way round. This adds to the difficulty of application which can take a considerable period to apply[1] (up to 9–11 years in some countries) and causes delay in the implementation of other financial management reforms. Such systems also tend to be very expensive. Claims are also made that implementing such a system will result in improvements in efficiency and effectiveness but, such claims can only apply to the financial processes and not to the delivery of public services where the crucial factor is the quality of management. Consequently, that such systems may exist should not be a reason to argue that a PFM/IC reform is unnecessary. Their existence also does not guarantee that a robust PFA/IC presently exists. The adoption and application of the PFM/IC policy will not automatically remove any weaknesses. The same types of operational challenges will remain.

3.1.2 The Control Environment

Parliament through its approval of the budget and, in most countries the accompanying budget law, should dominate the approach to control. Parliament should approve variations to budgetary allocations in accordance

[1] 'The introduction of an FMIS in a developing country should be regarded as part of a long process of reform. This process takes years to fully implement, costs millions of dollars, and has a substantial recurring operating cost.' Introducing Financial Management Information Systems in Developing Countries by Jack Diamond and Pokar Khemani: OECD JOURNAL ON BUDGETING, Volume 5, No. 3 2006.

with the requirements of the budget law, where these are found to be necessary. It should also be informed of significant variations in the income generating capacity of government. The ministry of finance has a responsibility for the overall operational control of the budget, reporting to parliament where budgetary spending changes are required and seeking parliament's approval.

The budget law with PFA/IC will focus on financial limits rather than also on the 'outputs' to be achieved although the statements accompanying the budget are likely to include broad political aims, rather than specific managerial objectives. Some countries have experimented with different forms of budgeting such as programme and performance budgeting in order to increase the emphasis upon 'outputs' but with different degrees of success. Such budgetary reforms have not usually been accompanied in developing and transition economy countries by any managerial reforms, which are essential if they are to be effective. The following is a quotation from an OECD report on 'Budgeting and Public Expenditures in OECD Countries 2019'.[2] It illustrates the importance of the comprehensive cultural change that is required to extend the concept of control based upon the budget to include 'outputs'. Adopting PFM/IC, although not specifically referred to in the quotation, is an important element in that change:

> [Performance budgeting] PB is a recurring focus of innovation because efforts to base allocations on results often fall short of the mark. Instead of abandoning the pursuit of performance, various countries have retained the PB label and reoriented it from performance-based to performance-informed budgeting or from central budget decisions to performance management in line ministries. Many countries have repeatedly tinkered with the definition and classification of key concepts, such as outcomes and results, and with their use in the submission and review of budget requests. Others have shifted from PB's original focus as an instrument for deciding the budget to a means of classifying or displaying decisions taken during constructing the budget.
>
> Some Member countries [i.e. of the OECD] have had considerable success with PB-type arrangements by recognising that performance has to be embedded in the culture and systems of public management, especially the strategic processes and goals of government, and has a robust infrastructure across government to support the production and use of performance information. These critical linkages are recognised and defined in the OECD Good Practices for Performance Budgeting. To this writer, several key insights emerge from the Good Practices and if properly adopted, will open the door to more effective

[2] https://www.oecd-ilibrary.org/docserver/9789264307957-en.pdf?expires=1596273746&id=id&accname=guest&checksum=502CA11F8D42BE832A2E23BACABBCC68:pp27 and 28: author Professor Allen Schick.

> application of performance budgeting. First, PB cannot be a stand-alone innovation; it must be closely aligned to national performance and medium-term expenditure frameworks and evidence- based assessments of policies and resources. Second, PB should be adapted to country circumstances, with due regard to the role and interests of important stakeholders. Third, there should be systematic use of performance information, guided by the central budget authority, but also involving line ministries, the legislature, and the supreme audit institution. Centres of Government (CoGs) have a critical stake in orienting programmes and line ministries to performance and results, but their role usually is limited. COGs can inspire and prod, they can demand performance information, and occasionally review budget options in the light of evidence on results. Overall, however, COGs have many other things on their mind that crowd out sustained attention to performance. Moreover, they may regard it prudent or necessary to leave sensitive questions—for example, how to improve the performance of teachers and schools—to others.

With PFA/IC the responsibility for detailed day-to-day financial and budgetary control lies with the ministry of finance or its equivalent. Thus, with PFA/IC the central ministry of finance is initially responsible if there is evidence of losses due to the failure of budgetary and financial control. Of course, it may seek to blame others, but the initial question is why it was possible for such losses to occur? Why were the ministry of finance controls not effective? Whilst deliberate manipulation may have occurred within a line ministry or other public organisation which the central ministry responsible for control did not identify, the question then becomes, why not? Consequently, although the actual source of the failure may lie within a line or spending ministry or other public organisation a ministry of finance cannot shift all responsibility for the ineffectiveness of the control arrangements onto individual organisation managements. With arrangements for PFA/IC line ministry or service administrators[3] will be subject to the detailed central control over 'inputs' exercised by central controlling ministries. The usual organisational structure in line ministries and other organisations is for administrators to be appointed who may be politicians or civil and local government officials. Their control focus will be on 'inputs' because that will be the primary concern of the controlling central organisations and parliament. They usually will not have the performance and financial analytical information to enable them to deliver services and activities efficiently and effectively and to standard or to ensure that the arrangements for the collection of income have the same

[3] The term 'administrators' in used in this context rather that 'managers' because with PFA/IC the administrator has such limited scope for taking managerial actions.

characteristics. The likelihood also is that clarity of objectives will be lacking and management disciplines such as risk management will not exist or if they do, they will tend to be cosmetic in nature.

Whilst the main input controls exercised by a ministry of finance with PFA/IC will be financial ones, a central ministry, either the ministry of finance or another central ministry may also control the numbers and types of personnel who may be employed. Such numbers may be included in the budget documents and may in some countries form part of the budget law. Such personnel controls may also extend to the rates of pay that may be available, including payments to consultants, such as engineers working to support particular public service provision. This also has the effect of removing an important area of responsibility from a line organisation's administrations, such as a ministry responsible for delivering individual services. Similarly, line organisations may have responsibility for the instigation of procurements, although often the actual procurement processes are managed through a central ministry. Where though a line organisation has a responsibility for the actual procurement process, it should be expected to operate within centrally specified procurement rules.

Improvements to PFA/IC will be focussed by central ministries upon securing a strengthening of control over 'inputs', including commitments. In some developing and transition economy countries attempts may be made to incorporate 'outputs' especially where countries are seeking to introduce programme budgeting. Control over 'inputs' is an important requirement but, as explained, can be a limiting management requirement if those controls are externally imposed and have no regard to the expected outputs. Such financial and budgetary controls will be designed to ensure that spending does not exceed that approved for individual budget lines or groups of lines and that the detailed financial control regulations are observed. This process in effect denies to administrators the discretion they would require as effective managers, as well as not recognising that they will need different and more detailed information if they are to deliver objectives efficiently and effectively. Managers also need more flexibility if they are to succeed in this and that means that the virement rules need to be more relaxed. This, in turn, depends upon the attitude of parliament. Budgetary policy will also be designed to ensure that budget funds are allocated in accordance with government 'input' priorities such as 'we wish as a government to spend more money on schools, or healthcare, or prisons, or infrastructure'. Only rarely will this be translated into a specific objective linked directly to the available budget because the information available to do so does not usually exist. And then with PFA/IC a management with the discretion able to actually deliver the specific objective will not exist either.

Because responsibility for the strength of such financial and budgetary controls with PFA/IC rests with the ministry of finance within any confines set by parliament, that ministry will dominate the control process requiring public organisations to meet its requirements. In other words, the ministry of finance will define and secure the application of the control processes and how those control processes will operate. The aim will be to ensure that through its control mechanisms, spending conforms to budgetary limits, that is, 'inputs', specified in the budget law.

The budgetary structure is also important in determining how effectively managers can operate. With PFA/IC line ministries and other public organisation administrators may have little or no say in the budgetary structure and they will be responsible for compiling the budget in accordance with that externally imposed structure. That externally imposed budget structure will be approved by parliament and be designed principally to meet the needs of the ministry of finance. These needs, in turn, are likely to reflect the analysis required for international statistical reporting purposes, not the needs of the individual public organisations. In some countries the ministry of finance may also set out in detail how budgets are to be constructed indicating, for example, unit allowances for such items as vehicle running costs, or even ministry administrative costs. Where variations are required to any budget heading or, in some countries, groups of headings, ministry of finance approval will be required.

No matter how detailed ministry of finance control is over the construction of the budget it may also specify in financial regulations how day-to-day financial control is to be exercised to ensure that financial resources (both current and investment resources) are used to ensure that they are used only for public purposes and that effective day-to-day control exists to ensure that fraudulent, corrupt, or other improper activity does not occur. As was pointed out in the previous chapter those affected by the ministry of finance control processes are unlikely to have any say in how they should be applied.

A further control exercised by a ministry of finance is cash flow control. This will require other public organisations to ensure that spending complies with forecasts of cash flow requirements. Cash flow controls in some countries can be very detailed and be applied to most (or all) budgetary headings and in others can be limited to the main headings only. The dominating interest with cash flow controls is likely to be that of the ministry of finance. However, the more detailed the cash flow controls the more this draws a ministry of finance into line ministry and other organisation decision making processes. Also, the more detailed the cash flow controls are the more unreliable they are likely to be, and this is likely to affect the level of 'trust'.

In summary, systematic accountability arrangements with PFA/IC within line organisations is likely to be limited to ensuring that budgetary and financial controls over inputs are maintained and that the requirements of the associated regulations are met.

These budgetary control rules may or may not apply to second-level non-market organisations such as agencies but are unlikely to apply to state owned enterprises. If they do not apply in detail to agencies, they will usually apply to the subventions from the first to the second-level bodies. In some countries this allows second-level bodies direct control over what is regarded as its 'own income', where it engages in activities that provide sources of income. Consequently, income generated by an agency may not be subject to control at all and may not even be reflected in the budgetary calculations of the controlling ministry or local government. (Indeed, one of the reasons in some countries for establishing such agencies is to avoid the detailed budgetary controls that would apply to the controlling first-level organisation.) Although this is the reality of the situation this arrangement is inappropriate and can lead to abuse. In particular, an agency's 'own income' ought to be incorporated into the budgetary process and the controlling first-level body should ensure that the methods used by an agency to determine 'own income' charges are appropriate and that forecasts of 'own income' are reliable and are met in practice. The first-level body should also ensure that all second-level bodies, other than state owned or local government owned enterprises, apply the same budgetary and financial control rules as the first-level body irrespective of whether PFA/IC or PFM/IC applies.

Where state owned enterprises are exempted from budgetary control rules and the financial regulations that apply to non-market public organisations the controlling or owning first-level body should have a responsibility to ensure that equivalent or appropriate controls are applied and are effective. These other forms of control should include the arrangements for governance and could also include specific financial controls such as rates of return on capital to be achieved, limitations on payments to members of boards of directors, limitations on certain types of expenditure such as entertainment, a ban on the acceptance of fiscal risks without the specific approval of the controlling/owning first-level body and/or the ministry of finance. In Chap. 12 a more extensive discussion of the controls that should exist over second level organisations is set out.

3.1.3 Limitations of PFA/IC

PFA/IC, when applied well, is a robust system to ensure financial probity and compliance with public budgetary rules and regulations. However, even when applied effectively there remain limitations, hence the general drive towards the development and application of PFM/IC.

The principal deficiency with the whole concept of PFA/IC is the narrowness of the focus of the financial interest onto budgetary and financial compliance. A complementary focus is also on the current budget, whether 1 year or 3 years. The broader financial and operational environment with the ability of the manager to deliver better value is not addressed and neither is the longer-term financial viability of the organisation. Also, there is no linking of finance with objectives and performance standards and with the establishment of mechanisms to determine efficiency and effectiveness. In other words what is lacking is a reference to the quality of public expenditure and sustainability. (PFA/IC is not alone in this and international measures, such as PEFA[4] also just focus upon expenditure and do not reflect quality.) In addition, even with a sophisticated IFMIS the system itself says nothing about the quality of public expenditure, that is, whether it is efficient or effective. Adopting PFM/IC will not change this if it simply concerns itself with technical changes and ignores the managerial impact dimension. Corruption, where it exists, complicates the introduction of PFM/IC because PFM/IC relies on the integrity of the managerial structures.

What is important in the development of a PFM/IC reform is a strengthening of the quality of policy development and operational management. As was pointed out in the previous chapters this requires the separation of policy and strategy development from operational management with the delegation of operational management responsibility from the political level coupled with greater accountability. But this can only occur with the development of a quality, managerially oriented civil or local government service. Added to this should be a strengthening of the overall governance arrangements and greater transparency. This will improve the quality of the checks and balances in the system, enhance user pressure to make public services more efficient and responsive to user needs (i.e. effective) as well as lessening the risks of corrupt and fraudulent activity.

This also impacts upon the role of a ministry of finance. The more the ministry of finance seeks to control the detail of public expenditure the more it

---

[4] PEFA: Public expenditure and financial accountability framework: PEFA is a methodology for assessing public financial management performance. It identifies 94 characteristics (dimensions) across 31 key components of public financial management (indicators) in seven broad areas of activity (pillars).

discourages line ministry and other officials from becoming 'financially aware' and ensuring that public funds are spent efficiently and effectively and achieve specific objectives.

3.2 Comparing PFM/IC and PFA/IC

3.2.1 An Overview of the Comparison

This next section compares PFA/IC and PFM/IC and highlights the systemic and operational changes that need to be considered in any transition to PFM/IC.

With the application of PFM/IC the parameters that need to be kept under review are much more extensive than those required with PFA/IC. A comparison is summarised in Table 3.1 (a detailed comparison is set out in the Annex to this chapter.)

Table 3.1 Summary comparison of public financial administration and public financial management

Public financial administration	Public financial management
Budgetary control	Budgetary control
Financial control	Financial control
Compliance with the law and regulations	Compliance with the law and regulations
	Strengthened policy development and implementation strategy capability
	Operational management focus on meeting policy objectives within a specified time, efficiently
	Operational management focus on meeting performance standards
	Operational management focus on meeting performance objectives[a] efficiently within a specified time
	Operational management controls extended to ensuring that the activities/services provided meet the needs of the client/customer, i.e., effectiveness
	Focus on business and strategic planning and long-term financial planning, not least to secure the financial sustainability of the organisation

[a]Performance objectives cover the amount of work to be undertaken in a specified time. An example would be the number of social security claims to be dealt with in a specified period. This contrasts with performance standards which would be the quality of the way in which claims have been dealt with, such as responses within a specified time by officials, say within 1 week, and the number of errors made. All of this would be within an overall service objective of ensuring that the organisation had the capacity to deal with a forecast number of social security claims within the agreed budget

Introducing PFA/IC compared with PFM/IC does not have the same impact upon traditional customs and practices and therefore is easier and speedier to develop. In practice in this author's experience many of the reforms aiming to introduce PFM/IC have only had the effect of strengthening PFA/IC. This is not a 'bad thing' but it does not achieve the benefits that can be achieved through the application of PFM/IC.

Key elements that need to be considered before any move to PFM/IC should be considered are encapsulated in the comments of Antoinette Sayeh, former Director of the IMF's African Department:[5]

1. 'Budgets are often better prepared than they are executed: Even though the credibility of the annual budget remains work in progress in many African countries, the budget preparation PEFA[6] scores are on average better than scores for budget execution and oversight.
2. There is a severe implementation gap: Laws and processes may be in place but are not necessarily implemented.'

Antoinette Sayeh went on to say:

3. 'Consolidation of responsibilities often yields better results. The success of Treasury Single Account development and strengthened cash management in some countries is an impressive example of how consolidation can achieve excellent results. For macroeconomic stability, centralized decision-making is important to enforce fiscal rules and budget discipline. These topics, with reliable fiscal reporting, still comprise the "bread and butter" of technical assistance by the IMF in African countries.'

These three elements need to be addressed before a move to PFM/IC should be contemplated. However, point 3 potentially conflicts with the PFM/IC requirement for the devolution of decision making and authority to make budgetary decisions. Central departments with control responsibilities, because of these types of risk and for other reasons can be very reluctant to relinquish their responsibilities. Also, there is a certain tension between point 3, 'the consolidation of responsibilities', and the devolution of responsibilities envisaged by PFM/IC. The example from hospital services provided by De

[5] Keynote speech by Antoinette Sayeh, Director of the IMF's African Department at the UK's Overseas Development Institute's annual CAPE Conference, November 2013.

[6] PEFA—Public Expenditure and Financial Accountability (PEFA) is a tool for assessing the status of public financial management. See also footnote 4 above.

Geyndt and quoted in Chap. 1[7] also illustrates this tension. Yet to achieve improvements in performance, change is needed and that change requires managerial involvement in the delivery of services and activities with managers having a focus on the quality of services provided, that is, 'outputs' and the authority to make changes without central authority, except in specific cases, such as those involving high political resonance or high cost and risk. The introduction of PFM/IC makes this change possible but a critical factor in the devolution of responsibility is the existence of confidence by central controlling ministries, not least the ministry of finance, that devolution will not result in a damaging loss of control over 'inputs' and will actually achieve the 'output' benefits that are claimed. Those damaging consequences can be caused by incompetence, a failure to recognise the importance of control and not least financial and budgetary control, an inability to balance off service demands against available resources and worst of all, corrupt practice. What this does is to emphasise yet again that central to the success of PFM/IC reform is managerial reform and the prior existence of a robust PFA/IC. In turn it also emphasises that ministries of finance and other central controlling organisations need to rethink how they exercise control. Unless demonstrably, the concerns expressed by Antoinette Sayeh in point 3 of her remarks can be met the PFM/IC should not be proceeded with until macroeconomic stability, fiscal rules and budget discipline together with reliable fiscal reporting can be achieved.

3.2.2 The Objectives of Control

As described in Chap. 2, the objectives of control are different between PFA/IC and PFM/IC. Control with PFM/IC is not simply about financial, budgetary, and legal/regulatory control as with PFA/IC (see Sect. 3.1.1 above) but is also about achieving objectives to time, to standard, efficiently and effectively. Parliament and a ministry of finance (and possibly another ministry if a separate ministry is responsible for investment expenditure) will have an interest in each of these elements of control, but a ministry of finance cannot be held responsible for these wider elements of control, nor is it in any position to achieve them. Responsibility firmly lies with the manager of a line ministry and other public organisations.

[7] See footnote 18 of Chap. 1.

With PFM/IC responsibility for the quality of controls is moved away from a ministry of finance (and that other ministry if applicable) onto the management of each public organisation. The primary responsibility for control therefore lies with the line ministry or other public organisation management and not with a central ministry. Consequently, blame cannot be so easily shifted. This creates an opportunity for the development of greater public transparency and accountability, not least to parliament who should be able to broaden its interest to the quality of the management responsible for the delivery of public objectives, that is, the quality of public expenditure. Parliament may need to adapt its scrutiny arrangements through the development of specialist committees to enable it to do this and with the support of the state auditor.

What should be of particular concern to a ministry of finance is securing the achievement of overall macroeconomic stability, the observance of fiscal rules and overall budgetary discipline together with reliable fiscal reporting. It will want to secure the quality of the budget process ensuring that the objectives and performance standards for which the budget has been allocated are delivered. In addition, a ministry of finance may wish to ensure that expenditure on certain key items, such as personnel does not exceed specified limits and where that is the situation it may introduce specific controls to secure its interest (although it should be borne in mind the more it does so it detracts from the management of a public organisation responsibility for the delivery of its objectives). With PFM/IC therefore the ministry of finance in particular and also possibly the ministry responsible for personnel management, should be substituting detailed control for a macro type of control to enable line ministry management to exercise its full control responsibilities. However, to allow a ministry of finance to do that it must be satisfied that the overall financial and budgetary control and personnel controls will be effectively exercised by line ministries and the subsidiary organisations for which they are responsible. The offsetting potential gain is an improvement in the quality of the utilisation of public resources in terms of achieving objectives and not least in efficiency and effectiveness. Consequently, the development of PFM/IC represents a risk for central controlling ministries, although as noted in Chap. 1, the need to prevent the misuse of funds may be superseded by the need to deliver results.[8] In other words, is the traditional practice of detailed control of inputs still relevant, to quote Schick in 'an era of big activist government'?

But whether that 'fundamental shift' will occur depends very much upon the existence of 'trust'. Do those central ministries or politicians who will be

[8] See footnote 15, Chap. 1.

required to relinquish control or the opportunity to make decisions through the development of delegation really trust others, line organisations and officials, to actually take on the responsibilities for control and to make decisions? Merely saying that they will be required to do so will not be effective! This is because ways will always be found round any notional reforms. Sometimes there is more at stake than simply concern about control, as was pointed out in Chap. 2, because the PFM/IC reform can mean a loss of authority and power and even opportunities for promoting particular objectives or indeed personnel. 'Trust' has to be built over time and 'trust' will develop when it can be demonstrated that devolution of control can work well, that objectives can be delivered and that public organisations can operate more efficiently and effectively. This in turn affects the length of time that will be needed to implement the reform. Consequently, building 'trust' is a factor that reformers should not overlook (although unfortunately this never seems to be a factor in reform agendas).

The central point, made in previous chapters, is that ministries of finance should recognise that with PFM/IC to the traditional 'inputs' focus of control is added a focus on 'outputs', which are what service users and taxpayers are really interested in, that is, the quality, relevance, timing, and volume of public service availability. Unless attention is paid to 'outputs' no improvements in efficiency and effectiveness can be achieved. Service quality, relevance, and timing are very much functions of management. Service volume in most countries will be linked to the totality of the budget inputs rather than to a conscious decision about service quality and effectiveness (i.e. the outputs).

An unresolved question is whether 'outputs' should be incorporated into the budget and hence into the budget law. The introduction of PFM/IC because of the emphasis placed upon management and managerial discretion would clearly help but it would be impractical to incorporate into the budget law and for parliament to seek to exercise oversight at the managerial level. It would equally be difficult for a ministry of finance to also exercise such detailed output control and this would also risk a ministry of finance in effect becoming the ultimate decision maker rather than the manager of the line ministry or other public organisation. However, what could be appropriate in some countries, but only as a managerially oriented public service becomes established would be for the ministry of finance to require line ministries and other public organisations to specify what is to be achieved from the utilisation of budgetary resources and how performance is to be assessed. This would be difficult to specify where public service outputs cannot be easily defined in specific performance terms (see Chap. 6 on risks and unintended consequences). However, making line ministries and other public organisations more managerially oriented through budgetary disciplines should be a characteristic of the development of PFM/IC and of accountability and transparency.

An article in 2007 in the OECD Journal on Budgeting[9] discussing the benefits of incorporating performance information commented:

> Increasing the use of performance information in budget processes is an important initiative that is widespread across OECD countries. It is part of an ongoing process that seeks to move the focus of decision making in budgeting away from inputs (how much money can I get?) towards measurable results (what can I achieve with this money?). OECD countries have reported a number of benefits from the use of performance information (PI):
>
> - It generates a sharper focus on results within the government.
> - It provides more and better information on government goals and priorities, and on how different programmes contribute to achieve these goals.
> - It encourages a greater emphasis on planning and acts as a signalling device that provides key actors with details on what is working and what is not.
> - It improves transparency by providing more and better information to parliaments and to the public, and has the potential to improve public management and efficiency.

3.2.3 Budgetary Control

There are two types of budgetary control, namely one centralised within the ministry of finance and the other decentralised within ministries and agencies. These have been described in an IMF paper[10] with their advantages and disadvantages as follows:

> Centralized systems, particularly with centralized commitment and accounting controls, have the advantage of: (i) reducing the scope for variable interpretation and application of control criteria by multiple agencies; (ii) facilitating integration between aggregate cash control and commitment control at the transaction level; and (iii) allowing the ministry of finance direct access to a centralized repository of expenditure data for budget execution monitoring/reporting. At the same time, centralization has the disadvantage of: (i) undermining spending responsibilities of managers in line agencies in the day-to-day management of line ministries/agencies' budgets; (ii) increasing the risks of noncompliance and/

---

[9] Improving Public Sector Efficiency: Challenges and Opportunities: OECD Journal on Budgeting Volume 7 –2007.

[10] https://www.imf.org/external/pubs/ft/tnm/2016/tnm1602a.pdf.

or collusion (as both the authority to spend and the responsibility to ensure the regularity of transactions is assigned to the same agency) in the absence of strong internal and external audit functions; and (iii) inefficient decision-making (including superimposed prioritization) and rigid controls by the ministry of finance when it lacks the detailed information on the spending requirements of agencies; and (iv) presenting opportunities for rent seeking by officials implementing multiple and cumbersome controls.

Decentralized frameworks have the advantage of: (i) aligning expenditure decision making with the spending priorities of line agencies; (ii) minimizing/eliminating redundant controls which in turn improves the efficiency and speed of expenditure execution; and (iii) making each line agency directly accountable for its spending programs. At the same time, they have the disadvantage of: (i) potential disparate application of controls by various agencies particularly when the control criteria are not well defined; (ii) increasing the risks of noncompliance and/or collusion (as both the authority to spend and the responsibility to ensure the regularity of transactions is assigned to the same agency) in the absence of strong internal and external audit functions; and (iii) prolonging the preparation of financial reports (as expenditure data has to be collected and complied from multiple sources) required by central agencies for budget execution monitoring.

The actual process of budgetary control where PFA/IC exists will normally be exercised by the ministry of finance through an IT-based IFMIS (see Sect. 3.1.1) and therefore be representative of the centralised system also described above. The approved budget will be entered into that system as will actual line ministry spending (and for local governments if they are using the same system). That system would normally block any proposed spending for which there is no budgetary provision. Ideally commitments should also be entered into the system but this can be a weakness or if commitments are entered the information is not comprehensive being limited to current orders for goods and services and not reflecting future orders to be placed during the remainder of the year or impacting upon future years. However, how effective such systems are in facilitating budgetary control depends upon the controls that in turn exist over the operation of this system and the managerial attitude to control. As was pointed out in Sect. 3.1.1, weaknesses in security particularly, can lead to abuse and misuse of resources.

Consequently, with PFM/IC the budgetary control process will be more devolved and hence more representative of the decentralised system referred to above. A ministry of finance will still require information about spending in accordance with the framework specified by that ministry no matter how budgetary and accounting information is reanalysed for internal public organisation managerial purposes. How frequently the central ministry of finance will require that information will depend upon local country arrangements. An example from Canada (see also Chap. 5) illustrates how such information can be collected by the central ministry:[11]

> The government-wide chart of accounts is a framework that explains how departments [i.e. ministries] and agencies should identify, collect and report financial transactions to consistently satisfy the government's corporate information requirements. The chart of accounts contains the accounts and codes for all the fields that comprise the government-wide coding block.
>
> Departments and other reporting entities use these accounts and codes to input their monthly trial balances in the fields that make up the government-wide coding block. The departments then transmit these balances to the Central Financial Management Reporting System.

What this shows is that decentralisation does not automatically prevent the ministry of finance from obtaining the information it requires.

A crucial control where PFM/IC has been established is to ensure that the information contained in the financial information system used by the manager is entirely consistent with that used by the ministry of finance. To secure that consistency should be a responsibility of the head of finance (see Chap. 8 on the role of the head of finance). Regular reconciliation between the line ministry system and the ministry of finance system should be a consistent feature of financial management. This can be ensured through a coding system which has the flexibility to allow both the manager in a line ministry or other public organisation and the ministry of finance to obtain the information that they both require. This may be facilitated using modern IT systems.

3.2.4 Development of Budgets

The responsibility of line ministry administrators where PFA/IC applies from a financial perspective is limited to ensuring that budgetary limits are not exceeded, that financial regulations (including procurement regulations) and any cash flow limitations are observed. These line ministry responsibilities are usually exercised by the line ministry or local government accountant/finance officer, rather than by the actual administrators. The administrator responsible for a particular area of activity may not know exactly what budget is available for what service delivery purpose, because the structure of the budget and

[11] https://www.tpsgc-pwgsc.gc.ca/recgen/pceaf-gwcoa/index-eng.html.

the corresponding accounting arrangements will be designed to meet the needs of the ministry of finance rather than the needs of the administrator. For example, personnel budgets may be amalgamated into a single heading for a whole ministry rather than be allocated to each element of a service or activity and budgetary control will be exercised on that basis.

With PFA/IC there is often no linkage of budgets to specified managerial objectives and performance standards, although broad political objectives (aspirations!) are frequently included in budget statements. Neither is there a requirement to achieve efficiency and effectiveness except again as a broad political objective. There will be no specific managerial structures with delegated powers and accountability arrangements specifically designed to deliver objectives or improvements in efficiency and effectiveness. The budget making process is likely to be dominated by the interests of the ministry of finance who will specify in the annual budget circular how the budget is to be compiled. Administrators are unlikely to have the ability to intervene in budget making, except at the margins, and anyway without objectives and performance standards or the information to enable a judgement to be made about efficiency and effectiveness the relevance of budgetary allocations to political policies and objectives is difficult to determine with any sort of precision. What will dominate is the overall fiscal situation and the government view of political priorities. Therefore, budgets can come to be regarded as being 'imposed' externally rather than being 'owned' by the administrator. The result is therefore that pictured by Antoinette Sayeh, namely that budgets can be better prepared than executed.

Service administrators are under different pressures than a ministry of finance. Service administrators will want to respond to pressures from customers or clients of the public services for which they are responsible. However, the likelihood is that budgets in these circumstances will be dominated by the objectives of the ministry of finance rather than jointly determined between the ministry of finance and the line ministry administrator.

This contrasts with the situation where PFM/IC exists and where there is a much greater actual or potential opportunity for the establishment of budgetary 'ownership' by the manager and hence for both better-quality budget making and execution. This is because the manager should have a responsibility not only to secure budgetary control but also to deliver a set of objectives and performance standards. If the manager is to do that, that manager must be involved in the budgetary decisions. If the manager is not involved no commitment can be given to deliver those objectives and standards.

How the information about actual levels of spending (and income) against the budget will be provided will depend, as shown above, upon whether the budgetary control system is centralised or decentralised. In some countries information about spending against budgets is provided within line organisations only every three months although in others the routine is monthly reporting. With more advanced IT systems, whether there is a centralised or decentralised system, 'on-line' arrangements mean that spending information is current but only provided in accordance with the budgetary analysis required by the ministry of finance because of the need to control against budget inputs. The frequency of reporting is important for management reasons but with PFA/IC these management reasons are limited to those seen as important to the ministry of finance. With PFM/IC three monthly reporting is quite inadequate because it gives too little time for adjustments to be made to spending patterns to enable managers to maintain or adjust service levels where budgets appear as though they will be exceeded *and* objectives may not be met. Or if the indication is that budgets will be under-spent and yet objectives met managers, with three monthly reporting managers are in no position to consider alternative fund usage provided the ministry of finance budgetary controls permit this. With PFM/IC managers should also be provided with information about performance and such information, depending upon the activity, could be provided at different intervals, some of which could be very short intervals. Consequently, managers should be making operational as well as financial performance judgements and therefore reporting arrangements do need to be linked as far as possible.

With PFA/IC 3-monthly reporting anyway is also inadequate. This is because if spending appears as though it will not meet budgetary limits, and the emphasis is simply upon spending, and the indicator is that if budgets will be under-spent the incentive will be just to increase spending not least in order to maintain a claim on the same level of budget for the next financial year. This is even if funds are allowed to be transferred to meet an overspending elsewhere. If there is a possibility of overspending the incentive will be to make cuts to spending levels without necessarily any regard to the quality of service or the achievement of objectives. If, as with PFA/IC, the focus is only on spending levels, rather than also on the achievement of objectives, and there is a risk of overspending the budget, pressure is then generated to permit supplementary estimates or budgetary variation arrangements or to use 'other devices' to avoid breaching budgetary limits. An example of 'other devices' would be allowing the accumulation of arrears of payments to creditors or service levels are abruptly reduced or attempts can be made to reclassify current expenditure as capital investment. Such devices usually result in increased costs or greater inefficiencies or ineffectiveness in public service delivery and there is no regard to the achievement of objectives. This could also happen with PFM/IC but the likelihood is that the incentives will be less and the circumstances in which the possibilities will arise will be fewer, not least because of the focus upon the achievement of efficiency and effectiveness.

An associated weakness with PFA/IC is that countries do not seem to require that regular re-forecasts are made of expenditure and income to the end of the year. Consequently, there is no opportunity to plan for how potential overspendings might be accommodated (or under-spendings). Such re-forecasting ought to be an automatic requirement exercised by the head of finance where PFM/IC has been implemented although there is no reason why it should not occur with PFA/IC. However, the incentive is much less because the focus is simply upon budgetary control not also on the delivery of objectives.

3.2.5 Parliamentary Scrutiny

Another factor affecting the frequency of reporting is the need to keep parliament informed of progress against the budget (i.e. for both expenditure and income) and to allow for effective financial scrutiny by parliament. The purpose of parliamentary financial scrutiny is part of the process of developing transparency and accountability. The aim is to make the government, individual ministries and other public bodies accountable for their financial decisions—in other words, requiring them to justify their revenue-raising and spending plans. With the development of PFM/IC the government and individual ministries and other public bodies should be able to explain whether the expenditure achieved its objectives and, if not, why not. The degree of detail involved in the parliamentary scrutiny process will vary between countries, but the underlying principles should be to:

- Make the government's financial decisions transparent, including the relationship between its stated priorities and its funding decisions.
- Encourage civil society to become involved in discussions about public expenditure through the provision of evidence to parliament as part of the process of informing the parliamentary debate.
- Influence the government's financial decisions.

- Hold the government, individual ministries and other public bodies to account for their financial decisions and quality of financial management; and through the scrutiny process to contribute to an improvement in the quality of financial decisions and management and improved value for money in public services.

> Financial scrutiny matters because the quality of financial decisions and financial management is likely to be higher if they are made transparent and if those responsible for them know that they will be scrutinised rigorously and mismanagement will be exposed. Better financial scrutiny should therefore result in more efficient and effective public services.[12]

To enable scrutiny to be effective parliament will need an appropriate level of support resources. This can be provided by the development of parliament's own staff and/or through support from the state auditor.

How frequently reporting to parliament should occur will depend upon local country circumstances but the OECD in a 2002 report on Best Practices for Budget Transparency[13]envisaged monthly, mid-year, and annual reports. These reports would serve different purposes, but detailed scrutiny could not occur monthly and probably only annually. In practice, the likelihood is that detailed parliamentary scrutiny of individual public service provision budgets would occur on a cyclical basis.

3.2.6 Internal and External Audit

Whether PFA/IC or PFM/IC exists there is an important role for internal audit. Internal audit should identify and suggest remedies to address control weaknesses. The potential weaknesses depend upon whether control is centralised or decentralised, as the IMF paper referred to above has identified. However, realistically, if control weaknesses are extensive with PFA/IC because of a divided responsibility between a ministry of finance and a line organisation or a lack of interest or involvement in financial, budgetary, and other controls by line ministry administrators, the likelihood of internal audit being effective will be limited, even where the internal auditor may report directly

---

[12] UK House of Commons Liaison Committee Parliament and Government Finance: Recreating Financial Scrutiny: Second Report of Session 2007–08: https://publications.parliament.uk/pa/cm200708/cmselect/cmliaisn/426/426.pdf#:~:text=The%20principles%20which%20should%20underlie%20the%20Government%E2%80%99s%20financial,an%20assessment%20of%20the%20quality%20of%20financial%20management.

[13] https://www.oecd.org/governance/budgeting/Best%20Practices%20Budget%20Transparency%20-%20complete%20with%20cover%20page.pdf.

to the political head of the organisation. This also suggests that changing to PFM/IC could enhance the effectiveness of internal audit because of the clear focus of responsibility for the operational effectiveness of all controls would be the responsibility of the head of operational management. But then that raises the question of to whom the internal auditor should report? With PFM/IC the more appropriate reporting line would be to that head of operational management, rather than to the political head. (This question of reporting for internal audit is discussed elsewhere in this guide, see Chap. 7.) Another factor affecting the quality of internal audit will be the relationship with and attitude of the external auditor. External auditor support for the internal audit in some countries will be essential in developing internal audit quality and independence. The development of PFM/IC also creates greater opportunity for the internal auditor to undertake value for money audits, partly because of the financial and performance information which becomes available and partly because the managerial orientation that would be required of management should encourage such an audit approach. The same would also be true for external audit which has an increasing focus upon audits which address the issue of public value through performance audits.

3.2.7 Consequential Features of PFM/IC That Do Not Exist with PFA/IC

There are consequential features of PFM/IC which do not exist, and usually cannot exist with PFA/IC. One important feature in securing the achievement of objectives is the development of risk management, that is the identification and management of those risks that will affect the achievement of the objectives and performance standards and performance objectives of the organisation. Another is that to be confident of achieving objectives managers must engage in strategic and business planning. Such planning will help managers identify the practicality of achieving the objectives of the organisation within the financial constraints that will inevitably exist, not only within the budgetary period but also over time, the length of time depending upon a particular service. A usually completely overlooked feature of PFM/IC, is that management should be always concerned with the longer-run financial resilience of the organisation. This is not simply, as has been indicated previously, a matter of preparing, say, 3-year medium-term budgets but of looking much further forward and assessing the impact of current policies and investment decisions as well as external factors (such as demographic changes) upon the possible future financial resources of the organisation.

Each of these features of PFM/IC is addressed in detail in later chapters of this guide.

3.3 Summary

Before PFM/IC is developed there should be in existence, as emphasised previously, a robust PFA/IC. The principal differences between them are:

1. Responsibility for detailed control of expenditure is shifted with PFM/IC from the ministry of finance to line ministries. (This can include 'personnel' controls as well.)
2. The focus of control with PFA/IC is on financial inputs whereas with PFM/IC control should incorporate the achievement of objectives and performance standards and performance objectives as well. This in turn provides an encouraging environment for the development of value for money (performance) audits by both internal and external audit.
3. The budget structure with PFA/IC will be designed to meet the needs only of the ministry of finance with little or no regard for line ministry managerial needs. With PFM/IC the budget structure must meet the needs of both the ministry of finance and the manager.
4. Controls over second-level organisations are likely to be weaker with PFA/IC than with PFM/IC.
5. With PFA/IC there is not the same possibility of achieving efficiency and effectiveness (no matter what laws and regulations say on achieving these characteristics).
6. PFM/IC is consistent with the development of a 'managerial culture' and raised financial awareness amongst managers.
7. The development of PFM/IC offers the potential to improve the quality of budgeting.
8. Managerial effectiveness with PFM/IC depends also upon the existence of a high quality of relevant financial information, such as information about cost drivers and cost centre analyses, not normally required with PFA/IC together with the existence of strategic and business planning as well as long-term financial planning.
9. With PFM/IC there is a greater opportunity to develop effective parliamentary scrutiny.

Annex: A Detailed Comparison of PFA/IC and PFM/IC

The chart set out below compares different aspects of public financial administration and public financial management.

Detailed comparison of key features of PFA/IC and PFM/IC

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
The control environment	Should be set by the top political official and administrative official of the organisation with the main focus being on the financial and budgetary controls to ensure that the resources of the organisation are only used for the approved purposes within any budgetary limitations. However, where traditional hierarchical management structures exist the control environment is likely to be heavily influenced by traditional custom and practice.	Should be set by the top political official and the head of the organisation responsible for operational management with the main focus being on the achievement of the objectives and performance standards of the organisation coupled with the efficient and effective utilisation of the resources of the organisation. All resources should be used only for the purposes of the organisation and within the budgetary envelope agreed with the ministry of finance.	Whatever the financial arrangements the 'tone at the top' set by the most senior officials permeates through the whole organisation. In implementing PFM/IC this is a particularly key factor because of the emphasis upon achieving objectives and efficiency and effectiveness. In some countries a single top administrative official post does not exist and the control environment is set by the political official and the ministry of finance. This will not facilitate the introduction of PFM/IC.
Managerial structures	Although there ought to be a clear distinction between those officials who are responsible for policy, strategy, and supervision of operational management (politically appointed officials), and operational management (civil servants and local government officials) even though desirable, no such distinction is absolutely necessary. Traditional hierarchical management structures are unlikely to accommodate such a distinction.	For effective PFM/IC there should be a clear distinction between those officials who are responsible for policy, strategy, and supervision of operational management (politically appointed officials), and those responsible for operational management (civil servants and local government officials). Without this distinction the politically appointed officials will have great difficulty in undertaking all the responsibilities required for effective PFM/IC.	This distinction between policy development and strategy and operational management is essential with PFM/IC because operational management involves many features that are totally absent from financial administration. For example, the operational manager will be responsible for risk management, for achieving objectives and for doing so efficiently and effectively, for supervising agencies and for enhanced accountability. Without this distinction it will be impossible for a single person to be responsible for policy, strategy, and operational management. Then the likelihood is that, at a minimum, the quality of policy and strategy development and operational management will decline. As effective policy making requires input from those responsible for operational management coordination is essential.

(*continued*)

(continued)

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
Delegation and managerial accountability	Even though desirable, no such structures are absolutely necessary because the role of management is much more limited. Where such structures do exist accountability should also exist. However, accountability will be limited to financial and budgetary compliance.	Management structures should exist at all levels within an organisation. Managers at all levels should have appropriate objectives, performance standards and performance objectives and be accountable to higher levels of management for their achievement as well as for financial and budgetary compliance.	Delegation is essential with PFM/IC if objectives are to be delivered efficiently and effectively. If decision making is held at the political level operational expertise cannot easily be developed and political interests can dominate decision making. Higher-level management time will also become crowded out by dealing with relatively minor issues. Effective operational management relies heavily upon experience which political officials are unlikely to have.
Internal control	Covers budgetary and financial control as well as ensuring legal and regulatory compliance. In some countries it may also include adherence to procurement controls. Controls are focussed upon inputs only.	Covers budgetary and financial control as well as legal and regulatory control AND those controls necessary to achieve the objectives of the organisation to time, to standard, economically, efficiently, and effectively. Controls should have a focus upon outputs as well as inputs.	A main advantage of PFM/IC is that it requires operational management to focus on the achievement of outputs and in this process to become 'financially aware', that is, to be aware of costs (which are not the same as budgetary allowances) and through the analysis of costs to make judgements about the most efficient and effective utilisation of resources, including the utilisation of the asset stock. Whilst the policy about the quality and structure of financial and budgetary controls will be determined by the ministry of finance (and with PFA/IC may be operated by the ministry of finance), with PFM/IC, implementation of the controls will be a responsibility of the line organisation manager. However, output controls designed to achieve objectives and performance standards should be controls established by the line organisation. Line organisation management should therefore have a specific interest in their appropriateness and success. PFA/IC does not present these issues to the manager because the focus of control is only on inputs.

Responsibility for controls	Ministry of finance with finance staff in line organisations ensuring financial and budgetary controls are followed. Other controls are most unlikely to exist.	Line organisation management whose responsibility covers all controls of whatever type, i.e., financial, budgetary, and managerial to secure the delivery of objectives efficiently and effectively.	With PFM/IC the line organisation manager has the primary responsibility even though for budgetary and financial control parameters will be set by the ministry of finance. With PFM/IC these controls ought to be modified to give line ministries more discretion than they would have with arrangements for PFA/IC. Output controls should be wholly the responsibility of the line ministry management This is especially important where the line organisation must deliver improvements in efficiency and effectiveness which may mean the rationalisation of assets, staff, and other resources as well as being needed to achieve objectives. Line ministry management may be subject to parliamentary scrutiny to explain how they have exercised control.
Information and communication	Although desirable with PFA/IC, in practice the limited emphasis upon management and the achievement of objectives and the focus on budgetary and financial control limits the scope for the development of this feature	This is a key feature of PFM/IC because of the focus upon the achievement of the objectives of the organisation. Effective information and communication are necessary to ensure that managers at all levels are aware of what is happening to and throughout the organisation in order to reduce the risk of a 'silo mentality' developing by encouraging the exchange of information between different parts of the organisation.	For internal control to be effective the managers and staff within the organisation need to know both what the organisation's overall objectives are as well as those objectives that are set internally for each level of management. Ideally, they ought also to know what the objectives are for the services and activities provided by other parts of the organisation as well as their own. In other words, managers and staff need to know what is expected of them and the operational context of their organisation as well as for their own part of the organisation. This is another reason why a single person should have overall responsibility for the operational management of a line organisation. The wider availability of information with PFM/IC also provides an opportunity for better-quality policy making.
Efficiency and effectiveness	At best only limited possibilities as part of the routine activities because the key financial and performance information is not available to administrators.	Responsibility of the line organisation management and should be a consistent feature of management.	Arrangements for financial administration do not facilitate the development of efficiency and effectiveness and there is no possibility that a ministry of finance can make those judgements about efficiency and effectiveness that ought to be the prerogative of the management of the line organisation.

(*continued*)

(continued)

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
Managing to achieve objectives, performance standards and performance objectives	Not possible as part of the routine control activities	Responsibility of the line organisation management with a key responsibility of top management to set objectives and performance standards for the different parts of the organisation. These objectives and performance standards should be reflected in the approved budget for the organisation.	PFA/IC does not require the setting of objectives, performance standards or performance objectives, all of which are necessary as part of PFM/IC.
Risk management to secure achievement of objectives	Risk to the achievement of the objectives is not possible as part of the routine activities because objectives do not need to be defined. Systems risk management can be undertaken and should be a responsibility of each level of administration. Systems risks are unlikely to impact upon the top level of management unless the system affected is central to the delivery of the services of the organisation.	Responsibility of the line organisation management for both managerial risks (i.e. to the achievement of objectives) and systems risks. Different levels of management will be responsible for different levels of risk reporting upwards as appropriate.	Because PFA/IC does not require the setting of objectives, risk management at best can only cover system risks. This is a limited role for risk management.

Budget period	Single-year budgets although nominally 3-year budgets may exist but it is questionable if such 3-year budgets represent a full assessment of the budgetary requirements for each of the forward years. Very often they are just a ‘roll forward’ of the existing budget with an adjustment for inflation.	Multi-year budgets are a desirable feature of PFM because delivery of most public service objectives can only occur over a medium term, and sometimes longer period. However, effective multi-year budgeting is extremely difficult and tends towards ‘tokenism’. Therefore, finance officers ought to undertake long-term financial planning to assess the forward financial impact of policy. Such financial plans would be outside the budget structure.	Many countries have developed what are called medium-term budgets even though in effect they are at the public administration stage of development. However, in these countries medium-term budgets will be largely nominal/presentational and will not be used for policy and service planning purposes. PFM/IC ideally requires the development of longer-term budgeting because the efficient and effective management of public services requires a longer-term planning horizon than a single year. Before medium-term budgeting can be effective, stability and robustness are required in the 1-year budgeting process with a formal process for approving budgetary variations.
Budgets linked to objectives, performance standards and operational performance	Budget setting focussed simply upon financial availability based upon macroeconomic forecasts. There is no linkage to objectives or performance standards except in the most general of terms.	Joint agreement with ministry of finance and line organisation management about the available budget and the linkage with objectives and performance standards. If reductions were made to finance availability objectives, performance standards and operational objectives should be amended accordingly.	Effective financial management which involves the setting of objectives and performance standards must involve the line organisation management in budget setting and the agreement of the manager to the budget. The result will be better-quality budgeting.

(*continued*)

(continued)

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
Budget structure	Budget structure would be designed simply to meet the needs of the ministry of finance and in some countries the ministry responsible for capital investment programmes.	Should have the flexibility to meet the needs of both the ministry of finance and the line organisation management. Line ministry management requirements are likely to be different from those of the ministry of finance. However, where the budget for investment expenditure is the responsibility of another ministry the manager will need to ensure that effective coordination of the current and investment budgets occurs.	
Coding structures	Coding structures would be designed to meet only the needs of the ministry of finance	To provide the information that managers require expenditure and income will need to be analysed to meet both the needs of the ministry of finance and, at the same time, the needs of the line organisation management, who may require the analysis of expenditure (and income) over any part of the organisation or activity for which the manager is responsible and which the manager deems to be a cost centre or for which the manager requires cost information to enable that manager to control costs and to make judgements about the allocation of resources and ultimately about efficiency and effectiveness.	With PFA/IC the primary purpose of coding structures is to facilitate budgetary control. They would not need to be so elaborate as to enable the manager to make judgements about efficiency and effectiveness and the delivery of objectives. With PFM/IC the coding structures should be sufficiently flexible to meet the needs of the manager as well as those of the ministry of finance. The manager's needs may vary from year to year depending upon operational circumstances. The coding structures should facilitate this. In practice line ministries and other organisations may need to develop their own coding structures but such structures should always be capable of providing the information the ministry of finance requires. (However, with commercial IFMIS packages this may not always be possible and to obtain the managerial information the development of individual management information systems may be necessary.)

Financial information	Designed to meet the budgetary and financial control, including cash control needs only	Designed to meet the budgetary and financial control needs AND the managerial needs based upon the managers responsibility to deliver outputs with efficiency and effectiveness. This would also facilitate better-quality budget preparation.	With PFM/IC the financial information system will include a financial analytical capacity which means that the managers of most organisations will require the development of cost and management accounting.
Performance information	This would only be required if a ministry had performance targets to meet.	PFM/IC requires in principle, the linking of finance with evidence of performance. Managerial and accounting arrangements taking performance into account would be an automatic feature of PFM/IC.	For some services objectives and performance information can be extremely difficult to determine in numerical or quality terms. Very often the best that can be achieved is that objectives may need to be subdivided, and then sometimes arbitrarily because of an inherent lack of clarity about an objective—e.g., what is the objective of prison—is it just to confine people or is it to secure a reduction in reoffending? This also affects the definition of appropriate performance information. Consequently, there may be no direct relationship between the availability of finance and performance.
Strategic planning	Not required because financial considerations are limited to the budgetary issues relating to the period of the budget. However, where it is required, the results may simply be token rather than substantive.	Effective PFM/IC requires that longer-term plans for the management and delivery of public services are prepared. These plans should include a financial element so that when decisions are made those making the decisions are aware of the longer-run implications for budgets. For example, the full-year effects of a policy decision should be identified, including the full-year effects of new investments. The strategic plan should also identify how utilisation and performance of services (and assets) can be expected to change over time.	Strategic planning is not a required element of PFA/IC. Officials could aim to engage in this activity but the substantive information required would be unlikely to be available.

(*continued*)

(continued)

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
Business planning	Not required because financial considerations are limited to the budgetary issues relating to the period of the budget.	This is an essential element of PFM/IC. This form of planning is intended to demonstrate how, in the near term, a particular policy will be implemented. Business cases should provide assessments of strategic fit, option appraisal, achievability, value for money and affordability.	Although business planning is not a required element of PFA/IC, officials could engage in this activity but the substantive information required would be unlikely to be available.
Long-term financial planning	At most would be likely to be confined to medium-term budgeting (i.e. 3 or 4 years) and even then, would be probably based upon current budgets adjusted for inflation and political policy changes.	An essential feature of PFM/IC. Management should look further ahead than a medium-term budget and should be concerned to identify the factors which would affect the long-term financial resilience of the organisation, ranging from long-term contracts or investments to demographic and environmental change as well as political policy changes.	With PFA/IC it would be most unlikely that there would be any requirement for long-term financial planning. Most of the information required would not be available.
Control of second-level bodies such as agencies	In practice limited to budgetary and financial control by the controlling organisations and then usually only of the totals of any payments by the controlling body. In theory the controlling organisations could enter into agreements about objectives and performance but these conditions would have to exist: 1. The controlling organisation has a managerial capability to set and monitor such agreements. 2. The controlling organisation has its own managerial objectives which can be reflected in those set for the second-level body.	Controlling organisations should enter into agreements with second-level body to ensure that their objectives and performance standards are coordinated with those of the controlling organisation, that the same internal control standards apply and that the performance of the agency is regularly monitored with the need for its existence being periodically reviewed. Therefore, a controlling organisation must have a capacity to determine the content of agreements and to monitor their implementation.	The extent of the control arrangements with organisations applying PFM/IC would be much broader and deeper than those applying financial administrative arrangements. No second-level bodies, whether PFA/IC or PFM/IC applied, should be allowed to accept fiscal risks without the specific permission of the controlling organisation and if appropriate the ministry of finance.

Control of state owned enterprises	'Owning' organisations should define the role and appoint the governing boards, define the governance structures, set rates of return and other performance objectives ensuring that appropriate allowances are made for the costs of capital and for commercial risk. However, in practice with PFA/IC, because there is no equivalent financial discipline applying to the owning organisation, the reality is that no such arrangements are likely to be made. Arrangements should exist for the regular and systematic monitoring of the performance of state owned enterprises with the periodicity of such monitoring depending upon the nature of the business of the enterprise, its political salience, and other local circumstances.	'Owning' organisations should define the role and appoint the governing boards, define the governance structures, set rates of return and other performance objectives ensuring that appropriate allowances are made for the costs of capital and for commercial risk. Arrangements should exist for the regular and systematic monitoring of the performance of state owned enterprises with the periodicity of such monitoring depending upon the nature of the business of the enterprise, its political salience, and other local circumstances.	Although the controlling arrangements would be similar, whether PFM/IC or PFA/IC were adopted, although in practice the likelihood is that the financial disciplines required for the effective application of PFM/IC would affect how the responsibilities of the 'owning' organisation towards a state owned enterprise were effected. The 'managerial culture' where PFM/IC is employed would be very different from that where PFA/IC exists and it would be exceptional to expect one culture to apply within an organisation and another towards a second-level organisation, whether an agency or an enterprise. No enterprises should be allowed to accept fiscal risks without the specific permission of the 'owning' organisation and if appropriate the ministry of finance.

(*continued*)

(continued)

Activity	Public financial administration (PFA/IC)	Public financial management (PFM/IC)	Comment
Monitoring	Systematic monitoring of financial administration controls will only occur if there is a strong and effective internal audit reporting to a top and senior political and operational management determined to secure the effectiveness of the controls. External monitoring should also be undertaken by the ministry of finance and also by parliament who should be informed by the work of the external auditor.	Systematic monitoring of the effectiveness of the control processes should be a feature of PFM/IC. Those monitoring processes should cover the full range of controls, i.e., including output controls as well as financial and budgetary controls Only in this way can the top and senior management be confident that the input and output controls are appropriate and effective. An important contributor to the monitoring process would be internal audit. Monitoring responsibility primarily should be a responsibility of the head of operational management reporting to the political head on the achievement (or not) of the objectives of the organisation. External monitoring spending against the budget along with performance would also be undertaken by the ministry of finance. Parliament should also monitor financial and activity performance against objectives and in this would be informed by the work of the external auditor.	The objective of monitoring is to evaluate whether the arrangements for internal control are themselves efficient and effective. Because the extent of the controls is more limited with PFA/IC the extent of the monitoring will be more limited. With both PFA/IC and PFM/IC parliamentary monitoring should occur. With PFM/IC parliamentary monitoring is likely to be more extensive than with PFA/IC because of the linkage of finance with objectives and performance standards and with the more extensive discretion available to line ministry and other organisation managers.

[a]Strategic plans should be accompanied by strategic financial planning which is about the matching of expenditure and revenues not only in the short and medium term but also over the longer term. (This is different from a 3- or 4-year budgetary framework, which is a reflection of the overall economic view of the ability of the economy to finance public expenditure.) A strategic financial plan is a forecast of what an organisation is committed to before it seeks to modify its programmes to meet any economic constraints

4

The Practical Steps for Initiating a Successful PFM/IC Reform

This chapter looks at the practicalities of introducing PFM/IC. It sets out a series of tests that should be applied before adopting and applying the reform. It also suggests that an initial study is carried out to assess whether a government is really willing and able to undertake the scale of the reform necessary to apply PFM/IC. The chapter builds upon the discussions in previous chapters but focuses on the practicalities of successfully achieving change and the consequences when this is only partially realised.

4.1 This Is a Management Reform!

4.1.1 The Managerial Impact

Government is about hard policy choices and those choices are bound to attract criticism from those who are adversely affected. Given the increasing significance of public expenditure and the impact upon individual lives improving the quality of the management and delivery of public services, that is improving public value, is essential. PFM/IC is an important contributor to achieving that objective. Simply regarding PFM/IC as a technical financial reform focussing on the arrangements for financial and budgetary control will not deliver that contribution. In the previous chapters the argument has been that not adequately considering the substantive management reforms that must accompany the technical financial reforms which are part of the PFM/IC reform will

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_4

prevent the achievement of the benefits of the reform and will probably add to costs. The overall purpose of the PFM/IC reform is to deliver better quality public services, to make better use of public money and assets and to ensure that income generating policies achieve their objectives. This reform also aims to ensure that both expenditure and income are efficiently and effectively managed. The reform can be summarised as aiming to achieve six purposes:

1. To facilitate the delivery of the government's policy and the associated objectives (and the equivalent for local government).
2. To ensure that public organisations deliver the relevant policies and objectives in a manner that is both efficient and effective.
3. To ensure that public funds and assets are used only for public purposes.
4. To secure the long-run financial resilience of public organisations.
5. To improve the quality of public governance.
6. To improve accountability of public organisations both internally to higher levels of management and externally to third parties and not least to parliament.

Achievement of these six purposes provides the basis for judging whether the reform has been successful. Quality management, including leadership, is central to this. Leadership means that the top and senior political and appointed officials are committed to and actively support the reform. Local ownership is also very important.

Introducing PFM/IC is a major reform. As has been pointed out in the previous chapters, PFM/IC can impact radically on the roles of elected and appointed officials. The extent of the change depends upon the present organisational arrangements. It may also lead to questions about the shape of the government organisation. Elected official's area of responsibility should be to concentrate on the development of policy and the strategy for the implementation of policy. Appointed officials, the civil and local government service responsibility, is that of operational management, that is, 'delivery'. To achieve effective policy development though, cooperation is required between operational and political management. A role of the operational management is to assist the politician turn political ideas into deliverable public services and activities.

Decisions about policy determine the objectives the political head of an organisation (a ministry or a local government) wishes to achieve. This will affect the management structure of an organisation and the range of staffing skills required. Clarifying objectives therefore may well raise questions about the appropriateness of the present organisational structure. The head of operational management should be responsible for determining the most appropriate structure to deliver the objectives. This though may be in consultation with the political head of the organisation.

Many of the most difficult problems that governments have to address cannot be solved by a single ministry or within a single year and decisions made by one ministry can have impacts upon other ministries and public organisations. They require cooperation between ministries and between different types of organisations, such as central ministries and local governments and sometimes private organisations. For example, homelessness cannot be solved simply by making more accommodation available and therefore be a sole responsibility of a ministry responsible for housing. Or again, solving a drugs problem is not simply a function of the justice system. Consequently, a focus on objectives will require a capacity for politicians and the officials responsible for operational management to cooperate across organisations to provide solutions, and this in turn requires a flexibility of approach to budgeting and to financial and performance reporting arrangements. Effective cooperation may require budget sharing and as has been shown earlier this can be very difficult to achieve without a determined 'whole of government' approach. The complex nature of many problems that the public sector is required to address does mean that thought should be given to the longer term financial consequences in managing these problems. Very few problems can be addressed within a single budgetary year or even over a medium-term budgetary cycle. As has been explained in the previous chapter this means much more than simply thinking about the current and medium-term budgets.

Devolution of operational management to the civil or local government service is a feature of PFM/IC but coupled with managerial accountability. In reality as this guide shows, it will not be feasible for operational management to be retained by the political level and at the same time implement PFM/IC. This is because of all the managerial features of PFM/IC. It requires the development of competent professional managers and, where appropriate, managers with specialist knowledge and experience. The search for efficiency and effectiveness requires the creation of opportunities for the exercise of managerial discretion. That discretion is necessary to enable managers to experiment with alternative solutions to problems, but they can only do that if financial analytical information is available coupled with performance information. In some circumstances the approval of the political management may be required to alternative operational solutions, but there will be many circumstances where operational managers should use their own initiative to achieve greater efficiency and effectiveness in the delivery of objectives and in the day-to-day management of public services.

To achieve these benefits the civil or local government service must be well organised. That means, as is shown in Chap. 14, that the organisational arrangements essentially follow the principles of bureaucracy specified by Max Weber[1] and then are adapted to a managerial style of public organisation.

The characteristics of an appropriate modern civil service organisation should include the following:

(i) Defined objectives and performance standards and performance objectives.
(ii) A strong managerially trained leadership with the authority to drive the organisation to meet its objectives, performance standards and performance objectives expressing core values based upon the needs of the client/customer.
(iii) Effective governance arrangements.
(iv) A powerful financial leadership (finance director type role), focussed upon achieving objectives efficiently and effectively with an aim of improving productivity and ensuring that all public resources are either properly utilised or disposed of and that regard is had to the long run financial resilience of the organisation.
(v) The management being responsible for internal control and the application of those external controls that would with PFA/IC have been directly implemented by external organisations, such as the ministry of finance.
(vi) A budgetary system which provides to managers the information they require as well as the information that the ministry of finance requires.
(vii) A stable budget for the organisation, including also stable funding of that budget during the year with the actual cash funding to an agreed timetable, so that managers can plan with certainty recognising that this may not always be possible in all circumstances.
(viii) A financial and management accounting system which provides managers with the financial control information and the financial analytical information managers require, such as cost centre and cost driver information.
(ix) A financially aware management.
(x) A management trained in managerial concepts.
(xi) Managers having the discretion to make decisions about how to achieve their objectives and therefore how to utilise the resources available to them, or in some instances to dispose of those resources such as redundant assets.
(xii) Individual managers being accountable for their achievements in terms of objectives and performance standards.

[1] Max Weber: a German-born sociologist and political economist who developed a theory of bureaucracy.

(xiii) An external organisational control focus upon accountability for the achievement of the organisation's objectives and performance standards, efficiently and effectively and within the relevant laws and regulations.

Each of these characteristics is addressed in the chapters of this guide.

As these characteristics indicate, operational managers should be accountable for their actions and for the performance that has been achieved. Accountability will be from lower to more senior levels of operational management and ultimately to the political levels of management and from them to parliament and the consumer/user of public services.

In some countries, as has been mentioned previously, extensive use is made by first-level organisations such as ministries and local governments, of second-level organisations whose objectives are intended to deal with specific problems. The first-level organisation must remain in effective control of a second-level organisation and should determine its objectives, performance standards and governance arrangements. This is essential, otherwise a second-level organisation will develop its own objectives and policies and make coordination between the first- and second-level organisation difficult. The introduction of PFM/IC should generate a discussion about the need for and the role and management of second-level organisations (see Chap. 12).

The need for coordination may also generate a challenge to other public financial management reforms such as programme budgeting where very often programmes are built around individual ministries and are designed to deliver the specific objectives of individual ministries, rather than around the problems that governments, as a whole, are aiming to address.

4.1.2 The Benefits of the PFM/IC Reform

The politician and the senior civil and local government officials should be aware of and seek to make use of the benefits that the policy of applying PFM/IC at all levels of government make possible. These benefits can be summarised as follows:

- The potential for an improved quality of policy making. This is because of the additional information that becomes available to operational management and hence the quality of the advice that operational management can provide to the political level of management.
- Greater discretion available to managers to make decisions about the utilisation of public resources to achieve objectives and performance standards and therefore provides an opportunity to build managerial capabilities.

This in turn reflects in the advice available to the political level of management.
- The better use of public resources through greater efficiency and effectiveness generated by better quality management who in turn should have available to them a wider range of information to enable them to make decisions.
- A better quality of governance, which is very important not only to ensure that decisions are properly made but also to ensure that all factors are fully taken into account in decision making.
- A public service that is more immediately responsive to public service user needs not least though a continuing search for effectiveness, that is essentially what the service user requires.
- A greater chance of achieving the governments and organisation's objectives and performance standards because a key management focus has to be on objectives and performance standards.
- More effective political control of the public administration because elected representatives have the opportunity to focus upon policy and strategy, the setting of objectives (and performance standards and objectives) and operational management performance without becoming engaged in the detail of operational management.
- More effective parliamentary control because parliament should have available to it more detailed information linking budgets and objectives with the opportunity to challenge the exercise of discretion by line ministry and other public organisation managers through financial scrutiny processes.
- Greater transparency being achieved through improved accountability arrangements not only to parliament but also to civil society.

These benefits are discussed in more detail in Chap. 10.

4.1.3 Control

Where the focus is simply upon budgetary and financial control maintaining that control, as required with PFA/IC, can be a relatively simple exercise. It does not require a sophisticated management, but with PFM/IC delivering a service and achieving an objective efficiently and effectively, does. Therefore, politicians and senior civil and local government officials in considering this reform need to question the quality of the managerial arrangements with honesty and openness. Success with the reform depends heavily upon the quality of management and whether the present managerial arrangements are fit for purpose or not? To answer this question politicians and civil and local government officials should consider not only the role of other civil and local government officials, but their own roles as well. Answering this question challenges how elected officials perform their responsibilities as well as appointed officials.

Financial and budgetary control, which is the focus of pre-PFM/IC policies, is not management. Certainly, financial and budgetary control are an essential precondition, a building block, in the process of establishing efficiency and effectiveness in the achievement of objectives. If, though, a ministry of finance or an organisation responsible for personnel controls tries to maintain exactly the same form of control with PFM/IC as it traditionally has, what it is likely to do is to actually prevent the development of PFM/IC. The approach to financial and budgetary control must change to reflect the managerial environment then applying in line ministries and other public organisations.

PFM/IC will also require the deployment of new skills, both financial and managerial skills. This will mean that considerable effort will need to be devoted to training and the practical development of both sets of skills in 'real life' situations. The training that is required is not simply technical training but very importantly should include the development of managerial skills which are essential to the development of a quality civil and local government service. How the operational management is appointed depends upon the arrangements in a particular country, but the underlying theme should be that such officials should be appointed on merit. A statement about the appointment of civil servants setting out 14 principles has been issued by the OECD[2] and SIGMA has published a set of 'Principles of Public Administration' which are discussed in detail in Chap. 14. These provide guidance to countries introducing PFM/IC on the professionalisation of public service management, but they also demonstrate how important is the integration of PFM/IC reform with public administration/civil service reform.

4.1.4 The Timetable for the Reform and the Role of Parliament

The full requirements of the reform cannot be accomplished quickly or even comprehensively across the public sector, except possibly in the smallest of countries. Where a country is decentralised with powers devolved to regions and local governments the time taken to undertake a comprehensive reform is likely to be even longer. This is not simply a matter of introducing new laws

[2] OECD, Recommendation of the Council on Public Service Leadership and Capability, OECD/LEGAL/0445: 2019.

and regulations, although this is likely to be part of the process, and then assuming that because such laws and regulations exist, they will be obeyed. (In the experience of this author this is how officials in some countries have reacted to the introduction of PFM/IC, largely because they have seen it simply as a technical reform.)

Treating the reform as a technical reform or even as a managerial reform does not necessarily consider the development of external accountability and in particular to parliament. In no policy papers seen by this author has the impact upon parliamentary accountability been discussed. Yet parliament through the development of PFM/IC should have a greater ability to review how decisions have been made and the factors that have been taken into account. In particular an issue that should be considered is the extent to which the budget should incorporate information about performance indicators and other managerial objectives (see Chap. 3).

As has been explained previously in Chap. 2, parliament ought also to be involved with the reform from the outset. It should be asked to approve the policy and its purpose. It should approve the timetable and proposals for the staging of the reform. It should also hold ministers, and in particular the minister of finance, to account for the achievement of the timetable and the objectives of the reform, including the benefits. In this sense parliament should act as a driver of the reform.

Countries are often under pressure from external organisations to introduce this reform, but such organisations seem to focus only on the technical aspects of the reform overlooking the managerial context. Yet whether this is an appropriate reform for a country depends upon the political, cultural and operational circumstances prevailing in a country and its willingness to undertake the scale of the reforms needed. To assist a country in making this decision a series of tests have been developed (set out below) which should be applied by those seeking to apply the reform.

Countries also tend to want to undertake this type of reform when there is a crisis. But that is often the worst time to do so because there are immediate pressures for results and yet as has been shown a PFM/IC reform is a long-term reform and managerial change often takes several years to become embedded. A much better approach would be to plan for and apply the reform in a more normal situation.

4.1.5 The Tests That Can Be Applied to Assess the Feasibility of the Reform[3]

Based upon the experience of this author, those governments contemplating the introduction of PFM/IC ought to apply the following tests to establish whether this is a feasible reform given the circumstances of the country. This would be a novel approach, but if the requirements identified in these tests cannot be met, the likelihood is that the reform will not be successful. Most of these tests cannot be met immediately. The aim should be to ensure that over time they can be.

Success should be measured by the extent of the achievement of the benefits of the reform. Success should not be judged by the existence of the bureaucracy associated with the reform: that is no test, although, in the experience of this author, that is the judgement that is often made.

The tests, and there are nine, reflect the political and senior official 'will' that is required to achieve the substantive change process that results in success and for the benefits to be fully achieved. They are separate from the structural systems and processes that provide the platform upon which PFM/IC can be built. Each test is individually important but a failure to meet one or more of the tests would not necessarily be fatal, apart from tests 1 and 2, but it would make the achievement of the benefits of the reform much more difficult. However, the experience of this author is that some form of these tests is rarely, if ever, applied. The assumption appears to be made that because PFM/IC represents 'international best practice' almost by definition, if the bureaucracy associated with PFM/IC is introduced, it will result in the removal of deficiencies that presently exist. It will not!

Test 1 *Is the present system of public financial administration and external control robust?*

This first test should be to assess the current strength of the present system of public administration and control (i.e., some form of PFA/IC). Does it suffer from those weaknesses identified in previous chapters? This is a crucial test. If this test is failed, then no further substantive progress can be made. The remedy is to ensure that this test can be met by strengthening the present system. This is because the change to PFM/IC shifts responsibility for budgetary and financial control from an external control, essentially by a ministry of finance, to an internal control by the managers of a public organisation. The

[3] These tests have been developed by this author and are based upon the analysis contained in this guide.

risk, if this test cannot be met, is that the ministry of finance loses control of the finances of the government and this is too great a risk.

In Chap. 1 the distinction between external control (i.e., by a ministry of finance or other ministries external to the organisation concerned) and internal control (i.e., by the management of the organisation itself) was identified, and in Chap. 3, the differences between public financial administration and public financial management were described. Only when weaknesses in the present controls have been removed should the introduction of PFM/IC be commenced. Unfortunately, in many countries in the experience of this author, this test is not considered.

Test 2 *Is there the recognition and acceptance by the government that PFM/IC is primarily a management reform and that its introduction will have an impact upon the allocation of responsibilities for operational management between the political and the official levels of management. Coupled with this are top operational managers (state secretaries and others) willing to accept the additional responsibilities and be prepared to fully support implementation? This also creates an opportunity to increase parliamentary accountability and is that recognised as acceptable?*

This is a critical test because it asks if the government and the top opertional management is willing to accept that PFM/IC involves significant managerial changes and the enhancement of accountability to parliament. This test strikes at the heart of the custom and practice often existing within a country. The most important change that is likely to be required affecting the political level of management will be to separate most decisions about operational responsibility for the day-to-day delivery of services from responsibility for the development of policy towards the delivery of those services and the oversight of the quality of service delivery. Responsibility for operational management would become a civil or local government service responsibility and policy, strategy and oversight would be a political responsibility. (There may be some exceptions to this general rule and these are discussed in Chap. 14.) Parliament also has a greater potential opportunity to assess managerial performance in the delivery of objectives and performance standards. The analysis of the PFM/IC reform contained in this guide as indicated above shows that in practice, given the additional managerial activities that PFM/IC imposes upon a manager and the experience and training required to undertake those responsibilities, continued political management of most operational activity would be most unlikely to be successful.

There are potentially significant cultural implications that may make this test difficult to address. It can also raise the question of 'trust'. The tradition in many countries is that an election gives to the elected officials authority to make all decisions and, as is pointed out elsewhere in this guide, that for some, unless elected officials have that power to make all decisions they do not feel in full control. That power to make all decisions, no matter how trivial, creates an illusion of control. An important activity in the establishment of PFM/IC is to encourage elected officials to recognise that PFM/IC is about the development of managerial professionalism. Elections give the elected official an implicit mandate to put into effect the policies that they have been elected to pursue. The emphasis is upon policies not upon detailed operational matters. A key question therefore is, is there the political will to accept the delegation of operational management to the civil and local government service? Is there also a corresponding willingness of the top operational management, not just in the ministry of finance but throughout the central and local government sector, to accept and support the reform? Involved in this decision is this question of 'trust'. Do the politicians trust the civil service and do the civil service trust the politicians?

A consequence of this separation will be that the civil and local government service organisational arrangements may need to be restructured to accommodate its additional responsibilities for operational management. For example, state secretaries, or equivalent, may need to be appointed with substantive executive authority over operational service delivery matters. Exactly where any boundary exists between decision making about operational matters and policy will be largely a matter for local decision based upon local circumstances. The precise boundary between policy and strategy and operational management will also vary over time, with personalities and operational circumstances. However, effective policy development depends upon an appreciation of the issues that will need to be addressed by operational management (emphasising the importance of cooperation between operational managers and those responsible for policy development), and not least the financial issues.

Another objection to the reform may be that enhanced accountability to parliament thus allowing parliament to question in more detail the quality of management would be inappropriate. But then transparency and accountability are essential to democratic control of government activity and can serve to support government in improving the quality of the management and hence delivery of the objectives efficiently and effectively.

This test will indicate whether the government and top appointed management accepts that this is a managerial reform or sees it simply as a technical financial control reform. If the latter, either the government needs to be persuaded otherwise or it should be made clear that the benefits of the reform will not be achieved. There is no point in spending public resources on introducing the appearance of a reform that will have no substantive benefits and will add to costs. The possibility also exists that pressure will develop to modify the cosmetics of the reform when there is a recognition that the benefits are not being achieved, and return to the status quo ante.

Test 3 *Is the budget designed to facilitate the development of managerial objectives and if not, can it be?*

Because PFM/IC should be regarded as a management reform as well as a technical reform, the budget should be designed to make it possible for management to deliver its objectives (i.e., outputs) as well as to secure the control of inputs. Most budgets focus on inputs although the accompanying budget statements very often describe the broad objectives to be achieved. Budget structures generally are designed to largely meet the needs of the ministry of finance, rather than those of the operational manager. For PFM/IC to be effective an important budgetary reform should be to develop linkages between budgetary inputs and the outputs expected from those inputs. These linkages can only be developed over time, and the reorganisation of the budget structures to meet the needs of the manager should depend upon individual managerial requirements. To meet this test initially the ministry of finance should first acknowledge that budgetary reform is required and that it needs to occur as PFM/IC is developed. It should then cooperate with those responsible for the PFM/IC reform to ensure that the two reforms are compatible. Budgetary reform should also make possible the development of parliamentary scrutiny. However, the main concern with budgetary reform should be to ensure that these three concerns are addressed:

(i) For what purpose, or need, is the money to be allocated?
(ii) How and where is it being spent?
(iii) What is expected to be achieved?

This may mean for some expenses, for example, such as personnel or property costs, that instead of such budget lines being consolidated, they are analysed over individual services or activities. This would have also the advantage of facilitating parliamentary scrutiny.

A feature of management in some developing and transition economy countries is that a main activity of managers/administrators within line ministries is to manage the delivery of public services within a context of unstable budgets or budgetary uncertainty with budgetary allocation shortfalls, often represented by a shortage of cash. Introducing PFM/IC in such circumstances is inappropriate. PFM/IC will do nothing to remove such problems. A key requirement of PFM/IC is the existence of a budget to which objectives and performance standards and performance objectives can be linked. This will facilitate effective management, and therefore, such budgetary and cash management deficiencies need to be addressed before attempting to implement PFM/IC.

Unfortunately, in the experience of this author, in no country has any consideration been given to the impact of the PFM/IC reform upon budgetary or cash management arrangements to meet either the needs of the manager or to facilitate improved parliamentary scrutiny. (See also tests 4 and 5.)

Test 4 *Is there a willingness by the ministry of finance to accept that changes to the traditional budgetary and accounting arrangements will be required to allow for the development of managerial control by individual managers and for the development of management accounting, thereby allowing managers to deliver improvements in efficiency and effectiveness?*

The first change that will be required for effective management is that budgets will need to take into account not only the financial limitations but also the policy objectives, performance objectives and performance standards the government wishes to see achieved. These will also have to be cascaded down to each level of management. It is these factors which ought to determine the available budget to each manager, not simply last year's budget plus inflation and then adjusted for the overall fiscal position. Therefore, if the financial ceiling is insufficient to facilitate the achievement of the desired policy objectives, performance objectives and performance standards one or other should be changed. The second change is that the traditional budget structure will not be analysed in a manner to meet the needs of the manager. (There is most unlikely to be any correspondence between the allocation of resources required for ministry of finance budgetary control purposes and the allocation of budgets for management purposes.) With PFM/IC a manager should know the total budget available to him/her (i.e., all budget headings) in order to achieve the objectives for which the manager is responsible for delivering. The manager should also be aware of those costs that are fixed and those that are variable and therefore those on which a manager can have an impact, sometimes short term and sometimes long term. This can be a particularly difficult analysis because some costs deemed to be fixed, although not in accounting terms, such as employee costs and some overhead costs, along with accommodation costs are, in reality, variable. To achieve efficiency a manager should be prepared to take on the challenge of questioning whether such costs are predetermined and necessary. For example, is it really necessary to occupy a particular building, or can the way in which the service is delivered be changed in order to increase efficiency or to take advantage of new technology or new ways of working using modern technology?

Meeting managerial needs can become more difficult where, as in some countries, there is a separation between current and investment budgets with the ministry of finance being responsible for the current budget and a separate ministry, such as a ministry of planning, responsible for the investment budget.

In summary, with PFM/IC the budgetary analysis (and hence also financial accounting information) needs to serve at least two purposes: the interests of the ministry of finance and the interests of the manager. It may also need to address the specific needs of the parliament for parliamentary scrutiny purposes. This will mean changes in some countries where comprehensive budgetary information is not available to the manager because some budgetary headings, as pointed out in the comments on test 3, such as personnel and overheads which can be regarded as 'fixed' costs, are not analysed over objectives but are held as centrally controlled budgets.

Consequently, a further test associated with the change from an administrative to a managerial culture is to recognise that budget structures required for managerial purposes, and indeed parliamentary scrutiny purposes, may require considerable reform.

A further consequence of this is that where the manager is expected to deliver objectives and performance objectives and standards within a specified budget, the manager responsible should be committed to the delivery of those objectives, to the performance standards *and* to the available budget because otherwise that manager cannot be held to account. This may require changes to the consultation arrangements associated with budget preparation (i.e. the budget circular) with the manager being involved in detail in budget preparation and agreeing that the available budget is sufficient to deliver the objectives and performance objectives and standards expected within a budgetary limit.

Experience shows that ministries of finance can be reluctant to see different forms of budgetary analysis and accounting information develop. This may be a particular problem where ministries of finance have adopted 'off the shelf' commercial software packages. This is because such commercial packages can be difficult to amend to facilitate managerial needs as well as those of the ministry of finance. Ministries of finance may also fear loss of budgetary and financial control and a potential weakening of their ability to provide internationally required statistical information. They may also be driven by a concern that they cannot trust other public organisations to properly control costs. Or as was pointed out by De Geyndt (see Chap. 1), central bodies can be unwilling to see changes which would affect their apparent authority. The result may be inappropriate budgeting and a budget which is incompatible with managerial objectives.

In general, changes to the arrangements for budgetary and financial analysis are not considered as one of the consequences of the introduction of PFM/

IC. However, they are essential if managers are to deliver objectives, performance standards and objectives and efficiency and effectiveness. If a ministry of finance is unwilling to accept the need for such changes, this will make difficult, if not impossible, the achievement of the benefits of PFM/IC.

(Some argue that a ministry of finance and the manager should be concerned not with outputs but with outcomes. However, outcomes are even more difficult to define and to manage than outputs, not least because the factors affecting outcomes are often not under the control of the manager and they are likely to take many years to realise.)

Test 5 *Is there the recognition by the ministry of finance that traditional budgetary, cash flow and personnel controls exercised by central ministries may need to change as may the virement control arrangements to accommodate the responsibility of managers to deliver improvements in efficiency and effectiveness?*

A key feature of a managerial culture is that managers have the freedom to develop initiatives to ensure that they can deliver objectives and performance standards along with improvements in efficiency and effectiveness. In practice this means that managers need the discretion to make changes to the allocation of resources.

Consequently, a managerial culture does mean that the traditional detailed control exercised by ministries of finance and by the ministry or department responsible for personnel management will require reform. Unless these ministries accept that discretion is needed line ministry management will not be able to take advantage of the managerial opportunities that the adoption of PFM/IC generates. Consequently, the controls exercised by the ministry of finance should also be reformed taking into account not only the control of expenditure (i.e., inputs) to a control based upon the achievement of objectives (i.e., outputs). A managerial capacity to develop initiatives may affect the timing of expenditure as well as the detail of expenditure, and this could also mean that cash flow control may also require review. Similar points apply to the central organisation responsible for personnel controls. Improvements in efficiency and effectiveness are not achieved simply by exercising financial and budgetary control or even by requiring that the lowest tender is always the one to be accepted, although this is sometimes how improvements in efficiency are defined. A consequence of the reform, therefore, is likely to be that line ministries will require considerable freedom about how they organise, direct and manage the resources put at their disposal through the budget process. Without that if a ministry of finance or the organisation responsible for personnel control seeks to continue to exercise control through detailed regulation requiring it to approve all changes, in effect that shifts responsibility from the line organisation manager to those central organisations who effectively become the decision makers. This is not to argue that such controls should be totally removed but it does mean that the way in which they are exercised may need to be changed. In other words, the introduction of PFM/IC should cause countries to review the way in which such central controls are applied. If a ministry of finance (and any other central organisation) is not willing to change their approach, the benefits of PFM/IC are unlikely to materialise, or at least fully materialise.

A ministry of finance or the organisation responsible for personnel controls therefore should change their approach to control from detail to focus on developing policy guidance about the types of transactions or personnel policies which they feel they ought to be consulted about, that is, a shift to a strategic form of control allowing the development of a managerial capacity.

Test 6 *Is a reform of the civil and local government service responsibilities and organisational structures (public administration reform) also being undertaken and is this review compatible with the requirements of the PFM/IC reform?*

Following on from test 5, whilst the PFM/IC reform has significant management characteristics, that reform on its own cannot drive public administration reform. That drive needs to come through an overall review of how the civil and local government service operates, that is, its responsibilities, management structures, leadership arrangements and the relationships with the political level of management. Public administration reform will also need to prepare the civil and local government service to take on the leadership, operational management and other responsibilities that the PFM/IC reform will require the civil and local government service to absorb. There is no feasible option for those involved in the PFM/IC reform but to ensure that a comprehensive management reform is compatible with the managerial reform requirements of PFM/IC. Success in improving the quality of public services depends very heavily upon the quality of management.

An essential feature of the reform therefore will be that the PFM/IC and public administration reform programmes are fully coordinated and are developed in parallel. The initial focus of the public administration reform should be to facilitate the separation of operational management from policy and strategy development responsibilities and to facilitate the development of management structures (see also test 7). What should not happen is a public administration reform that seeks to specify in detail how each ministry and other organisation should be structured and the different categories of official that should be employed. The person who is the head of operational management should have sufficient authority to determine the actual management structure within the organisation for which he/she is responsible.

Coordination of the PFM/IC and public administration reform programmes is not an activity that usually occurs. Both reform programmes are usually considered separately, and this is because the PFM/IC programme is simply regarded as a technical reform. But without that coordination, which has the practical effect of bringing finance into the management processes, the benefits of the PFM/IC reform will not be achieved. Therefore, can this test be met?

Associated with this test will be the need to establish an effective managerial control over second-level organisations. Not only will that mean the preparation of agreements setting out the objectives and performance criteria for such organisations and that such agreements are regularly reviewed, but also the first-level organisation having a capability to determine and systematically monitor the policies and performance of the second-level organisations it is responsible for.

Test 7 *Are the arrangements for the management and motivation of civil and local government officials consistent with the need for them to take on the responsibilities of management including taking initiatives and making judgements?*

Central to the successful application of PFM/IC are 'people' and their motivation. The reform is not simply about systems and technical 'fixes'. Systems and technical 'fixes' must be applied by people, that is, by the civil and local government service officials. With delegation and managerial accountability, an important consideration should be the motivation of civil and local government service officials to make judgements and to take decisions, that is, their engagement in the business of the organisation. This is not just a matter of training in the techniques and technical 'fixes', important though these may be, but it is also about culture and management: how to develop and direct organisations to achieve whatever it is they are expected to achieve and to do so in a manner that has regard to the public interest. This requires rather more than training but an investment in the development of civil and local government officials as managers and leaders. This involves the linking of theoretical training with problem solving as well as developing those skills that a manager requires. Such development training would include, for example, the transition from administration into management; an appreciation of the different management styles; communication and interpersonal skills; building teams and focussing on organisational goals; developing leadership skills, building relationships with ministers and mayors; effective policy making; as well as establishing an understanding of the tools, techniques and concepts of good financial management. This also emphasises the significance of the role of the head of the civil or local government service in an organisation and how that person exercises his/her leadership role.

The development of an effective management starts with the head of the civil or local government service in an organisation and then throughout the organisation. Management training is important because it involves planning and goal setting and creating a vision for the organisation. It requires the interpretation of the political objectives and putting them into a form that will be operationally practicable, along with motivation of staff to execute the operational plans. Staff management and motivation are also especially important (see test 8). Effective management creates a direction for the organisation and communicates the vision internally and externally to the different stakeholders.

To achieve this, though, requires the recognition by elected officials of the need for the motivation of the civil or local government service officials. With PFM/IC the role of the civil and local government service is enhanced. No matter how good the management and technical training, if officials feel frustrated or if they feel they have no effective authority, this will adversely affect their performance. "Effective government agencies have high levels of motivation among their members, including high levels of public service motivation, mission motivation, and task motivation."[4] Many of the reforms implemented in the public sector such as PFM/IC are likely to affect the incentives that influence motivation and thus affect individual and organisational performance. "Employees are an important ingredient in determining the quality, effectiveness and responsiveness of public services, especially when financial resources are scarce or there are novel challenges to face. How they think and feel about their jobs and working conditions inevitably affects the way they carry out their tasks (Rainey & Steinbauer, 1999)."[5] Much depends upon local circumstances but in introducing PFM/IC regard should be had to such factors because the introduction of a managerial work ethic is a significant reform and therefore regard should be had to those factors that inhibit performance. Motivation is not necessarily simply a function of pay and other financial rewards, although especially for specialist skills competitive pay should be offered. Motivation can be a function of a wide range of factors

[4] Rainey and Steinbauer (1999) Galloping Elephants: Developing Elements of a Theory of Effective Government Organizations: /Journal of Public Administration Research and Theory Jan 1999, p. 23.

[5] Quoted by Wouter Vandenabeele & Chris Skelcher: Public Money and Management: Public service motivation—practical problems, scientific evidence and the role of a research community: Ps. 321–327: July 2015 Pages 321–327 | Published online: 03 Jul 2015.

including the nature of the work, the effectiveness of the activity, the opportunities for preferment.[6]

The question that then arises is who is to be responsible for civil service and local government staff management and motivation within organisations? Given that delegation of operational management should occur, responsibility ought to lie with the head of the operational staff of an organisation such as the state secretary or the equivalent in local government. This is a question that ought to be addressed with the introduction of PFM/IC, but no evidence has been seen that it actually has been considered in countries introducing PFM/IC or in the relevant literature. Yet quality staff management and motivation is highly desirable, indeed essential, for successful management. (A reality that will need to be considered is that career development in many civil services is not affected by success or failure in meeting objectives but the development of a managerial performance-oriented culture, ought over time, at least, to challenge this reality even if it means allowing preferment to those with new ideas and able to develop and deliver new initiatives.)

Test 8 *Is there a willingness to rethink the penalties and sanctions and the arrangements for the discipline of civil and local government officials?*

In many transition and developing country economies, the disciplinary penalty and sanction arrangements, whether imposed upon civil and local government officials through the budget law or in other specific laws, are often designed to reflect the legalistic and authoritarian nature of the public administration regime that exists or has existed in the recent past. The aim is to achieve strict adherence to the laws, rules and regulations with little or no scope for the exercise of judgement. These disciplinary and sanction arrangements are often reinforced by specific inspection arrangements. They tend to impact more heavily upon lower level officials than upon either elected officials or senior appointed officials. A primary aim of such sanctions and disciplinary arrangements is often to reduce the risk of decisions being made that might cause budgetary constraints to be ignored or avoided or to minimise the risk of fraudulent or corrupt activity. Introducing PFM/IC places more responsibility upon officials to make decisions, and making decisions involves risk. Delegation of operational management will not be effective if those officials remain concerned about how the system of sanctions and discipline may

[6] There are many publications on staff motivation and, for example, see those of Neel Doshi and Lindsay McGregor. Pay is not necessarily a factor and what can be of significance are, for example, the quality of the job, the ability of the employee to engage with all aspects of the job, the corporate culture and leadership.

adversely affect them. In some countries the legal code affecting the way in which civil and local government officials undertake their responsibilities has provisions for sanctioning them for what may be vague offences such as, in an example from one country, 'exceeding competences' and 'criminal indifference'. In practice such provisions may be only rarely applied but the fact that they exist creates a perception that they can be used and this can cause officials to rigidly limit their activities and to avoid taking any risks by referring all decisions upwards. This discourages even senior officials as well as middle and lower level managers from taking risks or rethinking how public services should be delivered. Yet PFM/IC is about how public officials make decisions about the utilisation of resources to deliver public services efficiently and effectively and at the same time achieve their objectives within what can be a changing and challenging operational environment. With the delegation of operational management, operational managers (who ought to be the civil and local government officials) need to exercise judgements: that is what making decisions is all about. As any judgement involves risk and particularly where public services have a direct impact upon individuals who may object, officials, who have been traditionally risk averse, may have difficulty in accepting the responsibilities associated with a PFM/IC regime.

What this means is that where such a traditional legal and disciplinary framework exists, the introduction of PFM/IC will require change to avoid inhibiting management action by the operational managers. Without a reform which recognises the significance and consequences of devolving operational management responsibilities, the operational environment will discourage operational managers from taking those actions which will deliver more efficient and effective public services as well as those actions which will secure the delivery of objectives and performance standards.

A feature of introducing the PFM/IC reform, therefore, should be a review of the penalties and sanctions regime which can have a critical bearing on organisational performance. Is there a willingness to undertake such a review and if not the managerial reforms which PFM/IC envisages will be difficult to introduce?

Test 9 *Does the ministry of finance recognise that to secure success in the establishment of a managerial culture both it and the ministry responsible for civil or public service reform will require that they are able to provide a high quality of* *advice and support to line ministries that will complement the development of PFM/IC? This will mean that the role of a ministry of finance will need to change to become much more supportive than simply acting as a 'controller'.*

The main gains from this change will be a management focus upon the achievement of objectives, standards of performance and efficiency and effectiveness, that is, outputs as well as inputs. In other words, a better use of public resources. Consequently, there will be a much greater emphasis upon developing financial awareness, an awareness that goes well beyond knowledge of budgetary limits and financial control processes. That gain will only occur with the active and ongoing encouragement and support from the ministry of finance. With PFM/IC former administrators will be operating in a managerial environment, and this does mean changing the whole culture of the organisation including at the lower levels of staffing. This will require a radical change of approach in how the civil or local government service operates. The focus upon achieving outputs and doing so efficiently and effectively represents a very different approach from a traditional administrative approach dominated by concerns about budgetary and financial control.

The ministry of finance should provide advice and guidance on technical issues such as the development and interpretation of costing information, on fiscal risks, on the financial controls that should be applied to second-level organisation including state and local government-owned companies as well as on long-term financial planning. This advice should be available to both managers and to specialist officials concerned with financial management. Managers also will require advice, including training, on how to improve efficiency and effectiveness (e.g., on such issues as how to identify, manage and allocate costs against cost drivers, how to identify, manage and allocate costs against cost centres and how to develop the performance information that should accompany such analyses), how to identify risks and the management of those risks. Heads of finance and their staff may also require training in the development of analytical techniques such as cost accounting and managerial information systems such as new ministry or local government coding structures including how to link these with ministry of finance coding structures. This adds significantly to the role of the ministry of finance as well as changing the traditional role. Is there a willingness on the part of a ministry of finance to take on this 'educational' type role which will change its traditional relationships with line ministries and other public organisations?

4.2 How Is the PFM/IC Reform to Be Undertaken?

4.2.1 Who Should Be Responsible for the Development of the PFM/IC Reform Policy, Its Application and Local Ownership of the Reform

Because this is a major reform, political and top operational management support for it is essential. Also, because the reform involves long-term change, that support ideally should have cross party political support. In addition, the prime minister and minister of finance (and their successors) should be committed to the reform and their responsibility is to secure commitment from other ministers and where the reform extends to local government, from mayors and other local government leaders.

Very often the reform will be initiated by an external organisation such as an aid organisation or, for countries seeking to join the European Union or to benefit from its funding as neighbourhood countries, the European Commission. Financial support in these circumstances will usually accompany such an initiative. However, the timing and advice about the development of the reform policy and its application as well as the period of the funding in such circumstances will be determined by the provider of the funds. The driver in these circumstances will be external to the country and the motivation to introduce the reform may be wider than simply the PFM/IC reform itself. The fact that the driver is external to the country can affect how political support is mobilised and the continuation of that support, especially if there are differences of view about the wider objectives.

Because this reform has such an impact upon the roles and responsibilities of civil and local government officials, their commitment, through the support of the senior civil and local government service, is also essential. Once the principles of the reform have been established and parliamentary support obtained, the ministry of finance would normally be responsible for its application. Support for the actual application of the reform as it affected political officials should be the responsibility of the prime minister and the minister of finance. So far as the overall operational application of the reform is concerned, the responsibility for securing its application should lie with the state secretary (or equivalent) of the ministry of finance. That person should have the authority to require his/her equivalent in other ministries to apply the PFM/IC application policy and their commitment to and support for the reform is essential. Therefore, within each ministry or local government, subject to the overall guidance of the state secretary (or equivalent) of the ministry of finance, the application responsibility should be that of the head of the civil or local government service (i.e., the state secretary or equivalent) reporting as appropriate to the political head of the organisation. The head of the civil or local government service in each public organisation should have the authority to continue with the reform even when political personalities change, unless there is a central government political policy change affecting the acceptability of this reform. Without that delegation to the head of the civil or local government service, a risk could be that a 'stop/start' process occurs caused by changes of ministers (or mayors) which will be disruptive to the application process. Achieving that civil and local government service authority to proceed with the application of the reform is an essential practical requirement. The role of the state secretary in the ministry of finance is discussed in detail in Chap. 5.

However, there is a potential problem where politicians feel that they must be involved in all decisions, which could be the situation in some developing and transition economy countries (as well as in some developed economy countries). This potential problem is that as political post holders change, they may feel that even though the policy in principle remains they may wish to impose their opinions on the application processes. The result can become an erratic application which will be disruptive. A consistent approach is highly desirable, and it will avoid delay.

Whoever has responsibility for the development and application of the reform, a critical first step should be an assessment of the results of the tests described above. Unless the response is positive to these tests, even though the reforms needed cannot be implemented speedily, the benefits of applying the reform will not be achieved and that will raise questions as to whether the reform is worthwhile at this particular point in time. The attitudes of the ministry of finance and the department or ministry responsible for personnel management demonstrated in the response to these tests will affect:

- The timetable for the development of the policy and the application of the reform;
- How the reform should be applied (see next sections of this chapter) and
- It will also identify the complementary reforms that may be required.

As has been pointed out earlier, introducing PFM/IC is a major reform there is no 'quick fix' such as introducing a law specifying what is to be done coupled with the introduction of a series of additional bureaucratic procedures. The introduction of PFM/IC will take a considerable period to implement across a public sector, maybe 10 to 15 years[7] or more. Not only within this period will the techniques associated with PFM/IC need to be introduced, including the extended financial and performance information systems but also fundamentally the managerial changes that will be required, and it is with these managerial changes that the reform process should start. Unfortunately, this rarely, if ever, occurs and the reality is that reform usually starts with the introduction of the bureaucracy associated with the reform and with that associated with the introduction of international best practice, that is, the COSO requirements.

4.2.2 Achieving Local Ownership

Achieving 'local ownership' of the reform, even at an individual organisation level, is an essential step and it will be demonstrated by the strength of the commitment of the key political and senior officials. Ownership is important for these reasons:

- First, the effective management of public money is central to the achievement of the policy objectives of the government. How it manages that money should be its decision and the systems that it chooses to adopt should be those that it is comfortable with. Where systems have been imposed externally, the likelihood is that, in reality, they will only be implemented in a manner which suits the interest of the promoter of the reform and which justifies that organisation's support. The most obvious result in such circumstances is that the reform becomes a cosmetic reform. This is because a substantive reform would have a fundamental impact upon traditional customs and procedures. This is a real risk with the PFM/IC reform.
- Secondly, because government problems cannot easily be compartmentalised by making their solutions the responsibility of a single ministry, the budgetary and financial systems must have government-wide ownership. This is even though the reform may be implemented in stages, which means that some ministries and other public organisations may be implementing the reform much later than others.

---

[7] Comprehensive reform programmes usually have a time perspective of 10–15 years. This will allow capacity development measures to start at the earliest stage of reform planning without necessarily delaying the reform work. However, in practice, there may be a conflict between this view and the desire of certain donors and government to start implementation as soon as possible without providing scope for capacity development. The result may be the early production of reform plans that can be characterised as shopping lists rather than reform efforts. There will be a need for a strategy on when and how to use technical assistance and also to liaise with and incorporate ongoing reform efforts in order not to waste knowledge and lose momentum. Public Finance Management in Development Co-operation—A Handbook for SIDA Staff 2007 para 6.3.1.

- Thirdly, governments must retain ownership of their financial systems because weakness in public finances is often the result of poor execution, not of inadequate systems or procedures. Desirable reforms "will only be successful if they are accompanied by measures that enhance the accountability of those who operate the systems including enforcing the rules embodied in existing or reformed regulatory frameworks".[8] Accountability requires ownership.
- Fourthly, any reform is undertaken at a particular point in time. However, operational circumstances are changing constantly and therefore systems must be adapted to reflect such changes. Governments must own a reform to ensure that it is sustained and remains relevant in different operational circumstances.

The reform will involve the development and/or employment of skilled managers and, as indicated, a refocusing of elected official interests away from day-to-day administrative and operational arrangements towards the development of policy and strategy together with an oversight responsibility for operational management activity. This emphasises the importance of local ownership. None of these elements of the reform will be easy or short term.

4.2.3 The Role of Parliament

In many countries if this reform is to be driven forward, as has been explained in previous chapters, there is an important role for the parliament. Parliament should not be concerned with the detailed application of PFM/IC within individual public organisations except in the context of external audit reports about those organisations. However, parliament should be concerned firstly about the appropriateness of the proposed policy and that will mean that parliament has a clear appreciation from the outset of what the reform involves including its costs and benefits and then secondly about the progress with the reform as it is applied. This means that parliament ought to approve a timetable for the application of the reform and that the minister of finance should be accountable to the parliament for progress. Should the minister of finance wish to make changes to the timetable for application, then parliamentary approval should be sought. Through this process accountability pressure would be exerted on the minister of finance and that in turn would be reflected

[8] Lienert, Ian. 2003. "A Comparison Between Two Public Expenditure Management Systems in Africa." IMF *Working Paper* 03/2. January. 2003 Abstract.

on the officials responsible for the operational application of the reform, not least on the ministry of finance state secretary.

In effect through this accountability process, parliament becomes an effective driver of the reform requiring explanations where the timetable is not being met or the managerial changes required are not being made. If there is no such accountability process, the reform remains wholly an internal organisational reform to be pursued at a time of choosing by the minister or ministry of finance which in turn means that the timetable will be affected by the current priorities of that ministry.

The main adviser to the parliament would in most countries be the state auditor but exactly how a parliament would exercise this responsibility would depend upon its traditions. For example, it could do so through a specialist committee, such as a committee established to consider external audit reports.

4.2.4 The Basic Elements of This Reform Recognising That This Is an Ongoing Reform

As developing PFM/IC will take several years as experience is gained, new ideas will emerge and circumstances will change. This means that there should be a flexibility of approach. However, what is important in the implementation of PFM/IC is first to put in place the basic elements of this reform, that is:

- Ensuring that a robust and effective financial administration (test 1) exists at each of the organisations expected to implement the reform. (If this does not exist, then this should affect the timing of the 'roll-out' of the reform across the public sector because this must be established first.)
- Ensuring that the promoters of the reform have a clear appreciation of what the reform is essentially about with its managerial implications, including top management support, and that they in turn promulgate widely that appreciation both at senior political and at senior official levels across the public sector (test 2).
- Following on from the previous point that the ministry of finance budgeting and accounting departments are willing to allow information to be provided that meets individual managerial needs as well as their own and the available software has the capability to provide both sets of information, or if not that a capability and willingness exists to allow individual public organisations to develop their own budgetary and financial analytical systems provided they can also provide the information that the ministry of finance requires (tests 3, 4 and 5).

- Given that the state secretary, or equivalent, in the ministry of finance should be responsible for the management of the reform he/she will need support. This should be by the establishment of a department with responsibility for supporting the ministry of finance state secretary with the detailed implementation of PFM/IC across the public sector. The selection of the head of that department will be important because he/she should have a wide operational experience and recognise the managerial significance of the reform. (A summary of the responsibilities of this department are set out in Chap. 9.) The state secretary should, of course, be expected to report regularly on progress to the minister of finance (tests 6, 7, 8 and 9).
- Ensuring that a clear and supportive political and official leadership exists within each public organisation committed to the delivery of the reform. This is important because it enables 'local ownership' to be achieved at each public organisation level. This means that before the reform is formally announced there has been wide discussion at both the political and appointed official levels about the reform, how it will impact upon different groups of officials and how it will affect the future management of organisations. This is essential because it will be important to avoid too great a shock to the present administrative system which would only create an adverse reaction (tests 6, 7, 8 and 9).
- There is a willingness to coordinate public administration/civil service reform with the PFM/IC reform. There is little point in proceeding with the PFM/IC reform if proposals for the public administration/civil service reform are not compatible with the managerial requirements for the PFM/IC reform (tests 6, 7, 8 and 9).
- Personnel policies can be established which facilitate the development and application of managerial skills and that a civil service organisation exists which has the structures which can be developed to provide a managerial approach to the delivery of public services. This should include that a review is undertaken of the sanctions and disciplinary arrangements affecting civil and local government officials to ensure that they are compatible with the development of a managerial culture (tests 6, 7, 8 and 9).

Given that these initial elements have been established, then for each ministry implementing the reform the following steps should be taken (with the equivalent steps applying where local government is involved):

(i) The state secretary of the ministry of finance agreeing with the most senior appointed official in each ministry (state secretary or equivalent) undergoing the reform about how and when the reform will be implemented in practice including the acceptance within that ministry (or local government) of the delegation of operational management responsibilities to the civil (or local government) service. (See Chap. 14 for a detailed discussion of the limitations of the delegation of operational management.)

(ii) Each state secretary in the relevant implementing ministry to establish, in conjunction with the political leadership as necessary, service delivery objectives, performance objectives and performance standards to be achieved by operational managers and which are derived from the political objectives and strategy for the ministry.

(iii) Each state secretary to establish a managerial structure to deliver the operational objectives: this may require the agreement of the political leader of the ministry in some countries. These managerial structures should be accompanied by delegation and managerial accountability arrangements. This will also include arrangements for reporting to the political leadership.

(iv) A programme for developing financial awareness amongst managers is established with budgetary and financial accounting arrangements being developed so that they not only provide the information and budgetary control that the ministry of finance requires but also provide the managerial information the managers need to enable them to deliver their objectives efficiently and effectively, to standard, to time and within budget.

(v) A financial planning and analytical capacity and a long-term financial forecasting capability is developed and that the head of finance also has a capability and status to act as an adviser to management including to support and advise on the development of business and strategic plans.

(vi) Steps are taken to ensure that policy makers and managers have the performance data they require to accompany financial data for the purpose of setting objectives and performance standards.

(vii) Performance information systems are developed to provide the performance information managers require as they deliver their objectives and performance standards. (Such systems should operate independently of the manager to prevent managerial manipulation of the information.)

(viii) Arrangements are made to determine the governance arrangements, objectives and activities of second-level organisations (including both agencies and enterprises) and to monitor their activities to ensure that second-level organisations operate to the same standards as those expected of first-level organisations and that their objectives are compatible with those of the first level owning organisation.

(ix) A review of the human resource (HR) arrangements is undertaken to ensure that they facilitate the establishment of a managerial culture including a review of the penalty and inspection arrangements.

As has been pointed out earlier, what PFM/IC is *not* about is simply introducing a series of bureaucratic practices such as those relating to risk management or information and communication or the control environment, that is, the COSO bureaucratic requirements. Yet this has been the focus of much reform activity, especially in countries joining or aiming to join the European Union. These bureaucratic requirements are important, but they are only facilitators for management to use and what matters is the quality of leadership and management and how management utilises the information becoming available from those requirements. Those responsible for the reform ought to recognise from the outset that the long-term nature of the reform will require a consistent application policy. This again points to a need to ensure that the policy is 'politically neutral' in its application and therefore ideally that operational implementation is a function of appointed, rather than political officials.

Countries should also recognise that introducing PFM/IC is a continuing process as experience is gained and circumstances change. There is effectively no 'end date'. Whether or not external financial support is available (and such support is likely only to be available for the initial stages of implementation), the argument in this guide is that this reform is so important, with its managerial implications, and that it is desirable in any event. However, there is such a thing as 'reform fatigue' and therefore how the reform is implemented is important. There ought to be clear steps in the reform process when assessments of the success (i.e., benefits) can be made. The most important initial stage is to put in place the basic elements of the reform, that is, the managerial elements of the reform, the enhancement of the financial management capabilities and the reform to the budgetary and accounting processes. These should be supported through the enhancement of the parliamentary scrutiny processes. Beyond these basic elements of the reform the main driver will be 'practical experience' as managements, both political and civil service, become more confident about how they can improve quality in the utilisation of public expenditure.

To emphasise a point made previously, countries considering adopting the policy of PFM/IC will already have in place a more or less satisfactory version of PFA/IC. These PFA/IC arrangements may need to be considerably modified in some circumstances if:

- That system does not result in the effective control of public resources.
- Significant losses have occurred through inappropriate practices or system weaknesses.
- Serious shortcomings have occurred such as a major fraud or losses caused by corrupt practice or waste and which have resulted in a withdrawal of aid support.[9]

To emphasise a point made previously, before any attempt is made to introduce PFM/IC the PFA/IC system should be reformed to ensure that the PFA/IC is effective and that also means understanding why the PFA/IC control system has not been effective, if that is the situation. If the present control system is weak, the remedy is not to change the system by trying to introduce PFM/IC but to improve or remedy the deficiencies of the present system not least because the likelihood is that whatever the deficiencies of the present system they will creep into any new system. What should also be borne in mind is that if the objective is to make it more possible to achieve the objectives of the government, this will not happen without complementary reforms to management. This may mean that the PFM/IC reform ought to be delayed and sometimes for a considerable period. Against this though can be the political imperative that 'something has to be done'. The responsibility of the civil service in such circumstances should be to accommodate the staging of the reform in such a manner that the major deficiencies of the present PFA/IC system are addressed first. This is likely to mean that the discretion available to managers with PFM/IC is moderated recognising that this will defer the achievement of the potential benefits of the reform.

If, though, the reason is that the government wishes simply to adopt PFM/IC as international best practice, will such a reform for this reason be successful? Public financial reforms are not 'freestanding': they must fit into a context and the context is a country's history, culture, economic, political and bureaucratic arrangements. Financial reforms do not always succeed, and a real risk is that the formalities of a reform (i.e., the bureaucracy associated with it) may be established but not the substance. So, whilst the appearance of reform exists in practice, the benefits cannot be achieved. The result is more bureaucracy and higher administrative costs and ultimately disillusionment. International best practice has no regard for local contexts. It also carries with

[9] For example, Malawi following the 'cashgate' scandal discovered in 2013.

it certain assumptions (see Chap. 11 which discusses the COSO reform requirements) and the implications of these assumptions must be addressed. With PFM/IC those assumptions are about the existence of objectives, the existence of an effective management, the delegation of responsibilities and managerial accountability arrangements. A principal and possibly key reason that financial reforms have not been successful or at best have only resulted in more bureaucracy in developing and transition economy countries has been the attempt to insert best international practice into an inappropriate local context. This applies particularly to PFM/IC if the aim is to introduce it into a country that has a traditional system of public administration with no or a limited concept of management and a strong centralised control. If there is no indication that the government is willing either to recognise the need for managerial change or to actually undertake such change and to accept that decentralisation of control will have to occur or if there is no support for the reform amongst senior officials (both political and appointed) then the reform will fail. Aid organisations in particular ought to recognise these potential risks.

Change therefore may be the inappropriate answer, especially where change involves the introduction of sophisticated public financial management systems like PFM/IC when the real answer lies in making the existing system of PFA/IC work more effectively. Changing rather than improving entails significantly higher risk and cost. Changing to PFM/IC is both expensive and risky because it is a fundamental reform and is not a simple technical financial change. To emphasise, the change from PFA/IC to PFM/IC is to a major and very advanced reform.

An expert adviser on financial reform in developing and transition economy countries, Professor Stephen Peterson, has summarised the key factors that need to be addressed in reform using this acronym: COPS,[10] that is:

Context: Historical, cultural, economic, political and bureaucratic.
Ownership: Government, foreign aid, contractor.
Purpose: Financial administration or financial management.
Strategy: Recognise, improve, change, sustain.

The reform strategy which the state secretary in the ministry of finance, supported by the department responsible for the implementation of the reform, should consider is that it should have four elements: 'recognise' what exists; 'improve' what exists; 'change' [where necessary] what exists; 'sustain'

[10] Peterson, Stephen; Public Finance and Economic Growth in Developing Countries: Lessons from Ethiopia's reforms, 2015: pp. 13–36.

the improvements and changes that have been introduced.[11] It is not simply therefore just about change. Frequently the reform focus is on 'recognise', 'improve' and 'change'. The missing element is 'sustain'. This is one of the most important aspects of reform. Because the PFM/IC reform is not simply about technical systems but is about management and the distribution of powers within and between public organisations (and not least between elected and appointed officials and between the ministry of finance and line ministries), pressure is likely to exist over sustaining the reform. Because of the impact upon the distribution of 'power', pressures are always likely to exist to return to the *status quo ante* and therefore a positive sustain policy is necessary. The De Geyndt study is evidence of this.[12] Another factor affecting sustainability is 'cost'. The drive to sustain the reform should be led and resourced by a government itself because it is most unlikely that third parties, such as aid agencies, would be willing to finance such an ongoing activity over a long period of time. A further factor affecting sustainability is that those who will be expected to share resources to solve cross-boundary problems, which a focus on outputs will generate, will be reluctant to do so. Overall, therefore, the risk is that at least over time the internal pressures will be to return to a form of PFA/IC, that is, the *status quo ante*.

4.3 Will Delegation of Operational Management to the Civil or Local Government Service Cause Politicians to Lose Control[13]?

This question is not about 'internal control', rather it is about 'political control', and one that will be very important in some countries and can be central to addressing local culture. Those responsible for the implementation of PFM/IC will have to consider it. In some countries where PFM/IC has been, or is proposed to be, introduced, concern has been expressed by political officials that if they do not make all decisions (i.e., that there should be no delegation to appointed civil or local government officials), they will lose control of the organisation. This has been a cause of objection to PFM/IC reform in

[11] Peterson, Stephen; Public Finance and Economic Growth in Developing Countries: Lessons from Ethiopia's reforms, 2015: p. 36.

[12] See footnote 18, Chap. 1.

[13] See also Chap. 14.

some countries. Even if the reform proceeds, this concern may limit the extent to which delegation and managerial accountability develop.

Associated with this concern about a potential loss of political control, other concerns about delegation may exist including about the ability of civil or local government officials to undertake the delegated responsibilities or a lack of political trust in the civil or local government service officials and vice versa. The problem of inexperienced civil or local government service officials is not solved by appointing inexperienced political officials but has to do with the overall quality of the civil or local government service. This in turn raises questions about recruitment and training processes for such officials, but it also is affected by the atmosphere or 'tone' of the relationships between political and appointed officials. If that is threatening, the risk to officials is increased, and where there are few alternative job opportunities, officials will be unlikely to accept delegated responsibilities that involve a higher degree of risk. As has been pointed out previously, making decisions involves making judgements and, by definition, making judgements involves risk. 'Trust' is much more difficult to address and can involve many factors. Without the civil or local government service having a tradition of demonstrable independence, irrespective of the political control, political trust in the public administration can be difficult to establish. Control is not addressed by politicising the civil or local government service through appointing 'political friends' of the government to civil or local government service positions. Alternative solutions are required. The answer lies in civil service or public administration reform, including the training and entry requirements. Without a quality civil service, the introduction of the PFM/IC reform is much more problematic. This emphasises the importance of establishing a 'Weberian' style of civil service (see Chap. 14).

However, apart from these questions about competence and trust, the main points to be made in any debate about this question of potential loss of control by politicians include:

- The political head of a public organisation, a minister or mayor and their political deputies are frequently chronically overburdened given their responsibilities for the development of policy, the strategy for implementing that policy and the political considerations of government as well as detailed responsibility for operational management (where that is the situation). This adversely affects these officials' ability to focus on their most difficult task which is the development of policy and strategy and the management of their political relationships. Good quality policy is central to efficient and effective policy execution.

- When dealing with straightforward operational management tasks, the political leadership has, at best, only a limited time available for the many operational managerial tasks that exist. These include the exercise of organisational leadership, supervision and control of operational management activity including the setting of detailed operational and staff objectives, setting performance standards and performance objectives, maintaining quality, the supervision of second-level bodies and communication with the staff as well as ensuring that public resources are efficiently and effectively utilised. In practice most of this does not actually occur where there is no delegation of operational management to the civil service.
- Political leaders are not usually appointed for their specialist skills in a particular service or activity (although this is sometimes essential). Therefore, if they are to undertake responsibility for operational activities, they need to familiarise themselves with not only the policy objectives for the organisation for which they are responsible but also with operational matters and at the same time have the knowledge experience and capacity to manage a usually large and complex organisation (larger and more complex than most private companies). However, the reality is that given the complexity of most modern public services, nobody within a public organisation can be familiar with every detail of a subject matter. The result is that many decisions, taken in a strictly centralised and hierarchical process, do inevitably suffer from a lack of competence. Consequently, the quality of managerial decision making can be less than is desirable. (Even where a politician has top management experience in a commercial organisation, transferring that experience to a public sector context is not easy not least because of the complexities of public service management and the competing pressures upon leaders.)
- Operational decisions, as a general rule, should be made on the basis of operational related issues with political considerations being mostly of limited relevance, but if the decision maker is a politician rather than an appointed official, the separation of political considerations from operational or managerial considerations is very difficult.
- Even if staff are involved in the internal decision making process where the operational manager is a politician, they are unlikely to be either authorised to take the final decision or appear as the responsible person through their name and signature. This is de-motivating and a waste of, very often qualified and well-educated, personnel resources resulting in a lack of accountability of civil (or local government) officials.
- Challenge to political leaders by civil servants and local government officials in traditionally organised hierarchical public administrations can be

difficult in practice, and where this difficulty extends to operational management, the quality of governance inevitably suffers. (A responsibility of a civil service official is to set out the facts and relevant issues even where they make uncomfortable reading for the political officials, and they should not be adversely affected by doing so.)

- Many of the operational decisions that political leaders are involved with in traditionally organised public administrations are of a trivial nature, such as the signing of invoices or payment orders or job descriptions and leave arrangements, and have no political consequences. Requiring political officials to be involved in such activities is a misuse of their time.
- A requirement for political leaders to be involved in operational management decisions, because of the limited time that they have available, can lead to delay in the making of those decisions: this adversely affects the efficient and effective delivery of public services.
- Implementing PFM/IC adds to the responsibilities of the operational manager. If the political leader is to act as the operational manager, this adds to the demands upon that leader. In practice, either those added responsibilities would be ignored or addressed in only a superficial manner. An example would be improvements to efficiency and effectiveness, and another would be managerial risk management.

Trying to make every decision does not put the minister or mayor in control: the result is an illusion of control.

With PFM/IC in place and with the consequential establishment of delegation and managerial accountability, the head of the organisation is in more effective control of an organisation than by trying to take every decision. This enables those top and senior politically appointed officials to focus upon developing the policy and strategy for implementing that policy by the organisation and to supervise through the managerial accountability processes what is happening operationally within the organisation. It enables top and senior managers, both political and appointed, to just focus on the key issues and avoid involvement in items of lesser importance. Introducing PFM/IC adds to the responsibilities of the manager because it envisages a higher quality (i.e., professionalisation) of management than do traditional systems of public financial administration. This alone makes the task of the operational manager much more substantial. Overall, the likelihood is that without delegation the additional responsibilities arising from the adoption of PFM/IC would not be effectively undertaken and therefore the benefits would be lost.

There is a further aspect to the question of the allocation of responsibilities between political and appointed officials and that is how will parliament react to this element of the reform? As has been indicated earlier, parliament ought to be consulted about and kept informed of the reform progress and it can be kept informed regularly through the work of the state auditor. Parliament ought to have a view about the arrangements that are being made not least because of the accountability of the political leadership to parliament and the overriding concern that parliament should have for the utilisation of public resources. Parliament may wish not only to challenge political officials about policy and the delivery of the objectives of that policy, but it may also wish to question officials (political and appointed) on their utilisation of public resources in the delivery of policy objectives. Parliament may also be concerned about securing transparency and accountability in the utilisation of public resources. Properly implemented, PFM/IC provides greater opportunities for parliament to do all of this.

4.4 How Should the Reform Be Applied Across the Public Sector?

A decision needs to be taken about the practical arrangements for applying the PFM/IC reform throughout the public sector. This should be a government decision taken with the advice of the minister of finance who should in turn consult with other ministers and parliament should be informed of this decision. The questions are:

- Should all public organisations be expected to adopt the reform at the same time, or should it be phased over different types of public organisation (e.g., over initially central government ministries and then local governments or vice versa)? Or alternatively:
- Should a pilot process be established which would allow for an experimental approach and the identification of difficulties with the lessons to be learned?
- Should the reform be applied in stages, even within pilot organisations?
- Given the length of time the reform will take to implement, can the reform be staged in such a manner as to reduce the risks arising from 'reform fatigue'?

Operational managers at each stage would require extensive training support.

If the decision were to apply the reform in stages, the possible stages are set out in Chart 4.1. No specific reference is made in these stages to the application of international best practice (i.e., such as the COSO standards).

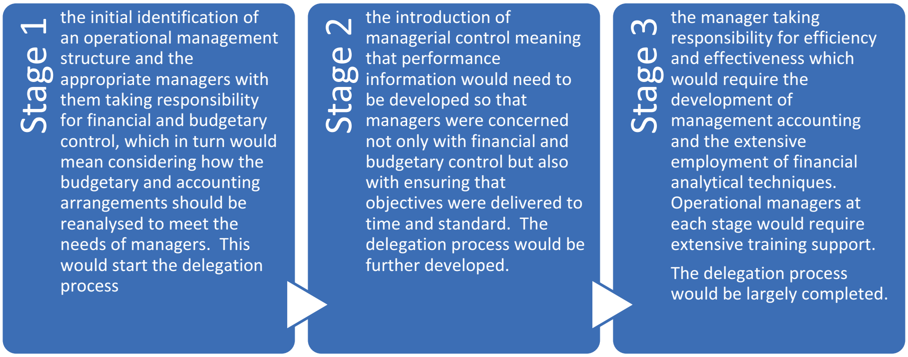


Chart 4.1 Stages in the application of PFM/IC

However, as operational implementation of those standards would be the responsibility of the operational management within each public organisation that management would require extensive management training. The expectation therefore should be that the application of such standards would be during stages 2 and 3, that is, not at stage 1.

The decision about how and when to proceed will depend partly upon the availability of resources to develop the detailed advice and support operational managers will require as well as the financial advisory functions and systems. Not the least of these will be the training needs of managers and heads of finance. If this advisory and training resource is limited, then this would inevitably point to the use of a pilot and staged application process. However, the most important factor determining the application arrangements will be the current administrative arrangements, the willingness of politically appointed officials and senior civil and local government officials to accept and adapt to the implications of the reform as it affects what they see as their authority, their responsibilities, their potential liabilities and their accountability. This very often revolves around the question of 'trust', which has been referred to earlier and an important issue should be how to build 'trust'. That question applies not only to political/appointed official relationships but also to relations between central and line ministries.

The strength of opposition to the implementation of the reform is likely to be a determining factor in the arrangements for its introduction. And that will only be established through extensive pre-reform consultation. (This is not something that usually occurs.)

4.5 Establishing a 'Driving Force for Change' Within a Ministry of Finance

For this reform to be successful there must be a 'driving force for change' within the ministry of finance. Although this guide suggests that this should be the most senior civil servant in a ministry of finance, this person will need to ensure that a detailed and practical day-to-day support is available to public organisations and to act as an adviser and supporter to themselves. The European Commission in its advocacy of the PFM/IC type reform for countries seeking to join the Union and for neighbourhood countries benefiting from European Union funds has recognised this and required that such countries establish a special unit or department specifically designed to promote, introduce and supervise the implementation of the reform and to maintain its continuing quality.[14] Its role is defined as:

> 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.

Note: Given the focus described in this guide the head of this unit's reporting line should be to the chief ministry of finance official, not directly to the minister.

The head of that department should be knowledgeable about PFM/IC and its managerial implications and provide detailed implementation advice and support, as necessary. The department should have the status of other ministry of finance departments, and it may well be required to challenge existing ministry of finance departments and their policies. That department should be staffed with the different skills needed in the application of PFM/IC including accounting, financial analytical and forecasting skills and, importantly, managerial experience. Unfortunately, where such departments have been established, because the broad managerial and financial implications of the reform have not been recognised neither have the broad staffing requirements. In European countries the initial focus has been on internal audit

[14] Welcome to the world of PIFC: 2006 http://ec.europa.eu/budget/index.htm.

which can result in an inappropriate approach to the PFM/IC reform. This has focussed the reform simply on financial and budgetary control. (Chap. 9 explains how this department should be organised and what should be its agenda of activity.)

The idea of establishing a formal 'driving force' to support the chief official in the ministry of finance is important but if not properly directed and supported such a ministry of finance department will find it very difficult to achieve its objectives. That direction and support must come initially from the chief appointed official in the ministry of finance who in turn should be reporting on progress to the minister of finance. The minister of finance should report to the prime minister and ultimately parliament. Without this chain there is a risk that other events will intervene to divert attention away from ensuring that the PFM/IC reform is effectively implemented and to time.

4.6 Summary

In implementing this reform, politicians should be clear about the five objectives involved in the management of public money and the nine tests that should be applied to determine whether the reform is practically possible and appropriate. The use of these tests will also help countries assess how long the reform is likely to take and what it involves. Once the policy has been determined and agreed with the parliament, responsibility for actual application should lie with the minister of finance under the authority of the prime minister with managerial implementation being the responsibility of the most senior official in the ministry of finance. That official should be supported by a specialist 'driver' department which should be appropriately staffed and have the status of other ministry of finance departments. That department would have the practical responsibility of driving the reform forward under the authority of the chief civil service official within the ministry of finance.

The chain of responsibility back to parliament is very important to ensure that reform progress occurs.

The reform is fundamentally about the professionalisation of the management of the delivery of public services and as a result imposes considerable additional requirements upon civil (and local government) officials. These additional requirements make it difficult to see how politicians in countries where they have maintained responsibility for operational management can continue to undertake such responsibilities. Consequently, a feature of the reform will be the delegation of operational management responsibility from the political level of management. This also means that public administration or civil service reform should be coordinated with the PFM/IC reform.

Because the reform is complex and has wide-ranging consequences, countries do need to consider how they will implement the reform. Should it cover all public organisations at the same time, or be phased? Should the reform be staged to allow lessons to be learnt as each stage is implemented? In driving the reform forward regard to the risk of 'reform fatigue' and to allow the benefits of the reform at different stages to be demonstrated.

5

The Responsibilities of the Minister of Finance, the State Secretary, and the Ministry in the Development of a PFM/IC Policy

In this chapter the main responsibilities of the minister of finance in the application of PFM/IC are described, including the impact that the reform will have on the main departments and activities of the ministry of finance itself. The reform is a complex reform, and as with many complex reforms, there is always a risk of unintended consequences. The possibilities of this occurring are discussed in Chap. 6. If ministries of finance stand in the way of such developments and do not recognise the managerial consequences, this will make achieving the benefits of the reform very difficult.

The reform will impact upon the budgetary and financial accounting arrangements within line ministries and local governments, and the ministry of finance should both recognise and encourage this development. This is because individual managers within line ministries and local governments with PFM/IC will want to know what the total budgets are for their areas of responsibility set against their objectives and performance standards. They need this information to establish efficiency and effectiveness in service delivery. A consequential need will be to develop management and cost accounting because the traditional financial accounting arrangements will not provide the type of information a management requires to secure efficiency and effectiveness.

An important activity of a ministry of finance ought to be to challenge line ministries about the cost and quality of the policies ministries are proposing to adopt and the quality of their proposed objectives and performance standards, along with the resources they require to achieve them.

The reform will also impact upon the parliament by increasing the ability of parliament to scrutinise the budget and the operational management of line ministries and other public organisations. The ministry of finance as a

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_5

result is likely to be expected to provide evidence to parliament to support its scrutiny arrangements.

Successful application of PFM/IC also depends upon the management of line ministries and local governments accepting that they are responsible for adopting a disciplined internal control structure and ensuring that internal control is effective. An objective of internal control is to control risks to an organisation. Those risks can be to the delivery of the objectives and performance standards of an organisation, to achieving efficiency and effectiveness as well as financial, legal, environmental, and wider reputational risks. Where a ministry of other organisation is involved in the collection of income, including taxation, internal control applies equally to these activities. Internal control is not simply about financial and budgetary control, and neither is it simply about the short-term financial/budgetary situation.

In some countries other ministries besides the ministry of finance may also be involved in the financial management process such as a ministry of planning responsible for the control and approval of investment expenditure. Whatever the benefits of such an arrangement, this does complicate the implementation of PFM/IC. It also adds to the complexities of the role of the head of finance not least because constraints on current budgets may not be replicated in the investment budgets. This also has to be taken into account in implementing PFM/IC.

5.1 The Responsibilities of a Minister of Finance and Senior Officials

This chapter covers the impact of the application of PFM/IC on and the specific responsibilities of the minister of finance, the most senior civil servant within that ministry, and other senior ministry officials. Application success depends very heavily on the extent to which these officials recognise their responsibilities for the reform and the changes that the reform will bring about. Also discussed is the relationship of the minister with parliament.

The chapter covers the critical aspects of the reform that are likely to require decisions by the minister and the ministry staff before, during, and in sustaining the reform. Although the minister will take the key decisions, in practice many of the day-to-day responsibilities will be addressed by staff within this ministry. The key figure in the ministry who should, in effect, supervise application throughout all line ministries and other public organisations should be the chief official of the ministry (the state secretary or equivalent).

5.1.1 The Minister of Finance and PFM/IC

The finance minister will be a senior minister within a government responsible usually for the management of the government finances, economic policy, levy and collection of taxes, government borrowing, and financial regulation. This minister may also be responsible for monetary policy, although this can be a responsibility of the central bank. (Actual responsibilities do vary widely between countries.) Within this broad range of responsibilities, the ministry of finance will have the specific objectives of determining and raising taxes, maintaining budgetary and financial control of public expenditure, and improving public sector productivity. It will also be concerned with the achievement of the government objectives and ensuring that line ministries and local governments do not enter into commitments which may be difficult to finance in the future or which to finance them may have adverse effects upon other current activities of an organisation. The minister of finance would normally be the minister with overall responsibility for the introduction of the policy of PFM/IC.

In exercising these responsibilities, a particular activity of a minister of finance and by extension the ministry of finance should be to challenge how well a line ministry or other public organisation has defined and costed policy and used available public resources to achieve its objectives and performance standards. In assessing the quality of that utilisation, a ministry of finance should be concerned about the improvements in efficiency and effectiveness, if any, with which those resources have been used. The implementation of PFM/IC will help them to achieve these objectives:

> The challenge function will be thought of as the investigation and scrutiny of the spending, expenditure management processes and policy choices of line ministries, departments and agencies. Where these do not align with the objectives of the finance ministry, an effective challenge function typically means the finance ministry asking, requiring or persuading line ministries to do something different to what they might otherwise have done. Such a relationship is necessary if a finance ministry is to deliver its many functions and achieve its economic, spending and policy goals.[1]

Whether or not the tests described in Chap. 4 to assess the feasibility of the reform can be met depends heavily upon the reaction of the minister and staff

[1] The ministry of finance 'challenge function': A public financial management introductory guide Sierd Hadley and Bryn Welham pp. 7/8: https://www.odi.org/sites/odi.org.uk/files/resource-documents/11067.pdf

of the ministry of finance. The most important departments of the ministry that will be directly affected by the reform are the budget department and the department responsible for treasury matters including financial accounting and overall government financial control. (If the ministry of finance is also responsible for procurement, that department too is also likely to be significantly affected.) Not only will these departments be affected technically but they will see the modification to some of the powers that they presently have. If the minister of finance, and by extension the ministry of finance, is not willing to agree to the quite fundamental changes which will facilitate the establishment of a managerial culture, then the PFM/IC reform should not proceed. Therefore, that these departments of the ministry should have a clear appreciation and an acceptance of their role in the reform, is pivotal.

Earlier chapters in this guide show how the application of PFM/IC impacts upon the whole approach to public financial management. It shifts the focus of management from control of inputs to control of outputs, although still requiring a control of inputs. The result, if the reform is successful, is the establishment of a managerial culture compared with a traditional administrative culture.

5.2 Before the Reform!

Introducing PFM/IC should not be regarded as simply a matter for officials. As was pointed out in Chap. 4, parliament has a potentially powerful role in approving and driving forward the application of the reform. In doing so parliament would hold the minister of finance to account for progress. As was pointed out in Chap. 4 a reform of this operational significance in the management of public expenditure is, in reality, likely to cause resistance to change, especially to the managerial reforms that will be required and potentially delay the implementation timetable. Parliamentary support for the reform can therefore be of considerable assistance to a minister of finance in broadening political support, even within the government.

The responsibility of the minister of finance should be to secure parliamentary appreciation of the significance of the reform, what the reform requires by way of managerial changes and the distinction that will be necessary between responsibility for operational management and that for policy and strategy development. Parliament should also be made aware of the potential costs and benefits as well as approval to the reform application arrangements. This would include the reform timetable. The minister of finance should report periodically on the progress in the application of the reform, say six monthly, with parliament then being required to approve changes to the timetable for application and made aware of major difficulties.

The involvement of parliament is not normal practice in this author's experience nor is this a requirement referred to in literature on the subject.[2]

5.2.1 The Initial Assessment

As has been previously explained, establishing a managerial culture has a major impact upon how line ministries and local governments are organised and the relationships between political officials and the civil or local government service officials. PFM/IC affects the relationship between central ministries, particularly the ministry of finance, and line ministries. Public administration (civil service) reform and PFM/IC reform activity also needs to be integrated. Before any decision is made to adopt this reform there ought to be a clear appreciation of these impacts (see the tests outlined in Chap. 4) not least because this indicates not only the managerial impact but also the scale of the reform. This may of course lead to a decision that this is not an appropriate reform at this time. It is far better to make such a decision at the outset rather than part way through the process.

As was explained in Chap. 4, the person who should have responsibility for explaining these impacts at the highest levels of the public administration ideally should be the chief civil service official in the ministry of finance (the state secretary or equivalent). This official should have a central role in the development of PFM/IC. Not only has this official responsibility for explaining to the minister of finance what the implications of the reform are, but for the reform to be successfully applied, he/she needs to convince and involve the equivalent officials in line ministries (and in some countries, local governments as well) in the development of the reform. Not only does this provide a greater appreciation of what the reform involves, but it also encourages 'local ownership'. In those countries where there is a separate head of the civil service, then the ministry of finance state secretary should also consult with this official whose support would be essential. He/she may also need to consult with the staff of the parliament to explain how the changes are likely to impact on the role of parliament.

The aim of the ministry of finance state secretary should be to establish an appreciation throughout government of what this reform involves and the benefits arising from the reform. This may require collaboration with those

[2] See, for example, Welcome to the World of Public Internal Financial Control, European Commission, 2006.

responsible for civil service reform to ensure that such reforms are compatible with the needs arising from the PFM/IC reform. It will also mean collaboration with the most senior civil servant in each ministry or public body to inform them of the main consequences of the reform for themselves and the civil service organisation they are, or should be, responsible for. Not least this will involve a switch in the focus of control from simply a control of inputs to in addition a control of outputs and then to ensure that regard is had to enhancing public value, that is, the efficient and effective use of public resources.

As was pointed out in Chap. 4 to assist the ministry of finance state secretary ideally a specialist department should be established with a specific responsibility for *driving* the implementation of the reform. (The responsibilities of such a department are discussed in Chap. 9.)

The first step in the implementation of PFM/IC should be for the ministry of finance state secretary, with the assistance of the *driver* department, to commission research into the practical implications of the reform and to prepare a 'strategic analytical and planning policy paper' for the minister of finance and the cabinet of ministers to explain the implications of the reform. (How this should be undertaken and the details of the areas that should be covered in this policy paper are described in Chap. 9). In preparing this policy paper the ministry of finance state secretary should consult with the chief civil servants in other ministries and public organisations. This 'strategic analytical and planning policy paper' would cover not only the principles of the reform but also the key changes that would be required including such matters as the management changes, budgetary and accounting changes, the redistribution of authority between the politician and the civil servant, the implementation processes and timescale, the costs that are likely to arise from the application of the reform policy and the potential benefits. (The benefits and costs are described in detail in Chap. 10.)

Where the reform is also intended to cover local government then all the points referred to above would also need to be discussed with representatives of local government.

5.2.2 The Appropriateness of the Decision to Introduce PFM/IC

The 'strategic analytical and planning policy paper' would enable the government to decide whether to proceed with the PFM/IC reform. This is not necessarily an easy decision especially where a country is under pressure from external organisations, such as aid organisations, to introduce the reform because it represents best international practice (and consequently, by definition, must be a 'good thing'). Such pressure usually comes with an offer of funds. However, there are critical factors in determining whether to proceed with the reform and which should be addressed by the minister of finance and the state secretary. These are described in the nine tests set out in Chap. 4 which may be summarised as the potential risks arising from the reform. These include whether:

- The present civil service organisational arrangements are appropriate, and the civil service has the capacity to accommodate the reform.
- A willingness by ministers exists to delegate operational management to the civil and local government service.
- The changes that may be required to the governance arrangements[3] including those of second-level organisations are acceptable.
- The quality of the present financial and budgetary controls and therefore the level of budgetary discipline is adequate to allow delegation.
- There is a high risk of fraudulent and/or corrupt activity by officials, political or appointed, within the organisation (e.g. rent seeking by corrupt officials) which would be accentuated by the delegation arrangements associated with PFM/IC.
- The capabilities of public organisation finance departments are adequate to provide the information managers will require.
- The public finances are stable and are likely to remain stable given current internal and external factors.
- There will be resistance to the development of transparency and public accountability.

Some argue that where weaknesses exist in the control arrangements a strengthening of internal audit within organisations would be the reform that is required. That though is an inappropriate reform where the management is weak, governance poor and financial analytical capability low. It would certainly not address the managerial or the financial management problems that are necessary to achieve a successful PFM/IC reform.

To make a thorough assessment of the risks associated with the reform the ministry of finance state secretary risk assessment should be an important factor in the discussions with other senior officials before drawing up the strategic analytical and planning policy paper.

---

[3] Good governance means there should be a focus on the interests of citizens and service users, that decisions should be informed and transparent and that there should be clear accountability for decisions. (A summary of advice contained in The Good Governance Standard for Public Services published by the Office for Public Management [OPM] and the Chartered Institute of Public Finance and Accountancy [CIPFA] 2004—see Chap. 1.)

Unless the proposed strategic analytical and planning policy paper can be positive about the issues referred to above, introducing the PFM/IC reform would be inappropriate and other reforms would be required first.

To emphasise, where such a strategic analytical and planning paper demonstrates that adverse circumstances exist for the introduction of PFM/IC then a conclusion is likley to be that this is the wrong reform. Instead probably the most appropriate reform should be to strengthen PFA/IC. This could be coupled with proposing the introduction of the basic managerial elements of PFM/IC through proposals for the reform of the public administration. This will mean maintaining the external controls exercised by the ministry of finance over line ministries and local governments, or if the external controls exercised by the ministry of finance are weak, strengthening those controls.

5.2.3 A Critical Issue for a Minister of Finance

A principal responsibility of a minister of finance is that of the annual budget preparation. In preparing the budget a minister of finance will almost always be under pressure to increase public expenditure. This pressure may come from parliament, civil society as well as individual line ministries. As result the minister is bound to ask this question: 'if we adopt PFM/IC, can we still maintain control of public expenditure when line ministries and local governments[4] have more control over expenditure decisions and can we raise our income more efficiently and effectively?' As adopting PFM/IC, introduces a managerial culture into line ministries and local governments, managers need to have the discretion to make decisions and those decisions may affect both the levels and the distribution of public expenditure. Hence, potential ministry of finance anxiety!

However, the PFM/IC reform, *if properly applied*, is consistent with ministry of finance objectives of maintaining budgetary and financial control of public expenditure, securing adherence to the laws and regulations, achieving objectives, improving efficiency and effectiveness and ensuring that line ministries and local governments do not enter into commitments which may be difficult to finance in the future or which to finance them may have adverse effects upon other current activities of the organisation. In addition, PFM/IC should result in an improvement in the quality of the operational management and ultimately in the quality of policy making. Managers should also become more financially aware. In addition here should be a greater focus

[4] The references to line ministries and local governments throughout this chapter include their second-level organisations.

on the effectiveness of public sector activity, improved availability of the information necessary to inform effective policy making, a better quality of accountability and an improvement in corporate governance, not least because of improvements in decision making processes, including in internal control. It should also result in an improvement in the budgeting process because of an increased emphasis upon the linkage of financial inputs with the outputs expected from those inputs. In the managerial environment that PFM/IC introduces, as has been shown, finance is not simply about costs and income and comparisons with budgets. It is also about how well the money is spent and how all resources are raised and used in achieving the policy objectives and performance standards and objectives expected of an organisation. All of these benefits would be of advantage to a ministry of finance.

Parliamentary and ministry of finance interests in the establishment of PFM/IC should in large measure coincide. PFM/IC creates the opportunity for parliament to have available to it a better quality of information about objectives and performance, with potentially greater accountability and transparency and that in turn improves the quality of parliamentary scrutiny of the budget, of line ministry and other public organisation management which in turn impacts upon the quality of budgetary preparation and accountability.

To enable managers to make judgements about how well money is being spent or being raised, as has been pointed out previously, they are likely to require different analyses of information than that required for ministry of finance purposes. The minister of finance (and, by extension, the officials in that ministry), should accept this. They should also accept that this reform has consequential effects upon traditional budgetary and financial accounting arrangements within line ministries and local governments. The minister should recognise that as PFM/IC is a management reform, managers within line ministries, whilst continuing to meet the financial, budgetary and cash flow controls set by the ministry of finance, will need extended budgetary and accounting information in order to deliver their objectives efficiently and effectively. This will require the development of management accounting (including costing) within line ministries and local governments and the minister of finance should encourage this. Management accounting will provide a different form of analysis from that required for ministry of finance financial accounting and statistical reporting purposes. (A fuller description of the differences between financial and management accounting and the relationships between the two is given in Chap. 8.) The main point is that the determinant of that analysis should be the individual manager, usually in conjunction with the line ministry or local government's head of finance, *not* the ministry of finance. Budgets also should be much more closely tied to expected outputs than normally occurs with traditional arrangements. (These radical changes point to advantages accruing from a pilot reform process before launching a full scale reform so that the ideas associated with the reform can be tested.) Individual operational managers will also need information about the total budget for their areas of operation, not just some elements (and very often with traditional arrangements in many countries heads of departments (the potential managers) will only have available to them limited budgetary information) . This will mean that the ministry of finance should accept from the outset that line ministry and local government budgets will probably have to be reanalysed to allocate them over managerial responsibilities. This reallocation would be a responsibility of the different public organisation managements. This means, for example, the allocation of all personnel, supplies and services, transport costs, all maintenance costs of assets and overhead costs. With current arrangements some, or all, of these costs may be held centrally by each line ministry or local government. The management accounting information required by the manager should enable the manager to identify the costs of different areas of activity including different cost centres and cost drivers. (See previous chapters.) A minister of finance should ensure that the top operational managers in line ministries and local governments have the willingness and capacity to provide the information managers need to deliver their objectives efficiently and effectively and within budget limits.

As a result, the minister of finance should recognise that ministries and other organisations will want to develop their own analyses of expenditure and income and hence coding structures for their own management purposes. This will be in addition to the coding specified by the ministry of finance for its purposes. The responsibility of a minister of finance is not to prevent this but to encourage it and at the same time ensure that the information it requires for financial reporting, international statistical purposes and for budgetary control purposes in accordance with the format of the budget approved by the parliament, is still available. An example of how this objective might be achieved is set out below in Sect. 5.3.4.

5.2.4 The Benefits and Costs of the Reform

The minister of finance will want to ensure that the benefits arising from the reform are achieved and the areas of cost arising from the application of this reform are fully identified. The minister will also require an assessment of the period over which these benefits will accrue, and costs will be spread. Chapter 10 describes in detail the range of benefits and costs that could result. The benefits potentially are substantial because they arise from a better quality of management and that strengthening internal control, which with the introduction of PFM/IC will have a focus upon outputs as well as inputs. However, such benefits are not immediately quantifiable. Costs can be immediate and quantifiable, and the principal costs will arise from the development of IT systems needed to facilitate financial analyses and to provide performance information, as well as investment in training of both managers and finance staffs. IT costs can be very substantial, especially if the country adopting PFM/IC has purchased an 'off-the-shelf' IFMIS which is not sufficiently flexible to allow alternative analytical information to meet the needs of managers.

The minister of finance should be determined to ensure that policies are developed to ensure that the potential benefits actually emerge, and that in turn depends upon the quality of management.

5.2.5 The Ministry of Finance and the Finance Function Within Line Ministries and Local Governments

An assumption in this section is that the current and investment budgets are integrated. If they are not this adds to the complexity of securing quality in public expenditure, especially where the different budgets are subject to different financial pressures. A further complication may also be that responsibility for expenditure on staffing may also lie outside the ministry of finance. A risk in such circumstances is to the development of a managerial culture within a line ministry of other public organisation, again raising questions about the appropriateness of the PFM/IC reform.

A managerial culture if properly developed should raise questions about how well public money is being spent and whether public resources are achieving the objectives and performance standards and objectives expected of line ministries and local governments. This, in turn, raises further questions that should exercise the minister of finance and the staff of that ministry about the quality of the financial and performance information on which a line ministry or local government's policy and the strategy decisions for applying that policy are made. This should affect how a ministry of finance looks at their expenditure planning and budget execution processes. Other questions will include those about the financial resilience of the organisation. The answers to these questions, given a decision to proceed with the reform, will (or should!) affect ministry of finance judgements about the allocation of budgetary resources and how far it feels able to relinquish or modify its own controls. This consequently draws a minister of finance into considerations about the quality of line ministry or local government financial management.

An important feature therefore of the introduction of PFM/IC is the development of the role and responsibilities of the head of finance within ministries and local governments. A key management challenge is how to make the best use of public resources and an understanding of finance is central to that. The internal control standards referred to below in Sect. 5.3.5 (i.e. COSO) emphasise the importance of achieving efficiency and effectiveness. The head of finance is central to achieving that objective. The head of finance should aim to develop and maintain financial awareness and the policies and processes, such as management accounting and costing to control and manage the efficient and effective use of resources by the organisation's management including that of second-level organisations. The head of finance should also be required to develop a long-term financial planning capability. All this information should be designed to support managers in the delivery of objectives efficiently and effectively. In Chap. 8 the responsibilities of the head of finance are described in detail. Given the enhanced role of the head of finance with PFM/IC the position should be of high status and where the senior staff of an organisation are formed into a 'management team' then the head of finance should be a member of that team. The state secretary in a ministry of finance should exercise influence to ensure that this occurs.

In many countries the quality of financial management (i.e. as compared with financial control) will be a new area of interest for a ministry of finance. A ministry of finance should want to ensure that each line ministry or local government has a sufficiently high quality of financial management to enable it to deliver the objectives and performance standards and objectives that are or should be incorporated within the budgetary settlement, do so efficiently and effectively, and at the same time maintain budgetary and financial control. A better quality of financial information should also feed into the policy making process as operational management provides advice on the practicality of political proposals. With PFM/IC finance should be at the heart of decision making within each line ministry and local government. Because the role of finance is so central to the development of efficiency and effectiveness, as well as to control, a ministry of finance, with the application of PFM/IC should want to ensure that the quality of financial management across the public sector is of a consistently high standard. This would mean that as part of the reform the ministry of finance should consider the possibility of incorporating within it a department with a specific responsibility for enhancing the quality of financial management in all line ministries and local governments by:

- Developing through training a resilient and expert community of finance professionals.

- Ensuring that these finance professionals have a capability to provide the financial analyses that operational managers require to deliver objectives efficiently and effectively.
- Establishing robust financial systems, standards, and policies, that provide reliable financial information, are up to date, cannot easily be corrupted because they are accompanied by standards and policies that are rigorously reviewed and enforced and that there is an appropriate division of responsibilities.
- Sharing knowledge and best-practice across line ministries and local governments and with internal audit.
- Developing frameworks, guidance, and tools to facilitate more informed, effective, and financial planning, performance, and management.
- Developing those linkages that would facilitate effective cross-government collaboration, that is, the avoidance of 'silos', recognising that this is a difficult objective to achieve and demands cooperation at the highest levels.

A head of finance in a line ministry or local government adopting PFM/IC is not simply to act as a recorder of financial information, that is, levels of spending and income, acting as a financial controller. In most developing and transition economies, currently this is what the role appears to be. With PFM/IC it must be much more than that and a purpose of a ministry of finance should be to ensure that this wider role is appreciated and established in practice. This wider role includes ensuring:

- In developing organisation policy, finance is fully considered.
- Operational management is financially aware, has the financial management information it requires and incorporates financial judgements in its operational decision making.
- Resources, both current and capital/investment, are used efficiently, effectively, and economically. (This may be complicated where different ministries are responsible for the current and investment budgets and where there are different pressures on those budgets.)
- Management recognises that decisions made in one organisation can have significant impact upon other organisations (e.g. raising the school leaving age can affect employment policies, youth policies and policing policies).
- Sound financial forecasting and long-run financial resilience is maintained.

This also means ensuring that financial data and data impacting upon finance, such as performance data, is robust.

The competencies needed by a head of finance have been defined by the Chartered Institute of Public Finance and Accountancy (CIPFA) and include:

- Innovator: exploring ways to make the taxpayers' money stretch further, often in collaboration with other organisations.
- Business partner: influencing strategy and business outcomes, collaborating with managers to further policy goals, offering expert analysis and interpretation, presenting options to resolve problems and exploit opportunities; developing financial understanding and informed decision making.
- Steward: safeguarding resources from loss, waste, abuse, or corruption; giving a reliable account of how resources have been used.
- Provider/commissioner: maintaining the financial operation infrastructure and core financial administration processes, including specialist services, both directly and through commissioning external providers.[5]

Because the capability of the head of finance coupled with the capabilities of the finance department of each line ministry and local government are central to the successful delivery of PFM/IC, the ministry of finance through the department responsible for the application of PFM/IC should be confident about this capability. Without this the benefits of the reform are unlikely to be achieved. Judgements about the head of finance capability would be based upon actual performance in the post and in the effectiveness of the finance department in meeting managerial requirements, and where appropriate those of the ministry of finance.

The development of the role of the head of finance may have the consequence that it leaves that official exposed to inappropriate pressures to approve of managerial actions (sometimes official and sometimes political) affecting finance which the head of finance may find difficult to resist even though such pressures may lead to a breach of the government wide financial regulations or to inappropriate decisions being made. Examples of inappropriate decisions are the overstatement of likely revenues to be derived from a particular activity, an understatement of the financial or fiscal risks that might accrue from pursuing a particular course of action. An issue therefore that a minister of finance should consider is whether the appointment and dismissal of a head of finance should be subject to the approval of the minister of finance, even

[5] Finance competencies for public services: Shaping the finance function to meet new and future challenges: CIPFA: https://www.cipfa.org/policy-and-guidance/reports/finance-competencies-for-public-services-shaping-the-finance-function-to-meet-new-and-future-challenges.

though the actual appointment may be the responsibility of the relevant line ministry or local government. The need for the approval of the minister of finance to the appointment and dismissal of a head of finance would have the effect of strengthening the position of the head of finance where inappropriate pressures may develop. However, the role of the minister of finance would have to be exercised sensitively because a head of finance could not function effectively if he/she were regarded as a creature of the minister of finance rather than being wholly committed to the employing organisation.

In Chap. 7 the responsibilities of the head of operational management within a line ministry or local government are set out, and in Chap. 8 the changed role of the head of finance is discussed in depth.

5.2.6 How the Minister of Finance Should Regard PFM/IC

Critical to the introduction of PFM/IC is that the minister of finance regards the introduction as a:

- Necessary reform to provide an overall better-quality management of public resources with greater financial awareness.
- Complement to the introduction of other reforms designed to secure greater efficiency in the allocation of resources, such as long-term financial planning with the aim of securing long-term financial resilience in line ministries and other public organisations, medium-term budgeting, programme/performance budgeting, and gender budgeting.
- Reform designed to create a greater possibility of achieving the objectives of the government.
- Reform designed to improve the quality (i.e., better value for money) of public expenditure and income collection given the focus on achieving greater efficiency and effectiveness in the utilisation of resources.
- Factor in reducing the need to resort to tax increases or borrowing to finance increasing or new demands for public services or to raise the standards of existing services because of the potential improvements in efficiency and effectiveness.
- Method of improving the quality of governance so that there is a reduced risk of misuse of public resources through improper use of assets and other resources, fraudulent and corrupt behaviour.
- Reform that the ministry of finance should want to see introduced irrespective of any requirements by an aid donor or other external organisation.

A minister of finance should accept that this reform is neither easy nor quick to introduce. It is a major reform which has an impact upon how public services and activities are managed. The impact of the reform may require a considerable change to traditional human resource (HR) and other administrative arrangements (see Chap. 14).

5.2.7 Coordination with the Different Ministry of Finance Technical Departments

Close cooperation will be necessary between the ministry of finance departments responsible for budgeting, treasury, and financial accounting activity (depending upon how the ministry of finance is organised) and a department established to support the state secretary in overseeing the application of PFM/IC. This is because the interests of the budgeting, treasury, and financial accounting departments will dominate the control interests of the ministry of finance; whereas the department responsible for the application of PFM/IC has a wider management focussed remit. These traditional departments of the ministry of finance may also perceive a loss of power because responsibility for some expenditure decisions will be transferred to line ministries. An objective of the department responsible for the application of PFM/IC should be to introduce into these ministry of finance departments an appreciation of the financial management information needs of management. The person with the principal responsibility for securing coordination between these different departments should be the ministry of finance state secretary. However, experience indicates that those more well-established traditional departments within the ministry of finance can be difficult to convince of the need for those changes that will be required for the effective application of PFM/IC. The overriding concern of those departments will be to ensure that budgetary control in the format for which the ministry of finance expects to be accountable is not weakened and that the ministry of finance's ability to complete international statistical returns for organisations such as the IMF, the UN, Eurostat, and the Organisation for Economic Cooperation and Development (OECD) is not affected.[6]

However, another problem will arise from the impact of the reform upon the financial information system in use by the ministry of finance. Where the ministry is using a standard 'off the shelf' commercial package there could be these types of problem which could cause difficulties for a ministry of finance:

[6] These returns will usually follow internationally defined formats such as the Classification of the Functions of Government (COFOG) developed by the OECD.

- The 'off-the-shelf' packages tend to be very rigid in their design. Governments must adapt their procedures and data to the computer system—not the other way around: therefore, providing the additional information or information in a format managers may require could be difficult.
- The commercial suppliers of these packages may charge for the simplest modification/addition—typically if the ministry of finance or a ministry asks for some new reports they will be charged for, and therefore if managers require different reports from the standard reports this could be costly. This could also apply if managers wanted more detailed information which would require the development of the chart of accounts coding structures for an individual ministry (and each ministry could require that).

If a country has developed its own financial information system, these problems may not apply, but even so such a system is likely to require modification, not least to accommodate the additional information managers may require. Individual ministries may still need to develop their own financial information systems which must link with the ministry of finance system (see also Sect. 5.3.5).

The department responsible for the application of PFM/IC should recognise the existence of these concerns but at the same time explain the needs of line ministry and local government managements if they are to deliver objectives and performance standards efficiently and effectively. Some of the fears of these departments of the ministry of finance should not be realised provided that line ministries and local governments have an appropriate managerial and technical capacity to apply the PFM/IC reform. This is the point where confidence (trust!) does need to be built and if that does not exist these departments of the ministry of finance may be reluctant to engage in the reform.

The coordinating role of the ministry of finance state secretary is more complex in those countries where the investment budget is the responsibility of a ministry other than the ministry of finance and where responsibility for civil service staffing (HR) is also the responsibility of an organisation lying outside the ministry of finance. The policies of these ministries/organisations will need to be adjusted to reflect the development of PFM/IC.

5.2.8 The Minister of Finance and Other Ministers

PFM/IC should be accepted as a government wide reform with the prime minister (or in some countries, the president) having an overall responsibility.

The minister of finance would need to work closely with this official to secure acceptance of the reform and this is likely to include the minister of finance having a responsibility to persuade fellow ministers of the need for this reform and the benefits that will accrue from its application. This will be part of the process for achieving local ownership at the organisation level. The minister of finance will also have to persuade them that to achieve the benefits of PFM/IC, organisational changes will be necessary to establish a managerial culture including changes to the public administration and HR arrangements. Therefore, other ministers would need to accept that there would be changes in how they work and in their day to day responsibilities. The changes were described in Sect. 4.2.4 of Chap. 4 and may be summarised as ministers responsible for line ministries should recognise that responsibility for operational management should be delegated to experienced civil service managers and that their own focus should be on policy and strategy development with an oversight role of the performance of the operational management. The minister of finance responsibility would be to persuade other ministers that this separation would be essential to the introduction of PFM/IC and the benefits it could bring. This also recognises that with the introduction of PFM/IC management becomes much more demanding. No longer will it be simply a matter of delivering an activity within budget. The minister of finance will need to make clear to other ministers that the PFM/IC reform will also require that 'activities' are clarified with objectives and performance standards and objectives and that their responsibility is to ensure that those objectives are delivered to time, to standard, efficiently and effectively as well as within budget and in conformity will all legal and regulatory requirements. As a result, the quality of budgets will need to be improved with objectives and performance standards and objectives being linked to budgets. This means that ministers and their operational managers agree that the objectives and performance standards and objectives are capable of being delivered within the available budget. (If not, as has been explained previously, then either the budget or the objectives and performance standards should be changed.) A similar understanding would need to be communicated by the ministry of finance state secretaries to equivalent officials in other public organisations.

Political management will also be required to satisfy itself that senior operational managers at all different levels, as well as themselves, can maintain overall control of the organisation, including over second-level organisations (see Sect. 5.3.9 and Chap. 12). To achieve that managerial accountability arrangements will have to become established which complement the arrangements for delegation. Ministers will also have to be persuaded by the minister of finance that they should invest in improving the capabilities of their organisations to deliver services efficiently and effectively. This means that operational managers have the financial and performance information that they need to secure efficiency and effectiveness.

Whilst the ministry of finance should welcome this reform other ministers may not do so. This can be due to several factors. For example, there may be resistance to increased transparency and accountability, a lack of willingness to delegate operational responsibility, tighter control over second-level organisations may be objected to because it reduces the scope for budgetary manipulation, tighter budgetary control because ministers will be accountable for delivering objectives and performance standards and objectives, as well as meeting budgetary controls, and doing so efficiently and effectively. A minister of finance should be prepared for these arguments and be willing to resist them.

Where the reform is intended to apply also to local government the minister of finance and the state secretary will need to establish similar relationships with mayors or their representative bodies.

In some countries a ministry of finance may seek to impose its view of efficiency. However, a ministry of finance is really in no position to make such a judgement. The responsibility lies with the operational management within a line ministry. However, a ministry of finance should have the capacity to challenge the judgement of that management and ought to do so where appropriate. Such challenges may occur during, for example, budgetary negotiations. Success in such negotiations depends upon the establishment of trust between a line ministry and the ministry of finance. A line ministry should set realistic and deliverable performance targets and not try to 'game' the system. The ministry of finance should be able to trust the judgement of line ministry specialists and as a result make available reliable funding.

5.2.9 The Minister of Finance and Parliament

The minister of finance should have not only a responsibility to agree the introduction of the PFM/IC policy with parliament and that means explaining all the different features of the policy, but also a responsibility to keep parliament informed of progress. This means that the minister should report regularly to parliament and where changes to the implementation policy occur, as they could well do, that parliamentary approval is sought. The minister should be accountable for success or failure to parliament.

The success with implementation should be assessed annually through the preparation of a 'statement of internal control' (see Chap. 13). This statement would be prepared by each public organisation, submitted to the ministry of finance who in turn should report on this statement to parliament. The statement would also be available to the external auditor who should review progress as part of the normal external audit activity and will provide a brief to parliament. This may form the basis for the interrogation of the minister of finance.

5.3 During the Reform!

5.3.1 Establishing the Appropriate Organisational Structures to Apply the Reform

As has been pointed out previously, the responsibility for operational application should be delegated from the minister of finance to the ministry state secretary who should be supported by a specific department responsible for the operational application of PFM/IC throughout the public sector. This department should issue detailed guidelines about how to apply the reform and should report to the chief official in the ministry of finance about the organisational application of the reform. It should also be responsible for maintaining the quality of the reform over time ensuring that the PFM/IC arrangements also reflect the changing operational environment.

The minister of finance, together with the state secretary should ensure that the department is appropriately staffed and has an ongoing capacity to oversee the reform. (The capacity requirements are set out in Chap. 9.) Countries wishing to join the European Union are required to establish such a department, often called a central harmonisation unit or department. The existence of such a department is regarded as one of the three pillars to the successful application of PFM/IC within those countries aspiring to meet the European Commission requirements. This arrangement provides a model that other countries could well follow. However, other aid organisations involved in supporting the application of PFM/IC may take a different view of the need for such a specialist department, although this author would regard such a department as an essential feature of the successful development of PFM/IC.

There will be some responsibilities that the state secretary can alone undertake. That official should have a personal responsibility for informing and coordinating the responses of equivalent chief officials in line ministries and for establishing regular meetings with such officials to review progress and to decide collectively how to address emerging problems. These personal responsibilities could also extend to local governments but whether they would depends upon the constitutional relationships between central and local government (see also Chap. 7). How the coordination arrangements should operate and the role of the state secretary are described in Chap. 9.

5.3.2 Cooperation with the Ministry or Department Responsible for Public Administration or Civil Service Reform

A crucial feature of success in the application of PFM/IC will be cooperation between the department responsible for overseeing the reform in the ministry of finance and the ministry or department responsible for civil service and public administration reform. If coordination does not occur, perhaps because no public administration reform programme exists (which in this author's experience does occur) the PFM/IC reform, because it is a managerial reform, will seek to drive civil service and public administration reform. However, in practice it cannot do this. The minister of finance, and by extension the state secretary, has a responsibility to ensure that this coordination occurs, and that civil service and public administration reform takes into account the requirements of the PFM/IC reform. If no public service reform plan exists then it is doubtful if the PFM/IC reform will be successful. Consequently, this need for coordination will affect the timing of the arrangements for the application of PFM/IC reform. (It should be borne in mind that even though PFM/IC is a major reform, so too is civil service/public administration reform and it will similarly take a long time to become established.)

5.3.3 The Use of Performance Information

Many governments, usually through the ministry of finance, use performance indicators (sometimes called 'key performance indicators'—KPIs) to assess the performance of organisations towards achieving policy objectives. These indicators can be simple (recording one element only of an activity), or composite (covering several aspects of an organisation's activities). An example of a performance indicator is measuring the number of caesarean births (C-sections) and using that as a proxy indicator for the availability of certain maternity services. Such a measure could also be used as a key performance indicator expecting that a level of between, say, 5% and 15% of such births in a population would be through C-section with a higher or lower proportion raising questions about why this is the situation. Such a measure could then lead on to an investigation into the reasons.

However, performance information also needs to be used with care and can lead to unanticipated consequences. There is always the risk that a management focus is on what can be measured rather than the total service delivery context and ministries of finance should be aware of this.

A further issue that the ministry of finance ought to consider is whether performance objectives and/or performance indicators should be published along with the relevant financial information. This is important from an accountability point of view and the information needs of its key stakeholders such as consumer groups, parliament, and taxpayers. Publication may also be required for some services to meet international statistical requirements, such as those of the World Health Organisation. Publication may lead to challenge, but the benefits of challenge should not be overlooked, uncomfortable though on occasion, challenge might be.

The ministry of finance with the development of PFM/IC in making budgetary allocations should take an interest in the development of objectives and/or performance indicators by line ministries and other public organisations. Its interest will be much wider than that of external parties because it will need to be satisfied that the relationships between the financial allocations and the objectives, performance standards and performance objectives are robust and therefore that, as far as possible, each element represents reality. This again points to the need for trust to be established between the ministry of finance and line ministries.

Achieving precision in policy objectives is likely to take some time and the reality is that policy objectives and performance indicators will be refined over time. That precision will usually focus on the definition of the 'outputs' of policy objectives which for some services can be relatively easily defined, but for others, not, or there can be conflict in the objectives. Consequently, performance measurement can be difficult.

However, some would argue that anyway, 'outputs' are not that important and that what governments should aim for, is to achieve 'outcomes'. The problem with 'outcomes' is that from a management point of view not only are they difficult to define with precision but 'outcomes' so far as public services are concerned can be influenced by many factors which lie beyond the ability of individual managers to control the results, no matter the level of budgetary resources which are available. 'Outcomes' rarely can be captured by a single budget or programme heading or even by a single public organisation. Outcomes can also take many years to achieve and would require very long-term budgeting, that is, well beyond the 3 years that apply even in the most developed economy countries. Therefore, for all practical management purposes the focus of financial management and internal control should be upon the achievement of the 'outputs' of policy objectives, with high-quality managers recognising that this only represents an interim step in achieving policy 'outcomes'. For example, a policy outcome of reducing crime depends upon many factors and the activities of many organisations. First, the nature of crime has to be defined and what type of crime is the policy aimed at? Secondly the causes of that type of crime need to be understood and these can include, poverty, social attitudes, quality of housing, levels of policing, policing policies, public attitudes to the police, sanctions (that is both the level and types of sanction) and so on. The policy 'outcome' can only be achieved through a management structure designed to address each aspect of the policy with the results then coordinated. To do that effectively, individual managers need to be clear about what they are to achieve, that is, the 'outputs' and their activities need to be coordinated with a wide range of other managers, including coordination of budgets (often an impossible task). Some desired policy 'outcomes' are also not capable of being managed and require long-term societal changes of attitude, for example, to the role of the police and how society regards its relationships with the police.

Another approach is to require objectives to be broken down into sub-objectives because the sub-objectives are easier to define and hence the subsequent performance measures. This would then allow policy makers and senior officials to make decisions about what they wish to achieve in specific areas, rather than in a broader, but less easily definable, overall objective.

The same points also apply to 'performance standards'. As indicated, an important element of management is to define the operational performance standards that should be applied. Some will be quite simple to apply, at least superficially, such as all customer queries must be replied to within 1 week, but that says nothing about the quality of the reply. That can only be judged by the quality of the managerial supervision and the existence of arrangements where the customer can complain about or follow up, in this example, on the quality of the reply. Other performance standards can be extremely complex, such as assessments of the educational performance of children, which in turn can depend upon a wide range of factors, or in the development of health policy measures to assess public and personal health. And then there is the question of performance objectives. These will identify or set targets for the amount of work to be undertaken, such as to undertake a particular number of vaccinations within a given period or to complet a specified number of asylum claims within a given period.

Or again both objectives and performance standards and objectives can be short term or long term, such as care for homeless persons. If the objectives or performance standards are short term, this will not address what could be the underlying problems and in that event the problems that they are designed to address will merely be repeated.

This though is the nature of public services. Political decisions may be required about specific objectives and performance and that can add to the complexity of any measures. (This is what makes the management of public services so difficult compared with the management of market based services and why political judgements need to be made.) However, despite these difficulties, with PFM/IC some measurement of success should be available to the manager even if it does not specifically address the overall main objective that a top or senior political manager is concerned about. Therefore, the reality is that in practice compromises may be necessary because precision in objectives or performance standards cannot be achieved.

None of this means that PFM/IC should not be developed; it however does demonstrate that achieving public policy objectives can be very difficult in practice and the limitations should be recognised. The boundary of these limitations will change over time as more experience is gained and information is obtained. PFM/IC is a practical recognition of that and that is why the implementation of the PFM/IC policy is so desirable, but the appropriate conditions must exist if the benefits are to be achieved. The benefits are also likely to take some time to emerge because of the fundamental nature of the reform and the learning processes involved.

5.3.4 The Organisation of Financial Information for Management Purposes

To facilitate the achievement of the benefits of PFM/IC managers in line ministries and local governments will require that budgetary and financial information is available to them in a form that suits their needs as well as those of the ministry of finance. There is no reason why individual line ministries (and local governments) should not develop their own financial analyses to suit their own needs and a ministry of finance should not stand in the way of this. In practice it would mean that individual public organisations develop their own coding structures designed to meet their own managerial needs but with the important proviso that such coding structures should link with those of the ministry of finance. The head of finance should have a key role in working with individual managers to determine their financial information requirements. (However, as has been pointed out previously, where countries have purchased off-the-shelf IFMIS this may be difficult because of the inflexibility of their coding structures.)

To illustrate the approach an extract is set out below from the government of Canada[7]:

[7] Government of Canada—Section 2—Introduction and description of the coding classification structure for 2018 to 2019: https://www.tpsgc-pwgsc.gc.ca/recgen/pceaf-gwcoa/1819/2-eng.html

The **Receiver General—Central Accounting and Reporting Sector**[8] is responsible for maintaining the accounts of Canada under Section 63 of the *Financial Administration Act* which includes the day to day management of the government-wide Chart of Accounts (COA) which specifically involves the creation, deletion or modification of accounts or codes, and the publishing of updates on the Receiver General government-wide COA website. In addition, the Receiver General provides functional direction, supporting operational instructions and other guidance to departments and agencies pertaining to the government-wide COA and government-wide coding. The Receiver General also performs a monitoring role for the overall quality of the information contained in the departmental monthly trial balances submitted to the Central Financial Management Reporting System (CFMRS) for inclusion in the accounts of Canada.

Departments are responsible for ensuring that their departmental coding is linked to the appropriate accounts and codes contained in the government-wide COA and that their financial transactions are complete and accurate. At the end of each month, departments summarize their financial transactions (based on the government-wide coding) and send their trial balances to the CFMRS for inclusion in the accounts of Canada. (Author's emphasis)

Although this extract reflects the arrangements in Canada for the management of financial information for the purposes of financial and statistical reporting purposes, it also recognises the need for individual departments [i.e. ministries] to develop their own financial analytical arrangements but with the condition that whatever those analytical arrangements, each organisation must retain the capability to provide the information that the central finance organisation requires. Therefore, management accounting information, however it is produced, should be linked to the financial accounting systems of the ministry of finance to ensure that the ministry can fulfil its responsibilities. This linkage also ensures that the same basic financial information is used for budgetary control, financial reporting, and managerial purposes.

A consequence of introducing PFM/IC therefore will be a need for additional information technology capacity (IT) to provide the analysis managers require.

Because the PFM/IC reform extends the idea of control beyond simply budgetary and financial controls to include those controls designed to achieve the objectives of an organisation, to standard, to time, efficiently and

[8] The Receiver General for Canada is responsible for making and accepting payments to the Government of Canada each fiscal year and preparing the Public Accounts of Canada, containing annual audited financial statements of the Government of Canada.

effectively this extension creates the opportunity for ministries of finance to link budgetary inputs with the outputs expected for those budgetary inputs. This also means that managers should commit themselves to delivering those outputs. This is an important feature of PFM/IC.

5.3.5 Internal Control Arrangements Within Line Ministries and Local Governments

Success in applying PFM/IC depends upon the management of line ministries and local governments adopting a disciplined internal control structure and a ministry of finance has a key interest in this. Internal control enables the management of an organisation, and external stakeholders, including the ministry of finance, to have greater confidence that its objectives will be achieved, that financial and performance reports are reliable, that resources will be used only for the purposes of the organisation and that they will be utilised efficiently and effectively. The minister of finance should be responsible for specifying the principles of internal control that should apply within line ministries and local governments. In many countries the principles would be those developed by the Treadway Commission (COSO)[9] and these are explained in detail in Chap. 11. The responsibility for applying those principles within each line ministry and local government lies with the management of the organisation. The actual person responsible for the quality of internal control would be the person responsible for operational management, that is, the head of the civil service within a ministry (or equivalent in local government). That person should then report to the political head as appropriate under the managerial accountability arrangements. The ministry of finance should satisfy itself about the quality of these internal control arrangements which also provide an indicator of the success of the implementation of PFM/IC, and that the effectiveness of such controls is monitored and maintained as operational circumstances, policies, and personnel change over time. (See Sect. 5.4.3 on the annual review arrangements and also Chap. 13 on the 'statement of internal control'.) The quality of the internal control arrangements would be subject to review by the state auditor who should report to parliament on that quality.

[9] There are different definitions of internal control but one that is widely applied in a European context, and which has been adopted by the European Commission and the International Organisation of Supreme Audit Institutions (INTOSAI), is that advocated by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). (Other countries may adopt different definitions of internal control.)

The responsibility of the ministry of finance (if a country decides to adopt the COSO approach) should be to ensure that the principles of internal control defined by COSO are properly applied. 'Properly applied' means that the management regards them as central to the management process, appreciates the managerial assumptions that lie behind them and is not prepared to accept a superficial approach which amounts to a focus only on the bureaucracy of the application of the 5 standards. That approach amounts to 'tokenism'.

5.3.6 PFM/IC and Budgetary Control

The minister of finance, as part of the budget preparation process, will issue a budget circular. This circular will set out the guidelines for framing the budget and any instructions about how to address specific items. It will include a timetable for the provision of information to the ministry of finance and may also include a set of forms which individual ministries will be expected to complete. A consequence of the application of PFM/IC is that the content of the budget circular should be expected to change, and in some countries, this would be a considerable change, especially where the current budget circular contains very detailed instructions about the calculation of individual line item. (In one country known to this author the detail required included a specification of the amount of drinking water that could be allowed for by ministry employees.) This type of detail would be inappropriate with PFM/IC. The government through the ministry of finance would still determine budgetary policy including policy decisions about the overall allocation of resources and the totality of expenditure within any ceilings although the assessment of those ceilings should be better informed because of the linkages between input costs and outputs. Where medium-term budgeting has been developed the existence of detailed instruction about the development of the future year's budgets will also require change. The reason for such changes is that as a key objective of PFM/IC is to encourage line ministries to become managerially oriented making their own decisions about the best way of achieving objectives efficiently and effectively, they need the scope to do so. In other words, PFM/IC allows managers increased discretion to use their initiative and detailed instructions from a ministry of finance about how to construct budgets can have the effect of removing or at best limiting managerial initiative.

PFM/IC also can affect the way in which many ministries of finance exercise control over budgetary changes proposed by line ministries, that is, over virement arrangements. The extent to which approval currently may be required depends upon the precise arrangements within the country and specified within the law. With PFM/IC ministries of finance should not seek to 'second guess' line ministries or seek to control at a detailed level the decisions of line ministries, or local governments especially where their managers are aiming to make changes to improve efficiency and effectiveness. For a ministry of finance to question every detail of a proposed change effectively puts them into a form of 'superior' manager exercising financial control, even if it does not intend to act in that way. This is incompatible with the idea of managerial competence, discretion, and hence accountability.

Consequently PFM/IC will impact upon ministry of finance/line ministry relationships, that is, they cannot remain the same. Indeed, if a ministry of finance tried to ensure that they remained the same this would undermine a key objective of PFM/IC which is to encourage line ministries to become managerially oriented making their own decisions about the best way of achieving objectives efficiently and effectively. In other words, PFM/IC allows managers increased discretion to use their initiative. Tight budgetary development rules and virement controls stifles initiative.

Therefore, some 'control' changes affecting the ministry of finance will be required, for example:

1. Traditionally the management of a line ministry or other organisation usually cannot adjust a budget at its own discretion unless the budget code within a particular country permits some change, but the degree of change is often set to ensure that a ministry of finance effectively retains a monetary budgetary control, rather than facilitating the achievement of objectives. Total budgets for an organisation usually cannot be changed although some redistribution over different detailed budget lines (i.e. 'virement') may be permitted. Some countries allow a ministry or other organisation to make changes up to a specified percentage, others require ministry of finance approval to any change. Exactly how these virement controls operate and the impact they have depends upon the extent to which they apply to each budget line and each department or activity of a ministry. If the virement control operates at a detailed level, then a line ministry or other organisation has little or no scope to make changes without the approval of the ministry of finance. This will inhibit effective management and should change.
2. In many countries the detailed budget is enshrined in legislation (the annual budget law). Changes to budgets affect the budget law and therefore at some point the approval of parliament is required. Limited changes initially may be approved by a ministry of finance, but the risk is that the bureaucracy may inhibit the extent to which managerial flexibility is required in order to improve efficiency and effectiveness.

3. Cash flow controls are again largely determined by the interests of the ministry of finance and the more detailed those controls the less scope managers have for change. Cash flow controls also follow the budget as determined by the ministry of finance rather than the operational activity requirements of the manager. They are often determined by the overall state of the government's finances. Where ministry of finance approval is required to modifications to proposed cash flow this may prevent the line ministry manager making decisions, hence affecting that manager's ability to deliver objectives efficiently and effectively. Therefore, cash flow controls may need to be reformed. (In some countries cash flow can be the determinant as to whether or not a manager is able to deliver objectives and examples have been provided to this author affecting the delivery of health and education services. Weaknesses in cash flow control can have their roots in inadequate budgeting such as over optimistic assumptions about tax flows.)
4. Linking budgets precisely to objectives and performance for some services and activities can be very difficult to achieve, no matter how good any financial analyses are. Therefore, when changing from a focus on budgetary inputs to an output focus this again ought to be accompanied by a rethinking of the rules on virement. In any event budgets are just forecasts and can be overtaken by changes of circumstances which may arise for economic, environmental, legal, international, or other reasons. Budgets are frequently based upon what happened in the previous year and do not necessarily reflect the performance objectives of a management and managers may not be able to foresee exactly how circumstances arising in the current operational year are likely to affect their ability to deliver objectives. This again points to a need for more flexibility in a ministry of finance approach to virement and in turn the detail which is to be included in any budget law.

What this means for budgetary control is that the ministry of finance with PFM/IC should be willing to shift its 'control approach' with the adoption of PFM/IC from that of detail to a broader concern for how a line ministry or local government is delivering its objectives to time, to standard, efficiently and effectively but within an overall budgetary envelope. (A traditional budgetary process may result in a tight budgetary and cash flow control, but it effectively inhibits managerial initiative within line ministries or local governments, aimed at achieving objectives.) However, to emphasise, such a shift should not occur unless the ministry of finance has full confidence that overall financial and budgetary control will be maintained by the line ministry and other public organisation management (see test of 1 Chap. 4).

5.3.7 PFM/IC and the Quality of Public Expenditure

Developing managerial initiative is an objective of PFM/IC. The aim is to improve the quality of public expenditure. Improving the quality means considering not just the control of spending but determining what is being achieved for that spending and how it is being achieved. PFM/IC therefore has the effect of highlighting a conflict, which should not exist, between traditional budgetary and cash flow controls and a desire to improve efficiency and effectiveness in public expenditure. Traditional controls have no regard for efficiency and effectiveness even though they remain essential if the conditions described in test 1 of Chap. 4 cannot be met. A ministry of finance should recognise the existence of this conflict and its adverse effect upon any drive to improve efficiency and effectiveness. Consequently, ministers of finance should reconsider how traditional budgetary controls operate. Ministers of finance will always remain concerned about pressures to increase public expenditure and their budget officers will be very alive to this issue. With the introduction of PFM/IC a minister of finance should look for ways of reconciling the requirements for expenditure control (the inputs) with the policy outputs that managers should be aiming to achieve.

Similar types of control to those which exist for expenditure may also exist for personnel. They have the same effect of limiting a manager's ability to make changes to the personnel structure without the approval from another ministry or the ministry of finance. Again, the introduction of PFM/IC should cause a rethinking of the purpose and effectiveness of such controls. If a manager has no or very limited control over the utilisation of personnel resources, then the manager's ability to deliver objectives efficiently and effectively can also be limited. (An example given to this author by the head of a maternity hospital was that he was not allowed to change a gardener post for a nurse post, at the same cost, to improve the utilisation of resources because the ministry of finance would not approve because of the risk of creating a precedent.)

A further feature of PFM/IC is that a consequence of the requirement to improve efficiency and effectiveness is that line ministries and local governments should take a longer-term view of their finances. (A ministry of finance should encourage this.) This means that they will need to develop long-term financial planning, that is, which may go well beyond the requirements for 3- or 4-year medium-term budgeting. Public services usually require long-term commitments and therefore efficiency and effectiveness should also be considered over the longer term. Decisions should not be made which do not have regard to the long-run financial implications of that decision, both on a particular service or activity and on other services and activities provided by the organisation. (That a particular decision secures a lower cost result in the short term does not necessarily improve efficiency and effectiveness: consideration should also be given to those other factors, such as quality, which will affect the long-run costs even if that means higher immediate costs.) Assessing long-run costs should be a key factor in decision making. It should also be a factor in securing the long-run financial resilience of an organisation. This should be of active concern to a head of finance. (This also illustrates the difficulty of relying simply upon foreign aid finance to support the development of PFM/IC because such aid is usually only committed for short periods and can be variable depending upon the interests and circumstances of the donor country.)

5.3.8 The Impact of PFM/IC on the Control of Second-Level Bodies Such as Agencies and State-Owned Enterprises

The PFM/IC reform will also require a much tighter control by first-level organisations, that is, by line ministries and local governments over second-level organisations such as agencies and state- and local government–owned enterprises. Overall, there should be a strengthening of accountability between second-level and first-level organisations, whether agencies or state- and local government–owned enterprises. The ministry of finance should consequently encourage controlling or owning first-level organisations to set for second-level organisations, objectives, and standards of performance and then first-level organisations must develop a capacity to effectively monitor the activities of those second-level organisations. Without this second-level organisations will tend to drive first-level organisations, rather than the other way round. This is because a second-level organisation will always know in more detail than the controlling or owning first-level organisation about their operational environment, and they will also be protective of their own interests and resist pressure to reform including pressure to improve efficiency and effectiveness. Therefore, the first-level organisation must always have the capacity to challenge.

The minister of finance also should ensure that where a first-level organisation wishes to establish a second-level organisation, that this is an appropriate action. The minister of finance should also ensure that when established the second-level organisation is efficiently managed and effectively supervised by the controlling first-level organisation. Controls over second-level organisations in countries with traditional public administrative systems tend to be weak. Introducing PFM/IC creates an opportunity for the minister of finance to require the strengthening of the controls and reporting arrangements for these second-level organisations. Set out below are the key policy points the minister of finance should address in strengthening controls (control requirements are discussed in full in Chap. 12). These key policy points ought to be included within a report to parliament:

- The exact arrangements for the establishment of second-level organisations, including the content of the formal authorising authority, the minimum size before such an organisation may be established, the frequency of the review of that authorising authority including its continued existence.
- The corporate governance arrangements for the second-level organisation and this is especially important for state-owned or local government–owned trading enterprises.
- The arrangements for the appointment of the chief officials of the second-level organisation both members of any board and other senior officials.
- The content of service level or performance or oversight agreements between the first and the second-level organisations, including for state or local government–owned enterprises, the financial arrangements and financial expectations for the enterprise: specific conditions should apply where an organisation provides services both to the public and to the private sector; the ministry of finance (or another appropriate central ministry) may specify the financial returns which should be expected from state-owned enterprises.
- Where a state-owned or local government–owned enterprise operates in competition with the private sector it should be required to operate in such a way that it does not undermine the development of the private sector: this would be, for example, by ensuring that in developing its pricing structure a notional cost of capital was included, that it took into account commercial risk and that no cross subsidy existed between services and activities provided for the public sector and those provided for the private sector.
- Where a second-level organisation earns income, whether a trading organisation or not, the second-level organisation should not be permitted to treat any such income as private to itself and therefore outside the controls applying to public sector income.
- The arrangements for the making of payments (fees, salaries, and expenses) for members of the governing body of the second-level organisation.
- The financial reporting standards that are to apply to state- and local government–owned enterprises; these should be those that would be expected to apply to private sector enterprises operating within the country.
- The content of the formal annual report of the chairman and/or chief executive of a state- or local government–owned trading organisation and such a report should be a public document.

- The external audit arrangements for state- and local government–owned enterprises.

Parliament should have the ability to scrutinise the operations of second-level bodies and be able to call the management to account as part of the scrutiny arrangements.

No second-level organisation should be permitted to agree its budget directly with the ministry of finance and ultimately with parliament, apart from those with a judicial authority and the state auditor. This is the practice in some countries but with PFM/IC all communications with the ministry of finance should be through the first-level organisation. Budgetary information about second-level organisations should be incorporated into the relevant first-level organisation budget which in turn should provide appropriate reports to parliament identifying the budgets for the second-level organisations controlled by the first-level organisation. If there are to be any exceptions these should be specifically agreed with the parliament.

With non-market second-level organisations the minister of finance should ensure that first-level controlling organisations satisfy themselves that the objectives and performance standards of the second-level organisation are consistent with their own and that they monitor the performance of the second-level organisation during the year.

The ministry of finance should ensure that a periodic review process exists to determine whether the second-level organisation should continue in existence.

5.3.9 PFM/IC: Securing the Managerial and Technical Capacity: Advice and Training

A particular responsibility of the department within the ministry of finance responsible for the application of PFM/IC will be to provide advice on managerial questions and technical support to line ministries and local governments. Examples of the type of advice that may be required include on managerial structures, delegation, and managerial accountability arrangements and on the management of relations with second-level bodies. Technical advice could include the specification and utilisation of financial information and for finance officials on budgetary, financial, cost and management accounting and on longer-term financial forecasting.

Civil servants will require training to help them develop the managerial skills that will be required. Heads of finance will require training to develop the skills needed to support a managerially oriented public administration. Skilled managers and finance officers are in short supply especially in the public sectors in many countries. This indicates a serious need to accompany the PFM/IC reform with the development of appropriate training programmes. Such training can be expensive, but the issue is 'no training, no management'. (Note: this is NOT about training in the bureaucratic requirements of the COSO internal control arrangements.) The department responsible for the application of PFM/IC should not be expected to deliver such management and financial training but in conjunction with the organisation responsible for public administration/civil service reform should specify what is required. The training itself should be undertaken by an expert training organisation such as a local university and almost inevitably would require that training organisation to develop specialist post graduate courses. So far as finance officer training is concerned, such officials would require a basic training in accounting and economics, and they would need advanced training to develop the competencies set out in Sect. 5.2.5. The department responsible for the application of PFM/IC may specify what the training should cover but as with management training, the programme of training should be provided by a university or a similar training institution such as a professional accountancy body.

There is another aspect of training that is frequently overlooked and that is the training of parliamentarians and especially those involved in the scrutiny processes. Parliamentarians will need advice on the impact of PFM/IC and how it will affect the construction of the budget, the management of public services, the distribution of responsibilities between the members of the government and the civil service and the arrangements for accountability and transparency. Without such training there is a risk that parliamentary scrutiny will continue along traditional lines and that too, over time, at least, will affect the success of the PFM/IC reform.

5.3.10 Encouraging Managerial Initiative: A Need to Review Penalty and Inspection Arrangements

Test 8 in Chap. 4 identified a need to review the penalty, inspection, and sanction arrangements affecting civil servants and local government officials and the way in which inspection arrangements operate. The minister of finance should assess whether such arrangements remain appropriate in an environment where delegation and managerial accountability are such a key element in reform. This is because current civil service laws as well as existing inspection and penalty arrangements can act as a barrier to the exercise of initiative, and the delegation of responsibility. They can lead not only to financial penalties but also to disciplinary action being taken against a civil or local government official for making what some critics may regard as a wrong judgement. This is even though such a judgement has been made in conformity of all the relevant rules and regulations. This can occur where, for example, a political official takes a different view from that of the decision making appointed official. However, where the bureaucratic arrangements follow Weberian principles, civil service officials should be protected from political sanction. However, quite properly, civil or local government officials should be subject to disciplinary arrangements, and even to criminal investigation for wrongful acts, abuse of power, a failure to act in the public interest or actions which cause damage to public assets. The code of conduct affecting public officials should not expose officials to undue sanctions or pressure when making decisions under the delegation arrangements developed as part of the PFM/IC reform.[10]

A very useful paper[11] has been published which examines how a regime of penalties or sanctions for breaching public financial management (PFM) laws and regulations can be designed to increase compliance with these laws. It advocates that designers of penalty regimes should have regard to five principles, that is:

Principle 1: *Sanctions should be applied fairly, consistently, and impartially*. If this principle is not applied, the sanctions regime may be perceived as unfair, or designed to protect powerful elites. The regime will lose credibility, and the incentives to comply with sanctions are likely to be weakened.

Principle 2: *Sanctions should be proportionate to the severity of irregularities*. If harsh sanctions, such as imprisonment, can be imposed for minor irregularities, the regime may be used to target political opponents, especially in countries where corruption in the public administration is widespread.

Principle 3: *Sanctions should be applied with a high probability of detection*. Compliance with the regime may be reduced if wrongdoers know that irregularities are unlikely to be detected.

[10] See, for example, Liabilities and discipline of civil servants By Francisco Cardona—SIGMA 2003: http://www.sigmaweb.org/publications/37890790.pdf

[11] Do Sanctions Improve Compliance with Public Finance Laws and Regulations? Allen and Koshima: Public Budgeting & Finance: 10 July 2018: https://doi.org/10.1111/pbaf.12197

Principle 4: *Sanctions should be imposed transparently*. Even if all the principles noted above are satisfied, a sanctions regime will only be effective if information is published on the irregularities that have occurred and the sanctions imposed.

Principle 5: *The design of the sanction's regime should reflect that wrongdoers do not always react 'rationally' to the possibility of being detected*. Several criminological studies have proposed a 'tipping point' theory, in which a sanctions regime has a non-linear relation with a reduction in the number of irregularities. If the frequency of penalties exceeds the tipping-point, the number of irregularities tends to increase … In the context of PFM systems, this theory suggests that imposing more sanctions will not necessarily have a positive effect on compliance.

5.3.11 Financial Regulations and Other Advice to Be Issued by the Minister of Finance

Many governments through the minister of finance have issued a set of financial regulations which determine how specific financial transactions are to be dealt with. Such financial regulations ought to be issued and reviewed regularly by ministries of finance in conjunction with line ministries and local governments. These regulations could be significantly affected by the introduction of PFM/IC and the decision to introduce this reform should stimulate review. For example, because a feature of this reform is that delegation and managerial accountability are developed, this will impact upon existing financial regulations if there is no recognition currently of the existence of these features. Again, advice could be provided through the financial regulations on the scope that could be granted by individual ministers or other senior officials, such as state secretaries, for the delegation of the approval of contracts and invoice payments, depending upon the size, complexity, and sensitivity of the transaction.

The coverage of those regulations is summarised in an annex to this chapter.

5.4 Sustaining the Reform

5.4.1 The Minister of Finance and the Timescale for Application

As was indicated previously, because of the fundamental nature of the reform the timescale for application is likely to be lengthy. In Chap. 4 there was a discussion about timing. In summary, ministers of finance ought to envisage at least 10 years from the development of the policy to actual application although in reality, financial management and internal control reform is an ongoing process as new experience is gained, new ideas developed and operational circumstances change. Exactly how long the initial application process will take though depends upon the starting point. Thus, if there is already a developed managerial culture with extensive delegation of decision making authority and developed managerial accountability processes, the timescale could well be much shorter. Again, where management accounting (including costing) has already been developed then this too will permit a shorter initial application period. What could also be an important factor in the time period is the extent to which both management training and accounting technical skills require developing. The length of time required to introduce PFM/IC will also depend upon whether other public financial management reforms are being introduced at the same time. For example, where accrual accounting is being introduced, this will have a significant impact upon the management accounting arrangements, upon financial and budgetary control and upon the responsibilities of management. Accrual accounting is both a technical and a managerial reform, if properly introduced. Application of both reforms at the same time, if the needs of both are to be properly considered will be delayed. Again, the same applies where programme budgeting is being introduced as well as the PFM/IC reform. Whilst these are complementary reforms developing them at the same time will stretch out of the reform timetable.

Another factor affecting the length of time the reform will take to apply will be the timetable for the reform of public administration.

Too many reforms undertaken in parallel also risk overstretching the resources of the ministry of finance and those departments or ministries responsible for civil service or public administration reform.

5.4.2 The Need for a Consistency of Approach over Time and for Consensus Between Different Strands of Political Opinion

Because of the length of time that it will take to introduce the PFM/IC reform ideally an agreed approach supported by all strands of political opinion, should be adopted. An important responsibility of a minister of finance would be to encourage this 'cross-party' support. Consistency in the reform policy over time will be an important factor in securing effective delivery in the shortest possible timescale. Even though a government may still remain controlled by the same political group(s) individual ministers may change. In such circumstances ministers of finance should recognise that there is a real risk that approaches to the application of PFM/IC may also change. Therefore, a minister of finance should ensure that arrangements do exist to secure consistency over time. Parliamentary oversight of the reform could also secure consistency of support and stimulate application especially where there is a regular change to elected officials.

In some countries the administrative and managerial arrangements within a ministry are governed by a ministerial decree issued by a minister and those issued by one minister may not be automatically continued in force without the specific authority of a new minister. Such a decree is unlikely to challenge the principle but may affect how the PFM/IC reform is applied in practice. The minister of finance has a responsibility to ensure that this situation does not occur, and this can be achieved in several ways. One would be regular assessments by the cabinet of ministers of progress in the application of the reform. A second would be by legislation requiring that ministerial decrees affecting the application of PFM/IC were approved by the ministry of finance (perhaps by the department responsible for the application of PFM/IC on behalf of the minister of finance). A third would be by a legislative requirement that ministerial decrees affecting the application of PFM/IC had no effect unless they were agreed with the ministry of finance. Or alternatively, by some combination of these approaches!

5.4.3 The Ministry of Finance and Annual Arrangements for the Review of the Impact of PFM/IC

Annually line ministries and local governments should prepare a formal statement explaining how they have applied PFM/IC and its effectiveness, including what has gone wrong, identifying failures to meet objectives and performance standards and objectives, and what corrective actions have been taken. This statement could also incorporate information about the risk assessment arrangements, including information about the types and level of risk that the organisation is willing to accept (the 'risk appetite'). (See Chap. 11 for a detailed discussion about risk.) If this statement about the application of PFM/IC did not incorporate the information about risk, then a separate statement should be published. This statement should be signed both by the head of operational management and by the political head of the organisation. (A full description of such an annual statement, a statement of internal control, is included in Chap. 13.)

This is potentially a very important statement for a ministry of finance to consider. It should provide valuable information about the quality of PFM/IC within an organisation. Ideally this statement before it is issued should be reviewed by internal audit and following publication by external audit. The ministry of finance ought to consider the content of this annual statement and this should affect this ministry's view of the quality of the PFM/IC arrangements applying not only in a particular organisation, but as all line ministries and local governments should prepare such a statement, including state-owned enterprises, more generally across the public sector. (The department responsible for the application of PFM/IC should have the responsibility to prepare a report of findings from these statements.)

The ministry of finance should issue guidance on the content of such statements. These statements should be publicly available and ought to be submitted to parliament as a feature of the accountability and transparency arrangements. When submitted to parliament they should normally form an element of the annual report which all public organisations ought to prepare, and which should be subject to review by the state auditor.

So far as local government is concerned a minister of finance should ensure (subject to individual country constitutional arrangements) that individual local governments also make public annually such a statement including for local government–owned enterprises.

5.5 Summary

The minister of finance has the principal responsibility for securing the effective application of PFM/IC. The ministry of finance is the 'mechanism' through which this responsibility will be exercised and the benefits achieved. The main aims of the reform are to secure the delivery of policy with the achievement of the objectives of a line ministry or local government, to do so efficiently and effectively and to improve governance, transparency, and accountability. The driving force for the application of the reform should be the minister of finance together with the state secretary who should be supported by a specialised implementation department.

Because the PFM/IC reform is primarily a management reform a key minister of finance responsibility is to ensure that coordination exists between those responsible for public administration (or civil service) reform and the staff of the department in the ministry of finance responsible for the PFM/IC reform. The minister of finance should also recognise the broad impact the reform will have upon many of the responsibilities of the ministry of finance. In particular, the introduction of PFM/IC will affect or complement:

1. Budgetary reforms such as the introduction of programme, performance, and other developments in budgeting.
2. The structure of budgets because of the need to recognise budgets as an important operational management tool as well as an economic management/budgetary control tool and therefore the structure of the budget should take into account not only the needs of the ministry of finance but also the needs of the managers in line ministries and local governments.
3. The form of the control exercised by the ministry of finance over budgets and in particular over variations to budgets during the year (i.e. virement).
4. The development of management and cost accounting to provide managers with the information they need to enable them to make judgements about efficiency and effectiveness both in income collection and in expenditure. This will affect the development of individual organisation coding structures. Managers should be able to determine how costs should be allocated for management purposes whilst at the same time continuing to provide the information the ministry of finance needs for budgetary control and statistical purposes.
5. The budgetary arrangements which should have a focus on the achievement of objectives, performance standards and performance objectives, that is, to the achievement of outputs within prescribed budgetary ceilings.
6. Responsibility for detailed budgetary control in the delivery of operational objectives and performance standards, within any constraints specified by political leaders in determining policy and the strategy for applying that policy, will shift to individual managers within line ministries and local governments from the ministry of finance with the latter retaining responsibility for overall control.
7. The approach to efficiency and effectiveness in the collection of income and in the delivery of public services and activities.

8. Lead to a longer-run concern for the financial resilience of the organisation;
9. Cash flow controls may also need to be revised so that management has more scope to meet objectives, to deliver performance standards and performance objectives as well as ensuring that arrears of payments to suppliers do not occur.
10. The arrangements for the relationships between first- and second-level organisations, whether agencies or state-owned enterprises, which will need to become more disciplined with the minister of finance issuing guidance of these relationships.
11. The issue and up to date maintenance of a set of financial regulations which define how the financial affairs of line ministries and local governments are to be managed.
12. The status and responsibilities of a head of finance because of their additional responsibilities which should include acting as advisers to managers and providing leadership throughout the organisation on financial matters. Where organisations have established 'management teams' the head of finance should be a member of that team. The added responsibilities of the head of finance potentially expose that person to greater risk and criticism and the minister of finance may feel as a result that the ministry of finance should coordinate the development of the finance function and become involved in proposals to appoint or dismiss finance officers.
13. Delegation and managerial accountability, cornerstones of PFM/IC, which require managers to make judgements in the delivery of objectives. Inevitably this involves risk but the present administrative laws, financial inspection and penalty arrangements may act in such a way as to inhibit the development of managerial capacity. The minister of finance should review all such laws and arrangements to ensure that they are compatible with the development of PFM/IC.

The minister of finance should ensure that internal control arrangements exist in conformity with its guidelines and that it assesses annually the quality and adequacy of line ministry and local government compliance. Line ministries and local governments should be expected to prepare an annual statement setting out how well the internal control mechanisms have performed during the year including failures and deficiencies (such as not meeting objectives and performance standards) and the corrective actions that have been taken.

A critical feature in the success of the PFM/IC reform will be the ability of the prime minister or other head of government supported by the minister of finance to convince fellow ministers of the need for this reform and the benefits that will flow from effective application. The minister of finance will consequently require a capacity to challenge the arguments of those who wish to retain traditional arrangements.

The reform is a long-term reform. An important responsibility of the minister of finance is to maintain the momentum of the reform over time and to ensure that it has widespread political support, that is, local ownership of the reform. A key to maintaining the momentum of the reform will be the establishment within the ministry of finance of a well-resourced and expert specialist department responsible for the detailed introduction and development of PFM/IC. This department should have equal status to other ministry of finance departments.

The benefits from the application of the reform are substantial but there are costs that will offset some of those benefits. However, if the reform is not properly applied and is regarded simply as a technical financial control reform focussed on introducing additional bureaucratic procedures the benefits of the reform will not be achieved.

Annex

The content of financial regulations affecting transactions should include:

- accounting procedures and details of budget preparation;
- the powers and duties of internal audit;
- arrangements for the issue of orders for work, goods and services and payment of accounts;
- extent to which delegation of responsibility for the issue of contracts can be authorised and the procedures which should be adopted with such arrangements;
- arrangements for and limitations on the payment of expenses to civil and local government officials;
- arrangements for and limitations on the payment of expenses to elected officials and other politically appointed officials;
- arrangements for the payment of salaries, wages, pensions, travelling and subsistence allowances and financial loss allowances;
- arrangements for the collection of income, that is taxable and other income, including an assessment of the distribution of subsidies where income is designed primarily to recover costs including writing-off of bad debts;
- security of assets;
- insurance; and
- banking arrangements.

They may also cover arrangements for the:

- certification and payment of accounts;
- control of income;
- custody of stores and stores accounts;
- imprest accounts;
- procedure for making insurance claims;
- management of trust funds or similar funds on behalf of third parties; and
- how budgetary and financial control should be applied within ministries and local governments.

The regulations may also include requirements about consultation with the head of finance:

- where circumstances exist or decisions are being made which may result in the incurring of financial and other risks;
- over policy decisions where there will be an impact upon the finances of the organisation;
- about the arrangements for the assessment of efficiency and effectiveness; and
- the arrangements for the preparation of the annual statement of internal control.

6

Risks and Unintended Consequences of the Reform

As with many reforms there are risks and unintended consequences. These can affect the level of benefits that may be achieved and the utilisation of public resources causing actual losses through corruption or other forms of misuse of public resources as well as a misdirection of resources. Failure to achieve objectives and performance standards may also be an unintended consequence. Pressure may also emerge to either abandon the reform or focus on the bureaucracy of the reform rather than its managerial substance because it will impact upon individual responsibilities and the distribution of responsibilities and power within and between organisations. Those who feel they have lost may wish to regain that power and those responsibilities or they may not feel that the new managerial environment is appropriate for their organisation, or indeed country. A responsibility of the head of the government (prime minister or president) and the minister of finance is to ensure that regard is had to these potential risks and unintended consequences that might arise. This chapter suggests some areas where these phenomena could emerge.

6.1 The Background to Risk and Unintended Consequences

6.1.1 Definitions

What constitutes risks and what are unintended consequences in the context of the PFM/IC reform? Risks arise from not addressing adequately the nature of the PFM/IC reform and in not addressing the management as well as

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_6

technical considerations. These risks may also arise from the approach of donors where they are driving the reform as well as from internal actors involved in the reform. The most important of those risks is that a country ends up with a 'fake' or 'non-reform', leading to higher costs with little or no benefits plus the costs and disruption caused by seeking to impose a reform that may be inappropriate for a country at this particular time given its current circumstances. As has been shown in earlier chapters if this reform is to be undertaken properly, it is a major reform with a very large 'to do' list of activity to be undertaken over a long period of time. This all adds to risk.

Unintended consequences are those consequences that result from the reform being applied correctly, but still having unforeseen effects. An example would be that as budgetary and financial controls are relaxed to allow managers greater scope to make decisions to improve efficiency and effectiveness the traditional 'checks and balances' are not replaced by 'checks and balances' attuned to the changed operational environment and decisions are made which result in consequences that undermine the benefits of the reform.

Donors and others advising on the reform should bear in mind that this reform is a major reform and that many developing and transition economy countries may not have the administrative and technical capacity to undertake all aspects of the reform and therefore the risk of unintended consequences is that much greater.

6.1.2 Causes of Unintended Consequences

In 1936, Robert K. Merton, the American sociologist listed five possible causes of unintended or using his terminology, unanticipated consequences.[1] The five are as follows:

First—ignorance. It is impossible to anticipate everything, thereby leading to an incomplete analysis.
Second—incorrect analysis of the problem or following habits that worked in the past but may not apply to the current situation.
Third—immediate interest, which may override long-term interests.
Fourth—basic values may require or prohibit certain actions even if the long-term result might be unfavourable. These long-term consequences may eventually cause changes in basic values.
Fifth—a self-defeating prophecy. Fear of some consequence drives people to find solutions before the problem occurs, thus the non-occurrence of the problem is not anticipated.

[1] *Sociological Review* Vol. 1, No. 6 (Dec., 1936), pp. 894–904 (American Sociological Association).

Introducing PFM/IC, as has been said, is a major reform and as with all major reforms the possibility of risks emerging and of unintended consequences is greater and potentially more damaging than with lesser reforms. Not the least of these risks is that as the PFM reform will result in changes to existing power structures within and between organisations inherent pressure will exist, at least for a considerable period of time, for those who perceive a loss of power to seek to recover that loss by one means or another (see De Geyndt, Chap. 1).[2] Consequently, a risk for a minister of finance is that the reform may not be properly or fully applied in individual organisations or may have consequences that were not anticipated. The factors that ought to be taken into account in deciding whether or not PFM/IC is an appropriate reform have been explained in previous chapters but they may be summarised as: culture; relevance to the country's own administrative and organisational structures; appropriateness given the current circumstances in the country, including levels of fraudulent and corrupt activity; and the quality of management. If these are not fully taken appreciated in the processes of reform there could well be unintended consequences.

The World Bank has described a set of five principles[3] to reflect good practice in public financial management (PFM) reform, whatever the precise nature of the reform. The approach set out in these principles is in the form of advice to World Bank staff but is relevant to a minister of finance engaged in PFM/IC reform to ameliorate the possibility of unintended consequences emerging (but not remove the possibility entirely). The application of these principles will militate against potential risks as well as unintended consequences. The principles are:

- PFM work should facilitate and encourage country leadership in setting/managing the PFM reform strategy and action plan.
- PFM diagnostic work should be conducted in an integrated and coordinated manner, drawing upon the distinct competencies of the [World Bank—which may not be relevant for some countries] PFM country team and other donors, with the timing and scope determined largely by country needs.
- PFM work should be weighted towards supporting PFM implementation reforms and capacity building rather than detailed diagnostic analysis,

[2] See also footnote 18, Chap. 1.

[3] Public Financial Management in World Bank operations: a strengthened approach to enhance development and fiduciary objectives 2004.

should add value to Government budget and reform processes, and should be aligned with government decision-making cycles.
- PFM reform work should be framed within a multi-year horizon, sequenced around agreed priorities, and built upon a coordinated donor approach.
- PFM work should be linked to a robust monitoring and evaluation framework that clearly articulates the gains in PFM system performance that are sought or achieved.

These principles emphasise the importance of the reform having regard to local circumstances and that adopting a reform merely because it represents international best practice, as has been pointed out, is a mistake. However, these principles are not always followed and, for example, donors, despite good intentions, may focus simply upon their own interests and approach. In practice, donor support for capacity building can be limited in scope or simply focus on the legal and procedural aspects of a reform and ignore the wider managerial constraints that go with, in this example, the PFM/IC reform.

An international programme designed to measure improvements in public financial management is the PEFA[4] framework. However, whilst this is a very useful tool countries should recognise that it is a one dimensional metric and does not have regard to the quality of public expenditure, yet a focus of PFM/IC is upon quality. PEFA does not attempt to assess the quality of the managerial structures affecting public financial management.

An article by Polzer et al. in their analysis of the application of the international standards of public sector accounting drew out issues which have similar characteristics to those which would apply with the application of PFM/IC, that is,

> the hesitation amongst politicians to give up their budgetary control and their attempt at maintaining dominance in public sector decision-making has in many developed countries resulted in extending uncertainty in the diffusion trajectory of ACC.A [accrual accounting] at the implementation phase.

And again:

> [T]he forceful adoption of IPSASs in many African countries, as part of complying with the WB's [World Bank's] lending conditionality, has resulted in

[4] PEFA: Public Expenditure and Financial Accountability Framework: "The PEFA program provides a framework for assessing and reporting on the strengths and weaknesses of public financial management (PFM) using quantitative indicators to measure performance." (Quote from the PEFA website: https://www.pefa.org/about.)

disastrous results, promoting the rise of corruption, patronage politics and neo-patrimonialism (Hopper et al., 2017). For instance, in their study of IPSASs in Nigeria, Bakre et al. (2017) have demonstrated how the adoption of these IPSASs enabled the politicians to conceal widespread patronage and corruption in the sale of government properties. A similar situation has been experienced in Benin where IPSASs and other public sector accounting reforms have provided a space for clientelism, corruption and patronage to flourish rather than leading to any improvements in governance and accountability (Lassou, 2017). It is concluded that 'decoupling appeared to be facilitated or prompted by the prevailing neo-patrimonial governance system wherein implementation decisions are taken in informal settings underpinned by a culture of secrecy.' (Lassou, 2017, p. 502)[5]

6.1.3 Reducing the Potential for Risks and Unintended Consequences

To achieve effective change the minister of finance with the ministry state secretary, will need to prepare carefully for the introduction of the reform. As has been pointed out in Chap. 5, to do that the minister of finance and the state secretary ought to consult widely about the PFM/IC reform and endeavour to ensure that it is not perceived as being imposed. In other words, 'local ownership', which has been pointed out as necessary in earlier chapters, is equally important to reduce risks and unintended consequences. 'Local ownership' means involvement in the design, staffing, and funding of the reform and it can also mean instead of launching an entirely new system, building upon what currently exists, identifying the weaknesses and correcting these because otherwise these may merely repeat themselves in any reformed system (see Chap. 9 on the need for a strategic analysis of and plan for the reform before implementation). The 'tone at the top' in each organisation should be one of commitment to the reform. The point also has been made previously that, because of the wide ranging nature of this reform, in turn this means that both politicians and appointed officials (civil service and local government officials) should be involved in the discussions about its application and the commitment of top and senior officials is essential to success. However, in general the wider the consultation process the better and limiting consultation to just a single group, such as finance officers or even to the top political and civil service and local government officials, in an organisation would be a mistake as would a ministry

[5] These quotations have been taken from "Does your walk match your talk?" Analyzing IPSASs diffusion in developing and developed countries: Polzer, Gårseth-Nesbakk, Adhikari: International Journal of Public Sector Management Vol. 33 No. 2/3, 2020, pp. 117–139.

of finance deciding to apply the reform without consulting other ministries and public organisations. Also, because this is a reform impacting upon both technical and managerial arrangements, consultation may be extended to others, such as academics, where they may have specific experiences in both these areas. In some circumstances consultation may also be extended to civil society. These different consultees will have different views and they will bring different perspectives to the reform. These views should affect how the reform is to be applied. What this consultation process will also do is to provide the minister of finance with an indication of from where the risks to the reform and the nature of those risks, is likely to emerge as well as the possibility of unintended consequences. This will provide an essential underpinning of the reform. This emphasis upon wide consultation is quite contrary to the approach of many transition and developing economy countries which is to regard this reform as wholly a ministry of finance reform with only those who should be consulted being the finance officers within public organisations. This reflects that the reform, in practice, is perceived of as just a technical financial reform.

6.1.4 Protecting Against Risks and Unintended Consequences, Including a Role for Internal and External Audit

The minister of finance and the ministry state secretary should be aware that introducing PFM/IC, as with many other reforms, may result in added or different risks from those that have existed prior to the reform as well as unintended consequences. Risks to some extent can be foreseen and planned for but obviously, by definition, unintended consequences will be difficult to foresee. However, these officials should be aware of the possibility of such risks and unintended consequences occurring and therefore should ensure that within the ministry of finance a resource capability exists to monitor the possibility of risks emerging and be able to respond should unintended consequences emerge. Also, by envisaging how and why risks and unintended consequences might develop precautionary steps could be taken to protect against their emergence. That resource capability would largely (but not wholly) be expected to be a responsibility of the specialist department of the ministry of finance established to support the state secretary with the implementation of the reform.

There does exist though a potential additional resource capability to assess the quality of application and that is the state auditor. The state auditor has an important role in not only auditing the financial statements but also assessing the quality of the financial systems which underpin those financial statements and for reviewing the efficiency and effectiveness of public expenditure and the use of public resources as a contribution to improving public value. This should include the PFM/IC reform and particularly the regulatory framework governing the reform. The head of the department responsible for the application of PFM/IC should cooperate with the state auditor, taking into account the advice that the auditor is able to offer. That advice offered in an independent manner could well help to reduce the level of potential risk and unintended consequences.

As this is a major reform covering a wide range of factors one unintended consequence is that of 'reform fatigue'. Those responsible for the application of the reform should take this into account in the planning for the reform. That will mean that the reform programme probably should be broken down into identifiable stages so that clear assessments of progress can be defined and judgements made about the successes and problems which have emerged or may be emerging.

With PFM/IC the control exercised through the managerial accountability arrangements is internal to the organisation and allows for the exercise of increased discretion by internal management. As has been pointed out earlier, this changes the framework of external control exercised particularly by the ministry of finance, but also some other central organisations. The role of the ministry of finance and other central organisations with PFM/IC is to set the guidelines and to create the conditions in which the management of those organisations responsible for the delivery of public services can do so efficiently and effectively and meet their objectives and performance standards. Assuming that the PFM/IC reform has been properly applied there remains a possibility that the changed role of these central organisations may result in the unintended consequence that the managements of line ministries and other public organisations may take actions which can be disadvantageous to the government and/or add to risk through, for example, inappropriate contracting and procurement arrangements, the accumulation of debts, weak income collection arrangements or make poor investment decisions and adopt policies that have unforeseen consequences. To reduce the possibility of this occurrence, although it cannot be removed entirely, the ministry of finance and other central organisations should balance the freedoms that PFM/IC requires with a strong regulatory type framework which would prescribe how certain activities were to be undertaken, the roles and responsibilities of different officials and the managerial and accountability context in which decisions were to be made, reviewed, and accounted for.

Therefore, accompanying the decision to adopt PFM/IC should be a review of existing regulations covering the following areas, or if no such regulations presently exist, such regulations should be developed, that is,

- Codes of practice governing the actions and behaviour of politicians and senior civil servants (and local government officials)
- Managerial accountability arrangements, including rules about the delegation of authority for decision making and reporting arrangements
- Contracting and procurement
- Investment decision making
- Financial transactions and all aspects of financial activity (see also Chap. 5 and the annex to this chapter on the content of the financial regulations)
- Risk management, including both systems risks and managerial risks
- Corporate governance arrangements

Review of such regulations, where they currently exist, should be one of the first actions to be undertaken by those responsible for the development of the PFM/IC policy. The head of operational management in each public organisation should be responsible for ensuring that such regulations are properly followed within the organisation.

There would also be consequential effects upon the role and responsibilities of internal audit which should help to limit unintended consequences. These effects would not change the international internal audit standards but they would affect their application. For example, those standards refer to the 'chief audit executive' having 'direct and unrestricted access to senior management and the board'. (These terms need to be interpreted in the context of the governance arrangements within each public sector organisation in a country.) In some countries this requirement is interpreted as the internal auditor should report directly to the political head of the organisation rather than to the chief operational management official such as a state secretary. The point has been made elsewhere in this guide that with PFM/IC there should be a clear distinction between the political level of management and its responsibilities for policy setting and strategy along with the overall supervision of operational management from responsibilities for operational management, including policy execution. This latter should be the responsibility of the civil or local government service officials under the authority of the head of operational management (i.e. the state secretary or equivalent). The internal auditor should therefore, in the normal course of internal audit reporting, report to the head of operational management with the application of PFM/IC rather than directly to the political head of the organisation. The only exception to this should be where the internal auditor felt that such were the circumstances that to report to the head of operational management would be inappropriate. The reporting arrangements would be different again where an audit committee existed or where some form of board arrangement existed responsible for operational management. In such circumstances the auditor should also report to the audit committee or to the board (where one existed). This means that the internal auditor should have a clear understanding of the roles of the different officials with the application of PFM/IC, that is, the roles of the political head of the organisation, the head of operational management, the head of finance and where one exists, that of the audit committee, a board and other key officials or relevant decision-making groups as well as how they relate to each other.

This regulatory framework developed to accommodate PFM/IC should be designed to ensure that these organisational structures and arrangements which are fundamental to accountability and governance are strong enough to withstand the pressures upon them that will undoubtedly emerge and which could lead to unintended consequences. These could include, for example, pressure from politicians or from senior operational management to present results in a manner that may be regarded as politically or managerially attractive but which do not actually demonstrate the reality of the situation, or to take short-term decisions where a longer-term approach would be more appropriate. Another potential area of weakness (i.e. risk and unintended consequence) is likely to be in the relationships between first and second level bodies and as is shown in Chap. 12 in the need for robust agreements between such bodies to determine the areas of competence of the second level bodies, the arrangements for their management and governance and the financial parameters within which they are to work.

Unforeseen consequences could also arise from pursuing policies that may apparently achieve the result intended but which have other effects that were not envisaged. In this circumstance the procedures may have been correct but the initial analysis leading to the policy decision was inadequate. The regulatory framework could not be expected to cover such unintended consequences which may always be a possibility, particularly given the complexity and wide ranging effects of many public service decisions. Consequently, the accountability and governance processes should provide for systematic arrangements for policy review. Again, this would impact upon the role of internal audit given the definition of internal audit as: 'Internal auditing 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.'[6] The consulting services of internal audit which should be designed to add value and improve an organisation's governance, risk management and control processes with the application of PFM/IC should provide a facility to advise operational management on the types of risk that the PFM/IC reform could generate, including those that might lead on to unintended consequences.

Again, those responsible for the regulatory framework should ensure that it is properly monitored. This should be by the department responsible for the application of PFM/IC and could be a feature of an annual review being treated as an aspect of the proposed statement of internal control (see Chap. 13). That regulatory framework should also be subject to review by the state external auditor.

In Chap. 5 the point was made that the ministry of finance state secretary should be confident that a robust financial management structure exists within individual line ministries and other public organisations and that those responsible for that structure (the head of the civil service within the organisation and possibly also the head of finance) have a specific personal responsibility to object where decisions are proposed to be taken which are contrary to regulatory requirements or which potentially add to financial risk. (That objection may be simply made internally within the organisation or in some countries to an external authority. Whatever the arrangements that objection should be 'on the record'.) Internal, and external audit, may have specific added responsibilities to report on the circumstances leading to the objection.

Another important potential source of information which could reveal unintended consequences is the assessment of effectiveness. For example, where a service impacts directly upon civil society, systematic assessments involving civil society cooperation can provide an important source of information about the impact of public service delivery. In the private sector the customer determines effectiveness through purchasing decisions. In the public sector, this is usually not possible so a more direct approach to the service user, or the service user representatives, may be necessary.

Following such arrangements will help to reduce the possibilities of risks and unintended consequences emerging. However, this author has not come across any country which has sought to establish such a framework which is a significant weakness in reform arrangements.

[6] https://www.iia.org.uk/resources/ippf/definition-of-internal-auditing/.

6.2 Examples of Unintended Consequences

A main purpose of the PFM/IC reform is to ensure that the potential benefits become substantive benefits and that unforeseen adverse effects do not occur. Those benefits will emerge from the managerial element of the reform and unforeseen adverse effects will require management action to overcome them.

Examples from countries of the failure of reforms to impact upon decision making processes and more generally to deliver the envisaged benefits are given below.

Accrual Accounting in the United Kingdom National Health Service

This study about the application of accrual accounting to the UK National study into the Health Service showed that a number of technical reasons caused a failure to achieve the benefits of the reform but in addition, and these reasons have more general relevance, a number of behavioural issues were uncovered, that is: 'The first (reason) related to the level of diffusion, that is, the spreading of new ideas and the second to the level of organisational coupling, which reflects the level of communication between those whose activities are subject to the new measurement system and those imposing the system.'

The study found that 'the revised accounting policy … was not well received and had not been diffused throughout the organisation. Implementation at the operational level did not occur, as top level management was focussed on the satisfying of regulatory requirements.' This example also showed that in slightly different organisational circumstances (i.e. in Northern Ireland), '[i]nformation was retained within the ambit of high-level managements rather than being devolved to the day to day users who should have been the ultimate drivers of the reform'.

Introduction of Programme Budgeting in Korea

The Korea example, showed how a failure to properly address the managerial arrangements and managerial requirements associated with the reform meant that problems emerged which affected its success.

What both these examples from the UK and Korea show is that a focus on technicalities and not paying enough attention to the managerial environment associated with the reform risks losing some, or all, of the benefits.

The Use of Targets in the United Kingdom

A feature of PFM/IC is the emphasis upon the development of measurable objectives and performance standards where this is possible and the linking of those measurable objectives and performance standards to budgetary availability. However, there are potential unintended consequences arising from an emphasis upon the use of performance data as targets. An example was well illustrated in a review of the use of targets in policing in the United Kingdom:[7]

> Numeric targets have seen extensive use in policing for many years, as part of both local and national police performance frameworks. The Public Service Agreements (PSAs) of the 1990s in particular created a slew of national targets in policing and across the public sector more widely. Since then, problems associated with targets such as 'gaming' and 'perverse incentives' have been well documented and targets have gradually been dropped by many [police] forces.
>
> What has come through most clearly in the review is the difference between performance cultures that are narrowly focused on 'chasing numbers' to the detriment of other aspects—and those that have developed a broader definition of performance, which supports evidence-based problem-solving and genuine improvement of services. The review has found that while the former was often associated with targets, the simple removal of targets by itself does not turn the one into the other. Over time, the priorities, processes and behaviours that develop under a target-driven regime can become entrenched—and the removal of targets alone is not sufficient to effect change. The challenge [police] forces face is to develop a performance framework that not only provides a good understanding of the business in order to help effective decision making, but also enables individuals to be appropriately held to account, whilst ensuring that they remain focused on doing the right thing for the public and for victims and in an environment where they are empowered to do so.

What this report illustrates is the importance of wide ranging consultation and the need for high-quality management.

Relying simply on measurable targets can also generate other forms of unanticipated behaviour. For example, research has shown that

> linking high-powered incentives to targets will result in improvements in reported performance and also in attempts to game the system, such as 'hitting the target and missing the point'. This highlighted two strategic lessons for policymakers on when such an approach will and will not result in improved performance outcomes for public services. First, targets with sanctions can work when the targets accurately measure key dimensions of performance that cannot easily be manipulated by gaming. Examples include hospital waiting times,

[7] The use of targets in policing—Review 2015. https://assets.publishing.service.gov.uk/government/uploads/system/.

> ambulance response times and school league tables. Second, where targets can only be framed as proxies for important dimensions of performance, the manipulative effects of gaming may undermine their use. An example is policing, where the nature of the targets means that pressure to meet them can result in such dysfunctional behaviour that performance deteriorates.[8]

In those countries where public administrative arrangements are based upon a legal tradition, the greatest risk is that the focus of reform will be on the bureaucratic arrangements, including any specific legal requirements. As has been pointed out, such a focus will not achieve the benefits that the PFM/IC reform is intended to achieve and those responsible for this reform need to pay particular attention to this risk, not least to the risk of slipping back into a legalistic approach unless that approach can be made compatible with the managerial environment implicit in the PFM/IC reform.

Similarly, people may adjust how they behave (gaming) to the reward and penalty system that exists. Such reward and penalty systems which in the public sector are often designed for reasons which have nothing to do with improving managerial performance, will affect how managers behave. (see also Chap. 5).

What is essential where a culture of meeting targets exists is that an essential feature of management is the application of 'common sense'.

Accounting Reform in Ghana and Benin and in Egypt, Nepal, and Sri Lanka

An example of unintended consequences of a public financial management reform was documented in a recent study which showed that formal government accrual accounting reforms, including the implementation of IPSASs,[9] have been used in two developing economy countries as a façade to hide 'patronage and clientelism [which] abound within an informal setting, which make adopted accounting rules and procedures redundant; hence the observed limited role of accounting in improved accountability, governance, and ultimately development (e.g. poverty reduction)'.[10]

This example illustrating the reaction to advanced financial management reforms where either strong coordination/support with local management did not occur or was inadequate or the purpose of the reforms was not fully

[8] http://www.lse.ac.uk/Research/Assets/impact-pdf/public-services-targets-sanctions.pdf.

[9] IPSASs is an abbreviation for international public sector accounting standards.

[10] Lassou, P. (2017), "State of government accounting in Ghana and Benin: a 'tentative' account", Journal of Accounting in Emerging Economies, Vol. 7 No. 4, pp. 486–506.

understood has been described in a study investigating the implementation of public sector accounting reforms in Egypt, Nepal, and Sri Lanka. This study described the factors that affected implementation resulting in 'resistance, internal conflicts and unintended consequences, including the fabrication of results, in all three countries without any evidence of yielding better results for public sector accountability'.[11]

PFM/IC in some respects has similar characteristics to accounting reform in that if properly implemented, as with accrual accounting reform, it does devolve power thus reducing detailed central control. Yet few commentators or advisers appear to address the managerial consequences of this feature of the reform. Again, like accrual accounting, it is also appears relatively easy to introduce the bureaucracy associated with the reform, but not achieve the substance of the reform. Therefore, the reform can appear to have been applied when in practice it has not. (i.e. the 'fake reform' syndrome). A minister of finance should be very alive to this application risk.

6.3 Performance Information and Using 'Bureaucracy' as an Indicator of Performance

In Sect. 6.2 above a reference was made to the possible problems which can emerge from a managerial emphasis upon the use of performance information. This showed that the development of performance measures and indicators is not easy and unless carefully thought through can have entirely unintended consequences. A discussion about the issues that should be considered is included in a World Bank paper 'Defining and Using Performance Indicators and Targets in Government M&E [monitoring and evaluation] Systems'.[12] The paper makes the point that '[l]ow or inadequate use of performance information in management and particularly budgeting is often a problem for many indicator systems. Quite frequently this situation signals not only problems with performance data availability and quality, but also the existence of challenges with political consultation or a lack of buy-in of the performance indicators and the types of information produced. Lack of consultation and validation are often signs of a weak institutional environment, which tends to result in indicator "inflation"—too many indicators but a very

[11] Unintended Consequences in Implementing Public Sector Accounting Reforms in Emerging Economies: Evidence from Egypt, Nepal and Sri Lanka: Adhikari, Kuruppu, Ouda, Grossi, Ambalangodage: International Review of Administrative Sciences October 2019.

[12] PREM*notes* July 2011 no. 12: https://openknowledge.worldbank.org/bitstream/handle/10986/11061/643870BRI0Defi00Box0361535B0PUBLIC0.pdf;sequence=1.

low rate of utilization—which in turn deteriorates their quality. Officials in such environments tend to perceive that information is not a problem; for them, information may in fact be abundant, while for others (the producers), underutilization of the information they produce provides a very weak incentive to take data and indicators seriously.' The final section of this World Bank paper 'emphasises the importance of quality data and processes and the necessity of tailoring performance indicator systems to match available resources and capacities'. Other World Bank information is also available as is information from countries about their use of performance information.

An evaluation of World Bank projects by the Independent Evaluation Group commented: 'Many of the stories of success were actually limited to improvements in better forms i.e., what laws, systems, and processes "look like" which were unlikely to have a noticeable positive effect on the overall performance of the public sector'.[13]

This 'bureaucracy' is very often the indicator of performance that many aid agencies look for when judging the success of PFM/IC reforms, but that is a mistake. It is not even a proxy. Another factor regarded by aid agencies and other international organisations is improvements in the effectiveness of financial and budgetary control. Important though this is, what also matters is improvement in the quality of public expenditure and international comparative assessments, such as PEFA[14] do not address this. To do this they should be looking for the achievement of the benefits or a proxy for that, but the problem is that the benefits usually take some time to emerge, that is, beyond the end of any aid period. A consequence is that it does mean that the external pressure upon those concerned with the application of the reform is on the form, rather than the substance, of the reform. The comment about 'fake' reforms (see footnote 1 of Chap. 1) is relevant. Countries engaged in a reform process need to recognise that risks and unintended consequences do exist. Where they rely upon aid agencies for advice and financial support risk and unintended consequences should be taken into account, and that would mean for example, being cautious about advice and recommendations that focus on the form, rather than the substance of the reform (see Sect. 6.4 below).

A question that those responsible for the development of the PFM/IC policy and for the development of the budget should consider is, in the interests of accountability and transparency to what extent should performance indicators along with objectives be incorporated into the budgetary documents for

[13] Quoted in a report by the World Bank on Malawi: How (Not) to Fix Problems That Matter: Assessing and Responding to Malawi's History of Institutional Reform: 2017: Policy Research Working Paper 8289.

[14] See footnote 4.

approval by parliament. Too much information would not actually be helpful but parliamentary scrutiny would be facilitated by including key objectives and the associated performance indicators. The inclusion of objectives and performance indicators would also facilitate the development of an informed civil society. Such parliamentary and civil society scrutiny would have the benefit of providing challenge to management (political and operational management) and through challenge improve the quality of the information being made available. It can also reduce risk and unintended consequences through the strengthening of the scrutiny process. As has been indicated previously, challenge may be uncomfortable but it can be a very valuable learning tool.

6.4 Managing Relations with Aid Agencies with the Aim of Avoiding Risks and Unintended Consequences Arising from Aid Support

Aid agencies are a very important source of finance and technical support. Their contributions are usually highly welcome by benefitting countries. But benefitting countries should recognise that whilst the benefits can be considerable potential problems can emerge which may affect the success of the reform. These problems can include or arise from (some of these have been referred to already):

- the relatively short timescales for aid interventions compared with the length of time that reforms take to mature, particularly managerial reforms such as PFM/IC;
- that aid availability can depend upon the domestic circumstances of the donor irrespective of the needs of the recipient;
- that aid organisations can focus on the technicalities of the reform not recognising the managerial impacts;
- that measures of success can be judged by superficial consideration such as the introduction of the bureaucracy, including laws (see the Independent Evaluation Group comments referred to above);
- that training tends to be limited to technical training in how to apply a particular technique (in the example of PFM/IC, how to develop risk management) rather than to have regard to the training needed to reflect the managerial and cultural changes that will need to accompany the reform;

- a focus on the adoption of international best practice and not taking into account local organisational and cultural circumstances;
- seeking to introduce the most advanced solution even though local circumstances suggest that a lesser solution may be more appropriate, at least at the time; and
- cash flow policies designed to meet the needs of the aid agency, rather than be linked to the specific requirements of the project (an example of this is that an aid agency can require that, say, 90% of a budget has to be spent in the first three-fourths of the year and that only 10% can be spent in the last quarter and this is irrespective of the programme requirements of the project).

Therefore, in deciding whether to accept aid agency financial support and advice, benefitting countries should consider what drives aid agencies to give that financial aid and advice. The following are factors that a ministry of finance should bear in mind:

- Firstly, be clear about the problem to be solved to avoid the situation arising of a solution (i.e. a standard aid package) looking for a problem.
- Secondly, have a clear appreciation of what the problem actually is and what any solution should involve, which in the example of PFM/IC means recognising that what is likely to be required involves a management reform as well as technical changes, not least because this affects the extent of any technical changes and the structural order of the reform process.
- Thirdly, consider to what extent improvements to the existing arrangements can be made rather than engaging in a major reform process.
- Fourthly, from the outset have a clear view about how long the reform is likely to take to implement.
- Fifthly, determine the agenda for reform rather than allowing a third party, the aid agency, to do so.

The benefitting country should have a clear idea of what the problem is and what needs to be done, how long the reform is likely to take and then having control of the aid supported reform process. It should aim to achieve local ownership of the reform. Unfortunately, this is hardly ever the situation and countries may not have the capacity to undertake the initial analysis of what is required. They may need a third party to assist them. A useful model is provided for countries wishing to join the European Union or neighbourhood countries benefitting from its funding and who know that they will be expected to apply PFM/IC, because the European Commission through

SIGMA[15] is able to provide policy advice which would form the agenda for aid support. Of course, it is up to a country to decide whether to accept such advice and if several aid agencies become involved, some of whom may have strong views about a particular reform, compromises may be made over which a beneficiary country may have little influence. This raises the question of sovereignty.

Public money and its administration/management is at the heart of a nation's sovereignty and therefore allowing a third party to dominate the reform agenda adds to risk, not least to the long run sustainability of a reform and particularly to a complex and major management reform like PFM/IC. The reform process should be dominated by the interests of the country and owned by the government. If aid agencies dominate the agenda, they are in effect demeaning that sovereignty.

Of course, aid agencies will be concerned about the misuse of aid funds and that will affect their attitude to the utilisation of such funds. As the PFM/IC reform will take many years to achieve this timescale is usually wholly incompatible with the timescales available to aid agencies. The risk for a country is that the agenda of the reform process acceptable to an aid agency may be incompatible with what is appropriate to achieve a long run reform. Using examples given earlier in this chapter, changes to the law and the institution of a bureaucracy provide 'easy' performance indicators for an aid agency but do not necessarily provide substantive evidence of the reform. Thus, a country may introduce the bureaucracy associated with risk management but this is of little value if no policy objectives linked to budgets exist or management to make judgements about the significance of the risks. Therefore, the risk, in this example, for those responsible for the application of PFM/IC is that they may think they have introduced risk management, when, in reality, they have not.

Another area of potential risk is that as introducing PFM/IC is a management not just a technical reform there is a possibility that an aid agency may not appreciate the full extent of the reform required or the length of time is will take to develop and apply. This reform is risky not least to the aid agency because it has very long time scales, 10–15 years according to SIDA (see footnote 25 of Chap. 1). The risk for a benefitting country is that as a result an aid agency may try to convert the reform into a shorter run technical reform.

[15] SIGMA: (Support for Improvement in Governance and Management) is a joint initiative of the OECD and the European Union. Its key objective is to strengthen the foundations for improved public governance, and hence support socio-economic development through building the capacities of the public sector, enhancing horizontal governance and improving the design and implementation of public administration reforms, including proper prioritisation, sequencing, and budgeting.

Alternatively, another risk is that an aid agency may try to convert the reform into a larger scale reform such as a reform affecting the whole budgeting and financial control process. There can be strong incentives for an aid agency to support such a wider reform especially where an aid agency wishes, for its reasons, to establish an enduring ‘business relationship’.

A country should be prepared to resist this even though it may mean forgoing aid funding in the short term. The main message for a country seeking to benefit from aid support is that there are risks associated with aid funding which should not be overlooked. To minimise such risks, the recipient country should follow the five points set out above, which can be summarised as ‘retain control of the reform agenda’.

Where an aid agency is not prepared to allow a recipient country to retain that control or to accept that PFM/IC is a managerial reform or wants to simply focus upon limited bureaucratic indicators, or the government does not have the managerial capability to engage in a wide ranging reform, the recipient government may find it more appropriate to seek support for a more limited reform. That would mean seeking aid support for the strengthening of the current PFA/IC process.

6.5 The Factors Which May Be a Cause of Risks and Unintended Consequences

Examples of the factors which may generate adverse effects leading to unintended consequences are set out below. These are not simply factors caused by the introduction of PFM/IC, although some are. They can apply equally to other financial based reforms. The examples include:

- Underestimation by the political level of government and the senior civil service of the major managerial significance of this reform (this applies equally to some budgetary reforms such as programme budgeting and in another financial area, to accrual accounting).
- The introduction of PFM/IC when the basic structures do not exist. The example given earlier in this guide is that of trying to introduce PFM/IC when a robust PFA/IC is not in place. (This applies equally to other financial reforms.) The ‘siren call’ of best international standards can be very appealing to ministers of finance and their advisers but it should not be heeded unless the circumstances are appropriate.

- Whether or not there is a perceived need within public organisations of the desirability of the reform. This in turn may also depend upon whether the need for the reform has been generated within the country or whether the reform is being introduced because of the requirements of external organisations. A lack of local ownership can be damaging. (This too applies equally to other financial reforms.)
- A failure to recognise, and therefore plan for, that PFM/IC will result in a redistribution of power within and between organisations. The potential consequences of such a failure are that

  – over time the original power structures will reassert themselves and therefore the benefits of the reform will be lost;
  – second level bodies will be used to avoid controls placed upon first level bodies unless specific steps are taken to prevent this; and
  – the existence of a new range of powers for some organisations will be exploited sometimes for corrupt or fraudulent purposes unless the overall regulatory framework is strengthened.

- Not recognising that for the PFM/IC reform to achieve results a managerial cadre must exist with that managerial cadre must be supported by an effective financial management expertise: if this is not perceived as an essential feature of the reform it will fail to deliver the benefits. (Other financially based reforms require managerial changes but these are often overlooked.)
- Even though an aim of PFM/IC should be to make finance a central feature in policy decision making, this does not in practice happen and as a result the benefits of better utilisation of resources does not occur.
- The inappropriate use of targets in attempts to measure performance can result in

  – a narrow interpretation of policy objectives;
  – an overemphasis upon performance measures which can result from a political emphasis upon a simplistic message, with consequently managers not having regard to the wider operational environment; and
  – the development of ‘gaming’ to demonstrate policy achievement: where targets are a key factor in assessing performance an important feature of the performance management process is that it should be entirely independent of the manager because otherwise the manager will be under pressure to manipulate the performance information to demonstrate

success.[16] Without this independence the manager can manipulate performance information to suit his/her particular needs. The result can be unforeseen misjudgements about progress, efficiency and effectiveness and the utilisation of budgets.

- A failure to recognise that most issues governments need to address cannot be dealt with by a single public sector organisation but require the utilisation of resources by several public organisations (and sometimes also private organisations): coordination can therefore be central to effective management but coordination also creates the opportunity to shift blame for policy failures leading to loss of accountability.
- Poor-quality definition of objectives and performance standards coupled with a failure to link either objectives or performance standards to budgetary provision: this could result in

  - reduced efficiency and effectiveness and
  - poorer standards of accountability resulting in corruption in reporting.

- A government cannot make effective decisions about levels of spending or the allocation of resources unless it knows, or has a genuine perception of, what the impact on performance in achieving objectives might be: PFM/IC should require this focus which involves service user participation (i.e. civil society involvement) even though it increases official exposure through accountability and transparency which consequently may generate pressure to restrict these features of PFM/IC.
- A failure to properly track performance against objectives resulting in inefficient utilisation of resources and pressure upon the quality of accountability processes caused by a concern not to expose such weaknesses.
- Not having regard to the long run financial resilience of public organisations: this can be caused by

  - committing to policies or investment decisions that have long run financial consequences without a financial plan about how such costs would be financed;
  - not recognising the ongoing costs of current activities resulting in, for example, cutting those costs in order to finance new policies or investment activity; and

[16] A notable comment was once made to this author when performance was questioned because it appeared to be too good to be true was 'this is what they want so this is what they get'.

– not being prepared to address (i.e. manage) what may be defined as fixed costs (although not necessarily in accounting terms) such as employee and property costs as well as overheads because existing policies or methods of delivering services are not being reconsidered given other new commitments or changes in circumstances.

The consequences will include inefficiency in public expenditure and damage to accountability. To overcome this problem, managers should be aware therefore of the need to develop strategic financial and business planning so that when decisions are made regard is had not only to the more immediate financial and operational impact of those decisions but also to their longer-run impacts, and particularly financial impacts. (Note: the development of medium-term budgeting is not an adequate response to this problem.)

- Failing to recognise and consider the impact of other reforms and especially the consequences where other reforms have not been successful or have been delayed. An example would be the introduction of complex and extensive technical reforms, such as the introduction of an integrated financial management information system (IFMIS), which are not always successful and can take considerably more time to implement than originally envisaged and may also be incompatible with managerial needs, even though meeting the needs of the ministry of finance (a reference was made to this in Chap. 5).
- Failing to recognise that changes in budgetary funding, impact upon corresponding policy and or performance changes: similarly, not ensuring that funding will keep pace with the factors affecting the demand for public services, such as a growing older or younger population or climate change.
- Failing to recognise that a change in some problems, such as an increase in certain types of crime, can have impacts not just on one public service but on a range of public services, including in this example, the police, the judicial system, the prison and probation services, and the education and social services: this results in inefficiency and damages accountability because it allows blame for inefficiency or for a failure to meet policy objectives to be shifted.
- Other possible unintended consequences include damage to the financial and budgetary control processes, efforts to avoid accountability and the consequences of transparency.

What these examples indicate is that the benefits of the reform depend very heavily upon the recognition of the cultural and management changes that will be required. The specific features of these cultural and management changes have been referred to in earlier chapters but if this recognition does not occur then the prospect is that they could result in added risks and unintended consequences which may include the deterioration in the quality of public services; attempts to conceal that deterioration (for example through 'gaming'); and weakened accountability.

Corruption, as an unintended consequence, is always a risk. A feature of PFM/IC should be a strengthening of governance:

> The presence of corruption generally indicates shortcomings in 'good governance', which have, at the end, consequences for the effectiveness of PFM [public financial management] processes and controls. One important lesson is that PFM diagnostics require a rigorous understanding of the political context of the country, how political power is exercised, and how corruption fits into the country's political and administrative culture.[17]

An appreciation of the cultural and managerial changes that will be required to avoid or minimise risks and unintended consequences can help reformers determine the extent to which political leaders and decision makers are committed to PFM reform and, if not, how best to influence their thinking.

The extent of these risks and unintended consequences will depend upon the circumstances and not least upon the regulatory framework governing those areas of potential risk which has been referred to above. The minister of finance and the ministry of finance state secretary should therefore take all these different factors into account in how it assesses and makes judgements about the success of the application of this reform. The solution though does not lie in a reversion to a traditional approach to public administration, for example, to a detailed external line-item control by a ministry of finance (i.e. a reversion to PFA/IC). Rather it lies in a strengthening of corporate governance, in the leadership provided by ministers and particularly by the most senior civil and local government service officials and by the recognition of the importance of the quality of the internal and external accountability arrangements. Internal accountability is a two-way process meaning that it is not simply a matter of junior officials reporting to more senior officials but of senior officials taking action on accountability reports and doing so in a non-threatening manner. PFM/IC will result in a more demanding external accountability process because of the focus upon both the control of inputs and the management of outputs. Accountability is also an important factor in

[17] Integrating PFM and Anti-Corruption Strategies; IMF Blog Feb. 4th 2019: Concepcion Verdugo-Yepes.

helping the ministry of finance develop effective budgetary arrangements through providing information about the utilisation of resources and with PFM/IC, including the achievement of objectives and performance standards. As has been pointed out previously, external accountability together with transparency are both key features of the PFM/IC reform and facilitate challenge which ultimately is beneficial to the whole process. Therefore, attempts to reduce transparency and accountability should be firmly resisted.

These and other areas of the possibilities of unintended consequences occurring arise from the improper or inadequate application of the reform and poor-quality management, including financial management. Both political and operational management need to work together to increase success in meeting objectives and performance standards and in enhancing efficiency and effectiveness.

6.6 The Warning Signs Leading to Potential Unintended Consequences

The main warning signs of unintended consequences emerging arise from:

- Lack of local recognition of the need for the reform at the very top of government (i.e. by the prime minister or president) as well as by the minister of finance and its wide acceptability, not least by the cabinet of ministers and the most senior civil servants: this means that 'preparing the ground' (an activity of the minister of finance and the state secretary, or equivalent) should be an essential first element of the reform in order to achieve local ownership.
- A failure to recognise the major material change that will occur to the responsibilities of elected officials from being the operational decision makers to being that of the supervisors of the operational decision makers as well as being the policy makers and strategists: this requires that there is a clarification of the roles of politicians and their expectations and this clarification may well require specific induction arrangements for those appointed to political positions.
- Not recognising that the role of parliament also requires change, partly to extend transparency and accountability through the inclusion of objectives and performance information in the budget, partly to facilitate enhanced parliamentary scrutiny (including civil society scrutiny) and partly to recognise parliament's role as a driver of the reform.

- A failure to accept that there will also be a major change to the responsibilities of civil and local government officials and that such a change needs to be accompanied by complementary reforms to the way in which human relations (HR) management operates: if this does not happen (and this appears usually to be the situation) there is likely to be a drift back towards the traditional arrangements for public administration.
- A failure to create a financially aware management exemplified by not recognising the enhanced role of the finance officer, the wide range of responsibilities that accompany the role of head of finance and to regard finance simply as a bookkeeping/controlling responsibility.
- A failure to have regard to local culture which it likely to reassert itself by adapting the imposed system to suit that culture: this requires that those responsible for applying the PFM/IC reform consider how the requirements of the reform conflict with traditional values and the modifications that may be required to the application and training arrangements to ensure that those traditional values do not adversely affect the objectives of the reform. To avoid this problem emerging may also affect the timing of the reform.
- Associated with the question of local culture is the relationship between elected and appointed officials: if, say, the politically appointed official seeks to dominate the decision making process irrespective of the concerns of the relevant civil service or local government official unless there is a process of effective support for such officials, this is a warning sign that unintended consequences may emerge.
- Inadequate attention being paid to civil and local government service capacity development with inadequate regard for existing staff attitudes and capabilities: this means that the reform application timetable should be to a considerable degree determined by the extent to which the civil or local government officials accept the significance of a changed managerial approach with its increased responsibilities and risks.
- Lack of coherence between the different public financial management (PFM) reforms which may be being introduced such as programme budgeting, medium-term budgeting, output budgeting and accrual accounting and associated with this, a lack of coherence between civil service and public administration reform and the public financial management reforms all of which have managerial impacts if they are to be effective. This emphasises that 'PFM reform work should be framed within a multi-year horizon, sequenced around agreed priorities, and built upon a coordinated donor

approach'.[18] (Although this ought to be an objective, as has been pointed out above in Sect. 6.4 there can be considerable risks from relying heavily upon the advice of aid agencies.)

- A focus upon building the bureaucracy associated with the reform, rather than the substance of the reform, perhaps under pressure from aid agencies: this is entirely the wrong priority but unfortunately the existence or not of the bureaucracy is the easiest to monitor.
- Monitoring is not directed towards whether the purposes of the reform are being achieved? These purposes include, are objectives being delivered to time, are performance standards being met, are improvements in efficiency being delivered? The annual reporting process should be directed to this purpose and not simply to assessing whether or not the appropriate bureaucracy is in place.
- A complementary management reform is not being undertaken? If there is no evidence of this reform coordination the focus and timing of the PFM/IC reform activity is almost certainly wrong.
- The ministry of finance focus and that of top and senior political and civil service (or local government) official concern has not changed from simply the control of 'inputs' to having regard to the 'outputs' that should be expected from those 'inputs'.
- The existence of attempts to avoid financial controls through inadequate management and supervision of second level organisations or with an increasing tendency to exempt them from controls.
- The extensive use of second level organisations to deliver public services without the application of strong first level management controls and monitoring.
- The extensive use of 'off-budget' funds and devices such as leases by both first- and second-level bodies.
- The recognition of a need to refocus internal audit to support the introduction of PFM/IC in order to specifically address the risks and the possible development of unintended consequences.

The effectiveness of the reform may well depend heavily upon a better understanding of behaviour and what is necessary to change behaviour. This is not a usual area of concern for those responsible for PFM/IC (and other PFM reforms for that matter) but especially because this is a management reform affecting how officials behave full regard should be had to this in the development of the reform. This aspect of a reform process is described in a

[18] See footnote 3.

Guide prepared by the UK National Audit Office.[19] A summary of this Guide's findings which relate to the development of ministry programmes of activity, covers:

> Behaviour Change and Value for Money [VFM]
>
> Behaviour change is important for value for money (VFM) because it can often contribute to, or be a prerequisite for achieving a policy outcome cost-effectively. Risks to delivery will be exacerbated if departments [ministries] have a poor understanding of either the behaviours they are seeking to change or the impact of different behaviour change mechanisms. Broadly, risks to VFM can arise at these stages:
>
> - Design—inadequate theoretical and/or evidence base
> - Application—absence of process evaluation
> - Evaluation—lack of objective measurement
> - Absence of convergent evidence (triangulation)
> - Failure to establish cause and effect.

The Guide acknowledges that reporting on the VFM of behavioural change can, however, be difficult:

> [P]rogrammes may involve a variety of interventions, be of long duration, and produce benefits that can be hard to assign a monetary value to.

This is typical of a PFM/IC reform. Although this Guide is designed for auditors specifically concerned with VFM assessments of ministry programmes, those responsible for the PFM/IC reform ought to equally have regard to its findings in both formulating how the reform should be applied and the assessment of application progress particularly to lessen the risk of unintended consequences and risks arising from the reform.

According to the Guide there are five key areas to consider when assessing a behaviour change and these are:

Understanding the audience
Understanding behaviour
Understanding the levers
Designing the intervention
Evaluating the intervention

---

[19] See UK National Audit Office Guide to auditing behaviour change 2011. Although this guide is directed to auditors and their work in reviewing the effectiveness of government policy towards the provision of public services, this Guide has important lessons for those concerned with behavioural change in other circumstances.

Take as an example, understanding the levers! What are the levers that are available to achieve effective PFM/IC reform? Are they just legislative levers, as occurs in many countries (i.e. this is what the law says and as it is the law it will be obeyed: this has been said to this author in several countries) or could such levers include financial levers, such as budgetary allocations being dependent upon the development of PFM/IC, or will personal promotion depend upon success in establishing PFM/IC, or how material is training or the incentive of more freedom in decision making?

This is an area of activity where the head of the department responsible for the PFM/IC reform should seek specialist advice, probably from a university or other organisation specialising in human resource management. Introducing PFM/IC will require significant behavioural change within organisations but this is not normally addressed in policy papers concerned with the introduction of the reform.

6.7 Arrangements for the Monitoring and Evaluation of the Reform

The ministry of finance responsibility is to monitor, report on, and evaluate the application of PFM/IC. This is a vital activity which should be undertaken by the department responsible for the application of PFM/IC. A specific purpose of monitoring and reporting is to identify problems. Examples of the problems include: is an organisation achieving its objectives and performance standards and performance objectives and if not, why not (see Chap. 13); are the managerial structures appropriate, is delegation of operational responsibility actually occurring, do examples exist to prove this and similarly for the managerial accountability arrangements, what difficulties are developing, what unexpected consequences are emerging or have emerged? Recommendations then need to be made for solving emerging problems as the strategy is applied. That may mean adapting the strategy. The monitoring, reporting, and evaluation system should be developed and established as part of the development of the PFM/IC strategy. Which issues are then likely to be addressed as a result of the monitoring process should be made clear to those responsible within public organisations for the application of PFM/IC. The form of the monitoring should be expected to change over time. Initially the monitoring should be designed to establish how far the principles of PFM/IC have been accepted by public organisations. Once the principles have been applied monitoring should be able to focus on the results identified in the preparation by public organisations of the statement of internal control (see Chaps. 5 and 13).

A SIGMA toolkit on public administration reform clarified the role of monitoring, reporting, and evaluation as a

> help to identify and present information about emerging challenges and implementation bottlenecks. Such knowledge can be used to design and propose solutions for improving the strategy design and operational plan, overcoming specific implementation difficulties, and making better use of the existing management and co-ordination structures. In other words, proper use of the system of monitoring, reporting and evaluation is fundamental for timely, effective and efficient achievement of the planned reform results. In addition, monitoring, reporting and evaluation are also about accountability. The information and data generated through monitoring and reporting help to hold public institutions accountable for commitments made and reflected in the strategies. It is fundamental that results of the monitoring process, as well as any evaluation, be shared with stakeholders and the wider public, both to ensure that all affected parties are informed about what has or has not progressed, how and what results have been achieved, as well as to validate the key findings themselves.[20]

Internal and external audit also have a role to play in assessing the content of the statement of internal control.

This annual process of review will impose an additional burden upon the department responsible for the application of PFM/IC and it should therefore be staffed to enable it to properly review these statements and to report to the minister of finance on their findings. As indicated in Chap. 13, that report ought ultimately to be presented to the cabinet of ministers and, depending upon individual country arrangements, to the parliament.

The ministry of finance, through the department responsible for the application of PFM/IC, may also consider commissioning specialist research to establish whether unintended consequences are occurring along with the causes.

6.8 Summary

As with most reforms there are risks and not all consequences can be fully foreseen. Ministers of finance and the ministry state secretary (or equivalent) should be aware of the risks arising from the application of the reform along with the possibilities of unintended consequences. Most of these risks and

[20] SIGMA Paper 57 Toolkit for the preparation, implementation, monitoring, reporting and evaluation of public administration reform and sector strategies, p. 85.

unintended consequences are likely to emerge from imposing an advanced reform upon an administrative culture that is unprepared for the changes that will result and where there is unfortunately an acceptance of corrupt practice. At one extreme these risks will add to that risk of corruption. Equally likely though is that the risks that will arise will not just be in the abuse of public funds, but to the quality of public services, in decision making, and to accountability and to transparency.

The cause of unintended consequences will usually lie in a failure to appreciate the managerial context in which PFM/IC should be developed and therefore the strengthening of management should not be overlooked as an essential feature of the reform.

Because this is a radical reform involving significant changes in the distribution of power and responsibility, including the move from external to internal control, an important complementary feature of the reform should be a strengthening of overall regulatory controls which affect key areas of risk and the potential for the emergence of unintended consequences.

The ministry of finance through an annual assessment process of the quality of the reform (i.e. by developing a statement of internal control) should address the potential for weaknesses to emerge. This statement should not simply focus upon procedural arrangements. In some circumstances the ministry of finance should consider commissioning a specific study into whether unintended consequences are emerging, or have, emerged.

7

The Responsibilities of the Top Operational Management Official in Public Organisations for the Implementation and Quality Control of PFM/IC

The responsibility for the day-to-day application of PFM/IC and the maintenance of the appropriate standards within a line ministry or other public organisation should be that of the top civil or local government official responsible for operational management. In a line ministry or other public organisation, this would be a state secretary or equivalent. Their responsibility as the top operational management official is to ensure that throughout the organisation, PFM/IC is properly applied and follows guidance issued by the ministry of finance. That official would be accountable for the quality of the application of the reform.

In countries where a minister or mayor or other politically appointed official is nominally responsible for the effective and efficient administration of a public organisation, the reality is that a politically appointed official normally would have neither the time nor the relevant background to introduce such a significant managerial reform as PFM/IC. Their responsibility in such circumstances should be to ensure that the reform is properly applied by the top operational management official. The political head of the organisation would be accountable to the government for that.

This chapter describes the responsibilities that fall upon this top operational management official with the application of PFM/IC.

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_7

7.1 Nominal and Real Responsibility for the Application and Quality Control of PFM/IC

7.1.1 The PFM/IC Leadership Application Arrangements

The top political official such as a minister or mayor may have a nominal legal responsibility for the overall quality of the management of a public organisation. However, the person who should have the substantive responsibility for the overall quality of the management of a public organisation including the operational application and maintenance of the quality of PFM/IC should be the most senior operational management official within the organisation. This would be a state secretary[1] or equivalent or a similar status official in local government. This should be the normal situation and is a prerequisite to applying the PFM/IC reform. If there is no such official it will be impossible to properly implement PFM/IC even where a politician has nominal responsibility for the quality of the public administration. This chapter therefore is written on the assumption that responsibility for operational management within a line ministry or other public organisation has been delegated to the civil or local government service and that the head of that service in that ministry or other public organisation is therefore responsible for the application of PFM/IC and the maintenance of its quality. The range of responsibilities that will fall upon that head will be substantial and in the sections below the 'before PFM/IC and after' responsibilities are compared. How a politically appointed official, if there were no delegation, given the level of practical knowledge and experience that would be required and the day-to-day demands upon his/her time, could undertake this responsibility and at the same time also carry out their political responsibilities is difficult to see. The state secretary (or equivalent) would be responsible for not only implementing the reform but also for ensuring that the administration remains capable of addressing whatever is required by the current operational environment. This official has a key role in securing the quality of operational management. He/she also has a responsibility to advise the politicians on the practical application of political objectives and that in turn affects the quality of operational management. The practical application of policy includes the politician working with the operational manager to set the objectives and performance standards and objectives which the operational management should be expected to meet. Operational management in the

[1] In Anglophone systems the title would be 'permanent secretary' or 'principal finance and establishment officer'.

main (see also Chap. 14) should be delegated to the civil (or local government) service. In those countries where the delegation of operational management has not occurred, as has been explained in previous chapters, the reality is that PFM/IC could not be properly applied. (In some countries the state external auditor may be asked to comment upon the quality of the proposed arrangements with the application of PFM/IC. The state auditor would not approve the procedures but usually would offer advice.)

Given that a state secretary, or equivalent, is responsible for the application of the PFM/IC reform, this official would then be accountable to the top political official, the minister or mayor for the quality of the application and the maintenance of that quality. This is how the legal responsibility of the top political official would be fulfilled, that is, through the accountability arrangements. The state secretary or equivalent would also have a responsibility to the ministry of finance because that ministry would have overall responsibility for the application of the PFM/IC policy and quality maintenance. In effect, a state secretary has two reporting lines, one to the relevant minister and the other to the ministry of finance state secretary.

For second-level organisations the top official should be the responsible official for the application of PFM/IC. He/she should be accountable to the head of operational management for the controlling first-level organisation for the quality of application, that is, to the state secretary or equivalent. (The exact accountability arrangements for local government would depend upon the constitutional relationships between central and local government but an important element of that accountability would be from the chief official to the mayor or in some countries to a political leader where the mayor has only ceremonial responsibilities.)

In some countries a state secretary has only limited responsibilities such as those only relating to administrative matters. However, with the introduction of PFM/IC and the increased emphasis upon the delegation of operational management responsibilities from the political level, this limitation cannot be sustained. That would mean that either the current state secretary's responsibilities were extended or another official was appointed with the appropriate authority.

Again, in some countries no state secretary post exists and the different 'directors' or heads of department report directly to a minister or deputy minister. This arrangement with PFM/IC cannot be sustained (see Sect. 7.1.5 below).

Whatever the exact civil service or local government organisational arrangements, with PFM/IC the person holding the role of state secretary (or equivalent) should have two essential characteristics. One is that they should be 'politically' aware because they work directly at the interface between the political and operational elements of public administration. The second is that they should possess leadership qualities. Leadership qualities include being willing to accept the risk that reform entails and to overcome the systemic constraints that tend to exist in established bureaucracies. Leadership qualities have also been described as inspiring, confident and empowering.[2]

7.1.2 The Responsibilities of a State Secretary or Equivalent Before the Application of the PFM/IC Policy

The exact responsibilities of a state secretary (or equivalent), where such a post exists, before the introduction of PFM/IC will vary from country to country but they could include the following, although this is unlikely except in those countries where advances are being made in the quality of the public administration and where the implementation of PFM/IC is likely to be most successful:

- Allocation of resources within the organisation in accordance with any budgetary constraints and collection of any income that is due;
- Advising the minister on policy matters;
- Addressing major administrative problems which may emerge;
- Monitoring performance insofar as performance is specified;
- Disseminating information;
- Providing leadership in staffing and motivating staff.

Prior to the implementation of PFM/IC in many countries, there is unlikely to be a clear distinction between the responsibilities of the political level of management and the civil service for operational management activity. Also, in some countries on a change of government the state secretary may also change and where this occurs political loyalty may be regarded as more important than actual experience or even competence. But then with traditional public administration arrangements, the emphasis is upon administration, adherence to the relevant regulations and financial and budgetary control, rather than management, that is, the delivery of objectives and performance standards and objectives efficiently and effectively. As is shown in the next section, the former is less demanding in terms of experience and technical knowledge than would be required of a state secretary

[2] Civil Service Leadership Statement: https://www.gov.uk/government/publications/civil-service-leadership-statement/civil-service-leadership-statement: 2016.

with the implementation of PFM/IC. For example, in practice objectives may have been specified by a minister but they are unlikely to be defined in a manner which is suitable for management purposes. Performance standards and objectives are unlikely to exist. Nor will an effective requirement exist to secure efficiency and effectiveness in the delivery of objectives. Objectives and performance standards are unlikely to be linked to budgetary availability. Consequently, the state secretary and the administrative staff are most unlikely to have available to them the information and authority they require for effective management purposes. (This would be true whether the operational manager was a political appointee or a civil or local government official.) The state secretary would be likely to have these financial, as opposed to financial management, related responsibilities:

1. Supporting the preparation of a budget for the next financial year within any constraints required by the ministry of finance: in some countries with good financial administrative support, broad policy objectives of a ministry or local government may be defined as part of the budget process, even though not directly linked to the budgetary availability.
2. Administering current services or activities, sometimes with broad operational objectives and sometimes without. However, whether there are objectives or not the likelihood is that the objectives will not be defined with such a precision that the administrator can be held to account for delivering those objectives.
3. Meeting budgetary constraints, which can be very restricting about how funds can be spent because the focus will be on the control of 'inputs' not on what those 'inputs' are achieving. Those budgetary constraints in some countries can be very detailed and inhibit managerial initiative. Any budgetary variations, such as substituting one type of employee for another, would be subject to approval by the ministry of finance or another central ministry.
4. Ensuring that financial and procurement regulations are adhered to, with the risk that if they are not, penalties could be imposed through financial inspection regimes and other administrative rules, although not usually on the senior administrator, especially where the administrator is a political appointee, but on the subordinate staff.
5. In some, more advanced developing and transition economy countries, making administrative decisions affecting finance and related matters necessary for the day-to-day running of the organisation such as those relating to approval of expenditure, securing income sources, staff management, office materials procurement and the security of stores. In other countries (and these are probably in the majority) responsibility for all or most of

these matters may be retained by political appointees such as the minister or deputy ministers or equivalent in local government.

6. Providing financial reports to the minister of finance, including year-end financial statements and responding to external audit enquiries.

The state secretary may also have what amounts to a token responsibility for securing efficiency and effectiveness but in practice such a responsibility will be simply nominal because neither the budgetary nor accounting and performance information systems are likely to provide the information that will be required to enable these to be achieved. The linkage of the performance information systems, where they exist, to the budgetary and accounting systems is also unlikely to occur. Certainly, it would be possible to make savings by, say, improving purchasing arrangements, but that is different from achieving efficiency and effectiveness in the delivery of objectives. This is more about 'economy' and sometimes may be counter-productive in efficiency and effectiveness terms. Savings may also be made by introducing IT systems and the adoption of 'e-government' arrangements. Managements should always be encouraged to make such savings, under whatever financial management arrangements exist, but this is not the same as delivering the wider efficiency and effectiveness gains that become possible with PFM/IC. For example, switching to an IT system to deliver a service will not somehow automatically improve efficiency and probably not effectiveness, although it may be more economical. To achieve greater efficiency requires a systematic approach to the reform of the way in which services are delivered involving detailed cost analysis compared with operational performance. Effectiveness involves the measurement of achievements against defined objectives including identifying the views of the user of the service or activity. The state secretary would have no responsibilities for risk management which is a key requirement of PFM/IC and is necessary to secure the achievement of objectives. Internal audit would usually report directly to a minister rather than to a state secretary.

7.1.3 The Role and Responsibilities of a State Secretary (or Equivalent) Operating in a Managerial Environment

While the minister or mayor may ultimately be held to account by parliament for the effective application of the PFM/IC policy with actual application being the responsibility of the most senior civil or local government official (i.e., the state secretary or equivalent), the political head should be confident about the quality of the application through the delegation and managerial accountability arrangements that should be established. Those managerial accountability arrangements should be focussed on the key issues of concern to the political head and should not be overwhelmed by detail. (The arrangements for parliamentary accountability may require in some countries that the appropriate minister and the most senior official should appear together to answer to parliamentary scrutiny. Parliamentary scrutiny may be informed by reports of the state auditor who would be expected to review the quality of the PFM/IC arrangements.) Given the complexity of contemporary government ministers and mayors cannot be held directly responsible for all operational failings in their ministries or local governments, or in the second-level organisations through which services and activities are often delivered unless they can be shown to be systemic or of major significance. If they are systemic or significant, they should have been identified through the managerial accountability arrangements and then the political leadership can be held accountable.

The role of state secretary (or equivalent) is extremely demanding and complex. Introducing PFM/IC as has been shown previously, means that the style of public administration needs to change which adds to the complexities of the role. The change would be from a traditional administrative style to a managerial style (see also Chap. 14).

The functions of a state secretary with a managerial style of government include the following[3]:

I. *Act as the 'principal policy adviser' to the minister.* This role may complement other sources of policy advice to a minister.
II. *Secure the implementation of ministerial policy priorities.* This will be a critical responsibility so far as a minister is concerned because a ministerial reputation is likely to hinge on the success of policy implementation.
III. *Be the manager of the day-to-day 'business' of the ministry.* The emphasis should be on management and the continuous improvement of current

[3] These seven roles summarised in the italicised script were defined in a paper published by the Institute for Government for the equivalent of a state secretary in the UK civil service. In some respects, the UK civil service is unusual, so some of these seven different roles may not apply or only partially apply in a particular country. For example, the UK civil service must be apolitical and prepared to serve any government. However, the UK has a well-established PFM/IC system. This model could be adapted to suit individual country needs, culture and circumstances.

Accountability at the Top: Supporting Effective Leadership in Whitehall: Paun and Harris: Dec 2013 p12–14: https://www.instituteforgovernment.org.uk/

policies, personnel and systems. This is of particular importance when there is an emphasis upon improving efficiency and effectiveness in the delivery of public services, including the collection of any income that is due: this is a key feature of PFM/IC. This may well require state secretaries to become involved in the direct management oversight of operations, or management oversight through networks of complex devolved relationships to second-level organisations or where activities are contracted out to the private sector, to the implementation of those contracts. For second-level bodies, the first-level state secretary remains responsible for ensuring that effective arrangements exist to ensure that second-level bodies and market-based contractors deliver the required results.

IV. *Be responsible for ensuring the 'financial control and propriety of spending' within the ministry.* This is a traditional and very important role which requires ensuring that spending is in conformity with ministry of finance regulations and with parliamentary approvals.

V. *Be the 'guardians of propriety' and of the rules and conventions of how government should operate*. This would include ensuring that codes of practice were observed (e.g., on the behaviour of civil servants and ministers) and on advising ministers on issues such as potential conflicts of interest between ministerial and private or constituency matters.

VI. *Be responsible for the broader capability and organisational health of the civil service within their ministry.* 'Organisational health' is defined as meaning that the state secretary should ensure that the civil service for which he/she is responsible is kept in a fit state to deal with future and longer term policy challenges, for instance, by maintaining sufficient research and foresight capacity. The state secretary should also ensure that the civil service is able to serve effectively a future minister or administration with different objectives. That would include the management of the transition to a new government if and when that occurs.

VII. *Support the 'collective leadership of the civil service' as a whole.* This would be particularly important, for example, with the implementation of policies that apply to all ministries, such as PFM/IC. In this example the state secretary would have a responsibility to cooperate with the state secretary in the ministry of finance, or the head of the civil service where such a post exists, to secure the application of the reform.

7.1.4 The Specific Financial Responsibilities of a State Secretary with the Implementation of PFM/IC

Applying PFM/IC[4] is about the professionalisation of management. This affects the financial management responsibilities of a state secretary. As change in operational and policy circumstances will inevitably occur this also means that a state secretary will need to initiate changes to the PFM/IC arrangements.

To undertake all these responsibilities arising from the implementation of PFM/IC, a state secretary, because he/she cannot possibly undertake all these responsibilities personally, will need to be supported by several departments within the ministry administration. Exactly what those departments would include would depend upon local circumstances but should normally include the finance/economics department, the administration department, the procurement department, the human resources department, the legal department and any general policy department, for example, a policy department which should be responsible, amongst other things for the supervision of second-level bodies.[5] The internal audit department should have a close working relationship with the state secretary and for most internal audit activity the reports ought to be to the state secretary and only exceptionally to the political head of the organisation. The state secretary should agree the internal audit programme of activity. (In some countries where audit committees have been established, the internal auditor will also report to that committee.)

In the table below the specific responsibilities of the state secretary or equivalent are described and compared with the seven different roles of a state secretary referred to above. (This range of responsibilities contrasts with those which would exist for a state secretary acting simply as an administrator (Table 7.1).)

[4] In the paragraphs below, the references are to a ministry but apply equally to local government and other public organisations. Readers would therefore need to apply the observations if they are not from a central government ministry to their own circumstances.

[5] Second-level bodies would include those agencies and state-owned enterprises and the equivalent in local government for which the first-level body has a responsibility.

Table 7.1 The seven different roles and the duties of a state secretary

The seven different roles	The duties of the head of a state secretary with PFM/IC
I. Act as the 'principal policy adviser' to the minister	Effective policy development cannot be achieved by political officials in isolation. It depends upon an appreciation of the practical operational circumstances in which it will be applied. Similarly, policy proposals also need to be interpreted for effective execution and linked to budgets and that would include setting realistic policy objectives and performance standards. This will require close cooperation between the state secretary and his/her staff and the political officials responsible for policy and strategy development. Close cooperation involves a state secretary: 1. Ensuring that ministers and other politically appointed officials have the financial and performance information, including research outcomes they require to develop policy and strategy 2. Secures the accountability arrangements that allows ministers to exercise their organisational monitoring responsibilities, not least the achievement of objectives and performance standards as well as satisfying themselves that adherence to budgetary limits is occurring 3. Setting the objectives and performance standards that the operational management is expected to deliver, that is, the outputs. (A state secretary would then need to agree the more significant of these with ministers) 4. Ensuring that budgetary availability is compatible with the ministerial objectives and performance standards. This in turn means that the state secretary is fully involved in the budget preparation process (and he/she should be advised on this by the head of finance) 5. Ensuring that no decisions are made without full consideration of the long-term financial impacts upon the organisation (which requires good quality financial inputs from the head of finance as well as from economists and specialist service experts) 6. Identifying the impact that possible future events could have upon the organisation and its finances 7. Ensuring that appropriate legal authorities exist to implement policies and achieve objectives and performance standards

II. To secure the implementation of ministerial policy priorities	1. Establishing a management structure for the ministry designed to deliver the objectives of the ministry and ensuring that that management structure remains relevant as operational circumstances and policies change. This structure may need to be agreed with the political leadership. Exactly how appointments would be made to the senior positions within that managerial structure would depend upon individual country arrangements, but the state secretary ought to have a key role in the decision making process because of his/her overall responsibility for securing the delivery of the objectives and performance standards and for the quality of the operational management. (Officials should not be appointed merely because of their political connections) 2. Requiring the development of delegation and managerial accountability within the ministry and within agencies and other second-level bodies controlled by the ministry and ensure that those arrangements are effective. The extent of delegation and accountability arrangements would though depend upon the judgement of individual managers within the organisation. (An effective internal managerial accountability arrangement means that the top and senior management can feel justified in delegating authority to more junior managers and, in turn, that ministers and other politically appointed officials can feel justified in delegating operational management to civil service officials)
III. To be the 'manager of the day-to-day business' of the ministry	1. Developing a managerial culture within the organisation that is consistent with that required to achieve the objectives, performance standards and performance objectives of the organisation. This means first that the standards of 'good governance are applied (see Sect. 7.1.6 of this chapter and Sect. 1.4.3. of Chap. 1) and secondly that an operational environment is established which encourages individual managers to 'own' their objectives and to take such actions as are necessary to ensure that they are delivered, to time, to standard and efficiently and effectively 2. Ensuring that each manager has available to them the appropriate information (which includes budgetary, financial accounting, cost and performance information) to enable them to deliver objectives and performance standards (outputs), to time and within budget efficiently and effectively 3. Ensuring that appropriate accountability arrangements exist at each level of management and ultimately to the top level of operational management officials and then onwards to ministers 4. Developing managerial risk management and applying it throughout the ministry and second-level organisations. This means that objectives will need to be identified with some precision, that is, exactly as they would for accountability purposes. In addition, there will be some risks that can be significant for an organisation to identify but which are not directly linked to objectives, such as risks to reputation including ensuring that the organisation does not breach legal requirements. Linking risks to objectives also has the benefit that it enables the state secretary to advise the minister and other politically appointed officials about whether an objective is worth pursuing, no matter how desirable it might be for other reasons. It also provides the opportunity for the state secretary to object to ministerial proposals for expenditures that are inappropriate in the view of the state secretary or do not conform to ministry of finance expenditure rules. This is an authority which a state secretary ought to have.[a] (Risk management is addressed in more detail in Chap. 11)

(*continued*)

Table 7.1 (continued)

5. Developing a managerial approach that incorporates financial awareness as a key feature of management
6. As part of that managerial culture establishing an approach which is focussed upon the needs of the customers or clients of the organisation and which is responsive to changes in customer/client circumstances
7. Ensuring that a communications process exists which allows information to be disseminated throughout the organisation, that is, flowing up, down and across the organisation and including with second-level organisations. This communications process should also include coordination of activities and proposed policy developments with other ministries as appropriate. For effective management, managers at all levels and staff within a ministry and second-level bodies need to know both what the ministry's objectives are as well as their own objectives. This enables the organisation to 'pull together' in the same direction. In other words, managers need to know not only what is expected of them but also the operational context. That operational context includes information about the resources available to them in a format they require, that is, their budgets, how actual expenditure or income is occurring during the year, performance information that relates directly to their areas of responsibility, whether the demands upon a particular service are rising or falling, the short- and longer term strategic objectives, the pressure to improve efficiency and effectiveness, actual and potential legislative, environmental and other changes affecting their operational environment. The extent of the information which is made available will obviously depend in large degree upon the specific responsibilities of individual managers and staff members
8. Discouraging through communications within the organisation and with controlled agencies and other second-level bodies, the development of a 'silo' mentality which reduces the degree of cooperation between the different parts of the organisation and with other organisations, enabling a more efficient utilisation of resources. Usually, organisations do not want to share budgets but at least within the same organisation improved communications can lessen the risk of a silo mentality developing. (As has been pointed out elsewhere, many public sector problems cannot be addressed by a single organisation)
8. Ensuring that second-level organisations have clear policy and operational objectives which are consistent with the government and ministry objectives (and in practice with programme objectives where programme budgeting has been established)
9. Ensuring that the second-level organisations have established performance standards setting out the quality of services that they aim to provide and that those standards are compatible with those of the controlling ministry
8. Specifying the format of service-level or performance agreements with second-level organisations, having regard to advice from the ministry of finance on the content of such agreements, and that such agreements are prepared for each second-level organisation and for state-owned enterprises. (Chapter 12 includes a description of such agreements)
9. Ensuring that the ministry and its second-level bodies comply with the law and regulations and that due regard is had to user, customer and other stakeholder interests

IV. To be responsible for ensuring the 'financial control and propriety of spending' within the ministry	1. Establishing internal control activities covering both expenditure and income which should apply throughout the ministry and in second-level organisations to ensure (a) that the objectives and performance standards of the organisation can be, and are being, delivered to time, to standard, within budget and within any legal constraints and (b) that the resources of the organisation, including assets, are used only for the purposes of the organisation, that they are 'properly used' and used efficiently and effectively. 'Properly used' means that not only are resources used solely for the purposes of the organisation but that financial and budgetary controls, the financial regulations issued by the ministry of finance and procurement rules are adhered to including that the day-to-day procurement activities fully follow the approved procedural rules. The control activities should focus on outputs as well as inputs, that is, the organisation achieving its objectives, performance standards and performance objectives, and this will require systematic reports on the achievement of objectives and the quality of that achievement, that is, the managerial accountability arrangements 2. Ensuring that each level of management has appropriate management arrangements covering systems risks as well as managerial risks 3. Ensuring that the control activities are systematically monitored and that any report on the quality of those controls and on the application of PFM/IC required by the ministry of finance is available. (Whilst monitoring is the responsibility of the state secretary in practice in many organisations a state secretary will have established a team of top managers to assist in the overall management of the organisation and that team would have the monitoring responsibility) 4. Control coverage should also extend to proposals for future investment and activities. Therefore control arrangements should ensure that business plans are developed which describe how any new operations will be delivered, the activities that will be undertaken, the resources (of all types, including finance, personnel and assets) that are required, who the beneficiaries will be, specific performance standards that will be aimed for and such other information as is relevant to the achievement of the strategic objectives of the ministry within the time period to be covered by the business plan. In addition, the control activities should ensure that all proposed new investments and new policies are subject to investment appraisal[b] and that that appraisal includes the consequential impact upon the ministry finances. Proposals from agencies and other second-level organisations should also be subject to similar forms of appraisal and the extent to which they should be subject to review by the ministry will depend upon the arrangements which exist between the ministry and second-level bodies

(*continued*)

Table 7.1 (continued)

	5. Controls should also ensure that no fiscal risks are entered into which could adversely affect the longer term financial viability of the ministry and that no second-level organisations (agency or state-owned enterprise) also enter into arrangements which could result in the incurring of significant fiscal risks. (Fiscal risks include those arising from, longer term contracts with price variation clauses, lawsuits, guarantees, public/private partnerships and environmental risks. Fiscal risks can include the risks associated with financial support from aid organisations because promises of aid and even ongoing aid support can be withdrawn because of changes in the policy of the aid giving organisation) 6. Although monitoring is a management responsibility, management can be assisted in this if the internal audit programme of activity is adjusted to reflect the managerial environment of the ministry (see next section of this chapter). The effectiveness of the control activities should be assessed by each level of management as part of the routine accountability reporting process. (There could be circumstances where a separate specific investigation may be commissioned by the state secretary where a particular problem has occurred such as a significant failure to deliver objectives or performance standards or where serious losses have occurred through error or misjudgement or fraudulent activity) 7. Ensuring that regard is given to external accountability, particularly to the government via the cabinet of ministers, to the parliament, to the public service user (or customer/client) and where appropriate to the taxpayer through ministry reporting arrangements. Accountability for this purpose includes transparency. This may also include responding directly to parliamentary scrutiny requirements or providing 'briefs' to political officials to enable them to do so. (Effective external accountability including transparency gives confidence to the voter and taxpayer and to them also via pressure groups, the media and other forms of public scrutiny) 8. Providing financial reports to the ministry of finance, including the year-end financial statements, and ensuring that they are prompt, reliable and accurately portray the financial position of the ministry 9. Completing statements of internal control (see Chap. 13) to demonstrate the effectiveness of the internal control arrangements 10. Responding to the requirements of the state auditor
V. To be the 'guardians of propriety' and of the rules and conventions of how government should operate	Developing an ethical approach within the organisation such that in conducting its business it treats its employees, customers/clients, the wider community and the assets and resources of the organisation, responsibly; this includes strengthening arrangements for transparency and accountability The state secretary should also ensure that problems are identified early and dealt with appropriately, that the ministry and second-level organisations take into account wider social and environmental issues in making decisions and that a high reputation for the integrity of the organisation is established. This also means that it aims to protect the broader government interest, the interests of employees and others with a direct interest in the performance of the organisation

VI. To be responsible for the broader capability and organisational health of the civil service within their ministry	Developing a management approach which allows or encourages managers to use their initiative and discretion and to develop new ideas; this will be expressed through the degree of delegation which is permitted and how the processes of accountability operate, not least that they should be non-threatening 1. A key feature of the development of a managerial culture should be that the state secretary develops personnel policies which support the ministry in achieving its objectives. Different personnel will have different needs but the necessary materials, systems, frameworks and training should be provided for line managers in order to develop, attract and retain talent and experience. Retaining talent is not necessarily just a matter of remuneration. What is probably more important is that staff feel that they are doing a worthwhile job and that their efforts are properly recognised. Recruitment should take into account the needs and diversity of the organisation, identifying individuals with potential for development. Employees should be supported in developing their professional capability, managing their careers and identifying development opportunities for them. Performance is a key feature of a management culture and an objective should be to maintain and improve employee performance in line with the ministry's objectives. Another important feature of a managerial culture should be that managers at all levels encourage and promote an attitude where speaking up about any issue is considered normal and safe to do so 2. Ensuring that sudden operational and financial shocks to the organisation are avoided through strategic planning, including strategic financial planning 3. Ensuring that as part of the strategic planning process possible changes in operational circumstances impacting upon the ministry are fully considered such as the consequences of technological change, economic change and climate change. These should also be properly reflected in the strategic financial plan Note: The possibility of a public bureaucracy developing a broader capability and organisational health depends upon several factors which are not necessarily within the authority of the state secretary of a particular ministry. Thus, to achieve this a bureaucracy should have: • relative autonomy to make organisational and managerial decisions; • stable funding; • an ability to recruit, train and retain good quality staff exists (i.e., that nepotism and political favouritism is avoided in appointments to the bureaucracy); • there is effective accountability

(*continued*)

Table 7.1 (continued)

VII. To support the 'collective leadership of the civil service' as a whole	Each state secretary should be expected to support the chief official for the whole civil service and the ministry of finance state secretary in the development of the policy for the implementation of PFM/IC and in the monitoring of the application of that policy. Not only would this include the establishment of the procedures associated with this reform and the managerial consequences but also the application of policies to improve the efficiency and effectiveness of public expenditure. (See also section below of this chapter on the relationship between individual state secretaries and the ministry of finance state secretary)

[a]The role of a state secretary or equivalent ought to include a requirement to object to unlawful, unduly risky expenditures or expenditures which conflict with specific ministry of finance guidance about financial and budgetary control. At the least if a state secretary is required by a minister to continue with the proposed expenditure, then this requirement should be put in writing by the minister because otherwise the state secretary could become directly accountable to parliament for the authorisation of inappropriate or unauthorised expenditure

[b]Appraisals should provide an assessment of whether a proposal is worthwhile and clearly communicate conclusions and recommendations. The essential technique is option appraisal, whereby government intervention is validated, objectives are set and options are created and reviewed, by analysing their costs and benefits. (Quoted from UK HM Treasury Green Book 'Appraisal and Evaluation in Central Government' https://transportknowledgehub.org.uk/directory/hm-treasury-green-book)

7.1.5 Where No State Secretary Post Exists But Each Department Within a Ministry Is Headed by a 'Director' Who Reports Directly to a Minister

In those countries where there is no single civil servant responsible for all the activities of the civil service in a ministry and instead individual senior civil servants, sometimes called directors, are appointed to report directly to ministers or deputy ministers on particular topics, can this arrangement be maintained with the introduction of PFM/IC? The answer is 'no' for the reasons set out below.

Whilst each 'director' could take on the individual responsibilities described in items I to VI in the table above there would be no coordination at the civil service level of the standard of those individual activities and there would be no routine exchange of information or coordination of actions. In effect, what would exist is a series of 'sub-ministries' with the only coordination occurring at the ministerial level. This is not consistent with the idea of delegation. Also, the idea that a minister could ensure that the same standards applied in every department of the ministry would in effect turn that minister into a part time secretary general. This is not feasible given all the pressures upon a minister.

With PFM/IC, this arrangement therefore needs to be rethought because effectively it means that there is no single person responsible for the management of the whole ministry. Efficiency and effectiveness apply throughout the whole ministry as does finance. And where the functions of a ministry are divided over different directors and there is no single head, the opportunities for coordination and common approaches to problems are small or non-existent, and what develops is a 'silo mentality'.

Few public sector problems can be fully addressed by a narrowly focussed approach. The result is a lack of sharing information, objectives, ideas, priorities and processes. Given that there is a single source of finance, the taxpayer, this is highly inefficient with, for example, no opportunity for savings in one area of activity to be used to support other areas within the same ministry. Similarly, within a ministry there is a need to ensure that all regulations are properly followed throughout the whole organisation. There would be no single person able to do that, unless that were a responsibility of the minister. Within a ministry there would be a single finance department having overall responsibility for budget preparation and the overall quality of financial management. As was explained in Chap. 6 the ministry of finance state secretary should be confident that a robust financial management structure exists within individual line ministries (and other public organisations). Unless a state secretary position exists the only person the ministry of finance state secretary could look to would be the head of finance. And that head of finance then ought to have a specific personal responsibility to object where decisions are proposed to be taken which are contrary to regulatory requirements or which potentially add to financial risk. Would a head of finance have the authority to challenge individual directors? This would be most unlikely and the only available appeal would be to the minister again drawing the minister into operational management issues. Similarly, internal audit would have no single authority to agree an audit programme with or to report to other that the minister which again negates the idea of the delegation of operational management to the civil service.

7.1.6 The Importance of Good Corporate Governance Arrangements

Good corporate governance is fundamental to any effective organisation and not least to public sector organisations. A failure of the corporate governance arrangements is likely to be a cause of serious difficulty to the top management, political and operational. Corporate governance is discussed in Chap. 1 but given the managerial responsibilities that will be expected to fall upon the civil and local government service with the introduction of PFM/IC, the quality of the corporate governance arrangements assumes added significance. The responsibility for securing the quality of corporate governance in an organisation lies with the head of the organisation, that is, both with the relevant minister and the state secretary. The corporate governance arrangements should not be regarded as 'one-off' arrangements but should be expected to evolve over time. The corporate governance processes should consider the arrangements for:

- Leadership: the arrangements should distinguish between the responsibilities of the civil or local government operational service head of the ministry or local government and that of the minister or mayor: this should clarify first the roles of the political leadership and its responsibility for setting the objectives, performance standards and the performance objectives and, secondly, the operational leadership responsibility for securing the performance of the organisation in accordance with those objectives and for doing so efficiently and effectively.

- Monitoring: the operational management head (the state secretary) should have a responsibility to monitor the performance of the organisation and to engage in active management to secure the ability of the organisation to deliver on its objectives, performance standards and performance objectives, including the arrangements for reviewing the performance and productivity of the organisation.
- Risk management: as this should be a key element in securing delivery of the objectives the risk management policy should be determined jointly by the relevant minister and state secretary: that would include the key risk policies such as setting the risk appetite for the organisation and determining the arrangements for the management of risk (see also Chap. 11) with the actual implementation of the risk management policy being the responsibility of the state secretary.
- Civil service competence: how the quality of the civil service would be established, its training, its political independence and its ability to provide independent advice, with that quality being assessed by the state secretary.
- Defining relationships: especially between the ministry or local government and second-level bodies: a state secretary responsibility.
- Consultation: arrangements with stakeholders which would include users of the services of the ministry or local government, the local community in the case of local government and any formal representative bodies, paying particular attention to their needs and interests: this would be primarily a responsibility of the state secretary with the minister becoming involved only in specific politically sensitive issues.
- Accountability: to parliament, primarily a ministerial responsibility; to other ministries where appropriate, to regulatory and supervisory bodies and to third parties, (depending upon the issues) either a ministerial or a state secretary responsibility); responsibility for securing the preparation of and the quality of the statement of internal control (see Chap. 13) which should also be agreed with the minister.

Good corporate governance is an important tool for securing the quality of the services being provided by ministries and local governments and how they treat their clients/customers/patients. Where the corporate government requirements are incorporated into a formal code, then the general rule should be that public organisations should comply with the code or where they do not, explain the reasons for this.

7.1.7 The Relationship Between Line Ministry State Secretaries and the Ministry of Finance State Secretary with the Application of PFM/IC

The ministry of finance state secretary has a critical role in the development and application of PFM/IC and in the maintenance of its quality, that is, unless another official had this responsibility such as a head of the civil service. The list of responsibilities falling upon a state secretary described above in Sect. 7.1.4 with the implementation of PFM/IC is substantial. Therefore, the likelihood is that considerable advice and support will be required as well as detailed guidance. This means that an important initial role of the ministry of finance through its state secretary should be to engage with line ministry state secretaries and other heads of public organisations to explain the nature of the reform and its implications for them. This would be an important element in developing 'local ownership'. State secretaries together could act also as an advisory group on the processes of implementation. Without local ownership, resistance could well emerge and pressure to return to the *status quo ante* could well develop over time. Ideally the ministry of finance state secretary should establish an ongoing relationship with this group of key officials throughout the whole development and implementation process. A useful addition to this group of officials probably in the form of a commentator would be the state external auditor who could make an important contribution to issues about 'control' in its broadest forms. Another adviser to the group could be the head of the government training institution or a university tutor responsible for management development training. As the leader, the ministry of finance state secretary should ensure that an agenda item was 'emerging concerns'. The ministry of finance state secretary would almost certainly require support in undertaking this responsibility. Probably the head of the department responsible for the day-to-day application of PFM/IC should act as secretary to the group and coordinator of its activities (see Chap. 9 which discusses the functions of this department). An ongoing responsibility of this group should be to review and advise on the arrangements for the application of PFM/IC to coordinate experiences and encourage discussion between the different state secretaries involved. Coordination at this high level within the civil service is very important. However, in most countries applying PFM/IC discussions usually occur at a much lower level because it is seen as just a technical financial reform with no impact upon management.

A state secretary involved in this activity would need to consider and report upon:

- The willingness/capacity of his/her organisation political leadership to respond to the separation of operational decision making from strategy and policy development and how in his/her opinion the political officials would react to the changes that would flow from that.
- The capacity of the civil service within the ministry (or other public organisation) to absorb responsibility for operational decision making, the organisational restructuring that would be required, the additional staffing and the training that would be needed to achieve that, that is, the extent to which managerial training would be required.
- The possibilities, and over what timescale, of defining detailed policy objectives, performance standards and performance objectives.
- How to obtain the additional performance information needed and financial analytical information that would be required for effective management and to enable managers to improve efficiency and effectiveness.
- The support and training that would be required for the finance officer and his/her staff to enable them to provide the information and professional support that the state secretary and other managers would require.
- The difficulties and risks that would need to be addressed to secure effective implementation of the reform policy, not least the impact on personnel management arrangements as well as on penalty and inspection arrangements.

The ability/willingness of an organisation to respond to the requirements of PFM/IC and its capacity to absorb those requirements will depend heavily upon the characteristics of the current bureaucratic organisation and the capacity of the civil service. Thus, ideally the existing organisation should have the characteristics which are appropriate to the needs of a managerial style organisation, that is, the employees have specific objectives and performance standards and objectives they are expected to work to, an appropriate organisational structure exists, employees are clear about the scope of their responsibilities through the existence of written rules and procedures, all employees are required to conduct their activities in an unbiased manner, and employees should be appointed to jobs based upon their technical skills. If these characteristics do not exist or only partly exist, the first step is to establish these characteristics as part of the initial moves to PFM/IC.

Once a decision has been made to implement the PFM/IC reform policy, this process of consultation and coordination should be continued so that state secretaries (and as necessary other officials such as the finance officers) could participate in a continuing process of learning. (If the reform is being financed from aid funds it may also be desirable to include within the consultation process officials from the aid organisation.)

7.1.8 The State Secretary, Internal Audit and Inspection

In previous chapters and earlier in this chapter, the changed reporting arrangements for internal auditors have been discussed. Prior to the introduction of PFM/IC the traditional arrangement would be that the internal auditor would report directly to the political level of management, the minister. In some countries an inspection regime also exists designed to secure adherence to formal rules and procedures. Sometimes there is an overlap with internal audit. However, a clear separation of internal audit and inspection responsibilities should exist. To summarise those changes and the particular impact upon state secretaries, with PFM/IC as the quality of operational management is firmly the responsibility of a state secretary (or equivalent) in the normal course of internal audit activity, the auditor should report to the state secretary about the internal control arrangements rather than to the minister. (Bearing in mind that the definition of internal control with PFM/IC is much wider than in a traditional organisation.) This is because with PFM/IC the state secretary would have a direct responsibility for internal control. A minister would not have such a direct responsibility, except in the broad terms of having responsibility for the overall quality of the management of the ministry. With PFM/IC if serious problems exist, the internal auditor could always report directly to the minister although in practical terms, this would be likely to raise serious tensions with the state secretary to whom the auditor should normally report.[6] Exactly the same arrangements should apply with inspection.

Auditors may feel that this change would be a cause of concern. However, such a concern could be alleviated by the appointment of a truly independent audit committee and some may regard such a move as an appropriate complementary reform to the implementation of PFM/IC. The internal auditor would then report not only to the state secretary but also to the audit committee.

[6] The conventional theory is that the internal auditor should report directly to the head of the organisation. However, the head of the organisation, the minister or mayor, in practice is unlikely to have the time or the detailed knowledge to enable him/her to make the judgements necessary to properly identify which elements of internal control should be reviewed by the internal auditor or to evaluate internal audit reports about the internal control activities. On the other hand, the senior official responsible for the implementation and monitoring of PFM/IC, that is, a state secretary, would have that detailed knowledge. For this reason, the suggestion is made here that as part of the usual work routine the internal auditor should liaise closely with this official in formulating the internal audit plan of activity for reviewing the internal control activities and be responsible for considering the reports of the internal auditor. However, with this practical arrangement, nothing should prevent the internal auditor reporting directly to the political head of the organisation where the internal auditor feels that that would be appropriate. In some countries, a more appropriate arrangement may be the appointment of an independent audit committee, as discussed in the main text.

7.2 Summary

The responsibilities of the official (i.e., state secretary or equivalent) for the application of PFM/IC within a public organisation are considerable and much greater than those exercised by such an official prior to the implementation of PFM/IC. They reflect the fact that applying PFM/IC is about managerial reform and therefore is about how public organisations are organised and managed to deliver objectives as well as to ensure that public resources are properly utilised and deliver better public value, with responsibilities being allocated between the political and the official levels of management. Consequently, the responsibilities of that official are not just about the technicalities of PFM/IC but they also cover the managerial implications of the reform. The significant change that this reform will bring about is the professionalisation of civil service management coupled with the delegation of operational management from the political to the official level. Consequently, an important responsibility of a state secretary will be to retain the confidence of the political level of management in the competence of the operational management and its capacity to deliver the objectives and performance standards set by the minister efficiently and effectively and to maintain financial and budgetary control.

A ministry of finance through its state secretary should systematically engage with other public organisation state secretaries (or equivalent) about the application of PFM/IC through establishing a coordinating group. The role of the head of the department in the ministry of finance responsible for the application of PFM/IC should be to support the ministry of finance state secretary and act as secretary/coordinator of the group of state secretaries. Such engagement arrangements would form part of the process of generating 'local ownership' of the reform. That coordinating group should be prepared to consult with other persons as necessary such as the state external auditor and the head of the government's training institution or a university tutor with experience of managerial training.

The introduction of PFM/IC will also affect the role and reporting responsibilities of internal audit and those of an inspection arrangement. Those reporting responsibilities should primarily be to the state secretary but with a right to still report to the minister where necessary. Internal audit concerns about this reporting change could be alleviated by the appointment of an independent audit committee to whom the internal auditor would also be required to report.

8

The Role of the Head of Finance and the Finance Department in Line Ministries and Other Public Organisations with the Application of PFM/IC

Prior to the introduction of PFM/IC the role of the head of finance would be largely limited to that of financial controller including that of bookkeeper. The head of finance would be the main channel of communication with the ministry of finance and in those countries which have separated the responsibility for the capital or investment budget from the current budget, with the ministry responsible for the capital or investment budget too. A principle responsibility of the head of finance would be the development of the budget but in many developing and transition economy countries that budgetary role would usually be limited to the assembly of the budget in accordance with the ministry of finance and other central ministry requirements. The head of finance would not be expected to advise the manager on the appropriateness of the budget or on the linkages between the budget and expected performance (if the latter linkage is considered at all). The focus of accounting would be on financial accounting with little or no attention paid to management accounting (including costing).

However, with the introduction of PFM/IC the role of the head of finance would be expanded considerably. This chapter describes that expanded role. Where there is a separation of the current and investment budgets the head of finance will be expected to bring these together so that each manager is aware of the total availability of resources. Again, the head of finance will have a key role in raising manager financial awareness and be expected to analyse the available budgetary resources over cost centres, cost drivers and any other form of analysis that a manager requires. Finance staff therefore will need to have the expertise and information to enable them to properly support the management of organisations, not least in providing managers with the

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_8

financial information they require to deliver greater efficiency and effectiveness. That will involve the extensive development of cost and management accounting, as well as the reallocation of budgets to meet the needs of managers. The head of finance will also need to develop an advisory role to support managers in interpreting financial information, especially in the context of performance and to help them analyse information so that they are able to fulfil their responsibilities to deliver objectives and performance standards efficiently and effectively. This applies to both expenditure and income. It will mean that financial information systems will require development so that they can meet not only the needs of the ministry of finance but also those of the manager. Other responsibilities of the head of finance will include advising the manager on the difference between fixed and variable costs and on the management of fixed costs, not least because fixed costs dominate the budget. The head of finance should undertake the monitoring of both financial and operational performance and provide an assessment of the short- and long-run financial resilience of the organisation.

As the civil (or local government) service will have a responsibility to support the political level of management in the development of policy the head of finance is likely to be an important contributor to that process. An appreciation of cost and affordability should be important components in policy decision making.

8.1 The Significance of Financial Management

8.1.1 Financial Management in Public Organisations

Public service organisations are unlike many private sector organisations because they are highly diverse and complex and their objectives can be difficult to define with precision. There is no equivalent to market share or return on capital or profitability or other commonly used market-based measures that a head of finance should be constantly monitoring. Public service organisations are also usually very much larger than private commercial organisations and often more complicated organisationally. Current or ongoing expenditure is usually financed from taxation or for some activities an element of funding will be raised from charges. Current expenditure should not be financed from borrowing because that will result in structural deficits. On the other hand, investment expenditure will usually be financed from borrowing rather than from internally generated funds or from investment capital. There will be no share capital. In some countries these various sources of funds may be supplemented from grant aid, for example, from the European Union, and where this occurs special rules may be applied to demonstrate how such funds have been used. Heads of finance should have a thorough appreciation of the different sources of finance and where it is appropriate to use those different resources.

The accounting arrangements will traditionally have been based upon cash but there is an increasing tendency to move towards accruals-based accounting systems but only for financial reporting purposes. Budgets are almost always prepared on a cash basis. Because of the different approaches to funding, budgets have always assumed a much more dominant role in the public sector than in the private sector. Effective public financial management does not require the development of accrual accounting or variants of the cash and accrual accounting bases. As has been shown earlier in this guide, accrual accounting, unless properly implemented with a well-trained management, can be a cause of additional risk from a public financial management perspective and is not a precondition to an improvement in the quality of public financial management.

A major problem in managing public expenditure at the organisation level arises from these features of public expenditure:

- The policy objectives upon which a public organisation intends to spend money are not always capable of precise definition.
- The outputs of a service cannot always be easily measured.
- There is not always a clear relationship between resource inputs and the benefits which flow from the use of those resources.
- Public services, unlike private services, do not serve a 'niche' market: they should be comprehensively available to the whole group or area that they are aimed at.
- Public services also must be reliable, that is, available in all circumstances subject to any policy changes, and this means that inevitably sufficient delivery resources should be available to secure delivery even with changes in operational circumstances. Consequently, for many public services some excess capacity must always be available, although how much is a matter for managerial judgement.

These features are why public services are not provided by the market. A consequence of these features is that 'financial awareness' is not an inherent characteristic of public sector management. A further complication is that many of the problems that public sector organisations seek to address cannot be solved by a single public sector organisation and require cooperation between public organisations, such as other ministries and local governments (always very difficult to achieve in practice), and sometimes also with private sector organisations, such as charities. The timescales for achievement are frequently inconsistent with the timescales for resource availability. However, heads of finance should always be aware of 'avoidable costs' and that the factors above should not provide an excuse for a head of finance not to pursue a rigorous assessment of the costs of providing public services.

A principal concern of a head of finance has traditionally been to ensure that expenditure is controlled so that budgetary allocations are not overspent and that decisions about spending conform to legal and regulatory requirements. An important aim has been to prevent the misuse of public funds. However, given the increasing importance of public expenditure and the size of many public sectors, a single focus upon 'financial and budgetary control' is no longer adequate. Much greater regard should be had to the quality of public expenditure and that requires a more sophisticated approach to public financial management focussing, as far as possible, upon what is being achieved for the input of resources. Heads of finance should also be concerned about the future sustainability of public services and that will mean having a concern for the long-run future financial viability of the organisation.

8.1.2 Financial Management, Decision Making and the Role of the Head of Finance

As has been explained previously, a core principle of PFM/IC is that operational decision making is delegated to operational managers. They are the managers who are nearest to the problem and have the greatest need for operational information, both financial and performance. They are also those most likely to be more familiar with the risks and problems that affect the arrangements for the delivery of a service. Such officials probably also will be best placed to judge the value of the expenditure and corresponding opportunities, provided they have the information and support that they require to make good quality decisions. The accountability arrangements for such officials (and for subordinate organisations where they are involved) should reflect the delegation arrangements.

An essential feature of that information and support that such managers need is that derived from effective financial management. An important element of the PFM/IC reform is driving higher standards of financial management and ensuring that finance is integral to decision making at the very highest levels in public organisations. Finance leadership in a line ministry or other public organisation is central to this. The head of finance should be the principal financial adviser to the management and most particularly to the top operational manager, the state secretary or equivalent. In this leadership role the head of finance must ensure that financial standards are maintained and that the finance function is developed so that it is able to provide the information managers at all levels require in a timely manner. An important requirement of the head of finance is that he/she should possess excellent interpersonal skills, have experience of managing what is likely to become, especially in larger ministries a large, complex finance function, and have a considerable appreciation of the political context in which public organisations operate.

Financial management therefore goes well beyond exercising financial and budgetary control. The management information that managers require includes the full costs[1] of the services and activities that they are responsible for and what drives those costs, then ensuring that this understanding will be used to better inform decision making. This means that a head of finance identifies, with managers, the information they require, not least to ensure that services and activities are delivered efficiently and effectively (and the same applies to the arrangements for the collection of income). This will mean that a responsibility of the head of finance will be the development of management accounting and costing systems relevant to the needs of the manager.

The head of finance should have a specific responsibility for:

- The management of overall organisation spending with individual managers being responsible for the management of their own specific areas.
- Supporting managers in generating improvements in value for money by raising standards of financial management.
- Raising financial awareness amongst all levels of management; this means creating amongst managers a better understanding of the costs of activities and services they are responsible for and ensuring that this understanding will be used to better inform decision making.
- Monitoring the delegation arrangements to ensure that the financial conditions attached to delegation are fully observed.
- Developing techniques for forecasting so that an appreciation exists of the long-run costs of policy and investment decisions as well as changes in the operational environment caused by legislative, demographic, environmental and other factors.
- Have an appreciation of the services, activities and proposed developments of other public organisations so that cross organisation efficiencies can be exploited.
- Development of financial and operational strategies.

[1] Full costs include personnel, supplies and services, transport, property costs, overheads and an appropriate share of investment costs.

- Assisting managers in the development of budgets and for local government advising on local taxation policies.
- Accounting and financial reporting.

A state secretary (or equivalent) has a responsibility to support the political level of management with the development of policy and the strategy for the implementation of policy. This support will largely be based upon the practical experience of operational management. To develop effective policy the politician requires information about costs and in particular what drives costs. The politician also requires an appreciation of how proposed policies are likely to fit with the budgetary envelope likely to be available to the organisation as well as upon the future finances of the organisation. This will be important information in negotiations with the ministry of finance about the implementation of a proposed new policy. The head of finance should have a central role in providing that information.

The personal qualities of the head of finance should include the skills and personality to act as financial adviser to the most senior operational management officials and where a management team exists, to that team. He/she should have an ability to communicate and manage; strong problem-solving skills and ability to make decisions based on accurate and timely analysis; a high level of integrity and dependability; good delegation skills; an ability to show and exercise good judgement, to make recommendations and to implement decisions. Also, because there is likely to be a large volume of data the head of finance should have an ability to determine what is important and what is not.

8.2 Functions of the Head of Finance Prior to the Application of PFM/IC

8.2.1 The Background

With traditional systems of public administration, financial considerations generally are not central to decision making except in one respect which is to secure budgetary and financial control. Managers are not required to constantly search for ways of improving efficiency and effectiveness in the delivery of public services or activities nor indeed are tools and advice available to enable them to do so. (There may be 'token' requirements in legislation but mostly these will have no substantive meaning.) Nor are managers required to look forward to assess the financial impact that current and future policy developments as well as any external factors, such as environmental or demographic change, may have upon the longer run financial resilience of the organisation. Similarly, the stock of public assets is not treated as something to be managed so that effective use is made of this very important resource. The asset stock is not usually regarded as a manageable resource. Accounting is primarily a bookkeeping function dominated by the need to maintain budgetary control. The budgetary analysis will be determined by the requirements of the ministry of finance with the manager having little or no say in that analysis. There will be little or no management accounting to meet the needs of individual managers. In countries with traditional systems of public administration, budgets are usually based upon historical information and then sometimes adjusted for inflation. (In reality, budgets are frequently prepared hurriedly with little time for detailed analysis and the previous year's budget is then repeated with no amendment to reflect changing circumstances. So quality is not necessarily a defining characteristic.) The detailed formulation of the budgets and the budgetary calculation processes may be specified by the ministry of finance leaving little or no discretion to the manager of the service or activity. As some key budgetary elements may be determined centrally by a ministry of finance or another central ministry, they may not be within the discretion of the manager responsible for the delivery of the budget. An example of this would be personnel budgets. In some countries, even relatively minor budgets may also be determined centrally, such as vehicle fuel consumption and as noted in a previous chapter even the allowance made for water consumption by individual members of staff. Because the structure of the budget and hence the financial control processes will be determined by the ministry of finance, this in turn affects the design of the accounting system and the information which is available to the manager of the service or activity. Overoptimistic assumptions about income, both taxable and non-tax income, can also be a feature of budgeting.

A consequence of poor quality budgeting, and particularly instability of funding, is that heads of finance are frequently engaged in crisis or 'cut-back' management to accommodate unforeseen circumstances and emerging deficits during the year.

8.2.2 A Summary of the Responsibilities of the Head of Finance Before the Introduction of PFM/IC

The primary responsibilities of the head of finance with a traditional system of public administration reflect the more limited role of a state secretary (see Chap. 7) and include:

- Leading the promotion and delivery throughout the whole organisation of good financial and budgetary control so that public money and public assets are always safeguarded, used only in accordance with the approved budget, that spending complies with the relevant laws and regulations and that it occurs only for public purposes.
- Ensuring that financial regulations issued by the ministry of finance are fully observed throughout the organisation, including the segregation of duties.
- In cooperation with financial information systems experts and internal audit, introducing appropriate measures to prevent and detect fraud and corruption and that all financial and personal information systems are protected against electronic or other forms of attack.
- Supporting the state secretary in the development of the budget by assembling the budget documents prepared by the different departments or units of a ministry or local government (but not necessarily be involved in any assessment of what level of finance is actually required); reviewing budgetary demands to ensure that the calculations are consistent with any requirements specified by the ministry of finance (i.e., not to assess the quality of those budgetary demands); informing the head of the organisation of the budgetary requirements and discussing the details of the budget with the ministry of finance in order to correct any mistakes or misunderstandings; revising the budgetary calculations if the ministry of finance requires reductions in order to conform with a budgetary ceiling, but not making any decisions about or advising on where those reductions should fall; once the budget is agreed, informing the budget holders of the sums available for spending.
- Preparing cash flow calculations and agreeing them with the ministry of finance or treasury and then maintaining cash flow control in accordance with the ministry of finance or treasury requirements.
- Monitoring actual spending against the budgetary provision to ensure no overspending occurs or, that where overspending is likely to occur, that appropriate approvals for variations are obtained (virement) and similarly with variations to actual against forecast cash flow.
- Checking that orders for goods and services are consistent with the procurement legislation.
- Checking all invoices to ensure that they have been properly certified. This means ensuring that delegated financial authorities are respected and that the goods and services have been supplied in accordance with the specification. The relevant documents would then be passed to the appropriate minister or deputy minister or other senior official to sign (with equivalent arrangements in local government).

- Issuing payment orders to the ministry of finance or treasury for the appropriate minister or deputy minister or other senior official to sign (or equivalent arrangements in local government).
- Collecting revenues that are due such as rents, concessions, charges for services, income from sales of non-financial assets, and so on, or if not directly responsible for revenue collection, monitoring revenue collection activity (and in local government this would apply to local taxation income, but probably not for central government).
- Advising the state secretary on current expenditure trends against the budget and when authority for variations needs to be sought.
- Maintaining the financial records of the organisation in the format prescribed by the ministry of finance.
- Ensuring that where grant aid funds are provided that any financial conditions accompanying such aid funds are followed.
- Preparing on behalf of the state secretary any financial reports (annual, semi-annual, quarterly) required by the ministry of finance.

Variations to this list of responsibilities may occur depending upon local circumstances. For example, a head of finance may have a responsibility for the transfer of funds from a ministry to a second-level organisation or a non-governmental organisation (NGO) and then act as a financial controller to ensure that such funds are not overspent or are spent in accordance with any accompanying conditions.[2] Where the budget includes a medium-term perspective, a head of finance may be involved in the calculation of forward year forecasts although frequently this just involves an adjustment for anticipated inflation beyond the base year. A head of finance may also be involved in preparing forecasts of the future ongoing costs of new investment. The extent of the head of finance's role in preparing any financial statements and supporting documents will depend upon whether a single set of financial statements is published for the government as a whole or each public organisation is required to publish a separate set of financial statements. Again, these responsibilities will be affected by whether a cash- or modified cash-based, modified accrual- or accrual-based accounting system is in place. The head of finance may also have a responsibility for treasury management, particularly for the investment of short-term (e.g., overnight) funds, especially where there is no

[2] With the introduction of PFM/IC the responsibility for transfer of funds should lie with the relevant manager responsible for the oversight of the second-level organisation and that manager should also ensure that the transferred funds are used only for the purposes for which the funds were made available. 'Control' should therefore extend well beyond simply financial control.

centralised treasury single account. Otherwise, that responsibility will lie with the ministry of finance or treasury.

The head of finance will usually have no role in the assessment of the appropriateness of the budgets of second-level bodies, other than for the purpose of assimilating those budgets into the budget proposals for a ministry as a whole (or a local government) or for the review of the financial performance of a state-owned enterprise which a ministry is responsible for supervising.

Little or no management or cost accounting is likely to exist and the head of finance is unlikely to be required to analyse the budget or accounting information in a way that would facilitate the development of efficient and effective management. There would be no long-term financial planning (which should not be confused with medium-term budgeting). The head of finance would not be required to act as a financial adviser to the manager other than for financial and budgetary control purposes.

The advice of the head of finance is unlikely to be sought in the development of policy and the head of finance is unlikely to have the type of information available that would enable the head to make an effective contribution other than to the possible impact upon budgetary limits.

In summary, the principal functions of the head of finance would be to act as bookkeeper and financial controller. These are important responsibilities and are consistent with the requirements of public financial administration as described in Chap. 3, but they are not sufficient with the development of the managerial culture implicit in the introduction of PFM/IC.

8.3 The Responsibilities of a Head of Finance with the Introduction of PFM/IC

8.3.1 The Changed Background

The most important changes affecting the role of the head of finance following the application of PFM/IC are that the head of finance must respond both to the development of a managerial culture and to the consequences of a greater focus on the interests of the stakeholders. This latter is demonstrated by the linkage between PFM/IC and improvements in transparency and corporate governance. These changes have a significant impact upon how financial information is analysed, utilised and made available both internally to operational managers and externally to stakeholders. The budgetary analysis arrangements required by the ministry of finance, which dominate traditional arrangements, are unlikely to be adequate for operational managerial purposes and the information required for public financial reporting purposes is unlikely to be relevant to the needs of most stakeholders. Traditional financial reporting arrangements will not in general facilitate transparency about how an organisation has utilised available public resources when compared with the achievement of objectives. The operational manager as has been shown previously, if he/she is to be effective, will require that financial information is provided in different ways, that is, it will need to be interpreted, classified, analysed, reported and summarised differently for management and stakeholder reporting purposes compared with that for year-end financial reporting and ministry of finance budgetary control purposes. With traditional pre-PFM/IC public administration systems these managerial and stakeholder needs have not been regarded as important, or recognised at all, because 'control' has been the driving factor rather than 'management' with 'control' and reporting being focussed upon the requirements of the ministry of finance. The responsibility of the operational manager to achieve objectives efficiently and effectively will not have been a central requirement. With the application of PFM/IC the control of inputs remains important but there is an added focus upon achieving the outputs (i.e., the objectives of the organisation) and doing so efficiently and effectively. To do that there has to be effective management. Heads of finance with traditional systems of public administration have not therefore expected to be trained professional financial managers in the way they would be expected to be in a managerial environment. Consequently, with the introduction of PFM/IC the responsibilities and approach to finance must change significantly to complement the adoption of a managerial approach to the delivery of public services.

An aim of the finance function within each public organisation should be to drive improvements which support the delivery of high-quality efficient and effective public services. To do this the head of finance should seek to provide management-focussed advice, that is, to respond to the manager's needs and to provide those specialist financial services that the manager requires. An example would be specialist management accounting information. A further aim should be to ensure that the capital stock of the organisation is used efficiently and effectively. This includes not just assets but also ensuring that the levels of debtors and creditors are being effectively managed.

As a manager operating in a managerial environment will require different forms of analysis to those provided by conventional budgetary documents, the determinant of that analysis should be the manager rather than the ministry of finance. The adviser to the manager for this purpose should be the head of finance for the organisation. This requires the development of an operational partnership between the manager and the finance official. In addition to this for effective financial management with a focus upon efficiency and effectiveness, the manager will require detailed information about operational performance. This is likely to require the development of new information systems and the linking of operational performance information with financial information. This will mean that cost and management accounting information the manager will require will affect the range of financial support available to the manager. Consequently, this is likely to affect how that information is provided and the specialist skills and analyses that will be required. For example, each hospital or major educational establishment will require particular forms of financial analytical information. That need, in turn, may affect how the finance function is organised. Thus, should the whole finance function be centred on the head of finance or should particular managers (such as of a hospital or a major college or university) have their own finance staffs. If the latter they, in turn, would need to liaise with the ministry or local government head of finance. (This is discussed in Sect. 8.7 below.)

Appreciating these requirements also shows that with the introduction of PFM/IC the professionalisation of financial management is a necessary condition. The role of head of finance as well as of operational management with PFM/IC is more demanding and hence more time consuming than that expected with traditional public administration arrangements. A higher level of technical knowledge is required as well as considerable experience of the operational environment.

For the finance role to be effective in a PFM/IC-dominated environment the head of finance must ensure that the core financial processes, systems and management information provide the information the manager requires. As that information is likely to differ from manager to manager, the head must ensure that consistent financial standards and policies are applied and that managers are familiar with them and regard them as relevant to their operational environment. To achieve that the head of finance must ensure that expert people are employed in finance departments and that they have a clear career structure and opportunities for training and development exist (see Sect. 8.5 below). The organisation structure should promote collaboration with management and knowledge sharing. Finance officials should strive to become trusted partners of the management at all levels in the organisation. A main point that should come to be appreciated is that: "Finance is not just about money: it is about whether our organisations are delivering expected policy outcomes on time and to budget. This means we need to understand how policy and strategy connect through to delivery performance, and how risks and opportunities are identified and managed."[3]

8.3.2 The Key Changes That the Head of Finance Should be Prepared for, Including Support to Managers

With PFM/IC a key change, as was pointed out above, will be in the information that a manager requires and which the finance department will be expected to provide. This will involve not only different budgetary analyses but also the provision of cost and management accounting information where required by management to complement financial accounting information. This is part of the process of preparing financial information for operational managers in a form that is required by the manager. The analysis of budgetary information should be designed so that information is provided in a form that allows for the interpretation of that information for managerial purposes. The management accounting reports should provide accurate and timely financial and performance information to managers. This is to enable them to make short-term and long-term decisions about the achievement of the objectives of the organisation, including whether it is doing so efficiently and effectively and at the same time containing expenditure and income within prescribed budgets.

In practice, line ministry managers will require considerable support in developing a managerial approach to managing public money and not least over how to achieve improvements in efficiency. This is likely to be entirely new to them and will require advice and training on how expenditure and income should be analysed. For example, an operational manager may require analysis over cost drivers and cost centres, the development of appropriate cost accounting techniques (see a later section of this chapter) and so on. The head of finance should be able to provide that advice.

Management accounting differs from financial accounting. Financial accounting provides the information to a ministry of finance and to the management of an organisation primarily for budgetary control purposes and to enable the ministry of finance to prepare the annual financial statements. That information will be organised to suit the needs of the ministry of finance, rather than those of the manager. Cost accounting provides an analysis of the

[3] Government Finance Function Strategy 2019–2023 Executive Summary: Comment by Rachel McLean Finance Director General, Ministry of Housing, Communities and Local Government p5: UK Government: Government Finance Function—GOV.UK (www.gov.uk).

actual costs of service operations, processes, activities or products and the analysis of variances from the detailed budgets for those individual activities and where standard costs are calculated variances from those standard costs. (A standard cost is the estimated cost of a providing a service, activity or product.)

In summary, with PFM/IC the financial information system must provide two basic analyses of information:

(i). The information the ministry of finance requires to enable it to be confident that budgetary control is being maintained and therefore spending is consistent with the budget law approved by parliament and that it can complete the government wide chart of accounts (CoA) used for financial reporting purposes. This CoA should be used by all ministries, second-level bodies and other public organisations of the government for financial accounting purposes. It would also be used by a ministry of finance for international statistical reporting purposes.

(ii). The information managers (both political and civil service) within ministries, second-level bodies and other public organisations require for management and policy development purposes. How it will be organised will depend upon the requirements of individual managers, that is, not the ministry of finance and it could be different for operational managers and political-level managers.

The analyses that will be required will be more complex where there is a separation of the current budget from the investment budget with reporting to two different ministries. Managers will require detailed information about both budgets and meet what may be the different control requirements of different ministries.

The head of finance must ensure that these two forms of analysis utilise the same basic accounting information.[4] Consequently, the coding structure should be devised in such a manner that it can provide both the information that the manager needs and that required by the ministry of finance for its purposes. (Very often coding structures are devised simply to meet the needs of the ministry of finance and then only for budgetary control purposes.)

The operational manager will require the management and cost accounting information necessary to enable him or her:

[4] See Chap. 5 and the reference to the Canadian arrangements.

- To maintain budgetary, financial and cash control over the area of activity for which he/she is responsible;
- To understand how well each part of the organisation for which the manager is responsible is performing and
- At the same time fulfil the responsibility for delivering objectives and performance standards and doing so efficiently and effectively.

Thus, the head of finance in conjunction with the operational managers in an organisation will need to develop a financial analytical system, that is, a management accounting system, specifically designed to meet the needs of each manager's area of responsibility. Therefore, the coding structure should be designed to provide the information that individual managers may need as well as the ministry of finance.

8.3.3 The Head of Finance and the Development of Policy, Including Securing Short- and Long-Run Financial Resilience

With the managerial information requirements that should be developed with the implementation of PFM/IC the head of finance should be able to make an effective contribution assisting the state secretary support the political leadership in the development of policy. As the role of the civil service in policy making is to provide advice on how political ideas can be converted into practical public services able to be delivered within budget and in such a manner as to be capable of being maintained within a longer term forecast financial framework for the organisation, the financial contribution is extremely important.

Effective policy can only be developed if it is accompanied by an analysis of the financial consequences of that policy including the identification and impact of the relevant cost drivers (such as pupil/teacher ratios or penal policy). The head of finance should be able to contribute to that policy making role. For this contribution to be effective the head of finance must gain the confidence of the head of operational management, (the state secretary) and the policy maker.

Both the political head of a ministry or local government or other public organisation and the head of the operational management within that organisation should also be concerned about the short- and long-run financial resilience of the organisation.

What is meant by financial resilience? In simple terms, this is the ability, from a financial perspective, to respond to changes in delivery or demand without placing the organisation at risk of financial failure. This means having the ability and flexibility to forecast and manage both expenditure and income to meet requirements as they change while delivering a balanced budget. What are the key indicators of financial resilience? They will depend upon the type of service that a public organisation is providing and the circumstances in a country under which a public organisation is operating. Each present a risk to the viability of an organisation. A head of finance together with the head of operational management should assess and report to the political head of the organisation on the financial resilience of the organisation following the assessment, because the result may have a major impact upon existing and future policy.

In assessing financial resilience an aim will be to identify those factors,[5] which might impact upon the longer run finances of the organisation. A result should be that consideration is given through the development of contingency plans to how costs should be managed in the event of adverse financial circumstances emerging, as periodically they inevitably will. This approach would be much more effective and facilitate the more efficient utilisation of resources than simply reacting to a financial crisis without any pre-planning. Short-, medium-term and longer run finances will be affected by such factors as an economic downturn, increases in interest rates, the impact of legal changes, technological change, environmental change and, where foreign aid is significant, changes to the level of that foreign aid. Another feature in assessing financial resilience will be to ensure that new development proposals can be introduced without impacting adversely upon the ability of the organisation to maintain its current services and assets. In assessing new development proposals a factor that should be considered should be how that new policy could be affected if in the future, economies have to be made because of changed economic circumstances or a failure to generate the revenues that underpin the budget.

Of course, the head of finance will need to continue to provide the information the ministry of finance requires and to ensure that the budgetary and cash flow controls established by the ministry of finance are fully observed, that is, through the financial accounting system. But such controls are nowhere near enough to secure financial resilience. Short-run financial resilience requires that flows of service delivery activity are consistent with the availability of finance, both domestic and foreign aid, not simply that budgetary

[5] See also Sect. 8.3.6 below.

controls are observed. This means that commitments must be fully recorded even though no actual payments may have been made. Therefore, an important element of financial management is to ensure that payments and commitments together do not cause budgets to be exceeded. Consequently, the head of finance and the manager together should review budgets monthly and re-forecast the likely outturn for the remainder of the financial year. In practice in many developing and transition economy countries, particularly in southern and eastern Europe, financial reports are prepared only three monthly and no re-forecasting occurs at all. Consequently, towards the end of the year the risk is that the manager suddenly finds that the budget will be overspent and that a supplementary budget is required or short-run cuts must be made to the provision of services and activities. Either way the result is inefficient management. Three monthly financial reporting does not allow sufficient time to make realistic service or activity adjustments to ensure that budgets are not overspent and that is why activity and spending should be reviewed monthly. Re-forecasting enables managers to take decisions earlier in the year to avoid overspendings occurring or to ensure that unused funds are not hurriedly spent at the end of the year, merely to utilise a budgetary allowance irrespective of the merits of that expenditure. Spending should also be linked with performance, that is, is the spending achieving the objectives? Over- or under-spending on its own is not a sufficient indicator and the responsibility of the head of finance and the manager is to link spending with performance. This will indicate whether there is genuine under- or overspending, or merely if overspending, increased inefficiency.

The argument put to this author in some southern and eastern European countries is that there is no need for short-run financial planning because there can be no budgetary overspending. This is because 'the treasury control system would prevent it' and therefore effective budgetary control exists. This, however, ignores the point that commitments may be entered into particularly affecting future periods and that arrears of payments to creditors can and do exist as one of the processes for ensuring that overspending does not occur (or more accurately can be concealed). Therefore, the fact that the ministry of finance treasury control system prevents overspending does not mean that there is effective budgetary control; it can merely disguise the fact that such overspendings are occurring and the consequences are being borne by the following year's budget or by the creditor, that is, the private element of the economy. (This can be accompanied by price inflation as creditors seek to recoup their added costs.)

Many ministries and local governments establish second-level organisations. A further factor therefore that the head of finance should be concerned about is the financial management of such organisations, whether agencies or state-owned public corporations. A state secretary (and the political level of management) should want to ensure that not only are the objectives of such organisations consistent with the policy expectations of the first-level organisation but that all second-level organisations are managed in such a manner that their objectives and performance standards are delivered efficiently and effectively and that they do not incur liabilities which could have an adverse effect upon the first-level organisation. The head of finance should ensure that he/she is well informed about the quality of financial management in such second-level organisations so that, in turn, the state secretary and/or the political level of management can be properly informed (see also Chap. 12).

Longer run financial resilience depends upon the quality of all those processes that involve finance including the relevant corporate governance arrangements such as:

- The realism of forecasts of costs and savings plans;
- The realism of projected income streams;
- The quality of performance monitoring;
- Where cash reserves are a factor in financial planning that such reserves are not used to finance long-run developments and that they are maintained at a level which is appropriate given the uncertainties that are likely to affect the financial resilience of the organisation;
- The compatibility between the different development plans for the different services and the medium-term and long-run financial plans for the organisation. And if such plans do not exist, then they should and the head of finance should encourage their preparation;
- The operational environment including a willingness to recognise the importance of 'challenge' by the head of finance and the recognition by top operational and political management of the importance of maintaining financial discipline.

In Annex 2 to this chapter the different criteria which should be considered in assessing financial resilience are discussed.

8.3.4 Accountability and Transparency

A feature of PFM/IC is increased accountability and transparency. The COSO framework referred to in Chap. 5 is described in detail in Chap. 11, included reporting objectives. These objectives are about both internal and external reporting and accountability and transparency. They relate to financial and non-financial reporting. The factors in the COSO framework specifically referred to include reliability, timeliness and transparency but the framework recognises that other factors may be relevant as well depending upon local requirements, and for public sector organisations, this should include information about whether violations have occurred to budgetary allocation limitations. Bearing in mind that the COSO framework applies to private sector companies, application to the public sector could introduce a range of additional requirements. Not the least of these requirements would be those expected by parliament to enable it to fulfil its scrutiny responsibilities. Transparency also embraces the information required by civil society and how that information is presented. The linkage of finance with objectives and performance will be key elements in accountability and transparency.

The head of finance will have a responsibility to prepare the annual financial statements of the organisation or alternatively provide the information that the ministry of finance requires to enable it to complete the financial statements of the whole of government. These statements will be subject to external audit, whether they are published separately for each organisation or sent to the ministry of finance for consolidation into a government wide set of financial statements.

Financial statements, especially consolidated financial statements, do not provide the information that stakeholders, not least parliaments, usually require about the operation of individual public organisations. From a corporate governance point of view this is inadequate and information should be published in a form which is accessible to the user or stakeholder in each public organisation and that information should inform the reader about much more than the finances of the organisation. This may require the publication by each organisation of an annual report which specifically addresses the interests of the stakeholder and demonstrates how public funds have been used against budgets, the level of performance achieved against objectives set, the factors which are likely to affect performance into the future, details of strategically important matters such as sustainability, ethics, values and/or corporate social responsibility and information on environmental matters (exactly what should be published will depend upon the scope of the responsibilities of the organisation) and also the strengths and weaknesses of the internal control arrangements (see also Chap. 13 on the statement of internal control).

The head of finance has a key role in enabling management to fulfil its accountability and transparency responsibilities. This raises the question as to whether in addition to the conventional financial statements, if an organisation is to fulfil the accountability and transparency requirements envisaged by COSO, it should also publish separate financial and performance reports to complement consolidated financial statements published by the ministry of finance?

The department responsible for the application of PFM/IC should issue guidance on how ministries, local governments and other public organisations should meet accountability and transparency requirements. Particular attention in developing the reporting specification should be paid to the needs of parliament so that parliament has an opportunity to appreciate the extent to which the government and/or individual public organisations have met their objectives and performance standards. This is not simply about under- or overspending compared with budgetary approvals.

8.3.5 Managing Costs

Maintaining financial resilience as well as improving efficiency and effectiveness also depends very heavily upon a public organisation's ability to manage its costs. Improving efficiency and effectiveness very often requires that difficult decisions are required, not least in attacking what are often deemed to be the fixed costs[6] of an organisation. Those fixed costs can include employee pay (not least because of the contractual arrangements with employees and perhaps a political unwillingness to change the level of the number of employees), social benefits, the costs of servicing debt, the costs of maintaining assets which may be out of date or are inefficient to use or which are surplus to requirements or cannot be adapted to meet modern conditions (such as medical facilities) and staffing. Yet it is these 'fixed' costs that dominate budgets and which often cause so much difficulty when budgetary changes are required.

How budgets are developed will, or should, also be affected by the development of PFM/IC. For example, budgetary calculations should reflect the underlying performance information and the management/political policies. To manage costs an operational manager should not simply be concerned with how much individual transactions cost but with what causes those costs to be what they are, that is, what is it that drives the costs and can those cost drivers be changed. Consequently, in developing budgets regard should be had to the identification and impact of those cost drivers. Substantive cost management should be aimed at those cost drivers, rather than simply at cost totals. Managers should be judged therefore not just by their ability to keep costs within a defined budgetary allocation but also by their ability to deliver performance and at the same time to identify and manage those factors that drive those costs. (Changing cost drivers may not always be possible for an

[6] Fixed costs in accounting terms include those costs which remain the same whether activity increases or decreases. However, in the public sector this definition can be widened to include those costs which the politician does not wish to see changed, such as employee costs, whatever the circumstances and such costs can be a major contributor to total budgetary costs.

operational manager and political authority may be needed and that of course shifts the responsibility to the politician and away from the operational manager.)

Associated with the identification of cost drivers by those responsible for the development of budgets within ministries delivering public services is also the need to ensure that ministry of finance officials responsible for negotiating budgets (and if there is a separate budget for investment, the officials of the ministry responsible for that budget) in turn have an appreciation of what drives costs. That will require close coordination between those officials and the head of finance within ministries responsible for the delivery of public services. Unless officials from these central ministries have an appreciation of what drives costs in individual ministries, the risk for them is that they will not be able to make effective judgements about the appropriate allocation of budgetary resources.

A related factor is that individual ministries or other public organisations may not be totally in control of their own costs, and decisions made by other ministries and public organisations can influence them. An important responsibility of the head of finance is to ensure that he/she is aware of such possibilities. For example, should a decision be made to increase significantly the number of police by the responsible ministry that will influence the budgets of other ministries such as those responsible for the court system, for prisons, for the probation service, for the maintenance of family cohesion where there may be an increase in the arrest of the main family income earners.

8.3.6 The Role of the Head of Finance as a 'Check' on Managerial Aspirations and as a Reviewer of the Utilisation of Assets

The head of finance will also be the person who acts, either directly or through the state secretary, or equivalent, as a 'check' on the aspirations of managers (political and appointed) because their proposals are not financially viable. The head of finance may also wish to secure transparency and accountability by publishing information those managers may prefer to not disclose. These responsibilities may put the head of finance into conflict with managers, even political managers within an organisation, and this will require that the head of finance has the support of the state secretary in a ministry (or equivalent in local government) for the actions proposed to be taken. What should not happen is that the head of finance allows another official to determine the content of a financial report or advice. In extreme circumstances a head of finance may need to discuss the circumstances with the external auditor and/

or with the ministry of finance. The overriding responsibility of the head of finance is to secure the financial integrity of the organisation and to make clear where there is a possibility of that financial integrity being compromised. Financial integrity is central to the determination of the reputation of an organisation and to public confidence in the organisation.

A further important role of the head of finance with PFM/IC, which has been referred to above, should be to have regard, *inter alia*, to the stock (value!) of the assets that an organisation owns and the utilisation of those assets. The head of finance therefore ought to be engaged in balance sheet management. This requires much more than the recording of the assets. Balance sheet management would be an entirely new concept which should be a critical part of any change to accrual accounting but even without that the head of finance should ensure that asset records are not only maintained for control purposes (in one respect this is a minor element) but more importantly to ensure that those assets are fully and effectively used. This is an essential element of PFM/IC. This is not about the delivery of public services but the efficient and effective use of resources.

Consequently, each head of finance of a public organisation should ensure that the managers of that organisation have due regard to the stock of assets and the extent of their utilisation and if not fully used what are the possible alternatives, which may include an alternative use by either the present owner or by transfer to another public sector body or ultimately sale. A further feature of the need for effective asset management has been demonstrated in an IMF Country Report on Ireland:

> The lack of asset surveys, together with issues concerning valuation and ownership, present a challenge for the management and maintenance of public assets. With no solid estimate of the capital stock, the amount that should be provided for maintenance and rehabilitation of the assets is unclear. Currently, funding of maintenance is provided on a relatively *ad hoc* basis, and anecdotal evidence gives a clear sense of premature deterioration in assets. The absence of systematic data on the stock of assets is also likely to present a challenge when asset sales take place. A current example is the planned combination of three hospitals into a single national paediatric hospital in Dublin. Two of the hospitals to be replaced are owned by private orders, though these have been state funded for decades, while the third is a state hospital.[7]

This is a clear example of the importance of asset management and of the implications for future liabilities. None of this though means that effective

[7] Technical assistance report—public investment management assessment IMF country report no 17/333 Ireland.

asset management depends upon the development of accrual accounting. It does not and what is more important is the maintenance of accurate asset records coupled with a managerial determination to ensure that assets are used in the most efficient and effective manner or are disposed of. (The experience of this author is that a weakness in many countries of the approach to accrual accounting is that the arrangements for the identification of the current values of assets are inadequate and a need for a current valuation is regarded as unnecessary because the written down original cost is regarded as appropriate. This ignores how changes in the distribution of asset values occur with changes in circumstances and not least changes in demand for certain types of assets in particular locations over time. Accrual accounting can also require complex valuation arrangements to be adopted, for example, for infrastructure assets and spare parts when valuing plant and equipment, and a reality is that valuation expertise is not always available.)

8.3.7 A Summary of the Role of the Head of Finance with the Introduction of PFM/IC

In summary, the head of finance with PFM/IC will still have the responsibilities of bookkeeper and financial controller and those other responsibilities which may exist under the pre-PFM/IC arrangements. However, with PFM/IC the head of finance in addition must develop those additional financial services and provide the advice and information that will meet the needs of the policy maker and the operational managers at all levels in the organisation. The state secretary (or equivalent in a local government) should ensure that all these elements of financial management exist. In addition, the head of finance will have a key role in developing the information required for external reporting and the development of transparency. The head of finance will also be responsible for securing the financial integrity of the organisation, both in the short and long run.

Four consequences of this expansion in the role of the head of finance and the development of PFM/IC are that he/she:

- Needs to develop financial analytical skills, including costing, financial forecasting skills and financial appraisal skills.
- Has the technical capacity to apply financial reporting standards and other transparency requirements (which may include how information is to be presented to ensure that it is accessible).

- Has the personality and knowledge to challenge managers and those in authority, to justify the decisions that they may be making. Close cooperation with the state secretary or equivalent is essential and very importantly, maintaining the confidence of the state secretary or equivalent is equally essential.

Appointments should be based upon competence, not political affiliation, and the head of finance should be able to provide impartial advice, not least to the political level of management (in other words there are no political constraints determining the nature of that advice).

8.4 The Head of Finance Role in Developing a Financially Aware Operational Management

8.4.1 The Centrality of the Role of Head of Finance

With PFM/IC finance has a much more significant role than with the traditional arrangements for public financial administration. The head of finance responsibility is to support the head of operational management (e.g., a state secretary), develop a financially aware organisation and support the head of operational management in creating a managerially oriented organisation aiming to improve efficiency and effectiveness in the delivery of public services and activities and in meeting the objectives of the organisation. The head of finance therefore will need to become a key adviser to management at all levels in the organisation on the financial implications of proposed policy and investment decisions, on the costs of current operational activities, on the efficiency and effectiveness of those operations and similarly on income generating activities, as well as on the utilisation of the assets of the organisation.

The responsibility of the head of finance is to push out the boundaries of financial management knowledge. The focus upon outputs with PFM/IC rather than simply upon control of inputs creates new areas of financial management development. As performance information is developed over time the opportunities for strengthening the relationships between inputs and outputs will grow and the head of finance should be a key contributor to driving improvements in performance measurement.

These changes will affect the status and authority of the head of finance. The head of finance responsibility changes from simply acting as a channel providing information to assessing information critically and at times to resist managerial proposals and/or to make clear why objections are being made. These are reasons why the head of finance should be a member of the top management team of an organisation or, if such a team does not exist, should be a key adviser to the state secretary (or head of a local government service). An assumption is that the state secretary (or equivalent in local government) is, in turn, a key adviser to the politically appointed officials on the development and strategy for the application of policy and that advice will include financial advice.

In considering the role of the head of finance a useful model is to compare it with that of the finance director within a private company. The finance director would have a very senior role on the board of management and the same should be true in principle within public sector organisations, even though the organisational circumstances may be different. Without that status and authority, finance is likely to be treated simply as a control function.

The analysis in this chapter also serves to demonstrate that to improve efficiency and effectiveness, the control of expenditure against the traditional budgetary analysis required for ministry of finance purposes is not sufficient. It may achieve budgetary control but this form of control does not tell a manager anything about efficiency and effectiveness or whether what has been spent has achieved was what was expected to be achieved when the budget was agreed. In other words, the traditional approach to budgetary control tells the manager (and the ministry of finance) nothing about the outputs that are expected to be achieved for the inputs.

Overall, the head of finance should provide financial leadership throughout the organisation including the promotion of financial literacy and awareness. With PFM/IC finance assumes a much greater significance within an organisation and the head of finance has a key role in making clear to managers at all levels the importance of finance as a main driver in improving managerial discipline within the organisation, in the search for improvements in efficiency and effectiveness and of the importance of finance to the development of effective strategic and business planning. The financial integrity of the organisation is central to its overall reputation and the maintenance of financial integrity depends very heavily upon the capability and authority of the head of finance.

8.5 The Training of Heads of Finance

What is set out above represents a considerable list of additional responsibilities falling upon the head of finance compared with those which exist with pre-PFM/IC arrangements. If these responsibilities are to be properly applied, they will require the development of a professional cadre of financially trained officials. If the organisation were operating in the private sector, this need would be taken for granted, but that usually does not occur in public sector organisations. The message from this though is that the PFM/IC reform is unlikely to be successful unless a commitment exists to secure the training that many current heads of finance are likely to require. (A need for specialist training for internal auditors is accepted in most countries, yet the same perception does not appear to exist for the technically much more specialist, more demanding and higher status role of a head of finance.) Therefore, a consequential responsibility of a ministry of finance should be to prepare a development plan for the strengthening of finance departments so that they have the complementary skills to support the managers. This plan should include ensuring that heads of finance and their senior staff members have knowledge of the legal framework and regulations affecting finance, an understanding of the principles of PFM/IC (as, e.g., identified in this guide), the theory and practice of accounting, financial planning and the development of financial strategies including long-term financial strategy (see section on business and strategic planning and strategic financial planning below), all aspects of costing and how and when it can be used (see section on cost accounting below), all aspects of budgeting, investment appraisal, the management of income (including taxation in those organisations which have their own taxation resources, such as local governments), financial reporting and audit, the identification and management of risk and especially fiscal risk, the exercise of financial leadership and the provision of advice to managers and policy makers.

A discussion of these different areas of knowledge is included in a publication by the Chartered Institute of Public Finance and Accountancy (CIPFA).[8] Exactly what technical skills will be required will depend upon the business of a particular organisation. However, an important operational risk for a head of finance is that he/she becomes absorbed in the various techniques and loses sight of the main responsibility flowing from the development of PFM/IC which is the provision of financial advice and support to management at all levels in an organisation. Therefore, an important feature in the training of heads of finance should be in management and in the 'softer management skills' such as communications, negotiation, presentation and networking.

[8] International Public Financial Management: Essentials of Public Sector Accounting CIPFA/Routledge 2019.

8.6 Accrual Accounting and Its Impact upon Financial Management and Financial Reporting

A factor which could affect the financial management and reporting arrangements is the introduction of accrual accounting. Considerable pressure exists on countries to harmonise financial reporting by adopting the international public sector accounting standards, IPSASs (although for European countries a set of European standards are being developed[9]). These standards are not designed for management accounting purposes. However, should countries decide to adopt these standards, heads of finance would need to become familiar with them and decisions would have to be made about how they would impact upon the management accounting arrangements. Consequential decisions would also have to be made about whether the budgeting arrangements should be converted to an accruals basis or not, and if not, arrangements would have to be made to reconcile systematically the results of two different bases for the provision of financial information. Very few developed economy countries have adopted accrual budgeting.

Again, the head of finance will need to recognise the impact that a change to accrual accounting will have upon the information available to managers particularly about the utilisation of assets and the management of debtors and creditors. Ideally accrual accounting reform should be accompanied by a managerial reform like that required for the PFM/IC reform in order to create the managerial environment which would require managers to utilise the accrual accounting information to improve the quality of public financial management.

What can be said though is that an unwise decision would be to adopt these accrual accounting standards at the same time as adopting PFM/IC because the impact upon management accounting arrangements and hence upon both managers and heads of finance would be significant.

8.7 The Organisation of the Finance Function

Given the additional responsibilities falling upon managers and the head of finance with the introduction of PFM/IC, an important factor that should be considered is how the finance function should be organised. Traditionally in most countries the finance function has been centralised for each

[9] European public sector accounting standards, EPSASs, are based upon the international standards.

organisation. This may continue to be appropriate for small organisations but with larger public organisations such as ministries of defence, internal affairs, social services, health and education (as well as in large cities) there is the possibility of decentralising the finance function. Individual top managers of large-scale services or activities may require the support of their own 'in-house' financial experts if they are to perform their responsibilities effectively. For example, the manager of a major police department will require a finance office capable of working with him/her to identify cost centres and of analysing costs over those costs centres and their activities as well as comparing cost centre performance. This is even though there will be a finance officer employed within a ministry of the interior. Or again, the manager of a hospital or a university will want to identify the costs of different departments of a hospital or university as well as the activities within those departments, such as the utilisation of operating theatres or the costs of particular types of educational courses or of treating certain types of patients. This is even though there will be a finance officer in the senior management team of the health and education ministries. Each of these major organisations will require their own cost analyses and the management accounting information should be capable of providing such information.

The question that flows from this is if finance staffs are to be decentralised should they be members of the finance department of the organisation as a whole or should they be members of the staff of the relevant manager? The answer will depend upon local circumstances. There is no right or wrong answer but if the answer is that the decentralised finance staff should be members of the staff of the relevant manager, they would be the principal point of liaison about financial matters between the central finance organisation and the individual manager's area of responsibility. Consequently, they would need to retain the confidence of the head of finance of the organisation as a whole and meet the same professional standards expected of the centralised finance organisation.

This is a complex question to consider and it may be appropriate to seek external advice perhaps through an aid agency or a specialist organisation but that advisory organisation should have experience of public sector management and not merely bring forward proposals based upon how private organisations manage their business. The political dimension applying in the public sector should not be overlooked.

One other factor that should also be considered is the extent to which the ministry of finance should be involved with the appointment (and dismissal) of the head of finance. This chapter illustrates the significance of this role and the extent of responsibility for supporting all levels of management. These responsibilities may occasionally lead to conflict between the management, both political and operational, and the head of finance where a manager wishes to undertake an activity or incur expenditures which the head of finance may regard as inappropriate. In such circumstances the ministry of finance may feel that should such a conflict occur, it should be consulted and therefore the ministry of finance may wish to issue a decree or some other form of regulation requiring this to happen. (Where the operational managers are politically appointed the head of finance could become especially vulnerable.) This potential for conflict, regrettable though it might be, could also cause the ministry of finance to take the view that it should be consulted over the appointment or proposed dismissal of the head of finance. (See also Chap. 5.)

Overall, though, there is the question as to whether, given the significance of the role of head of finance, the ministry of finance should prepare a 'scheme of service' for finance officials. Also, as part of that, should it develop a forum where heads of finance could meet together to discuss common problems as well as emerging policies that could have a particular impact upon the role of the head of finance.

8.8 Costing

Costing is a development of management accounting. Its purpose is to identify the cost of providing a service, or activity, or individual product. Costing is an essential tool in the development of the budget as well as in the day-to-day financial management of an organisation. Costing is a subject that a head of finance should be particularly familiar with although the evidence available to this author from at least European and European neighbourhood countries is that there is little or no familiarity with this subject.

The objective of costing is to help managers decide on the most cost efficient method of delivering services or activities by identifying the determinants of cost and how costs vary in different circumstances. As part of this managers will also need to know the comparative costs and performance of different units of activity providing the same type of service or activity such as regional offices or schools or different regional or district police centres so that they are able to question why performance and costs differ where essentially the same service is provided by different cost centres. Cost accounting can provide the manager with the information to determine which are the efficient parts of a business and which are not. It can be used by managers to establish how to deliver services at lower costs and at the same time maintain volumes and quality; it allows a manager to assess the value of a proposed investment (and disinvestment). Using costing, the manager also can be provided with the type of analysis which would enable the manager to decide upon what would be an appropriate charge for a service (where such charges are levied). This would then enable policy makers and managers to determine who would be the beneficiaries of any consequential subsidies and therefore whether they regarded this as appropriate or not.

Cost accounting therefore provides the information a manager requires to:

- Make decisions about the efficient allocation of resources and where to make investment choices.
- Formulate the financial impact of policy proposals for incorporation in the budget.
- Control operational activities more effectively.
- Plan and manage services where demand is likely to vary depending upon local circumstances (e.g., changes in the patterns and types of crime).
- Make decisions about what is the appropriate charge to levy for a service or activity and the distribution of the resulting subsidies if that charge is to be below cost.
- Compare the costs and performance of each element of activity with other similar activities (e.g., the costs and performance of operating theatres in different hospitals) in order to determine efficiency and effectiveness and to determine the most economical level of performance (e.g., for an operating theatre, say, 16 hours a day rather than 24).
- Assess the comparative costs of public and private service delivery, that is, whether to contract out or not.

All of this will also help to improve the quality of budgets as well as how well resources are being used.

One of the most important questions to ask is what is meant by cost? ‘Cost’ is much more than the financial allocation for budgetary purposes. The definition of cost depends upon the decision the manager is trying to make. The manager should be clear about the cost object and this can be a unit of service or activity, a process, a service itself, an organisational unit or a user of a service or activity. The manager manages the inputs that drive the costs but the actual cost driver is the policy which generates the costs in the first place. Examples have been given in previous chapters such as the cost of educating a pupil (which in turn depends upon the pupil/teacher ratio), but could be extended to cover the cost of a school (which depends upon the school building and maintenance policy as well as decisions about class sizes), the cost of a particular teaching activity, such as language teaching (which depends upon the educational policy), the cost of educating different age groups of children (which also depends upon educational policy), the cost of educating children from different social backgrounds, children with disabilities and so on (which all depend upon educational policy). Or to take another service, the costs of holding prisoners, the costs analysed over different types of prisoners, such as male, female, child, mentally disturbed, high risk, low risk and any other categories the prison managers require (all of which depend upon penal and judicial policy).

Costs can include 'direct costs' and 'indirect costs'. Direct costs are those costs that can be attributed to a single cost object (e.g., a child or a school or a prison). Indirect costs cannot be traced in full to one cost object and therefore must be shared between two or more cost objectives (as would, e.g., the costs of a specialist classroom teacher if the cost object was a pupil). Indirect costs also can be called overheads and the definition of an overhead can change depending upon the 'cost object' the manager is concerned about.

Costs can also have different characteristics. They can be classified as:

- Variable costs (e.g., varying with the number of pupils).
- Fixed costs (e.g., costs which normally do not vary with the number of pupils such as the school building).
- Semi variable costs (e.g., utility costs which include a fixed cost element and a variable element depending upon usage).
- Semi fixed costs (e.g., where the number of pupils increases beyond classroom capacity and additional space is required—can also be called 'stepped costs').

Costs can also be avoidable by providing a service or activity in a different manner from that adopted in the past.

There are a range of costing techniques or systems that can be employed and which is the most appropriate depends upon the circumstances. The main costing techniques include:

- Absorption costing
- Unit costing
- Job costing
- Process costing
- Activity-based costing
- Marginal costing
- Relevant costing
- Standard costing
- Life cycle costing

Where costing techniques are to be used, the head of finance should be required to prepare an analysis of the results and provide advice in the form of a commentary to the manager rather than just present the manager with a set of information. A working partnership between the manager and the head of finance is essential. What is also required is a management accounting information system which enables cost and relevant performance information to be collected which, as has been pointed out above, will require not only a much more elaborate analysis of expenditure and income but also other analyses, including the preparation of timesheets to show how individual members of staff have allocated their time.

However, developing management accounting including costing is only worth investing in if there is a genuine desire and willingness for managers to focus on improving efficiency and effectiveness. The main point of the information that is produced is to enable the manager to more effectively control the service or activity for which the manager is responsible (i.e., exercise managerial discipline), to challenge present practice and to make reforms which will improve efficiency and effectiveness and to make service delivery more responsive to changing circumstances.

The exercise of operational managerial discipline and challenging present practice can be a cause of friction and dispute (including political opposition). For the operational manager to do this effectively will require considerable managerial skill and as has been pointed out previously, the independence of operational management from political interference. This manager should also be supported by the head of finance and the provision of such support to management, assuming that the head of finance agrees with what the manager wishes to do, should be an essential feature of the head of finance/manager relationship.

Heads of finance should be familiar with these different types of costing with the extent of familiarity required depending upon the business of the organisation. Which costing techniques should be applied will depend upon the circumstances.

8.9 The Head of Finance and Strategic and Business Planning and Strategic Financial Planning

A distinction should be made (which has been pointed to previously) between longer term financial planning and medium-term budgeting. The introduction of PFM/IC with its emphasis upon strategic planning, strategic financial planning and business planning will require the head of finance to become much more involved in these activities and the financial analysis of policy developments and new investment proposals. As part of strategic planning, very importantly, the head of finance will need to identify and assess the future costs of demographic, legal, technical, economic and environmental changes. An assessment should also be made of the impact of existing policies, recent investment decisions which may not yet have come on stream, proposed policies and investments, the costs of renewing existing investments, such as buildings and equipment or other infrastructure investments, and the maintenance of existing investments and any other factors which are likely to affect the long-run future financing of the organisation. The head of finance should also be aware of the policies of other public organisations that could have financial implications for his/her own organisation. Against this forecast of costs would be set the likely income that will be available from budgetary and other sources, including foreign aid (considering the risks that have been referred to previously, see Chap. 6, about the continued availability of foreign aid). This may affect medium-term budgets but the objective of longer term financial planning is to prepare an assessment of the future financial health of the organisation taking into account all its known or likely commitments. Such an assessment will, at a minimum, provide key evidence during budget negotiations with the ministry of finance and will also inform the political head of the organisation about the feasibility of the policies that are being proposed, especially given the likelihood of the availability of budgetary resources.

This type of analysis provides to the political head of the organisation (the minister or mayor) a financial perspective that would not otherwise be available and therefore allows them to make judgements about what may or may not be affordable, no matter how politically desirable a particular policy may be. It also demonstrates that economies may well be needed to be made in the relatively near future and therefore a requirement from a ministry of finance to cut costs does not come as a surprise resulting in hasty and inefficient decisions. Of course, such long-run forecasts will be tentative but if properly prepared such forecasts provide a broad perspective that is very important for the effective management of public organisations. This will be particularly true for social and environmental programmes, such as social services or in deciding how to respond to the impact of climate change. Demographic analysis will also help determine the future cost of pensions policies.

As part of the long-run financial planning the head of finance should aim to identify any factor, such as the state of the economy or levels of unemployment, affecting the finances of the organisation over the current, medium and longer term. An organisation that does not plan to match expenditure and revenues over these periods will very quickly get into financial difficulty making it necessary to undertake those short-term and undesirable and inefficient decisions.

A state secretary should therefore be concerned to ensure that the head of finance identifies any factors, commitments and policies which could cause significant variations to occur or might damage income earning activities, not just in the current year but also in the future and whether those commitments and policies are unlikely to be financeable from future budgetary resources.

With PFM/IC service managers should be expected to prepare strategic plans for the services for which they are responsible. These should always be accompanied by a financial assessment with the head of finance being a key contributor advising on the long-run financial implications of such plans.

Strategic financial planning would also enable managers to take longer term decisions about how to develop strategies to deal with the possibility of future budgetary restrictions. Related to this is an increasing requirement that for proposed new laws and regulations a fiscal impact assessment should be undertaken showing the financial consequences they will have on public and private expenditures and revenues. Such an impact assessment, if it is to be effective, will require close cooperation between a head of finance and the service managers responsible for the drafting of such laws and regulations.

Quite separately, the head of finance should ensure that managers within the organisation prepare a business plan when proposing new activities (and indeed also update regularly existing business plans). A business plan is in effect a mission statement that sets out the vision, structure and methods that are to be employed to achieve a particular business objective. Business plans have the following benefits:

- Enable management to think through the proposal for service development or modification in a logical and structured way.
- Requires that the proposer of the service development or service modification defines the objectives and performance standards that will be applied.
- Requires the proposer to make judgements about the demand for the service or how it will be received by the service beneficiaries (which may require the production of evidence through market research).
- Defines the stages for the achievement of the objectives and performance standards and hence the overall timescale for achievement.
- Explains how the proposed service or modified service will be delivered and its relationship with existing services (if any).
- Explains the resources that will be required such as investment resources, staffing, equipment, transport and when they will be needed.

- Requires the development of a budget for the proposed service development or modification.
- Through the definition of the stages enables senior management to plot progress against the plan.
- Facilitates decision making by the civil or local government service and political leadership by providing the operational and financial information that is essential to effective decision making but in doing so also provides the opportunity for senior decision makers including the ministry of finance (and/or the ministry responsible for investment) to challenge the assumptions contained in the business plan.
- Explains how the proposal will be integrated into the budget for the organisation or if it cannot be integrated, the additional funds, both current and investment, that will be needed.

This analysis of the role of the head of finance with the introduction of PFM/IC emphasises that the head of finance should be a significant contributor to the development of the business of the organisation and all aspects of its financial management. To regard the role as one limited to bookkeeping and financial control, as occurs with traditional systems of public administration, is a serious mistake.

8.10 Summary

Introducing PFM/IC significantly changes the role of finance within an organisation. Finance becomes central to decision making, whether of policy and strategy or of operational activity. The head of finance should be a leader ensuring that all operational managers within the organisation become financially aware. Traditional financial control remains important, although the form of it may change. There is much more to financial management than simply maintaining financial and budgetary control. PFM/IC impacts upon the type of financial information that an operational manager requires. Traditional financial accounting designed to meet the financial reporting and international statistical reporting responsibilities of the ministry of finance does not provide the information that a manager requires. The head of finance should develop management accounting systems, including costing. Costing is valuable not only for managers to assess value for money but also in the development of the budget by identifying and assessing the financial implications of cost drivers. The development of operational management will also impact upon how the budget is analysed because if each manager is to be responsible for ensuring that control over their budget is maintained, as they should be, they must know what the available budget is. The budgetary analysis that meets the needs of the ministry of finance is unlikely to meet the needs of the manager.

The additional financial information that is required for effective management is also the type of information that will be required for policy making. Therefore, the head of finance can have an important role in supporting the state secretary (or equivalent) in advising the political level of management in the development of policy and the strategy for the implementation of that policy.

PFM/IC also affects the 'discipline' applying within an organisation. It affects not only how operational managers behave because it introduces much tighter constraints, but as finance becomes central to policy making and to business and strategic planning it affects the political level of management. Effective financial management also requires that regard is had to the long-run financial resilience of the organisation. An important responsibility of the head of finance is to identify and analyse how different factors, both internal and external, are likely to affect the finances of the organisation over the longer term. This may result in the head of finance objecting to proposals even though there may be a managerial desire to implement them.

Another factor is that where a public organisation is responsible for second-level organisations, the operational management of the first-level organisation, including the head of finance, should ensure that the objectives of such second-level organisations are consistent with those of the first-level organisation, that the finances of those second-level organisation are well managed (no matter how they are financed) and that the objectives of these organisations are delivered efficiently and effectively.

The head of finance should also ensure that neither the first- nor second-level organisations should enter arrangements which would expose them to fiscal risks without a full consideration of those risks including the impact they would have if they matured.

PFM/IC has an emphasis upon accountability and transparency. Traditional methods of financial reporting are unlikely to be adequate to meet the requirements of the international standards (i.e., those specified by COSO). Each public organisation ought to publish an annual report showing how it has used its financial resources, its performance against its objectives and how effective its internal control arrangements have been (see also Chap. 13).

The head of finance has a key role in the development of strategic financial planning and in other planning exercises such as strategic planning and business planning.

Introducing PFM/IC consequently means that the role and responsibilities of the head of finance will be significantly enhanced. The role becomes a professional financial management role and, in most countries, this will require the development of specific training arrangements. These enhanced responsibilities of the head of finance can only be effectively undertaken if the head is able to withstand political pressure so that he/she can offer independent impartial advice. The head of finance should work closely with the most senior official (e.g., the state secretary or equivalent) and this is especially important where the advice of the head of finance is contentious. The head of finance should operate within the context of a civil or local government service which is not politicised.

Because of the significance of finance in management an issue that will need to be addressed is how should the finance function be organised? Should it be centralised or decentralised because certainly in larger organisations managers will require specialist technical support and advice. This should be matter for local decision.

Another factor that should be considered is whether the appointment and dismissal of the head of finance should be solely a responsibility of a particular organisation or whether the ministry of finance should be consulted.

Annex 1: The Responsibilities of a Head of Finance in Supporting the Development of a Financially Aware Management

With PFM/IC a main responsibility of a head of finance is to support the head of operational management (a state secretary or equivalent) in developing and establishing a financially aware management. Set out below are the key activities the head of finance should be engaged in.

- Leading the promotion and delivery throughout the whole organisation of good financial management so that public money is always safeguarded and used appropriately and effectively.
- Being a member of the 'leadership team' of the organisation and if such a team does not exist being a key adviser to the state secretary of a ministry or the equivalent in other public organisations and as a part of this ensure that finance is central to policy making and strategy development.
- Interpreting financial trends and the possible impact of factors that could affect the finances of the organisation so that, as far as possible, financial 'surprises' are avoided.

- Encouraging individual managers to become more financially aware, not least that they know what the real costs are of providing the services and activities for which they are responsible (i.e., not just the budgets).
- Co-ordinating the planning and budgeting processes and advising managers on the development of their budgets including developing the organisation's own internal rules/regulations in conjunction with managers, which set out the procedures/steps managers should follow during the budget cycle process: these rules/regulations would cover such items as who is responsible for what; who is authorised to do what; what kind of data/information/reports are required from managers and how often (the process of preparing budgets ought to change with the application of PFM/IC with managers having a more significant role).
- Providing advice to managers on the linking of objectives, performance standards and performance objectives with available budgetary resources and ensure that managers agree that the available budget is consistent with the policy and performance objectives and performance standards the manager is expected to achieve.
- Advising the state secretary (or equivalent) and/or the political head of the organisation during the budgetary negotiations with the ministry of finance.
- Re-analysing the budget agreed with the ministry of finance which will be issued by that ministry in the format required for its budgetary control and financial and statistical reporting purposes, into a format that allows individual managers to be made aware of how the budgetary constraints directly affect them.
- Setting financial targets and performance indicators in conjunction with operational managers and the state secretary (or equivalent) to help assess service and activity delivery (these financial targets and performance indicators may be incorporated into the budgets of individual managers).
- Developing with operational managers the management accounting, including costing information, that each manager requires including supporting managers in the development and utilisation of costing techniques so that managers are able to assess and improve the efficiency and effectiveness of operational decisions.
- In developing management accounting information ensure that actual costs are analysed in such a manner that the manager knows what drives those costs and how and where those costs are being incurred, on what purposes and for what outputs; this would include the costs incurred by

different cost centres[10] and provide a commentary to assist managers make decisions about the efficiency and effectiveness of those different cost centres.

- Ensuring that cost and management accounting information is reconciled with financial accounting information so that the organisation is still able to provide the information that the ministry of finance requires and that overall budgetary control is maintained.
- Presenting to managers at all levels relevant, objective, reliable and timely financial analysis and advice, clearly setting out the financial implications and financial risks and not least comparing financial with operational performance: these reports should be delivered in a format which meets the needs of the individual manager and, for example, should analyse expenditure, income and activity over costs centres if that is what the manager requires.
- Working with managers to ensure that services and activities are delivered economically, efficiently and effectively and that agreed objectives and performance standards and objectives are met.
- Maintaining effective control over commitments by requiring managers to re-forecast each month to the end of the year the likely expenditure and income and performance against budgeted objectives and performance standards and objectives.
- Monitoring the financial and operational performance of the organisation at least monthly and reporting on this to the operational head of the organisation and the leadership team, where appropriate, and to third parties (such as the ministry of finance).
- Ensuring that neither the first-level organisation nor second-level organisations, whether responsible for market or non-market activities, enter into arrangements which result in potential fiscal risks, without an assessment of those risks and the appropriate approvals. This would include ensuring that no fiscal risks are accepted which could adversely affect the financial resilience of the organisation (such as 'off-balance sheet' activities or private finance activities including public/private partnerships) without a full assessment of the costs and risks including an assessment of the possibility of such risks occurring and their consequences.
- Ensuring that the policy for developing income sources and the arrangements for the collection of income is properly assessed, that income due achieves the policy objectives determined for that activity and that all

[10] Examples have been given earlier in this guide but to summarise could include regional offices, police units, types of crime, individual departments of universities and schools, academic courses, military units, military training, individual sports facilities, types of sport, types of disease or medical care required, types of medical facility and units such as operating theatres and so on.

income is promptly collected: the costs and losses arising from the income collection arrangements should be kept to a minimum; this responsibility would include assisting managers make decisions about the level of charges for services and whether the proposed charges reflect the full or marginal costs of providing such services or activities, depending upon the approved policy, or if charges are intended to recover only a proportion of the cost that clarity exists over the level of subsidies that are being provided and to whom.

- Ensuring that financial considerations are fully taken into account in developing the organisation's policies and strategic plans including the impact upon the finances of the organisation and that financial considerations are fully reflected in the delivery of those policies and strategies; as part of this ensure that commitments are not entered into which would adversely affect the ability of the managers of the organisation to contain expenditure within approved limits, either for the current year or for future years both covered by the budget period.
- Preparing long-term strategic financial plans for the organisation taking into account all the external and internal factors likely to affect the financial resilience of the organisation over the medium and longer term, reporting on the findings of those plans and updating those plans as necessary.
- Working with operational managers to develop business plans to deliver the organisation's operational objectives; challenging managers at all levels in the organisation as necessary on the affordability and value for money of service or activity development proposals; this will involve testing assumptions and forecasts about costs for their reliability, including the reliability of any cost forecasts, including any income forecasts arising from the proposed development of services or for new investments.
- Ensuring that the organisation's investment projects are chosen after appropriate value for money analysis and appraisal using, as appropriate, relevant professional guidance.
- Assessing the financial implications of any alternative types of arrangement that are proposed for the delivery of services and activities such as through contracting out, public/private partnerships and other types of arrangement and advising upon whether they represent value for money.
- Assessing the financial implications of alternative investment financing arrangements to conventional borrowing arrangements, such as leasing and advising upon whether they represent value for money.

- Ensuring that proposals for new laws, regulations and other legislative proposals made by managers include an assessment of the financial impact on future expenditures and/or revenues not only of the organisation making the proposals but also on those affected by their impact.
- Monitoring the asset stock of the organisation and ensuring that that stock is properly utilised and if not, that surplus assets are disposed of in accordance with the policies of the government.
- Providing the financial inputs into service level or performance agreements with second-level organisations, including advising on the performance criteria that are to apply to those second-level organisations (whether agencies or state-owned enterprises) and monitoring the financial performance of those organisations.
- Supporting managers in ensuring that all second-level bodies, whether commercial or not, act in a manner which is consistent with the objectives of the controlling/owning ministry (first-level organisation) and that they are well managed, have strong governance arrangements and, also for state-owned enterprises, are set and meet financial targets set by the first-level organisation. This will include monitoring the finances and performance of second-level non-market organisations to ensure that they are in conformity with the performance expectations set out in the service level or performance agreements.
- Similarly monitoring the finances of state-owned or municipal enterprises for which the first-level organisation has an overall responsibility and ensure that the financial returns expected from those organisations and set out in the service level or performance agreements are being met.
- Managing the finance function including the recruitment and training of staff.
- Establishing business continuity arrangements for financial processes and especially for IT systems.
- Negotiating with the ministry of finance the changes that introducing PFM/IC will have demonstrating how the specific budgetary and accounting systems that a ministry or other public organisation requires will result in improvements to the utilisation of public resources.
- Reporting on and securing the discharge of accountability through the preparation of the annual financial statements and other statements about the performance of the organisation.

- Ensuring that the organisation's conduct demonstrates probity and a sound financial administration, including compliance with regulatory standards as well as the actual control activities.

The head of finance whilst having a responsibility to interpret and secure the application of the financial regulations and other approved controls and procedures including those relating to procurement issued by the ministry of finance should ensure that they are compatible with the management arrangements that exist within the organisation.

Annex 2: Financial Resilience

The following is based upon a financial resilience tool developed by the Chartered Institute of Public Finance and Accountancy for use by local governments in the United Kingdom. It facilitates comparisons between different local governments. However, the principles underpinning this tool are equally applicable to all public sector organisations including government ministries. Details of the financial resilience tool are set out at https://www.bing.com/search?q=cipfa+financial+resilience+model&form.[11]

Developing financial resilience is neither easy nor quick. It requires organisations to ask themselves difficult questions, challenge pre-existing decisions and consider new solutions. This means developing an approach to financial management that helps with scenario planning and decision making. This can lead to questions about the:

- Robustness of the annual budget;
- Quality of the forecasts contained in the medium-term financial strategy (and there should be one) and whether longer term forecasts are necessary;
- Adequacy of reserves and balances (for some public organisations such as government ministries cash reserves may not be available but for other 'standalone' public organisations they should always exist);
- Compatibility of the operational, development and financial plans of the organisation.

When assessing an organisation's financial resilience, the key factors that should be considered are:

[11] CIPFA offers an advisory service to public organisations wishing to assess financial resilience.

- The extent to which service developments are being funded from reserves: a rapid decline in reserves by, for example, using reserves to avoid cuts or for short-term benefit will only provide temporary relief;
- The ability to achieve savings, particularly those arising from improvements in efficiency: a failure to plan and deliver savings in service provision and not living within resources. For example, where plans state 'still to be found' or include optimism bias in timing or optimism in the level of income sources, and scale of savings, has the potential to damage financial resilience.
- Unplanned overspending or ineffective control of expenditure: the tendency for unplanned overspends to occur or the carrying forward undelivered savings into the following year only creates the need for greater cuts in subsequent years if financial targets are to be met.
- Ineffective financial planning including a shortening of medium-term financial plans and a failure to integrate financial plans with service development plans including policy objectives: a failure to plan ahead could indicate a lack of strategic thinking including an unwillingness to confront tough decisions. The existence of a robust medium-term financial plan (MTFP) is a key element in achieving financial sustainability coupled with the monitoring and delivery of that plan. The plan should be a live and constantly reviewed plan. The plan should have at least a three-to-five-year horizon. There are always uncertainties, but following a rigorous process to develop and manage the plan will help to mitigate financial resilience risk and allow the development of alternative scenarios. The MTFP will support delivery of the organisation's corporate strategy, helping to develop priorities and supporting resource allocation decisions within the financial environment presented in the MTFP.
- Integrated and aligned strategies and plans: financial resilience and sustainability are reliant on a series of plans and strategies developed and delivered by the organisation. Poor-performing organisations do not have these integrated, and they lack recognition of the impact of actions or decisions on one or more of these strategies. The key strategies that need to be integrated include (but are not limited to) the corporate plan, the MTFP, the savings plan, service delivery plans, reserves strategy, the commercial strategy, capital and the investment strategy. A decision on one of these will have an impact on the others. The delivery, oversight and challenge around each of these individually and collectively will support improved knowledge and decision making to consequently place the organisation in a better position to respond and adapt to changes in demand and external factors.

- A failure of effective corporate governance including a willingness to challenge policy decisions: the processes in place to support decisions that have a financial impact now or in the future must be robust and rigorous from both an operational official and a political official perspective. This means ensuring that decisions have a sound evidence base, concise and understandable information is presented, time is allowed for adequate scrutiny and advice or guidance is sought from subject matter experts and put into practice. Strong governance through oversight is also crucial following a decision to ensure effective performance management from a corporate, service and detailed operational perspective.
- Effective performance monitoring and reporting against financial plans should exist: the ability to respond and adapt to financial challenges should be underpinned by effective monitoring and reporting against the annual budget, capital programme and savings targets, while in turn recognising any impact on the MTFP. It is important to recognise risks to delivery of the planned budget as early as possible. This requires not only robust reporting and review but a culture of being open about performance and delivery from a financial and service outcome perspective. The earlier these messages are delivered, the greater chance there is of mitigating or responding. High-performing organisations will ensure that the culture encourages challenge, that the data and information is appropriate in detail and presentation and that a programme of review, whether by operational or political management, is frequent and timely. Unfortunately, what normally occurs is that risks around delivering the budget materialise late in the financial year. This may be a consequence of poor planning, optimistic budgets and savings plans, combined with a reluctance to recognise and report early enough to put mitigating measures in place. Effective ownership and accountability for an organisation's financial performance is collective, that is, it includes both operational and political management responsibility. Their collective responsibility is to deliver a balanced budget. The need is to ensure the concept of ownership is effective. Developing a culture of ownership and accountability will support the development of an approach to financial resilience that has an impact.

9

The Role of the Department Responsible for Advising on and Securing the Application of PFM/IC

This chapter describes the role of the ministry of finance department responsible for supporting the state secretary in driving forward the application of PFM/IC,[1] the driver department. Overall responsibility and hence accountability for the operational application of the reform, within the context of policies specified by the minister of finance and by the government, should lie with the state secretary in the ministry of finance (see Chap. 5). Given the volume and often detailed nature of the work involved in the day-to-day application of the reform, the state secretary ought to be supported by a specialist department with the necessary expertise and resources. One of the main responsibilities of this department is an educational responsibility to secure a real appreciation of what the reform means and what it involves for those most directly affected by the reform. As has been explained in previous chapters, this is that the reform is not simply a financial control reform, of only interest to finance staffs, but has a significant impact upon how organisations are managed which in turn affects the budgetary and accounting arrangements. It impacts too upon the arrangements for transparency and accountability and requires that attention is paid to the quality of governance. The head of this department should recognise that the reform affects both politicians and officials and therefore that both groups need to be informed and their concerns addressed. Also, the reform should ultimately impact upon all public organisations, whether

[1] In European influenced countries this department is often called a central harmonisation unit or department—a CHU. The European Commission policy on financial management and internal control envisages that the most appropriate method of actually securing the application of that policy (as well as internal audit) is through the appointment of a specialist department or unit within the ministry of finance. Countries not subject to European Union influence may wish to make other arrangements.

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_9

first- or second-level bodies, and therefore the application plan should take this into account. The head should use the information and arguments contained throughout this guide as a help in that educational process.

An important preliminary step prior to the formal decision to adopt PFM/IC should be a strategic analysis of the impact of the reform considering current cultural and managerial arrangements including how the reform would impact upon those arrangements. The risks with implementing the reform can be considerable and these should be explored. Merely deciding to adopt the reform without this type of strategic analysis exposes the minister of finance and the ministry state secretary to added risk in the effective implementation of the reform.

9.1 Introduction

As the PFM/IC reform is about management and the quality of financial management, this should be the central issue for the department of the ministry of finance responsible for its detailed implementation if PFM/IC is to be effectively introduced. This appreciation of the reform should be acknowledged from the outset. It is not simply a financial control reform. The quality of management determines how successful a public organisation will be in delivering its objectives and doing so efficiently and effectively.

The head of the department responsible for advising on and securing the application of PFM/IC must work closely with the state secretary (or equivalent) in the ministry of finance who has overall responsibility for the introduction of the reform on behalf of the minister of finance. The head would have the implementation responsibility to demonstrate to public organisations the benefits of introducing PFM/IC and how they can be achieved. Because the reform is likely to require quite radical changes to the management arrangements for the delivery of public services, some public officials (political and appointed) may find these changes difficult to accept and consequently the support of the state secretary will be essential to achieve the necessary changes.

This specialist department of the ministry of finance is in effect the PFM/IC 'driver' department supporting the state secretary. Establishing such a department would be an important statement of a substantive policy intention to introduce this reform. This department would be responsible for advising on the development of PFM/IC by individual ministries and other public organisations; on training and for systematically reviewing (annually, at least) the operational quality of public financial management and internal control throughout the public sector.

This chapter explains the main issues with which this specialist department should be involved with the introduction of PFM/IC. Because of the extensiveness of the reform PFM/IC can only be introduced effectively over time. There is no 'quick fix' solution but the basic managerial element of the reform should be established from the outset. Not only would this department, acting on behalf of the state secretary, be responsible for driving the reform, but to secure the quality of the reform and the maintenance of that quality over time, the department would in effect also become an oversight body.

9.2 Before a Decision Is Made to Introduce the Reform!

What is essential before the 'driver department' is established is that key preparatory work is undertaken. The critical feature of this reform, as has been explained earlier in this guide, is to deliver the policy objectives of the government along with the aimed for performance standards and objectives and to do so to time, within budget and efficiently and effectively having regard to the quality of corporate governance, accountability and the arrangements for transparency. This also means establishing an appreciation that the reform is not simply a financial control reform (which in this author's experience is how it is often perceived). If simply strengthening control is what is required this can be achieved without the need for the extensive managerial reforms that PFM/IC requires. In previous chapters the point has also been made that the achievement of objectives and performance standards to time, within budget, efficiently and effectively requires positive managerial actions, and it is to these 'positive managerial actions' that the PFM/IC reform should be directed. With the PFM/IC reform 'positive managerial action' must come from within the civil service, and in some countries, this will require civil service reform before the PFM/IC reform can be effectively introduced. But this can only come from within the civil service if there exists a government willingness to see this happen.

Therefore the policy initiative to introduce this reform should ideally come from government itself. However, as has been pointed out previously, it frequently comes from outside, from third parties such as aid agencies or other international organisations and sometimes from commercial consultancies seeing it as a potential source of work. This immediately raises four questions which need to be addressed before those responsible for driving the reform forward can effectively operate. One question is that of 'ownership'. For the reform to be successful, as has been pointed out, local ownership and local leadership are extremely important and are made more important because of the radical nature of this reform. The second question concerns the recognition by those advocating the reform that PFM/IC is as much a managerial reform as a technical reform. The third question to be addressed is about timing: is this an appropriate reform for the country at this time? There are many reasons why it may not be. The fourth question particularly arises where an aid agency is promoting the reform because implementing PFM/IC is a long-term reform and the question is, would long-term financial support be available? As this would be unlikely to be forthcoming this adds to the risk that the reform will not be successful unless the government itself recognises that it will be required to provide the funding at some future point.

These are questions that should be addressed by the minister of finance, supported by the ministry state secretary. And the answer may be that this is an inappropriate reform at the present time. In Chap. 4, nine tests were described which ought to be considered by the minister of finance and the state secretary before a decision is made to implement the reform. To do otherwise, as has been explained earlier in this guide, would be likely to increase costs without any corresponding benefits and could only make a weak financial and budgetary control system worse. Where there is external pressure to introduce this reform, this would require resistance to that pressure on the grounds that the reform is premature. (Section 9.2.1 below suggests how an initial report should be framed before a decision to proceed is made.)

What is also necessary is that a recognition should exist amongst senior officials (political and civil service) that reform is necessary and that the adoption of PFM/IC will make possible improvements to the utilisation of public resources, will lead to a better quality of governance and enhance democracy through greater transparency and accountability. A question then is, how is the nature of this reform to be communicated to parliament and to senior political officials beyond the minister of finance (and indeed also senior civil service officials) recognising that some at least will regard it as essentially simply a technical financial reform of benefit largely to the ministry of finance? The problem is made more complex if there is a high turnover of these officials. The introduction of PFM/IC, as has been explained in earlier chapters, has significant implications for:

- The role of ministers, deputy ministers (mayors and deputy mayors in local government) as policy makers and strategists, and changing their role as operational managers.
- The civil service (and local government service) officials giving them greater responsibilities for operational management decision making and consequently for how the civil service (and local government service) is organised and managed.
- Consequently, the relationships between the political and official levels of management.

- The quality of the budget for both income and expenditure because effective operational management depends upon certainty about the availability of funds and cash flow.
- The reform of traditional budgeting and financial accounting arrangements to provide the information managers require if they are to deliver services efficiently and effectively.
- Accountability arrangements including the scrutiny role of parliament and the information available to civil society through increased transparency.

These implications need to be explained and if they are not acceptable, the reform should not proceed. An important initial step therefore should be to achieve widespread key official, including parliamentary, appreciation of and support for the reform in principle at the highest political and official levels. This means that the decision to introduce PFM/IC should not be made before the main features which would affect the implementation of the reform have been considered. All this should occur prior to the establishment of the specialist 'driver' department in the ministry of finance. However, this preliminary exercise would provide essential training for those who would provide the nucleus of that department should a decision be made to proceed.

9.2.1 The Strategic Analytical and Planning Report

To prepare for the policy decision to introduce PFM/IC an initial step should be the development of a strategic analytical and planning report. This would consist of a preliminary analysis of the current public administration arrangements based upon those nine tests referred to in Chap. 4. This report should be prepared by or on behalf of the chief official within the ministry of finance and would be designed to ensure that before any decision is made to implement the reform, that PFM/IC is an appropriate reform for the country at the time and that it can be properly implemented or implemented in such a manner that the objectives can be achieved considering the cultural and political environment. This may affect how the objectives of the reform can be achieved and the timescale for achievement. The starting point in the preparation of the strategic analytical and planning report would be the undertaking or commissioning by, ideally, a person familiar with the operational environment within government and the public sector as a whole. This report should not simply be concerned with the present administrative arrangements but also with the power distribution between different groups and individuals and the processes that create and sustain those relationships over time. This is what the PFM/IC reform should address because it is likely to challenge existing traditions and the current decision making processes. The issues that such an analysis might consider and how they would change include:

- Roles and responsibilities of institutions: Who would be the key stakeholders in the PFM/IC processes, including parliament, central ministries and line ministries?
- Roles and responsibilities of officials: What are the formal/informal roles and mandates of different players, such as ministers, civil servants, advisers, others?
- Power relationships between and within ministries: What are the actual power relationships between central and line ministries in the provision of public services? How are those power relationships exercised?
- Power relationships between specific individuals, groups and public officials: To what extent is power vested in the hands of specific individuals/groups, whether within or outside the formal governing structures? Are decisions within organisations made collectively within public organisations or are they made by a single individual or a small group?
- Ownership: What is the balance of ownership between central/line ministries/local authorities in provision of services and private organisations? How are the different ownership relations managed?
- An assessment of current strengths and weaknesses of the current public financial management arrangements: including are they delivering the government's objectives efficiently and effectively, within budget and in accordance with the laws and regulations. That will require identifying whether public organisations have specific objectives or more general aspirations, how the present budgetary arrangements affect managers ability to deliver public services and how assessments are made of efficiency and effectiveness, if any.
- Financing and control: What is the balance between central ministry and line ministry control over the determining, allocation and utilisation of funds?
- Information and costs: How well informed are decision makers in the delivery of public services about operational performance, about costs and about the longer run impact of decisions on future service delivery and the financial resilience of public organisations?
- Service financing: How are individual public services financed (e.g., public/private partnerships, user fees, taxes, donor support) and what is the rationality for these arrangements?
- Interest groups and their influence: How do different interest groups outside government (e.g., private sector, NGOs, consumer groups, the media) seek to influence policy and is there a policy facilitating transparency?
- Historical legacies: What is the history of previous reform initiatives? How does this influence current stakeholder perceptions?

- Corruption and rent-seeking: Is there significant corruption and rent-seeking in government/local government? Where is this most prevalent (e.g., at point of delivery; procurement; allocation of jobs)? Who benefits most from this? How is patronage being used?
- Service delivery: Who are the primary beneficiaries of service delivery? Are particular social, regional or ethnic groups included/excluded? Where subsidies are provided, which groups benefit most from these?
- Ideologies and values: What are the dominant ideologies and values which would shape views about PFM/IC? To what extent may these serve to constrain change?
- Decision making: How are decisions made about public service delivery, that is, including objectives and performance standards? Who is party to these decision making processes?
- Implementation issues: Once made, are decisions implemented? Where are the key bottlenecks in the system? Is failure to implement due to lack of capacity or other political reasons?
- Potential conflict with other reforms: some may be in progress or proposed, particularly to the civil service and to financial management arrangements (such as the introduction of accrual accounting and programme budgeting) and an assessment should be made about the impact of the PFM/IC reform upon those other reforms. A risk that should be addressed is that unless this assessment occurs different reforms may be inconsistent in their impact and produce conflicting results. A second risk is 'overload' because too many reforms are occurring. A third risk is that technical financial reforms may not take into account the managerial implications of those reforms and that could cause conflict with the PFM/IC reform which has such a significant managerial focus.
- Potential for reform: Who are likely to be the 'winners' and 'losers' from the PFM/IC reform? Are there any key reform champions within the sector? Who is likely to resist reforms and why? Are there 'second best' reforms which might overcome this opposition?[2]

The author of this report should recognise that decision making around any politically driven process takes place in both formal and informal spaces and that an appreciation of both is necessary. Without that the recipient of the report will not have the right information to be able to create the reform pathway.

[2] Ibid.: These questions are based upon questions incorporated into the UK Department for International Development 'How to' note, Box 3: Sample Questions for Conducting Sector Level Political Economy Analysis, page 12 and adapted by the author to reflect the requirements of the PFM/IC reform.

The strategic analytical and planning report should include an assessment of the quality of the civil and local government service and the entry qualification arrangements and therefore specific questions should be asked about the civil service arrangements. Are those entrance qualifications appropriate and the university educational arrangements appropriate? On entry are the training arrangements appropriate given the managerial responsibilities that will fall upon civil servants with the implementation of PFM/IC? What will be the extent of higher level management training that will be required? Another issue that should be addressed is an assessment of the quality of the public financial administration arrangements. Are they robust and can that robustness be maintained when authority for decision making is transferred from central ministry controls to local controls exercised by individual public organisations? A further factor that should be covered should be to ensure that the ministry of finance itself is comfortable with how the reform will impact upon its role.

Those responsible for the implementation of the reform should also ensure that there is an appreciation of the implications of the reform for the relationships between politicians and civil servants (and equivalent in local government). This will also raise the practical question about the changes to the responsibilities of the elected and the appointed official within individual organisations. If these power changes cannot be resolved, then it is more than likely that the reform will fail. Again, are the managerial structures suitable for the application of the processes that will facilitate the achievement of the reform objectives efficiently and effectively? Do organisational structures require reform? These elements of the reform affecting the managerial arrangements need to be fully coordinated with other civil service/public administration reforms. Is this feasible or are such reforms taking different reform paths? Will the personnel management arrangements require reform, especially given that with PFM/IC civil servants will be responsible for making operational management decisions? And very importantly, will the reform in reality have top level (political and appointed official) support?

The person responsible for the preparation of the strategic analytical and planning report, if a civil servant, would be ideally placed to become the state secretary's chief adviser on PFM/IC and the head of the department responsible for advising on and securing the application of PFM/IC (i.e., driving forward the reform). That civil servant should be well informed about PFM/IC and ideally be an experienced manager.

A problem that this author has encountered is that many advisers and aid organisations responsible for supporting the application of this reform do not appreciate the political, managerial and cultural impact significance. They tend to have a 'standard template' approach and focus simply on the technicalities of the reform. They have not appreciated the impact upon the relations between elected and appointed officials, often on the grounds that this is either too difficult or premature or not relevant to the culture of the country. They have also not appreciated that success with improving the quality of public services, both policy and delivery, is not about techniques but about people and the skills they bring to the formulation of policy and the implementation of that policy. Neither have they appreciated the wider implications of the reform such as the effect that this reform will have upon budgeting and accounting arrangements both for the ministry of finance and within public organisations. They have also not considered whether this is an appropriate reform at this time given the current political, organisational and cultural background. The reform can be seen as 'best international practice' and therefore, by definition, a 'good thing' to adopt. The idea of initially developing a policy design approach, given the managerial implications of the reform, is not recognised and therefore a strategic analysis and planning approach (as with many other technical reforms) is not perceived as a necessary step in the reform process.

9.2.2 The Risks with Implementing This Reform

Implementing this reform is far from being risk free. The possibilities that risks may arise should be considered in the planning and implementation process. The potential risks fall into several categories and these are set out in the table below.

Possible areas of risk	
(i).	Opposition to the reform from political officials and senior civil servants.
(ii).	Those arising from the likely length of time the reform is likely to take.
(iii).	The problems of integrating this reform with civil service reform.
(iv).	The possible difficulties with providing the budgetary information that managers require and the changes needed in the structure of ministry of finance control over spending.
(v).	The problems associated with the need to achieve the integration of the ministry of finance financial information system with the managerial needs of ministry managers: this is potentially a major risk where a standard commercially based financial information system has been acquired and an expert assessment will be required to establish to which the system can be adapted to provide the information managers require.
(vi).	The difficulties with developing the performance information and systems that managers require enabling them to manage effectively the delivery of objectives to the appropriate performance standards.
(vii).	Creating a financially aware management.
(viii).	Developing the appropriate management training arrangements and achieving the changes to personnel management that will be required.
(ix).	Recruiting appropriately skilled staff and retaining them within the public sector and in particular skilled finance staff able to provide the management accounting information managers require.

As the reform will be a long-term reform, clear milestones should be identified and a risk that should be recognised is that of 'reform fatigue'. Those milestones should be identified as achievements with which politicians and the civil service can identify.

The main risks will be to those elements of the reform that result in changes to the distribution of power between political and appointed officials and between central and line ministries. The underlying pressure will be to return to the *status quo ante* at least over time. This emphasises why it will be important to have wide support for the reform from parliament, the prime minister or president, the cabinet of ministers and very importantly from the most senior civil servants. That means that their concerns should be explored from the outset. Other risks are mainly of a technical nature and over time should be capable of solution.

9.3 Implementing the Reform

9.3.1 Learning from Others

This guide demonstrates what a considerable change will be required. What matters most is the people not the procedures, although this author's experience is that with PFM/IC reform the focus is always upon the procedures. And the reform must start at the very top of the organisation, considering both the political and civil service roles. At the civil service level, a mistake (which again in this author's experience occurs too frequently) is to start lower down the organisation with the head of finance.

A practical problem with implementing the reform is that of finding a role model to learn from. This is very difficult. There are many models existing of developing and transition economy countries that have regarded the reform as just a financial and budgetary control reform treating the COSO standards as simply procedural technical standards. The result has added to bureaucracy, and cost, but with no benefit gain. Countries rarely discuss failures although it is from failures that the most important experiences can be gained. "There is not enough attention in the PFM community to failure. Failure is a better teacher than success! If I could see one change in the PFM community, I'd like to see a more open and forthright conversation regarding success and failure in PFM innovation."[3]

[3] IMF Public Financial Management Blog: Interview with Allen Schick Sept. 2011.

The best models come from developed economy countries but this illustrates a major difficulty with implementing PFM/IC reform. That problem is building a modern sophisticated reform onto a traditional system of public administration without also recognising that that system too also requires reform if the PFM/IC reform to be successfully implemented. To move from an administrative culture to a managerial culture is not at all easy. Apart from the reform requiring changes in the distribution of power between different groups, the willingness of civil service (and local government) managers to take risks and to develop new analytical skills can be problematic. The reform is likely to generate resistance, sometimes overt and sometimes covert especially as it may mean making personnel changes and that may require redundancies, promotion of some staff and the transfer of some existing staff to alternative employments.

Success depends on persuading individuals to change the way they work and that requires altering the mind-sets of civil servants and politicians. This is no easy task and the requirements generated by PFM/IC cannot be separated from a more general reform to civil service culture. A publication by the consultants McKinsey on the psychology of change management included these remarks which although directed at private sector organisations are relevant to the civil service: "But what if the only way a business can reach its higher performance goals is to change the way its people behave across the board? Suppose that it can become more competitive only by changing its culture fundamentally—from being reactive to proactive, hierarchical to collegial, or introspective to externally focused, for instance. Since the collective culture of an organization, strictly speaking, is an aggregate of what is common to all its group and individual mind-sets, such a transformation entails changing the minds of hundreds or thousands of people."[4]

McKinsey went on to identify four conditions that were regarded as important:

- Employees will alter their mind-sets only if they see the point of the change and agree with it—at least enough to give it a try;
- The surrounding structures (reward and recognition systems, for example) must be in tune with the new behaviour;
- Employees must have the skills to do what it requires (this emphasises the significance of in-service training);
- [Employees] must see people they respect modelling it actively.

[4] https://www.mckinsey.com/business-functions/organization/our-insights/

What this emphasises is that the strategic analytical and planning report ought to make clear that the PFM/IC reform must be integrated with civil service reform more generally. To treat it as simply a reform of limited interest to the ministry of finance, albeit with a managerial context is not sufficient. An important component of the reform therefore, is how it fits with civil service reform more widely. It also means that those responsible for the development and application of the reform should have regard to the psychology of reform. To do that should mean consultation with experts in organisational change and in particular the psychology of organisational change. Once the strategic analytical and planning report is agreed, then this creates the policy framework to move to the next stage. The head of the specialist 'driver' department should recognise the importance of this point about the psychology of reform.

9.3.2 The Preparation of an Operational Implementation Policy Paper

Once the policy decision has been made to proceed with the reform, a detailed operational implementation policy paper should be prepared. This would be prepared in the name of the ministry of finance state secretary but the head of the specialist PFM/IC 'driver' department normally should prepare this policy paper on behalf of the state secretary. This paper should form the basis for the operational implementation of the reform and it would be based upon the strategic planning and analytical report. It should address the practicalities of the reform, that is:

- Explain how the reform would affect the current administrative/managerial arrangements and how delegation would impact upon the role of political officials separating policy and strategy setting from detailed operational management. The latter would be a civil service responsibility unless there were specific reasons for ministers not to delegate (see next point).
- Central to the success of PFM/IC is the development of delegation and managerial accountability. Delegation tends to be treated as a broad policy requirement but in fact what should be delegated and what not often requires sophisticated judgements and the policy paper should explain the principles that should lie behind the arrangements for delegation and accountability. (This is referred to in Chap. 14.) To ensure there are no misunderstandings, the head of PFM/IC department needs to work closely, as was pointed out in Chap. 5 and above, with those officials responsible for civil service/public administration reform. (Note: The PFM/IC reform

cannot drive the civil service/public administration reform but a failure of the civil service/PFM reform to match the requirements of the PFM/IC reform can prevent that reform being effective.)

- Demonstrate the impact that the reform would have upon civil service organisation and responsibilities (e.g., that each ministry should appoint a senior official to be responsible for the overall management of the ministry, that is a state secretary, with the relevant responsibilities and authority) and not least for the development of managerial structures and responsibilities throughout the organisation including those of the head of finance.
- Consider the practicalities of coordinating this reform with civil service/ public administration reform and the requirement for the civil service personnel policies to be compatible with the personnel policies necessary to implement PFM/IC.
- Because the focus of PFM/IC is upon improving the managerial quality of the civil and local government service, it should include a commentary upon the changes that might be required to the day-to-day personnel (HR) management arrangements (see Chap. 14).
- Consider whether reform is required to the present civil service reward, disciplinary and sanction arrangements.
- Explain the need for each organisation to develop operational objectives and performance standards and performance objectives based upon government policy also recognising that for some services and activities this could be extremely difficult.
- Explain that management responsibility for internal controls would extend to the delivery of objectives and performance standards and objectives and that managers would be accountable for the delivery of outputs as well as inputs and would be required to do so efficiently and effectively.
- Point out the need to develop performance information systems linked to the objectives of the organisation and to ensure that managers could not manipulate such systems to show a better performance than is actually being achieved.
- Emphasise the need for training and especially managerial training for civil servants and financial management training for heads of finance and finance staffs.
- Explain how the reform would affect the budgetary and financial accounting arrangements including the linking of budgets with objectives and performance standards, ensuring stability in cash flows during the year, as well as providing the information managers could need whilst at the same time meeting the needs of the ministry of finance: this would include:

- – Ensuring that budgetary and cash flow forecasts were more stable, especially forecasts of income flows because of the need to avoid significant changes to resource availability for managers during the year;
  - – The changes to the budgetary and financial information available to individual managers and how this may impact upon existing financial information systems;[5]
  - – The impacts upon the role of the head of finance in ministries;
  - – The need for the development of managerial and cost accounting in addition to financial accounting.

- Explain how the reform would affect governance, transparency and accountability arrangements including the consequences for parliamentary and civil society scrutiny.
- Explain how the reform would affect the arrangements for the control of second-level organisations (whether non-market or market-based organisations) and that the first-level organisation must retain a capability to ensure that second-level organisations establish policies that are consistent with those of the first-level organisation and that they operate efficiently and effectively.
- Provide a requirement that strong governance requirements were applied to state-owned enterprises to ensure that such organisations were effectively managed and that their resources were not misused.
- Provide an overview of the benefits and costs (see Chap. 10) including an assessment of the time period over which those benefits and costs may accrue or be incurred.
- Explain the changes that would be required to existing legislation, including the budget law and regulatory arrangements along with those disciplinary and regulatory arrangements which could adversely affect managerial willingness to make decisions and hence the establishment of a managerial culture.
- Follow research advice on the most appropriate ways of introducing the reform, such as using pilot organisations or phasing in over different types of organisations.
- Indicate whether the reform should be introduced in stages or not and whatever the arrangements identify the key milestones that should be achieved to demonstrate progress with the reform. An example of the possible stages is set out below:

[5] Very often financial information systems will have been installed by external consultants and will be 'standard' packages. This may make changes to those systems more difficult to achieve. Alternatively, where a country has developed its own financial information systems, it will need the technical capacity to make the changes that will be required.

Stage		Comment
I.	Clarify the separate roles of ministers and deputy ministers and operational managers	This should be addressed first. The boundary between the responsibilities of political appointees and civil servants will vary over time and may differ between individual ministries. In general, operational responsibilities should be allocated to civil servants with overall responsibility for the quality of operational management lying with the top official within the ministry. He/she would be responsible to the political head of the organisation. However, delegation is a complex issue and the issues to be considered are addressed in Chap. 14.
II.	Require that ministries adopting PFM/IC should define the managerial structures under the chief official to deliver services efficiently and effectively. Regard should be had to the appropriateness of the corporate governance arrangements.	How these management structures should be developed will depend upon types of services being provided. These structures should not be regarded as fixed but capable of change as circumstances change. Particular regard should be had to the role of head of finance.
III.	Arrange with the ministry of finance, and if investment is managed separately with the ministry responsible for investment, the provision to individual managers of the budgetary and accounting information they require to enable them to deliver services efficiently and effectively.	Such detailed information does not have to be available to every level of manager but it should be up to senior management within individual ministries to decide. Again, the allocation of this information may change over time.
IV.	Ensure that individual ministries adopting PFM/IC have developed objectives and performance standards and objectives for individual managers and the arrangements to monitor performance. These objectives and performance standards should be linked to budgetary availability. They should also be accompanied by reporting arrangements.	This could be very difficult to develop for some ministries and managers may require considerable support to achieve this. It will also require clarification of the budgetary arrangements. This process is one that is likely to be refined over time.

(continued)

(continued)

Stage		Comment
V.	Ensure that financial and performance information is available to individual managers to complement the efficient and effective delivery of objectives and performance standards.	This stage will also take time to develop as individual managers and heads of finance gain experience. The extent to which financial and performance information is available affects the extent to which delegation from political to civil service officials can occur.
VI.	Introduce the 'managerial disciplines' that follow from the COSO report.	To try to introduce these disciplines earlier in effect demeans the significance of these disciplines. They can only be of effect in a managed organisation with individual managers taking responsibility for their effective implementation under the authority of the head of operational management of the organisation.
VII.	Develop reporting arrangements about the performance of the ministry and the quality of the internal control arrangements. If possible, also identifying the benefits from the implementation of the policy.	This will include reports to different parties including to the ministry of finance, parliament, taxpayers, civil society and users of the public services. This is an essential element in the development of transparency.
VIII.	Reviewing the successes and failures of the policy to establish how the quality can be improved.	This process of systematic review is important to consider lessons learned and to explore emerging ideas from other countries.

- Clarify the timescales for the reform implementation and given the length of time that will be needed when the key assessment stages (milestones) are expected to occur where progress can be judged.
- Explain the reporting arrangements that will be implemented to the cabinet of ministers.
- Explain the proposed parliamentary reporting processes.

In preparing this policy paper the head of the 'driver' department should:

1. Undertake an assessment, after consultation with state secretaries and other relevant officials including the state auditor, of the strength of the current internal financial and budgetary control arrangements.
2. Assess after consultation with state secretaries and other relevant officials, the appropriateness of managerial structures that presently exist and their adaptability to the managerial requirements of PFM/IC. Establish the cur-

rent extent of delegation of operational management to the civil service (if any) and the arrangements where delegation exists for accountability to the political level of management.

3. Discuss with the ministry of finance department responsible for budgeting and financial accounting arrangements the changes that will be needed to provide managers with the information they require and establish if there will be any difficulties in providing that information. An element of these discussions should be to ensure that the arrangements to link budgets with objectives and performance standards are effective. These arrangements will determine whether such objectives and performance standards and objectives are defined in such a manner that they have the capability of being translated into actual operational objectives. (These difficulties may be of a technical nature, such as the inability of the financial information system to provide the additional information or they arise from other concerns about the potential loss of ministry of finance control. Whatever the difficulties these must be resolved.)
4. Establish what performance information systems exist and the extent to which they will need to be developed.
5. Assess the capabilities of the heads of finance to provide the management and cost accounting information that managers will require.

This operational implementation policy paper should be agreed ideally by the state secretary in the ministry of finance with the most senior civil servant in each ministry before submission to the minister of finance and the government. This is because of the impact that the policy will have upon the organisation and operational management of each ministry. As with the strategic planning and analytical report an aim with the operational implementation policy paper should be to obtain the widest political support (as well as wide civil service support), including the support of politicians who are not presently part of the government. The operational implementation policy paper, or a version of it, should be submitted to parliament. As has been explained above, wide political support is highly desirable because application of the reform is likely to take much longer than the period of office of any one government, and consistency in the policy of application is essential.

Because management and financial training will be a key component of the reform, the policy paper could also explore with academic institutions how this might be developed, and if there is to be an in-service training institution (or one may already exist) how this could contribute to the training needed.

An important feature of the policy paper should be an explanation of how transparency and external accountability will be affected and not least how parliament should be informed about the details of the reform and be able to make comments.

As a result of the discussions that should occur during the preparation of this policy paper, variations from the proposals and information contained in the strategic planning and analytical report may occur. Such variations should be discussed with the key political and senior civil servants before publication.

9.3.3 Actions of the Head of the PFM/IC Department Following the Approval of the Operational Implementation Policy Paper

Once this policy paper has been approved practical implementation will commence. The head of the PFM/IC department should focus initially on the managerial consequences of the reform. Whilst budgetary and financial control remains important, the key to success lies in strengthening or introducing those managerial arrangements, including managerial controls, that facilitate the delivery of the objectives of the government and the aimed for performance standards and objectives, to time, within budget and efficiently and effectively.

Control will no longer simply be about 'inputs', important though that will remain but will also be about the delivery of 'outputs'. Failing to emphasise how important the managerial context along with the consequences for the political and top and senior civil service and local government officials and other levels of management of public organisations, would lessen he emphasis upon achieving objectives and performance standards and objectives efficiently and effectively.

The introduction of a managerially oriented approach to public service delivery with its focus upon outputs and the delivery of those outputs efficiently and effectively will require that a set of managerial disciplines is employed to facilitate the development of a quality management approach. These managerial disciplines which are discussed in detail in Chap. 11 are usually described as international standards of internal control or the COSO standards.[6] However, for the purposes of this reform those responsible for implementing the reform would be better to regard them as 'managerial disciplines' because they inform managers of the features that should exist if an organisation is to be well managed. These managerial disciplines cover five

[6] https://www.coso.org

main areas, that is, the control environment, information and communications, control activities, risk management and monitoring. However, these managerial disciplines will be of little value if a number of preconditions applying to those five areas do not exist. These are referred to in Chap. 11 but include clarity about objectives and performance standards, a managerial structure designed to deliver those objectives and performance standards, the consistency of budgetary allocations with the objectives and performance standards and the linkage of budgetary and accounting information with managerial needs as well as those of the ministry of finance.

An important activity of the head of the department driving the PFM/IC reform, once the decision has been made to implement this reform is to ensure that these standards (managerial disciplines!) are applied. This is not a simple training exercise, not least because these standards impact upon each other and cannot be introduced completely in a single reform process. The quality of application will evolve over time. Whether or not they have been properly applied can only largely be demonstrated by the quality of the outputs of the public organisation. That is, has the organisation achieved delivery of its objectives and performance standards and objectives efficiently and effectively, to time and within budget. Success cannot be judged by whether the bureaucracy associated with those managerial disciplines exists although this is often how application is in practice judged. An important statement which should be required of management annually from which success can be judged is the statement of internal control (see Chap. 13).

9.4 The Ministry of Finance State Secretary Relations with Individual Ministries

Whilst the state secretary of the ministry of finance should have overall responsibility for the application of the reform, each ministry state secretary should also be intimately involved as the reform. This applies equally to spending ministries and income raising ministries such as those responsible for the different forms of taxation. There ought to be regular meetings of these officials chaired by the ministry of finance state secretary. This process will require managing and this will usually occur through secretariat arrangements. The head of the PFM/IC driver department should act as that secretary. The agenda for such meetings should include:

- A review of the implementation arrangements within the affected ministries;
- Overall progress against 'milestones';
- The effectiveness of the coordination arrangements with the organisation responsible for civil service reform and with other reforms which may impact upon the PFM/IC reform;
- Reactions of ministers and other political appointees to the delegation and managerial accountability arrangements;
- Reactions of the civil service to their added decision making responsibilities;
- Emerging difficulties and how they are being addressed and not least in the development of objectives, performance measures and performance standards;
- Arrangements for the development of performance information systems;
- Comments on the availability of budgetary and financial management information for managers;
- Developments in training in managerial disciplines, how this training is proposed to be undertaken and the impact of the reform on personnel management and development arrangements.
- Observations on the enhanced role of the head of finance and the significance of finance in establishing efficiency and effectiveness: is that role being effectively undertaken and if not, what is required for improvement;
- An update on the benefits and costs of the reform.

As part of the practical application arrangements, it would be desirable for the head of the PFM/IC department to also establish two subordinate coordinating groups. One would be with those officials involved with public administration and/or civil service reform and a second with those involved with the practicalities of this PFM/IC reform within individual ministries, particularly those concerned directly with the financial management arrangements. Both groups should have a particular responsibility to identify problems and develop solutions. These groups should in turn 'feed into' the state secretary group chaired by the ministry of finance state secretary.

A main source of information about emerging problems should be through the work of the 'driver' department supporting the state secretary because it should be in regular contact with each ministry implementing the reform. Potential emerging problems could include difficulties in developing objectives and performance standards and in developing the necessary financial and performance information systems required by managers to enable them to be confident about delivering objectives efficiently and effectively. Another problem area could be in securing the appropriate training for managers. A further problem could arise over the development of personnel policies that are consistent with a managerial approach to public administration (see Chap. 14). One of the most sensitive changes that should result from the introduction of PFM/IC will be the delegation of operational management for the implementation of policy and strategy from the responsibility for the development of policy and strategy. In some countries this will have a major impact upon the role of political appointees, including ministers and mayors and on the role of top and senior civil servants. This separation is fundamental to the reform but is not intended to weaken political control but rather to strengthen it by causing control to be focussed on key issues with those key issues being defined by the political management. This is to change from a political management trying to make all decisions, no matter how trivial, on both policy and operational matters.

A further problem with implementing the reform is that the delegation element can be misunderstood leading to resistance and this may be an especial problem where the civil service is not well trained or is politicised (which anyway should raise questions about the appropriateness of this reform). The result can be 'tokenism' in the development of delegation. Similarly, the requirement for each ministry (and other public organisations) to prepare annually a statement of internal control may be a cause of difficulty because this statement involves disclosure of internal control problems that have emerged during the year and the actions taken to correct them.

An important function in the development of relations between the ministry of finance state secretary and other state secretaries is to identify and address these areas of potential problem.

9.5 The Experience, Skills and Attributes Required to Build a Successful PFM/IC Application Team Supporting the State Secretary

The PFM/IC 'driver' department should be staffed with, or have available to it, the following range of skills:

(i). Staff experienced in organisational management, including the setting of objectives, performance standards and performance measures and indicators or that advice on these topics is available (which may include academic advice); and (ii). Persons who are experienced in all aspects of financial management, including budgeting, that is, economists, financial accountants, experts in cost and management accounting and experts in interpreting the trends revealed by financial and performance information.

Such staff may be seconded from other ministry departments or from outside the civil service such as staff linked to university management schools and similar institutions which have an interest in promoting improvements in public sector management practices. (Some of these experts would not be full-time appointments but should be available as required and could be experts specially hired for the purpose, such as experts in the management of taxation.)

Because support may be required in the development of budgeting, financial and cost and management accounting, and these are often in short supply in the public sector, this may involve recruiting or 'borrowing' staff from the private sector. The support that should be looked for should have the capability to assist public organisations in the development of objectives, performance standards, performance measures and indicators, in developing strategic financial planning, in suggesting cost centre analysis and in routine performance analysis. They may also need to assist managers in ministries in developing business and strategic plans. In addition, such staff should be familiar with pricing where public organisations earn income from charges so that organisations can be helped to identify whether charges properly reflect the costs of providing services and activities and where costs are not to be fully recovered, the extent of any subsidies and who benefits from those subsidies. The budget available to the 'driver' department should reflect the wide diversity of skills that are required to apply the reform.

In those countries where PFM/IC has been interpreted as primarily an enhanced form of financial control, the initial focus in the introduction of this reform has been upon the development of internal audit. This is very unfortunate and ignores the key managerial perspective of the reform. It is in effect 'putting the cart before the horse'. First, it confirms preconceptions that PFM/IC is simply a finance orientated and basically financial control activity. Secondly, it tends to encourage politicians (who may be wholly unfamiliar with the requirements of management) that this is simply a financial reform and that it does not have the wider impacts upon managerial structures, budgetary and accounting and performance information arrangements, if the benefits are to be achieved. Thirdly, this in turn affects attitudes towards what is the necessary staffing structure and organisation of the department within a ministry of finance responsible for supporting the state secretary. Of course, improvements to internal audit should always be looked for but they are not a precursor to the development of PFM/IC. Internal audit will be affected by the development of PFM/IC, but then so will many other aspects of public financial management, as this guide shows.

In summary, the successful application of PFM/IC requires a broad managerial approach to the reform; it requires reforms to budgeting and accounting arrangements and the availability of a wide range of skills within public organisations. The 'driver' department will require a corresponding range of skills. Not all will be required immediately and not all will be a full-time requirement so the staffing arrangements for this department should be flexible. A responsibility of the head of the 'driver' department should be to ensure that the relevant skills are available when needed and of the right experience and calibre. That is likely to require a flexible approach to staffing and quite different from traditional arrangements. The head basically requires the same flexibility in the delivery of the objectives of the department as the department will be trying to encourage to exist in other managements.

9.6 Achieving Local Ownership of the Reform

Ensuring local 'ownership' at each ministry level is an important factor in the successful application of the reform. Although this reform will be promoted by the minister of finance, the potential benefits to individual ministers in helping them to achieve their objectives are substantial. The reform also provides opportunities for the civil service to develop its skills, responsibilities and initiative in achieving the relevant minister's objectives.

At the political level achieving local ownership will be primarily a responsibility of the minister of finance. At the operational civil service level this will be a responsibility of the ministry of finance state secretary working in partnership with other state secretaries (or their equivalents). These officials will generally provide the continuity of 'ownership' that political officials cannot provide. The head of the 'driver' department has a duty to make clear, either directly or through the ministry of finance state secretary, that responsibility for applying the reform within each public organisation and for ensuring that the quality is maintained should lie with the most senior appointed official in the organisation, that is, the state secretary (or equivalent in local government). Therefore, a considerable effort will be required in presentations to and discussions with these officials. In this author's experience a frequent mistake is that too much focus is given to informing and training more junior officials such as heads of finance in line ministries and then only in the bureaucracy of the reform processes rather than in informing and generating an understanding of the purpose of the reform at the highest levels of the administration. This does not achieve local ownership.

The role of the minister of finance is very important in the actual application of PFM/IC because that minister will need to act to ensure that political colleagues accept and in turn also fully appreciate what the reform means for them. The ministry of finance state secretary with the support of head of the 'driver' department consequently has an important role in providing a full brief to the minister of finance on the implications of introducing this reform, for supporting the minister in the promotion of the reform, and for informing the minister on progress with implementation. The head of the 'driver' department may do this directly or through the ministry of finance state secretary.

9.7 The Practical Issues the Head of the PFM/IC 'Driver' Department Should Address

Set out below are the practical issues the head of the PFM/IC 'driver' department should consider in supporting the ministry of finance state secretary in the application of PFM/IC. Essentially the aim is to create a modern management style of organisation. Therefore, coordination with civil service reform is so essential and the civil service personnel policies should be compatible with those needed for the application of PFM/IC. These issues are all covered elsewhere in this guide, but are brought together here as a form of 'checklist' for the convenience of the head of this 'driver' department to ensure that his/her advice to the state secretary covers all the issues. The order of the items is also important. For example, there is no point in seeking to introduce the bureaucracy of the procedures associated with the reform until other elements of the reform process, and not least the managerial elements, have been introduced. The procedures should be designed to facilitate the development of quality management. They are not ends in themselves. Therefore, for example, the introduction of the COSO standards (managerial disciplines) should come later in the process rather than as almost the first steps to be taken following the approval of the policy paper. To regard them as 'first steps' indicates that the COSO standards are not seen as managerial disciplines but as the equivalent of other technical standards such as internal audit standards. Yet these managerial disciplines, as the name implies depend upon the existence of an effective management and that management is also responsible for maintaining their quality of application. This is a primary responsibility of the head of operational management in each public organisation.

As this is a long-term reform some of the activities will only mature over a long period of time such as raising financial awareness or improving the efficiency and effectiveness in the delivery of public services. However, what is important is that the structures are put in place to facilitate this. An example would be making it possible for managers to have available the type of budgetary and management accounting information that they may require. Also, some of the issues that need to be addressed are complex, and whilst the principles can be stated the actual practice can require careful consideration. This applies to one of the central features of PFM/IC which is delegation and managerial accountability. In Chap. 14 the issues about the appropriateness of the arrangements for delegation and the development of managerial accountability are discussed in some detail. There is not necessarily a simple solution.

The references in the schedule of activities set out below are to ministries and civil servants, but as local governments and other public organisations should also, at least over time, apply the reform these requirements should be adapted to cover local governments and other public organisations and to their officials.

The practical issues that the head of the PFM/IC 'driver' department should be responsible for include:

1. The preparation of an operational implementation policy paper, action plan and timetable on behalf of the state secretary. (The possible contents of this paper have been set out above.)
2. Once the operational implementation policy paper has been approved the head should prepare with the appropriate legal authorities any new laws and regulations to facilitate the processes of application envisaged in the paper. Those new laws and regulations, if required, should cover, *inter alia*:

   – Codes of practice governing the actions and behaviour of politicians and senior civil servants;
   – Managerial accountability arrangements including rules about the delegation of authority for decision making and reporting arrangements;
   – Contracting and procurement (which should be regarded as integral to the development of effective PFM/IC);
   – The rules about approvals for investment decision making;

- The rules about who can accept responsibility for what types and values of financial transactions and other aspects of financial activity (see also Chap. 5 and the annex to that chapter on the purpose and content of the financial regulations);
- The arrangements for risk management, including both systems risks and managerial risks; and
- Corporate governance and financial reporting arrangements.

3. The head should ensure that the arrangements for internal audit reflect the change in the style of public administration to one of management and that managers in making decisions involve them in accepting some degree of risk. Internal auditors should be aware of the impact that the reform will have upon the current reporting arrangements and the issues they should be concerned about, not least how managers not only exercise their responsibilities for financial and budgetary control but also for improving efficiency and effectiveness.
4. The head should arrange on behalf of the ministry of finance state secretary the coordination arrangements with all other state secretaries creating the secretariat arrangements for that coordinating body (see earlier in this chapter).
5. The head should discuss with individual ministry state secretaries and other chief officials, as necessary, the arrangements for the development of operational objectives and performance standards based upon ministerial determined objectives and performance standards and objectives; the need for performance information; the linkage with the arrangements for organising managerial structures to deliver those objectives and performance standards and objectives. This may require the employment of specialist experts, for example, on education and social welfare policy, on policing or on the management of prisoners. Exactly what may be required will depend upon the objectives of the relevant minister. It may also require that the head of the department responsible for implementing PFM/IC may need to give advice on what is required and where the 'delegation boundary' should be drawn permitting civil service officials to make operational decisions.
6. Because of the impact upon the budgeting and accounting arrangements, the head should discuss with the ministry of finance budget department and the financial accounting department as well as with state secretaries how to achieve budgetary and cash flow stability and the information that managers will require if they are to deliver the objectives and performance standards required of them efficiently and effectively. The latter is likely to

require a radical change to the current arrangements for budgeting and financial accounting. (See Chaps. 5 and 8.)

7. The head should also discuss with the relevant ministry of finance departments the revised arrangements for the exercise of budgetary controls to ensure that the authority of managers to deliver objectives efficiently and effectively is not inhibited by too detailed an external control process.
8. A critical activity for the head would be to continuously ensure that there is compatibility of the civil service/public administration reform policies with those for PFM/IC, including the timing of the two reforms.
9. As success in the application of PFM/IC depends upon people the head should ensure that a relevant and effective HR policy exists to support managers. (See also Chap. 14. This may be for individual organisations or collectively and it may require change to existing arrangements.) Therefore, the head should discuss with the ministry of finance state secretary the personnel management implications of the reform with the aim of ensuring that the organisation responsible for civil service personnel management arrangements and individual state secretaries accept the need for personnel management arrangements which are compatible with those necessary to recruit, train and manage the managerial and financial staffs who will be required to secure an effective reform. This should also include that state secretaries should ensure that appropriate channels exist to allow staffing concerns to be identified and addressed. This may require the development of staffing review, whistle-blowing and similar arrangements.
10. This review of the personnel arrangements should also include a review of the staff reward, disciplinary and sanctions arrangements. As has been explained earlier in this guide, PFM/IC requires that civil servants make operational decisions and all decision making involves risk. An inappropriate disciplinary and sanctions process can inhibit the willingness of civil servants to take risks and hence in turn inhibit the development of delegation.
11. The head should advise the ministry of finance state secretary who in turn should advise the minister of finance about:

   – The consequences of the development of external accountability and transparency (see Chap. 8 and the role of the head of finance) including the information parliament and civil society is likely to require once the reform is introduced (which probably will be more extensive than that traditionally made available);
   – The arrangements for reporting to parliament on the proposed reform and then on the progress of the reform;

- The impact on the role of the state auditor and parliamentary scrutiny processes.

12. Even though there may be acceptance at the government level of the implications of the reform, at the individual organisation level different ministers and the senior civil service officials may in practice have reservations and differing views about how far this distinction between the responsibilities of ministers and operational managers is acceptable to them. This is even though the political heads of organisations may have volunteered to be pilot organisations, but they may have done so without realising the practical consequences. The result is that this is likely to involve the head of the 'driver' department in extensive negotiations. Very often the issue is about personalities, confidence and hence trust. Trust is especially needed since many governments have experienced previous reform failures leading them to ask—will this work? Establishing confidence in the reform at the most senior levels, particularly at the most senior civil service levels, is essential because it is they who will communicate confidence (or lack of it) to other more junior officials.
13. The head should introduce to state secretaries the managerial disciplines associated with PFM/IC, that is, the five COSO standards. The preferable order of introduction should be that set out in Chap. 11, that is, the control environment standard; the information and communications standard; the control activities standard; the risk management standard; the monitoring standard. The responsibility for securing the application of these standards is that of each state secretary, who should also ensure that the same standards are also applied in the controlled second-level organisations. As these standards are about management, there may be a need to involve academic management trainers in providing support, on the understanding that those trainers have an appreciation of the public sector operational environment. Over time the most effective alternative may be for a country to develop its own in-service management training organisation. This training should include the setting of operational objectives and performance standards, the development of managerial structures and arrangements for delegation and managerial accountability. It should also include training in leadership and in the management of people.
14. Ensure that the head of finance (who would almost certainly be involved in the training envisaged in point 16 below) is familiar with those requirements of PFM/IC that will impose on him/her additional responsibilities. These arise because of the change to a managerial approach to

the delivery of public services coupled with the need to improve efficiency and effectiveness. The head of the PFM/IC 'driver' department should initiate the development of training programmes to improve the quality of management. These training programmes should also cover cost and management accounting and longer term financial planning. The capabilities of the head of finance and those of the finance staff should be particularly addressed. This is because with PFM/IC the responsibilities of the head of finance and the staff of a finance department go well beyond budgetary and financial control. Training should also be provided to managers in the utilisation of cost and management accounting. (Training requirements for the head of finance and finance staffs were discussed in Chap. 8.)

15. The head should also ensure that state secretaries recognise that because of the introduction of the PFM/IC reform there will be a greater emphasis upon strategic planning and strategic financial planning and where appropriate business planning (see Chap. 8). This longer term approach to management is essential in improving the efficiency and effectiveness of public expenditure as well as ensuring the long-term financial resilience of the organisation. The head of the 'driver' department should ensure that these longer term financial planning processes are a feature of individual ministry financial management arrangements and therefore that that department has a capability to support management in this development.
16. The head may also need to support the state secretary in individual ministries, as necessary, in developing the delegation and managerial accountability arrangements to be applied within the operational management structure for the ministry (see Chap. 14).
17. A feature of management with the introduction of PFM/IC is that 'financial awareness' needs to be developed throughout the organisation. The head of the 'driver' department should ensure that this is a feature of the development of operational management. Consequently, managers at all (or most) levels will become primarily responsible for the effectiveness of the budgetary and financial controls as well as the controls necessary to deliver objectives. This latter group of controls should be designed to deliver the objectives of a ministry to time, to standard, within budget and efficiently and effectively. The head should ensure not only that the state secretary and other senior civil service officials appreciate the significance of this change but also managers at all levels are properly trained and have an appreciation of the need for financial awareness.

18. Following on from the previous point, for budgetary control and financial management purposes, the financial information that an operational manager needs to have available, given the requirement to deliver efficiency and effectiveness, should be designed to meet the operational manager's needs and not just the needs of the ministry of finance for budgetary control purposes. Where this need will be entirely new (as it is likely to be in the majority of circumstances) specialist advice should be available to managers either provided directly by the staff of the 'driver' department or obtained by that department from third parties such as academics and/or private organisations delivering services and actively aiming to control costs. Some of the factors that should be considered were referred to in Chap. 8 but include:

 – Managerial financial and performance analytical needs which will include, for example, analysis of costs over objectives, cost centres, cost drivers and any other form of analysis that a manager deems helpful. Budgetary and accounting coding structures should be sufficiently flexible and elaborate to permit this and this may mean, as has been shown in earlier chapters, that each ministry should be able to agree with the ministry of finance the development of the national chart of accounts coding structures (a top-down responsibility of the ministry of finance) so that managers have available to them the information they require (a bottom-up responsibility of individual ministries). This would enable the need of both the ministry of finance and that of individual ministry for management accounting information to be met.
 – Managers should be able to determine the values that should be included in the budget relative to the objectives and performance standards they are expected to deliver, if they are to accept it. In some countries the extent of the discretion available to managers in the formulation of the budget is extremely limited by the ministry of finance and this will need to change. The position should be that if the manager considers that the available budget is inadequate to meet the objectives and performance standards and performance objectives these latter should be adjusted as part of the budget negotiations so that budget, objectives and performance standards and objectives are compatible.
 – Again, change may also be required to the arrangements for contracts for the procurement of goods, services and assets where they are incompatible with the development of managerial accountability. This can occur, for example, where the administrative or other rules may require that only lowest price tenders are acceptable, irrespective of the

quality of the proposal or indeed the reputation of the contractor. Also, a manager may have no ability to change from an original procurement plan where a change of specification occurs or even a change of price. All these restrictions inhibit the ability of a manager to exercise discretion, achieve efficiency and effectiveness and hence impact on the manager's accountability.

– Managers can have relatively little discretion in some countries to change agreed budgets even when circumstances change. Whilst it may be appropriate for a manager to seek authority for change where that manager regards change as necessary (after all a budget is only a plan), limitations can reduce the discretion available to the manager and hence his/her accountability. The introduction of PFM/IC should cause the head of the department responsible for the reform to encourage a review of the scope for discretion over budgetary changes, that is, to encourage the adoption of virement rules which are relevant to the managerial context that applies with PFM/IC.

19. State secretaries should be responsible for the ongoing quality of financial management and internal control. This should culminate in the annual publication of a statement of internal control (see Chap. 13). The head of the 'driver' department should specify on behalf of the ministry of finance the content coverage of this statement. In preparing that statement the state secretary will require the cooperation of the head of finance and of internal audit. This statement, which will focus on the achievements and non-achievements in terms of meeting objectives and performance standards as well as on the strengths and weaknesses of the financial and budgetary controls, will provide the main indicator of the effectiveness of the reform. In monitoring whether these guidelines have been successfully applied, the evidence trail should start from whether agreed objectives and performance standards and objectives have been delivered within budget and to time, and if not, then the question is why not? These statements ideally should be published and should be regarded as a key source of evidence by the 'driver' department of the effective application of PFM/IC by a ministry.
20. An important feature of public sector management in many countries is the existence of second-level organisations. A discussion about these organisations is included in Chap. 12. The head of the 'driver' department should ensure that service level agreements (or equivalent) exist, that state secretaries have the necessary support in developing such agreements and that they are regularly reviewed (as should the need for the continuation of the existence of the second-level organisation). The head should also

ensure that the controlling ministry exercises effective supervision of such organisations. Effective supervision means that the controlling organisation:

- Always approves the budget of the second-level organisation;
- Requires that the second-level organisation budget is incorporated into its own budgetary requirements and is not, as in some countries, submitted separately to the ministry of finance;
- Ensures that the budgetary requirements are linked to the expected objectives and performance standards;
- That those objectives and performance standards are met, or if not, that the reasons for failure are adequately explained;
- That the financial returns expected of state-owned or local government trading organisations should be subject to the approval of the controlling ministry and that such organisations should not operate in a manner which could prevent the development of the private sector market; that the controlling first-level organisation has a detailed concern about the financial returns being achieved, investment requirements, the corporate governance and accountability arrangements and certain types of payments such as for entertainment, travel and senior official remuneration.

The head of the department responsible for the application of PFM/IC should also ensure that the controlling ministry has a policy and technical capacity to fully monitor the activities of second-level organisations.

21. Corporate governance along with transparency and hence external accountability (not least to parliament and civil society) are features of PFM/IC. Advice and support are likely to be required by ministries to establish each of these features, particularly over the publication of financial and operational information. The COSO framework specifically refers to reliability, timeliness and transparency in external reporting but the framework recognises that other factors may be relevant as well depending upon local requirements. Not the least of these will be parliamentary requirements. The likelihood is that each public organisation should be expected to produce an annual report explaining the utilisation of financial resources and what it has achieved or not achieved compared with its objectives. A further example of transparency will be the need to prepare statements of internal control (see point 22 above) including, or as a separate statement, information about how the organisation addresses risk along with its risk appetite. This transparency requirement could well

be a cause of difficulty because the identification of deficiencies which may have occurred and been included in the statement of internal control, or of the extent to which an organisation is prepared to accept risk, may cause public controversy. However, transparency is a key element in the accountability process and attempts to suppress transparency should be resisted by the head of the 'driver'. (The external auditor is also likely to have a specific interest in the external reporting arrangements and in the extent to which transparency has been achieved.)

22. Increased transparency and accountability have two practical consequences that the minister of finance should consider (and hence that the head of the 'driver' department and the state secretary should be aware of). These are first, that members of parliament should receive training to enable them to appreciate the managerial change that PFM/IC will bring about and therefore how their enquiries should be focussed to secure effective parliamentary scrutiny. Secondly, both senior official managers and politicians should also receive training in how to respond to external, particularly parliamentary, scrutiny.
23. An important activity of the head of the 'driver' department will be to ensure that internal audit has a full appreciation of the managerial implications of this reform and that it sees its role as a support to management and that control is about much more than traditional financial and budgetary controls. This developed role will include advising management on:

    – The quality of budgeting when related to envisaged objectives and standards of performance and performance objectives;
    – The relevance of the financial and performance information available to managers to assess and improve the level of efficiency and effectiveness;
    – The quality of the widened scope of the internal control arrangements;
    – The accuracy and appropriateness of the annual statement of internal control;
    – The relevance, accuracy and timeliness of the financial information being made available to managers and on the arrangements for transparency and corporate governance.
    – The key internal audit reporting line, as was pointed out in Chap. 7 should be to the head of the civil service in the organisation and an audit committee where one exists, with the right to report to the appropriate political official where the auditor deems that appropriate. A training programme should therefore be developed for internal auditors.

24. The managerial context of the PFM/IC reform ought to set the context for other reforms. The head of the 'driver' department should recognise that other public financial management reforms cannot be effective without the development of a managerial context. Managers must make decisions based upon the tools and information available to them. If there is no managerial context such other reforms are unlikely to be successful. Examples are the introduction of programme/performance budgeting and accrual accounting. These reforms impact upon the PFM/IC reform, and for them to be successful the managerial framework of the PFM/IC reform should exist. These different reforms need to be integrated because they all require a focus on management, the setting of objectives and operational standards and objectives and on the availability of information. A responsibility of the head is to ensure that this integration occurs. This of course also means that the head of the 'driver' department should be familiar with the operational implications of these other reforms. The head should seek to ensure that the timing of those reforms is linked to the development of PFM/IC. (It cannot be to the complete development of PFM/IC because of the long-term nature of that reform but the essential managerial framework with the acceptance of the ideas of objectives, performance standards and objectives, delegation and accountability including the reforms to budgeting and accounting should already be in place.)
25. At least annually and probably more frequently in the early development stages of the reform, the head should prepare for the state secretary in the ministry of finance a formal report on progress with the reform, i.e. a monitoring report, identifying any problems, with possible solutions and changes that may be required or new developments that might be proposed. This report should be discussed at the envisaged meeting of state secretaries (see above) and in turn should be submitted to the minister of finance. The minister in turn should be accountable to parliament, perhaps six monthly as well as annually, for the progress being made. This is a report that the state auditor ought also to see.
26. Supporting the state secretary by acting as the secretary to the group of state secretaries in the practicalities of applying PFM/IC. (See Chaps. 5 and 7.)

9.8 Summary

The head of the PFM/IC 'driver' department has a very important role in ensuring that there is a full appreciation of what this reform means for the management of public services including those organisations responsible for the collection of taxation and other forms of public income. The key challenge is the creation of a modern managerial style of organisation. The ministry of finance state secretary, under the authority of the minister of finance, should have overall responsibility for the application of the reform throughout the public sector. The head should support the ministry of finance state secretary in promoting the reform to other senior civil and local government appointed officials responsible for the operational management of public organisations. Promotion of the reform to public organisations should start with these senior officials and not with lower level officials. The aim should be to secure local ownership of the reform and to make the officials aware of the benefits that can be achieved. This is particularly important where foreign aid agencies are involved who may have a limited appreciation of the country cultural and managerial context. Where support with the reform is being provided by foreign aid organisations, the head of the 'driver' department should ensure that their recommendations are relevant to the needs of the country and are not just a 'standard package' of reform proposals. An important responsibility of the head of the 'driver' department is to maintain control over the direction of the reform and to do that the head must have a thorough appreciation of what the PFM/IC reform is really about.

Not the least is the recognition that coordination of this reform with civil service or public administration reform is essential.

The introduction of PFM/IC will cause radical changes to the way in which public organisations are managed and this could well generate opposition. There is every possibility that senior officials (political and appointed) may object to the reform and this reaction should be anticipated and policy options prepared. Failure to address this potential problem is likely to result in, at least, the gradual re-establishment of the former administrative arrangements.

An essential feature of the reform process should be a strategic analysis of the strengths and weaknesses of the present arrangements, including the budgetary processes and the problems and risks that implementation will generate. This analysis may result in the conclusion that this reform is inappropriate at the present time and that a different reform would be more appropriate. The fundamental point is that this reform requires a complete change in the style of the management of public services, including how its finances are managed. The emphasis adds to the traditional financial input controls the control of outputs, although such a shift can only be justified if input controls are strong and remain strong. A consequence of the reform is that the responsibilities of the most senior civil service or local government administrator in a public organisation change considerably and become much more extensive compared with those of a traditionally organised public administration, not least because of the focus upon improving efficiency and effectiveness. This means that an important emphasis should be on developing policies to respond to the potential opposition from senior officials who have an entrenched view about traditional approaches to the administration of public services and this may require that they be replaced. Another important emphasis should be placed on management training, rather than simply on the bureaucracy associated with the reform, which is what very often happens. Because finance becomes a central feature of decision making with PFM/IC, the development of the role and skills of the head of finance is very necessary. The responsibility of the head of the 'driver' department is to design and facilitate both these areas of training, not to undertake them.

The responsibilities falling upon the head of the PFM/IC 'driver' department as well as upon the ministry of finance state secretary are considerable. Together they should ensure that the 'driver' department is properly staffed with a range of expertise to support the reform. To support the application of the reform the state secretary with the support of the head of the 'driver' department should aim to achieve coordination of the reform through regular meetings with other state secretaries and officials to discuss application issues and solutions to problems that may be emerging.

10

Achieving the Benefits That Introducing PFM/IC Can Generate and Accounting for the Costs

Adopting PFM/IC creates the opportunity to achieve important benefits. These are explained in this chapter. However, these benefits will only materialise if the political and senior official management of public organisations recognise these benefit opportunities and are determined that they should be achieved. To achieve these benefits the political and senior official levels of management need to recognise that PFM/IC should be treated as fundamentally a management reform. The benefits arise principally from the better quality of management that PFM/IC facilitates.

The application of the reform is not 'cost free' and the full range of costs should be identified. They cover a wide range of issues and are about the professionalisation of civil and local government service management. The process of identifying and assessing the costs will help, particularly ministries of finance, to establish the range of issues that need to be considered to apply the reform and perhaps may also help them decide how they wish to proceed or even whether to continue with the reform. Exactly what a particular country's costs will be depends upon the starting point, that is, what information is currently available and the extent to which the associated managerial arrangements require reform. However, whatever the circumstances a major cost will be an investment in training, not just training in technical matters but in developing the skills of management. Success with achieving the benefits of the reform ultimately depends upon the quality of management. Other factors in assessing the costs include the proposed coverage of the reform (i.e., affecting all public organisations or only some), proposals for the phasing of the reform and the likely time the reform will take to achieve comprehensive application.

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_10

10.1 Management and Policy—The Core Factor in Achieving the Benefits of PFM/IC

The PFM/IC reform is not easy to apply. The benefits do not 'automatically' emerge and they will mainly only emerge over time. Achieving the benefits is made possible through the development of good quality policy and the actions of managers responsible for the operational delivery of public services which the introduction of PFM/IC facilitates. Policy making is improved because PFM/IC potentially makes available better quality information to policy makers and to the operational managers advising them. Operational managers are enabled to make better quality decisions based upon the financial and performance information that should become available to them. But they need to know how to use that information, including how to motivate their staff to secure efficient and effective delivery of objectives and performance standards and objectives. In other words what becomes available is a combination of performance and financial analytical information to support the political and operational management objectives.

A feature of PFM/IC is effectiveness along with increased transparency and accountability. Effectiveness in expenditure requires that regard is had to the interests of the user of the service being provided, that is, is it relevant to their needs and provided in a manner which is convenient to the user? Effectiveness in income generation, particularly taxable income, depends upon clarity of the income generating policy (especially true for tax policy) and its consistency with government expenditure policies (e.g., fuel duties could be consistent with a government policy to reduce harmful emissions). Tax policy ought not to distort the development of the economy. Effective tax policy often also evolves from wide consultation, something that governments are not necessarily particularly good at. Introducing PFM/IC means that Top management will need effective communication skills to respond to increased parliamentary and civil society scrutiny of operational and tax performance.

None of the available literature on the development of PFM/IC[1] specifically refers to the benefits that can accrue from the reform. The impression given is that the benefits that do arise come from strengthened internal control processes and then largely limited to financial and budgetary controls. The linkage with an enhanced role for management and the controls it needs to deliver objectives and performance standards and objectives is usually not

[1] For example, the 'Orange Book' published by the European Commission: Welcome to the World of PIFC: 2006.

considered. The discussion usually does not extend to the quality of management or the impact of enhanced transparency and accountability.

In describing the opportunities for generating benefits, Sect. 10.2.2. below shows how the focus on management, coupled with the additional financial and performance information required by the development of PFM/IC, creates the possibility to improve the efficiency and effectiveness with which public services are delivered and public resources used. This is central to the achievement of the benefits because it facilitates better quality policy making as well as better quality operational management. The section builds upon comments made in previous chapters of this guide. But to allow those benefits to emerge, budgetary stability is of central importance. Without the implementation of PFM/IC these benefits would not be available.

10.2 The Benefits of the Reform

10.2.1 Budgetary Stability

To achieve the benefits of the reform, one of the most important factors besides the opportunity to improve the quality of policy making and operational management is budgetary stability and its accompanying partner cash flow stability. Budgetary stability means reliability in funding from the ministry of finance to individual ministries and other public organisations. The reality of management in many developing and transition economy countries is that budget funding is unstable (often caused by unreliable forecasts of taxable income) and managers are consequently very often mainly concerned with how to manage with shortfalls in funding and budgetary uncertainty. Such uncertainty effectively prevents management from achieving efficiency and effectiveness and diverts the management focus from achieving objectives. An example of this is from a report into the effectiveness of the Health Sector Services Fund (HSSF) in Kenya. Here researchers from the KEMRI-Wellcome Trust Research Programme and the London School of Hygiene & Tropical Medicine evaluated the HSSF. One key challenge (and there were several) to effective implementation that they identified was delays in receiving funds and arduous financial reporting requirements, both of which affected the ability of facilities to deliver services effectively.[2] Similarly, a report prepared by US Aid on challenges to ensuring adequate and timely funding

[2] https://resyst.lshtm.ac.uk and Policy Brief, April 2015 KEMRI/Wellcome Trust: Health sector planning and budgeting in Kenya: recommendations to improve alignment.

for maternal, new born and child health commodities covering Bangladesh, Kenya, Nepal and Uganda identified major bottlenecks that adversely affect financing and therefore access to the required commodities. These bottlenecks included, funds for health commodities were not allocated based on evidence, which leads to inadequate funding or budget allocations, disbursed funds do not always match the allocated funds or budget, delays in disbursement slow commodity procurement and distribution and complex processes for budgeting and financial reporting delay auditing.[3]

A good annual budget is underpinned by at least a realistic annual plan. Where inadequate budgeting arrangements are the reality, it does raise a question about whether PFM/IC is an appropriate reform in such circumstances. Regular instability and shortfalls in funding indicate that the budget process is deficient and, in such circumstances, aiming to build a sophisticated system like PFM/IC is almost certainly inappropriate without basic budgetary reform. Introducing PFM/IC will not solve underlying budgetary problems (just as it will not solve underlying financial control problems caused by indiscipline or by fraudulent or corrupt activity. These problems must be addressed first.)

10.2.2 The Sources of Benefit Derived from Better Quality Management

The benefits that are potentially available from introducing PFM/IC arise from the following.

(i) *Linking financial inputs with outputs and the professionalisation of 'management'.*

PFM/IC adds significantly to the responsibilities of management because it requires that management should have objectives and performance standards and objectives and be expected to deliver them efficiently and effectively. Given the size, complexity and the nature of the objectives of most public organisations, responsibility for operational management activity ought to lie with a professional managerial civil or local government service. Professional management requires specialist skills and experience and advantage cannot be taken of the benefits of applying PFM/IC without the existence of such a management. As is pointed out elsewhere in this guide, civil service reform is an essential concomitant to PFM/IC reform. It would be most unlikely

[3] https://www.usaid.gov: Challenges to Ensuring Adequate and Timely Funding for MNCH Commodities.

that a single individual (a minister or mayor) or a small group (deputy ministers and deputy mayors), appointed for political reasons without the practical experience of public service operational management would have the skills needed to deliver complex public services, no matter how skilled they may be, and be able to generate the benefits that PFM/IC potentially makes available. In practice, without managerial reform, many elements of PFM/IC, such as all those necessary to achieve efficiency and effectiveness, will go by default. Therefore, introducing this reform will, or ought to, lead to the development of a more professional operational management. Successful operational management depends upon the employment of persons with managerial skills and with considerable experience, or whose managerial skills can be developed.

The quality of operational management determines the quality of policy application, the efficiency and effectiveness of the utilisation of public resources and the ability to engage with parliament and civil society in the scrutiny of public organisation activity. Without good quality operational management, the political level of management is exposed to added risk and criticism. It also cannot take advantage of the benefits that PFM/IC makes possible.

(ii) *The focus of the management interest has a greater emphasis upon outputs (what is being achieved) and performance, and not just with what is being spent (the inputs).*

The immediate impact of this change of emphasis is to improve the possibility that a government (central or local) will achieve its objectives. But it will only do so if those objectives are well defined and the focus on management attention is upon delivering those objectives, to time, within budget, efficiently and effectively. All of this requires a much higher quality of and well informed operational management. Management activity will take up more time than the relatively simple task of delivering services and only being concerned with controlling 'inputs'. PFM/IC is designed to provide the tools to assist managers in this complex task. PFM/IC provides politicians with greater confidence, although not absolute confidence, because no government controls all circumstances (witness the 2020 corona virus pandemic) that its objectives will be delivered and that they will be delivered efficiently and effectively.

Therefore, applying PFM/IC in substance is essential if a government is serious about achieving its objectives and doing so efficiently and effectively.

(iii) *A feature of PFM/IC is the need for better quality planning such as business planning, forward strategic planning and strategic financial planning*

Business planning (described in Chap. 9) should be undertaken by operational management and should involve the head of finance as well as the relevant managers. The benefit that business planning has is that operational managers are required to define how they will deliver a policy, examine the alternatives in a disciplined manner and then selecting the most appropriate arrangements, subject to any political approvals that may be required. The political level of management consequently has the benefit of a well-informed assessment of a policy. That in turn may result in a reassessment of political policy decisions. The benefit is the reduced possibilities of wasted resources and more effective delivery once the policy is determined.

Another factor affecting the delivery of objectives is the focus on strategic planning. This means that much more emphasis is placed on assessing all the factors affecting the delivery of objectives including the current and longer run financial and operational implications. This reduces the possibility of 'unforeseen' events including financial pressures impacting upon the ability of an organisation to achieve its objectives. Top operational management should engage in strategic planning as part of the process of informing political management. Strategic planning requires a longer term assessment of what is needed to achieve an objective and of the constraints including financial, environmental, personnel, technical and other constraints that will impact upon the possibilities of achievement. This makes the likelihood of achieving the objectives more likely and reduces the risk of unforeseen events impacting adversely upon the level of achievement. Therefore, again there is less likelihood that resources will be wasted.

Strategic financial planning requires a forward look at all the factors which could affect the finances of the organisation into the future. For a public organisation to run out of funds, sometimes almost 'overnight' is both a reputational and an operational disaster as well as causing an actual or potential significant waste of resources. A feature of effective financial management is that decisions are not made which impose unsustainable financial commitments on the organisation in the future. Effective management of commitments is essential to avoid overspending. A manager must consider the impact that policy and investment decisions will have upon future current budgets and whether the costs of current policies can be afforded or whether those policies need to be changed.

Long-run financial resilience of an organisation should be a managerial aim and strategic financial planning enables decisions to be made which are less likely to over commit the organisation financially into the future. This, therefore, reduces the risk of political and top operational management having to make short-term, often inefficient cuts to service provision in order to meet a budgetary or other financial constraint.

(iv) *Managers are required to address the risks that may affect the delivery of the objectives.*

Delivering objectives carries elements of risk. This requires operational management to identify and consider the impact of those factors (i.e., risks) which may make it difficult or impossible to deliver the objectives that have been set and to consider how to best manage those risks. Risk management also reduces the costs that may be incurred because of the occurrence of unforeseen events. This again reduces the possibility of waste of public resources and makes more likely the achievement of political objectives.

(v) *Managers can actually achieve greater levels of efficiency (see also item xi).*

An effective operational management should always be concerned to achieve improvements in efficiency. The operational manager should therefore know what drives costs, the costs of each operational activity, each cost centre and how costs would be affected by different pressures, such as more or less demand for a particular service or activity, that is, how performance affects costs. This emphasises the importance of linking performance information with costs. Cost analysis is also essential if appropriate decisions are to be made where the provision of services or activities involves charges levied upon the users of those services. Where charges are not based upon full cost recovery, this means that some users will be subsidised and the manager should know which users and the extent to which they are being subsidised. Cost analysis should not only consider the current year costs but also the forecast costs for forward years (the exact number of forward years depending upon the circumstances). Managers should also know the value and costs of the assets being employed to deliver those services and activities and whether they are being used in the best way or could be disposed of and used for other purposes. Determining efficiency is not a 'one-off' process and managers should have a constant regard for efficiency and that to secure and maintain it is a systematic process. Through the managerial accountability process top and senior political management has not only the opportunity to obtain the information to enable it to set the efficiency targets that it wants operational management to achieve, but also the knowledge of what is being achieved. To support the manager this means that the skills and role of the head of finance and the finance department will need to be enhanced including the development of management and cost accounting. All of this requires a much greater appreciation of financial awareness than that of simply ensuring that expenditure does not exceed budgetary limitations.

PFM/IC requires that finance plays a much more central role in management than in traditional systems of public administration.

(vi) *Managers are expected to develop an assessment of effectiveness*

Effectiveness is derived from an understanding of what the user of a public service wants rather than assuming that the user wants what the supplying organisation continues to provide (the user could be another ministry or department or a third party such as a beneficiary recipient, a student, parents of schoolchildren, a patient, a central or local government taxpayer, a supplier of services to the public sector or any other user of a public service). If a service is being provided that either is not required or is not being delivered in a way that is of value to the user or at a time the user requires, then resources are being wasted no matter how efficiently that service or activity is being provided. Because very often public services and activities are provided in a manner which is convenient to the provider, rather than the user, assessing effectiveness may well cause this to change. The user should be consulted. As national economies improve and society becomes better educated and wealthier, the demand to be consulted will grow. Consumers of public services are also likely to make comparisons with how private sector services are provided and expect the public sector to follow the same standards. Therefore, effectiveness should become a much more important feature of public service delivery. The only way to find out what the user requires is to ask them. Asking them can take many different forms but establishing effectiveness should become an important feature of public service management. This is a key reason why parliamentary and civil society consultation is so important because it provides *inter alia* information about effectiveness.

PFM/IC encourages the development of a focus on effectiveness and it also does this through requiring enhanced transparency and accountability,

(vii) *Requires of managers greater discipline and quality in the operational management process both for top and senior management and for lower level managers.*

PFM/IC clarifies and extends the responsibilities of operational management by introducing more structure and discipline into the management process, including accountability. Managers should be held to account for achieving objectives, performance standards and performance objectives, not just for financial and budgetary control. The responsibility of the political and the top operational management is to set those objectives and standards and to determine the policy framework within which they are to be achieved, along with the strategy for achievement. Their responsibility is then to ensure that operational management delivers those objectives and performance standards to time, within budget and efficiently and effectively.

A consequence of the PFM/IC reform will be that HR policies will need to be modernised with recognition being accorded to the role of civil and local government officials as managers and therefore being required to take risks. Managers will have to make judgements in taking decisions.

(viii) *Facilitates better quality policy making and strategy development*

If effectively implemented, PFM/IC facilitates better quality policy making and the strategy for the implementation of policy. It does this through potentially making available to the policy maker a better quality of financial and performance information and by introducing delegation. Delegation allows for more time to be available to political management to develop policy along with the implementation strategy by removing most operational management responsibilities through delegation. Delegation has the further advantage that it facilitates the development of the experience and quality of the civil or local government service and through that creates the potential for a better quality of policy implementation advice to the political management. Delegation has the benefit that it allows for a full political management focus on the issues that really matter politically, and for the civil (or local government) service to gain practical operational management experience. Critical to successful policy development and the strategy for its implementation is the need for effective coordination between policy makers and those experienced in delivery. The more experienced those responsible for delivery are, the more effectively they can support policy makers.

(ix) *Facilitates improved operational management decision making.*

Improved operational management decision making is made possible because with PFM/IC managers can be provided with both performance and financial information. This is not available with traditional administrative systems. The focus on financial awareness (see item xi below) makes possible an improved utilisation of public resources and through that more effective and consistent service provision. By delegating operational management decisions, apart from those with a significant political relevance or where there is considerable uncertainty, decisions will be made nearer to the problem, that is, decisions can be made by persons more expert and experienced in the delivery of the service concerned. Delegation means that, on the whole, extraneous and irrelevant factors (including political advantage) as far as possible do not enter into the routine operational decision making process. Consequently, the concerns of political management can be focussed only on those operational matters that may be of a particular interest for them.

(x) *Potentially reduces the risk of the development of a 'silo' mentality within a public organisation and hence enhances the opportunities for managers to make more effective use of available resources.*

Features of PFM/IC are a strong operational managerial leadership and improved communications within the organisation. This facilitates coordination of activity and more effective utilisation of resources. This applies whether services or activities are delivered by the first-level organisation itself or by second-level organisations controlled by the first-level organisation. A 'silo' mentality means that resources may not be effectively used and activities duplicated or different standards and objectives applied by different parts of the organisation. Through the development of information and communications senior management can rationalise service delivery and activities.

(xi) *Operational managers are made more financially aware and this in turn encourages better quality budget making, more effective use of resources and performance delivery.*

This is because through the operational manager's involvement in the budget making process which ought to occur with the introduction of PFM/IC and the provision of cost and performance information:

- Budgets can be more effectively linked to strategy, objectives, performance standards and performance objectives.
- Performance indicators can be included within the budgetary documentation which enhances accountability.

- The relevant operational manager will be responsible for delivering the objectives to standard and within budget. The operational manager should therefore agree the adequacy of the budgetary provision. (Those objectives and standards should be agreed between the political and operational managers as being capable of delivery within the specified budget.)
- The relevant operational manager will know how all the elements of the budget are constructed (i.e., including personnel, supplies and services, transport, accommodation costs and overhead costs). Therefore, that manager should be able to make judgements about the appropriateness of the allocation of resources over these different elements if the objectives are to be achieved.
- The focus upon efficiency and effectiveness with PFM/IC encourages operational management to systematically aim to improve use of resources. The operational manager should have available the financial and performance information to enable judgements about efficiency and effectiveness to be made.
- The operational manager can be held specifically accountable for delivery of the agreed outputs efficiently and effectively. This is because of the operational manager's commitment to the level of resources being made available, compared to the objectives and performance standards expected to be delivered with agreed improvements in efficiency and effectiveness.

(xii) *Better quality of control can be exercised by political management and by top and senior operational management.*

Making every decision, no matter how trivial, does not put political management in effective control of an organisation, although some believe that it does. Establishing an effective management structure with operational managers appointed with delegated powers and accountable for how they have used those powers in the delivery of objectives and performance standards will give to political management a much clearer understanding of what is happening in the organisation. Political management also retains the power to 'call-in' decisions if they feel that appropriate or can set specific conditions affecting the exercise of delegated powers. Through these types of arrangements introducing PFM/IC provides a greater opportunity for political management to be in control of an organisation without feeling the need to try to make every decision.

Managers exist at all levels in an organisation and ought to work within a policy framework defined by the political and top operational management or by their immediate superior manager. The organisational structures that should be introduced with PFM/IC mean that higher levels of management will also decide on what the lower levels of operational management are to achieve. They will also determine the powers and resources individual managers will have available to them. These conditions mean that managers at all levels can be held accountable.

By adopting the PFM/IC reform the political management are more able to secure control through the managerial accountability processes that will be established.

(xiii) *Creates the opportunity to identify much more systematically fiscal risk.*

Fiscal risks ought to be identified and assessed, and if they are not, a consequence could well be of an entirely unforeseen impact upon the finances of an organisation. Fiscal risks can arise from a variety of circumstances. They may be treated as part of operational risks but very often they are not. They can arise from arrangements designed to defer immediate costs into the future, from long-term contracts, such as for specific commodities (e.g., oil, or minerals), from certain types of contracts, such as public/private partnerships, from the issue of guarantees, from assumptions made in entering into agreements with third parties or from changes in economic conditions. They can also arise from arrangements made with aid agencies and other third party organisations, not least because the policy considerations of those third parties can change without any regard for the impact upon particular local circumstances. Specific and potential fiscal risks ought to be disclosed along with estimates of their magnitude and, where practicable, their likelihood. A particular responsibility of the head of finance within a ministry or local government should be to ensure that top and senior political management is aware of such risks and that before such risks are accepted that appropriate consultation occurs with the ministry of finance. Performance agreements with second-level organisations should include a specific requirement that a second-level organisation should not enter into arrangements that may lead to fiscal risks arising without the specific approval of the first-level organisation. Political management is particularly vulnerable where fiscal risks emerge which ought to have been foreseen and PFM/IC should help to protect them from such a possibility.

(xiv) *Improves the quality of budgetary and financial control by operational management.*

Budgetary and financial control is improved because the operational manager responsible for a budget has to take direct responsibility for managing the budget on a day-to-day basis and for the way in which resources are used. At the same time the operational manager should deliver the objectives and the prescribed performance. The primary responsibility for financial and budgetary control is not that of the finance officer but the operational manager. However, the head of finance should be advising the operational manager about spending and income (where appropriate) on a regular basis and should ensure that appropriate managerial action is taken should variations from the budget appear likely. Nor can the responsibility for budgetary and financial control be 'delegated upwards' to a political level or left to an external controller such as the ministry of finance. PFM/IC involves a stronger financial discipline by ensuring that no commitments are entered into that will lead to a potential overspend at year end or generate unpaid liabilities that are not reflected in the budgetary allocation. It should also require systematic re-forecasting of income and expenditure during the year measured against operational performance in achieving objectives. The benefit of these arrangements is that there is a greater likelihood that resources will be well used compared with the traditional arrangements partly because an operational manager has a specific responsibility and therefore can be challenged about those decisions and partly because the whole process results in the manager becoming more financially aware.

(xv) *Improves the quality of governance within public organisations.*

Because of the consequential separation of responsibilities for policy and strategy setting from operational management, if properly applied no single person should have full responsibility for all aspects of all decisions. This reduces the risk of mistake, because it makes challenge possible, and allows for different views to be considered. The risk of corruption is also reduced. The opportunity for 'challenge', as has been pointed out elsewhere, can be a valuable tool to test the quality of decision making. In some countries the idea of 'challenge' is not acceptable and this can be a legacy of the historical development of a country, including its colonial history. No one individual has perfect knowledge, particularly where complex issues arise. For their own sake top and senior management should not be 'sheltered' from what may be uncomfortable realities. For financial management and internal control to be effectively applied, scope for 'challenge' should be accepted.

(xvi) *Improves accountability externally*

With the development of PFM/IC and the availability of additional information about performance, the opportunity for parliamentary scrutiny of managerial performance is enhanced. Scrutiny of managerial performance by the state external auditor is also enhanced. The state auditor usually has a responsibility to undertake performance audits and to report to parliament. The additional managerial and performance information developed as part of the PFM/IC process will facilitate this. (Added parliamentary scrutiny is not always welcomed by a government but is a very important benefit from the point of view of transparency and accountability in a democratic environment. To be effective though, parliament may need additional technical assistance to enable parliamentary members to analyse information and to focus enquiry. Members of the parliament may also need to have available to them training support.) Not only is this an important element in the development of 'challenge' but it also provides an opportunity to inform civic society. External 'challenge' is a necessary element in the development of democratic processes and will serve to stimulate an improved quality of management.

Accountability should also indicate to interested parties, who may be external to the organisation, how all aspects of internal control have been applied including, where objectives and performance standards have not been met, what has gone wrong and the changes management has made in response. Political management needs to know this in order to avoid or lessen potential public criticism. External accountability is also improved with the publication of information about the quality and effectiveness of the internal financial control arrangements (see Chap. 13).

Externally, the civil or local government service is usually completely anonymous to the service user and yet with the delegation of operational management that anonymity should not necessarily remain, although much depends upon individual country traditions. In the normal course of business, the service user should know with whom they are dealing and should be able to directly communicate with them and not just via the political head of the organisation. Public accountability should be a feature of delegation.

The accountability arrangements should also put the political head of the organisation in a better position to exercise pressure to improve the quality of operational management. These internal accountability arrangements also provide the political level of management with an 'early warning' system if something is going wrong or external events are occurring which are likely to affect performance. In summary, improved accountability, which PFM/IC requires, encourages the systematic improvement of the operational quality of public organisations, provided the signals generated by the internal and external accountability arrangements lead to appropriate managerial action being taken at whatever is the relevant level.

(xvii) *Effective mechanisms can be introduced where second-level agency and similar public organisations are established to ensure that the interests of the first-level or controlling public organisation are properly protected.*

Second-level organisations should be properly supervised by the controlling organisation and should not be allowed to pursue their own objectives. They should also be set specific terms of reference and objectives by the controlling ministry or local government and these should be set out in a formal agreement such as a service level or performance agreement (see Chap. 12). These may change from budget year to budget year depending upon the objectives and budget of the controlling ministry or local government. PFM/IC requires that better supervision of second-level organisations occurs and that mechanisms are put in place to ensure that this happens. This 'better supervision' will mean that the objectives and activities of second-level organisations will be more effectively coordinated with those of the controlling first-level organisation. It will also require the second-level organisation to apply standards, including internal control standards set by the first-level organisation and at the same time establish effective accountability arrangements between the second- and first-level organisations. To achieve this though, the controlling ministry or local government must develop a policy capacity to oversee and test the objectives and performance of second-level bodies. With PFM/IC controls should exist to prevent second level bodies being used as a mechanism to avoid budgetary and other controls.

(xviii) *Effective mechanisms exist to supervise those state-owned enterprises for which a ministry (or the equivalent in local government) has an ownership or supervisory responsibility.*

State-owned enterprises have a degree of independence not available to other public organisations. However, very often the performance of such enterprises is poor. They can be used to avoid fiscal controls and are a potential source of corrupt activity. Governance arrangements can be particularly weak. They also may accept fiscal risks which if they mature could have significant adverse effects on the owning or supervising ministry or local government. Where they operate in a contestable market place unless they are charged for the cost of capital and an allowance is made for risk in the financial returns they are expected to make, they can undermine the development of private market participants. The introduction of PFM/IC creates the opportunity for the ministry of finance and owning or supervising ministries (and local governments) to establish greater discipline over such enterprises and therefore limit losses and costs arising from inadequate performance. The performance and governance arrangements of state-owned enterprises (and local government equivalents) should be systematically reviewed by the owning ministry or local government (see Chap. 12).

10.3 Summary on Benefits

These benefits will only accrue with the recognition that PFM/IC is a comprehensive managerial reform. If governments are not prepared to undertake the managerial reforms that are required as part of the PFM/IC application programme, these benefits will not be achieved.

None of the available literature, so far as this author has been able to establish, refers to this catalogue of potential benefits or to the significance of the linkage with managerial reform. This lack of any reference to the benefits which flow from adopting the PFM/IC reform has the consequence that it serves to emphasise the impression that the reform is a financial reform of interest only to a ministry of finance and to finance staffs in ministries, rather than being primarily a management reform affecting the interests of government as a whole and promoting the opportunities to enhance transparency and accountability, not least to parliament and civil society.

A ministry of finance responsible for applying this reform should aim to ensure that these areas of potential benefit are identified in any policy paper and that an objective of the reform should be to ensure that the potential benefits are achieved. They will not be achieved immediately but over time and they require managerial reform. In the periodic reports by public organisations on the application of PFM/IC, the ministry of finance should assess the extent so far, to which the benefits have been achieved and highlight the difficulties where achievement is proving problematic. Equally the state external auditor in reviewing the performance of public organisations should include an assessment of effectiveness of the PFM/IC arrangements.

This schedule of benefits applies both to the management of public expenditure and to the management of public income and particularly taxable income. Most of the benefits described above apply equally to the development and management of tax policy and the arrangements for the collection of taxable income. In particular, the linkage of tax and expenditure policies is very important to avoid conflicting signals developing in the economy.

10.4 The Main Areas of Cost

Applying PFM/IC is not cost free and the analysis contained in this guide demonstrates the extent to which reform may be required, depending upon country circumstances. This affects costs. The costs fall into 12 main categories and these are set out below. The calculation of these costs should reflect the period over which they would be expected to be incurred. In addition to these costs will be the costs of familiarising parliamentarians with the new processes and the utilisation of the information that will become available.

(i) *The costs arising from the establishment of a specific 'driver' department to assist in the application of PFM/IC.*

There will be considerable additional responsibilities falling upon the state secretary in the ministry of finance to develop the policies and to secure their application. Because of this, the state secretary will require extensive support from a specialist department and an important area of cost would be that of this department. As explained in Chap. 9, the staffing of this department should reflect the comprehensiveness of the PFM/IC reform. (This would be in addition to the staffing required for the development of internal audit which would probably also be a responsibility of the same department.) Associated with the department staffing costs will be a range of other costs arising from the equipping and running of any ministry of finance department, that is, office costs, transport costs and staff training costs. Such costs could also include the costs of visiting other countries which have either developed a PFM/IC policy and then applied it, including considering how they have responded to the managerial consequences of the reform.

(ii) *The costs arising from the impact upon civil service and public administration reform coordination arrangements.*

Additional costs will be incurred falling upon the organisation responsible for civil service or public administration reform because of the very strong interdependence between the PFM/IC reform and civil service/public administration reform. These costs though should not be significant but may require that an additional official is appointed to act in a continuing liaison capacity. The extent of this cost will depend upon the stage in the development of civil service/public administration reform that has been reached.

(iii) *The costs of creating appropriate managerial structures.*

To reorganise the administrative arrangements within public organisations to create appropriate managerial structures will also add to costs and will take time (i.e., measured in years). This may mean introducing new levels of official civil service/local government management, especially where the delegation of operational management responsibility is a new development. In some countries it may even require the development of a professional civil and local government service (see training below) and not least the appointment of an official head (a state secretary or equivalent) in each public organisation, where such officials do not presently exist. This is a critical appointment given this official's key role in the application of PFM/IC. It may also mean introducing new levels of management where the existing 'span of control'[4] would be too great for effective management. This could be a substantial cost with the scale of those costs depending upon the present organisational arrangements. Because PFM/IC imposes additional responsibilities upon the manager, this is likely to require the appointment of additional staff to support state secretaries and other managers. Examples would include those responsible for the supervision of second-level organisations, for developing and undertaking risk management analyses, for those who will need to collect and interpret performance information.

(iv) *The cost of providing management training for senior operational management.*

Training costs are likely to be significant and cover both this item and item (v). Specific management training for the top and senior operational managers in public organisations (i.e., such as a state secretary or chief local government official and their immediate deputies) will be required. A related area to managerial training will be to ensure that these managers have an appreciation of the implications and requirements of PFM/IC and are familiar with their additional responsibilities as the top operational managers and know how to take advantage of the additional information that should become available from its application.

Training in the development of managerial skills will be a critical activity. Where previously civil servants have not had managerial responsibilities, such training probably will require the support of a specialist

[4] The area of activity and number of functions or people for which an individual manager is responsible.

organisation such as a university or perhaps the development of a governmental training institution. This training should include leadership skills and the raising of political awareness. Another important element of this training would be to develop the financial awareness of the top operational management including a focus upon the management of the finances of the organisation, short and long term. Some technical training may also be required including in the specific features of PFM/IC such as risk management, although what is central to this reform is management training.

These training costs may need to include financial support to a local academic organisation to provide appropriate courses where an 'in-house' training programme cannot be provided. The cost of 'in-house' training is not cost free but its cost will depend upon the extent to which in-house training resources already exist.

The costs incurred in this area of training and the types of training to be provided may need to be agreed with the ministry/department responsible for civil service/public administration reform.

Given the scale of the reform, training is likely to be an ongoing process over several years.

(v) *The cost of training for lower level operational managers.*

Training for operational management at lower levels in public organisations will be required. This training should cover a wide range of managerial topics such as developing leadership skills (see previous point), decision making, delegation, management of staff and time management. For certain officials it would include technical training in the key elements of PFM/IC and not least in an appreciation of the financial aspects of PFM/IC, including what to seek for and how to interpret financial information. This training should also include raising financial awareness and creating an understanding of the manager's responsibility for managing the financial resources that are available, not least to improve efficiency and effectiveness in the delivery of services and activities.

As with the previous item these costs may include financial support to a local academic organisation to provide appropriate courses. The types of training to be provided may need to be agreed with the ministry/department responsible for civil service/public administration reform.

(vi) *The cost of developing a future civil service with a capability to manage in a changing environment*

Training is not a 'one-off' activity for a particular group of officials at a particular point in time. Public organisations should be concerned about the systematic development of staff at all levels in the organisation over time because the operational environment is constantly changing, not least because of technological and economic change. The objective should be the establishment of a civil and local government service which has the capacity to respond to such changes. The OECD in its publication on Skills for a High Performing Civil Service[5] referred to the three main drivers of change:

1. The complexity of policy challenges
2. Digital transformation and future of work
3. The changing demographics/plurality of modern societies and the civil service workforce.

The publication indicated that this requires the development of a civil service:

- which is professional, independent of political control and driven by a common set of values that emphasises an ethical orientation to the public good;
- has a strategic dimension which can use its professional skills to create impact and improve public value for their citizens and clients;
- which is innovative.[6]

Again, to develop such a civil service and local government workforce may involve coordination with an appropriate academic organisation and allowance ought to be made for the cost of the long-run provision of such courses that will facilitate the development of such a service. These are the characteristics that will be required as PFM/IC becomes embedded in the management processes.The costs incurred in this area of training and the types of training to be provided may need to be agreed with the ministry/department responsible for civil service/public administration reform.

(vii) *The cost of familiarising all other staff with the changed operational environment*

Training should not focus simply upon the staff most directly affected by the reform but should also include the familiarisation of staff with the new managerial operational environment for the public sector.

[5] Skills for a High Performing Civil Service (oecd-ilibrary.org) 2017: pp. 114–116.

[6] This is the authors summary of the OECD text.

Achieving staff commitment throughout the organisation is essential to creating an effective operational organisation. This will be necessary to support the managerial changes that PFM/IC will engender. It will also be necessary to engage staff in the whole reform exercise and to avoid the development of 'staff cynicism' about the reform. An example is that in many public organisations what appears to be paramount are the interests of the organisation rather than those it is supposed to be serving. There is in effect no 'customer orientation' of staff. Yet both efficiency and effectiveness require that orientation and that is emphasised in the OECD report referred to above.

(viii) *The cost of introducing performance information systems and developing a data analytical capacity*

To enable managers to focus upon outputs they require performance information systems. Building such systems and collecting the data to feed into those systems will be expensive both in terms of the systems themselves and the personnel required to collect and manage the information. This will also require developing a data analytical capability that will allow budgets and financial information to be analysed in a format that facilitates efficient and effective management. This will add to costs. This capability should be designed to allow budgets and financial information to be linked to individual managerial objectives and performance standards. At the same time the arrangements must facilitate the financial and budgetary controls. Those controls should also provide the information that the ministry of finance requires for its own budgetary control, financial reporting and statistical purposes. This may involve the commissioning of specific consultancy support to advise on appropriate data analysis systems and the purchase of additional IT hardware and software, including the ongoing costs of providing technical support. A factor that should be considered in designing performance information systems is that it will also be essential to ensure that individual managers are not able to manipulate that performance information and those systems. This means considering security issues. Developing such systems and ensuring that they are robust and not capable of manipulation is likely to be an expensive exercise involving new information recording systems, staffing and supervision arrangements.

Accounting arrangements should allow for the allocation of costs (and any income) over *inter alia* individual cost centres, with the range of cost centres being determined, as explained in previous chapters by individual managers not by the ministry of finance, and over those factors that a manager deems appropriate for his/her purposes which may include cost drivers. (The forecast of costs should also include those for the retraining of internal audit staff to ensure that they are familiar with the managerial context in which they will be expected to operate.)

(ix) *The cost of the research and analysis necessary to identify objectives and performance measures/indicators.*

To facilitate effective management, it will be necessary to identify and develop clear, definable and measurable objectives and the associated performance measure/indicators and performance information systems, including the linking of those, as far as possible, to budgetary systems. This may require the employment of consultants and academic researchers.

(x) *The cost of developing the finance function.*

This will include both training costs and systems costs. Costs will also include raising the status of the head of the finance department. Training will be required to enable the finance department to undertake those financial analytical responsibilities that managers will require. The role of the head of finance as an adviser to operational management will also need to be developed. A state secretary will also require skilled financial managers who can advise on the development of policy and the strategy for its application as well as supporting the development of strategic financial planning including the provision of advice on the long-run financial resilience of the organisation. An important technical component of the training for a finance function within an organisation will be the development of management and cost accounting. If these skills do not presently exist, then they will need to be acquired and that can be either through recruiting additional staff or training.

(xi) *The costs or training the budgetary and finance staff of the ministry of finance.*

Ensuring that the capabilities of the ministry of finance, especially of the staff concerned with budgetary management and financial accounting, are fully appraised of the revised arrangements and have the capacity to work with the management structures in public organisations. The work of such staff is likely to be considerably developed by the increased emphasis upon performance with the application of performance measures and objectives including the linkages to budgets. Failure to do this is likely to create conflict between the perceived needs of the ministry of finance and those of ministry operational managers.

(xii) *The costs of employing consultants for specific activities.*

Employing the consultancy advice that may be necessary to properly apply all the changes that will be required can be expensive. Developing the management of some public organisations in order to improve efficiency and effectiveness may require the employment of specific specialist consultancy advisors, especially where complex reforms are required. Envisaging what such advice may be required is difficult, but in assessing the overall costs of the reform this is a potential cost which should not be ignored. For example, assessing effectiveness is not necessarily a simple exercise and may require specialist research and advice. Therefore, those responsible for the application of this reform policy should consult with public organisations about what their consultancy requirements could be and when they might arise. A problem with employing external consultancy advice is that such advice needs to be directly relevant, familiar with the public sector operational environment and consistent. Such conditions may add to costs.

The total of these costs depends entirely upon the base position, that is, the present administrative structures, budgetary and accounting arrangements. For example, if all decision making responsibility presently lies with politically appointed managers and there are no effective civil service or local government managerial structures within government organisations, then the extent of the reform required will be substantial and so will be the costs. Again, if the budget and accounting systems are designed to meet only the interests of the ministry of finance, as, for example, most IFMIS systems are, or those of the finance department of a ministry or local government, the costs also will be quite high. If though, for example, an elaborate coding structure already exists so that budgets and accounting information can be analysed over alternative headings to those required for budgetary control and statistical reporting purposes and that costing is a current feature of the financial management arrangements, then costs will be much less. Similarly, where management structures already exist based upon civil service or local government managerial arrangements and those managers have significant service or activity delivery responsibilities, the costs of the reform will be less. Another example would be that in some countries programme budgeting has been developed. In theory this should lead to lower costs of application, but only if the programme budgeting arrangements are themselves accompanied by managerial reform (which in practice does not always occur). Managerial reform would mean that a manager has specific operational responsibility for the delivery of a programme and that each programme is accompanied by clear and measurable objectives and performance information. The budgeting and accounting arrangements should fully reflect the costs of implementing that programme.

Unfortunately, the reality is that the only costs that are usually identified with the application of PFM/IC are those directly associated with the additional costs falling upon the ministry of finance for staff employed in the PFM/IC 'driver department'. The other costs which may also be identified are training costs, but only of finance staffs and of administrative/managerial staffs in undertaking the additional bureaucratic activities, such as risk management arrangements associated with the introduction of the managerial disciplines identified by COSO. None of this covers the need for managerial training or recognises the different needs for different levels of management or the changes that are likely to be required to the approach of staff generally. Such costs are usually ignored including the additional costs falling on the organisation responsible for civil service reform as well as all costs associated with developing more elaborate managerial structures, coding, budgeting, accounting and costing systems.

A further factor associated with the costs of applying PFM/IC is the timeframe over which costs are likely to be incurred. That timeframe should be realistic and it should reflect an assessment of what requires to be changed including how far and how quickly a government is willing to accept change, especially through the delegation of responsibility to civil service (or to local government service) managers. Another factor affecting costs is the decision about whether the application of the reform is to be through a single reform programme for the whole public sector or is it to be applied through pilot arrangements and in stages. Or alternatively, are the different types of public sector organisation to be reformed in sequence (e.g., central government, then local government, then second-level organisations such as public agencies or some other sequence)? Exactly what that sequencing should be will depend entirely upon local circumstances and hence local decisions. However, it should be borne in mind that some elements of the PFM/IC reform may be very difficult to implement in stages, such as personnel reforms.

This lack of cost identification with little or no regard to the timeframe over which the costs are likely to be incurred usually happens because of a lack of a substantive appreciation of what PFM/IC involves. Identifying the costs and the timeframe represents an important form of analysis that ought to be undertaken because it has the benefit, not just that it identifies the costs, but that it also recognises the scale of the reform required and therefore makes clearer the extent of the political decisions that will be needed.

This broader identification of costs will encourage governments to consider other factors such as:

- How the costs are to be funded, for example, from a country's own budget or from aid funds or both. Ideally, given the nature of this reform and timescales involved, it ought to be funded directly from a country's own resources with foreign aid only being involved for specific and definable elements of the reform. In reality, it would be most unlikely that a single donor would be willing to provide the finance over the whole period of the development of the reform.
- The sequencing of the reforms, because it is important that reforms do not occur out of sequence[7] because this will only add to costs and waste resources.
- The timing of the whole reform process and how it should be undertaken.

What should be recognised though is that many of these costs arise from the need to professionalise the civil and local government service. Introducing PFM/IC is the stimulus for that but such costs should be accepted as necessary in any event if a country is to manage its resources efficiently and effectively and to meet the needs of its citizens and the users of public services.

10.5 Summary on Costs

The costs of applying this reform can be substantial. A key responsibility of political leaders (and a minister of finance in particular) is to ensure that the full costs are fully identified, even if precise numbers cannot always be demonstrated. The timeframe over which they are expected to be incurred should also be shown. Decisions can then be made about how those costs are to be financed.

The costs that are to be incurred mainly arise from establishing the managerial structures that are required to deliver services efficiently and effectively, the professionalisation of civil and local government service management and the consequent costs of managerial training and development. In addition, costs will also arise from generating the financial and performance

[7] If reforms occur out of sequence, for example, risk management being introduced before clear and definable objectives have been set, the exercise will not be successful and resources will have been wasted. Similarly, if a requirement is imposed on managers that they must operate efficiently, then this too will fail unless the budgeting, accounting and performance reporting systems have been established and staff trained in how to use them and to undertake financial analysis.

information that managers require if they are to manage efficiently and effectively the resources that are made available to them through the budgetary process. These could be significant areas of cost.

Overall, the costs are wide ranging reflecting the impact that this reform will have upon the arrangements for the management of the delivery of public services including a refocusing of the civil and local government service to have regard to public service user needs and interests rather than simply those of the organisation itself. They are not simply administrative type costs and they involve the acquisition of information and the utilisation of that information by managers to deliver more efficient and effective public services.

Although these costs can be wholly attributed to the implementation of the PFM/IC reform, in practice many of these costs are essential to the creation of an effectively functioning civil (or local government) service.

11

International Standards of Internal Control Relevant to the Application of PFM/IC

Countries aiming to introduce PFM/IC, as well as other public financial management reforms, are usually encouraged to adopt internationally recognised standards as best practice. However little or no thought is often given to the context in which such standards are to be applied. These international standards, and especially those relating to PFM/IC, reflect several assumptions about the organisations which are to adopt them. For PFM/IC those assumptions are about the application of the standards to a managerial-based organisation. Where the current context is that of traditional administrative-based government organisations, these standards cannot be applied without managerial reform. And this reform ought to come first. (The experience of this author is that those assumptions are not generally recognised by those seeking to apply them in developing and transition economies nor recognised by those advising them.)

Therefore, as has been pointed out earlier in this guide, trying to apply such standards may not be appropriate for a particular country at the time the PFM/IC reform is proposed to be implemented. In adopting a managerial approach various factors need to be considered. These include local cultural traditions, the relationships between political and appointed officials, the organisation and quality of the civil service, the existing management arrangements (or lack of them), the authority that individual managers have with the current arrangements over operational activity, the experience and training of managers to enable them to apply the standards in a managerial context, the quality of the existing budgetary arrangements and the strength of the existing financial control arrangements. In Chap. 3 a distinction was drawn between

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_11

PFA/IC and PFM/IC and this distinction illustrates when adopting international standards may not be appropriate.

This chapter accepts that it would be appropriate to adopt PFM/IC international standards, that is, the standards published by the Committee of Sponsoring Organizations of the Treadway Commission' ('COSO').[1] There are five standards and these cover the control environment, risk management, control activities, information and communication and monitoring, although updating has resulted in some modifications to them.

These five standards of internal control exist to secure the achievement of the objectives of the organisation and to do so within the legal constraints and regulatory requirements, efficiently and effectively and with proper regard for accountability. They therefore have a clear purpose and are not simply bureaucratic requirements associated with the development of internal control. They are integral to management. They are not 'stand-alone'. This is an appreciation that those responsible for the application of PFM/IC should achieve. The five standards are about managers having the authority and the information they require to make those judgements necessary to enable them to achieve their objectives. This would include meeting any regulatory requirements, including legal, financial and budgetary limitations, in the most efficient and effective manner. They provide an important improved procedural approach to the management of public organisations. However, most countries implementing PFM/IC have treated these standards simply as bureaucratic 'stand-alone' requirements, rather than being integral to the managerial process. They have therefore focussed their implementation upon the bureaucracy of the procedures to be adopted, rather than upon the effectiveness of management, that is, the manager as decision maker. (In most developing and transition economy countries a 'nominal' responsibility has been placed upon the political head of the organisation, the minister or mayor, to ensure that these standards are implemented. This cannot be a 'substantive' responsibility without other changes being made. The necessary changes have been described earlier in this guide. Given the wide range of responsibilities that fall in practice upon a minister or mayor, an expectation that they will exercise anything other than a 'nominal' responsibility is misplaced. In other words, countries have not taken account the managerial context in which COSO is meant to apply and therefore the assumptions that lie behind the COSO initiative.)

Each of the five standards of COSO as they were originally specified is discussed in this chapter. They may be more appropriately described as 'managerial disciplines'. (Other examples of these standards exist such as the ISO 31000 standard which applies to risk management but again the responsibility is focussed upon the management.)

[1] https://www.coso.org.

The COSO standards are normally treated as applying only to public organisations concerned with public expenditure, but they should apply equally (albeit with some adaptation) to those organisations concerned with the generation of income.

They are about 'good quality' management!

11.1 The Implicit Assumptions Contained Within the International Standards of Best Practice (COSO)

COSO is about how large international private companies should be managed and describes five standards of internal control that should be applied.

Internal control has been defined by COSO "as a process, effected by an entity's board of directors, management, and other personnel, designed to provide 'reasonable assurance' regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations."

These standards, of which there are five, that is, the control environment, risk management, control activities, information and communication and monitoring, reflect the requirements of the private sector. The standards are periodically updated with the latest comprehensive update being in 2017.[2] In addition, COSO also published guidance on specific features of enterprise risk management such as on cloud computing and artificial intelligence.

The public sector provides services which are not subject to a market test and it also has the responsibility to levy and collect compulsory taxes. Citizens of a country cannot escape from this compulsory levy except by legislative permission: there is no option available, as there would be in the private sector by not utilising a public service. Effective management of public expenditure and taxation policies is essential. These standards, which have been described previously as 'managerial disciplines' should be adapted to apply to organisations responsible for the development and management of both expenditure and tax policies.

In the public sector a critical feature of public financial management is the existence of the budget and that budget will have legislative approval. Governments and local governments are also required to ensure that public

[2] https://www.coso.org/Pages/erm.aspx.

services are delivered consistently and evenly to those members of society that they are expected to serve. Reliability and sustainability ought also to be characteristics in the management of the delivery of public services, and governments generally (subject to political policy change) should be assumed to have a continuing existence. They are not subject to the vagaries of the marketplace.

In applying these standards to public organisations, a ministry of finance, the state secretary for that ministry and the head of the department responsible for the application of PFM/IC (the 'driver' department) should recognise that they contain implicit assumptions about the organisations to which they are being applied. Therefore, a simple 'read across' from the private to the public sector can be misleading. Unless public organisations recognise the significance of these assumptions, applying these standards will not achieve the objective of introducing effective internal control.

"Learning another language is not only about learning different words for the same things but learning another way to think about things" (Anon). This applies to these standards. The assumptions contained in the COSO model are about the management and objectives of organisations. The standards will only help top and senior management if those assumptions are replicated in the management and objectives of a public sector organisation. To regard these five standards as 'stand-alone' features which, if adopted, will deliver effective PFM/IC is mistaken. The key assumptions lying behind these five standards are that:

- There is a process for setting objectives and performance standards and ensuring that externally set regulatory requirements are met which are consistent with budgetary availability.
- A professional operational management and supporting staff exists, and if not, either staff will be replaced or added to as necessary.
- An effective operational managerial structure has been established or can be established designed to deliver the objectives and performance standards of the organisation including meeting externally set regulatory requirements and that would include appropriate personnel management arrangements.
- The objectives and performance standards exist in a form that operational managers can be held to account for any failure to deliver them.
- Operational managers have the delegated authority to undertake their responsibilities and are accountable for their performance.
- Financial information is available which allows operational managers to make decisions both about the volume of activity and the most efficient and effective way of delivering their objectives.
- Performance information is available which enables an operational manager to make judgements about achieving the expected level of operational

performance, including externally set regulatory requirements against the available financial resources.
- Constant regard is had by all managers to the level of efficiency and effectiveness, that includes the impact upon the user/customer of the outputs of the organisation.
- Financial and performance reports are available which enable not only internal management at all levels but also external stakeholders (which for public sector organisations would include parliament or the local government council, external regulators and civil society) to make judgements about the performance of the organisation.
- Financial management is integral to the management of the organisation and a feature of that is that the organisation is managed in a manner which is financially stable. Without that reliability in service delivery cannot be achieved.

These assumptions which are implicit in the COSO standards (as has been indicated) might be better described as managerial disciplines demonstrate very emphatically that introducing PFM/IC is as much a management reform as a financial reform. As a management reform the requirements of PFM/IC need to sit within a managerially focussed organisation. Consequently, the COSO standards will not produce the potential benefits unless the public sector organisation has moved from a traditional administrative style (usually a firmly 'top-down' style) to a managerial style of organisational arrangements. This does mean that if these standards are to be effectively applied a competent, managerially oriented civil service (or local government) organisation needs to exist. Managers then need information about objectives, performance and finance to enable them to meet their responsibilities. Countries should not assume therefore that a simple bureaucratic implementation of these standards can be achieved without ensuring that a public organisation exists which has a managerial capability. Civil servants (and local government officials) need to be trained managers and therefore be prepared to take decisions.

Treating these standards as managerial disciplines designed to help managers achieve their objectives efficiently and effectively and to improve accountability demonstrates that civil and local government service and other reforms, such as budgetary and accounting reforms, may be necessary prior to the introduction of these standards. The standards are not 'ends in themselves'. The COSO executive summary points out the five standards are integrated[3]

[3] Executive summary—page 4: https://www.coso.org/Documents/990025P-Executive-Summary-final-may20.pdf.

and therefore their impact should be considered as a whole. The COSO standards are about improving the quality or, to put it another way, the professionalisation of management.

In developing and transition economies aiming to apply the COSO standards, none of the assumptions summarised above is recognised. The usual practice, in the experience of this author, is to treat the COSO standards as only about financial and budgetary control, not management. This seems to be because the personnel involved in the reform process are usually only concerned with such issues and often start from an internal audit perspective. As this is a wrong approach, the minister of finance, that ministry state secretary and the head of the 'driver' department should ensure that in applying these standards there is a recognition of the assumptions implicit in these standards and that the managerial context is reflected in the reform processes. This means, as has been explained previously in this guide, that;

- Clarity exists over the different roles of the political level of management and that of the civil or local government service officials.
- An appropriate operational management structure exists.
- Objectives exist which have been set by the political level of management but only following consultation with operational management and those objectives should recognise the need to meet externally set obligations and should be consistent with available budgets.
- Performance standards and objectives exist which again should be consistent with available budgets.
- Operational managers have the necessary delegated authority to make decisions and to expend resources coupled with an accountability process to senior civil service management and ultimately from it to the political level of management.
- Appropriate skilled staff are available.
- The performance information a manager requires is available.
- Constant regard is had to the effectiveness of operations and to user/customer reactions and attitudes.
- The financial information a manager needs to deliver objectives efficiently and effectively is available.
- Which means the development of cost and management accounting and that the relevant reports are available to managers at all levels in a form that the manager needs.
- Financial and performance information is also available to external stakeholders, not least the parliament, who are then able to exercise influence over the operations of the organisation, that is, transparency and external accountability.

These are the characteristic features of a managed organisation: they are not those of a traditionally administered organisation.

The fact that COSO was primarily aimed at commercial companies makes no difference in principle to its use for non-market organisations, merely that it requires an appreciation of the differences between the private and public sector contexts and consequently an appropriate adaptation. (Management in the public sector, as has been pointed out earlier, for many services is much more complex with more confusing signals than in the private sector.)

The effectiveness of the application of these standards depends upon the quality of management, both political and operational. What is important is clarity about the policy, objectives and performance standards and objectives set by the political level of management including the strategy for delivering them. Clarity is also required about how a ministry or local government or other public organisation is managed, both operationally and financially, to secure the efficient and effective delivery of those objectives and performance standards. The introduction of these international internal control standards ought to be a signal that a managerial/performance culture is being established. Therefore, as has been explained earlier in this guide, accompanying the application of these standards a parallel managerial reform process should occur, and if this does not occur, then these standards will not be properly applied.

Previously in this guide, the person responsible for the application of PFM/IC within an organisation was identified as the chief civil service (or local government) official such as a state secretary within an organisation. That official should ensure that introducing these standards results in an organisation capable of delivering its objectives and performance standards and objectives, efficiently and effectively and within any legal, financial or other constraints and that due regard is had to the interests of the users of the service or activity. Merely introducing the bureaucracy associated with the application of the international standards will not, of itself, demonstrate that PFM/IC has been applied and that the ministry or local government is well managed. This is not correct at all.

In many countries a responsibility is placed upon the political head of the organisation, the minister or mayor, to ensure that these standards are implemented. This cannot mean that this official must make all implementation decisions. The substantive implementation responsibility should fall upon the head of operational management, that is, the most senior civil service or local government official with that official being accountable to the political head for the effective application of the standards.

11.2 Appreciating the Impact of COSO

11.2.1 The Standards of COSO

Countries which have implemented PFM/IC following the COSO standards have tended to address four of these standards, 'the control environment', 'control activities', 'information and communication' and 'monitoring activities', in general terms only. They have merely required the responsible official to pay attention to them, with the evidence of their application being the additional bureaucratic procedures that have been introduced. However, as has been pointed out, evidence of the existence of the bureaucratic procedures is not the same as the substantive application of those procedures. In most countries little specific indication is provided of what managerial and operational changes have resulted from their application.

The exception to this is the standard relating to risk management. A great deal of attention has been paid to risk management, but much of the emphasis has been upon risks to financial control systems such as risks of losses through error, fraud or other misuse of resources rather than to the risks of not achieving objectives and performance standards or of not providing a consistently reliable service or of meeting externally set regulatory requirements. With risk management the bureaucratic procedures are easy to specify and their existence can be easily checked. However, this does not mean that risk management is being effectively deployed by managers. Risk management has been regarded as perhaps the most important element and much energy has been devoted to providing advice and training programmes. Unfortunately, much of this is misguided. The officials being trained have largely been finance officials and internal auditors and this may be appropriate if risk were confined to financial control matters (i.e., not to broader financial management matters). But it is not so confined! COSO is fundamentally about those risks which will prevent managers (at all levels) achieving their objectives and performance standards and objectives, including any externally set standards and doing so efficiently and effectively. This goes well beyond audit and accounting. Therefore, a priority before risk management is introduced is the existence of objectives and performance standards and objectives, a management structure with managers having an active concern to utilise risk management as a way of ensuring that their objectives and performance standards and objectives can be achieved. For effective management an information and communications process should also exist that provides the information that managers need and which facilitates the establishment of a 'corporate' approach to the management of the organisation so that in making decisions managers have regard not only to their individual objectives but to the broader objectives of the whole organisation. (A 'corporate approach' is 'an approach to managing people that supports an organisation's long-term goals with an overall planned and coherent framework. This helps ensure that the various aspects of people management work together to develop the behaviours and performance needed to create and distribute value. It focuses on longer term people issues, matching resources to future needs and large-scale concerns about structure, quality, culture, values and commitment'.[4])

The officials who should be trained in risk management should be the operational managers because risk management should be their responsibility. They will not be interested simply in financial systems risks unless they have a material impact upon their part of the organisation, upon its reputation and its ability to achieve its objectives. They will need to consider all risks, of whatever type, affecting their ability to deliver their objectives and performance standards. Some risks will also be of interest to the political level of management, such as a failure to meet political objectives or reputational risk (and reputational risk often can be adversely affected by a failure to meet externally set regulatory requirements) and the responsibility of a state secretary or equivalent is to ensure that information about such risks is available to that level of management.

The development of risk management has been regarded as a priority activity in introducing COSO but this is not how it should be. Other standards of the COSO framework, apart from monitoring, should come first. Again, this illustrates how risk management has been regarded as a 'stand-alone' activity rather than being integral to the managerial processes.

As with other international standards, the COSO standards are regularly updated and the head of the department responsible for the application of PFM/IC should familiarise him/herself with those and be aware of updates. In doing so the head should recognise that the updates tend to be written in the language of business enterprise and therefore need adapting to the operational environment of the public sector.

[4] Strategic Human Resource Management/Factsheets: CIPD www.cipd.co.uk.

11.2.2 COSO and Management

As COSO is about management, the emphasis in introducing PFM/IC should be on a management structure with managers appointed and their responsibilities defined. Those managers, at all levels, need objectives and standards to work to, including performance objectives and standards. Those objectives and standards should be derived from the objectives for the organisation as a whole, which should be set by the political level and then cascaded down the organisation by the senior operational management. The performance standards should be, in general, related to user needs and any externally set regulatory requirements.

This is what is required before any of the standards of the COSO internal control framework can be made effective. Unfortunately, in most countries, none of this occurs. The experience of this author in the application of PFM/IC in most countries shows that the focus of application has been upon whether the bureaucratic procedures associated with the five COSO standards have been applied. Assessments of reform performance have been based around assessments of the extent to which the bureaucracy associated with these five standards has been introduced. They have not been regarded as managerial disciplines. This is a mistake and a mistake encouraged very often by aid organisations because the existence of the bureaucracy provides evidence of apparent action by the recipient country. Unless these five standards are linked to managerial reform, with the development of a managerial structure, the appointment of managers, the setting of objectives, the development of information and financial systems with the accompanying accountability arrangements, these standards will have little or no practical effect upon the achievement of the objectives of the organisation efficiently and effectively.

Another issue that should be addressed is how is that management to be made effective, with effectiveness being defined for this purpose, as delivering the objectives and performance standards set for them to time, to standard, within budget, efficiently and effectively. Considerable emphasis is placed upon the issue of laws, decrees, rules and regulations and checking that the content of these has been obeyed. Whilst this can be important, management cannot easily be defined in such documents. Management at the top level in organisations is about setting the strategy, leadership, coordinating staff activity, making judgements between competing objectives, taking initiatives and applying the available budgetary and other resources to and ensuring that objectives are delivered efficiently and effectively. This also requires a willingness to take risks because management involves making decisions and all decisions involve some element of risk. However, in most countries whether or not the requirements of these laws, decrees, rules and regulations introducing the five COSO standards have been obeyed has tended to be the measured by how they have been incorporated into the internal rules of the organisation, not by the effect they have had upon the decision making processes. This is the 'check list' approach. What is much more important is an assessment of managerial effectiveness. In other words what matters is the impact that these five COSO standards have had upon the performance of the management and hence of the organisation. Therefore, this is what the department responsible for implementing PFM/IC should concentrate on in assessing the quality of their application.

A particular example of the difficulties of just looking at the literal application of laws, decrees, rules and regulations is the application of the first standard, the control environment. Injunctions incorporated into laws and regulations about setting the 'right' control environment (very difficult to define in any event) will not work unless accompanied by a commitment from the highest levels such as the prime minister and the cabinet of ministers to the need for all public organisations to ensure that appropriate ethical values and integrity ('tone at the top') are expressly stated and implemented. This requirement should cover both politically appointed officials and civil servants (including local government officials). This should also be accompanied by a further requirement that each organisation is committed to 'good governance' (see Chap. 1). However, none of this can be fulfilled in practice unless an appropriate managerial structure exists with the assignment of authority and responsibility, including accountability arrangements for the different levels of management.

An approach to an assessment based simply upon the application of the laws, decrees, rules and regulations would in practice tell the department responsible for the application of PFM/IC very little about the real success in implementing the five standards of COSO.

11.3 The Five Standards of COSO

In this section of this chapter each of the five standards is explained. They are discussed in the order in which they should be applied not in the order incorporated into the COSO or INTOSAI publications. This changed order reflects the reality of the operational/managerial arrangements that apply before the introduction of PFM/IC. For example, and as indicated previously, risk management relating to objectives cannot be applied until objectives exist and a management structure has been established with managers appointed to deliver those objectives.

11.3.1 An Overview

The extent to which each of the standards can be applied depends upon the extent to which a managerial approach has been established. For example, the application of the control environment standard, as has been said above, depends upon the extent to which a managerial structure has been developed, including the separation of policy and strategy development from operational management, managers appointed and objectives and performance standards and objectives established with accountability arrangements defined. Those accountability arrangements should not just be the internal accountability arrangements but also external accountability, not least to parliament and civil society. Although the political top manager may nominally be responsible for setting the control environment in practice, the application of that environment depends heavily upon the approach adopted by the top operational manager, in a ministry that would be the state secretary (or equivalent). However, the behaviour and attitude of the political official(s) responsible for the ministry or other public organisation can affect how operational management is implemented and its success. The political head may also change relatively frequently compared to an appointed official and it would be totally inappropriate to expect the control environment to change with each new political head. That way would lie instability. In practice none of these five standards could be introduced completely, certainly during the early stages in the development of PFM/IC: they will evolve over time. Also, as each of the five standards overlaps with others, it is difficult, if not impossible, to disentangle the extent to which a particular standard has been applied compared with another. For example, if objectives are not being achieved is it because of inadequacies in the risk management processes or is it because of weaknesses in the provision of information or communications with another part of the organisation or with third parties, or again a weakness in the controls designed to secure the delivery of the objectives, or just poor management?

Chapter 13 of this guide refers to the need for management to prepare a statement of internal control. This statement should explain how management has performed during the year in terms of meeting its objectives and performance standards. The statement should give the reader a clear understanding of the challenges facing the organisation and how those challenges have been responded to including remarks about what has gone wrong and the actions taken to make corrections. In other words, the statement should be an indicator of the quality of management. This statement would provide an important indicator of the quality of the internal control arrangements and would provide the best source of evidence.

11.3.2 The Individual Standards

11.3.2.1 The Control Environment Standard

> Internal control (IC) encompasses more than financial and budgetary control and more than compliance checks. It is a set of management arrangements that enhances the efficient and effective delivery of the organisation's objectives on time, in line with the performance standard and within the established budget. IC is based upon the COSO model. Both PIFC and IC should apply across the entire public sector and are applicable for the management and implementation of both national and EU funds.[5]

The control environment determines the management attitude to the achievement of objectives, to the quality of the performance standards including externally set regulatory requirements, the operational processes, how operational managers and staff relate to each other, to the political management, to parliament and to the stakeholders in the organisation, particularly the users of its services (i.e., its clients/customers) and suppliers. It also determines attitudes to the utilisation of public resources and to developing efficiency and effectiveness. Overall, it provides the basis for internal control across an organisation. The control environment depends very much upon the personalities of the top and senior management (political and official) and the personnel policies that are applied. (See also Chap. 14 which includes a discussion on delegation and personnel policies.) In the public sector, the control environment also should have regard to the principles of 'good governance' (see Chap. 1) although experience shows that this is rarely considered and neither are the principles of public administration considered (see Chap. 14), including the circumstances where delegation is appropriate or not. Again, the appropriateness of the personnel policies and their relevance to the

[5] SIGMA paper 59 June 2019 'Guidelines for assessing the quality of internal control systems' (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), page 21.

control environment are not considered. A characteristic of a control environment should be that it encourages a focus on the achievement of the objectives and performance standards and objectives of the organisation, so therefore these need to be in place first. The control environment should define the standards of conduct that are expected to be applied throughout the organisation. That includes the integrity and ethical values of the organisation, how they can be embedded in the organisation and how the organisation's relations with third parties are to be conducted. It also requires the development of a 'can do' approach. The control environment is also affected by the distinction made between the responsibility for policy and strategy development and operational management. As has been explained previously, this is because successful operational management depends upon the professional capabilities of the manager. To a large extent the control environment illustrates the 'intangibles' of management, that is, features that cannot be precisely described in a 'job description'.

In practice this standard is very difficult to implement and to demonstrate with evidence that it exists. Civil servants and other public officials appointed to managerial posts ought to be appointed basically for competence reasons, although this does not always happen and staff may be appointed for political reasons. The expectation for the most senior civil service and local government officials (e.g., the state secretary and departmental heads) should include a capacity to set the control environment, even though it may not be defined in precise terms, and through their leadership ensure that the requirements of the control environment are implemented throughout the organisation.

A feature of the control environment should be a well-developed and managed personnel policy with a good and consistent leadership. As has been indicated, introducing PFM/IC represents a considerable change to the way in which public organisations are managed. Change can be very damaging to organisations unless it is well handled by the leadership of the organisation, that is, by the top and senior operational management. Staff must be motivated to work hard and use their talents and abilities, including initiative to make the best contribution they can to the work of the organisation. Change can cause morale to decline and be a cause of insecurity. Motivation is not just simply a function of financial reward, and in practice, different people are motivated by different things, in different ways and at different stages of their careers. A very important factor in staff motivation in the public sector is the quality of the work that is being undertaken.[6] Other factors affecting quality

[6] See footnote 10 of Chap. 14 for an example.

can include how far staff are allowed to 'self manage' aspects of their jobs, the extent of staff development through training and the existence of development opportunities and feedback.[7] Monetary rewards can work very well for tasks that are routine and measurable, but are less successful when creativity and imagination are required. Staff development policies designed to help staff develop their careers should be an important feature in motivation. Organisational culture also has a key role to play in the motivation of employees. If they are to be genuinely motivated to do a good job, rather than simply to comply with organisational rules and regulations, a sense of common purpose needs to be developed and employees need to understand how their individual contributions 'fit' within wider organisational objectives. Leadership and clarity are essential components of good personnel management. Yet this author has not come across any linkages between the introduction of PFM/IC and the development of personnel policies.

Associated with the control environment should be the development of professionalism within the civil and local government service. Professionalism is not just about competence and technical skill but is also about ethical behaviour. To reinforce behaviour codes of conduct or integrity for both politically appointed officials and civil servants should exist. The content of the civil service or public official code should be determined by the organisation responsible for the public service within a country and that for the politically appointed officials should be determined ideally, by the prime minister's or president's office. These should not just be 'token' codes but should be rigorously enforced.

The reality is that an assessment of the quality of the control environment where there is no or very limited delegation with operational decisions being made by politically appointed officials would be very difficult to make (or even perhaps impossible). In such circumstances, assuming that the assessment would be undertaken by the 'driver' department in the ministry of finance on behalf of the state secretary in that ministry, any remedial action probably could only be taken by the minister of finance and his/her hands may be tied by political considerations especially if it involved criticism of another minister. If that other minister is not interested in the control environment or does not conform to the expected principles underpinning that control environment (e.g., the principles of good governance) unless there is a response to minister of finance criticisms, the responsibility for action moves up to the prime minister which in turn makes any decision even more

[7] Debate: Motivating civil servants—insights from self-determination theory: Berend van der Kolk: Public Money and Management: published online 22 Jan 2020.

political. If in these circumstances the offending minister is not really interested in or committed to applying the standards of internal control, then it is impossible to ensure that the rest of the organisation has that commitment. This is an important reason why the separation of operational management from policy and strategy development, with the application of PFM/IC, is so desirable.

A key factor in the establishment of the control environment is financial resilience. Without that the control environment will be subject to stresses that affect an organisation's ability to achieve its objectives. The COSO commentary on the control environment does not specifically refer to the establishment of a stable or predictable financial environment. However, implicit in the whole of COSO is that effective financial management and internal control exists and that means that the organisation management needs to be able to demonstrate that it is currently financially stable and has the financial resources to enable it to meet its objectives and that it will remain stable in the medium to longer term. Financial resilience means that expenditure and income will be matched at least over time and consequently that decisions made by the management or which are the consequences of external factors will not result in the financial destabilisation of the organisation. It also means that even within a financial year, budgetary flows are predictable and stable. However, experience shows that for countries introducing PFM/IC financial resilience is not considered as a factor in the management and delivery of public services and activities, and whilst an important feature of public financial management is the maintenance of financial resilience, in many developing and transition economy countries financial resilience depends upon the quality of the budgetary process, including its links with government objectives, and the quality of the assessment of the economic position of the country.

The arrangements for assessing the quality of the internal control environment were described in the SIGMA paper referred to above (see note 6) issued by the OECD: Support for Improvement in Governance and Management Guidelines for assessing the quality of internal control systems.[8] This paper described a set of principles that should be followed by managers. Five principles were described covering the quality of the internal control environment, that is, the public organisation:

Principle 1: Demonstrates a commitment to integrity and ethical values.
Principle 2: Exercises oversight responsibility.

[8] SIGMA paper 59 June 2019 (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), pages 22 to 32.

Principle 3: Establishes structures, reporting lines, authorities and responsibilities.
Principle 4: Demonstrates commitment to competence.
Principle 5: Enforces accountability.

> IC quality assessment is a primary responsibility for the public organisation's management. This should not only consist of the evaluation of overall conformity with the established regulatory framework, but rather focus on how the functioning of IC enhances the operational efficiency and effectiveness of the public organisation and the achievement of its objectives.[9]

The characteristics that should be looked for in assessing the quality of the control environment were summarised in a European Commission paper based upon COSO as:[10]

1. The organisation demonstrates a commitment to integrity and ethical values.
2. The oversight body demonstrates independence from management and exercises oversight of the development and performance of internal control.
3. Management establishes, with oversight by the oversight body, structures, reporting lines and appropriate authorities, responsibilities and empowerments in the pursuit of objectives.
4. The organisation demonstrates a commitment to attract, develop and retain competent individuals in alignment with its objectives.
5. The organisation holds individuals accountable for their internal control responsibilities in the pursuit of objectives.

The oversight body referred to here is taken from the COSO principles and refers to the controlling board of a company. In the circumstances of developing and transition economy countries, the oversight body cannot be assumed to be the politically appointed top and senior management where that management has operational responsibilities and therefore has no role which is independent of the day-to-day operational management. It is doubtful if the politically appointed top and senior management could act as the oversight body even where that management is not responsible for operational activities unless it included a significant and genuinely independent membership which

[9] Guidelines for assessing the quality of internal control systems SIGMA Paper No. 59.

[10] Principles of Public Internal Control: Position Paper no 1: Public Internal Control an EU approach Ref 2015–1.

in a politically based organisation would be most unlikely. The question then is who could form this ‘oversight body’? There are four possibilities. One is that the ministry of finance exercises this responsibility through the ‘driver’ department, acting on its behalf. A second is that this is made a specific responsibility of the external auditor. A third is that each public organisation is required to appoint a body, such as an audit committee, which is independent of management and which has a capacity to report directly to the most senior level of management in an organisation (and that could be the political level of management) and that its reports are also copied to the department of the ministry of finance responsible for the implementation of PFM/IC. A fourth is that the government or parliament establishes a new body with a specific responsibility for overseeing the development of internal control activity within public organisations. Which solution should be adopted will depend upon local circumstances and that any organisation responsible for assessment has a high degree of independent membership. This points towards the third or fourth solutions. In addition, the external auditor should always review the quality of the internal control arrangements and report on them to parliament. What will be critical in assisting that organisation make a quality assessment of the internal control arrangements will be the statement of internal control referred to in Chap. 13.

11.3.2.2 The Information and Communication Standard

There is in practice potential overlap between this standard and the ‘*control environment*’ standard. For internal control to be effective the managers and staff within the organisation need to know both what the organisation’s objectives are and those that are set for themselves. Ideally, they ought also to know what the objectives are and the services and activities provided by other parts of their organisation. In other words, managers and staff need to know what is expected of them and how their responsibilities relate to those of others in the organisation. They also need to know the operational context for the whole organisation, as well as for their particular part of the organisation. That operational context includes knowing the resources available to them, that is, their budgets (i.e., *total* budgets including all elements of expenditure, not just some, such as only the sums available for procurement), how actual expenditure or income is occurring during the year, performance information that relates directly to their areas of responsibility and how performance is developing during the year, whether the demands upon a particular service are rising or falling, the short- and longer term strategic objectives, the pressure to improve efficiency and effectiveness, the reaction of users of the service (whether internal or external to public organisations), actual and potential legislative, environmental and other changes affecting the operational environment.

The exact information that will be required will depend upon the role and responsibilities of the manager and individual staff members. But, for example, if a manager has responsibility for the delivery of an objective, information about performance towards achieving that objective should be available to that manager as well as information about the financial resources that have been consumed. This should be available on a systematic and regular basis. If that manager is also responsible for efficiency and effectiveness, as he/she should be, then that manager must know not only what the *total* available budget is but also in a format that is relevant to the manager. The manager should receive financial accounting information showing progress against the budget in a similar format. In addition, the manager should have available information showing the allocation of budgets and accounting information over, for example, different cost centres, what drives costs or whatever else the manager requires. The manager should also have available costing information so that judgements can be made about the most efficient methods of undertaking activities. In addition, effectiveness can only be judged by the impact that the activity is having and therefore the manager should be provided with user or customer information, whether the user or customer is internal to the government or external. The 'driver' department should ensure that managers and staff have available to them the information they need. Unless they have that information, managers cannot effectively be responsible for risk management which is central to the successful delivery of objectives and performance standards.

Again, where a first-level organisation uses second-level organisations to undertake activities on its behalf, the managers of the first-level organisation must have the information necessary to enable them to exercise effective control and supervision of second-level organisation activity. The manager must also ensure that second-level organisation activity is coordinated with that of the first-level organisation and of other second-level organisations. This applies whether the second-level organisation is non-market based or market based (a state- or local government-owned enterprise). The question that should be asked is, are the communication arrangements between the controlling or supervising organisation adequate to enable it to properly exercise its responsibilities?

The responsibility of the political leadership of an organisation is to ensure that the top and senior operational management is kept informed of political developments that would affect the operational management. The responsibility of the top or senior operational management is to ensure that the information individual operational managers require is available to them. If all this information is not available, managers can hardly be blamed for a failure to deliver objectives efficiently and effectively. On the other hand, managers themselves may need to specify the information they require, and if top and senior management refuse to make the information flow possible, then at least some part of any responsibility for the failure to achieve objectives is transferred to those top and senior managers.

No organisation operates within a static environment and the changes affecting the operational environment need to be communicated throughout the organisation. Changes may become apparent at any level in an organisation, not just at the top and senior management level. Managers at all levels need to be aware of their responsibility to communicate significant change upwards to more senior managers through the accountability process.

Information and communication are not simply about internal activity. It is also about the provision of information to external organisations and individuals, its clients and customers. Communications with each of these groups should be clear, purposeful, relevant and timely. Without that the effectiveness of the organisation will be difficult to judge and its reputation could be adversely affected. Such external communications can include financial reports (but designed in a manner that is relevant to the reader of the report), communications about the organisation's policies and proposals and why the services that it delivers to its publics are designed in the way that they are and why any charges that it levies are also what they are and why they have changed (if that has occurred) from one period to the next. Clarity should also exist about arrangements for appeals against the actions of the organisation and how, where appropriate, compensation can be sought.

There are many factors that should be considered in assessing whether the information and communications strategy is being properly implemented. The analysis shown below illustrates the difficulty that exists for both management and the ministry of finance 'driver' department in trying to identify separate features of management within each of the control standards. Overall, the real issue is the quality of management (Table 11.1).

Where there is little or no delegation of operational management responsibility from the political level, there can be difficulties with communicating the policies and strategies within an organisation. This is because politically appointed officials do not normally regard staff communications as falling within their remit, except for those with whom they directly work. Again, the appointment of different political officials responsible for different policies

Table 11.1 Factors affecting information and communications that top and senior operational management should be concerned about

Factor	Top and senior operational management should	Evidence/action
Ethical standards and behaviours (this links with the 'control environment standard')	Make clear throughout the organisation the ethical standards and behaviours that are expected to be applied both internally and externally to colleagues, to users of the services and activities, to suppliers, to enquirers for information	Does the information and communication process make clear, both internally and externally, what those ethical standards and behaviours should be? What is the evidence: is there, for example, a specific responsibility upon a department within the organisation (such as an HR[a] department) and does it produce information about the expected ethical standards and behaviours for circulation within an organisation?
Relevance, reliability, timeliness and quality of information to both internal managers and staff and to external parties	Ensure the information provided is relevant to the needs of the managers, staff and external parties and that it is reliable, timely and in a form that can be used (rather than just in a format convenient to the provider of the information).	Have manager's, staff and external party's views been sought on the relevance, reliability, timeliness and quality of the information available to them?
Coverage of the information	Ensure the information coverage to the manager includes financial and performance information as well as other information affecting the particular managerial operational environment. Similarly ensure that the information to external parties is comprehensive.	Has the manager been asked whether he/she is receiving the full range of information required for effective managerial purposes? Is there any process of regular review? The same applies to external parties.
Organisational arrangements to secure delivery of information internally	Ensure that systematic arrangements exist to establish the information requirements of managers, given that they are expected to meet objectives and performance standards efficiently and effectively.	Does a particular official have a specific responsibility to ensure that the information and communication arrangements within the organisation are appropriate to the needs of managers? Similarly for information to external parties.

(*continued*)

Table 11.1 (continued)

Factor	Top and senior operational management should	Evidence/action
Accountability arrangements (this links with the 'control environment' standard)	Ensure that they do not lose touch with the reality of the day-to-day operational management environment. Effective accountability arrangements should help prevent this. However, accountability is only effective if the consequences are not threatening and that lower levels of management feel that top and senior management pay attention to what they are being told and are responding appropriately.	Is there a regular review of the quality and effectiveness of the accountability arrangements including arrangements for an independent review of their effectiveness either by internal audit or an external consultancy organisation on behalf of the top and senior operational management? An important feature of PFM/IC is external accountability to parliament and other third parties. This demands that the information they require is also subject to review to ensure its relevance.
Provision of advice and correction of mistakes (this links with the 'control environment' standard)	Ensure that top and senior managers correct mistakes or give advice without creating a hostile work environment. The real possibility, if relationships are threatening, is that lower level staff will only tell top and senior management what they feel they want to hear, rather than the reality of a situation as perceived by the employee. Mistakes in the provision of information to third parties should also be corrected immediately.	The top and senior management set the culture and attitudes that apply within an organisation and externally. The interest of the top and senior operational management is to ensure that a hostile work and external environment does not exist.
Employee perception of risks to themselves and their careers (this links with the 'control environment' standard)	Recognise that the risks that an employee perceives to him/herself will affect employee willingness to be frank. If employees perceive the risk to be high, then they will not be frank in their accountability reporting. The result is that it becomes more difficult for top and senior management to understand the reality of any situation. An inappropriate and threatening approach as perceived by lower level managers can generate an attitude of 'this is what they want so this is what they get'. This problem may be more acute in some organisations compared with others particularly in 'disciplined' organisations such as the prison, police and military services.	Top and senior operational management should be very concerned that employees do not perceive themselves in normal situations to be 'at risk'. A responsibility of an HR department within a public organisation should be to assess 'risk perception' amongst employees.

Disciplinary and penalty arrangements (this links with the 'control environment' standard)	Recognise that a potentially threatening and hence damaging situation can also be compounded by the approach to discipline and penalties that apply within the organisation. Traditional disciplinary and penalty arrangements can be vague and inappropriate where a managerial rather than an administrative approach is being introduced. With a managerial approach, managers at all levels will have to make decisions and this involves potentially elements of risk. Managers should not be deterred from taking such risks provided they operate within clear guidelines.	With the introduction of PFM/IC disciplinary and penalty arrangements should be reviewed. Top operational management have a responsibility to ensure that this occurs. Are individual managers clear about the extent to which they can take risks and where they need to seek higher level authority?
Development of a 'silo' mentality	Recognise that a factor affecting the performance of public organisations, especially those public organisations addressing complex social problems, such as social and medical care for disadvantaged persons or the application of policies to combat the use of illegal drugs, is that cooperation within organisations between different departments and with other public, private and not-for-profit organisations can be essential. This is especially true where service delivery and/or the responsibility for policy development and application lies with second-level organisations (agencies or similar organisations) established for specific purposes. Is there a process for securing cooperation?	A responsibility of top and operational management is to ensure that a 'silo mentality' does not develop. Do arrangements to share or exchange information with other relevant organisations exist and does sharing actually happen? What is the evidence?

(*continued*)

Table 11.1 (continued)

Factor	Top and senior operational management should	Evidence/action
The use of IT and social media	Recognise that the opportunities for improving communication flows within organisations as well as externally, are increased with the extended use of IT. Providing information though does not automatically mean that there is 'good communication'. A variety of reasons can exist as to why 'good communication' is difficult to achieve. Staff and managers and external parties can be overwhelmed with information if it is not properly targeted. They may also regard information as 'propaganda' on behalf of the top management of the organisation rather than as a dispassionate commentary about the business.	In any organisation top and senior operational management have a responsibility to ensure that 'good communication' does occur both vertically (down and up) and laterally across the organisation and also externally. Social media can be a valuable tool in the development of communications, both internally and externally. What is the evidence that top and senior operational management are aware of the need to an effective communications policy?
Training in achieving effective communications	Recognise that good communication arrangements involve meetings, formal and informal conversations, presentations, written reports and emails. Good communications though do not just occur and often staff require training in how to conduct meetings, to write reports and other forms of written communication including when to use written or verbal communication and how to use social media. A feature of internal good communications can be 'one-to-one' meetings between employees and their superiors but again training is likely to be required to ensure that this form of communication is effective.	Has any need for training been defined and provided to management at all levels in order to secure effective communication arrangements?

[a]HR—Human Relations or sometimes Personnel Department

(e.g., several deputy ministers or mayors) without any recognition of the need for coordination to harness the resources of the whole organisation itself encourages the development of a 'silo' mentality. (The existence of 'silo mentalities' is a classical feature of public administration organisations.) A 'team meeting' of top politically appointed officials does not automatically mean that coordination will exist at lower levels in the organisation. Where operational implementation of policy is a responsibility of a civil or local government service management, then the development of a staff communications policy and associated activities should be easier to achieve provided that the top and senior civil or local government service management perceive the necessity and are willing to implement such a policy. The organisational arrangements should accommodate this. But whatever the top management structure, emphasis should be put on developing an information and communications strategy for the organisation and an operational environment that encourages open and trusting relationships.

A feature of an effective information and communications policy is that if it is to encourage open and trusting relationships there must be adequate protection for 'whistle blowers'.[11] This means that public organisations must find a reliable method of identifying and correcting any unlawful or unethical conduct that occurs within their organisation. Consequently, public organisations should:

- Not obstruct officials from reporting misconduct potentially harmful to the organisation or to the public it is serving;
- Introduce procedures for ensuring reliable reporting without incurring any penalties.

Whatever the information and communication arrangements within an organisation, there can be a lack of understanding or interpretation between those making any statements (in whatever form) and those hearing or reading them. Merely issuing advice or an instruction does not mean that it will necessarily be interpreted in the way in which the author intended. How the recipient interprets that advice or instruction depends very much upon the position and perceptions of the recipient. Senior managers communicating with their staffs must be aware of the potential risk of the recipient of the communication hearing what they want to hear, rather than what the senior manager

[11] A whistle blower is an employee, who reveals information about activity within a private or public organisation that is deemed illegal, immoral, illicit, unsafe or fraudulent.

wanted them to hear. This author has been told by officials from several different countries that all that is necessary is to issue an instruction or regulation and it will be followed. That is a mistake! The same problems exist with external communications. Care should be taken to avoid the use of 'jargon'.

Effective communication in the workplace helps staff and managers form highly efficient teams. It builds trust, reduces competition and encourages cooperation within and between units and departments and helps staff work together harmoniously leading to higher productivity, integrity and responsibility. Staff must know their roles and should know that they are valued.

A manager who openly communicates with staff can foster a positive relationship that benefits the whole organisation. Good communications can also improve employee morale. Employees do appreciate good communication from more senior management.

The department responsible for the application of PFM/IC therefore should not just rely on legislative requirements set out in a public internal control or public financial management law or other formats to ensure that good communications are a feature of the internal control arrangements. This is though the apparently usual process in some countries adopting this reform. A deep understanding of effective communications is necessary and in reviewing the application of this standard, evidence that this exists should be looked for. In other words, the 'driver' department responsible for applying PFM/IC should look for the features of an information and communications strategy outlined here and for the effectiveness of the strategy. That responsibility also extends to external communications.

A European Commission paper based upon COSO defined a set of principles affecting information and communication. These were that the public organisation:

Principle 13: Obtains, generates and uses relevant, quality information.
Principle 14: Ensures proper internal communication.
Principle 15: Ensures proper external communication.[12]

11.3.2.3 The Control Activities Standard

The political management should have a responsibility to ensure that the objectives of the organisation are delivered, that they are delivered efficiently

[12] SIGMA paper 59 June 2019 'Guidelines for assessing the quality of internal control systems' (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), pages 47 to 52.

and effectively, that performance standards and objectives are observed and especially those set by external regulators, that the resources of the organisation are properly safeguarded and used only for the purposes of the organisation and not, for example, for political or personal purposes. They also have an obligation to ensure that the objectives imposed upon the organisation by others and most notably by the ministry of finance to maintain adequate budgetary and financial control are properly met. Top and senior operational and political management also have a responsibility to ensure that the financial reports to the ministry of finance, including the year-end financial statements and other statement, are reliable. Controls should also be concerned with the longer term financial viability of the organisation. The actual application of these responsibilities, as has been shown in earlier chapters, should be undertaken in practice normally by the operational management and this should be made clear through the delegation and accountability arrangements. The accountability arrangements should be designed to ensure that the political management can be confident that the operational management is acting competently and responsibly. The aim of the control activities should be to ensure that all this is achieved. The control activities should be designed to reduce the risk of failure by the operational management to achieve objectives and performance standards efficiently and effectively and that public resources are being properly utilised. The operational management should also ensure that commitments are not entered into which would affect adversely the financial sustainability of the organisation and should advise the political management where such a risk appears to be occurring or would occur if particular decisions were made.

A key feature of control activity is 'accountability'. Lower levels of management are accountable to more senior levels for the delivery of their objectives within the relevant constraints. Top and senior operational management responsibility is to test out in its actions whether the control activities are effective and this should be demonstrated in the accountability arrangements. That is, are the reporting systems effective; do they address the key issues; are reports used as the basis for decisions; do follow up processes exist and are acted upon? Similarly, the accountability arrangements between the top operational management and the political level of management should be assessed by both sets of management to ensure that they provide the confidence that the political level of management requires.

The department responsible for the application of PFM/IC should assess as one of its monitoring activities both how well the control activities within an organisation are operating and the range of those control activities, most notably that they are not limited to traditional financial and budgetary controls. An indicator of this is by establishing how successful the organisation has been in achieving its objectives, within budget, to time, to standard, efficiently and effectively and meeting all regulatory requirements. Some of the detailed analyses to assess the quality of the individual internal control processes include:

- Is each level of management clear about the scope of its responsibilities and the extent of its discretion?
- Are the internal management reporting arrangements consistent with the delegation arrangements?
- Do senior managers respond effectively to reports?
- Is there onward reporting to higher levels of management in appropriate circumstances?
- Do clear guidelines exist which indicate how management at all levels should respond to accountability reports?
- Are such reports supplemented by 'face to face' meetings?
- Do opportunities exist for group discussions so that issues and the information associated with them may be more widely shared or challenged?

The control activities should focus on outputs as well as inputs and a responsibility of top and senior operational management is to ensure that the appropriate controls exist.

One area of internal control activity that is frequently overlooked is that concerned with the risks to the longer run financial resilience of the organisation. This is discussed in Chap. 8. Most internal controls are focussed upon current operations, yet the ability to continue current operations into the future is heavily influenced by longer run financial considerations. By undertaking strategic financial planning an organisation should be able to forecast its future demands for current funding from the national budget or for new capital investment. Only then will an organisation be able to either argue for additional resources or to assess the scale of the cuts to existing activities (if that is the situation) or consider adjustments to its strategic plans that it may need to make. Strategic plans should also exist and those strategic plans should include a financial dimension to demonstrate what the costs will be of achieving strategic objectives.

To assist top and senior operational management determine the appropriateness of the internal control arrangements (and it is their responsibility to ensure that these controls are appropriate) they ought to ask themselves a series of questions covering output and input controls and the controls concerned with longer term financial sustainability. (These questions which link with other internal control standards should also enable the 'driver' department responsible for the application of PFM/IC to form a judgement about the effectiveness of the controls.) Examples of some of the questions which refer to ministries, but which can be adapted to meet the needs of other types of public organisation such as local governments, are as follows:

Overall Questions:

(i) Can we (i.e., the top and senior operational management) be sure that managers at all levels have the right information, at the right time, in the right form to enable the organisation to deliver its objectives, to time, to standard, within budget, efficiently and effectively:

- Is each manager within the organisation clear about the objectives and standards that the manager is expected to meet?
- Are the relevant managers fully aware of externally set regulations and do systems exist to demonstrate how they are being met?
- Has each manager the information available so that not only can that manager monitor what is happening but also be fully and properly accountable?
- What controls exist to ensure that objectives and standards are achieved efficiently and effectively?
- Where the health and safety of clients and staff is a major concern (as in hospitals or high-rise housing or child care facilities), is there absolute clarity about standards expected and do management systems exist to secure observance of health and safety standards?

(ii) As each manager should be expected to deliver the objectives efficiently and effectively, has each manager the full budgetary and performance information available to enable the manager to do so? Has the manager also the appropriate management accounting information and does the necessary cost and management information system exist; is the management as well as the finance department staff sufficiently well trained to use that information?

(iii) Has each manager the appropriate technical guidance to enable the relevant operational standards to be delivered and do monitoring arrangements exist to secure observance?

(iv) Where charges are levied for services provided or for the use of assets and other resources, do those charges fully reflect the costs of provision or where a policy decision has been made to subsidise those costs or to provide a surplus, that the financial information has been properly and fully calculated and therefore that the real level of subsidy is apparent and to whom?

Questions About Input Controls:

(v) Do the appropriate controls over inputs exist to ensure that:

- Assets and other resources (including stocks and stores) are used only for the purposes of the organisation, that is, exclude use for political or private purposes?
- No significant liabilities, including all fiscal liabilities, are entered into without the specific approval of top management and, if necessary, with the specific approval of the ministry of finance?
- No contracting out of the delivery of public services exists without a thorough investigation into the financial and operational viability and quality of the private companies or other private institutions involved?
- No future contractual obligations to suppliers exist which will make the future financing of the service or activity difficult to achieve or which may lead to an imbalance in the provision of other services or activities?
- Procurement is only undertaken in accordance with the procurement regulations/legislation?
- All externally set technical regulatory regulations concerning the delivery of particular services are observed?
- All financial regulations issued by the ministry of finance are being adhered to (if such regulations do not exist, then either the ministry of finance should be asked to issue such regulations or the organisation itself should develop and issue its own financial regulations)?
- All income and payment arrangements adhere to the requirements set out in those financial regulations, including where appropriate the separation of duties?

(vi) Do controls over inputs inhibit or support management's ability to deliver the objectives of the organisation? Where those controls, especially over the number of personnel or the allocation of personnel, require decisions to be made by someone other than the manager or even by another organisation, the responsibility of the manager is diluted. The question then is, is this desirable and to what extent does it reduce the accountability of the manager? The consequential question for top and senior management then is how does this, in turn, affect their responsibilities and should any external controls be challenged, for example, over staffing arrangements?

(vii) Do the ministry of finance budgetary and cash flow controls reflect the needs of the operational management or is change required? The question that has then to be addressed by top and senior operational managers is what are the most appropriate controls to meet the needs of operational management? This is likely to require significant new controls or an adaptation of those required by the ministry of finance, for example, to give managers greater ability to manage resources to achieve objectives.

(viii) Are the arrangements for the recruitment, allocation, retention and training of staff consistent with the needs of the organisation or do they inhibit the organisation in the delivery of its objectives? (Sometimes organisational managements have little control over the recruitment, promotion and training of staff. Staff may be appointed for political reasons rather than because of their competencies. Is that an appropriate arrangement given the need to achieve objectives and to secure managerial accountability?)

(ix) Are the controls that exist within the IT systems sufficient to protect against fraudulent misuse through inadequate security arrangements and against hacking and other forms of attack: what is the evidence that those controls have been fully tested? Are the controls only nominal or are they properly applied in practice and what is the evidence for that?

(x) Have all operating system updates issued by software manufacturers been applied?

(xi) Is there confidence that the reporting to the ministry of finance (and where appropriate to other third parties) is accurate and timely and that the financial statements properly present the financial position of the organisation? (Internal and external audit have an important role but the primary responsibility is that of the management.)

(xii) As the organisation will have a responsibility to store information and that may be physically and electronically, are the archiving arrangements consistent with the centrally determined arrangements for archiving (if any) and are those arrangements adequate for the purpose, both physically to ensure that the records are not damaged, and are they held securely to prevent misuse or change to those records? Are the records properly maintained so that they are accessible to future enquirers? Are the systems sufficiently secure to prevent loss of data though breaches of security, mismanagement or IT breakdowns? Do 'back-up' systems exist? Archiving applies to all operational as well as financial records. Can these questions be answered positively for electronically held records as well as for physical records?

Questions About the Controls Concerned with Longer Term Financial Sustainability:

(xiii) Does a process of strategic financial planning exist which evaluates the impact of present and proposed policies upon the organisation's future finances considering all those factors that are likely to impact upon those finances?
(xiv) Is there a process which assesses the commitments of the organisation given its current policies, such as public/private partnership arrangements, and tests the financial viability of those policies over the longer term, considering likely trends in the availability of budgetary funds and other sources of income (which may be affected by the state of the economy)?
(xv) Does a long-term financial planning process exist which systematically informs the political level of management and the top and senior operational management of the forecast financial resilience of the organisation given the commitments that have been entered into with the development of current policies? Does that planning process inform the political level of management about the financial consequences of the introduction of new policies and other likely new commitments that may be or are emerging (e.g., through climate and legislative change) which are beyond the control of the management of the organisation, and which could affect policy making decisions?
(xvi) Do those processes consider the impact of any fiscal liabilities that have been entered into?
(xvii) Does a process of consultation exist with the ministry of finance about its judgement of the future government financial planning, based upon economic forecasts, and how this may impact upon the finances of individual ministries given government priorities?

These examples of control activities also demonstrate the interlocking of this standard with those for the control environment and information and communications. They also emphasise that control activities are not simply about financial and budgetary controls but that technical controls also are very important and a failure to observe technical controls is likely to result in major future costs as well as costs to reputation.

A European Commission paper based upon COSO summarised the requirements of control activities as the public organisation:

Principle 10: Selects and develops control activities
Principle 11: Selects and develops general control activities
over technology
Principle 12: Deploys control activities through policies and procedures[13]

The responsibility of the top and senior operational management should be to ensure that the control activities that are employed are effective and that the political management is satisfied with their quality. They also need to satisfy the external auditor and consequently parliament, and those to whom the organisation is accountable (e.g., to the cabinet of ministers, to parliament and to civil society). The top operational manager should ensure therefore that appropriate control activities actually exist, operate effectively and be confident that all staff are familiar with the controls that affect them and how they should operate. This would mean that staff job descriptions fully cover the responsibilities for the relevant controls and that staff appraisal arrangements also cover references to awareness of those internal control arrangements. Periodic assessments of the efficiency and effectiveness of these controls should occur with internal audit and any relevant external organisation being assessors.

The exact form of the control activities will depend upon the services and operational activities that the organisation is engaged in.

11.3.2.4 The Risk Management Standard

An Overview

An important element of control activity is that the risk management processes operate effectively. The aim of risk management is not to eliminate risk because only by taking risks will change and improvements in the delivery of services and activities occur. The purpose is to identify and then manage the

[13] SIGMA paper 59 June 2019 'Guidelines for assessing the quality of internal control systems' (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), pages 41 to 47.

risks so that objectives and standards can be achieved and that adverse consequences can be avoided or minimised by careful assessment, planning and management. The 'driver' department of the ministry of finance should issue detailed guidance on how the reporting associated with risk management should be developed and applied taking into account the arrangements for delegation and managerial accountability that exist at the time.

The key to the effective management of risks is the 'tone at the top' of the organisation (the 'control environment standard'). This affects the priority that the different levels of operational management and staff give to risk management and the comprehensiveness of the risk management arrangements. The behaviour and actions of the top and the senior management and how they communicate with and challenge the different levels of management about risk illustrates the degree of significance attached to risk management. If the leadership attitude is one of indifference and there is no real top-level ownership, especially by top operational management, or the messages from the political leadership and top-level operational management are inconsistent, this will be damaging to the risk management process.

The primary concern of the political level of management should be with the relevance and quality of the organisation's risk management policy.

Whatever the managerial circumstances and the level of risk, there are various ways in which risks can be addressed. One way is through building in additional controls, another is by changing the management arrangements, or by some form of insurance, by sharing the risk with a third party, by changing designs or even not going ahead with a policy, project or activity because the perceived risks are too great.

The UK Treasury issued a publication on the Management of Risk—Principles and Concepts. This emphasised significance of the role of management as: "For the risk management framework to be considered effective, the following principles shall be applied: A. Risk management shall be an essential part of governance and leadership, and fundamental to how the organisation is directed, managed, and controlled at all levels. B. Risk management shall be an integral part of all organisational activities to support decision-making in achieving objectives. C. Risk management shall be collaborative and informed by the best available information and expertise. D. Risk management processes shall be structured to include: a. risk identification and assessment to determine and prioritise how the risks should be managed; b. the selection, design and implementation of risk treatment options that support achievement of intended outcomes and manage risks to an acceptable level; c. the design and operation of integrated, insightful and informative risk monitoring; and d. timely, accurate and useful risk reporting to enhance the quality of decision-making and to support management and oversight bodies in meeting their responsibilities. E. Risk management shall be continually improved through learning and experience."[14] (Although this publication has been issued by a country with a well-developed public sector management structure, it does contain very clear guidance which could be usefully applied in countries introducing PFM/IC.)

For risk management to be effective:

- The political head of the organisation and the person responsible for the quality of PFM/IC within the organisation, that is, the state secretary in a ministry, recognise the significance of risk management in the achievement of the objectives and performance standards of the organisation including technical performance standards and provide leadership in its development.[15]
- Clarity of objectives and performance standards and objectives exist and a management structure is in place designed to deliver the objectives and standards.
- An appropriate control environment exists.
- Adequate information flows and communication arrangements exist.
- Internal controls are effective.
- Accountability arrangements exist, both internally and externally.

If the top political and operational management are not interested in the development of risk management throughout the organisation (i.e., genuinely interested as opposed to 'going through the motions'), then there is something wrong not only with the risk management process but also with the management arrangements themselves. The risk management process must be of genuine interest to these top officials. They cannot though be expected to personally manage all risks. Their personal concerns should be that there is effective risk management throughout the organisation and that they are focussed on the significant risks to the organisation, perhaps no more than 15 to 20. However, this number does depend upon the nature of the service or activity. If the number rises above this level, then there is almost certainly

[14] The Orange Book—Management of Risk-Principles and Concepts: P6: Published by UK Government, updated 2020. Orange Book—GOV.UK (www.gov.uk).

[15] The official within an organisation responsible for the managing and effectiveness of the risk management process should be the official responsible for the application and quality of the PFM/IC reform within an organisation, that is, the state secretary or equivalent. If there is no delegation, in practice how a political official could actually take on the responsibility for risk management is difficult to see because of the detailed operational management knowledge that is required and the detailed bureaucracy that is likely to be involved. However, the top political manager must recognise and accept the importance of risk management in ensuring that the political objectives of the organisation can be achieved. Therefore, interaction between the political head and the top operational manager is essential.

something not right about the risk management assessment arrangements and the top management is being drawn into too much detail. This is likely to devalue the risk management as a process. Once a risk has been accepted, then what matters most, given systematic review, is change in the level of risk. Why is that change occurring?

The Orange Book referred to above also defines 13 different categories of risk, that is, Strategy risks—Governance risks—Operations risks—Legal risks—Property risks—Financial risks—Commercial risks—People risks—Technology risks—Information risks—Security risks—Project/Programme risks—Reputational risks.[16] For countries adopting PFM/IC to analyse risks over these 13 different categories at the initial stages of development may be too complex. The following may be an oversimplification but initially an important distinction should be made between managerial or strategic risk management and systems risk management.

Managerial or strategic risk management should be concerned with the key or strategic risks facing an organisation, which could fall into any of the categories identified above. A responsibility of the top operational management is to work with the political management to identify those risks with which the political management is concerned and how it wishes that they should be managed including being kept informed about them. Most risks will be managed by the operational management but others may have aspects which are of particular interest to the political management as well as to operational management. The top operational management should identify and focus upon those managerial or strategic risks that have a direct impact upon their effective management of the organisation.

Examples of high-level risks that political management may be concerned about include significant potential damage to the reputation of the organisation, significant legal action against the organisation, significant financial losses, risk of death or serious injury to users of the service or to employees, an attack on the IT security systems that results in the theft of private personal data or the corruption of a major IT system that prevents a service or activity being delivered, such as social security payments or the taking of decisions that could significantly affect the long-run financial resilience of the organisation.

Another example of high-level risk that organisations should take into account is risk to the continued operation of the organisation as a whole or significant parts of it. An important responsibility therefore of top and senior

[16] Orange Book—p. 38.

management (political and official) is business continuity planning in the event of some major external threat to the organisation. A recent example of this is the impact of a disease upon management and the clients/customers of the organisation and on the organisations that are major suppliers.

Systems risks may or may not be important to top and senior operational management, and sometimes political management may need to become involved. However, it all depends upon the circumstances. If the system is vital to the effective functioning of the organisation (such as a social security system or disease prevention in a hospital), then the top political management would inevitably become involved. Otherwise, most system risks could be managed by operational management.

As has been pointed out previously, all decisions involve some element of risk and in some countries the risks associated with usual day-to-day management activity have been incorporated into the formal risk management processes. This is a mistake. These normal operational responsibilities should not be included in the formal risk management processes and to include them, as some organisations do, is to devalue the impact of risk management.

Whatever decisions are made about risk management, whether by political or top operational management, risks should be subject to regular review because circumstances change. How frequently such reviews should occur should depend upon the particular risk being considered!

Managers and Risk

The introduction of risk management into the management process adds considerably to the responsibilities of managers. In some organisations, defining and managing risk will be a complex process requiring considerable skill, expert knowledge and the exercise of judgement. Hence there may be a need to appoint staff to support the managers who are expert in identifying and making judgements about risk in a particular area of activity, for example, in the provision of health services, in the development of infrastructure, in policing and prison services, in services with a high risk of fraud such as those providing benefits to individuals or in fraud and corrupt practice in purchasing and supply arrangements. Those risks that involve the health and safety of employees should always be discussed with the potentially affected employees, or their representatives, including the proposed mitigation measures.

The management approach to risk at lower managerial levels should be based upon the risk to the achievement of that manager's objectives and the relevant performance standards (emphasising again that each manager should have objectives and standards). The process for addressing lower level risks should be, in principle, the same as that described above for high-level risks. Each lower level manager should report those that he/she regards as the more serious risks to the next higher level of management to determine whether in turn they should be referred further up the management structure until they reach top and senior management. They should also report to the next higher level of management on changes in the level of risk, especially where those changes indicate a worsening of the level of risk. Once risks have been identified, the individual manager's responsibility is to analyse those risks to determine how those risks should be managed and which risks may need to be reported to and agreed with more senior management.

An example of a service that will require specialist risk management skills is that of the management of hospitals. Hospital management will be concerned with the management of clinical and non-clinical risks and these will be managed in different ways.

> Through risk management there are significant opportunities for achieving improved quality of care, major costs savings, improved public perception and a reduction in clinical negligence claims by having the correct risk management strategy. The goals of the risk management strategy could include:
> - enhanced quality of care;
> - protection against criminal prosecution;
> - financial savings from reduced risk, which includes reduction in claims against the trust [hospital] and optimisation of insurance premium expenditure;
> - cost-efficient risk reduction;
> - improved public image;
> - improved staff morale and productivity.[17]

Another example is the management of schools. A major immediate concern to the managers of a school will be the health and safety of pupils. Risk assessment involves considering the severity of consequences if a person or pupil is exposed to a potential risk, combined with the likelihood of it happening. The level of risk will increase as the likelihood of injury or illness or its severity increases. A risk assessment can help determine:

- How severe a risk is;
- Whether existing control measures are effective;

---

[17] Extract from 'An exemplar operational risk management strategy' UK NHS January 1997: file:///C:/Users/User/Dropbox/Reference%20sources/Risk%20Management/An_exemplar_operational_risk_management_strategy.pdf.

- What action should be taken to control the risk; and
- How urgently the action needs to be taken.[18]

The Practicalities of Introducing Risk Management

A degree of bureaucracy is necessary to identify risk, indicate who is responsible for its management, demonstrate the actions that have been taken and identify the trends in the development of the risk. A formal risk register therefore should be established: a single register covering all risks can be unwieldy and a more practical approach can be to establish risk registers that address managerial or strategic risks and separately for lower order risks.[19] Again, different risk registers can be developed for different parts of the organisation. Which is the most appropriate approach depending upon the management arrangements within the organisation? Top and senior operational management, subject to any political management concerns, should determine the monitoring and reporting arrangements. The overall responsibility for the risk register process should lie with the head of operational management. However, the actual 'process' responsibility could be delegated to another official. That a specific official should have this bureaucratic responsibility in no way removes from the top operational manager, the state secretary or equivalent, their ultimate responsibility for managing risk and for ensuring that an appropriate risk management process applies throughout the organisation.

Decisions should also be made about the frequency for the reporting of risks. This could vary depending upon the type of risk and the personalities involved. This will mean that the risk register(s) will need to be updated (and coordinated) so that each higher level of management is aware of the development of risks and the effectiveness of the mitigation measures. How often updating or review of risks should occur will depend upon the nature of the

[18] Taken from https://www.education.govt.nz/school/health-safety-and-wellbeing/managing-risks-and-hazards-at-school/risk-identification-assessment-and-management.

[19] A typical risk register contains:

- A risk category to group similar risks
- A brief description or name of the risk
- The impact (or consequence) if an event actually occurs (usually identified by a numerical score)
- The probability or likelihood of its occurrence (usually identified by a numerical score)
- The risk score (or risk rating) is the multiplication of the impact and probability scores leading to an overall ranking of the risks
- The mitigation steps
- The name of the person responsible for monitoring that risk.

risk and the bureaucracy should have the capacity to be flexible about the updating arrangements. Particular regard should be had to trends in the movement of individual risks—is the risk declining or increasing?

The Responsibilities of the Top and Senior Operational Management

The top and senior operational management have a substantial range of risk management responsibilities even though in practice some would be delegated to other officials. The main responsibilities of the head of operational management should include to:

a. Ensure that risk management is incorporated within the operational management processes, including job descriptions and that all risks are fully identified and managed at an appropriate level.
b. Ensure that those management processes are actually undertaken and are regularly reviewed with active steps being taken to mitigate risks.
c. Provide direction, guidance and advice on risk management best practice throughout the organisation.
d. Determine the risk appetite/tolerance for the organisation (see below for a discussion on 'risk appetite') and to inform and agree the risk appetite parameters with the political head of the organisation, also after considering the views of any external advisers.[20]
e. Receive regular reports on managerial and strategic risks and the trends which are emerging so that he/she can require corrective actions to be taken.
f. Prepare reports to the political head of the organisation on those managerial and strategic risks which directly affect the political head, paying particular attention to changes in the levels of risk.
g. Provide any feedback from the political level of management to other managers on the risk management process.
h. Ensure that appropriate training is provided to the different levels of official on risk management (whether politically appointed or civil or local government officials) and/or that specialist officials are appointed where fraud or corrupt practice is a high area of risk.
i. Ensure that a process exists which identifies the possible causes of risk appetite/tolerances being exceeded. Those causes can include mismanage-

[20] This should be regarded as a dynamic activity because determining risk appetite is not a single fixed concept and it will vary both for individual types of risk and over time, all depending upon circumstances.

ment, natural events, unforeseen international price movements, failures in a supply chain such as bankruptcy (but this risk in some circumstances should have been foreseen and therefore the real cause is mismanagement), misjudgement of demand for a service or activity (again a potential cause is mismanagement) or in construction, unstable ground conditions or unavailability of key workers such as engineers.

j. Ensure that systematic communication arrangements exist within the organisation to raise awareness about risk and the policies of the top management so that there is a wide understanding throughout all levels of management of the level of risk that is acceptable: this should inform all activities, that is, policies, programmes, projects and operational service delivery.
k. Ensure that second-level organisations establish risk management and that top and senior operational management of the first-level organisation are informed of the strategic risks and all fiscal risks that affect the second-level organisation so that the top and senior operational management of the first-level organisation can decide whether they need to become involved in the management of those risks and whether they should inform the political level of management.
l. Where an external advisory committee, such as an audit committee, exists which has an interest in the quality of risk management, maintain a close liaison with that committee and ensure that its recommendations are fully considered.
m. Prepare an annual risk management/risk appetite statement.

How does top and senior operational management undertake these responsibilities towards risk management in practice? The United Kingdom National Audit Office addressed this in a publication by setting out a series of questions for top and senior operational management to consider.[21] These are:

1. "How do we ensure that our focus is on managing the things that matter? Are we content that management's assessment of risk is not overly optimistic?
2. Are we clear about where we are prepared to tolerate differing levels of risk and, in turn, how these influence and drive the actions of management?
3. How confident are we that risks are being managed appropriately and that we will be informed of the most significant risks to our business?

[21] Managing Risks in Government: National Audit Office 2011.

4. What information do we need both to take decisions and to challenge the rigour with which risk is managed throughout the organisation?
5. How do we ensure that our decisions are based on a clear and balanced evaluation of the costs and impacts associated with risks and mitigations?
6. How do we learn from successes and failures both within our own and other organisations?"

Risk Appetite Impact and Likelihood

'Risk appetite' has been defined as "the amount and type of risk that an organisation is willing to take in order to meet their strategic objectives". Even though the top operational management may define the policy on risk appetite, the political leadership should agree that policy because of its significance. "Organisations will have different risk appetites depending on their sector, culture, and objectives. A range of appetites exist for different risks and these may change over time."[22] No risks should be acceptable which exceed the defined risk appetite. However, 'risk appetite' is not always quantifiable and may require managerial judgement. PFM/IC requires a managerial approach to the delivery of the objectives of an organisation, and as all managerial decisions involve a greater or lesser degree of risk, the existence of a risk appetite statement provides guidance to managers about the risks that can be taken to achieve an objective.[23]

In making decisions about risk two features are important. These features are what is the likelihood of the risk occurring and if the risk does occur what will be the impact? The management should assess these in terms of how the risk will affect the achievement of the objectives and performance standards and objectives. The estimates of the costs can then be compared with the costs of taking mitigating actions and the extent to which those mitigating actions will reduce the risk. This type of analysis can be undertaken with varying degrees of detail and complexity, depending on the purpose of the analysis, the availability and reliability of information and the resources available. Also risk analysis can be influenced by opinions, biases, perceptions of risk and judgements and the quality of the information used. Often a scoring method

[22] Institute of Risk Management UK 2017 (https://www.theirm.org/knowledge-and-resources/thought-leadership/risk-appetite-and-tolerance/).

[23] A risk appetite statement sets out the amount and type of risk that an organisation is willing to take in order to meet its strategic objectives. The appropriate level of risk will depend on the nature of the work undertaken and the objectives being pursued.

may be applied to provide a basis for assessing the significance of the risk. Both impact and likelihood should be scored (although some risks may be difficult to quantify and managers will need to make judgements).[24]

The Institute of Risk Management has listed stages in the development of risk appetite statements.[25] These are:

1. "Identify stakeholders and their expectations, together with an analysis of the risks to strategy, tactics, operations, and compliance, as set out in the risk register.
2. Establish the desired level of risk exposure that will lead to a risk appetite statement that provides a set of qualitative and quantitative statements.
3. Define the range of acceptable volatility or uncertainty around each of the types of risks leading to a statement of acceptable risk tolerances.
4. Reconcile the risk appetite, risk tolerances with the current level of risk exposure and plan actions to bring current risk exposures into line with risk appetite.
5. Formalize and ratify a risk appetite statement(s), communicate the statement with stakeholders and implement accordingly."

Publication

Risk management/appetite statements ideally should be published on the grounds of transparency and accountability and as one of the improvements emerging from the development of the quality of corporate governance. In countries which are in the process of adopting PFM/IC, there are basically two other significant reasons for the ministry of finance 'driver' department to require the development of annual risk management/appetite statements and for the completion of such a statement to be a specific responsibility of top and senior management. These are:

- To cause top and senior management to be aware of their risk management responsibilities and that risk management is not a lower level requirement which can easily be met by leaving it to lower level staff or internal audit and to be completed through the traditional bureaucratic procedures; and

[24] Scoring may be on a three- or five-point scale. With a three-point scale the scoring would be 'high' (3), 'medium' (2) or 'low' (1). The five-point scale elaborates on these three points. The overall risk assessment calculation is made by multiplying the two scores.

[25] https://www.theirm.org/media/3296897/0926-IRM-Risk-Appetite-12-10-17-v2.pdf.

- To require top and senior management to engage in the systematic and ongoing review of risks and to then make decisions about the range of risks that the organisation faces, the extent to which risk is acceptable in order to achieve objectives and the appropriate mitigating measures.

Examples of risk management statements are included in the annex to this chapter. They reflect different approaches to risk management. The common features are that the details are published and the approaches to risk management as well as who is responsible are also made clear. In other words, they meet the most desirable features of transparency and accountability. Unfortunately, countries currently adopting PFM/IC do not appear so far, to publish such types of statements. Yet a requirement for top and senior management to publish such statements would encourage risk management to become embedded into managerial arrangements. In the examples, risk management is shown to be a fundamental feature of management processes and therefore the operational context will reflect this as will the existence of objectives and performance information coupled with accountability pressures to achieve those objectives and levels of performance. Without a specific requirement falling upon top and senior management to specify the risk management arrangements they have established and the extent to which risk is considered and is acceptable, there is every possibility that considerations about risk will be superficial. This in turn, means that there will be less likelihood of objectives and standards being achieved. What is published for external stakeholders such as other ministries and the ministry of finance as well as parliament, pressure groups and service users (i.e., civil society) may be different from that published for the benefit of internal stakeholders (i.e., primarily the managers within the organisation). Without such an internal statement, lower level managers within the organisation will be providing services and activities with no or insufficient guidance on the levels of risk that they are permitted to take. They may also be deterred from developing new ideas and proposals to improve services and activities for fear of taking on additional risks because they do not know what level of risk is acceptable to top and senior management. In an administrative culture that has been traditionally risk averse, which is the situation in most of the countries adopting PFM/IC, clarity about top and senior management towards risk is very important.

Where publication of comprehensive information is deemed to be too difficult in a particular country, then all such reports should be available internally within a government. Similarly equivalent reports for individual local governments and state-owned enterprises should also be published.

Where agencies and state-owned enterprises are subject to the control or supervision by a ministry or local government, that ministry or local government should ensure, as part of its performance or service level agreement with the second-level organisation, whether market or non-market based (see Chap. 12), that risk management is introduced in those organisations. The risk management arrangements that have been put in place should be covered in the reporting arrangements between the second-level organisations and the controlling or supervising ministry or local government. (NB. A particular feature of the risk management control arrangements between first- and second-level organisations of whatever type should be that no fiscal risks should be entered into without the specific agreement of the first-level organisation.) [26]

A European Commission Overview About Risk Management and COSO

A European Commission paper based upon COSO summarised the requirements of risk assessment as the public organisation:

6. Specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives.
7. Identifies risks to the achievement of its objectives across the entity and analyses risks as a basis for determining how the risks should be managed.
8. Considers the potential for fraud in assessing risks to the achievement of objectives.
9. Identifies and assesses changes that could significantly impact the system of internal control.[27]

11.3.2.5 The Monitoring Activities Standard

The purpose of monitoring is to evaluate whether the arrangements for PFM/IC are making it possible for an organisation to achieve its objectives, doing so efficiently and effectively, to time, to standard and within budget and also

[26] Sources of fiscal risks include inadequacy of budgetary contingencies, guarantees given to third parties, public/private partnership arrangements, long-term contracts, environmental events, risks arising from the disposal or acquisition of assets and liabilities, compensation or other payments arising from legal challenges.

[27] SIGMA paper 59 June 2019 'Guidelines for assessing the quality of internal control systems' (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), pages 70 to 79.

within the laws and regulations to which the organisation is subject. Monitoring is also concerned to ensure that the organisation has adopted and is applying a commitment to integrity and ethical values. If these features are not occurring, the next question is why is this? The focus of monitoring in many countries that are introducing PFM/IC has been simply on whether the bureaucratic processes relating to the four other standards are in place with observations about the deficiencies that exist (if any). However, the SIGMA Guidelines for assessing the quality of internal control (IC) systems states that "Monitoring of the IC system is essential to ensure that IC remains aligned with changing objectives, environment, laws, resources, and risks. IC monitoring assesses the quality of performance over time and promptly resolves the findings of audits and other reviews. Corrective actions are a necessary complement to control activities in order to achieve objectives."[28]

The monitoring processes that have been adopted in this author's experience do not in general appear to address the main purpose of the reform. In most countries they also do not recognise that each standard is not a 'standalone' process which can be separately assessed. The procedural processes associated with each standard, as has been shown, are not easy to separately identify except at the most superficial level. Because the standards are interlocking, the monitoring process needs to reflect this. This will be best achieved by looking at the overall performance of the organisation in achieving its objectives and performance standards and objectives efficiently and effectively. Reliance is also often placed on 'self-certification'. What this means in practice is difficult to understand. The monitoring process needs to establish how far the assumptions, referred to at the beginning of this chapter, that lie behind the COSO process have been recognised. Monitoring is not therefore a simple 'tick-box' end of year type of process checking that the required bureaucratic procedures have been implemented. To emphasise, introducing the COSO standards is not simply a bureaucratic exercise but it has a specific purpose. This purpose is to achieve the objectives of the organisation efficiently and effectively, to time within budget, to standard with proper regard for integrity and ethical values, transparency and accountability and as part of this ensure that the law and regulatory requirements to which the organisation is subject are fully met. Monitoring should be aimed at this purpose, that is, is it being achieved and if not why not? Anything else at best can be regarded as an interim process. Each of the individual standards is ultimately aimed at

---

[28] SIGMA PAPER No. 59. Para 2.5 p. 51: OECD iLibrary | Guidelines for assessing the quality of internal control systems (oecd-ilibrary.org).

this purpose. The most effective test for the application of PFM/IC is how successful the organisation management has been in meeting this purpose. That is the point from which monitoring should start.

Without such an evaluation, whether the COSO standards have been properly applied cannot be established. Therefore, whether the policy of PFM/IC is meeting expectations also cannot be established. So, the question cannot be asked. Monitoring should start from whether the objectives and performance standards and objectives of the organisation have been achieved efficiently and effectively, within the law and budgetary constraints. The monitoring aim should then be to identify if they have not, what are the weaknesses that have allowed this to occur.

Monitoring responsibility within an organisation should be that of the top and senior operational management where the overall responsibility lies for the achievement of the objectives and performance standards. Monitoring should form part of the accountability arrangements flowing up the organisation, ultimately to the top and senior management, official and political. Monitoring should identify weaknesses in the quality of the management of the organisation itself (i.e., technical, operational and financial). A failure to properly carry out certain procedures is a management failure, not just a procedural failure which can simply be corrected by bureaucratic action.

Apart from the top and senior management, monitoring will be of concern to others. One will be to external regulators concerned with the observance of technical standards, another will be to the 'driver' department of the ministry of finance responsible for the application of PFM/IC and a third will be to parliament. The role of the ministry of finance in monitoring should be to judge the quality of operational management. Lack of achievement of objectives and performance standards, a failure to meet external regulatory standards as well as the quality of financial control should affect future budgetary allocations. Parliamentary monitoring (i.e., scrutiny) should have a central concern for the quality of management, the delivery of objectives efficiently and effectively and the meeting of technical regulations. Parliament may have its own scrutiny requirements and it may rely for advice on the external auditor who should have a concern about the quality of public expenditure through its assessments of value for money. This may lead on to a further form of external scrutiny, that of civil society.

What should also stimulate monitoring is that it should result in each public organisation publishing an annual report covering all its activities and, unless consolidated into a whole of government statement, its financial statements, along with a 'statement of internal control' (see Chap. 13). The 'statement of internal control' should describe the effectiveness of internal controls applying within an organisation.

Monitoring should be an ongoing process and the PFM/IC driver department should provide advice on how that is to be undertaken, including the extent of the monitoring required. As PFM/IC is developed it may also wish to regularly review the outputs of those monitoring arrangements.

Internal audit has an important role in the monitoring process. But it can only undertake this role effectively if internal audit recognises that it is operating within the managerial context set by PFM/IC. This means that internal audit should have a thorough understanding of the PFM/IC reform and how it affects decision making by managers. Therefore, the training of internal audit should be aimed to ensure that internal audit capability extends beyond traditional internal control monitoring based simply upon systems controls with a focus upon financial and budgetary controls.

The aim of an internal audit evaluation is to provide a 'lens' to show to the top and senior operational management how effective the application of the COSO standards by management is.

A European Commission paper based upon COSO summarised the requirements of monitoring as the public organisation:

16. Selects, develops and performs ongoing and/or separate evaluations.
17. Evaluates and communicates deficiencies.[29]

11.4 Summary

In this chapter the international standards of internal control have been described. These standards are essentially managerial disciplines. The context into which they are to be applied is an operational management context. These international standards cannot be isolated from this managerial context and treated as individual 'stand-alone' features of PFM/IC. The impact of each standard also cannot be clearly separated one from the other. Yet that is how they are treated in many developing and transition economy countries applying the standards. In considering the application of these standards regard should also be had to the assumptions that underpin these standards and these assumptions reflect the managerial context in which the standards are to be applied. Again, this is not usually something which is either recognised or considered.

[29] SIGMA paper 59 June 2019 'Guidelines for assessing the quality of internal control systems' (https://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=GOV/SIGMA(2019)1&docLanguage=En), Pages 92 to 96.

The detailed analysis of the application of each of these standards demonstrates how they impact upon the managerial arrangements. Those managerial arrangements should be designed to deliver the objectives and performance standards and objectives of the organisation efficiently and effectively within the budgetary and legal framework. These standards apply principally to operational management. Therefore, an important precursor to their implementation is the separation of operational management from the political level. These standards though also provide an opportunity for the political level of management to have an informed insight into how well the operational level of management is working. From this point of view therefore the political level of management should support the full application of these standards, but again what is essential is managerial reform.

An indicator of how well the standards have been applied would be described in the statement of internal control which each organisation ought to prepare as part of the annual reporting arrangements (see Chap. 13). This statement should be available to the ministry of finance, to parliament and to the wider public (civil society) as part of the transparency and accountability arrangements. Either accompanying the statement of internal control or separately, a public organisation should publish a statement about its approach to risk, that is, its risk appetite.

Annex 1

Examples of Risk Management Statements

Examples of risk management statements are set out below in a summarised form. Practical examples can be found by searching the web. Not all organisations are willing to publish such statements but with the introduction of PFM/IC and the emphasis upon transparency and accountability and an increased quality of governance, the managerial assumption should be in favour of publication unless there are very good reasons not to do so. These examples are for a hospital, a university and a state-owned industry and are based upon UK organisations. (These statements have been slightly edited by the author for publication within the context of this guide.)

Example 1. *A hospital* (Hospitals provided as part of the UK National Health Service (NHS) are established as trusts and are governed by trust boards. An operational management with a chief executive has the delegated responsibility for the day-to-day management of the hospital and is accountable to the board.)

Risk Management Example Statement

Overview

The aim is to provide high-quality, effective and safe services which improve the health, wellbeing and independence of the population it serves. The Board [i.e., the governing board of the hospital] recognises risk is inherent in the provision of healthcare and its services, and therefore a defined approach is necessary to identify risk context, ensuring that the Organisation understands and is aware of the risks it's prepared to accept in the pursuit of the delivery of the Organisation's aims and objectives. This Statement sets out the Board's strategic approach to risk-taking by defining its boundaries and risk tolerance thresholds and supports delivery of the Risk Management Strategy and Policy.

Risk Appetite Statement

Clinical Effectiveness

- We will provide high-quality services to our patients and not accept risks that could limit our ability to fulfil this objective. This key value is a driver that directly supports our core objective to improve our patients' care outcomes, and that of their family and friends, by providing personalised and responsive services.
- We are strongly averse to risks that could result in poor quality care or unacceptable clinical risk, non-compliance with standards or poor clinical or professional practice.

Category	Board Committee/ Sub-committee **(12+)**	Divisional Governance **(9+)**
Clinical & Care Outcomes	Risks relating to clinical & care outcomes scoring 12+ will be reported to the Quality & Safety Committee.	All clinical & care outcomes risks scoring 9+ will be reviewed at the appropriate monthly divisional governance meeting.

Patient Safety

- We will hold patient safety in the highest regard and are strongly averse to any risk that may jeopardise it. This key value is a driver that directly supports our core objective to improve the safety of our services to patients.

- It can be in the best interests of patients to accept some risk in order to achieve the best outcomes from individual patient care, treatment and therapeutic goals. We accept this and support our staff to work in collaboration with people who use our services to develop appropriate and safe care plans based on assessment of need and clinical risk.

Category	Board Committee/ Sub-committee **(9+)**	Divisional Governance **(6+)**
Patient safety	Risks relating to patient safety scoring 9+ will be reported to the Quality & Safety Committee.	All patient safety risks scoring 6+ will be reviewed at the appropriate monthly divisional governance meeting.

Finance

- We will strive to deliver our services within the budgets modelled in our financial plans. However, budgetary constraints will be exceeded if required to mitigate risks to patient safety or quality of care. All such financial responses will ensure optimal value for money.

Category	Board Committee/Sub-committee **(15+)**	Divisional Governance **(12+)**
Finance	Risks relating to finance scoring 15+ will be reported to the Finance & Performance Committee	All finance risks scoring 12+ will be reviewed at the appropriate monthly divisional governance meeting.

Patient and Service User Experience

- We will accept risks to patient and service user experience if they are consistent with the achievement of patient safety and quality improvements.
- We will only accept service redesign and divestment risks in the services we are commissioned to deliver if patient safety, quality care and service improvements are maintained.

Category	Board Committee/Sub-committee **(12+)**	Divisional Governance **(9+)**
Patient and service user experience	Risks relating to patient experience, engagement or stakeholder relationships scoring 12+ will be reported to the Quality & Safety Committee	All risks relating to patient experience, engagement or stakeholder relationships scoring 9+ will be reviewed at the appropriate monthly divisional governance meeting.

Workforce

- We are committed to recruit and retain staff that meet the high-quality standards of the organisation and will provide ongoing training to ensure all staff reach their full potential. There are few circumstances where we would accept risks associated with the delivery of this aim.
- We will not accept risks associated with unprofessional conduct, bullying or an individual's competence to perform roles or tasks safely and nor any incidents or circumstances which may compromise the safety of any staff members and patients or contradict our values.
- For patient safety, quality care, service delivery and financial sustainability reasons we are prepared to consider risks associated with the implementation of non-NHS [National Health Service] standard terms and conditions of employment, innovative resourcing and staff development models.
- We are strongly averse to any risk that could result in staff being in non-compliance with legislation or any frameworks provided by professional bodies.

Category	Board Committee/Sub-committee **(12+)**	Divisional Governance **(9+)**
Workforce	Risks relating to workforce scoring 12+ will be reported to the Workforce & Organisational Development Sub-Committee	All workforce risks scoring 9+ will be reviewed at the appropriate monthly divisional governance meeting.

Infrastructure

- We are committed to providing patient care in a therapeutic environment.
- We will provide staff with appropriate space and supporting infrastructure in which to perform their duties.

Category	Board Committee/Sub-committee **(12+)**	Divisional Governance **(9+)**
Infrastructure	Risks relating to infrastructure scoring 12+ will be reported to the Quality & Safety Committee.	All Infrastructure risks scoring 9+ will be reviewed at the appropriate monthly divisional governance meeting.

Risk Tolerance

Risk 'tolerance' is the minimum and maximum risk the organisation is willing to accept as reflected in the risk appetite themes above.

Detailed thresholds are articulated in the Risk Management Strategy & Policy statement and are dependent on the type of risk, against which all identified risks are assessed for their likelihood and impact using a risk scoring matrix.

The Executive Risk & Assurance Group will oversee all risks that score outside the risk appetite monthly and has established a rolling programme where each division (including Corporate Services) will present their full risk registers.

The Trust Board have agreed that all risks with total risk score of '12' will require executive oversight by the Executive Risk & Assurance Group.

In addition, risks with an impact score of 5 (catastrophic) and likelihood of 2 (unlikely) will also be regularly reviewed at executive level.

Finally, themes and trends in reported risks will be identified and escalated as appropriate to ensure that multiple similar risks of a low impact and likelihood are not ignored.

The Board has a range of committees and groups all charged with the responsibility of reviewing risks related to their terms of reference and subject matter ensuing those risks are controlled and, where necessary, escalated.

Note by author: This statement is complemented by an appendix showing a risk management governance map, guidance on risk management scoring and guidance on risk likelihood scoring.

Example 2. *A university* (The governance arrangements for a university in the UK are determined by the university's constitution which in turn depends upon how the university was originally established. There is therefore no standard model.)

The university in this example has published a Risk Policy and Risk Appetite Statement. This is set out below as an example of a different approach to the publication of information about risk management.

The university is governed by a 'court' which is the equivalent of a 'board' in other types of organisations. The chief official of the university who is the chairman of the university executive is the principal (other terms are used in other jurisdictions such as 'vice-chancellor'), and the principal is responsible for the overall operation of the university including that risk is identified and effectively managed.

The Risk Management Objectives

The university's risk management objectives are as follows:

1. Strategic-level decision making and planning are informed by accurate and congruent assessment of risk across the diverse colleges, groups and subsidiaries through formal university-wide enterprise risk management (ERM) framework and processes.
2. Effective college, group and subsidiary operational decision making is guided by accurate and congruent assessment of risk within and across their diverse business areas. The risk management framework and process in place at this operational level supports and feeds back into the strategic-level ERM framework, while meeting the needs of each distinct organisation.
3. All risk management across the university adheres to the current risk management framework established by the court, while encouraging a culture of innovation and opportunity, informed risk-taking within the university's risk appetite and an acknowledgement of risk as inherent in all activities of the university.

Framework

The management of risks in the university is undertaken within a framework comprising:

a. the values, vision, culture, mission and goals of the university and its constituent organisations;
b. the university's governance and reporting structures;
c. this *Risk Policy and Appetite* statement issued by the court;
d. *BS/ISO 31000:2018 Risk management—Guidance standard*, which defines the risk management process adopted by the university;
e. the *University Risk Management Guidance Manual*;
f. supporting tools and documents, such as risk register templates, likelihood and consequence criteria, and partner policies such as insurance, procurement, emergency management and business continuity, security, IT and financial control policies; and
g. the assurance and audit processes.

Roles and Responsibilities

An effective risk management programme should permeate existing management processes and provide assurance over the management of key risks. It requires interdependence between strategic and operational objectives, management processes, governance arrangements and other policies.

The court recognises that in order to pursue its objectives and to take advantage of opportunities, the university cannot avoid taking risks and that no risk management programme can aim to eliminate risk fully. Accordingly, the university's approach to risk management is intended to increase institutional risk awareness and understanding and thus support taking risks where appropriate, in a conscious, structured and controlled manner. Risk management must be embedded throughout the university. It is not the sole responsibility of senior managers but should be exercised by all staff, particularly those with management or operational responsibilities.

Role of the Court

Court has a requirement under the legislation to ensure the establishment and monitoring of systems of control and accountability, including risk management. Accordingly, its role is to:

a. Set the tone and influence the culture of risk management within the institution.
b. Determine the nature and extent of the principal risks it is willing to take in pursuing the university's strategic plan. This includes determining what types of risk are acceptable and which are not, and providing a risk appetite framework within which the appropriate level of exposure to risk can be determined in particular circumstances.
c. Approve major decisions affecting the university's risk profile or exposure.
d. Ensure the establishment and maintenance of a risk register.
e. Provide an annual disclosure about risk management in audited financial statements and submit an annual corporate governance statement to the Funding Council [an external body responsible for providing funding to universities] following advice from the audit committee, risk management committee, senior management, external and internal audit.

Role of the University Executive (UE)

The UE is responsible for:

a. Implementing court's risk management policy.
b. Ensuring that the major risks associated with significant proposals put to it have been properly considered and can be appropriately managed within the policy framework set by court.
c. Ensuring that corporate risks are properly managed, reviewing evidence to this effect and ensuring measurement of results as appropriate.
d. Communicating university policy and information about the risk management programme to all staff, subsidiary organisations and external partners.

Roles of Heads of Colleges, Schools and Professional Services

Responsibility for identifying and managing the risks in the university, as in any other organisation, lies with the management of the university. Heads of colleges, schools and professional services are responsible for:

a. Appointing a senior manager to coordinate risk management within their organisation.
b. Ensuring compliance with university and college policies. They have a responsibility to identify, evaluate and manage strategic and operational risks in accordance with the university's risk management policy and process, ensure each risk is assigned a risk owner and bring emerging corporate risks to the UE's attention.
c. These managers should ensure that everyone in their area of responsibility understands their risk management responsibilities and must make clear the extent to which staff are empowered to take risks.

Role of the Risk Management Committee

The role of the risk management committee is to support and advise the management, and through it the court, on the implementation and monitoring of the risk management policy. Its remit is to:

a. Ensure that the identification and evaluation of key risks that threaten achievement of the university's objectives is carried out and that a register of these risks is maintained.

b. Identify the strategy in place to manage such risks, including identification of appropriate risk owners and monitoring the satisfactory operation of the management strategy.
c. Satisfy itself that other risks are being actively managed, with the appropriate strategies in place and working effectively.
d. Report regularly to the court through the UE and the audit & risk committee on the achievement of the remit. Contribute to raising awareness of risk generally across the University and to maintaining the profile of risk management.
e. Address such other matters related to risk as may arise from time to time.

The University Risk Manager

The risk manager is a part of corporate services group. The risk manager is responsible to the risk management committee for:

- Facilitating the implementation of the standard risk management framework and process across the university.
- Assisting with the analysis of operational-level risk and the roll-up of significant risks to the strategic level.
- Providing risk management advice and assistance to all organisations within the university.

Role of Internal Audit

Internal audit is responsible for independently and regularly reviewing the operation of the overall risk management process in the university. In doing this, it has regard to best practice as recommended by professional institutes and other relevant organisations. Internal audit will:

a. Report its findings to the audit & risk committee.
b. Advise and make recommendations to the risk management committee and senior managers as appropriate.

Role of the Audit & Risk Committee

The audit & risk committee is responsible for monitoring the university's general arrangements for risk management, and specifically for:

a. Advising the court on the effectiveness of policies and procedures for risk assessment and risk management.
b. Annually reviewing the university's approach to risk management and, if appropriate, recommending changes or improvements to key elements of its processes and procedures. Providing a statement to the court annually indicating how the university has complied with good practice with regard to corporate governance and, in particular, in relation to effective risk management.

Role of All Faculty and Staff

All faculty and staff have a critical role to play in risk management. As a minimum, all members of the university have a responsibility to:

a. Effectively manage risk within their areas of responsibility in accordance with the university's risk management policy and process.
b. Report risks beyond their scope of authority or resources to their superiors.

Risk Appetite

The risk policy and appetite establish the court's commitment to the risk management framework and process, set the goals and objectives of the university's risk management process, lay out risk management roles and responsibilities throughout the university and specify the amount of risk the university is willing to seek or accept in the pursuit of its long-term objectives. It indicates the parameters within which the university would want to conduct its activities.

In terms of priorities, the need to avoid reputational, compliance and overall financial risk will take priority over other factors, for example, it will be acceptable to undertake risks in research activities providing they do not expose the university to undue reputational, compliance or financial risk. Similarly, the university is open to innovation in education and student experience, if this supports and enhances its reputation and does not expose it to undue finance or compliance risks. A balanced assessment has to be taken of risks—in many cases there are risks attached to both doing something and doing nothing.

Given the devolved nature of the University, the Statement is intended to act as a set of limitations within which academic and professional managers and committees should conduct their affairs, indicating:

a. the areas where colleagues should step out and be innovative;
b. the areas where colleagues should be conservative and compliant in their activities and
c. the 'lines' across which the university court and senior management do not wish to cross and where the university's senior management and court would need to be notified.

Where appropriate, the implementation of the statement will be incorporated into processes and procedures of the university.

Responsibility for managing the activities of the university within the statement of risk policy and risk appetite lies with the management of the university, in particular heads of colleges, schools, professional services and subsidiary companies, as well as key university and college committees.

Statement of Risk Policy and Risk Appetite

The university's approach is to minimise its exposure to reputational, compliance and financial risk, whilst accepting and encouraging an increased degree of risk in pursuit of its mission and objectives. It recognises that its appetite for risk varies according to the activity undertaken and that its acceptance of risk is subject always to ensuring that potential benefits and risks are fully understood before developments are authorised and that sensible measures to mitigate risk are established.

The university's appetite for risk across its activities is provided in the following statements and is illustrated diagrammatically.

	Unacceptable to take risks					Higher willingness to take risks				
	1	2	3	4	5	6	7	8	9	10
Reputation	<	>								
Compliance	<	>								
Financial			<		>					
Research						<				>
Education and student experience					<				>	
Knowledge exchange						<				>

	Unacceptable to take risks					Higher willingness to take risks				
	1	2	3	4	5	6	7	8	9	10
International development				<			>			
Major change activities		<				>				
Environment and social responsibility					<			>		
People and culture		<			>					

Risk Appetite Criteria:

Score	Description
1	Court unwilling to accept risks with potential to impact this operational area, as extreme damage to the viability of the university could result. Sub-optimal performance is unacceptable. Failure is not an option. No margin for error.
2	Very reluctant to accept risks. Potential pay-off must substantially exceed costs, and robust controls must be in place to prevent or mitigate potential harm. Court must specifically approve taking these risks. Continual monitoring and regular reporting to court is expected if approval to proceed is granted.
3	Reluctant to accept risks in this operational area. Detailed business plan with formal risk assessment would be required demonstrating value of taking these risks. Existing risks above 'medium' in these categories must be reported to risk management committee.
4	Colleges and support groups can retain high risk in these areas, provided substantial potential benefits exist. Robust risk management and ongoing monitoring by heads of college is required.
5	Retaining these risks can be considered by colleges and group provided resources exist internally to absorb potential losses and costs without impacting key operations and services, or other parts of the university.
6	Pursuit of opportunities is encouraged provided risks are considered and documented, and resources applied are commensurate with the potential benefit to the existing goals and objectives of the organisation.
7	Stretch targets are encouraged, even if failure is possible. Should not threaten the delivery of current key programmes, but project failure is possible and acceptable in pursuit of potential benefits.
8	Project teams and service groups can proceed in the face of significant risks provided reasonable mitigation strategies are in place. Heads of school should likely be aware of these activities' risks.

Score	Description
9	Individuals are free to innovate and take intelligent risks provided some potential benefits exist.
10	Risk taking is encouraged, assuming it is legal and a degree of due diligence is applied. Chance of failure can be high and failure will be accepted in the pursuit of moderate rewards.

Note: Any particular activity may incorporate many categories of risk. A research project, for example, may in and of itself be at high risk of failure, and the court may be willing to tolerate this. They would be unwilling, however, to accept any risk associated that the same project's failure to comply with statute, regulation, professional standards, research or medical ethics, bribery or fraud and would similarly want reasonable assurance that the project did not pose an undue financial liability risk

Reputation—It is regarded as critical that the university preserves its high reputation. The university therefore has low appetite for risk in the conduct of any of its activities that puts its reputation in jeopardy, could lead to undue adverse publicity or could lead to loss of confidence by the Scottish and UK political establishment and funders of its activities.

Compliance—The university places great importance on compliance and has no appetite for any breaches in statute, regulation, professional standards, research or medical ethics, bribery or fraud. It wishes to maintain accreditations related to courses or standards of operation and has low appetite for risk relating to actions that may put accreditations in jeopardy.

Financial—The university aims to maintain its long-term financial viability and its overall financial strength. Whilst targets for financial achievement will be higher, the university will aim to manage its financial risk by not breaching the following minimum criteria[30]:

Operational, Quantitative, Quarterly test

- *We will ensure the basket of financial sustainability metrics is always at a weighted acceptable level.*

Liquidity and gearing, Quantitative, Monthly test

- *We will maintain at least one month's equivalent average spend in cash or short-term deposits or negotiated bank facilities.*
- *We will ensure that the annual surplus before interest is at least two times the annual interest charge, except in exceptional circumstances as approved by Court.*
- *We will limit borrowing over one year to 35% of net assets except in exceptional circumstances approved by court.*
- *We will ensure that all cash invested through the endowment fund portfolio can be liquidated with three months' notice and that 30% can be liquidated with one month's notice.*

Qualitative

- *We will maintain access to liquidity that will allow us to meet our obligations, even under stressed scenarios.*
- *We will limit volatility impact by securing fixed-rate long-term borrowing.*

[30] These have been developed in conjunction with the Director of Finance.

- *We will maintain a portfolio of highly liquid assets to meet the liquidity outflows that may occur over the near-term.*
- *We will maintain a contingency plan to address any unforeseen events.*

Surplus, Quantitative, Annual test

- *We will deliver a minimum annual operating surplus of at least 2% of turnover over any three-year period unless court approves a specific alternative.*
- *We will operate with a staff cost/total expenditure ratio of less than 60%.*

The above statements take priority over the statements of areas of risk appetite below.

Research—The university wishes to be at the leading edge in the creation of knowledge and making a difference to society. It wishes to grow its research activities and improve its performance in each REF [research excellence framework] assessment compared to the previous assessment. It recognises that that this will involve an increased degree of risk in developing research activities and is comfortable in accepting this risk subject to (a) limitations imposed by ethical considerations and (b) ensuring that potential benefits and risks are fully understood before developments are authorised and that sensible measures to mitigate risk are established.

Education and Student Experience—The university wishes to stimulate students to develop a lifelong thirst for knowledge and learning and encourage a pioneering innovative and independent attitude and an aspiration to achieve success. It expects as a minimum to be in the top quartile of surveys related to student experience. It recognises that this should involve an increased degree of risk in developing education and the student experience and is comfortable in accepting this risk subject always to ensuring that potential benefits and risks are fully understood before developments are authorised and that sensible measures to mitigate risk are established.

Knowledge Exchange—The university wishes to be amongst the leaders in transforming knowledge, ideas, skills and expertise into advice, innovation, intellectual property and enterprise, thereby enriching society. It recognises that developing this may involve an increased degree of risk and is comfortable in accepting this risk subject always to ensuring that potential benefits and risks are fully understood before developments are authorised and that sensible measures to mitigate risk are established.

International Development—The university aims to achieve global impact in its activities and to promote research and other collaborations and staff/student exchanges with leading institutions across the world. It has a strong appetite for developing such networks to the extent that they support the mission and reputation of the university, a medium appetite for investing in research facilities overseas and a low appetite for investing in the development of student campuses outside of the UK.

Major Change Activities *(e.g., projects, collaborations, mergers)*—Major change activities are required periodically to develop the university and to adapt to changes in the regulatory and technological environment and in the nature and conduct of the university's activities. The university expects such changes to be managed according to best practice in project and change management and has low appetite for deviating from such standards.

Environment and Social Responsibility—The university aims to make a significant, sustainable and socially responsible contribution to Scotland, the UK and the world through its research, education, knowledge exchange and operational activities. It recognises that this should involve an increased degree of risk and is comfortable in accepting this risk subject always to ensuring that potential benefits and risks are fully understood before developments are authorised and that sensible measures to mitigate risk are established.

People and Culture—The university aims to value, support, develop and utilise the full potential of our staff to make the university a stimulating and safe place to work. It places importance on a culture of academic freedom, equality and diversity, dignity and respect, collegiality, annual reviews, the development of staff, and the health and safety of staff, students and visitors. It has low appetite for any deviation from its standards in these areas.

Example 3. A State-Owned Enterprise: (This is an extract from NETWORK RAIL LIMITED ANNUAL REPORT AND ACCOUNTS 2016[31])

Network Rail owns and operates most of Britain's railway infrastructure, including 20,000 miles of track, 30,000 bridge and viaducts and thousands of signals, tunnels, level crossings and points. We also manage rail timetabling and operate 20 of the largest stations. Our role is to provide a safe, reliable and efficient railway while growing and upgrading the network to better serve passengers and freight.

Network Rail is a public sector company, answerable to the Department for Transport (DfT) and Transport Scotland. It is governed by a board.

OUR APPROACH TO RISK MANAGEMENT

Our assets across the country work 24 hours a day, seven days a week, to provide a safe, reliable rail network. We are committed to providing a railway infrastructure that meets the performance and safety expectations of the travelling public, operating companies, and the tax payer.

With many assets working with often extreme environmental pressures, occasionally things break down. We are committed to resolving issues quickly in order to maintain service. We are also committed to improving our assets through comprehensive enhancement and maintenance programmes. In scheduling this work we recognise the disruptive impact on both the public and our commercial customers and strive to minimise disruption to complete works as efficiently as possible.

The purpose of our Enterprise Risk Management (ERM) process is to identify and mitigate risks to the delivery of a safe, reliable, and efficient service to

[31] https://www.networkrail.co.uk/wp-content/uploads/2016/11.

our customers. Our ERM framework supports all areas of the business to recognise both risk and opportunity early. Early recognition of risk allows us to work collaboratively and proactively with customers, stakeholders, and suppliers to manage our extensive portfolio of works better. Being better every day requires us to look at areas where we can improve our service. By careful consideration of risk, we can focus on those opportunities that have the highest potential to increase efficiency and provide a better experience for our customers.

Introduction:

Across Network Rail our approach to risk management balances the risks associated with our operational environment with identifying opportunities to improve performance through careful acceptance of some risk. We recognise our status as a regulated rail network infrastructure provider and the importance of maintaining essential service provision.

We have reviewed the original risk mitigations in place to manage the costs of our enhancement and maintenance works portfolio. The three major reviews … completed this year have also affected our risk landscape. Whilst the full extent of any future structural changes are yet to be understood, we will be proactive in looking at the opportunities available and how we can effectively manage the risks.

Due to the nature of some of our principal risks and the level of uncertainty, we continually assess both the risk and the appropriateness of mitigations.

Embedded Risk Management Processes:

We take an enterprise-wide approach to risk management and have in place an ERM framework for the identification, analysis, management and reporting of all risks to strategic objectives. The framework also takes account of operational risk and recognises the need for specialist approaches in areas such as safety, project management and information security. The use of a standard risk assessment matrix and defined risk appetite supports and enables the integration of the strategic and operational risk management approaches. Clear escalation criteria and the use of business assurance committees throughout the business provide structure, increasing visibility and challenge on the management of risks.

Whilst the ultimate responsibility for risk management rests with the board, it delegates the more detailed oversight of risk management and internal control principally to the audit and risk committee, which reports the findings of its reviews to the board.

The audit and risk committee receives regular reports from the internal auditors and independent auditor and reviews progress against agreed action plans to manage identified risks.

Detailed oversight of safety-related risks is delegated to the safety, health and environment committee.

Approach to Risk Assessment:

The ERM framework provides a standardised approach to the identification, assessment, recording and reporting of significant risks. We analyse the possible causes of a risk and assess what the impact could be if the risk were to occur. By using standard risk assessment criteria based on our performance targets we are able to have a visible link to the achievement of business objectives.

For each risk we identify current controls and their effectiveness to manage underlying causes and minimise consequences. We identify risks from a strategic view (top down) and from the operational environment (bottom up) to give better visibility of risk exposure across the business.

Monitoring risk exposure and the effectiveness of the controls in place is an ongoing part of risk assessment. The establishment of early warning indicators is one of the most recent areas of improvement activity within the framework. We have introduced visualisation boards to aid the monitoring of performance against operational targets. These boards, as part of the periodic reporting process, are also being used to track early warning indicators linked to risks.

We have also introduced further clarity around linked risks through innovative use of visualisation technology. This allows us to see the relationships between risks and analyse potential aggregated impacts or weak controls.

Through the use of defined risk appetite and our ability to see the relationships between our principal risks we can further analyse our capacity to manage risk outcomes. This also enhances our ability to make decisions on which risks require further mitigation or where we can pursue opportunity.

Categories of Risks (i.e., Safety, Performance, Value) and Who Manages Them:

All principal risks are mapped to performance reporting and strategic objectives. The assessment of risk is informed by the performance targets and the company's risk appetite statements. Each principal risk is appointed an executive committee owner.

Network Rail's Defined Risk Appetite Is as Follows:

'Network Rail has no appetite for safety risk exposure that could result in injury or loss of life to public, passengers, and workforce. Safety drives all major decisions in the organisation. All safety targets are met and improved year on year.'

'In the pursuit of its objectives, Network Rail is willing to accept, in some circumstances, risks that may result in some financial loss or exposure including a small chance of breach of the loan limit. It will not pursue additional income generating or cost saving initiatives unless returns are probable (85 percent confidence internal (CI) for income; 60 percent CI for cost where potential for cost reductions are large).'

'The company will only tolerate low to moderate gross exposure to delivery of operational performance targets including network reliability and capacity and asset condition, disaster recovery and succession planning, breakdown in information systems or information integrity.'

'The company wants to be seen as best in class and respected across industry. It will not accept any negative impact on reputation with any of its key stakeholders, and will only tolerate minimum exposure i.e., minor negative media coverage, no impact on employees, and no political impacts.'

Risk Area:

Safety

Three strategic risks are identified. The responsible risk owners are: The Group Director of Safety, Technical and Engineering and the Managing director, England and Wales.

Value:

One strategic risk is identified. The responsible risk owner is the Chief Financial Officer.

Performance:

Six strategic risks are identified. The responsible risk owners are: the Group Human Resources director; the Managing director, England and Wales; the Managing director, Infrastructure Projects.

The annual report identifies in detail each area of strategic risk and these can be found on pages 38 to 42 of the annual report.

12

Managing and Controlling Second-Level Organisations: The Responsibilities of the First-Level Organisation

A feature of many public sector organisations is the existence of 'second level' organisations. In considering the introduction of PFM/IC regard should be had to how these organisations are managed by the controlling or first level body. There are different types of second-level organisations and the focus in this chapter is on those that have delegated powers from the central or local government. Second-level organisations are widely used by central and local governments with many different types of organisational arrangement. There is no single model which can be regarded as appropriate for all countries and all types of second-level organisation operating with a delegated power structure. Included in this chapter is a reference to private finance initiative (PFI) arrangements, which although do not strictly fall into the category of a second-level organisation, but can have similar characteristics from a control perspective.

There are different reasons for establishing second-level organisations, not all of which may be appropriate. Specific regulations should be issued indicating when such organisations can be established. These regulations should specify a formal process of approval which for central government should involving not only the ministry concerned but also the ministry of finance. Second-level organisations with delegated powers can be used for commercial and non-commercial purposes and sometimes they provide both types of services or activities at the same time. The evidence from several developing and transition economy countries is that such organisations may not be well managed by their owning or controlling first-level organisation and they may set their own agendas rather than have them set for them, as they should, by the controlling or owning first-level organisation. Regular reviews of such

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_12

organisations, including whether their continued existence can be justified, do not happen but again such reviews ought to occur.

This chapter describes the actions that first-level controlling or owning organisations should take to properly exercise their responsibilities towards their second-level organisations operating under delegated powers and towards PFI arrangements.

Examples are also included of how two developed economy countries manage the establishment and control of second-level organisations. They both require tight oversight by the controlling or owning first-level organisation to be exercised over the second-level organisations.

12.1 An Overview of the Control of Second-Level Organisations with the Development of PFM/IC

12.1.1 The Context for Establishing Second-Level Organisations

Second-level organisations also come in various forms. These have been classified by Cohen and Peterson[1] into three types of decentralisation, that is, devolution, de-concentration, and delegation:

1. Devolved decentralisation is autonomous local government although the interpretation of the term 'autonomous' can vary widely and heavily depends upon the financial relationships between central and local governments. Local governments can issue their own laws and regulations within defined limits, prepare budgets, raise local taxes, publish annual financial statements and be subject to external audit. They may or may not be able to borrow. They may be able to develop their own chart of accounts but in some countries, they may be required to utilise the one available through a central government Integrated Financial Management Information System (IFMIS).
2. De-concentration: This is where a central ministry retains what it regards as the most significant powers, particularly over the development of policy and finance for a service but delegates to regional or branch offices responsibilities for the implementation of the service.

[1] Administrative Decentralization: Kumarian Press 1999 pp. 24–29

3. Delegation: This refers to circumstances where a central government, or a local government, delegates responsibility for defined areas of policy to organisations which are under its direct or indirect control or in some circumstances may be autonomous such as non-governmental organisations. Delegation may sometimes include power to develop particular areas of policy, as well as being responsible for the implementation of certain areas of policy. This usually occurs where a central government (or ministry or local government) feels that a service can be provided more efficiently, effectively, and accountably. It may also occur where a particular service or activity is revenue raising. Delegation can sometimes lead on the privatisation.

In this chapter the definition of second-level organisations is limited to the third category of organisations, that is, those which have delegated powers. The problems that arise for governments to address is why have such delegation arrangements been made, how to ensure the highest level of effectiveness and efficiency are delivered and how to decide whether those arrangements should continue?

Other questions may arise, for example, about the desirability of pushing accountability downwards, about privatisation and limiting the size and role of the central state or indeed of local government. Consequently, a discussion about second-level organisations may not be simply limited to organisational issues but can develop into a discussion about how public services are to be delivered. Should they be retained fully under the control of the public sector or should they be delegated to the private sector through arrangements such as those associated with private finance initiatives (PFI). That is a question which can follow on from the examples taken from two developed countries described later in this chapter.

Second-level organisations can be responsible for almost any aspect of government, from delivering public services, to collecting taxes, to providing advice and to undertaking regulatory activities.

A primary question to be considered is the funding of second-level organisations. The ultimate guarantor of the financial resilience of a second-level organisation is likely to be either the central or the local government, that is, the provider of public money. Public money is not just that provided from the budget but it can include foreign aid as well as income earned by second-level organisations themselves, particularly trading second-level organisations. In some countries where foreign aid is important it can also include non-monetised support provided in various forms.

PFI arrangements have been defined as a system in which private companies build and sometimes manage large projects such as hospitals or roads, and then the government pays to use them.[2] The assets that are provided in this way very often are ultimately returned to the public sector at the end of the contract period.

12.1.2 The Criteria for Establishing Second-Level Organisations[3]

Second-level organisations with delegated authority can be grouped into three types depending upon their financial objectives. One type is those which are wholly funded from the budget of the first-level organisation. A second is those that provide services and activities for which they charge a fee although they may not actually be trading organisations with the budgetary contribution essentially being a residual payment to cover those costs which cannot be recovered through fees. The third type is those which operate essentially as state owned enterprises and which may or may not be 'profitable'. Ideally, criteria should be set which would define whether establishing a second-level organisation would be appropriate. The criteria should apply, in principle, to all second-level organisations. These criteria could include:

- By providing a service or activity through a second-level organisation it can be demonstrably proved that the service or activity will be provided more efficiently and effectively than it would by being delivered directly by the controlling organisation.
- The controlling organisation has a strong internal control and financial management capability along with a policy capacity to set the objectives, monitor the performance of the second-level organisation and to exercise effective oversight.
- There is a sufficient ongoing demand for the service or activity, which means that the proposed second-level organisation does not represent simply an immediate response to a short-term situation.
- The proposed service or activity is unique in that the same or a similar service or activity could not be provided by another second-level organisation, by the controlling organisation itself or by another first-level organisation.
- If the service or activity is to be delivered on a cost basis there are specific reasons why it should be provided by the public sector, rather than by the private sector and if provided by the public sector that it will be a service that can be expected to 'break-even' financially within a budget period or if

[2] *Cambridge English Dictionary.*

[3] Controlling organisations referred to in this chapter include central government ministries, local governments, and other public organisations.

a market based activity, that it will be a profitable activity according to conditions specified by the ministry of finance.
- A business case and rationale for the delegation of responsibility to a second-level organisation can be made, demonstrating that there is a clear benefit for a delivery function to be carried out by a second-level organisation rather than directly by the controlling organisation or by another second-level organisation: this business case should be reviewed by an organisation other than the controlling organisation, such as the ministry of finance.
- The service or activity proposed is a technical function for which external experts need to be employed rather than civil servants.
- The service or activity needs to be, and be seen to be, delivered with absolute political impartiality, such as a regulatory service.
- The second-level organisation will be of sufficient size that it can employ the appropriate staff and operate economically. That appropriate staff should include not only technical and financial expertise but also staff expert in personnel management because effective personnel management is essential to attract good-quality employees, to develop them and to retain them.
- There is an acceptance that the need for the continued existence of the second-level organisation will be subject to periodic review.

Proposals to establish second-level organisations should be measured against this set of criteria, along with any others that may be added to meet local circumstances.

Important features of the relationships between controlling and second-level organisations are:

- A clear separation exists of the management of the controlling organisation from that of the second-level organisation to avoid any conflict of interest emerging.
- The controlling organisation must have a capacity to determine the conditions of any performance or service-level agreement and to effectively monitor those conditions, taking corrective actions as necessary.
- Governance arrangements should be established including where appropriate governing boards for second-level organisations with the authority to ensure that the managers of those second-level organisations do achieve what they are expected to achieve.
- All second-level organisations should be subject to external and internal audit with the external auditor's report being submitted to the controlling organisation.

Where assets are provided through PFI-type contracts the reasons are usually financial, that is, off-balance sheet financing arrangements and not to do with efficiency and effectiveness. The public sector pays a charge (often monthly) for the asset and that charge covers the costs of building the asset, financing it, and operating it for the whole length of the contract.

Because operating circumstances do not remain the same for second-level bodies there should be a systematic review process, perhaps every 3 or 5 years (depending upon the service or activity being provided), so that whether the second-level organisation should continue is tested. That review process should involve the controlling organisation and at least the ministry of finance. For local government there should be a similar review process. With contractual arrangements such as those for PFI-type schemes the opportunity for review during the contract period depends entirely upon the terms of the contract but those opportunities are likely to be much less than with conventional second-level organisation arrangements.

12.1.3 Purpose of Establishing Second-Level Organisations and the Problems That Exist

There are some organisations such as an ombudsman or the state auditor or organisations with a judicial-type function which should be excluded from this discussion even though they depend upon public money for their effective functioning. They may also receive their funding through the ministry of finance rather than directly through parliamentary decision.

For second-level organisations with delegated powers, in general the main stated purpose of establishing them in developing and transition economy countries is usually to enhance efficiency and effectiveness through the development of a specialist management and by giving them more autonomy. There can be other reasons as well, often unspecified, including, for example, providing an opportunity to avoid budgetary controls or to create mechanisms to provide additional rewards to certain officials.

Very often though, the identification and measurements of efficiency gains and the effectiveness of second-level organisations does not occur, even with this being the *raison d'être* for the establishment in the first place. Experience shows that unless second-level organisations have clear objectives and there is clarity about the anticipated improvements in efficiency and effectiveness, that managements have the financial and performance information necessary to enable them to judge efficiency and effectiveness, and that they are properly supervised by the controlling first-level organisation, the likelihood is that they will pursue their own interests in their own way. The result will be that the controlling organisation will have difficulty in ensuring that the interests of the second-level organisation and those of the controlling organisation coincide and that what the second-level organisation is expected to achieve will in fact be achieved. One of the reasons for this will be an asymmetry of information. The second-level organisation will know more about all its activities and policies than the controlling organisation. However, the principle should be that the objectives and interests of the controlling and second-level organisations should be compatible.

Governments should have a developed policy, rather than ad hoc arrangements, towards the creation of second-level organisations. This developed policy should cover such issues as:

- Initiation of the proposal: who should be the initiator of proposals for the establishment of a second-level organisation and the approval processes? What are the approval processes: is there any role for an assessor other than the organisation making the proposal, such as the ministry of finance?
- Size: should there be a minimum size before any second-level organisation can be created?
- Governance arrangements: who should appoint the chairman, board members and the chief executive?
- Personnel policies: should these be specified covering, for example, the level of the personnel establishment and the reasons and arrangements for appointing staff as well as changing the level of staffing, the salary structures?
- Justification: what is the justification for separating the functions of the proposed second-level organisation from those of the controlling organisation?
- Periodic review: should there be an automatic process of review to determine whether the second-level organisation should continue in existence after a specified period?
- The arrangements of the controlling organisation: will the controlling organisation retain sufficient expertise to enable it to set objectives and performance standards including targets for the improvement of efficiency and effectiveness, to determine an appropriate budget and to ensure that it remains in effective policy control over the second-level organisation including that it meets the objectives and performance standards set by the controlling organisation?
- Performance measurement arrangements: how will the second-level organisation performance be measured in delivering its objectives and performance standards and how is it proposed that the efficiency and effectiveness of the second-level organisation will be monitored?

- Accountability arrangements: what will be the accountability arrangements to the controlling first-level organisation?

Establishing a second-level organisation is not 'cost free'. There are the costs of establishing and managing the organisation itself as well as the additional costs incurred by the controlling organisation in supervising the performance of the second-level organisation. Where there are several (or sometimes many) such organisations these costs are multiplied. Proposals to establish second-level organisations should be carefully reviewed, not just by the controlling organisation but also by others involved in the development and management of public services, not least the ministry of finance. (In local government there should be also a third party involvement in the assessment. Who it should be would depend upon how a local government was organised.) However, any such second-level organisation should be required to be subject to audit by the local government auditor.

Unless countries are clear about why they agree to the establishment of a second-level organisation and that they keep second-level organisation performance under review, a significant risk is that a second-level organisation will not only develop a 'life of its own' but the quality of performance may also deteriorate. A second-level organisation will generally want to justify its own existence and the continuation of its own programme of activity. If the controlling organisation is not either able or willing to exercise its control responsibilities the budget that the second-level organisation presents to the controlling organisation will be driven by the interests of the second-level organisation rather than by the interests of the controlling organisation. The controlling organisation, in effect, risks becoming subservient to the interests of the second-level organisation and therefore ineffective as a supervising organisation. This is inappropriate and the controlling organisation should be determining the policy and the strategy for the implementation of that policy by the second-level organisation. It should also be agreeing the performance standards and efficiency and effectiveness targets and hence the budget of the second-level organisation. This is a serious risk and the impact should not be underestimated.

12.1.4 The Responsibilities of Controlling Organisation

Controlling organisations as they represent the principal in the principal/agency relationship which exists between a controlling organisation and a second-level organisation, have several responsibilities. As the principal, the controlling organisation with PFM/IC should specifically determine the objectives and performance standards and objectives which second-level organisations are to achieve and should identify and agree the performance measures that are to be adopted to demonstrate whether they have been achieved in practice or not. These arrangements should be specified in some form of 'contract' or oversight agreement such as a performance or service-level agreement (see below). In legal terms an organisation cannot contract with itself and that agreement would need to be a memorandum of understanding or equivalent unless the second-level organisation was a separate legal entity. These documents have been used in developed economy countries.

Success in delivering objectives and performance standards will depend upon the accompanying financial settlement. (A risk with these types of arrangements is that the controlling organisation may seek to 'offload' its responsibilities onto a second-level organisation and not provide sufficient finance.) The controlling organisation should also specify in the 'contract' the standards of governance and of internal control that are to apply in the second-level organisation. An important activity of the controlling organisation is to monitor their second-level organisations to ensure that they comply with those standards of governance and of internal control and meet any regulatory and legislative requirements. The 'contract' may specify the monitoring arrangements. Performance monitoring should be a positive activity of the controlling organisation. Exactly how it is undertaken will depend upon local circumstances but it should include regular written formal reports as well as personal meetings between representatives of the controlling organisation (which for normal business relationships should be representatives of the operational management of the controlling organisation) and the chief executive and operational management of the second-level organisation. The head of operational management of the controlling organisation (e.g. the state secretary) should then report to the political level of management including his/her own observations on the performance of the second-level organisation. In normal operational circumstances the political level of management should not become involved in the management of second-level organisations. Where the political level of management should become involved is in the setting of the policies, objectives, and performance standards of the second-level organisation, in acting upon reports of the controlling organisation operational management, or where some unusual or inappropriate event or actions have occurred, such as a failure of governance or the making of inappropriate payments to senior executives. Such 'unusual' events anyway should have been reported upon by the controlling organisation operational management. This arrangement makes possible the development of political accountability without a minister (or mayor) becoming involved in the detailed operation of the second-level organisation.

Consequently, controlling organisations should have these capabilities, to:

- Prepare the 'contract' with the second-level organisation.
- Set the objectives of the second-level organisation along with the performance standards they should be expected to adhere to, whether they are trading or non-trading second-level organisations.
- Ensure that appropriate standards of corporate governance and internal control are applied in the management and organisation of the second-level organisation.
- In the application of the internal control standards approve the risk appetite proposals.
- Systematically monitor the activities of the second-level organisation requiring periodic reports about their performance.
- Determine the budget for the second-level organisation and the financial returns that should be expected if they are trading second-level organisations (subject to any ministry of finance specifications). That determination should include whether any subvention from the budget is gross or net and if net and fees or other earnings are expected to make up the balance what is to happen if there is a surplus: is it to be handed over to the ministry of finance or retained but only for specified purposes? Similarly, where goods are imported and costs include import duties the costs of those imported goods should be shown gross rather than net of import duties.

Unless these types of arrangement are made the controlling organisation loses effective control over the second-level organisation. If controlling organisations do not follow this procedure this is an unsatisfactory situation and not compatible with the principles of PFM/IC. This is because some portion of the budgetary expenditure (or income) for which ultimately the controlling organisation should be responsible, will fall outside its financial management and internal control requirements.

To enable a controlling organisation to properly undertake these responsibilities the controlling organisation will need to include within its own organisation a specific department or unit responsible for the management of second-level organisations. (Where the second-level organisation is small the controlling organisation responsibilities may be exercised by a specific individual such as the head of finance.) That department or unit should be able to define the objectives, performance standards, financial returns (where appropriate), the operating budget and expected efficiency gains of the second-level organisations for which the department has a responsibility and to then monitor what is happening. These are effective preconditions for the establishment of a second-level organisation and if they cannot be met then such an organisation should not be established.

The reality, in this author's experience, is that in practice the objectives of second-level organisations can be vague and are often described, but only in general terms, in the legislation establishing the organisation in the first place. Very often too that legislation has not been changed since its initial approval. Objectives are not usually linked to budgets, but they should be. (Where the objectives have been defined in the legislation establishing the second-level organisation, by definition, they cannot be linked to current budgets and to argue that this is an adequate arrangement, as has occurred in this author's experience, is inappropriate.) Those objectives can also be inconsistent with the objectives of the controlling organisation. Again, in some countries, the agreement of the annual budget and the consequential budgetary control arrangements are regarded as a sufficient form of control. However, these are nowhere near enough as a form of control for the following reasons:

- Political and operational circumstances change as does the operational environment: a single statement of objectives set out in the originating law does not necessarily reflect current operational circumstances or the environment in which the organisation is operating.
- Current objectives of the second-level organisation should be consistent with the current objectives of the controlling organisation which will also change as political and operational circumstances change. The management arrangements may also need to change to reflect any changes in the objectives.

Second-level organisations can be a potential source of mismanagement, fraud, and corrupt behaviour. There are many causes of this, not least ineffective management by the controlling organisation. But another cause is poor internal control and poor corporate governance. Good corporate governance is potentially an effective anti-corruption tool. Corporate governance promotes transparency and accountability, so that clarity exists about how decisions are made and why. Consequently, a requirement should be that second-level organisations meet the standards of internal control and corporate governance (see Chap. 1) that apply to first-level controlling organisations. To ensure that this does occur, effective supervision of second-level organisations by the controlling organisation is essential. Other steps may be taken to limit the possibilities of corruption including, for example, that second-level organisations may be restricted to procuring only low value items with high value items only being procured by the controlling first-level organisation or with the specific authority of the controlling organisation. The first-level organisation should always maintain an effective capacity to properly supervise the policies and activities of the second-level organisation. In practice this does not always occur.

A requirement should be that the internal control arrangements that apply to controlling organisations should apply equally to second-level organisations although they may need to be adapted to the second-level organisation's operational circumstances and management. Even so they should still follow the basic procedures of internal control that apply to the controlling first-level organisation. This means that the internal control arrangements, essentially managerial disciplines (see Chap. 11), should be designed, inter alia, to ensure that the second-level organisation delivers its objectives to time and standard, observes the approved performance standards and operates efficiently and effectively within approved budgets and the law and regulations and meets the specified standards of transparency and accountability. The delegation and accountability arrangements should also ensure that a second-level organisation does not enter into commitments or take on fiscal risks which could prejudice its future financial resilience and potentially that of the controlling organisation.

The point is that second-level organisations should not be 'free-standing' and should be subject to active engagement with the first-level controlling or supervising ministry. In general, under no circumstances should a second-level organisation negotiate its budget separately with the ministry of finance from that of the controlling organisation but in some countries this does occur. (The only examples where this could be appropriate would be, for example, the budgets of an ombudsman, the supreme audit organisation, and judicial bodies. The supreme audit organisation should not be regarded as a second-level organisation in any event.)

In many countries and especially in developing and transition economy countries the reality is that the essential control and review features of second-level organisations do not exist. Often the controlling first-level organisation does not have the capacity (or see the need) to exercise policy control (believing that the originating law is all that is required). The only advice that the controlling organisation very often receives about the operations of a second-level organisation is from the second-level organisation itself, so it is hardly impartial. There are no arrangements for independent assessment. Yet a controlling organisation should always have a policy capacity, even if this requires the employment of a specialist independent organisation, to enable it to challenge the management of a second-level organisation.

Second-level organisations can also become permanent features of management in transition and developing countries. They may even report directly on their performance to the parliament rather than through the first-level organisation. This effectively bypasses the controlling first-level management. This is an inappropriate arrangement. Also, no arrangements for periodic review of the continued existence of a second-level organisation exists.

The establishment of clear lines of accountability is crucial for controlling organisations. If the controlling organisation believes, through the exercise of its supervisory role that the second-level organisation is not performing as it should, then the responsibility of the controlling organisation is to take corrective action. Failure to do so leaves the controlling organisation exposed to adverse criticism. That corrective action may be taken directly by the head of operational management or by the political head on the advice of the head of the controlling organisation operational manager, depending upon the circumstances.

In some countries the only form of control exercised by a controlling organisation is budgetary control. This makes control one-dimensional and is not sufficient to ensure that objectives and performance standards are being achieved. This limited form of control also does nothing to ensure that there is any year on year improvement in performance or that the second-level organisation has responded to changing circumstances.

An important aspect of control is that the controlling organisation does *not* become part of the management of the second-level organisation. This does not mean that staffs cannot be interchangeable or that the rules that apply to the appointment of staff to first-level organisations should not apply to the appointment of staff to second-level organisations. Ideally, they should be the same. However, controlling organisations in some countries do feel that to exercise control their officials have to be appointed to the board of the second-level organisation (or other executive body) and approve the day to day managerial decisions of the second-level organisation. In this way the controlling organisation becomes part of the second-level organisation management. Very importantly it also places those staff in a position where conflicts of interest can occur. This is entirely wrong and can result in a failure of control by the first-level controlling organisation. This is contrary to the principles of corporate governance and would prevent the controlling organisation exercising an independent assessment role of the performance of the second-level organisation. (This author has come across examples of where controlling ministry civil servants have been appointed as members of the board of second-level commercial organisations, as have ministers. This arrangement creates opportunities for such appointees to receive additional remuneration and other benefits, which of course may also be a motivation for appointment and such officials and such appointments may occur even though the appointee may have no specific expertise. But in such circumstances the controlling ministry's ability to supervise and to independently assess the managerial performance of the second-level organisation can be heavily circumscribed.)

Overall, the responsibilities of the controlling organisation are to ensure that the second-level organisation:

1. Has strategic clarity—that is, agreeing with the vision and/or mission of the second-level organisation and ensuring all its activities either directly or indirectly, contribute towards those of the controlling organisation and that the second-level organisations have a properly funded mandate with appropriate powers.
2. Is set and meets objectives and performance standards that are consistent with those of the controlling organisation.
3. Is results focussed and has the skills, resources, and plans to achieve those objectives.
4. Has established performance measures and information systems which enable the second-level organisation to demonstrate that it is meeting the objectives and performance standards set by the controlling organisation.
5. Meets the corporate governance and internal control standards specified by the ministry of finance including any specific budgetary and financial control requirements.
6. Agrees the second-level organisation's risk appetite and satisfies itself that the second-level organisation management has controls in place to manage risk, that is, both the risks which may prevent objectives and performance standards being achieved and those inherent in the activities and services being provided.
7. Has established the appropriate managerial structures to secure delivery of the objectives and performance standards efficiently and effectively: this includes a high-quality financial management process, human resource management arrangement, with the appointment of appropriately skilled managers which together will make it possible to achieve the objectives of the organisation.
8. Does not accept any fiscal risks without the specific approval of the controlling organisation.
9. Follows the relevant legislation and administrative rules.
10. Informs the controlling organisation when approval is required to particular actions proposed by the second-level organisation or where cir-

cumstances arise not envisaged in the 'contractual' arrangements between the controlling and second-level organisation.

11. That reporting arrangements exist which enable the controlling organisation to effectively monitor the performance of the second-level organisation during the year.

Second-level organisations should also be required to prepare an annual report, including a statement of internal control, audited financial statements, that is audited by the state auditor, about their performance and activities. The controlling organisation should approve the publication of that annual report including the audited financial statements along with the statement of internal control. A consequence of this is that the activities of second-level organisations should, in the normal course of events, be subject to parliamentary scrutiny.

The focus of the controlling organisation should be on results not processes, on obtaining good and timely strategic management information, gaining strategic clarity about objectives and trends in performance, and ensuring that the second-level organisation has the management structure and staff capability to deliver its objectives and envisaged performance.

The controlling organisation should recognise that a second-level organisation will always find activities or reasons to justify its existence but this does not necessarily mean that those activities or reasons are compatible with the interests or objectives of the controlling organisation or are indeed necessary. Therefore, the process of periodic review, referred to above, should exist which will require the second-level organisation to justify its continued existence.

These requirements mean that the controlling organisation must have available to it sufficient knowledge and operational information about the second-level organisation to enable it to assess the performance of that organisation and whether it should continue in existence. Unless these requirements exist, there is a risk that because of an asymmetry of information developing between the second-level organisation and the controlling organisation this exposes the controlling organisation, and hence the minister (or mayor), to the charge that it is not actually in control of the second-level organisation.

12.1.5 The Information That a Controlling Organisation Should Have

A controlling organisation must have available to it sufficient knowledge and expertise to set objectives for the second-level organisation, to define appropriate performance standards as well as the financial parameters for budgetary purposes, and to monitor performance during the year. A significant risk, pointed out above, for the controlling organisation, is that because the second-level organisation has detailed operational knowledge of the area of operations, the controlling first-level organisation will not be able to properly exercise its control responsibilities. However, the existence of a 'contract' assuming that it is properly drawn up by the controlling organisation should ensure that the controlling organisation has the key information it requires to exercise effective control. With such 'contracts' the goals, targets, and financial resources should be agreed between the controlling first-level organisation and the second-level organisation. The second-level organisations should be held accountable for their achievement. The controlling first-level organisation, as has been indicated above, should systematically monitor the performance of the second-level organisation with the extent of the monitoring being determined by the conditions included in the 'contract'. Adopting a performance basis for control adds to the focus on compliance, a focus on results and their achievement efficiently and effectively. However, to achieve these benefits requires capacity building both in the controlling organisation and in the second-level organisation.

12.1.6 Oversight Arrangements by Controlling Organisations: Service-Level Agreements—Examples of Arrangements in Ireland and the Netherlands

Set out below are example arrangements which countries ought to consider in the establishment and management of second-level organisations. These arrangements are based upon a model published by the Irish Republic and regulations published by the Government of The Netherlands. The underlying principle is that the control arrangements and performance of second-level organisations should be carefully monitored by the controlling organisation.

A particular feature of the Netherlands arrangements is that the regulations governing the establishment of second-level bodies (called agencies in the regulations) specify different financial arrangements for agencies which are income earning from those which rely upon budgetary finance. There is no specific reference in the regulations to state owned enterprises.

In the Netherlands an agency is treated as a service part of a ministry that operates with its own management model and financial administration. It may be an income earning agency or an expenditure based agency. The aim is to establish a management model which facilitates a more efficient operational management but one not adversely affecting the overall control of public expenditure. The agency model is described as 'a form of internal independence in which the ministerial responsibility for the agencies is fully maintained'.[4] There are different financial regulations affecting the two types of agencies. The income earning agency, which is not a state owned enterprise, is required to prepare its financial accounts on an accruals basis of accounting and the expenditure based agency on a cash basis of accounting. This means that an income earning agency in determining the charges for its services, costs such as depreciation would be incorporated into the cost structure which they would not be were a cash basis of accounting employed. It also means that charges for the services provided by an income earning agency would be largely stable irrespective of the levels of capital expenditure incurred. An income earning agency is expected to earn sufficient income to meet its outgoings.

One important feature specified in the Irish government arrangements is that all second-level organisations whatever their type should implement good corporate governance standards. Those standards would be specified by the Ministry of Finance. A second important feature is summarised in the following extract from the Irish code: 'The oversight agreement should reflect the State bodies legal framework; the environment in which it operates (e.g., commercial, non-commercial, regulatory body); the purpose and responsibilities of the State body; the State body's level of compliance with this Code; details of the Performance Delivery Agreement (e.g., outputs to be delivered); and arrangements for oversight, monitoring and reporting on conformity with Government policy including those actions and areas of expenditure where prior sanction from the parent Department and/or the Department of

[4] www.rijksoverheid.nl/onderwerpen/rijksoverheid/inhoud/agentschappen; Published in the Official Gazette 4 December 2017: Arrangement of the Minister of Finance of 21 November 2017, laying down rules on the establishment and management of the agencies (Agency Scheme).

Public Expenditure and Reform is required.'[5] The starting point for clarity of accountabilities is a service-level or performance agreement (referred to in the Irish guide as an 'oversight agreement') between the relevant controlling organisation and the second-level organisation. This Code demonstrates that clear objectives, delegation, and accountability arrangements should exist which underpin effective managerial relations between controlling organisations and the second-level organisations for which they are responsible. Effective accountability depends upon the roles and responsibilities being clearly defined and understood by the controlling organisation and the second-level organisation.

The 'oversight' agreement 'demonstrates that clear objectives, delegation, and accountability arrangements exist which underpin effective managerial relations between controlling organisations and the second-level organisations for which they are responsible. Effective accountability depends upon the roles and responsibilities being clearly defined and understood by the controlling organisation and the second-level organisation.'

The contents of such agreements typically should contain the following sections (and these are based largely, but not wholly, upon the Irish and Netherlands requirements):

1. Introduction: which sets out the background to the agreement; the parties involved; it also clarifies the statutory tasks of the second-level organisation.
2. Corporate governance: this covers the underlying framework including the legislative context, compliance with relevant statutory and corporate governance obligations; as well as compliance with meeting good practice in public expenditure, not least in securing good value for money.
3. Management arrangements: this should include a requirement that the top management of the second-level organisation should be required to incorporate into the managerial arrangements the standards of internal control applying throughout the public sector, adapted as necessary for commercial second-level organisations.
4. Objectives of the agreement: this focuses on the key priorities/objectives of the second-level organisation. There must be a clear link between the second-level organisation's goals and objectives and those of the controlling organisation.

[5] The Irish government publication applies to both non-commercial and commercial second-level organisations. 'Code of Practice for the Governance of State Bodies: Business and Financial Reporting Requirements 2016': http://govacc.per.gov.ie/wp-content/uploads/Business-and-Financial-Reporting-Requirements.pdf

5. Mutual commitments: this is that an effective agreement should acknowledge the mutual relationship in terms of responsibilities and obligations between the controlling organisation and the second-level organisation. Therefore, the agreement should include a section clearly setting out the controlling organisation's commitments, for example, the controlling organisation will provide a range of operational supports X, Y, and Z, to enable the second-level organisation fulfil its mandate and that the level of funding is compatible with the second-level organisation's ability to achieve its objectives and performance standards.
6. Inputs: in order to provide a comprehensive picture and to allow for ready comparison with previous/future agreements, the inputs/resources of the second-level organisation in terms of income and expenditure (capital and current), including pay allocations/staffing for the period of the agreement together with any specific allocations for specific purposes, should be clearly set out. This should include whether funding is to be on a gross or a net basis after income earned and what happens to any surplus income which ideally should be transferred to the ministry of finance.
7. Performance/service levels and performance measurement: the agreement should specify the performance/services and outputs/service levels, based on the agreed inputs outlined in point 5 above, to be provided by the second-level organisation as well as the performance monitoring and measurement indicators. Performance/service actual levels and expected levels, including minimum levels, should be explicitly detailed, and agreed upon in order to avoid misinterpretation or misunderstanding between the controlling organisation and the second-level organisation.[6]

   The measurement indicators of outputs (what actions the second-level organisation carries out) and impacts or results (what the second-level organisation achieves) should be credible and reliable.

   As second-level organisations may carry out many functions/services, the focus should be on those functions/services which are central to delivering the strategic objectives of the controlling organisation, that is, the focus of control should be on the core activities. (This is to avoid overwhelming the agreement with bureaucratic requirements). Therefore, in selecting appropriate indicators, the aim should be on the quality of the information/indicators as opposed to quantity. Baselines should also be identified from which targets for improvements could be measured.

[6] The Irish government advice on preparing these agreements points out that the difficulties in defining these levels should not be underestimated and will depend on the functions/services of the second-level organisation, ranging from straightforward, for example, 'number of customer queries handled', to the complex, for example, 'the volume of policy advice provided'.

8. The financial accounting arrangements depending upon whether the second-level organisation is income earning or not and if it is income earning that accrual accounting should be applied (this would not apply if the income earning element was only marginal).
9. Potential risk factors: potential risk factors or other likely constraints, both internal and external, that might impact on expected performance/service levels over the duration of the agreement should also be highlighted. As the resources for the period of the agreement should be agreed and included in the agreement, resource constraints ought not to be a potential risk factor.
10. Flexibility and amendment of targets: on occasion performance/service targets may require to be changed or modified or added to during the period of the agreement, due to unforeseen circumstances. Where amendments become necessary, the controlling organisation should agree with the second-level organisation on the amended targets and the agreement should include a procedure for agreeing such changes.
11. Major new investments and policies: a requirement should be included for the second-level organisation to consult with and seek approval of the controlling organisation where major new investment projects or new policies are proposed: such large projects and new policies should be fully evaluated and consistent with the strategic vision of the organisation.
12. Monitoring arrangements: the specific monitoring and reporting arrangements of the agreement should be identified, as well as procedures for dealing with variations in performance against targets. For example, the arrangements may include reporting information on the operation of the agreement in annual reports, officials meeting on a regular basis to review performance against the agreement; and implementing an internal system to monitor performance against the activities outlined in the agreement. The successful monitoring of the agreement will be in large part dependent on how well defined the performance/service levels are set out. A feature of the monitoring arrangements should be agreement about the internal audit arrangements. Although a second-level organisation should have its own internal audit arrangements, whether by its own staff or through other arrangements the controlling organisation internal audit should have access to the management and records to support the monitoring arrangements specified in the service-level agreement.
13. All service-level agreements should include a requirement that each second-level organisation should publish an annual report and financial statements. The latter should be audited by the state auditor. The contents of this report should vary depending upon whether the second-level

organisation is an income earning organisation or receives its finance from the budget or is a commercial organisation. These reporting requirements should include:

(a) An annual report signed by the chairman of the board responsible for the management of the second-level organisation or if no board, by the chief executive which should cover:

  i. A review of the operational environment including changes that have affected the performance of the organisation.
  ii. An affirmation that controlling organisation policy is being complied with and if not the reasons for non-compliance.
  iii. The actual operational performance of the organisation against the objectives incorporated into the service-level agreement with an explanation for any differences.
  iv. An explanation of any policy changes or major initiatives during the year.
  v. The prospects for the next and future 3 years.
  vi. Any particular information that may have a political or public resonance in the country.
  vii. The statement of internal control (see Chap. 13).

(b) The financial statements which taken as a whole, should be fair, balanced, and understandable and:

  i. Provide the information necessary for an assessment of the organisation's financial position and its financial performance analysed over main activities compared with the budget forecast (i.e. over main activity/objective headings and not the subjective headings usually required for budgetary control purposes).
  ii. The income of the second-level organisation from all main sources and analysed over those different sources along with the costs of generating that income.
  iii. Any loans or other forms of financial support provided by the controlling organisation, or any other government ministry or agency or any commercial loans (which should be approved by the ministry of finance) and how such finance has been used.
  iv. The extent of liabilities including liabilities outstanding at the year-end.
  v. The extent of revenues due but not yet collected.

vi. The cash position at the year-end including deposits with all banking institutions (this will be affected by whether a treasury single account process exists).
vii. A forecast of the extent of any fiscal risks accepted by the second-level organisation or which potentially could occur.
viii. A statement about the longer-term financial resilience of the organisation taking into account the longer-term commitments (including contracts) of the organisation together with any other factors which could affect the future financial resilience of the organisation over at least the next 12 months, including inflation and other changes in market conditions or anticipated demands for the service.
ix. A statement about 'sensitive' information (with the term 'sensitive' being defined as including any particular items that the controlling organisation and/or the ministry of finance specify as necessary to be disclosed) but could include such items as remuneration, bonuses, and other payments to senior executives, termination/severance payments to employees, travel and subsistence payments analysed between national and international travel, hospitality expenditure, legal costs, and compensation paid.

(c) If the second-level organisation operates in a market place, then the range of financial information to be provided would need to be considerably extended. As the financial accounts should be prepared on the same basis as commercial organisations operating in the country the information provided should include such additional factors as:

i. The overall profitability, taking into account the cost of capital, depreciation, and an appropriate share of overheads.
ii. Information about losses on any business activities after appropriate allowances for depreciation, the cost of capital and overheads.
iii. The rate of return on assets employed and other appropriate commercial measures of performance.
iv. Market share, changes over time and prospects for future periods.

(Other examples of information that may be required by the controlling organisation of a state owned enterprise are included in Annexes 1 and 2 to this chapter.)

14. Duration and signatories to the agreement: this section should highlight the duration of the agreement and the commencement date. The period covered by the agreement will depend on the nature and services to be provided by the second-level organisation.[7]

This is a lengthy list of requirements which it would be inappropriate to expect to be completed where small second-level bodies are involved. However, this then raises the question as to whether such small second-level bodies should exist and whether it would be more appropriate for the functions of such bodies to be absorbed into the functions of the controlling first-level body. As has been pointed out above establishing second-level bodies is not 'cost free'.

In Annex 1 an example from Ireland of the requirements to be included in the chairman of a commercial state body statement is shown. Although this statement is designed primarily to reflect the circumstances of commercial state bodies much of the content would be equally relevant to a non-commercial state body. Annex 2 shows the Irish financial information requirements for shareholders in commercial second-level state bodies. Again, the approach adopted here would have direct relevance to commercial second-level bodies in developing and transitional economy countries.

The annual report and financial statements of all second-level organisations should be available as part of the accountability process to parliament, to users of the second-level organisation services and to civil society. Publication should be the normal practice and only withheld in exceptional circumstances.

The approach of the Government of the Netherlands has these particular features:

- To establish an agency the relevant minister is required to apply to the minister of finance for the designation of a service unit as an agency. In other words, an individual minister must seek the approval of the minister of finance to a decision to establish a second-level organisation.
- An important condition in obtaining approval to the creation of an agency is that the centralised state audit service (a technically advanced internal audit service), has not found any relevant deficiencies in the financial management arrangements.

[7] In Ireland the expectation is that these agreements would be typically for a 3 -ear period.

- As part of the application for the establishment of an agency, the relevant minister must submit an agreement with the agency describing the structure and expected functioning of the agency.
- The relevant minister must prove that the proposed agency:

  - Will have an expected turnover or expected revenue of more than €50 million on an annual basis[8];
  - Will have a result-oriented management model[9];
  - Will work more efficiently than as a regular service unit of the controlling organisation concerned and indicate how the service unit will further develop efficiency as an agency during the next 5 years;
  - Can establish a link between expenditure, costs, and performance in such a way that funding based on performance is possible;
  - Can guarantee a sufficient level of quality of the financial function and financial management;

- Provided these conditions can be met the relevant minister in conjunction with the Minister of Finance, submits the proposal to establish the agency to the council of ministers. If the council of ministers approves the establishment of the agency, the relevant minister notifies the parliament and provided the proposal is approved the decision establishing the agency will be signed by the relevant minister and the minister of finance. The decision to establish the agency is published in the government gazette and the Supreme Audit Institution (state auditor) is informed.
- The controlling ministry is responsible for supervising the policy of the agency and the quality of its management. The controlling ministry is also expected to establish a high-quality system for monitoring the budget of the agency, the continuity of the agency and the quality of the products. In addition, the controlling ministry is annually required to assess the financial management arrangements and to approve the annual report. The

[8] Whilst the Netherlands Government recognises that the independence of an agency brings advantages there are also additional costs associated with the establishment of agencies. These costs include transition costs, the management costs of the agency and for the controlling organisation the costs of supervision and control of the agency services. For these reasons to ensure effective policy implementation, a minimum size has therefore been set for agencies. This minimum size is set at an expected turnover or expected revenue of €50 million per year.

[9] The idea of the result-oriented management model is that agreements are made in advance between the relevant controlling organisation and the agency about performance, quality, costs, and risk management. Monitoring is based on these agreements. The controlling organisation supervises the agency and emphasises the importance of understanding the costs and efficiency of the implementation. The result-oriented management model is designed in such a way that incentives exist for all parties that encourage effective action.

agency has a responsibility to ensure that the quality of financial management is maintained.
- The agency must promptly inform the controlling ministry of proposed policy changes.[10]
- Reporting arrangements should exist that will enable to controlling ministry to monitor the performance of the agency

12.1.7 Arrangements for the Systematic Review of Existence of a Second-Level Organisation: A Netherlands Example

As has been explained above whether a second-level organisation should continue in existence should be subject to systematic review. The Netherlands Ministry of Finance reviews the necessity for the maintenance of the status of second-level organisations. This provides an example for other countries.

In the Netherlands, at least once every 5 years, the controlling minister and the minister of finance have a responsibility to jointly assess the efficiency and effectiveness of an agency. The relevant minister is required to publish the resulting report.

The review is undertaken by the state audit service (which is a different audit service from the State Auditor, the Supreme Audit Institution) and the purpose of the audit is to form an opinion on the functioning of the agency in the areas of (a) governance, (b) funding, (c) efficiency, (d) financial management, and (e) the future of the organisation.

Should a decision be made to close an agency, or to merge it with another agency, parliament should be informed and the Supreme Audit Institution.

On closure a financial audit is undertaken and the assets and liabilities of the agency are transferred to the organisation taking over the functions of the agency. (There are also special provisions relating to finance but these are specifically related to the Netherlands financing arrangements for agencies.) This provides a model arrangement which other countries could well follow. Without arrangements for regular review the possibility is that a second-level organisation could continue in existence when the underlying need for it has disappeared or it is not achieving its objectives or the standards set for it, assuming that they have been.

---

[10] A particular additional point that countries may wish to consider is that before a second-level organisation makes any decision to subcontract its responsibilities to a private sector organisation, or any other major policy changes, it should be required to seek the approval of the controlling organisation who should, if necessary, undertake a cost/benefit analysis of the proposal.

12.1.8 Questions to Be Asked About Second-Level Organisations When PFM/IC Is Introduced

Introducing PFM/IC creates the opportunity to re-examine the relationships between controlling ministries or local governments and their second-level organisations. This re-examination should be regarded as an integral part of the application process of PFM/IC and the following questions about second-level organisations and the control arrangements should be asked by the ministry of finance or the head of the 'driver' organisation responsible for the application of PFM/IC:

1. Have criteria been set to provide a basis for the establishment of second-level organisations (perhaps along the lines of those described above by the Netherlands Ministry of Finance and the Irish government), whether income earning, budget funded or commercial and if they have been set are those criteria being met by the second-level organisations?
2. If those criteria have not been set, then should they be? Importantly the controlling organisation should be satisfied that second-level organisations will have sufficient resources to enable it to employ the expert staff required and a management structure capable of delivering the objectives and performance standards and objectives set for them by the controlling organisation.
3. Does the controlling organisation itself have the capability to set clear managerial objectives and performance standards and objectives required for the second-level organisations (this is not simply about agreeing the budget), and to then monitor their performance and secure improvements systematically in the efficiency and effectiveness of the service delivery and related activities provided by second-level organisations?
4. Does a process exist allowing the controlling organisation and/or the ministry of finance to periodically review the need for second-level organisations to continue should operational or other circumstances change?
5. Has a results oriented management model been introduced in second-level organisations, irrespective of whether the objectives are commercial or not (because a results oriented model is consistent with the aim of improving efficiency and effectiveness)?
6. Have service-level or performance agreements been entered into and is the coverage of those agreements sufficiently comprehensive to ensure that the objectives and standards for the second-level organisations are clear? Do those agreements follow requirements specified by the ministry of finance?

7. Do clear performance targets exist and is performance information available to management and do appropriate monitoring and reporting arrangements exist?
8. Is the level of discretion available to the second-level organisations clear and when they must refer proposed decisions to the controlling organisation?
9. Are the governance and internal control arrangements robust and is there clarity in the separation of the roles of the management of the controlling organisation and of the second-level organisations? (This may include rethinking how the second-level organisations are governed such as should they have a governing board, who should be members of that board, what is the role of the chairman, who is the chief executive and to whom does the chief executive report, how are these different individuals to be appointed and removed? A separate section below discusses the appropriateness of a board structure.)
10. If the objectives of a second-level organisation are income earning or commercial then does a financial structure exist which ensures that the second-level organisation fully recovers all its costs and if operating commercially is effectively not subsidised in such a manner that it can unfairly compete with private sector competitors? Examples of subsidy would be that capital is provided free of charge whereas a commercially oriented second-level organisation should be charged for the cost of the capital that it is employing; public organisations may not include a charge for depreciation in their cost structure but if operating in a market place depreciation should be allowed for in costs; it should not be allowed to 'cross-subsidise' commercial activity from non-commercial activity and therefore accounting arrangements agreed with the controlling organisation should be employed to prevent this. A commercially oriented second-level organisation should be required to follow the accounting principles used by commercial companies in the country and not public sector accounting arrangements; second-level commercial bodies also should be expected normally to achieve a 'market rate of return' on the capital employed.
11. Can the first-level organisation demonstrate that by delegating responsibility to a second-level organisation management that the service and activities to be delivered will be more efficiently and effectively delivered than if those services and activities remained part of the controlling organisation?
12. Are the second-level organisations able to demonstrate how the service or activity they provide at least over the period of any performance or service-level agreement, will improve their efficiency and effectiveness?

13. Does the controlling organisation determine the second-level organisations budgets rather than a direct negotiation occurring between the second-level organisation and the ministry of finance? If the latter is the current arrangement, this should be changed.
14. Where new investment or activities are to be undertaken does the second-level organisation have the capacity to undertake an appropriate level of project analysis (depending upon the size of the project) and associated business planning, including considering the business risks that may arise?
15. Can the management of second-level organisations demonstrate an adequate quality in the finance function and of financial management in support of the management, so that the management is able to demonstrate how it is delivering improvements in efficiency and effectiveness?
16. Will those finance functions have the technical capability to assess and report on the financial resilience of the organisation over the medium to longer term?
17. Will a governance and reporting structure be established which will secure these characteristics:

    (a) ensure that the management of second-level organisations acts in accordance with the objectives set by the controlling organisation;
    (b) that the resources of the second-level organisations are used only for the approved purposes;
    (c) that the standards of internal control specified by the ministry of finance are fully applied throughout the second level organisations demonstrate the effectiveness of the internal audit function whether provided directly by the second level organisation or by the first level organisation (see also below);
    (d) that the management structure of the second level organisations evolves as the operational environment and objectives of the organisation evolve; and
    (e) that the accountability arrangements between the second-level organisations and the controlling organisation properly present the operational and financial performance, including the end of year financial statements and annual reports, of the second-level organisations?

12.1.9 Questions to Be Asked Where Private Sector Organisations Are Asked to Deliver Public Services

Where public services are to be delivered through private sector organisations using private finance initiative-type (PFI) arrangements other questions need to be asked of the organisation responsible for this type of arrangement, including:

- If the objective is to improve efficiency and effectiveness through introducing private sector market disciplines does the initiating contract allow for any form of assessment and if so, what mechanisms have been established to demonstrate that such improvements are occurring?
- What is the process for following up the evidence of improvement?
- The market place usually encourages providers to focus on the most profitable areas of activity, so where public services are to be delivered universally what steps have been taken to ensure that the least profitable areas of activity are still being covered (this can be particularly important in the provision of social and health services using PFI arrangements)?
- Profit maximisation does not automatically mean that services are being delivered efficiently and effectively: consequently, what actions are being taken to ensure that an appropriate proportion of resources are being utilised for public service delivery compared with reward to shareholders and senior executives?
- Has the PFI-type exercise simply been adopted for 'financial engineering reasons' such as to contain the level of public sector debt, and if so, has this been agreed with the ministry of finance?

The United Kingdom National Audit Office looked at the quality of the management of PFI contracts in the UK National Health Service. Its overall conclusions included:

> Most [Health] Trusts are managing their contracts well day-to-day and understand the risks to value for money. However, risks remain and, while many Trusts have recently increased the resources they dedicate to managing PFI contracts, some Trusts are not devoting enough resources. About 12% (9 of the 76) operational PFI contracts have no-one from the public sector assigned to contract management.
>
> It is likely that Trusts will be expected to make efficiency savings over the next few years, but their ability to make savings from their PFI contracts is very limited. Because Trusts pay an index-linked fixed sum, it is difficult for them to make savings without cutting back on services. Contractors who secure economies of scale through managing multiple PFI contracts are rarely required to share these efficiency gains with Trusts.[11]

[11] The performance and management of hospital PFI contracts—UK National Audit Office (NAO) Report

The National Audit Office also looked at the problems which can emerge with all types of PFI contracts at the end of the life of a contract[12] and there are lessons to be learnt from this. These included the following:

1. The public sector does not take a strategic or consistent approach to managing PFI contracts as they end and risks failing to secure value for money during the expiry negotiations with the private sector.
2. There is a risk of increased costs and service disruptions if authorities do not prepare for contract expiry adequately in advance.
3. Some authorities have insufficient knowledge about the assets' condition, which risks them being returned to the public sector in a worse quality than expected.
4. Many authorities start preparing for contract expiry more than 4 years in advance but there is a risk this is not enough time.
5. Authorities recognise that contract expiry will be resource intensive and require unique skills, and expect to fill gaps with consultants.
6. A misalignment of investor and authority incentives at contract expiry creates a potential for disputes.
7. Early PFI contracts are likely to contain significant ambiguity around the roles and responsibilities of the parties at contract expiry.

This illustrates the complexity of PFI contracts and why great care is required before they are entered into.

12.1.10 An Example of the Risks That Can Exist with Second-Level Organisations

12.1.10.1 Introduction

An example from a developed economy country, South Australia, of the problems that can emerge with the delegation of responsibilities from a controlling organisation is described below. This example also illustrates the significance of many of the issues that are relevant to the effective introduction of PFM/IC and the control of second-level organisations. In Australia private sector has been used to support the provision of technical and further education (TAFE) for young people. This example also demonstrates that a market solution requires regulation to secure the benefits as the quality review report[13]

[12] Managing PFI assets and services as contracts end (nao.org.uk)

[13] Nous Group: Department of State Development: Quality Review of TAFE SA: 4 April 2018.

referred to below shows: 'The early response by registered training organisations (RTOs) to the new market opportunities, and by students to the improved access to subsidised training, far outstripped expectations, with the consequence that government expenditure on VET [vocational education and training] ballooned and students were exposed to low-quality profit-seeking training providers.'[14] The response of the Australian government was to give a sharper focus to regulation; to introduce higher barriers to entry for the subsidised market; to provide incentives for students to enrol in courses with a higher public value; to provide improved information for prospective students so they could make better judgements about which course to choose.

12.1.10.2 The example:

The public authority in South Australia responsible for the organisation of the delivery of tertiary technical and further education in that State had come under criticism for being slow-moving, inefficient, and overly protected in a market place where there were both public and private sector providers. The quality of the educational outputs was, at that time, not contested. However, a quality review by the Australian Skills Quality Authority (ASQA) resulted in ASQA giving notice of its intention to suspend the registration of ten qualifications from the Technical and Further Education (TAFE). The shock of this finding was such that the then Government of South Australia (SA) sought the resignation of the Board chair and accepted the Chief Executive Officer's offer to step down. The purpose of this quality review was to 'make recommendations to ensure the quality, sustainability, and reputation of the state's public vocational and education training provider'. The criticisms included

- Insufficient attention was paid to the impact on volume of delivery.
- The amount of training declined overall and costs per hour did not improve (in fact, the TAFE SA's efficiency has steadily worsened since 2013).
- Most of the focus of an economy drive was on staff reductions, which could have been better targeted. Many high-cost staff left, there did not appear to be strategic consideration of how to realign organisational resources to improve efficiency and cater best to market demand.

[14] Ibid., Section 1, page 7

- The governing board, in particular, lost sight of the importance of quality both as an end and as a means. The board's single-minded focus on cost-cutting (and to a lesser extent, revenue generation) meant that quality issues were de-prioritised. Not only did this increase the risk of becoming non-compliant, it overlooked the need for TAFE SA to maintain a reputation for quality in order to compete effectively. The absence of a more balanced and strategic approach pointed to systemic issues. These weaknesses reflected in part the board's leadership and positioning of TAFE SA under the then chair, who was seemingly insufficiently challenged by either his colleagues or the then TAFE SA chief executive officer (CEO). In terms of systemic issues, the roots of these problems lay in the articulation of TAFE SA's strategy, and the governance arrangements as they pertain to the board and senior executives.
- On strategy, this report concludes that TAFE SA's strategic plan 'on paper' was generally sound but was communicated and executed in a way that unintentionally downplayed the importance of maintaining quality and training output. Improving TAFE SA's commercial performance was seen primarily in terms of an imperative to reduce costs.
- On the question of governance, board membership was unbalanced, the wrong structures were in place to effectively monitor risk to regulatory compliance and reputation, and performance metrics for executives were skewed. The most concerning finding, and an indicator of both the poor support provided to the Board and the limited sense of responsibility of its members, was that internal quality auditors (i.e. not financial auditors) had made discoveries similar to those later made by ASQA. They reported TAFE SA's noncompliance 'up the line', but these internal audit findings revealing a high degree of exposure were not given proper consideration at either the executive or the board level. Several aspects of organisational effectiveness and efficiency went unattended.
- Resource alignment—there was an apparent skew towards more staff in corporate functions that emerged as a result of the voluntary redundancy process and the potential need to review the spread of responsibilities at senior levels. The implication is that relatively fewer resources were dedicated to quality teaching and assessment.
- Internal governance—responsibilities and accountabilities within TAFE SA seem unclear, delegations needed an overhaul, and the performance management system required improvement.
- Capability—there has been a commendable effort since December 2017 to upgrade the formal training and assessment qualifications of staff and pro-

vide more professional development, particularly with respect to assessment processes.

- Culture—this presents both an opportunity and a risk for TAFE SA. There is large contingent of highly motivated and loyal staff who want to help restore confidence in the institution of which they are very proud, but who have felt alienated from and unclear about the overarching strategy and role of TAFE SA in the wider system. They have also been inculcated into a culture of fixed rules and entitlements that arguably diminishes a sense of trust, responsibility, and ability to 'lead from below'.

12.1.11 Controlling Ministries and Boards for Second-Level Organisations

There are different views on the appropriateness of boards to be responsible for overseeing the management of a second-level organisation. The lack of a board structure makes the controlling organisation management dependent entirely upon the most senior official (chief executive) of the second-level organisation. The advantage of a governing board is that it should be prepared to act independently of the most senior official. But it can only do this if the board includes independent experts, including the chairman. The advantage of independent experts is that they should be impartial and can bring an expertise to the oversight of the management of the second-level organisation. (Independent does mean 'independent' and that means no political or family or other types of relationship to other key government officials should exist.) This arrangement lessens the risk caused by the asymmetry of information existing between the second-level and the controlling organisation. The involvement of persons independent of the chief executive in the top-level decision making of the second-level organisation is a potentially very significant governance benefit! A board also provides in the second-level organisation governance structure a facility or feature able to challenge the chief executive of the organisation and therefore test out the plans, objectives, and assurances of that chief executive. This provides a degree of independent assurance to the controlling organisation.

However, appointing a board for every second-level organisation may not be appropriate where they are small or have a limited role (although this itself should raise questions about whether it is appropriate for such small second-level organisations to exist rather than their functions be undertaken directly by the controlling organisation), but for some and certainly for larger second-level organisations and especially for those that are commercially oriented the existence of a board would be entirely appropriate.

Where a board is created, particular attention should be given to its role, composition, and functioning. Governing boards should not interfere with the daily management of the second-level organisation. Their role is the strategic control and supervision of the organisation, that is, the oversight of the management. Many countries have taken initiatives to introduce corporate governance models to optimise the relationships between board and heads of second-level organisations. But corporate governance calls for a clear delineation of responsibilities between those responsible for daily management (the chief executive and operational staff) and the board. The board should be responsible for strategic decision making in terms of planning, overall budgetary envelopes, strategic tasks, reporting, and control of management. Board members should include persons with a range of expert knowledge, including in the subject matter of the second-level organisation activity, as well as in finance, and where appropriate commercial and legal expertise. The board should hold the executive head of the second-level organisation responsible not just for the quality and operational performance of the organisation but also for the way in which ethical and other control standards are introduced and applied. The existence of a board provides in practice a counterweight to the authority of the executive head of the second-level organisation and this reduces the chances of inappropriate action on the part of that executive head.

However, if a board structure is to be effective the board members should be appointed for their specific skills and this is especially important for the role of chairman. A risk that a ministry of finance and the PFM/IC driver department should be concerned about is that the appointments made to a board are simply made for political reasons, that is, to reward political friends and or to provide opportunities for rent seeking. Where such is the situation, the likelihood is that the board appointments will be entirely cosmetic and may well serve to disguise the reality of the power structures that exist.

An example of the responsibilities of board members is described in the Irish government publication on second-level bodies as follows[15]:

Principle:

Each State organisation should be headed by an effective Board which is collectively responsible for the long-term sustainability of the organisation.

---

[15] Some countries have published detailed advice on the governance arrangements for state bodies (i.e. second-level organisations), including the role of a board: a particularly good example is that published by the Irish government: available at http://govacc.per.gov.ie/governance-of-state-bodies

Non-executive Board members should bring an independent judgement to bear on issues of strategy, performance, resources, key appointments, and standards of conduct.

Fiduciary Duty: All Board members have a fiduciary duty to the State organisation in the first instance (i.e. the duty to act in good faith and in the best interests of the State organisation).

The principle fiduciary duties are (NB the references to 'company' below, should be interpreted as to the 'second-level organisation'):

1. To act in good faith in what the Board member considers to be the interest of the company;
2. To act honestly and responsibly in relation to the conduct of the affairs of the company;
3. To act in accordance with the company's constitution and exercise his or her powers only for the purposes allowed by law;
4. Not to benefit from or use the company's property, information or opportunities for his or her own or anyone else's benefit unless the company's constitution permits it or a resolution is passed in a general meeting;
5. Not to agree to restrict the Board member's power to exercise an independent judgement unless this is expressly permitted by the company's constitution;
6. To avoid any conflict between the Board member's duties to the company (i.e. second-level organisation) and the Board member's other interests unless the Board member is released from his or her duty to the company in relation to the matter concerned;
7. To exercise the care, skill, and diligence which would be reasonably expected of a person in the same position with similar knowledge and experience as a Board member. A Board member may be held liable for any loss resulting from their negligent behaviour; and
8. To have regard to interests of the company's member stakeholders.

The arrangements described above in Sect. 1.7 designed to monitor the ongoing performance of the second-level organisation would remain even with the existence of a board.

12.1.12 Audit and Second-Level Organisations

All second-level organisations should be subject to internal and external audit. External audit may be by the state auditor or could be both by the state auditor and by a commercial audit firm if the organisation is operating in the marketplace. Internal audit may be undertaken by either the second-level organisation's own internal auditor or the internal audit of the controlling organisation. However, even where the second-level organisation has its own internal audit the controlling organisation still has an obligation to satisfy itself about the effectiveness of the control activities and therefore any agreement between the first and second-level organisations should provide for the controlling organisation internal audit to undertake its responsibilities on behalf of the management of the controlling organisation. External audit should also encourage, for larger and commercial second-level organisations the establishment by the organisation of its own independent oversight organisation through, for example, the establishment of an audit committee. In some countries there already is a requirement that audit committees or audit and risk committees should be established by both controlling and second-level organisations with authority to:

- Evaluate management strategy and operations.
- Oversee and co-ordinate financial audit work.
- Report to the board (where there is one).

To whom the external auditor should report will depend upon local circumstances but where a board has been appointed to oversee the activities of the second-level organisation, the external auditor should normally report to that board, rather than to the chief executive and the report should be available to the controlling first-level organisation. If the second-level organisation is managed only by a 'head' or 'chief executive' the external auditor should always report to the controlling organisation with a copy to the head or chief executive of the second-level organisation. Usually, the external auditor will also provide a 'management report'. A question that each controlling organisation should consider is whether the external auditor should also be required to submit that management report to the controlling organisation.

Where responsibility for a service or activity is delegated to the private sector via a PFI-type arrangement that arrangement ought to include a recognition that the state external auditor should have access to assess performance under the PFI contract arrangements as well as ensuring that the PFI contract itself contains the appropriate range of controls and that those controls are being properly exercised.

12.1.13 Using 'Performance' as a Basis for Control

'Performance' ought to be used as one of the factors in the controls by the first-level organisation. The extent of the 'performance' information required will depend upon the service or activity in which the second-level organisation is engaged. The information required for managerial control purposes will also be different from that required for public accountability purposes and it will be more extensive.

Using 'performance' as a basis for control, places the focus heavily upon the drafting of the service-level or performance agreement and the results or outputs of a second-level organisation. However, 'performance' can be very difficult to define in precise terms for some organisations, and consequently some countries have combined input and output controls.

Service-level agreements should describe the basis for defining the financial and statistical information systems to be used. An example, would be whether a cash or accrual accounting basis should be adopted (and this will depend mainly upon whether the second-level organisation is engaged in commercial activities). For statistical reporting purposes, sometimes it may be appropriate to require the use of definitions developed by such recognised organisations as the World Health Organisation (WHO). The agreement should also specify which control bodies (e.g. external audit or some other regulatory agency depending upon the service being delivered) should be involved in measuring or checking performance where that is appropriate, as, for example, with some medical or educational performance.

Whether 'performance' can be defined also depends upon whether the objectives for the second-level organisation have been clearly defined and linked to budgets. Where objectives are difficult to define proxy indicators may need to be devised. For example, the performance of a second-level organisation responsible for improving health care cannot necessarily be precisely defined because almost every activity influencing healthcare, such a diet, housing, and lifestyle, would not be under the control of the management of a second-level organisation (or first-level for that matter). But it can take a range of actions designed to address specific areas of healthcare such as programmes of vaccination, encouraging residents to adopt less sedentary lifestyles, or healthier eating, encouraging the stopping of smoking, and such actions can be measured. This would mean that the controlling organisation, sets out more specific requirements than an overarching objective. These resulting performance measures though should be agreed between the controlling organisation and the second-level organisation and their impacts should be measured against objectives set by the controlling organisation. (The problems with using performance are discussed in more detail in Chap. 5.)

Because of these difficulties and sometimes the costs of obtaining detailed performance information for accountability purposes, the performance or service-level agreement should focus on the key performance information rather than try to incorporate every aspect of performance. However, for purely internal management purposes much more detailed performance information may be needed and especially given a requirement that an objective of management is to secure improvements in efficiency and effectiveness.

All these factors point to a need for a close management dialogue between the first and second-level organisation with the first-level organisation having the knowledge and capacity to set the performance standards and objectives it expects to be achieved, whatever the form of performance (i.e. financial and/or physical performance) and then having the capacity to monitor whether those performance objectives have been achieved.

12.2 Summary of Issues Concerning Second-Level Organisations and PFI-Type Schemes

The mere act of creating a second-level organisation, or of delegating responsibility for the delivery of a service or activity to the private sector via a PFI arrangement does not of itself guarantee improved performance (of whatever kind). Management action must be taken by the controlling organisation. PFI arrangements are usually entered into in order to bring forward investment activity, such as the advanced provision of a hospital rather than for any other reason. Autonomy alone for a second-level organisation is an insufficient condition to improve the quality of second-level management and performance. Improvements require constant vigilance by a controlling organisation to avoid the onset of management complacency and the pursuit by the second-level organisation of its own agenda. This is particularly true where there are no external incentives, such a competition, to drive improvements in performance, that is, in quality and in efficiency and effectiveness and no threat of operational financial risk.

An important feature of controlling organisation management of second-level organisations is that there should be consistency between the objectives and policies of the controlling first-level organisation and those of all second-level organisations. Controlling organisations should be organised in such a manner as to ensure this occurs. They should retain a capacity to set policy objectives for second-level organisations and a capacity to systematically review performance. The operational heads of controlling organisations (state secretaries or equivalent) should ensure that second-level bodies are well managed, have objectives and performance standards which are consistent with those of the controlling organisation, adopt internal control policies which are also consistent with those of the controlling organisation and that systematic monitoring arrangements are established.

In countries which have well established arrangements for PFM/IC the evidence is that there is active management of second-level organisations and this extends to regular reviews not only of performance but also to whether the need for a second-level organisations remain. Active management also asks questions about whether new second-level organisations should be established at all. Establishing them is not 'cost free'.

An important element in establishing a managerial relationship between first- and second-level organisations is the existence of agreements between the two levels of organisation setting out what each is expected to contribute and to achieve as well as how monitoring will be undertaken. The agreements (performance or service level or an equivalent term) do not need to just exist but they should be actively monitored by the first-level organisation.

A usual stated reason for establishing second-level organisations is to improve efficiency and effectiveness. However, there is little evidence that such a benefit is achieved in many countries and with some arrangements challenge to the managements of second-level organisations is difficult to mount unless the conditions to do so are established from the outset.

Second-level organisations should be subject to both internal and external audit. The specific arrangements may depend upon whether the second-level organisation has commercial or non-commercial objectives. The fact that audit arrangements exist does not mean that the controlling organisation should not directly engage in its own monitoring activities or in some way modify them. However, it should be clear about the role of its own internal audit organisation and ensure that it has access to the external auditor's report.

All second-level organisations should be expected to publish an annual report, a statement of internal control and financial statements.

Annex

Irish Government Agency Report Requirements[16]

Chairperson's Comprehensive Report to the Minister[17]

1. The Chairperson's report to the relevant Minister regarding the system of internal control. This statement should be reviewed by the external auditors to confirm that it reflects the audited body[18]'s compliance with the requirements and is consistent with the information of which they are aware from their audit work on the financial statements. The external auditors should include their report on this matter in their audit report on the financial statements.
2. The Chairperson's report to the relevant Minister should include a statement on the system of internal control in the format set out below and include, in cases where a breach of this system has been identified, an outline of the steps that will be taken to guard against such a breach occurring in future.
3. Outlining all commercially significant developments affecting the state body in the preceding year, including the establishment of subsidiaries or joint ventures and share acquisitions, and major issues likely to arise in the short to medium term.
4. The Chairperson's comprehensive report should provide summary details of all off-balance sheet financial transactions of the state body that are not disclosed in the annual report and financial statements of the state body, including information on the nature, purpose, and financial impact of the off-balance sheet financial transactions. The contents and format of this section of the report should be agreed in advance with the relevant Minister/designated Departmental officials.
5. Affirming that all appropriate procedures for financial reporting, internal audit, travel, procurement, and asset disposals are being carried out. For example, details of and explanations for the disposals of assets or grants of access to property or infrastructure for commercial arrangements with third parties above the threshold of €150,000 which have not been subject to auction or competitive tendering process should be included.

[16] The Chairperson's comprehensive report has been edited by the author to simplify the presentation by excluding references to specific Irish legislation.

[17] Chairperson's comprehensive report to the minister: https://www.gov.ie/pdf/?file=https://assets

[18] The reference to 'body' is an equivalent term to 'organisation'.

6. Affirming that Codes of Conduct for the Board and Employees have been put in place and adhered to.
7. Affirming that Government pay guidelines on the pay of CEOs and all state body employees are being complied with.
8. Affirming that Government guidelines on the payment of Board members' fees are being complied with. The Chairperson's comprehensive report should also include a schedule of the fees and aggregate expenses paid to each of the Board members.
9. As part of the Chairperson's comprehensive report, the Chairperson should affirm that the Government pay guidelines are being complied with in respect of such appointees who serve on the main Board and any subsidiaries of state bodies.
10. Explaining failure to comply with any of the above and stating any corrective action taken or contemplated.
11. Outlining significant post-balance sheet events.
12. Confirming that the appropriate requirements of the Public Spending Code are being complied with.
13. Confirming that procedures are in place for the making of protected disclosures in accordance with section 21(1) of the Protected Disclosures Act 2014 and confirmation that the annual report required under section 22(1) of the Act has been published;
14. Certifying that Government travel policy requirements are being complied with in all respects.
15. The Chairperson's letter should include the confirmation that the state body has complied with its obligations under tax law.
16. Providing details of/information on legal disputes involving other state bodies.
17. Confirming that this Code has been adopted and the extent to which the state body is in compliance with the Code.
18. Stating that any subsidiary of the state body (or subsidiary thereof) continues to operate solely for the purpose of which it was established, remains, and continues to remain in full compliance with the terms and conditions of the consent under which it was established.
19. Along with the unaudited six-monthly financial statements, the Chairperson should also provide an interim report to the relevant Minister and, where appropriate, on significant commercially sensitive developments in the preceding 6 months and likely developments for the rest of the year.

20. The Chairperson should, in the comprehensive report to the Minister affirm adherence to the relevant procurement policy and procedures and the development and implementation of the Corporate Procurement Plan.
21. Non-competitive procurement should be reported in the Chairperson's comprehensive report to Minister.

Statement on System of Internal Controls in a State Body

A statement on the system of internal controls in a state body should include the following items:

1. Acknowledgement by the Chairperson that the Board is responsible for the state body's system of internal control.
2. An explanation that such a system can provide only reasonable and not absolute assurance against material error.
3. Description of the key control procedures tailored to reflect the size and complexity of the organisation in order to provide a full understanding of the procedures, which have been put in place by the Board, to provide effective internal control.
   - (a) A statement in relation to when the annual review of the effectiveness of control was conducted or where such a review was not conducted, a statement that it was not conducted.
   - (b) Disclosure of details regarding instances where breaches in control occurred—such breaches might include non-compliance with procurement rules or instances where other elements of the control system (e.g. internal audit, Audit and Risk Committee or other committees) were not operational.
   - (c) Disclosure of details of any material losses or frauds.
   - (d) Statement on System of Internal Controls is to be reviewed by the Audit and Risk Committee and the Board to ensure it accurately reflects the control system in operation during the reporting period.
   - (e) Statement on System of Internal Controls is to be reviewed by the external auditors to confirm that it reflects the audited body's compliance with the requirements of paragraph 1.9 (iv) and is consistent with the information of which they are aware from their audit work on the financial statements and where this is not the case, the external auditor should report on this in the audit report on the relevant financial statement.

(f) the steps taken to ensure an appropriate control environment (such as clearly defined management responsibilities);
(g) processes used to identify business risks and to evaluate their financial implications;
(h) details of the major information systems in place such as budgets, and means of comparing actual results with budgets during the year;
(i) the procedures for addressing the financial implications of major business risks (such as financial instructions and notes of procedures, delegation practices such as authorisation limits, segregation of duties and methods of preventing and detecting fraud); and
(j) the procedures for monitoring the effectiveness of the internal control system which may include: Audit and Risk Committees, management reviews, consultancy, inspection, and review studies, the work of internal audit, quality audit reviews, and statements from the heads of internal audit.

4. Confirmation that there has been a review of the effectiveness of the system of internal control.
5. Information (if appropriate) about the weaknesses in internal control that have resulted in material losses, contingencies, or uncertainties which require disclosure in the financial statements or the auditor's report on the financial statements.
6. The information relating to weaknesses in internal control should be a description of the action taken, or intended to be taken, to correct the weaknesses, or an explanation of why no action is considered necessary.
7. Confirmation that the state body is in compliance with current procurement rules and guidelines as set out by the Office of Government Procurement.

Irish Government: Model Shareholder Expectation Letter[19]

Strictly Private and Confidential

SAMPLE LETTER TO COMMERCIAL SEMISTATE BODY FOR CORPORATE GOVERNANCE COMPLIANCE AND SHAREHOLDER EXPECTATIONS.

[19] See footnote 16: section on Government Accounting: Model Shareholder Expectation Letter.

[On Letterhead of Relevant Line Minister]

Author's Note: This is an illustrative example of a shareholder expectation letter setting out what typically should be included. Please note that the shareholder expectation letter should be tailored to meet the particular circumstance of the commercial State body.

[Date]

Intended Recipient:

Dear []

Introduction

The Minister for Public Expenditure and Reform and I have given consideration to the way in which Government objectives for [insert name of entity] are formulated and shared with the Board of Directors (the 'Board'). Arising from that consideration, we are now proposing a more structured approach to confirming Government's objectives for [insert name of entity] over the short and medium term with a view to assisting the Board in its operations and in complying with its obligations under the prevailing governance framework.

This letter is intended to provide guidance to the Board with respect to Government's current objectives for [insert name of entity] and the primary considerations which will be taken into account in respect of matters for which consent may be required under legislation, [the entities Constitution] and/or the Code of Practice for the Governance of State bodies (the 'Code'). We believe that this letter will be helpful to the Board, particularly in its corporate and strategic planning processes, and it is our intention that we would in future issue a similar letter on an annual basis.

The specific objectives outlined in this letter should be considered in the context of the Government's overall policy objectives for [insert name of entity], namely that:

- [Insert name of entity] should continue to deliver on its corporate strategy, [including]
- [Insert name of entity] should maintain financial policies and a capital structure, taking account of future obligations (including pensions), that facilitate the payment of dividends to the Shareholder(s).

Dividends

It is our view that a new Dividend Policy, tailored to the specific circumstances of each commercial semi-state body, should apply in the commercial state sector, with a view to facilitating management in prioritising objectives and providing greater clarity on dividend payments over the medium term.

We therefore request that the Board of [insert name of entity] would now develop a new formal dividend policy for [insert name of entity], which would take into consideration the following principles:

(a) an appropriate balance should be struck between payment of dividends and reinvestment in the business; in this context it is the strong objective that a robust medium-term framework for the calculation of dividends be put in place which will reflect the imperative that [insert name of entity] remain strong financially and in a position to invest commercially whilst also delivering an appropriate return to the Shareholder(s);
(b) the policy and its implementation should ultimately be comparable with peer companies within a period of 5 years, taking into account structural, ownership, regional and other relevant differences; and
(c) the policy should also be related to an agreed proportion of cash flow as well as net profit after tax (NPAT).

In this regard, it is proposed that a list of appropriate peer companies be agreed between our respective Departments and the Board. A suggested list of peer companies is set out in Appendix II.

As indicated above, the objective of formulating a new dividend policy is to assist the Board by bringing clarity to the Government's objectives as regards future dividend payments over the medium term, thereby avoiding the uncertainty created by special dividends potentially being requested from time to time. It may still be necessary or appropriate for special dividends to be paid from time to time (e.g. in event of sales of assets, windfall gains, etc.). However, to the extent that any special dividend is paid, it is our expectation that the likely impact of such payment on the policy would be reviewed at the time. We also believe that greater certainty on dividend policy will assist in enabling informed decisions to be made on financial management and investment, while providing an appropriate, regular, and predictable return to the Shareholder.

We ask that you engage with the Departments with a view to developing an appropriate new dividend policy, with a target of having this finalised no later than [deadline].

Return on Capital

A key focus for the Shareholder(s) in the commercial state companies is the return generated on capital invested. We propose to augment our monitoring and measurement of [insert name of entity] investment returns and in this regard Appendix [see below] includes financial performance measures in respect of profitability and investment return which we propose to use to assess company performance. While acknowledging that returns will vary from year to year, sometimes due to temporary or non-controllable factors, it is, however, a key Government objective that [insert name of entity] delivers investment returns over the relevant period that are in line with peer companies, while also having regard to the cost of capital.

This proposed approach to developing a perspective on shareholder return will be reviewed on an on-going basis and may be adapted as necessary.

Sectoral Policy Objectives

In addition to the overall policy objectives of [insert name of entity] listed above, we wish to ensure that [insert name of entity] continues to work actively to support general Government policy in the XXX sector [including … This will require an appropriate level of on-going investment by [insert name of entity], with care being taken to ensure that core areas of activity are prioritised within the resources available to the company for reinvestment.

Governance Arrangements

Corporate Plan

The Code of Practice for the Governance of State bodies (the 'Code') sets out the governance framework for the internal management, and the internal and external reporting relationships of commercial and non-commercial State bodies. As you know, the Code requires State bodies to prepare a rolling 5-year corporate plan, which should be submitted to the relevant parent Department within six months of the year end. We would propose to engage with you early on in the process of preparing/updating this corporate plan, in order that we can provide feedback to you on the plan in a timely fashion.

Reporting

The Business and Financial Reporting Requirements document, appended to the Code, sets out the reporting requirements to which State bodies should adhere, including the provision of interim and final financial statements. We would propose to enhance the existing reporting arrangements by introducing regular three-monthly review meetings between [insert name of entity] and the Departments, to review progress in relation to the financial performance measures referred to above (as set out in Appendix) and other key performance indicators.

Board Evaluation

Consistent with the requirement in the Code, we expect that the Board constantly reviews its own operation and performance and that of its committees and individual members and that the Board undertakes an evaluation of its performance on an annual basis.

Engagement

Our expectation is that you will engage with the Department in the near term to discuss the matters set out in this letter in more detail. Please make arrangements with your usual contacts in the Department.

Yours sincerely.

Minister for…

Financial Performance Measures

Shareholder Return

Measure	Calculation
Dividend pay out	1. Dividends paid/adjusted net profit after tax (prior year) 2. Dividends paid/net cash flow from operating activities 3. Dividends paid/(net cash flow from operating activities less capex)
Return on equity	Adjusted net profit after tax/average equity
Earnings growth	Compound annual growth rate in adjusted net profit after tax

Profitability/Efficiency

Measure	Calculation
Return on capital employed (ROCE)	1. Adjusted EBIT/average capital employed (EBIT = earnings before interest and tax) 2. adjusted EBIT/adjusted average capital employed

Wages & Salaries

Measure	Calculation
Average pay	Wages & Salaries cost/average no. of employees
Average pay incl. employer contributions	Wages & Salaries plus employer pension contributions/average no. of employees

Leverage/Solvency/Credit Metrics

Measure	Calculation
Gearing ratio (net)	1. Net debt/net debt plus equity plus minorities 2. Net debt/net debt plus pension liabilities plus employee related liabilities plus equity plus minorities
EBITDA interest cover (DA = depreciation amortisation)	Adjusted EBITDA/net interest payable
Interest cover	PBIT/net interest payable
FFO/debt (FFO = funds from operations)	Funds from operations/gross debt,
Financial covenant metrics	e.g., net debt/EBITDA, others

Definition of Key Terms Used in Calculations

Term	Definition
Adjusted EBIT	Earnings before interest and tax adjusted for exceptional items and IFRS fair value movements
Adjusted EBITDA	Earnings before interest, tax, depreciation, and amortisation adjusted for exceptional items and IFRS fair value movements
Adjusted net profit after tax	Net profit after tax adjusted for exceptional items and IFRS fair value movements
Adjusted capital employed	Net debt plus equity plus pension liabilities plus employee related liabilities
Capital employed	Net debt plus equity
Dividends paid	Dividends paid during the financial year per the cash flow statement (excl. special dividends)
Equity	Total shareholder(s) equity taken from the balance sheet
Funds from operations	Net cash flow from operating activities (post interest and tax paid and pre-working capital changes)
Gross debt	Interest-bearing debt such as loans, bonds, and commercial paper plus interest-bearing finance leases
Fair value adjustments	Includes unrealised fair value gains/losses on derivatives or all fair value gains/losses on derivatives where the entity does not separately identify unrealised items.
Net cash flow from operating activities	Taken directly from the cash flow statement—ensure interest paid is included
Net debt	Interest-bearing debt such as loans, bonds, and commercial paper plus interest-bearing finance leases less cash

13

Monitoring the Change from Administration to Management: Demonstrating This Through the Utilisation of a Statement of Internal Control

The PFM/IC reform is not simply about a reform to existing procedures. The reform is more fundamental than that. It is about moving from a traditional administrative approach to the utilisation of public resources to an entirely new environment, which is the management of public resources. The monitoring of this change should be an important dimension to the reform. A requirement for public organisations to prepare annually a statement demonstrating the recognition of this change and how it has impacted upon the ability of an organisation to achieve its objectives and performance standards and objectives and at the same time ensuring that its resources have been efficiently and effectively utilised and income collected should be an essential component of the reform. This statement, which is called here a statement of internal control (this statement may have different titles in different countries where an equivalent type statement exists), should explain how management has performed during the year. The statement should give the reader a clear understanding of the challenges facing the organisation and how those challenges have been responded to including remarks about what has gone wrong and the actions taken to make corrections. In other words, the statement should be an indicator of the quality of management. The statement should also address risk management. Where it does not do so a separate statement about how risk is being identified and managed also should be published. The publication of such a statement is an important feature in developing accountability and transparency and should be a requirement in the development of PFM/IC. The external auditor (the auditor general or equivalent) should be expected to review this statement and it should be available to the parliament. However, in many countries neither a statement

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_13

of internal control nor a statement about risk management are features of public organisation reporting. At the very least the ministry of finance should require that such statements are prepared and the information contained in these statements is available to it. Where individual organisational statements are not published a summary should be published as part of the annual report on the government's financial statements.

13.1 Reporting on the Quality of Internal Control

13.1.1 Management and the Statement of Internal Control

In the current climate of fiscal restraint and declining availability of resources, it is important that central government bodies can demonstrate the resources that they are responsible for are appropriately managed and controlled. High quality and proportionate internal control systems will help organisations achieve their aims. A useful method of demonstrating how well an organisation is performing would be a requirement on the operational management to prepare a 'Statement of Internal Control'. The Statement on Internal Control (SIC) should be a public accountability document that describes the effectiveness of internal controls in an organisation.[1]

As has been explained throughout this guide, the PFM/IC reform represents a significant reform from a traditional administrative approach with an emphasis upon establishing a managerial approach concerned not only with securing financial and budgetary control but also with the achievement of objectives and performance standards and doing so efficiently and effectively. The evidence of this change. The effectiveness of the reform should be demonstrated annually. This would be by the preparation and publication by the top operational management of public organisations (the state secretary or equivalent) of a statement of internal control. This would be an entirely new feature for most countries changing from traditional systems of public administration and for some countries that have already adopted PFM/IC.

The statement of internal control should normally be published along with the annual financial statements or if separate financial statements are not published for each public organisation (e.g., for each ministry), then the statement

[1] UK National Audit Office: https://www.nao.org.uk/wp-content/uploads/2010/01/statement_internal_control.pdf.

should be published either separately or it may be published in a consolidated form covering particular types of organisations, such as all ministries. However, as an objective is to achieve greater transparency and accountability, the greater the degree of consolidation the less the level of these characteristics, unless the consolidated statement addresses separately each public organisation. Transparency and accountability are important in generating pressure for improvements and to develop effective parliamentary scrutiny. Ideally statements of internal control should be published in such a manner that makes them also available to the taxpayer, the user of public services, suppliers and others who have dealings with public organisations. Some governments may resist this seeing publication as only necessary to a more limited group of users, namely, the minister of finance, the cabinet of ministers and in some form to the parliament. But this does not create transparency and accountability in the 'open government' sense and this limited form of publication should either be discouraged or at best seen as a step towards wider publication as experience and confidence in the PFM/IC reform become established. At the least an aim should be to ensure that parliament has access to the information and if necessary to any statement of the actions to be taken by the ministry of finance and/or the cabinet of ministers to correct weaknesses or to develop new policies to address emerging issues.

Statements of internal control are most effective where a distinction exists between political and civil service (or local government service) management (i.e., between the development of policy and the strategy for implementing that policy and day-to-day operational management). If that distinction does not exist, there is a possibility that what should be an annual assessment of the effectiveness of operational management internal control arrangements of an organisation could become a political criticism, both of policy and of operational management. Where this occurs, the risk then is that the conflation of the two quite separate issues will lead to a focus on policy rather than the quality of the operational management internal control arrangements. This will then cause those with political responsibilities to be cautious about publishing any material that could potentially lead on to political as opposed to operational management criticism. This then is another reason why with the implementation of PFM/IC delegation of operational management should occur.

The statement will be an important source of information about the development of internal control to the 'driver' department responsible for the implementation of PFM/IC.

13.1.2 The Responsibilities of the Official Preparing This Statement

The most senior operational manager, that is, state secretary or equivalent, who should also be responsible for the implementation of PFM/IC, should be required to prepare this statement each year. This official should take personal responsibility for the quality of the financial management and internal control systems.[2] In those countries where there is no such single official with individual heads of departments reporting directly to ministers, such a statement could not be effectively prepared. This is another reason why that arrangement would be inappropriate with the implementation of PFM/IC. The other key official who should be involved in the preparation of this statement should be the head of finance (see Chap. 8). The reason for the involvement of this official is the role that he/she has in ensuring that the organisation is financially well managed, that it has a focus on delivering efficiency and effectiveness and using its resources efficiently and effectively as well as economically. This head should also ensure that the organisation is managed in such a manner as will maintain its financial resilience over time.

In addition to provide confidence in the statement of internal control, the head of internal audit should also be asked to review the content of the statement.

Although the official responsible for the implementation of PFM/IC should have a personal responsibility for preparing this statement and signing it, the content of the statement also should be agreed with and approved by the political head of the organisation, such as a minister or mayor where that political head has an overall responsibility for the quality of the management of the organisation. Where an audit committee exists, it should also be approved by that committee. Approval requires the political head to acknowledge how well the organisation is being managed (or not!) and to understand how emerging problems and weaknesses in the internal control arrangements have been addressed as well as the corrective actions that have been taken. Where significant problems and weakness have been reported in this statement, the day-to-day managerial accountability arrangements should have ensured that the political head of the organisation was well aware of them before the statement of internal control was prepared. The political head should be fully informed about any significant weaknesses and be able to ensure that corrective actions have been taken. Ideally this should occur before external criticism emerges, whether from the ministry of finance or the external auditor.

---

[2] If delegation has not occurred (which would be most unsatisfactory so far as the application of PFM/IC is concerned) the responsible person would be the politically appointed official with the responsibility for overseeing the implementation of PFM/IC, which could be in some circumstances a minister or mayor.

13.1.3 The Benefits of This Statement

This statement, along with the results of any separate reports required by the 'driver' department of the ministry of finance, will help establish how successful the reform is being implemented. It will enable the 'driver' department prepare an assessment of what still needs to be achieved which could include training and the development of new systems. New systems could include management accounting and performance information systems.

Ideally, the statement should be a by-product of day-to-day internal control processes. This statement may also include a statement about the risk management arrangements. If it does not include the risk management arrangements, then a separate risk management/appetite statement should be prepared and be available as part of the transparency and accountability arrangements. (See Chap. 11 for a detailed discussion on risk management.)

The effectiveness of internal controls (and bear in mind that they are as much about the achievement of objectives and performance standards efficiently and effectively, as well as about ensuring that rules and regulations governing 'inputs' are complied with and that assets and other resources are not misused) should be under constant review. The information about the quality of those controls and the achievement of objectives and performance should flow up and down the management structure of the organisation to allow appropriate management action to be taken.

In preparing the statement of internal control the official responsible will need to rely on information provided by others such as heads of second-level organisations and heads of ministry or local government departments. The information required should largely be derived from the day-to-day implementation of the internal controls, especially identifying what has been shown to be weak or has revealed errors or risks or the reasons for a failure to achieve objectives or deliver specified performance standards or a failure to achieve improved efficiency and effectiveness.

13.1.4 The Issues That Should Be Covered in the Statement

The head of operational management in preparing the statement of internal control should set out his/her responsibilities for the internal control arrangements. The head should explain the purpose and provide a description of the system of internal control, that is, that it is designed to ensure that financial and budgetary controls are effective and that the objectives and performance standards can be delivered efficiently and effectively and to time and that they are being delivered within the relevant legal and regulatory framework. The statement should explain the arrangements for the management of public resources, including a description of how the top and senior operational management provide leadership to ensure that the internal control and risk management policies are embedded in the management processes of the organisation. It should also explain the training provided to staff to embed an appreciation of the internal control arrangements. This should also include how the internal control arrangements have been adapted to meet changing circumstances.

The statement should also include the following:

1. An explanation of the responsibilities of the head of operational management for the systematic oversight of the effectiveness of the system of internal control. This should include information about the extent to which the review is informed by the work of internal audit.
2. A review of the effectiveness of the internal control arrangements during the year.
3. The key elements in the risk management strategy, including how risk is identified, evaluated and controlled, how risk appetite is determined, including the roles of both operational and political management, and how risk management is embedded into management at all levels in the organisation. Any changes in the risk management strategy during the year should be disclosed along with the reasons for change.
4. A recognition that the system of internal control cannot eliminate all risk and therefore can only provide a reasonable and not absolute assurance.
5. Material changes to the internal control arrangements that may have occurred compared to the previous year should be disclosed.
6. A disclosure of weaknesses found to have occurred during the year, not just in the management of expenditure and income, including tax income, but also weaknesses, including those of risk management, which have resulted in the non-achievement of objectives and performance standards efficiently and effectively, to time and within budget. (The starting point for this review of effectiveness should be the evidence as to whether the organisation has achieved its objectives and performance standards.)
7. The arrangements for regularly reviewing the system of internal control and how identified weaknesses are being addressed.
8. An explanation of the remedies that have been adopted to overcome such weaknesses and to prevent such weaknesses recurring. (In reality, weaknesses will almost inevitably occur no matter how good management is and how resilient systems may appear to be. This is because of changes of

circumstances and personal as well as events occurring beyond the control of management.)

9. The actions taken or proposed to deal with any ‘significant’ internal control issues. Examples of ‘significant’ internal control issues would include those that:

   - might prejudice or prevent the achievement of the objective(s) and performance standards;
   - could have an impact upon budgetary and financial controls and financial reports to the ministry of finance;
   - would be regarded by internal or external audit as significant;
   - might attract adverse public comment and/or could result in a breach of the law and regulations;
   - indicate departures from established practices including over the arrangements for procurement: the reasons for such departures should be clearly identified;
   - would indicate weaknesses in the arrangements for the collection of revenues, including increasing levels of losses on revenue collection;
   - show any significant lapses in data security such as data losses or breaches of IT security;
   - have identified fraudulent or corrupt activity occurring which affects the organisation, analysed between fraudulent or corrupt activity occurring within the management and staff of the organisation and that effected by third parties upon the organisation.

The disclosure of significant internal control issues should be explicit and should include how the issue arose and the remedial actions taken and planned. Subsequent statements of internal control may also need to include progress in subsequent years in addressing identified problems.

10. A commentary on the extent to which responsibility for operational management had been delegated to civil or local government service officials and the corresponding accountability arrangements:

    - A statement about improvements in value for money in the delivery of the services for which the organisation is responsible and in the management of the organisation:

11. The extent to which second-level organisations (non-market and market based) have established effective management and internal control structures.

12. An explanation of how the first-level organisation manages its relationships with second-level organisations (i.e., both non-market and market based) and ensures that the objectives, policies and activities are consistent with those determined by the first-level organisation. This would include for market based, whether they have achieved the expected financial returns and any other key factors such as the impact of their activities upon the private sector marketplace.
13. Any wider public interest issues that have emerged during the year and how they have been dealt with, such as environmental issues including those arising from climate change.
14. The main challenges that are likely to face the organisation in the next year, including emerging risks and how the organisation envisages responding to them.
15. A commentary on the long-run financial resilience of the organisation.[3]

The exact content will vary over time with the developing maturity of the internal control arrangements.

The statement could cover the management of the relationships with all controlled second-level organisations, and whether in exercising this supervisory role, any difficulties have emerged during the period. The statement should disclose how they have been dealt with by the controlling organisation.

This represents a potential schedule of the issues that should be covered, but each country will decide what it wishes to see included within the statement and therefore may wish to amend this list.

13.1.5 The Role of Audit and This Statement and the Publicity Which Should Be Given

The head of internal audit should give an opinion on the overall adequacy and effectiveness of the organisation's internal control environment, providing any details of weaknesses. The head should bring to the attention of the official responsible for the implementation of PFM/IC (i.e., the state secretary or equivalent) any issues particularly relevant to the preparation of the

[3] This is relevant to the IMF Fiscal Transparency Code. "Fiscal transparency—the comprehensiveness, clarity, reliability, timeliness, and relevance of public reporting on the past, present, and future state of public finances—is critical for effective fiscal management and accountability. It helps ensure that governments have an accurate picture of their finances when making economic decisions, including of the costs and benefits of policy changes and potential risks to public finances." This code does not specifically cover the statement of internal control but the information contained in such a statement would be of assistance to the ministry of finance in compiling the information required by The Fiscal Transparency Code.

statement. In some countries the head of internal audit may also be asked to sign the statement of internal control as well as the head of operational management.

The state external auditor should also review the statement of internal control and provide observations on the quality of the internal control arrangements including whether the external auditor agrees with the remarks in the statement of internal control. The external auditor (as well as the internal auditor) should have a concern for improvements in public value through value for money audits and the auditor's ability to undertake such audits will be affected by the quality of the financial and performance information available to management and hence to the auditor.

13.1.6 Consequential Changes to Facilitate the Development of a Statement of Internal Control

In Chap. 4, reference was made to the need to modify the sanction arrangements which could be applied against civil and local government officials with the introduction of PFM/IC to reflect the change to a managerial culture. Unless such modifications occur, their existence may also cause civil and local government officials to be cautious about identifying weaknesses which may result in criticisms of them and which may, in turn, cause the application of penalties (because of a penalty culture which may exist). The implementation of PFM/IC which has a focus on the delivery of objectives efficiently and effectively should also cause, as indicated in Chap. 4 (Test 8), a review of that penalty culture. This is because the risk of penalty may prevent the disclosure of information about failings in the internal control system. Yet disclosure of failings is central to improving the quality of public financial management and internal control. A process which discourages disclosure ultimately is not in the interests of top and senior management or in the interests of the ministry of finance.

Quite separately the budget law in some countries may contain penalty arrangements which would fall upon any official who breaches the conditions set out in the budget law.[4] Such conditions may also require modification on the change from an administrative to a management culture.

[4] See, for example, the Croatia Budget Law 1994—article 49: worldbank.org/publicsector/pe/BudgetLaws/Croatia.

13.1.7 Signs of Weaknesses in the Internal Control Arrangements

Indicators of evidence of weaknesses in internal controls are:

1. Failure to achieve objectives and performance standards and objectives (e.g., to keep error and fraud in the tax collection system to, say, no more than 5%).
2. Poor quality of managerial supervision of staff evidenced by:

   - Managers not effectively supervising the work and outputs of the staff they are responsible for?
   - No training in leadership, organisation management and particularly in staff management has been provided.
   - Delegation may exist but the delegation arrangements are unclear about what is expected of the staff and the limits of any discretion.
   - In practice staff are left to effectively 'manage themselves'. The accountability arrangements are weak with superior managers not effectively supervising staff, not being concerned with outputs and not ensuring staff act in conformity with the delegation arrangements including any limitations on the exercise of discretion.

3. Staff management policies (HR policies) are inappropriate to the business of the organisation:

   Is there evidence that the organisation's HR policies and practices are consistent with the organisation's ethical values and facilitate the achievement of its objectives including the management's ability to manage their staff effectively? Do those HR policies recognise that to achieve objectives managers will need to take decisions and this involves risk? Do those policies facilitate risk taking (and this may link up with the existence and application of the penalty policies referred to above)? Do staff have the necessary training to give them the knowledge, skills and tools to support the achievement of the organisation's objectives? Is there an effective incentive and reward policy including promotional policy? Does top operational management aim to establish an atmosphere of trust and mutual support within the organisation to encourage the flow of information between members of the staff and in this manner prevent to development of 'silo' mentalities and facilitate effective performance towards achieving the organisation's objectives. Does a culture of honesty and ethical behaviour exist? In some countries HR policies are not the responsibility of the employing organisation and may not reflect the individual needs of particular organisations or are of low priority to top management. This can lead to managers seeking ways to circumvent externally imposed controls or a failure of the coordination of policies and activities within the organisation.

4. The types of control that exist are inappropriate or do not cover the business of the organisation:

   Looking at 'control' from the limited perspective of financial and budgetary control there are two types of control, preventative and detective. Preventive controls are designed to deter or prevent undesirable events from occurring. Detective controls are designed to detect undesirable acts. The latter provide evidence that a loss has occurred but do not prevent a loss from occurring. A good internal control system not only has detective controls, but also has preventative controls. If both types of control do not exist, this is a signal of internal control weakness. However, with PFM/IC other controls should exist designed to ensure that intended performance is achieved. Do such controls exist and if not, why not?

5. The objectives and/or performance targets set for managers are unrealistic or not compatible with budgetary and other resource availability:

   A temptation can exist for top managers to set unrealistic targets for managers to achieve, targets which are not compatible with available resources. This situation can arise where top managers themselves feel under pressure, perhaps because of political pressure or reasons external to the organisation (such as civil society pressure). The consequential risk then is that individual managers will seek to avoid the rules or take short-cuts in order to meet those targets, for example, to avoid competitive tendering because it takes time or to ignore health and safety requirements or to reduce the quality of services. Opportunities should exist for managers to express their concerns where they regard targets as unrealistic.

6. Risk management is not taken seriously by both top operational and political management:

   Is risk management a serious or token responsibility of top operational management? What are the arrangements to involve the political level of management in the risk management process? Have measurable objectives been defined and linked with budgetary availability? Have the significant or strategic internal and external risks to the achievement of the organisation's objectives been identified and assessed? Is there a focus of top management on those significant or strategic risks? There can be a real possibility that the importance of risk management is not well appreciated by top and senior management, and where this is the situation, this in turn affects confidence in the ability of the management to achieve its objectives efficiently and effectively.

7. Reports and supporting documentation and other significant documents are missing:

   Reports and original documents provide 'hard' evidence of business transactions and especially of sensitive decisions. They also provide the evidence that both the internal financial reports are reliable and the external financial reports. Missing reports and original documentation should raise uncertainty about the quality of the internal controls. This is a weakness that managers and staff would be able to take advantage of, particularly those that are under pressure to perform.

8. The arrangements for the separation of duties are inadequate:

   Not only is this relevant for the purposes of financial control but where performance and budgetary information is linked and managers are expected to achieve performance targets within specific budgetary limitations the manager should have no opportunity to determine or control that performance information. In other words, it should be independently derived. Unless this is the situation confidence in that performance information can only be limited and therefore managerial claims of meeting performance objectives within budgets can also only be of limited value.

9. The finance department capability to support managers in the search for efficiency is inadequate:

   Has the head of finance a programme to improve the financial awareness of managers and staff? Has the head of finance ensured that each manager has the budgetary and financial and cost accounting information that individual managers require? Has the head of finance the authority and status to assess and challenge managerial claims for improvements in efficiency? Does this in fact occur?

10. Written procedures to explain how the different processes and activities of the organisation are to be undertaken and their current relevance:

    Do such procedures exist and are such procedures regularly reviewed by managers to reflect changing circumstances? Without current written procedures, employees may not be aware of the proper processes and this may lead to errors in decision making and recording.

11. Customer complaints procedures and the recording of such complaints:

    Does a 'customer complaints' procedure exist? Is there a process for reviewing customer complaints? Levels of complaint should provide evidence of compliance with standards of performance as well as evidence of the quality and relevance of the service and activities being provided. If a high number of complaints is made or in some circumstances an increase in complaints occurs, this would be an indicator of weak internal controls.

12. Arrangements for the systematic review of controls:

    Is there a process which allows for a regular and systematic review of internal controls? Operational changes, procurement requirements, personnel changes, environmental changes, changes in financial constraints, changes in systems, changes in security requirements, especially for IT systems, all impact on internal controls or how those internal controls should be applied. Have such reviews occurred?
13. Managerial 'override' of controls:

    Is there any evidence of managerial 'override' of controls? Management is responsible for the design, implementation and maintenance of the internal controls and therefore could override these controls should it so wish. This is an especial risk in those organisations where lower level staff have difficulty in challenging a superior manager (e.g., as instanced above over unrealistic targets). This may lead on to fraudulent activity in one form or another. Examples would include the misappropriation of assets as well as financial resources or the favouring of certain suppliers or the entry into types of contracts which potentially could increase the fiscal risks to the organisation, such as public/private partnerships. An important factor in discouraging this type of action is the quality of the 'tone at the top'. Therefore, in any review to determine whether weaknesses exist in the internal control system regard should be had to the approach of the top management, both political and operational, of the organisation.
14. 'Whistle blowing arrangements':

    Does a 'whistle blowing' process exists which allows staff to expose inappropriate behaviours or actions? There are both advantages and disadvantages to the existence of such a policy which can be implemented in different ways. Sometime the 'whistle blower' can remain anonymous and sometimes not. Where such a policy exists, it can be a useful method of exposing weaknesses in the internal control systems sometimes resulting in fraud or the misuse of a public organisation's resources.
15. Effectiveness of internal audit:

    Internal audit should be "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." (IIA)

Is this the actual situation?

In assessing the effectiveness of internal audit, a series of questions for consideration has been suggested by a commentator who was a chief risk officer at major global corporations.[5] Such questions should be asked annually and they include:

- Do you believe internal audit has provided you with the assurance you need, in a useful way, when you need it, on what matters?
- Do you have the assurance you need that management has effective and efficient processes and systems to manage the more significant risks to the success of the organisation and the achievement of its goals and strategies?
- Has internal audit been sufficiently responsive to changes in risk, ensuring it remains relevant and on point?
- Has internal audit been an effective agent for change, improving business efficiency and effectiveness?
- Are you satisfied that the cost of internal audit is less than the value of the assurance and consulting services it provides?
- Are there activities that internal audit should stop performing? Have there been activities you would have preferred not to pay for?
- How can internal audit improve its services to the audit committee, management and the organisation as a whole?

13.1.8 Examples of Statements of Internal Control

Examples of statements of internal control are included at Annex 1. They are from the UK and Croatia. They illustrate different approaches to the development of statements of internal control (which in Croatia is entitled 'Financial Responsibility Statement' and is accompanied by a detailed questionnaire to be completed by all public organisations). In Croatia, first-level budget users (ministries, counties, cities, municipalities) must submit a 'Fiscal Responsibility Statement' to the department in the ministry of finance responsible for the oversight of the implementation of PFM/IC. Second-level bodies must prepare and submit a 'Fiscal Responsibility Statement' to their supervising or controlling ministry or if subordinate to a local government, to the supervising or controlling city or municipality.

These examples reflect the different political, managerial and financial management arrangements which exist in these two countries. However, the Croatia model reflects the careful thought that the ministry of finance in that country has put into the development of PFM/IC making it a leader amongst its peer countries.

[5] The IIA website: https://iaonline.theiia.org/how-to-assess-the-effectiveness-of-internal-audit.

In the UK each public organisation publishes its own financial statements and the statement of internal control forms part of that publication package. A managerial culture exists and there is a clear separation of operational management by civil servants and local government officials from the political level of management responsible for policy and strategy.

Countries with a less developed managerial approach may feel that the Croatia model, where there is not the same managerial history as in the UK, may be a more appropriate model for them to follow. However, that model is not entirely consistent with the approach to PFM/IC set out in this guide. The Croatia approach focuses heavily upon the implementation of the procedures (i.e., bureaucracy) involved in adhering to the five COSO standards (see Chap. 11). The approach adopted in this guide is to focus much more heavily on the impact upon management of the introduction of PFM/IC. (The effectiveness of procedures anyway depends almost entirely upon the quality of the management responsible for the implementation of those procedures.)

The UK approach emphasises two aspects of control. First, that a manager needs to be able to assure the ministry of finance that budgetary control is being observed in terms which meet the requirements of the ministry of finance. Secondly, the manager is also required to deliver efficiency and effectiveness and to explain how this is being done.

Therefore, if the Croatia model is to be adopted, countries doing so should consider expanding the content of the 'Financial Responsibility Statement' to cover the matters indicated above. For example, a particular reference should be made to whether objectives, performance standards and performance objectives, (i.e. the outputs), have been achieved and therefore whether the internal controls that should be designed to secure their achievement are effective. If the outputs have not been achieved, the reasons should be explained by developing the statement, including reference to any weaknesses in the control arrangements and/or managerial capabilities. Reference should also be made to the organisation's ability to achieve improvements in efficiency and effectiveness in its operational activities (not just in the control arrangements). Therefore the 'Financial Responsibility Statement' should seek information about the steps being taken to improve efficiency and effectiveness. Secondly, the content of the statement also needs to focus upon the quality of the management arrangements and the achievement of the outputs of the organisation as well as on how improvements in efficiency and effectiveness are being achieved. This would mean identifying:

- The extent to which reform of the traditional administrative approach to the delivery of public services has occurred and therefore how a managerial approach to delivery is being or has been developed.

- The extent to which delegation of operational and administrative decision making from the political level of management to the civil and local government level of management exists and if it does not, what are the problems preventing this occurring (which could include, for example, quality of staffing, need for further training, lack of managerial information but may also be a consequence of other deeper factors such as lack of trust between political and appointed officials which can be very hard to identify and to counter).
- The role of the head of civil service operational management (i.e., the state secretary or equivalent) in the development and oversight of the implementation of PFM/IC within each public organisation.
- Whether an effective managerial structure exists focussed upon the delivery of objectives.
- Whether the finance/economics department has a capacity to apply wider financial management skills such as cost analyses to facilitate assessments of efficiency and effectiveness and provide long-run financial forecasting so that managers making decisions are aware of the long-run financial impacts of those decisions and that they also can take into account possible changes in operational, legal, demographic and environmental circumstances.
- Whether there has been a development of the financial information analytical capacity of the organisation (i.e., the introduction of more elaborate coding structures) so that managers have available to them financial information analysed in any form that a manager needs (and this may require a willingness on the part of the budget department and the treasury in the ministry of finance to accept the necessity for developments to the budgeting and financial accounting arrangements and also to the budgetary control arrangements to give operational managers more scope to make decisions).
- How far performance information has been developed to allow managers to link financial and operational performance and also with budgets.
- Whether managers have clear objectives, performance standards and operational targets they are to meet.
- The extent to which accountability arrangements exist and the effectiveness of those arrangements.
- The extent to which there is transparency to the service user and civil society more broadly and to parliament.

However, what is also important to note about Croatia, which is an important message to countries following the Croatia model, is that the department responsible for the oversight of the implementation of PFM/IC should be regularly reviewing and developing its approach. This demonstrates as a model how important it is to regard PFM/IC as an evolutionary process. Politicians as well as managers and auditors should encourage this.

13.2 Summary

For most developing and transition economy countries a requirement to prepare a statement of internal control (or an equivalent statement) would be a totally new requirement. That such a statement should be published as part of the development of the transparency and accountability arrangements would be a further requirement. However, as the introduction of PFM/IC requires a significant managerial reform, the statement of internal control should focus upon the development of the managerial arrangements including the arrangement for delegation and accountability. Accountability, as has been pointed out previously, is not simply internal accountability but also external. External accountability is to several different parties. There is accountability to the ministry of finance about how public money has been used and whether the objectives for which it was allocated have been achieved. There is accountability to parliament and also to the user of public services, to the taxpayer and to other interested parties.

The statement of internal control represents a formal mechanism for establishing transparency and external accountability about the use of public money, the delivery of objectives and performance standards and the actions that have been taken where weaknesses have occurred. It should include information about controlled second-level organisations.

The person responsible for preparing this statement should be the official responsible for the implementation of PFM/IC within an organisation. In a ministry that would be the state secretary or equivalent. The statement should show how the implementation of PFM/IC has improved the utilisation of public resources. The statement should not simply be directed at the effectiveness of financial and budgetary controls but should explain, if this is the situation, why objectives and performance standards have not been achieved. It should also include information to demonstrate actual improvements in efficiency and effectiveness. An important feature of the statement should be a discussion on the arrangements for risk management and how risks are managed. If it does not do that a separate statement on risk management should be published.

For this statement to be a successful element in the development of PFM/IC it must contain full and frank disclosures. Such an approach should not be discouraged or even prevented by a sanctions system upon officials which imposes penalties and other forms of discipline if objectives or other elements of public administration are not achieved. The overall aim is to improve the quality of management and as management involves making judgements and taking risks inevitably different views may exist and some decisions will produce the anticipated results and others not.

Other officials who should be involved in the preparation of this statement should include the head of finance and the head of internal audit. The statement should be subject to review by the external auditor, the auditor general.

The statement should be prepared annually and published along with the financial statements of the organisation. Where only consolidated financial statements are published either the statement of internal control should be published separately or in a consolidated form but identifying the key issues that the statements have revealed.

Annex: Example Statements of Internal Control

Example 1: United Kingdom

A Central Government Ministry

The first UK example is taken from the Education Ministry. In the UK a ministry is called a 'department' and is headed by a 'permanent secretary' who is also titled the 'accounting officer'. This official is a civil servant and is responsible for the quality of operational management implementing policies set by the politically appointed ministers. Accounting is on an accrual basis but the basis of the accounting is irrelevant for the purposes of drawing up the statement of internal control. Although the permanent secretary is responsible, a board is appointed which provides advice to that official. The board provides leadership for the department's business, helping it to operate in a business-like manner. The board should operate collectively, concentrating on advising on strategic and operational issues affecting the department's performance as well as scrutinising and challenging departmental policies and performance, with a view to the long-term health and success of the department.

Advice on the content of the statement of internal control is provided by the Ministry of Finance. The title of the Ministry of Finance in the UK is His Majesty's Treasury or HM Treasury.

For the financial year 2011–2012 and onwards, the annual Statement on Internal Control has been replaced by a requirement for departments, their executive agencies and arm's-length bodies to produce a Governance Statement in their annual report and accounts. By uniting disclosures formerly required to be made in the Statement on Internal Control with other existing requirements to publish a comprehensive explanation of organisational governance, the Governance Statement brings together in one place all disclosures about matters relating to an organisation's governance, risk and control.

However, for the purpose of these examples the more focussed statement of internal control has been used. This explains why examples are drawn from earlier years.

Department for Education and Skills Resource Accounts 2006–2007

Statement of Accounting Officer's Responsibilities

Under Section 5 of the Government Resources and Accounts Act 2000, the HM Treasury has directed the Department for Education and Skills to prepare, for each financial year, Resource Accounts detailing the resources acquired, held or disposed of during the year and the use of resources by the Department during the year. The accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of the Department, and of its net resource outturn, resources applied to the objectives, recognised gains and losses and cash flows for the financial year.

In preparing the accounts the Accounting Officer is required to comply with the requirements of the *Government Financial Reporting Manual* and in particular to:

- observe the Accounts Direction issued by HM Treasury, relevant accounting and disclosure requirements and apply suitable accounting policies on a consistent basis;
- make judgements and estimates on a reasonable basis;
- state whether applicable accounting standards, as set out in the *Government Financial Reporting Manual*, have been followed, and disclose and explain any material departures in the accounts; and
- prepare the accounts on an ongoing basis.

HM Treasury has appointed the Permanent Head of the Department as Accounting Officer of the Department. The responsibilities of an Accounting Officer include responsibility for the propriety and regularity of the public finances for which an Accounting Officer is answerable, for keeping proper records and safeguarding the Department's assets, are set out in the Accounting Officers' Memorandum issued by HM Treasury and published in *Government Accounting*.

Statement on Internal Control

Scope of Responsibility

As Accounting Officer, I have personal responsibility for maintaining a sound system of internal control that supports the achievement of Departmental policies, aims and objectives, set by the Department's Ministers, whilst safeguarding the public funds and Departmental assets, in accordance with the responsibilities assigned to me in Government Accounting. Within the Department I require each Director General, and the heads of certain other units which report directly to me, to sign an annual statement covering risk management and the operation of related controls in their areas of responsibility, to supplement the regular reporting to the Board on their stewardship of risks. Similarly, the Chief Executives of the Non-Departmental Public Bodies (NDPBs), which are part of the Departmental Group, are responsible for the maintenance and operation of the system of internal control in their individual NDPBs[6] and have signed a statement relating to those systems which are reproduced in the accounts of each body.

The statements from directorates and NDPBs have been scrutinised and further information sought when necessary. Internal audit has examined the internal control systems and reported upon their effectiveness and the Audit and Risk Committee (ARAC) has made an independent assessment of the contents of the Statement and are satisfied that it is consistent with their knowledge of the Department.

The Departmental Board includes two non-executive members and regularly meets to discuss all strategic policy management issues. This includes providing direction on major policy, delivery and operational issues, reviewing performance and ensuring that the Department is working economically, efficiently and effectively.

The Purpose of the System of Internal Control

The system of internal control is designed to manage risk to a reasonable level, rather than to eliminate all risk of failure to achieve policies, aims and objectives. It can therefore only provide a reasonable, rather than an absolute, assurance of effectiveness.

The system of internal control is based on an ongoing process designed to identify and prioritise the risks to the achievement of Departmental policies, aims and objectives; to evaluate the likelihood of those risks being realised and the impact should they be realised; and to manage them efficiently, effectively and economically. The system of internal control has been in place in the

[6] Non-departmental public bodies [NDPBs] are a form of second-level body or agency. When such a body is to be established, a ministry must consider many factors amongst which are:

- define the functions, aims and objectives;
- define the relationship with the sponsor ministry and accountability to the minister;
- consider its financial management requirements (accountability, planning, funding and control);
- ensure that the NDPB has adequate accounting and reporting systems to enable it to produce auditable accounts from the day of establishment;
- determine how performance against objectives will be measured and decide on arrangements for monitoring;
- consider the extent of its delegated responsibilities;
- consider when the NDPB should be subject to a review or, for bodies with a finite remit, when and how they might be wound up.

Department for the year ended 31 March 2007 and up to the date of approval of the annual report and accounts and accords with HM Treasury guidance.

Capacity and Capability to Manage Risk

The Board recognises the importance of leadership to create an environment where risk management is effective and a Departmental Risk Improvement Manager is in place. Two department-wide reviews of our risk management practice have been conducted to assess the progress made over the year regarding the improvement of the Department's risk management capacity and capability. These reviews found that we continue to make sound progress regarding the way in which we manage our risk. They also identified several areas of risk management in the Department and its NDPBs which require further improvement.

These issues are now being addressed as part of the actions set out in the Department's Risk Improvement Plan.

Risk management continues to be embedded into the Department's finance and programme and project management training which is widely available and achieves high take-up. Guidance on the identification, assessment and active management of risk in the Department is available to all staff. The Department's Risk Improvement Manager has continued to work with corporate policy colleagues to ensure that risk management is further embedded into the Department's corporate governance, finance management, business planning and assurance and performance management arrangements and improvement activities.

The Department met the Corporate Governance Code of Good Practice criteria requiring a professional Finance Director to be on the Board by December 2006.

The Risk and Control Framework

The Department's approach is to assign risks to those best placed to manage them. Therefore, individual managers are responsible to the risk owners (Directors General) for managing risk as they have knowledge of the issues involved and can best manage risk and mitigate the potential impact. All managers are expected to systematically identify, assess and manage risk and document the underlying assumptions. Risk management guiding principles have been developed for NDPB sponsor teams for use with their sponsor bodies.

The risk management process is built into the Department's business planning and reporting processes. With most of the Department's expenditure being on specific programmes, the main risk management arrangements focus on the delivery of this work and the risks associated with changing the way public services are delivered. These are managed through a strong programme and project management framework. There is clear accountability and ownership of risk to ensure that risk is managed at the appropriate level and there are frameworks in place to escalate risks to ensure that significant risks are reported to senior management and, if required, the Board.

Improvements have been made over the year as to the way the Department manages its key risks via the Department's Risk Committee, which is separate from the Board and is chaired by the Director General of Corporate Services. In May 2006 the ARAC conducted a review of the Risk Committee. Sixteen recommendations for improvement were made and all of these have been implemented.

The key risks facing the Department have been identified and agreed by the Risk Committee. The Board regularly reviews these risks and also considers new and emerging threats, ensuring that all are effectively managed. Every quarter I discuss and review key Departmental risks with the Secretary of State [The Secretary of State is the equivalent of a minister].

The Department judged that although it had all the necessary guidance and instructions required for effective control, they were dispersed and there was no effective check that they had been read and understood. A review of corporate governance led to the Board identifying ten key areas of compliance—'the Basics'—that required particular emphasis. This led in turn to all members of the senior civil service receiving a corporate governance handbook, including a checklist covering these ten key areas. As part of the internal control framework, all members of the senior civil service will reaffirm their personal responsibility for their and their staff's compliance with the Basics.

To support improvement in the risk and control framework management a proactive approach to fraud awareness, prevention, detection and investigation is taken by the Department. This has been demonstrated by development of a Fraud Risk Assessment Tool (FRAT) which provides guidance to managers on assessing fraud risks and is part of enhanced risk assessment arrangements that have been put in place in year. Its use will be evaluated in 2007–2008 and reviewed by the Fraud Sub-Committee.

During the year the National Audit Office (NAO)[7] produced a number of reports which reviewed the value for money of operations involving the Department and its delivery agents. No serious issues were identified.

The recommendations in reports by the NAO and the Public Accounts Committee have been carefully considered during the year.

Review of Effectiveness

As Accounting Officer, I also have responsibility for reviewing the effectiveness of the system of internal control. My review is informed by the Directors General within the Department who have responsibility for the development and maintenance of the internal control framework, Internal Audit and

[7] The NAO, the National Audit Office, is the state auditor.

comments made by the external auditors in their management letter and other reports. I have been advised by the Board, ARAC, the Risk Committee and the Departmental Risk Improvement Manager.

The Department's internal auditors undertake a work programme approved by me to review risk management, internal control and governance. The Head of Internal Audit produces periodic reports on Internal Audit's findings, their assessment of risk management, corporate governance and control standards in the key corporate risks and delivery areas, and areas where action is required to address shortcomings. I meet with the Head of Internal Audit quarterly to discuss her report and consider progress in addressing major concerns. She also prepares an annual report which includes her professional opinion on the effectiveness of the overall systems of internal control and risk management within the Department. In addition, this year, Internal Audit have offered advice to Directorates within the Department to ensure issues identified through the audit work programme have been appropriately reflected in the preparation of the Directorates' annual statements.

For 2006–2007 ARAC supported the Accounting Officer by offering objective advice on issues concerning the control and governance of the Department. ARAC was chaired by a non-executive Board member and its role and composition was in line with the Treasury's best practice guidance. During the course of the year, ARAC also reviewed its own effectiveness. Again, a number of recommendations for improvement were made and all of these have been implemented.

The Department takes seriously the potential impact that fraud can have on financial control and achievement of objectives, and the Fraud Sub-Committee meets on a regular basis. Their role is to give assurance to ARAC that the risks to the Department's business from fraud and financial irregularity are being managed and monitored effectively and is another aspect of good governance.

Internal Control

General

From April 2006 the Department became responsible for payment of the Dedicated Schools Grant (DSG).

This involved the processing of additional £26 billion payments compared to previous years. Internal Audit have reviewed the DSG procedures and concluded that good control systems are in place over the payment process. This being the first year of the grant, assurance has been derived from certification of Section 52 Budget Returns by local authority Chief Finance Officers when they set their budget in spring 2006. This provides assurance that the authority has budgeted to deploy the grant in support of the Schools Budget. Assurance on regularity of expenditure will be from the Chief Finance Officer certification of the Section 52 Outturn Statements around November 2007.

This is in line with DSG operational guidance and with the assurance framework outlined in the Accounting Officer's letters of February 2006 to the Comptroller and Auditor General and March 2006 to Local Authority Chief Finance Officers.

2006–2007 has seen the second phase of Local Area Agreements. The pooling of budgets across Government departments brings with it questions of how to ensure regularity, and this year's control regime rests heavily on the Department for Communities and Local Government's Accounting Officer with whom I have agreed a Memorandum of Understanding. I am satisfied that the arrangements provide a reasonable level of assurance.

The efficiency programme has now delivered £2.46 billion, some 56% of our overall target and despite significant movement in a number of profiles we have maintained a contingency position of over £800 million through over attainment in the Technology Programme. We have also significantly reduced the risk associated with what were our two highest risk initiatives through substantial downwards re-profiling.

Issues

Our internal control regime has highlighted several policy areas where we have traditionally made direct grant awards to an organisation but where we now need to introduce an element of competition into the funding process. Transitional arrangements to review new grant proposals for 2007–2008 have been agreed and reviewed by Internal Audit. The review confirms that action has been taken in accordance with the transitional arrangements agreed by the Accounting Officer. Further work is to be undertaken in 2007–2008 which will both enhance value for money and further mitigate potential risks of the payments being regarded as state aid.

There have been some significant under-spends in 2006–2007. Some major capital programmes, notably Building Schools for the Future, have experienced slippage. The budget reporting regime did not always identify underspends sufficiently early for them to be deployed elsewhere to the Department's maximum benefit. The Department is strengthening its management accounting function to improve the scope and ability for redeploying resources.

Internal Audit and National Audit Office work identified some problems remained in the procurement and management of consultants by some users within the Department. We have continued to tighten the control regime and management information as part of our ongoing activity to improve further in this area.

There has been ongoing work by the Student Loans Company and the Department's Special Investigation Unit investigating Student Loan frauds. A Fraud project was set up in 2006–2007 to ascertain the fraud risks and to recommend and implement suitable treatments for these risks. A fraud risk exercise was commissioned and the initial estimate is that the fraud rate is around 0.6% of applications. Improvements have been made to fraud detection and prevention procedures throughout the student finance process to mitigate this risk.

Two other NDPBs have also notified us of frauds that could represent a reputational risk to their sectors. Both Accounting Officers have assured us that these do not represent a material threat to the operational effectiveness of the NDPBs and we are satisfied that appropriate remedial action is in train in both cases.

There have been some examples of NDPBs operating outside their delegated authority. None have been major in their own right, but they highlight the critical relationship between the Department and its key delivery partners, particularly its NDPBs. The actions within the Capability Review Implementation Plan will further strengthen these relationships. The monthly meetings between the Departmental Board and senior officials from our NDPBs and the various resulting working groups of functional leads from the DfES Group (including Finance Directors) will further strengthen the ongoing dialogue and foster a better shared understanding of areas of common concern.

Whilst recognising the above issues, good progress has been made in resolving them and there are plans in place to further enhance financial control systems and improve practice. As Accounting Officer, I am satisfied the above issues do not represent a material threat to operational effectiveness and that the Department and its NDPBs comply with the Treasury requirements on risk management, internal control and governance.

Signed by:

Accounting Officer/Permanent Secretary

A Local Government

The second example is drawn from local government which is subject to a different set of detailed rules, although the principles are the same, as for central government. A local authority in the UK is managed by an elected council with the controlling political majority appointing a 'leader' who is in effect the top political official of the local authority. The mayor or, for some types of local authority, the chairperson generally has largely ceremonial responsibilities but also acts as the chairperson at formal meetings of the local authority. Operational management is undertaken by appointed officials (chief officers) working under the overall leadership of a chief executive but reporting formally to the relevant committees and ultimately to the council. A recent reform though has introduced the idea of 'executive mayors' who take over the role of leader with the chief officers reporting directly to that person or designated politically appointed deputies.

London Borough of Bromley

Statement on the System of Internal Control

Statement on Internal Control 2006/2007

This statement is provided for the use of Bromley Council in support of its Statement on Internal Control (required under Regulation 4(2) of the Accounts and Audit Regulations 2003, as amended during 2006).

Scope of Responsibility

Bromley is responsible for ensuring its business is conducted in accordance with the law and proper standards and that public money is safeguarded and properly accounted for and used economically, efficiently and effectively. Bromley also has a duty under the Local Government Act 1999 to make arrangements to secure continuous improvement in the way in which functions are exercised, having regard to a combination of economy, efficiency and effectiveness.

In discharging this overall responsibility, Bromley is also responsible for ensuring that there is a sound system of internal control which facilitates the effective exercise of Bromley's functions and which includes arrangements for the management of risk.

The Purpose of the System of Internal Control

The system of internal control is designed to manage rather than to eliminate risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process which is designed to identify and prioritise the risks to the achievement of Bromley's policies, aims and objectives. It also evaluates the likelihood of those risks being realised and the impact should they be realised as well as managing them efficiently, effectively and economically.

The system of internal control has been in place at Bromley for the year ended 31 March 2007 and up to the date of approval of the annual report and accounts.

The Internal Control Environment

The internal control environment encompasses all the organisation's policies, procedures and operations in place. At Bromley the system of control is based on a framework of regular management information, financial regulations, administrative procedures (including segregation of duties), management supervision and a system of delegation and accountability.

Corporate Framework

Bromley's plans outline how we will deliver our services and include specific targets that allow us to measure our level of success. Some plans are produced in partnership with other agencies, which help us to focus our resources. The planning framework is arranged under portfolio headings. We operate with a Leader and an Executive. The Council maintains the policy and budgetary framework and appoints the Executive. In 2006/2007 this contained the Leader and eight Executive members.

Seven majority members of the Executive were responsible for their portfolios. Each portfolio holder annually outlines their aims over the coming three years, what they will be doing towards achieving their goals and their performance targets.

Formulation of Policies and Decision Making

Policy and decision making are managed and controlled within a strong well-established framework. The Council's written constitution sets out in detail how the council operates, how decisions are made and the procedures to be followed to ensure efficiency, transparency and accountability. Political and management control is exercised through the Executive who work to defined and established processes.

Compliance with Policies, Laws and Regulations

Compliance with policies, laws and regulations is dealt with through a range of written rules and procedures which are regularly reviewed and updated. These include the Constitution, Financial Regulations, Codes of Conduct and the Anti-Fraud and Corruption Strategy.

Performance Management

Performance management at Bromley is considered through a range of review arrangements including external inspection bodies, external/internal audit reviews and the detailed reporting of national and local performance indicators.

Financial Management

The financial management of the Authority is organised through a wide range of well-established processes and procedures which delivers strong financial control arrangements. Bromley has in place a strategic budget planning process which includes detailed written procedures and which is supported by comprehensive Financial Regulations and procedures. Members and Chief Officers receive and consider detailed financial information on a regular basis and this facilitates the political decision making process.

Review of Effectiveness

Bromley has responsibility for conducting, at least annually, a review of the effectiveness of the system of internal control. The review of the effectiveness of the system of internal control is informed by:

- The work of internal auditors;
- Comments made by the external auditors;
- Senior managers within the authority with responsibility for the internal control environment;
- The work of the Risk Management Group;
- Other review agencies and inspectorates.

The Audit Sub-Committee

The Audit Sub-Committee has the responsibility for developing and keeping under review all aspects of the Council's arrangements for audit and probity specifically including

- Financial regulations;
- Fraud prevention;
- Internal and external audit.

Internal audit reports all significant weaknesses to management and Members in the form of prioritised recommendations. All such recommendations are followed up for implementation or appropriate management action.

Internal Audit

Internal audit is an independent appraisal function that acts as a control that measures, evaluates and reports upon the effectiveness of internal controls, financial and others, as a contribution to the efficient use of resources within the Authority.

Internal audit's service aims are to:

- Independently review and appraise systems of control throughout the Authority and its activities;
- Ascertain the extent of compliance with procedures, policies, regulations and legislation;
- Provide reassurance to management and Members that their agreed policies are being carried out effectively;
- Facilitate good practice in managing risks;
- Recommend improvements in control, performance and productivity in achieving corporate objectives;
- Work in partnership with the external auditors;
- Identify fraud as a consequence of its reviews and to deter crime.

Strategic and Annual Audit Plans are used to map out the cyclical coverage of fundamental financial systems and other audits. These plans are based on the identification of the Council's systems and activities to be audited, each assessed for risk. Work relating to prevention and detection of fraud and corruption is integrated into this audit planning process. Internal Audit operates to defined standards as set out in the Chartered Institute of Public Finance (CIPFA) Code of Practice for Internal Audit in Local Government. The effectiveness of the system of Internal Audit is measured by compliance with this code.

Internal Audit provides an independent opinion on the adequacy and effectiveness of the system of internal financial control. Each audit is reported to the appropriate level of management together with agreed action plans where appropriate. The supporting summaries of audit reports help inform the overall assessment of internal financial controls. The Chief Internal Auditor is empowered to report any matter of concern directly and independently, to the Chief Executive, the Chairman of Audit Sub-Committee or the Leader of the Council, if necessary.

External Audit

Last year the external auditors in their assessment of Bromley's use of resources scored the Council 3 out of 4 for each of the five aspects that go to make up the overall judgement detailed below:

Element of the audit Latest score
Financial reporting 3 out of 4
Financial Management 3 out of 4
Financial Standing 3 out of 4
Internal Control 3 out of 4
Value for Money 3 out of 4
3 = consistently above minimum requirements—performing well

External Inspections

There have been no Audit Commission inspections published during 2006/2007 although their overall judgement, under the 2006 Comprehensive Performance Assessment, is that the Council has robust internal control and governance arrangements.

During the last year the Council has received the following assessments from other inspectorates:

Commission for Social Care Inspection—Adult Social Care Services

Rated as two stars out of three and 'serving most adults well with promising capacity to improve'.

The Benefit Fraud Inspectorate—Comprehensive Performance Assessment of the Benefits Service

Rated as Good (level 3), with the Council meeting 5 of the 12 performance measures where the Department had set a Standard and 52 of the 65 enablers.

Action plans to address the issues identified within these services are in place or under development.

Ethical Governance Audit

This audit was carried out by external audit and the results have been reported to the Standards Committee.

Significant Internal Control Issues

In 2006/2007 a number of control issues have been identified as a result of the Internal Audit work undertaken in the year. Improvement points and action plans have been agreed for all these areas and scrutiny will be maintained to ensure that all priority control weaknesses are fully addressed by management.

In addition, as part of the assessment of controls each Chief Officer has signed a statement giving assurance on the level of controls with areas of improvement. This process was based on an assessment of key controls within Departments.

Although no new significant control weakness has been identified for 2006/2007, the issues in previous years remain as those which will require ongoing monitoring, namely:

1) Embedding a risk management process throughout the Council
2) Full implementation of the procurement strategy
3) Greater and consistent use of sound programme and project management disciplines for large-scale projects
4) Business continuity plans

Although continuing progress has been made on all of the above, further work remains before these control issues can be reported as fully implemented. Arrangements for managing significant business risks need further work. Specifically, a detailed review of partnership/contractual risks needs to be completed and management training made available to all elected members targeted to relevant members initially. The procurement strategy is being implemented. Project and Programme management are still areas for further development; however, the approved standards are being implemented across the Council. There is an approved continuity plan in place as required by civil contingencies legislation, and work continues on developing service continuity plans.

Signed by:

Chief Executive (the top appointed official, and by the Leader of the Council (the top political official) [equivalent to an executive mayor in some countries]

Example 2: Croatia

A Central Government Ministry—Fiscal Responsibility Statement

In Croatia the requirement is that all public organisations are to prepare annually a Fiscal Responsibility Statement (FRS) which is designed to certify that:

- public funds have been spent for the purposes intended and that the spending has conformed with legal requirements and with the approved budget;
- the financial management and control system has operated efficiently and effectively.

The FRS is supported by a fiscal responsibility questionnaire and by an internal audit opinion on the system of financial management and internal control based on the internal audits performed in the previous year. These documents are to be sent to the department of the State Treasury [the Ministry of Finance] responsible for the implementation of PFM/IC.

In the period from 2011 to 2015, the arrangements for reporting on the implementation of financial management and internal control occurred in the following manner:

- All budget users (first, second and third level) have been obliged to prepare a Fiscal Responsibility Statement (FRS) responding to a questionnaire prepared by the State Treasury (the Ministry of Finance). Through this statement budget users have reported on the internal control arrangements in the budget cycle processes, that is, on budget planning, execution, accounting, public procurement and financial reporting.
- The reporting arrangements are that first-level budget organisations (line ministries, counties, cities, municipalities) were required to submit their FRS to the PFM/IC department of the State Treasury. Second-level budget organisations had to submit their FRS to their controlling or supervisory first-level budget organisation (e.g., schools had to submit their FRS to the appropriate county, universities had to submit theirs to the Ministry of Education and Science). The State Treasury PFM/IC department did not collect FRS's from second- and third-level budget organisations. The PFM/IC department analysed only the FRS of the first-level budget organisations.
- In addition the first-level budget organisations and the larger second-level organisations were also required to report additionally on the implementa-

tion of the five COSO components—control environment, risk management, control activities, information and communication and monitoring.

Under the control environment component, heads of organisations reported on ethics and integrity; the way in which management operates (how regular top management meetings are being held, involvement of the second-level budget user heads in the top management meetings about their budgets and other factors); the level of development of a planned approach to the operations (definition of strategic objectives, programme objectives, the objectives contained in the organisational units' annual plans, including linkages between these objectives); delegation of authorities and responsibilities for the objectives/programmes/activities and budget resources; alignment between the reporting lines (on programme/project implementation and the associated budget resources); cooperation between budget holders within the organisation.

Under the risk management component, heads of organisations reported on the appointment of persons responsible for risk management coordination; the identification of risks versus the objectives; assessment of risk likelihood and impact; documenting risk data (risk registers):

- risk reporting;
- the extent to which budget holders are informed of risks.

Under the control activities component, heads of organisations reported on:

- the existence of internal rules (ordinances, instructions, guidelines) covering the budget cycle processes, strategic planning, financial plan production and execution, business event and transaction records, procurement and contracting, asset management, own revenue collection, recovery of improperly spent or wrongly paid budget amounts; manner in which the segregation of duties principle provided for in the Budget Act is applied; how ex-post controls of the utilisation of budget resources are to be undertaken;
- information on how the control activities within the budget user are organised.

Under the information and communication component, heads of organisations reported on:

- the achievement of objectives, programmes, projects; arrangements for financial plan monitoring and analysis; the level of development of the accounting systems (monitoring cost/revenue by programmes, projects, activities, organisational units);
- the existence of the records of contracted commitments;
- internal reports for the financial reporting purposes;
- computerisation of the systems and the integration of IT systems;
- the documentation of the business processes;
- IT connectivity with the budget users in their structure.

Under the monitoring and assessment component, heads of organisations reported on:

- monitoring the functioning of the financial management and control system;
- how the head of the organisation ensures that internal regulations (ordinances, instructions, guidelines) are being implemented in practice and updated;
- the implementation of external and internal audit recommendations;
- the existence of reporting system within the first-level budget user which demonstrates how the financial management and control system is applied by budget holders within the organisation.

Where weaknesses and irregularities are identified, a weaknesses and irregularities removal plan is required to be completed which covers the following:

- A description of the weaknesses and irregularities with an analysis of the causes;
- A weaknesses and irregularities removal action plan with a list of the actions to be taken and by when;
- The person responsible for taking action.

Comment:

In 2015, Croatia adopted a new Public Internal Control (PIC) Law. This introduced a single form of reporting on financial management and internal control which was through a developed Fiscal Responsibility Statement (FRS). To facilitate this the questionnaire was expanded and the likelihood is that this questionnaire will be further developed in the future.

Budget user managers are expected to utilise the FRS as a ‘self assessment’ management tool. The department responsible for PFM/IC in analysing the

FRSs takes into account the State Auditor reports and internal audit reports. This department prepares an annual report on public internal control.

All of this activity involves extensive work but it enables the PFM/IC department of the State Treasury to establish what has to be improved in the PFM/IC methodology, where training should be directed, whether there is a need for additional guidelines and what are the priority areas for further development.

The Financial Responsibility Statement takes the following forms:

Where no weaknesses have been identified:

FISCAL RESPONSIBILITY STATEMENT*

I, (*name, surname, title and function*), the Head of (*name of a local and regional self-government unit/state budget user/state extra-budgetary user/local and regional self-government unit's budget user/local and regional self-government unit's extra-budgetary user*), on the basis of a completed Fiscal Responsibility Questionnaire covering the areas of planning, execution, public procurement, accounting and reporting, the available information, the internal and external audit work results and my own judgment, hereby verify that:

– funds have been used legally, in an earmarked and purposeful manner;
– the financial management and control system functions efficiently and effectively within the framework of the resources defined by the budget, i.e., the financial plan.

(*date and place of issuance*)
Head's signature

(*name, surname, title and function*)

Where weaknesses have been identified:

FISCAL RESPONSIBILITY STATEMENT*

I, (*name, surname, title and function*), the Head of (*name of a local and regional self-government unit/state budget user/state extra-budgetary user/local and regional self-government unit's budget user/local and regional self-government unit's extra-budgetary user*), on the basis of a completed Fiscal Responsibility Questionnaire covering the areas of planning, execution, public procurement, accounting and reporting, the available information, the internal and external audit work results and my own judgment, hereby state that I have detected weaknesses and irregularities in the areas of:

(*Please indicate the areas and questions from the Fiscal Responsibility Questionnaire with partially affirmative and negative replies provided*), which will be removed in compliance with the Weaknesses and Irregularities Removal Plan.

I hereby state that the said weaknesses and irregularities bear no influence on the legal, earmarked and purposeful use of the funds and the efficient and effective functioning of the financial management and control system within the framework of the resources defined by the budget, i.e., the financial plan.

On the basis of the aforesaid, I hereby verify that:

– funds have been used legally, in an earmarked and purposeful manner;
– the financial management and control system functions efficiently and effectively within the framework of the resources defined by the budget, i.e., the financial plan.

(*Date and place of issuance*)
Head's signature
(*Name, surname, title and function*)
Comment:

Croatia regards financial management and internal control as an evolving activity and therefore the form of these documents will change over time. A recent development, for example, has been to increase the emphasis upon risk management.

14

Public Sector Reform, Delegation, and PFM/IC

An organisation combines both human and material resources to achieve its objectives. The major players in establishing an effective public organisation are those with responsibility for giving direction to the organisation, the politicians, and the top executive management within the civil or local government service. In this chapter the linkages between public sector reform, incorporating civil service reform, personnel management, and public financial management and internal control reform are discussed, together with an analysis of what 'delegation' means and where it is appropriate to introduce it. Delegation is treated by many PFM/IC reformers as though it were a single activity, but, whether it is appropriate or not is a more complex issue which does require careful consideration and which also requires to be accompanied by other reforms. An important consideration depends upon the quality of the civil service (or local government service) and the extent to which it has been reformed moving from an administrative style to a managerial style. This guide shows what an extensive management reform introducing PFM/IC is. The reform does not just affect the top and senior management but how the personnel of an organisation perform. Effective personnel management (and personnel are the most important asset of an organisation) is of central importance to a successful organisation. To gain the benefits of the PFM/IC reform that reform should underpin civil service/public service reform by providing the information and analysis that managers require for the efficient and effective delivery of public services.

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5_14

14.1 Public Sector, Including Civil Service Reform, and PFM/IC

14.1.1 Introduction

A central feature of PFM/IC is that it is about making better use of public resources. The systems associated with PFM/IC make this possible but an essential requirement is the managerial reform that ought to accompany it. Without managerial reform PFM/IC will be just another bureaucratic system. That managerial reform should introduce significant change to a traditional style of public administration where top managers are political appointees and management structures are based upon a hierarchy of rules with a centralised hierarchy of decision making and controls with a civil service organisation and appointment system that in some countries was (is!) heavily dependent upon political patronage.

An important element of public sector reform is the recognition of the significance of the complementarities of the roles of the politicians and the top-level civil servants (or for local governments, top local government officials). For this to work civil servants must be well trained and apolitical. Unfortunately, many countries that have started to introduce the PFM/IC reform have not, in general, appreciated the extent of these complementarities because the reform has simply been regarded as a technical financial reform and training has tended to be in the bureaucracy of the reform rather than in the managerial opportunities that the reform creates. Earlier in this guide the impact of the PFM/IC reform upon different levels of management has been described and, particularly the impact upon the political and senior civil and local government officials. The impact upon the head of finance is also significant. What has also been pointed out is that the PFM/IC reform has a major impact upon budgetary, accounting, and financial reporting arrangements.

Because the PFM/IC reform has such a significant impact upon all these managerial arrangements, and not least upon the relationships between the political and the official levels of management, the PFM/IC reform ought to be coordinated with the arrangements for public sector and civil service reform.

Reference is usually made in policy papers prepared to advise on the implementation of PFM/IC to the need to delegate responsibility and to establish managerial accountability. Earlier in this guide the argument has been that broadly, policy and strategy should be the responsibility of the political level of management, whether ministers or deputy ministers, mayors, or deputy mayors and that operational management should be delegated to the appointed official level of management. However, the politician may not have the skills, experience, or technical knowledge to formulate policy or to define how it is to be implemented. The top civil service (or the equivalent in local government) should be the key advisers to the politician on the development of policy as well as having the responsibility for policy implementation. In effect their role is to turn political ideas into practical public services and activities. This requires though a stable, well-trained civil service (or local government service) with knowledge of the history of the experience of delivering the service or activity.

Although, in general terms, the civil (or local government) service should have the delegated responsibility for policy implementation, this is too simple a distinction. It does not recognise the complexities of many public service delivery arrangements and nor does it recognise the different circumstances often involved in decision making, and not least 'personalities'. These can complicate a delegation decision. In some circumstances politicians should become involved in operational management decision making. What should be avoided though, is politicians becoming involved in the day-to-day management of the organisation for this should be very firmly the responsibility of the civil or local government service top official.

The delegation of decision making is also a matter for operational management because delegation should be a feature of operational management. The question then is, what types of decision should be delegated by senior managers to more junior managers?

In this chapter an analysis of the different types of decision or factors affecting a delegation decision are discussed. This will allow ministers of finance and in particular the state secretary of the ministry of finance along with the 'driver' department responsible for the implementation of the PFM/IC reform to focus their efforts on specific areas where delegation can or should occur and where not or where delegation may be problematic. What to delegate and what not, does require careful consideration.

Along with delegation goes 'accountability'. In considering delegation and accountability the prior question is: 'what is management'? There is no universal definition but an authoritative definition is: 'management control is the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organisation's objectives'.[1]

This idea of management underpins the whole concept of PFM/IC.

[1] Anthony, R. N., Planning and Control Systems: A Framework for Analysis (Boston, Mass.: Division of Research, Graduate School of Business, Harvard University, 1965, p. 17).

Success with implementing the PFM/IC reform depends upon the extent of managerial reform, which should be at the core of civil service reform. Those responsible for civil service reform should recognise the implications for management of the PFM/IC reform. In most countries the impact upon management has not been the starting point and as a result there is no 'ownership' of the reform by organisation top and senior management. Consequently PFM/IC is often seen as an imposed ministry of finance reform of benefit to that ministry rather than one of benefit to the management of the organisation itself. Where the reform is a function of foreign aid arrangements then the dominant party is the foreign aid organisation which adds to the difficulties of achieving 'ownership'. Success in achieving 'ownership' makes possible the transfer of control from an external organisation, such as the ministry of finance and also, because of the centralisation of decision making about personnel matters, from the organisation responsible for personnel management, to the internal management of an organisation.[2]

Governments want to achieve their policy objectives. Assuming that the resources are available, this is not achieved by simply 'top-down' instruction. An effective managerial organisation coupled with effective personnel management are essential components. The following quotation illustrates this:

> If people are the greatest creators of value in organisations, then good performance management is critical for an organisation's success. Employees need to understand what's expected of them, and to achieve those goals they must be managed so that they're motivated, have the necessary skills, resources and support, and are accountable. Performance management is the activities and processes that focus on these areas to maintain and improve employee performance in line with an organisation's objectives. Ideally, performance should be managed holistically, throughout the range of HR [Human Resource] activities and processes.[3]

14.1.2 The Main Features of Public Management-Oriented Organisations

A pre-requisite therefore to the introduction of the PFM/IC reform is that there is a commitment to the reform of the structures involved in the management of government. The process of reform should be that the managerial approach to PFM/IC builds upon an existing robust public administration

---

[2] See Chap. 1 and the observations of Professor Allen Schick on internal and external control.

[3] The Chartered Institute of Personnel and Development: Performance management: and introduction 2019: https://www.cipd.co.uk/knowledge/fundamentals/people/performance/factsheet.

(i.e. essentially one based upon Weberian principles) but then evolves from that public administration style into a public management style. A 'Weberian'-type public administration is a bureaucracy that has these six characteristics:

1. Task specialisation (division of labour)
2. A hierarchical management structure
3. Formal selection rules
4. Efficient and uniform requirements
5. An impersonal environment
6. Achievement-based advancement

If a Weberian-style bureaucracy does not exist then the first step in the reform process should be its creation. To then move from a Weberian-type bureaucracy to a management style of organisation requires that the following features are established:

i. Defined objectives and performance standards
ii. A strong managerially trained leadership with the authority to drive the organisation to meet its objectives and performance standards and expressing core values based upon achievements and the needs of the client/customer (see Chap. 7)
iii. Effective governance arrangements (see Chap. 1)
iv. A powerful financial leadership, (finance director type role) focussed upon achieving objectives efficiently and effectively with an aim of improving productivity by ensuring that all public resources are either properly utilised or disposed of (see Chap. 8)
v. The management being responsible for internal control and the application of those external controls that would otherwise have been directly implemented by external organisations, such as the ministry of finance (see Chap. 3)
vi. A budgetary system which provides to managers the information they require as well as the information that the ministry of finance requires (see Chaps. 5 and 8)
vii. A stable budget for the organisation, including also stable funding of that budget during the year with the actual funding occurring to an agreed timetable, so that managers can plan with certainty recognising that this may not always be possible in all circumstances (see Chap. 4)
viii. A financial and management accounting system which provides managers with the financial control and the financial analytical information

managers require, such as cost centre and cost driver information (see Chaps. 5 and 8)

ix. A financially aware management (see Chap. 8)
x. A management trained in managerial concepts (see Chap. 9)
xi. Managers having the discretion within agreed boundaries, to make decisions about how to achieve their objectives and therefore how to utilise the resources available to them, or in some instances to dispose of those resources such as redundant assets (see also point iv above and Chap. 7)
xii. Individual managers being accountable for their achievements in terms of objectives and performance standards (see Chap. 7)
xiii. Senior appointed management, with a separate political management, which recognises that it has an external accountability responsibility for the achievement of the organisation's objectives and performance standards and objectives, efficiently and effectively and within the relevant laws and regulations and for the quality of its internal control system (see Chap. 13)

To summarise, for PFM/IC to be an effective reform, as opposed to a cosmetic reform or token reform, there should exist advanced management arrangements within government organisations. Those advanced management arrangements require the involvement of both the political officials and the civil (and local government) service appointed officials. This, in practice, means that political decisions about policy, including the strategy for the implementation of that policy, should have regard to the practical experience and advice of the civil (or local government) officials about implementation. These two groups of officials should not be operating independently of each other and neither should the political officials feel that they should have responsibility for making all decisions (i.e. both policy and operational). Political officials should recognise that the experiences and advice in the formulation of policy and on proposals for the implementation of policy gained by appointed officials can make an essential contribution to the development and implementation of effective policy. The benefits of PFM/IC will not be achieved without this cooperation between these two groups of officials.

However, to make this change is neither simple nor a speedy process. Some of the problems are discussed below in Sect. 14.2.1. An identifying aspect of a managerially oriented organisation is that managers have clear objectives and performance standards and objectives that they are expected to work to and that they have the performance and financial information to enable them to make the best use of public resources in the delivery of their objectives and performance standards and performance objectives.

Another identifying aspect is that the managerial structures in public organisations should be designed to reflect the objectives that the organisation is expected to achieve.

All this impacts upon the arrangements for civil service recruitment and training and can represent a significant change in their role. Civil and local government servants experienced in operating within a traditional public administration but expected to operate in future in a managerially oriented organisation do not become managers ‘overnight’. Managerial training should be an essential component of the reform.

If these management features summarised above do not exist or are not envisaged within the civil service/public sector reform programme, yet are requirements of the PFM/IC reform, clearly the two are incompatible. The experience of this author is that the question of compatibility is rarely considered by those responsible for implementing the reform. Civil service/public sector reform programmes and PFM/IC reform programmes are considered independently. This compatibility is also what foreign aid donors should be looking for before agreeing to support the introduction of PFM/IC, although they do not seem to do so. If that commitment to achieve compatibility does not exist then achieving success with the introduction of the PFM/IC reform is most unlikely.

14.1.3 Managing Complex Public Sector Organisations: Whether Delegation Is Appropriate or Not

A central theme of PFM/IC is the development of delegation and managerial accountability.

In practice, little is said in any of the literature or in advice from the European Commission or professional bodies such as IFAC[4] about the nature of delegation and managerial accountability and how it affects decision making. The central theme of this guide is that improving the utilisation of public resources depends upon developing a managerial approach to the management of those resources. It is not simply about introducing techniques: what matters is how those techniques are utilised and that in turn depends upon the quality of management. The IMF, for example, in its discussions about the introduction of performance based budgeting argues that ‘the introduction of performance based budgeting will ideally require greater flexibility for ministries and program managers, who are expected to become more

[4] The International Federation of Accountants: https://www.ifac.org.

accountable for results'.[5] Performance-based budgeting is a technique but its success depends upon the quality of the management, not simply the existence of the technique. An appreciation of the context in which delegation is to occur and then how managerial control is exercised through managerial accountability arrangements is necessary if PFM/IC is to be effectively implemented. Delegation is not a simple matter and depends upon particular circumstances. A more sophisticated approach to delegation and managerial accountability is needed than a simple blanket policy. Such a 'blanket' policy is simply unhelpful because it does not provide any clarity about what could or should be delegated and what not. The aim of this section of this guide is to explore what may be appropriate to delegate and what not. However, central to the idea of delegation and managerial accountability is the existence of a managerially oriented organisation.

Public sector organisations such as ministries and local governments will be headed by a single politically appointed official, a minister or mayor. Nominally this official is the single 'all-powerful' decision maker for the organisation and in many countries the law reinforces this position. But this person can maintain this 'all-powerful' position 'only to the extent that he is not dependent upon others within his organisation'.[6] The reality is that in practice in complex organisations, as are most public organisations, the objectives of the organisation are derived from compromises between different powerful groups (power bases!) within, and sometimes external, to the organisation. This single politically appointed official therefore cannot make all decisions about the operation of an organisation. He/she must have regard to those groups that exercise influence which can be internal or external to the organisation. One of those groups is, or ought to be, the bureaucracy bringing to any discussion information about the experience of policy development and application as well as a detailed knowledge of the 'market' for that policy. PFM/IC is about supporting the development of a more informed bureaucracy. A former foreign minister of Australia made the point that a minister (referring to the Westminster system) has 'two broad ambitions:

- To implement their policy ambitions, and
- To survive as a minister and even prosper to promotion'.[7]

[5] A Basic Model of Performance-Based Budgeting; by Marc Robinson and Duncan Last, IMF Fiscal Affairs Department; IMF Technical Notes and Manuals—TNM/09/01; September 1, 2009.

[6] Organisations in action: James D Thompson: 1967, Chapter 10, p. 132: McGraw Hill.

[7] Public Money and Management Nov 2020: Vol. 40: Alexander Downey, p. 551.

He also went on to say: 'In reality, for a minister the implementation of policy efficiently and effectively is by far the most important function of the civil service.'[8]

In a political organisation, key influencers will be the prime minister and the minister of finance. Other influencers will be external regulators and pressure groups. This idea of the 'omnipotent individual' is also negated by other conditions, which include:

- 'When the complexities of the technology or technologies exceeds the comprehension of the individual, and this is not to do with the individual's intelligence but rather his/her experience.'
- 'When the resources required exceed the capacity of the individual to acquire.'
- 'When the organisation faces contingencies on more fronts than the individual is able to keep under surveillance.'[9]

When such circumstances exist, as they will with most ministries and local governments, the number of power bases within the organisation expands and the result is that in highly complex organisations, such as ministries and local governments, power is, in reality, dispersed. Consequently, any decisions, apart from those that have only a very narrow impact, have to take into account the views and information available from those different power bases, That is, to use the observation of the former Australian minister, if the minister (or mayor) is to survive and prosper. A task of the bureaucracy is to bring together those different views and to ensure that the information available from those different sources is properly reflected in the advice to policy makers. The consequence of this is the emergence of what one academic commentator, Thompson, called a 'dominant coalition' which represents the different interests within an organisation. However, to get business done Thompson argued that what actually emerges in complex organisations is an 'inner circle'. This may be a formal or an informal group but which effectively conducts the business of the organisation that is, exercises leadership. Membership of that 'inner circle' should be dynamic to reflect changing circumstances and particular interests. The question then becomes who should be the members of this 'inner circle' in a public organisation? This is very important in considering the implications of the application of PFM/IC because it raises the question as to whether the membership of the 'inner circle' should be restricted only to the political appointees,

[8] Ibid., p. 552.

[9] Organisations in action: James D Thompson: 1967 Chapter 10, p. 133: McGraw Hill.

in effect shutting out the bureaucracy. It therefore affects delegation. An 'inner circle' that excluded the most senior official and possibly certain professionals, depending upon the nature of the organisation would not facilitate the development of an efficient and effective organisation and would be incompatible with the idea of delegation. This is because to achieve the objectives of a complex organisation different interests and experiences need to be considered, not least those of the bureaucracy. For example, in some public organisations where there is a high technical professional input into decision making processes, such as in health, military, or educational organisations the 'inner circle' ought to include representatives of that technical professional element of the organisation. However, in the operational delivery of public services there is always (apart from very small public organisations) a 'high professional input', but not necessarily just a technical professional input. That high professional input will include 'professional' officials (i.e. the civil or local government service) whose responsibility will be to ensure that operational delivery reflects not just 'technical professional' opinions, but also other opinions such as that the decision can be financed, that it is compatible with government policy, that it is legal, that it is practical, that it represents an efficient and effective utilisation of public resources. The implementation of PFM/IC improves the capability of the bureaucracy to make that 'professional' contribution.

The main representative of the civil service would be the most senior civil servant such as the state secretary in a line ministry (or the equivalent in a local government) and depending upon the circumstances other officials may be involved. In making their contribution to the decision making processes those senior civil servants should exercise judgement and political astuteness. They, in turn, will be advised by the different 'professionals' within the bureaucracy. One of those would be the head of finance. 'Developing capabilities, including judgement, in those civil servants whose roles bring them into a close working relationship with politicians starts with clear and evidence-based analysis of the requirements which make civil servants effective in working with politicians.'[10] This requires great skill and experience.

In all public organisations a critical factor is finance, that is the availability of appropriate financial resources, stability of the finances of the organisation and how well the available finance is utilised not only in its allocation against priority objectives but also in its operational utilisation. This means that that 'inner circle' in practice ought to include not only representatives of those responsible for operational delivery, but also including those responsible for

[10] Hartley and Manzie: It's every breath we take here: political astuteness and ethics in civil service leadership development: Public Money and Management: Nov 2020 Vol 40: p. 569.

the management of the finances of the organisation.[11] As public organisations operate in a dynamic environment and frequently in an environment where there are many complex issues and judgements that need to be made the responsibility of the political element of management in making decisions should have regard to the views of all those whose knowledge and experience would have an impact upon the quality of the decision.

This demonstrates the need to involve the civil or local government service in advising on the policy making processes as well as on operational management decision making processes. This involvement would be particularly appropriate where the decisions that need to be made are for those areas of business where the 'professional official' (technical and/or civil service) has the most appropriate knowledge. These are the circumstances which apply with both policy formulation and operational management. They would be the characteristics of a Weberian type civil service reformed to reflect a managerial operating environment.

Thompson pointed out that decisions involve two major dimensions: preferences regarding possible outcomes, the political values and beliefs or the facts about cause/effect relations.[12] Complicating any decisions are either 'certainty' or 'uncertainty'. This impacts upon who should make the decision, that is, on the appropriateness of delegation. These relationships were shown in a table by Thompson (which in turn was initially developed with a colleague[13]) and has been further developed by this author to reflect the operational environment of the public sector (see Table 14.2).

In the public sector the primary concern of the politician, the minister or mayor, should be about policy and securing the implementation of that policy. Political policy is an expression of 'values'. Central to policy decision making is judgement about values and the politician will make those judgements. The most important responsibility for a political leader is to reach an agreement on 'values'. Political values will be formed by many factors, including how special interest groups react, the views of independent policy 'think tanks', political party historical policy, and by the information available from the official bureaucracy. In a democratic country political policy is also likely to be challenged.

In developing policy, a wide range of factors, some of which are external to the country do need to be considered. This task of assembling, assessing, and advising on the impact is essentially the responsibility of the bureaucracy. For

[11] See also, Who *Really Governs* and How: Considering the Impact of the Dominant Coalition: Andersson and Renz: Non Profit Quarterly October 2019.

[12] Organisations in action: James D Thompson: 1967 Chapter 10, p. 134: McGraw Hill.

[13] James D. Thompson and Arthur Tuden, eds., *Comparative Studies in Administration* (Pittsburgh: University of Pittsburgh Press, 1959), pp. 195–216.

example, internal and external factors can include a wide variety of matters such as those affecting financial regulation, food safety standards, environmental management systems, taxation, intellectual property, telecommunications, and infectious disease control, all depending upon the coverage of the policy. The bureaucracy should be familiar with all such factors. External factors are likely to increase as the influence and activities of international organisations increases, for example, over addressing climate change, economic management, and world health.

An example of a 'value' question which only politicians may need to address is, should technical and further education be delivered by public sector organisations or by private sector organisations? Whatever the arrangement, a further element of 'value' is a decision about who should meet the cost? Should it be the state from taxation or the student or a combination of the two or in some circumstances an employer? Another example of a 'value' decision would be who should be responsible for the delivery of health care and if the public sector, should that cover all aspects of healthcare or only some and for those that are to be delivered by the public sector should the public sector have a monopoly in health care provision or not? Associated with these questions is a further question about how should the services be financed, such as through taxation or by charging or by some combination of the two? Another question that would arise would be about the practicality of any decision. If, say, a decision was made to require technical and further educational provision to be provided by the private sector then officials should assess the capacity of the private sector, the likely cost, the practicality of such a policy decision, the arrangements for the monitoring of quality (see example of the TAFE arrangement in Australia, Chap. 12) and for the audit of consequential public expenditure. All such 'value' questions are likely to be controversial with the parties to any debate being more or less certain about the outcomes.

In summary, the political decision about values should be informed by facts or factors and the responsibility for providing information about the facts or factors should lie with the civil (or local government) service. Where advice has been accepted by politicians about the development of a government policy from external sources or where much of the analytical work may have been undertaken by third parties, such as academics, the civil service should have the capacity to assess or to make an independent assessment of the quality of such analytical work, including about levels of certainty. This assessment should cover costs, impacts, and forecast outputs and practicality. For many public service activities, the facts or factors may be uncertain. Costs can often be defined with reasonable accuracy, although not with complex projects, when assessments of impacts and outputs can be very subjective.

The civil service should also advise ministers on an evaluation of possible alternatives and of the potential opposition to the proposed policy. This form of briefing serves to inform not only the political officials but also the civil service officials themselves about the strengths and weaknesses of policy proposals.

A summary of the facts or factors, including any international issues that the civil service should be concerned with in advising a minister on the development of a particular policy is set out in Table 14.1.

As for both the values and the factors affecting any decision there can be either certainty or uncertainty. An objective of both ministers and officials should be to achieve as much certainty as possible. Achieving certainty in values can be made more complicated where more than a single organisation is involved in making the judgement about values. For example, where different ministries or different levels of government are involved, each may have its own view of values. The same can be true for all the factors affecting any decision.

Once a political decision has been made because there is agreement or majority agreement on values, policy can then be defined. This will require, as shown above, the determination of the cost, the establishment of feasibility and the acceptability of the proposed policy. This would be the responsibility of the civil (or local government) service taking into account all possible sources of advice. Their further responsibility is to then implement that decision.

Table 14.1 Dimensions for analysing public policy[a]

Effects	Effectiveness	What effects does the policy have on the targeted problem?	Durability
	Unintended effects	What are the unintended effects of this policy?	
	Equity	What are the effects of this policy on different groups?	
Implementation	Cost	What is the financial cost of this policy?	
	Feasibility	Is this policy technically feasible?	
	Acceptability	Do the relevant stakeholders view the policy as acceptable?	

Durability is the capacity to be sustained over time—an important feature of public financial management summarised in the term 'financial resilience—see Chap. 8.
(This framework was developed for application by those persons working on public policies and who would interact with policy makers)
[a]A Framework for Analyzing Public Policies: Practical Guide September 2012: National Collaboration Centre for Healthy Public Policy: A Framework for Analyzing Public Policies: Practical Guide (ncchpp.ca): www.ncchpp.ca/docs/Guide_framework_analyzing_policies_En.pdf

Without agreement on values there cannot be a clear implementation of policy.

There will be occasions where changing circumstances mean a rethink of values and similarly with facts (as the Covid pandemic has shown) in which event, implementation policy may need to change. This though is not about uncertainty but is about changes of circumstances. How complex decision making can be is illustrated by the following matrix shown below at Table 14.2.[14]

The civil or local government official cannot be the decision maker so far as the values element of the matrix is concerned or indeed about the principles of implementation: that is entirely a political responsibility. But the civil or local government official should be able to advise on such decisions and should be particularly well informed given his/her responsibility for the development of information about the facts or factors affecting implementation and the historical knowledge of previous policy initiatives.

Where there is certainty about a particular policy and about both the values and the facts coupled with agreement that resources are available, no further political decision is required and implementation can proceed (i.e. implementation would fall into quadrant 1 with implementation being the

Table 14.2 The Thompson-Tuden matrix[a]

		Values	
		Certainty (Meaning in practice, political agreement about the policy to be adopted)	Uncertainty (Meaning in practice a lack of political agreement exists about the policy to be adopted)
Cause/effect relations, i.e., the factors affecting any implementation decision are known or unknown	Certain (the factors are known)	1	3
	Uncertain (the factors are unknown)	2	4
		The numbering of the quadrants is explained in the text below	

[a]Organisations in action: James D Thompson: 1967 Chapter 10, p. 134: McGraw Hill and James D. Thompson and Arthur Tuden, eds., *Comparative Studies in Administration* (Pittsburgh: University of Pittsburgh Press, 1959), pp. 195–216

[14] I am particularly grateful to Stephen Peterson, who served as the Faculty Chair of Harvard's Executive Programme in PFM (1986–2010) for his suggestion to use the Thompson-Tuden matrix.

responsibility of the bureaucracy, that is delegated to the official level of the organisation). As operational implementation is developed practical questions may emerge which may require political intervention but these normally should be at the margin.

However, where the political policy is agreed but there is uncertainty about how the facts or factors will affect the implementation of the policy then a political judgement should be made about whether to proceed with operational implementation, and if so on what terms? In this situation there will be an element of guesswork about the effects of implementation and therefore a learning process will be required in which the civil service (or local government) officials responsible for implementation will need to consult with the political level. The terms of the political approval to implementation will determine the scope that the bureaucracy has to make operational decisions and the point at which political approval will be required. The overall message should be that in such circumstances implementation should be applied with caution and is likely to involve more detailed consultation between appointed officials and the political level but that does not mean that the political level should be responsible for all implementation decisions. What it may mean is that implementation should be more tentative. Application of policy under these conditions would fall into quadrant 2.

An approach to implementation in such circumstances is that advocated by Karl Weick of looking for small wins: 'A small win is a concrete, complete, implemented outcome of moderate importance. By itself, one small win may seem unimportant. A series of wins at small but significant tasks, however, reveals a pattern that may attract allies, deter opponents, and lower resistance to subsequent proposals.'[15]

Small wins can also hugely influence motivation, by offering people a sense of progress and achievement.[16]

Where there is uncertainty about values but there is certainty about the facts or factors affecting implementation, application of the policy would fall into quadrant 3. Appointed official-level responsibility for implementation will be affected by the tentative nature of political confidence about the outcome of the policy to be pursued and the pressures upon the political decision maker will be intense as agreement is sought on values, or to find the best possible compromise. This may result in frequent modifications to policy. But this should not mean that the politician should seek to take over responsibility for implementation. Why should that occur? The problems of

[15] Small Wins Redefining the Scale of Social Problems: Karl E. Weick Cornell University: American Psychologist: January 1984.

[16] The Power of Small Wins: Teresa M. Amabile and Steven J. Kramer Harvard Business Review, May 2011.

implementation will become more complex and that requires a more professional and experienced official responsible for implementation capable of advising the political level about alternative policies to meet uncertainty about values. What it should mean is closer cooperation between the official and political levels of management.

Where policy development and application fall into quadrant 4, that is, uncertainty about both values and facts or factors, an impossible situation exists which neither politician nor official can fully address. In this circumstance, the most effective option is for the minister or mayor to work to achieve the maximum consensus on values when only then can a decision be made about operational implementation recognising the uncertainty about the factors affecting implementation. In such circumstances the official responsible for operational implementation should exercise great caution working with the political level but any attempt by the political level to take over responsibility for operational implementation should be resisted. However, the reality is that a decision must be made: there cannot be paralysis, and the politician should take that decision but knowing the level of uncertainties which exist and the responsibility of the official is to then implement that decision to the best of his/her ability. This also will require very close cooperation between politician and official.

Politics is the art of the possible. The aim of both the politician and the official should be to move all activity as far as possible into quadrant 1.

This type of Thompson-Tuden analysis can only be undertaken where there has already been established a Weberian style of public administration with its development into a managerial style. For many developing and transition economy countries this emphasises the need for civil service/public sector reform as a condition for the implementation of PFM/IC. Without that there is only limited clarity about the roles and responsibilities of politicians and officials. The experience of this author is that politicians tend to absorb the decision making responsibilities of the official, even for some of the most routine and minor administrative decisions. They would particularly see their role as decision maker where there are the levels of uncertainty as expressed in quadrants 2–4 and of course officials, who could be anxious to avoid criticism, may be willing to let politicians take decisions in such circumstances. The extent to which politicians take over decisions about implementation in effect limits the delegation of authority and prevents the development of the quality of the civil or local government service as an adviser to the political level. It also prevents the civil service being influential in the decision making process, that is, in the 'dominant coalition' or 'inner circle' envisaged by Thompson. That is detrimental to effective decision making because it removes an important dimension from the decision making process. Where such circumstances exist and there is limited clarity about the roles and responsibilities of politicians and officials, the application of the PFM/IC policy is inappropriate unless there is a commitment to civil service/public sector reform. However, sometimes politicians express a lack of confidence in the quality of the civil or local government service and resist delegation for this reason. In such circumstances the most appropriate course of action is to reform the civil or local government service, not seek to substitute for the existing service, elected officials or 'friends' of elected officials who are unlikely to be able to bring that detached view which is so essential to effective policy implementation and not least to provide 'challenge'. Where this lack of confidence exists the introduction of PFM/IC is inappropriate.

Taking the example above to illustrate the circumstances where there is an inappropriate distinction between the roles of politicians and officials would be decisions about the routine administration of a ministry or local government. Routine administration should be treated as a civil or local government service responsibility. Yet in many developing and transition economy countries this does not always happen or only happens in part. The politician becomes involved in the administrative decision making process. Delegation even at this most basic of levels is often limited and administrative decisions risk becoming politicised. Where the politician takes on the role of the administrator this also alters the structure of those comprising the 'inner circle' membership. The same information would still be required for effective decision making but the personalities making the decision would change from the official to the politician. In such circumstances the role of the politician in effect changes from politician to administrator and this will affect the membership of the 'inner circle'. That does not necessarily improve the quality of decision making, perhaps the opposite, and is likely to introduce other factors into administrative decision making, not least political values. Another factor that also should be borne in mind is that where the politician becomes the operational decision maker it creates opportunities for rent seeking because the politician has access to suppliers and the appointment of other officials. It also assumes that a managerial capability exists amongst elected officials not available to the civil or local government service. However, where such a situation occurs the message that really needs to be appreciated is that either there is a breakdown in the relationships between the political and appointed official levels (and the reasons for this need to be established) or the bureaucracy is not, or is not perceived to be, of the appropriate quality. This almost certainly means that the bureaucracy does not meet the requirements of a Weberian style bureaucracy with the capacity to develop into a managerial style bureaucracy which is a necessary reform with the implementation of PFM/IC.

An alternative analysis of decision making to the Thompson-Tuden matrix which has a similar focus, although using different language, has been developed by Hofstede.[17] The Hofstede classification asks these questions:

(a) Are the objectives of the activity unambiguous or ambiguous? From a PFM/IC perspective the greater the clarity of the objectives the greater the possibilities of delegation. This therefore asks the question of the politician, can he/she be clearer about what the aim of the policy is. If so, this would allow the politician/official relationship to be more clearly specified. This also has the added benefit that the political level itself must be more specific about what its aims are.
(b) Are the outputs measurable or non-measurable? Again, an aim of PFM/IC is to achieve a definition of outputs which is measurable, if possible. Measurable objectives would enable the politician to express more clearly what is expected of the civil service. This would then allow the political level to have more confidence in the performance of the civil service and therefore encourage delegation.
(c) Are the effects of management interventions known or unknown? Achieving an understanding of management interventions is an aim of PFM/IC. Where there is little or no awareness of the impact of civil service actions, the likelihood is that delegation will be extremely difficult to achieve and therefore an aim over time should be to focus on developing awareness before seeking to implement delegation.
(d) Is the activity repetitive or non-repetitive? If the activity is repetitive, then the politician should be aware of the results and that would argue in favour of delegation. If the activity is non-repetitive then whether delegation was appropriate would depend upon analysis based upon points (a) to (c) above.

Those responsible for considering the issues surrounding delegation should consider both the ideas contained in the Thompsom-Tuden matrix and those of Hofstede. Whether the objectives (or using the Thompson-Tuden analysis, values) are unambiguous or ambiguous (item a) above) is regarded by Hofstede as the most crucial criteria affecting how the activity is to be managed. If there is clarity about the objectives (or values) and this is a political responsibility to be derived from political values then there can be a clear target to be achieved and this makes delegation in principle to the civil or local government service

[17] Hofstede G., Management control of public and not-for-profit activities: Accounting, Organizations and Society. Vol. 6, No. 3, pp. 193–211,198l.

relatively easy (i.e. provided a managerial capability exists within the official level of management and is recognised by politicians to exist). However, the reality is that often objectives can be unclear for several reasons such as conflicts of interest and/or, of values. The example of a prison given in Chap. 1, illustrates the point: the director of the prison may be most concerned about security, psychiatric staff may be concerned about rehabilitation, and higher levels of management may be concerned about overall cost. Thus, what is the objective of management? This lack of clarity may require a political decision but once that decision has been made there is no reason why delegation could not occur. Other reasons for lack of clarity include rapid changes in the operational environment, such as new legislation, developments in IT, new drugs and so on where political agreement may be required to the appropriate response. However, responsibility for implementation, once agreement has been reached should remain at the official level and appropriate accountability arrangements then developed. Clarity of management responsibility then becomes clear. Where unambiguous objectives exist and there are no conflicts of interests and/or values then delegation to the official level would be appropriate.

The second Hofstede classification (b above) is, are the outputs measurable (quantifiable) or non-measurable. If measurable, management control presupposes that the output of an activity can be identified and compared to the targets that have been set (or could be set). Consequently, if variations occur during implementation, decisions can be made about how to ensure as far as possible that the original targets can be met or alternatively whether the original targets remain valid. Again, where such circumstances exist delegation to the bureaucracy is possible. However, many public organisation activities cannot be easily quantifiable and Hofstede gives as examples, an army in peacetime or a public relations department or the outputs of an education ministry. In these circumstances Hofstede argues that what can only be measured are inputs rather than outputs and those measures of input activities which can provide an indicator of the quality of performance in different circumstances should be used. Another example of the problem of measurement would be the assessment of the educational performance of individual schools. This may be measured by examination results although disputes may occur about the appropriateness of the examinations and whether, for example, they assess simply memory or a capacity for critical analytical thought. Another measure could be the proportion of children of different sexes and age ranges attending school and attending consistently or the proportion of children in a school from lower income families. The political responsibility is to provide clarity about the values and from that, about the objectives to be achieved by management. In all such circumstances delegation is appropriate once clarity exists although consultation with politicians may be needed, but a requirement for consultation does not mean that the politician should take on the responsibility for operational management.

The third classification (c above) is, are the effects of management interventions known or unknown? Where the civil servant or local government official knows how and when to intervene in order to obtain the desired result and has the authority to manage resources to enable the desired results to be achieved delegation could occur. Hofstede points out that the relationships between a manager's intervention and the reaction of the organisation must be clear. In practice these relationships are not always clear particularly with the delivery of 'social welfare' and 'educational' activities. Usually what is important in such circumstances is the historical knowledge and experience of the civil servant or local government official as manager. Where there is no delegation and politicians become the operational managers, such managers can change frequently and the opportunity for the political official acting as the manager to gain such a degree of historical knowledge and experience to achieve the objectives is likely to be very limited. This argues again in favour of delegation of operational management to a more stable group, which should be the civil or local government service officials.

The fourth classification (d above) is, is the activity repetitive or non-repetitive? Repetitive activities (those that occur daily, weekly, a few times a year, once a year) allow a learning effect to occur. Repetitive activities facilitate learning. But this again can only occur if the operational management is stable and therefore has the opportunity to learn from repetitive activity which again points to delegation to civil or local government service officials from the political level. (Securing operational management stability is an important responsibility of the top operational manager.)

What this analysis points to is that opportunities for delegation do exist. Whether delegation can be achieved depends upon several factors. Delegation to be effective must be accompanied by a range of other reforms referred to in this guide such as those impacting upon the organisation of the civil service, budgetary processes, and the development of financial analytical and performance information. A critical factor though in the development of delegation is the level of confidence that the political level has in the civil or local government service because with delegation the civil or local government service has to make decisions, including about the utilisation of resources. Political stability is also very important because where instability exists the boundary between political and appointed official decision making is also likely to be unstable and this will make delegation potentially much more difficult. Attempting to require delegation without looking at the wider consequences of delegation would be a mistake.

Having determined which decisions should be delegated and to whom, the form of the accompanying managerial control or how accountability arrangements should work, needs to be established. Hofstede defined six types of control. These are:

1. Routine control: This can be developed where there are unambiguous objectives, measurable outputs, known effects of interventions, and activities are repetitive. This type of control can be prescribed in precise rules and regulations and can be applied through the normal civil service/local government hierarchy. (Examples would be in the treatment of social insurance claims or the issue of passports.) Where routine control arrangements can be applied then the message is that this should be the first focus for the development of delegation and the consequential managerial accountability arrangements. Such controls should form the basis for reporting to higher levels of civil service management and ultimately to the political level of management.
2. Expert control: This applies where objectives are unambiguous, outputs measurable, the effects of interventions (i.e. outputs, not outcomes) known but the activity is not repetitive. In such circumstances appropriate expertise should be recruited to the civil or local government service. Utilising an expert in such circumstances enables the responsible public official to take advantage of the 'repetitive experience' of the expert even though the organisation itself may have no such repetitive experience. This points to a need for delegation to a civil or local government servant who is familiar with current operations and through that familiarity can ensure that expert activity is integrated with current knowledge and experience. The message is the same as for 'routine control', namely that such controls should be applied through the civil or local government service hierarchy and form the basis for reporting ultimately to the political level of management. (An example would be the introduction of new IT systems or development of new infrastructure.)
3. Trial and error control: This form of control can be appropriate if objectives are unambiguous, outputs measurable, the activity is repetitive but the effects of interventions are not known. The use of rigid rules and prescriptions is not possible but this type of control would be exercised through a thorough ex-post analysis of both successes and failures. Examples would be the introduction of new products, services, or treatments. The argument is that in these circumstances the organisation can learn to control through its own successes and failures. Expert knowledge of the operational environment in which the new product, service, or treatment is to be introduced though is essential. Because of the possible

level of uncertainty, the likelihood is that even though this type of control would be exercised at the appointed official level, probably this would be in close coordination with the political level. (Examples would be the use of new social welfare or child care procedures.) This would affect the form of the accountability arrangements.

4. Intuitive control: This is similar to the 'trial and error control arrangement but would apply where the activity is not repetitive. Intuitive control relies upon the quality of management and that means responsibility for the exercise of the control should fall upon a person or persons who can be trusted to intuitively find the proper form of intervention needed to achieve the desired results. An example of where intuitive control may be necessary is how to reinvigorate a demoralised group or unit. If the delegation of operational management has been developed then there is every reason to delegate activities to appointed officials where this type of control is appropriate. However, where delegation is only being currently developed control decisions of this type will probably tend not to be delegated, at least initially. Where delegation does occur, this again would affect the form of the accountability arrangements.
5. Judgemental control: What is to happen where outputs are not measurable even though objectives are unambiguous? In these circumstances the first question to be asked is whether any indirect measures of outputs (performance indicators) can be found which can be considered acceptable 'surrogates' or 'proxies' for the missing direct measures. If such measures can be found that make sense and are acceptable to the parties involved, the control problem will become similar to the case of measurable output. If no indirect measures are available control of the activity becomes a matter of subjective judgement. In such circumstance delegation does become more difficult and the political level may wish to retain responsibility for decision making. That though does not necessarily make the quality of decision making of any better quality. The circumstances in which judgemental control is exercised will determine the precise accountability arrangements.
6. Political control: This form of control applies where objectives are ambiguous (quadrant 4 in the Thompson-Tuden analysis). Here the political management should attempt to clarify the ambiguity by making a decision so that for those lower down the organisation there is no ambiguity. But until such a decision is made delegation is not possible. Political control may also be appropriate in the management of a reaction to an emergency such as a major fire or accident or earthquake or pandemic or a terrorist incident. Where there is political control, the involved politician will still be accountable to his/her peers. But in many circumstances of this type, col-

laboration between the political and appointed official levels is essential even though decisions may remain at the political level.

Because the provision of public services can be complex, cooperation between ministries and other public bodies (not least local government) can often be essential. Cooperation complicates decision making processes and when several organisations are involved, conflicts of objectives can occur. In such circumstances policy decisions will almost inevitably tend to remain at the political level but such political decisions can also determine how operational management decisions will be made.

14.2 The Effect of Introducing the Concept of Efficiency and Effectiveness into Public Service Administration

14.2.1 The Impact of Introducing Efficiency and Effectiveness into the Managerial Arrangements

A practical problem that public sector administrators have working within traditional public administrative arrangements is that they generally have little financial information on which to make decisions. There is no market test or pricing mechanism which limits or otherwise affects the demand for public services. Similarly, there is little or no information about the actual costs of providing a service or information about what drives costs or even detailed performance information. Therefore, a critical factor in the success of a move from public administration to public service management, as has been pointed out earlier in this guide, is the existence of public service financial management. The aim of public financial management is to provide the range of financial analytical information, linked to performance, that the manager needs as well as that needed to meet budgetary constraints.

Ministers responsible for the delivery of public services and other public service officials are prone to believe that the resources allocated through the annual budget are inadequate to meet the needs of the users of these services or activities. (There is never enough funding!) This can be a cause of tension between ministers responsible for service delivery and ministers of finance. However, unless a public financial management reform has been introduced incorporating financial information additional to that only usually available with traditional arrangements for public financial administration, neither ministers nor officials have a clear idea about what services actually cost. Generally, ministers and other public service officials want to provide the best possible quality of service and there can be a presumption that reducing the cost of service delivery conflicts with this objective. Yet reduction in cost may emerge through improvements in efficiency. An objective of ministries of finance in seeking to impose economies can be to drive service ministries into looking for improvements in efficiency.

Improving efficiency and effectiveness is not simply a function of a 'top-down' style of management. It requires the engagement of all who are involved in the management process, not least in the 'inner circle' identified by Thompson. That demands delegation. The benefits of delegation and managerial accountability in this context include:

- Allowing top managers (ministers and mayors and their deputies) time to focus on more important strategic and political issues.
- It motivates managers at different levels and their staff, boosts creativity and innovation, and facilitates ownership by staff of the particular area of business for which they are responsible.
- It creates opportunities for wider discussion and debate about alternatives (no single person has a monopoly of ideas and knowledge).

The idea of efficiency and effectiveness introduced into the delivery of public services changes the characteristics of public service administration into one of management, that is if the term 'efficiency and effectiveness' is to have substantive meaning. No longer is it simply a matter of delivering the same type of service or activity and keeping within budgetary limits. Yes, budgetary limitations do have to be observed, but if managers are to deliver efficiency and effectiveness, they will need more opportunity to use their initiative and to make decisions about how to best deliver services and activities. To improve efficiency and effectiveness requires a recognition that 'challenge' is a necessary component of management. Traditional hierarchical structures generally do not facilitate 'challenge'. A managerial approach would include not just considering ways in which the costs of present delivery arrangements could be reduced but also considering alternative methods of delivery. Managers within an organisation will themselves need to decide what they require in terms of resources to deliver their objectives but of course within any overall financial constraints imposed by the ministry of finance. The IMF paper on performance based budgeting referred to above makes the point about '[i]ncreased input flexibility: line managers should be given greater flexibility to choose the input mix that can most efficiently deliver services. This requires a reduction of the large number of distinct limits imposed upon expenditure by economic classification ("line item") in traditional budgeting.'[18]

The question then is, is it possible to manage public services and activities and deliver efficiency and effectiveness without moving to a managerially oriented organisation? As has been pointed out elsewhere in this guide many countries in seeking to introduce PFM/IC use the term 'efficiency and effectiveness' but without any recognition of what it actually involves. In this guide the point has been repeatedly made that managerial change is necessary. Managers will be required to spend more time on assessing costs and benefits and where changes in the arrangements for the delivery of services and activities are to be made this adds to the time demands upon those responsible managers. Expert judgements will be increasingly required to assess alternatives (and there will always be alternatives, although following analysis, one of which will be to maintain the *status quo* but this too must be justified). The ability to make expert judgements depends upon knowledge and experience as well as upon training. It is not feasible for traditional administrative structures with operational management a political responsibility, to be maintained and at the same time undertake all these additional activities. Delegation therefore becomes essential, not only from politicians to officials but also from senior to more junior officials. However, as has been pointed out, delegation itself is not a simple matter. The terms of delegation need to be clear. This means that those to whom responsibility is delegated must know what they are expected to do, that the delegated responsibility is within their competence and they have available and under their control the resources to enable them to deliver the delegated objectives. Only then they can be held fully accountable. If these conditions do not exist then accountability is diluted.

To establish a managerially oriented organisation with a focus on efficiency and effectiveness, radical change is very often required and delegation must become an essential feature of the organisation. Without delegation (and the accompanying managerial accountability) the top hierarchy cannot undertake all the analysis and actions necessary to deliver objectives with efficiency and effectiveness. If an attempt is made to retain decision making authority within a small group at the head of the organisation, that is, the politically appointed group, this small group is unlikely to have available within it the skills and specific knowledge that an operational manager requires and only through managerial activity can substantive meaning be given to the terms 'efficiency and effectiveness'. (Economy is easier to interpret because economy is often

[18] Ibid., p. 7.

equated with cheapness, or least cost, irrespective of the relationship with benefits and economy can be the enemy of efficiency.) Concentration of power as in traditionally organised public administrations, which is usually accompanied by penalties and other forms of sanction, means that the administrative structures which exist in many developing and transitional economy country public service organisations do not in reality facilitate effective management and consequently delegation. Delegation may exist in a nominal form but in practice decision making remains concentrated at the top of the organisation.

The development of managerial structures with appropriate arrangements for delegation facilitates the achievement of organisational objectives efficiently and effectively. Without a managerial structure delegation giving managers discretion and then accountability for how that discretion has been used, is not possible. A managerial structure enables higher levels of management to, in turn, become accountable and control the way in which the actions of individual managers at different levels in an organisation can be coordinated to achieve the delivery of the objectives of an organisation.

14.2.2 Achieving Delegation and Managerial Accountability in Practice: The Importance of 'Trust' and Other Factors

An important factor affecting membership of the 'dominant coalition' referred to by Thompson is 'trust'. Where, as with traditional systems of public administration, there has been historically no separation of policy and strategy development from operational management a failure to achieve separation is often caused by a potential lack of trust between politicians and appointed officials. As a result, politicians can be reluctant to delegate operational and administrative decision-making powers to civil service (or local government) officials or for those officials to accept such responsibilities. Sometimes, because of a lack of trust, key administrative positions may become politicised. This situation has several negative effects. These were described in a SIGMA/OECD paper as:

1. A tendency to politicise administrative decisions, that is, decisions tend to be based more on political convenience than in what is established in legislation so that it encroaches negatively on the principle of legality and legal certainty that must preside over administrative decisions.

2. This also promotes the blurring of political and administrative responsibilities and a clear distinction of either field.
3. Crowding the organisational top with any, big or small, administrative decision creates bottlenecks and overloads at the top that are inimical both to efficiency in administrative decision making and to the development of strategic approaches to policy making (politics becomes devalued and administration becomes miserable).
4. Civil servants at lower ranks in the hierarchy tend to inhibit themselves from participating in administrative decision making unless personally required to do so because they do not see it as constituting part of their jobs.
5. Weak participation, or lack of it, tends to produce de-motivating effects and in the end, it is an impediment towards developing a more professional civil service.'[19]

All of this destroys professionalism within the civil (and local government) service. The essential principles for any administrative organisation to work efficiently and effectively, as the SIGMA/OECD paper points out are lacking in traditionally organised governments. To achieve an improvement in practice according to this paper:

> there has to be an adequate distribution of work and responsibilities (competency), while ensuring internal and external coordination and cooperation, all this in pursuit of a common purpose (or mission) mainly through a more or less tight hierarchical control.

The paper also points out:

> However, one major problem is that the still prevailing culture is based on command and controls (verticalism) and makes it not easy to translate these constitutional principles into real administrative practice. A co-related problem is that certain administrative legal techniques that could contribute to efficiency and effectiveness of public administration are either conceptually underdeveloped or not sufficiently regulated in legislation or, what is even more worrisome, not applied in real practice of organisational behaviour in public administration.[20]

What is missing in this analysis is the point about inadequacy of information, financial and non-financial, leading to uncertainty. That information

[19] The delegation of administrative decision-making powers: a tool for better public performance, p. 2. Francisco Cardona SIGMA/OECD: www.nispa.org.

[20] Ibid., p. 2.

may not be simply performance information but also would include information about the adequacy of controls. Whilst there is no argument in theory about the effects of a failure to delegate, politicians are only likely to be persuaded to delegate where they can be confident that the change of culture (i.e. from a hierarchical command and control culture) will not cause them to lose control of operational activities even though ultimately, they remain responsible. Important factors in achieving such a change of cultural approach are the adequacy of the accountability arrangements, including the information available to the politician and the quality of the managerial controls. This presents a major problem for ministries of finance and their department responsible for the implementation of PFM/IC. Not only do they need to ensure that administrative law facilitates delegation (which in some countries it may not. Therefore, change will be required to effectively implement PFM/IC). However, where the operational culture discourages delegation, particularly through a lack of trust, information, and the quality accountability arrangements, that operational culture is much harder to change. Policy papers designed to facilitate the introduction of PFM/IC tend to overlook these problems and how they might be addressed unless careful preparation prior to the implementation of the PFM/IC policy occurs (see Chap. 9).

A failure to recognise these changes that the PFM/IC reform should bring about means that the implementation of PFM/IC will be more nominal than substantive. The SIGMA/OECD paper suggests that the best solution 'is to promote informed debates and training aimed at producing changes in the prevailing politico-administrative culture'.[21] Reviewing the law is relatively easy, what is much more difficult is culture change. The reality is that cultural reform cannot be achieved simply through pressure to implement PFM/IC. As has been said previously coordination with those responsible for civil service/public service reform is essential. Careful pre-reform preparation is also necessary as described in Chap. 9. Included in this is how to achieve recognition of the deficiencies with the traditional arrangements, not least the difficulties of delivering public services and activities within a constrained budgetary envelope against rising demands, particularly when there is a serious lack of information. Policy papers introducing PFM/IC do not in general address these difficulties because of the focus on the procedural features of the reform. The deficiencies also include (as the SIGMA/OECD paper points out) '[a]ccountability mechanisms for damage or losses caused by inefficient performance in traditional systems are in general weak or non-existent and

[21] Ibid., p. 3.

responsibility is difficult to demand from politicians and civil (or local government) servants'.[22]

Whilst laws introducing PFM/IC almost always refer to the delivery of public services and activities efficiently and effectively they do not indicate how this will be achieved and merely introducing these terms in legislation, as has been pointed out earlier in this guide, without recognising what is required to achieve them, is pointless. Given the need to change cultural approaches merely including such statements in the law is unlikely to have any practical effect, not least because not only is it necessary to introduce a managerial structure to facilitate delegation but those who have managerial responsibilities also need training and the support and information to enable them to determine whether a service or activity is being delivered efficiently, effectively as well as economically and is achieving its objectives. As has been indicated previously, this means that changes are also required to the budgeting and accounting arrangements with the complementary development of financial techniques, such as cost analysis, as well as operational performance information. None of this is usually referred to in policy papers leading to the introduction of PFM/IC.

Another pressure which exists on public organisations, which is complementary to the need to focus on efficiency and effectiveness, is a requirement for more openness through increased transparency and accountability for performance. This in turn should help politicians and senior civil service management to demand improvements in efficiency and effectiveness as well as generating wider debate about quality and value for money in the delivery of public services by parliament and civil society. PFM/IC is part of the process for remedying the deficiencies of the traditional arrangements.

The SIGMA/OECD paper also remarks:

> No administration can work effectively if all the decision-making power is wielded only by the top of the organisation. For an organisation to work smoothly it needs to delegate power down the hierarchical ladder. This delegation is also a condition of developing necessary policy-making capabilities, and administrative management skills and responsibility that will not emerge otherwise.[23]

Delegation requires a financially aware civil or local government service which understands the costs of providing services and activities and which has

[22] Ibid., p. 3.

[23] Ibid., p. 8.

the capability to decide on those reforms that will improve efficiency and effectiveness, some of which may require political-level approval and some may not. These are characteristics of an efficient and effective public management. They also facilitate a higher quality of corporate governance because the distribution of responsibilities allows for a wider range of factors and opinions to be considered in any decision. It also separates political considerations from managerial decisions where that is desirable (i.e. the majority of cases). Delegation creates the opportunity to develop sound management at different levels in an organisation and has a better chance of making the optimum use of resources (efficiency!). This is because it allows the development of expertise and it also creates more time for top and senior management to focus of developing a higher quality of policy and strategy which is the basis for an efficient and effective public management. In addition, delegation through the development of managerial accountability, provides the opportunity for the top and senior political management to assess how efficient and effective the civil (and local government) service actually is.

As the SIGMA/OECD paper points out:

> [Q]uality considerations include: cost to the budget and the economy; whether implementation can be assured and controlled/enforced; interaction with other policies; legal quality criteria in the case that the policy leads to a legal instrument that the text responds to. All this needs the expertise that a professional civil service is meant to input into the policy-making process.[24]

The paper further points out that 'good legal arrangements for delegation may promote improved administrative practices that in turn may have positive operational consequences in organisational design and in developing an efficiency-oriented managerial culture and that may ultimately contribute to:

- An organisation of ministries whereby ministers and policy staffs are freed from the day-to-day implementation of policies and can instead concentrate on devising policies, drafting statutes, and overseeing their implementation.
- A public sector which, in the areas in which it operates, is given specific tasks to fulfil with a degree of management autonomy, within the framework of clearly laid out legal structures.

[24] Ibid., p. 9.

- An administration where an accountable and committed professional management takes root.'[25]

Civil (and local government) servants should have the training, experience, and technical expertise to enable them to make operational decisions. Those operational decisions may involve a rethinking of how public services are delivered. An example is the increased utilisation of information technology and another would be the development of partnerships with other organisations such as charities, local governments, and private sector organisations. None of this detracts from the overall responsibility of the public sector manager to ensure that where public money is involved, such funds must be appropriately and efficiently utilised. Civil and local government servants because they would normally be in post for longer periods than politicians also provide continuity and knowledge of implementation that would not be available to politicians acting as operational managers. Their position is not, or should not be determined by the political cycle. Continuity and knowledge are essential to efficient and effective public management. Delegation coupled with accountability makes it possible for these beneficial features to be taken advantage of.

14.2.3 Delegation and Questions About the Activities of the Organisation

In Sect. 14.1.3 of this chapter the issues that should be considered in determining when and what to delegate were discussed. Delegation is not an absolute. In other words, there is no such thing as complete delegation. There will be some responsibilities of ministers and deputy ministers (or the equivalent in local governments) that are inappropriate to delegate at any point in time or, in particular circumstances. Also, those circumstances may change over time. Pressure to delegate (by the ministry of finance and the 'driver' department responsible for the introduction and oversight of the PFM/IC process) should be therefore an informed pressure considering the issues and circumstances that should be considered in any delegation proposal. A very important point is that delegation means nothing, as has been said earlier, unless accompanied by the authority to make managerial decisions and the availability of resources. Those promoting delegation should be looking for evidence of this. That authority to make decisions should include improving

[25] In a public management environment this would be better stated as a 'civil service' where an accountable and committed professional management takes root. Ibid., p. 9.

efficiency and effectiveness, and this requires, as pointed out previously, delegated control over material and human resources. Withholding that diminishes the extent to which managers can be held to account. (Yet in countries introducing PFM/IC delegation is usually considered but without any substantive regard to the extent to which delegation requires knowledge of and control over budgets or human resources.)

Accompanying delegation should be arrangements for accountability.

However, delegation occurs within a context which is the overall objectives of the organisation. In determining the appropriateness of the activities of the organisation for which he/she is responsible, the political leader in conjunction with the top operational manager (the state secretary or equivalent), should consider these questions:

- What is our mission, that is, why are we doing what we do?
- Who is our client/customer? Being clear about this is the basis for deciding what the clients/customers regard as important and this in turn helps in defining the results that should be aimed for and developing a plan of action.
- What does the client/customer value? That is, what satisfies the client/customer needs, wants, and hopes: this will include, for example, making clear that the client/customer views are listened to and that feedback mechanisms are effective.
- What are the expected results? Usually, ministries and local governments focus simply on ‘needs’, but information about results is essential to know whether those needs are being adequately met. Thus, does performance information exist which indicates progress and achievements both in quantitative and in qualitative terms. Having that information allows for programmes to be adjusted as necessary. Therefore, programmes should be designed in such a way that results can be identified.
- ‘What is the plan?’ A plan, which includes the budget, describes where the organisation is going and how it will get there.[26]

What this means is that decisions about delegation policy should be considered as part of an overall review of what the organisation is aiming to achieve.

[26] These questions are an adaptation of five questions suggested by Peter Drucker: The Five Most Important Questions You Will Ever Ask About Your Organization: ISBN: 978-0-470-22756-5 April 2008 Jossey-Bass 144 Pages

14.2.4 Professional Experts and Delegation

A complicating factor in making decisions about the delegation of responsibility in the provision of public services is the role of professionally skilled staff such as doctors, police, teachers, social workers, and engineers. (A further complicating factor in some countries will be the influence of foreign technical advisers.) The politician should not seek to impose his/her judgement over that of the professional in the professional's area of expertise. But where the professional is advising on the development of policy the situation is different. Such experts may have professional objectives that are incompatible with the objectives of politicians. Where the professional has a dominant role, the professional ethos will be to adopt the highest professional standards and approaches to the delivery of a service or activity. This may contrast with the approach of the politician who may have a limited budget and whose policy aim could be to deliver the maximum possible benefit for the least cost and who also may be subject to a range of political pressures which do not impact on the professional. That may require some form of compromise on professional standards or professional approaches to the delivery of a service or activity. (Professional standards can often be matters of opinion, rather than objective fact.) This raises questions about the ability of the politician to adjudicate on the views of the professional and in making the judgement the politician ought to be able to rely on the advice of the civil servant (or local government official). That would require that such officials are well informed about all aspects of a decision. A policy of delegation should result in a more informed civil or local government service better able to advise the politician. If there is no delegation then the risk is that a minister or other politician is exposed only to a single source of advice. A difficulty for the politician in such circumstances is how to decide which professional expert to rely upon and how far to rely on their advice and opinion.

An important consideration in the development of delegation arrangements and managerial accountability therefore is the capacity of the civil or local government service to effectively support the political management in policy development and to provide an objective assessment of the quality of any advice being provided by professional experts considering the overall limitations on the resources available to the organisation. This capacity should enable the politician to take a wider view of the policy and financial consequences of proposals advanced by professionals for the delivery and development of services and activities. That policy advisory capacity should be provided directly by or under the supervision of the most senior civil servant such as a state secretary (or equivalent). In other words, delegation provides a substantive opportunity to develop alternative arguments or approaches to those of the professional. Without the existence of delegation to an informed civil or local government service, the possibility is that the politician will become 'trapped' by the views of the professional. This may result in the inefficient allocation of resources given the totality of the demands upon the available budget and to increased risk for the political decision maker.

14.3 The SIGMA 'Principles of Public Administration'

14.3.1 The SIGMA Principles and Management

PFM/IC is about management not just about procedures and techniques. With PFM/IC control is about both control of inputs and of outputs and, at the same time, ensuring that those outputs are delivered efficiently and effectively. Managerial control is therefore 'multi-layered' compared with the administrative control that exists with traditional public administration arrangements. In effect, introducing PFM/IC is a commitment to moving from an administrative state where regulations, procedures, and techniques have priority to a managerial state where delivery of objectives, to quality, to time, to standard, efficiently and effectively but within the laws and regulations become the primary concern of the manager. That managerial concern must extend to the interests of the user of the public service. In November 2022, in a meeting of the Public Governance Committee (PGC) at ministerial level, OECD ministers committed to 'reinforce, promote and strengthen the foundations of democracies acknowledging that they should rise to the challenges of growing and changing citizens' expectations in terms of representation, responsiveness, open government, and integrity of institutions, as well as green policies including through innovative approaches in the public sector' and to 'continue efforts to build professional, effective and efficient public institutions, and high-performing leadership and civil servants in support of stronger democracies'.[27]

That affects the whole approach to the delivery of public services and which must be reflected in the application of PFM/IC.

[27] *Declaration on Building Trust and Reinforcing Democracy,* (2022), https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0484.

SIGMA publishes a set of 'Principles of Public Administration'. The latest edition (issued in 2017) is currently undergoing review. That review will reflect recent thinking about the organisational arrangements for public administration, which were summarised in the quotation above of the PGC. The emphasis upon the creation of 'professional effective and efficient public institutions and high-performing leadership and civil servants' supports many of the arguments set out in this guide. The ministry responsible for the policy of the PFM/IC reform and the head of the department responsible for the practical implementation of PFM/IC should therefore have particular regard to these Principles when they are published as relevant to this reform. The 2023 edition of the Principles will demonstrate some change and reflect more fully the managerial requirements of PFM/IC. In the Annex to this chapter an early draft of the revised Principles is shown but readers should recognise that this is not the final version. This will be incorporated into this guide when it becomes available.

Although the 'Principles of Public Administration' are primarily designed for countries wishing to join the European Union these Principles are equally applicable to a much wider range of countries. This is because they provide one of the most comprehensive statements of the issues that need to be addressed in public administration reform.

14.4 Personnel Management (Human Relations—HR)

14.4.1 The Significance of Personnel Management in the PFM/IC Reform

Success with the introduction of PFM/IC depends upon the existence of high quality operational management. This requires that a well-managed, incentivised, and well-trained civil and local government service exists. A key requirement is that '[p]rofessionalism of public service is ensured by good managerial standards and human resource management practices'.[28]

The SIGMA Principles make clear that recruitment of public servants based on merit is of utmost importance for developing and implementing policies as effectively as possible, regardless of the government of the day. The 'Principles' also make clear that the public service should be apolitical and that public servants are distinguished from political appointees (i.e. political

[28] Principles of Public Administration: Sigma 2017: p. 40.

positions are not included in the scope of public service). They also recognise that an effective public service also depends upon other factors such as level of remuneration, performance appraisal, professional training and development, integrity measures and disciplinary procedures. 'These are needed not only to attract quality employees to the public service, but also to retain them and motivate them to achieve the strategic goals of the state. The 'Principles' also make clear that 'regular professional training is recognised as a right and duty of all public servants. With PFM/IC that training not only has to cover technical training but, as has been pointed out earlier in this guide, it also should cover management training for all civil servants who have managerial responsibilities or who aspire to those responsibilities:

> Modernising public administrations remains a key concern throughout the enlargement countries. Politicisation continues to erode capacities and public administrations' attractiveness as an employer. While there is awareness of key reform needs for creating more professional and merit based administrations overall, more leadership and effort will be needed for improving policy planning, public finance, people management and accountability.[29]

In no policy papers relating to the introduction of PFM/IC has this author seen any reference to developing the quality of the civil service, apart from technical training in the bureaucratic arrangements for the implementation of PFM/IC. This is even though PFM/IC imposes quite significant additional and often completely new responsibilities, upon the civil or local government officials. Almost certainly this is because PFM/IC has been treated as simply a technical financial reform rather than as a reform impacting heavily upon management. The OECD has published several papers on civil service training which heads of the 'driver' department responsible for the application of PFM/IC may find helpful such as 'Skills for a High-Performing Civil Service'.[30]

Francis Cardona in a SIGMA paper 'On the Attractiveness of the Public Service' said:

> The correlation found between public service attractiveness and the idea of the public interest emphasizes the dimension of the quality of the public governance arrangements and management systems as a magnet attracting people to work in the public service. Such correlation is also vital in fostering the commit-

[29] 2022 Communication on EU Enlargement Policy-v3.pdf (europa.eu), https://neighbourhood-enlargement.ec.europa.eu/system/files/2022 10/2022%20Communication%20on%20EU%20Enlargement%20Policy-v3.pdf.

[30] https://doi.org/10.1787/9789264280724-en.

ment of individuals to public service values. This commitment may compensate for relatively lower financial rewards if compared with the private sector.[31]

This SIGMA paper also stated:

> If a good governance system is not in place it will be very difficult to attract a significant share of the most talented people in the country and to utilise them effectively, which is a condition to retaining them in the service of the state: Governance environments that do not effectively practice the rule of law and do not protect and defend due procedures, justice, integrity and transparency usually do not have good public institutions that are able to attract and retain bright professional people.[32]

PFM/IC, if to be effective, will require the employment of 'talented people' and some, such as heads of finance who in many countries do not presently have the required range of skills, will need to develop those skills or if that is not possible, they will need to be replaced. The difference between PFA/IC and PFM/IC from an administrative/managerial perspective and which summarises why talented people are required to establish PFM/IC is that PFA/IC is input driven and rule driven with an emphasis upon procedures that control resources, while PFM/IC is output driven with an emphasis on managerial initiative in using resources better to achieve objectives (see also Chap. 3).[33]

In Chap. 1 the aim of PFM/IC was described as: 'to provide the information management requires to deliver the objectives and performance standards of the organisation, as expressed through the budget, efficiently and effectively, to time and within budget'. Delivery occurs through the actions of the civil and local government service within the context of the policy and objectives determined by the political level of government. PFM/IC is about achieving delivery performance and that means that the personnel policies should be designed to support that. Consequently, an important feature of PFM/IC should be to support the development of a personnel or HR policy which has the following characteristics:

- establish objectives through which individuals and teams can see their part in the organisation's mission and strategy;

[31] Attractiveness of the Public Service: A Matter of Good Public Governance: June 2009: http://www.sigmaweb.org/publications/44110902.pdf.

[32] Ibid., p. 1.

[33] This distinction between PFA/IC and PFM/IC has been taken from a framework developed by Prof. Stephen Peterson in his book: Public Finance and Economic Growth in Developing Countries: Lessons from Ethiopia's Reforms: pp. 278–279; 285–286

- improve performance among employees, teams and, ultimately, organisations; and
- hold people to account for their performance by linking it to reward, career progression and termination of contracts.[34]

To these characteristics could also be added ‘provide challenging work’.

This does mean that personnel policies, as the Chartered Institute of Personnel and Development points out, should be established which aim to link an individual’s performance and development priorities with the objectives of the unit or department of the ministry or other public organisation in which an individual works, which in turn should be linked to the organisation’s objectives. This then allows individuals and managers to draw up appropriate plans and facilitates performance monitoring and allows for regular feedback between the manager and the individual employee. These feedback arrangements could be supported by periodic formal performance reviews. The plans can also highlight organisation-wide processes that are required to support performance; for example, leadership, internal communications, and others. This links personnel policies to the COSO control environment and the information and communications standards described in Chap. 11.

14.5 Summary

This chapter discusses the linkage between the PFM/IC policy and that for civil service/public service reform. It emphasises that that linkage should be extremely close and that if the two reform policies are not integrated either the PFM/IC reform will be difficult to implement or it will try to drive the civil service/public service reform, which would be inappropriate! Unless the objective of PFM/IC reform is clear, that is to introduce into government a managerial capability the likelihood is that the focus of public service reform will be simply limited to public administration reform, that is, a reform with no managerial focus. An important element in developing PFM/IC is an appreciation of the complexities of the decision making process and the uncertainties associated with that process, not just in terms of establishing agreement about the values leading to the policies that are to be pursued but also establishing as far as possible certainty about the facts or factors affecting the implementation of those policies. The greater the degree of certainty and

[34] Performance Management: an introduction: The Chartered Institute of Personnel and Development Nov.2019: https://www.cipd.co.uk/knowledge/fundamentals/people/performance/factsheet#6276.

the operational management has an important contribution to make to both elements, the better the quality of the decision. The decision about values is and will remain a political decision.

An important element of PFM/IC reform is the development of delegation and managerial accountability. The greater the degree of certainty, the greater the opportunity exists for delegation! Delegation and managerial accountability together are about making better use of resources. However, delegation is a complex issue and not all operational managerial activities are suitable for delegation. Different factors need to be considered in making decisions about the extent of delegation, including the nature of the activity to be delegated, and the control arrangements which exist or can be established.

In implementing the PFM/IC reform the relevant SIGMA Principles of Public Administration Reform should be considered recognising the greater emphasis upon the development of management that the latest version of the Principles envisage. This is a necessary pre-condition for the development of PFM/IC. However, there is little or no evidence that those responsible for PFM/IC reform in individual countries or donors supporting them consider the need for complementary managerial reform, or indeed that those responsible for civil service/public administration reform consider the implications for PFM/IC reform.

A further important factor in developing PFM/IC is personnel policy. Personnel policy is critically important in recruiting and retaining high quality staff which is essential for effective public service management. Effective staff management is linked to the COSO standards relating to the control environment and information and communications. Unless in applying these standards, personnel policies are also considered those standards cannot be effectively applied.

Annex: SIGMA Principles of Public Administration of Relevance to the Introduction of PFM/IC (An Early Draft of the 2023 Version Which May Be Subject to Change)

The Principles as drafted are grouped into the following thematic areas:[35]

[35] See para 21 of the Introduction.

Thematic areas	Core values
Strategy	The government ensures a strategic vision and leadership for an agile, innovative, and continuously improving public administration responsive to new challenges.
Policy development and coordination	The government ensures that policies and budgets are harmonised, effectively planned, coordinated across whole-of-government, implemented, monitored, and evaluated against clearly defined policy objectives. Ministries develop coherent public policies through an open and participatory process, informed by sound evidence and analysis.
Public service and human resource management	Public servants act with professionalism, integrity, and neutrality. They are recruited and promoted based on merit and equal opportunities and have the right competencies to deliver their tasks effectively.
Organisation, accountability, and oversight	The organisation of the public administration is efficient and effective across all levels of government. Public administration bodies are open and transparent and apply clearly defined internal and external accountability mechanisms. Strong oversight bodies protect the rights of citizens and the public interest.
Service delivery and digitalisation	The public administration places users at the centre and delivers high-quality and easily accessible services online and offline to all people and businesses. Digitalisation enables data-driven decisions, effective and efficient processes, as well as high-quality and accessible services.
Public financial management	The public administration plans and manages public finances to ensure that they are sustainable and transparent and allow the delivery of policy objectives. Control, procurement, and oversight arrangements are in place to ensure the economic, efficient, and effective use of public resources shared across all levels of government.

The Principles apply to all public bodies, including local and regional governments.[36]

To secure the effective application of the Principles, there are a number of prerequisites which are not written into every Principle. (All of which are fundamental to the introduction of PFM/IC and have been reflected in this guide.) They are:

- adequate legislative framework exists (both primary and secondary legislation);
- established institutional and organisational exists with clearly defined responsibilities, as well as adequate capacities of responsible institutions;
- the right people with the right skills, supported by good management are in place;

[36] See paras 18–20 of the Introduction.

- an orientation towards outcomes for citizens and businesses is established (in this guide the reference for managerial control purposes has been to 'outputs' and concepts of internal control should cover both 'inputs' and 'outputs');
- government decisions are informed by reliable evidence and data (emphasising the importance of clarity about objectives and performance standards and thorough financial analyses);
- systematic monitoring and evaluation of performance occurs to create a learning and feedback loop (and also necessary for effective management);
- organisational culture internalising the desired values and behaviours (emphasising good governance) is established; and
- change management is accepted.

Principle 1: A comprehensive, credible, and sustainable public administration reform agenda is established and successfully implemented, fostering innovation and continuous improvement.

Comment: Officials responsible for the implementation of PFM/IC should ensure that the public administration reform arrangements fully reflect the requirements of PFM/IC.

Principle 2: Public policies are coherent and effectively coordinated by the centre of government; decisions are prepared and communicated in a clear and transparent manner.

Comment: This also means from a PFM/IC perspective, that policies are affordable and do not have adverse effects upon financial resilience. It consequently means too that there is effective coordination between strategic plans, operational plans, and financial plans.

Principle 3: The government plans and monitors public policies in an effective and inclusive manner, in line with the government fiscal space.

Comment: This requires that policy and financial plans are aligned, that objectives and performance standards are defined and appropriate.

Principle 4: Public policies are developed based on evidence and analysis, following clear and consistent rules for law making; laws and regulations are easily accessible.

Comment: This means that the cost implications are calculated and are consistent with available budgetary resources. This also emphasises the importance of the role of financial analysis in the policy making process.

Principle 5: All key external and internal stakeholders and the general public are actively consulted during policy development.

Comment: Implementing this Principle means that financial assessments may be subject to challenge, not just internal challenge but also to external challenge. Heads of finance should be prepared for that.

Principle 6: Public policies are effectively implemented and evaluated, enhancing policy outcomes and reducing regulatory costs and burdens.

Comment: The head of finance should be involved in the evaluation process, not least because this will enable that person to assess the quality and robustness of initial financial calculations, and therefore the impact upon budgets and financial resilience.

Principle 7: The parliament effectively scrutinises the government policy making and ensures overall policy and legislative coherence.

Comment: Implementation of this Principle will mean that heads of finance are likely to be required to provide evidence which may be challenged as part of the parliamentary process.

Principle 8: The employment framework balances stability and flexibility, ensures accountability of public servants and protects them against undue influence and wrongful dismissal.

Comment: This Principle includes a requirement that public servants have the obligation to act professionally and neutrally and that they have the right to reject unlawful instructions, and that they also have protection against undue political and other interference in their professional judgement. Although not specifically identified in these Principles heads of finance can be subject to inappropriate interference, especially in circumstances where in their professional judgement policy proposals and other actions generate risks to financial resilience or offend financial principles such as those requiring that published accounts present a true and fair view of a financial position.

Principle 9: Public administration attracts and recruits competent people based on merit and equal opportunities.

Comment: Application of this Principle should help to ensure that competent staff are appointed to finance departments and that they have appropriate experience.

Principle 10: Effective leadership is fostered through competence, stability, professional autonomy and responsiveness of accountable top managers.

Comment: This is a very important Principle, not least because it defines 'top management' as: 'The term "top managers" shall apply to the highest levels of professional management in public administration bodies, where managers enter into direct interactions with the political leaders. It shall apply to top-of-pyramid public servants in ministries (general secretaries or professional state secretaries), general directors of ministerial departments or equivalent positions in ministries, and heads of agencies. It shall not apply to political leadership in the executive (prime minister, minister, deputy minister, political state secretary and similar).'

Throughout this guide emphasis is placed on the role of the 'top manager' and the leadership that that manager provides. This Principle reiterates that as follows:

a. The law establishes top managers as a specific category. The scope of top management is adequately defined, ensuring that senior managerial positions in ministries and agencies are not treated as political offices.
b. Top management positions are made attractive through fair recruitment, competitive remuneration, professional challenges, autonomy, and mitigation of career risks.
c. Recruitment procedures are merit-based, professionally led, impartial and transparent, allowing selection and appointment of top managers with sufficient high-level experience, knowledge, skills, and competencies to perform their job well against predefined standards.
d. Recruitment policies and practices support equal opportunities, gender balance and non-discrimination in top managerial positions.
e. Top managers in public administration have clearly defined objectives, aligned with the mission of the organisation and objectives of the government, and their performance is regularly assessed.
f. Top managers in public administration have sufficient professional and managerial autonomy, enabling them to assume responsibility for the management of staff, resources, and work.
g. Top managers in public administration develop their skills in line with the needs of the job, both present and future.

Each of these points is consistent with the effective introduction of PFM/IC.

Principle 11: Public servants are motivated, fairly, and competitively paid and have good working conditions.

Comment: This Principle is relevant to the appointment and maintenance of a high quality finance staff especially those requiring a skilled expertise. Public sectors generally have difficulty in attracting and retaining skilled financial experts (qualified accountants) and recruitment policies need to recognise this. As this guide has pointed out financial experts require a wide range of skills and such skill requirements will be increasingly needed by governments with the adoption of these Principles which emphasis the significance of managerial capabilities.

Principle 12: Professional development, talent, and performance management enhance the skills, efficiency, and effectiveness of public servants and promote civil service values.

Comment: This Principle refers to the need for employees to have clear objectives (which in turn means that organisations themselves require clear objectives otherwise the employee objectives have limited credibility), that continuous learning processes exist and that appropriate training programmes are in place. All of this is central to the effective development of PFM/IC.

Principle 13: The organisation and management of public administration foster accountability, effectiveness, and efficiency.

Comment: This Principle addresses the need for coordination between public sector bodies, to avoid the development of 'silo' mentalities and also the need for the first-level body to effectively manage the second-level bodies for which it has responsibility. It also includes the point that '[m]anagers at all levels have clearly assigned responsibilities, delegated authority for making decisions and the autonomy and resources necessary to achieve the results they are accountable for'. These requirements are all essential for the effective implementation of PFM/IC.

Principle 14: This is about the allocation of responsibilities between the different levels of government.

Principle 15: Public administration is transparent and open.

Comment: A feature of good corporate governance is that the public and interested parties have access to information. This includes access to all financial information, including budgets and financial statement. Heads of finance should bear in mind that the presentation of information in a format for management and statutory purposes can be inappropriate for public information purposes and therefore may require representation. Openness may also result in challenge about the quality and coverage of financial analysis on which policy decisions have been made which emphasises the need for quality.

Principle 16: The parliament, ombudsperson, supreme audit institution and civil society effectively scrutinise public administration.

Comment: This emphasis upon scrutiny may result in challenge to the quality in the arrangements for PFM/IC.

Principle 17: The right to good administration is upheld through administrative procedure, judicial review, and public liability.

Comment: This Principle is primarily concerned with the quality of the public administration.

However, it can ask questions about the quality of public financial management and may lead to challenge about the organisation of government institutions, both first- and second-level bodies. As has been pointed out in this guide, for example, the role and responsibilities of second-level bodies should be periodically review.

Principle 18: A coherent and comprehensive public sector integrity system minimises the risks of corruption.

Comment: This Principle is aimed at minimising the risks of corrupt activity occurring. Those responsible for financial management (i.e. the operational implementation of PFM/IC) could well come across potential instances of corrupt or fraudulent activity. Examples would include where decisions are made which are difficult to justify, or where conflicts of interest become apparent or transactions occur which are not properly authorised, or potential income is either not levied or collected, or assets are inappropriately used or disposed of.

Principle 19: Users are at the centre in design and delivery of administrative services.

Comment: This guide has pointed out that generally public services are designed with the interests of the supplier paramount. This is inappropriate and it diminishes the possibilities of achieving 'effectiveness'. This Principle emphasises that regard should be had to the interests of the user in designing public services and the bureaucracy that goes with them.

Principle 20: The public administration delivers streamlined and high-quality services.

Comment: This Principle emphasises again the need to take into account the interests of the user by ensuring that service delivery is streamlined for the maximum convenience of the service users.

Principle 21: Administrative services are easily accessible online[37] and offline, taking into account different needs, choices and constraints.

Comment: This Principle again emphasises the interests of the user and encourages the use of both offline and online methods of communication, including the use of concise and understandable language. This is particularly important from a PFM/IC perspective in terms of financial communications with the public and where relevant information about the collection of income such as taxation income.

Principle 22: This is about the digitalisation of public services and the maintenance of cyber security.

Comment: This applies equally to those financial services for which a head of finance is responsible.

Principles 23–32 are about public financial management. The summary of this section of the Principles is: 'The public administration plans and manages public finances to ensure that they are sustainable and transparent and allow the delivery of policy objectives. Control, procurement and oversight arrangements are in place to ensure the economic, efficient and effective use of public resources shared across all levels of government.' This theme is entirely consistent with that of PFM/IC. However, the Principles extend beyond the areas

[37] Directive EU 2016/2102 of the European Parliament and of the Council of 26 October 2016 on the accessibility of the websites and mobile applications of public sector bodies, http://data.europa.eu/eli/dir/2016/2102/oj.

covered by this guide to include economic management, purchasing, external audit, and the financing of local and regional governments.

Comment: Those involved in the development of PFM/IC and in PFM/IC activity in the course of public business must recognise the significance of all these Principles and that Principles 23–32 are essentially concerned with the technical aspects of PFM/IC and not with the managerial aspects which are addressed in the other Principles and which are essential to the effective application of PFM/IC.

Principle 23: The annual budget is comprehensive and formulated within a credible and rolling medium-term framework, balancing policy needs with fiscal constraints.

Comment: An effective budget underpins PFM/IC and effective financial management depends upon the linkage of service objectives and plans with those both explicit and implicit in the budget. Equally medium-term operational and financial plans should be consistent with the medium-term fiscal framework set out in the budget documents. This in turn is essential to securing financial resilience.

Principle 24: The government supports budget implementation and service delivery by ensuring liquidity in the short and medium term.

Comment: This Principle links with the point made in this guide that cash flow forecasts should be reliable and that liabilities should not be entered into which are inconsistent with the current budgetary allocations.

Principle 25: The government implements the budget in line with estimates and reports on it in a comprehensive and transparent manner, allowing for timely scrutiny.

Comment: This Principle embodies the requirements of financial control, including control of fiscal risk. Whilst aimed at central government, for this Principle to be effectively implemented all public organisations should follow the same requirements. This guide also emphasises two other key features that ought to apply, namely that the monitoring of the budget should be at least monthly and that accompanying the published financial statements should be a 'statement of internal control'.

Principle 26: Public administration bodies manage resources in an effective and compliant manner to achieve their objectives.

Comment: This Principle covers all the internal control requirements described in this guide also it does not specifically refer to COSO using instead the term 'international standards'. It identifies the need for objectives, for delegation, for managers to have the necessary information, including on performance, and that internal control arrangements should have regard to the risks that might affect the achievement of the objectives. It also refers to the need for appropriate controls to be exercised by first-level organisations over second-level bodies, including enterprises. The Principle makes clear that public managers are responsible for the implementation of management and control systems that ensure the legal, effective, efficient, and economic management of operations, assets, and resources. This guide makes clear that the ultimate responsibility for the quality of management lies with the head of operational management who in turn is responsible to the appropriate minister

Principle 27: Internal audit improves the management of public administration bodies.

Comment: This Principle requires the implementation of internal audit. This Principle advises that the internal auditor should report to the 'head' of the organisation which would be to the head of operational management. Principle 10, footnote 14, makes clear who should be the top operational manager. Where an audit committee exists the reporting arrangements would take into account the existence of that committee.

Principles 28–30 are concerned with procurement arrangements, including public-private partnerships and concessions.

Principle 31: All public funds are effectively audited by an independent auditor that provides assurance on the use of public resources and helps improve the functioning of the public sector.

Comment: Although this guide does not specifically address external audit, nevertheless effective arrangements for PFM/IC will be of concern to the external auditor particularly with the auditor's concern for how organisations are aiming to achieve the efficient and effective utilisation of public resources.

Principle 32: Regional and local governments have resources and adequate fiscal autonomy for exercising their competences, with financial oversight to foster responsible financial management.

Comment: This Principle addresses the need for subsidiary governments to have available to them a level of resources commensurate with their needs. This is a very important consideration in discouraging such organisations from taking

Index[1]

[1] Note: Page numbers followed by 'n' refer to notes.

N. Hepworth, *Public Financial Management and Internal Control*,
https://doi.org/10.1007/978-3-031-35066-5