CHAPTER 10
INTERNAL CONTROL AND INTERNAL AUDIT

A. Introduction

With the creation of the European Union and the current process of enlargement it is possible to get an increasingly clear overall view of the internal (management) control systems that different countries use to handle the management of revenue and expenditure. The picture that emerges reveals great variety in methods and procedures but at the same time a number of recurring features. Moreover, although this book is focussed on expenditure management issues in the public sector, it should be stressed that the approach to financial control is remarkably similar in the public and private sectors. It is, of course, essential in any organisation to ensure that financial control is proportionate, timely and effective, and that it is kept under permanent scrutiny to ensure that control systems do not become ends in themselves.

This chapter describes the concept of internal (management) control and internal audit systems and how these are applied in different countries, with an emphasis on European practice (Sections B and C). It also reviews in Section D the issues relating to control of funds channelled through the EU budget.

The essential features of control systems in the public sector and private sector are as follows:

- Identification of risk.
- The development of internal control systems and procedures to counter the perceived risk.
- The establishment of an internal audit procedure for checking that the systems of internal control are countering the perceived risk, and of identifying risks not covered, or not adequately covered, by the existing systems and procedures.

The concept of risk covers the following elements:

- Misuse, including waste, of financial, human and technical resources, including external aid.
- Failure to execute budgetary and other policy decisions in a regular and efficient manner.
- Fraud and error.
- Unsatisfactory accounting records.
- Failure to produce timely and reliable financial and resource management information.
B. Internal Control

1. Introduction

Internal control systems are those established in order to counter the perceived risk described above. It is clear, however, that such systems will vary widely from country to country and will reflect administrative culture and tradition. A system that works well in one country may not transplant successfully to another. The main test of a system is how effective it is on the ground.

Internal control may be defined as the organisation, policies and procedures used to help ensure that government programmes achieve their intended results; that the resources used to deliver these programmes are consistent with the stated aims and objectives of the organisations concerned; that programmes are protected from waste, fraud and mismanagement; and that reliable and timely information is obtained, maintained, reported and used for decision-making.¹

The way in which financial control is practised varies considerably from one European country to another. One broad approach, found in France, Portugal, Spain and many other continental European countries with a legal tradition based on the Napoleonic Code, puts emphasis on the controls that are exercised by a third party organisation, at the centre of government, often an agency of the ministry of finance or that

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**Box 10.1. KEY UK CONTROL ARRANGEMENTS AND RESPONSIBILITIES**

• Ministers are answerable to Parliament for the activities of their departments (i.e. ministries).

• Accounting officers (the senior full-time official responsible for the management of a department) are held personally responsible for:
  
  • Regularity and propriety of transactions.
  
  • Keeping proper accounts.
  
  • Prudent and economic administration.
  
  • The avoidance of waste and extravagance.
  
  • The efficient use of resources.
  
  • Ensuring compliance with the requirements of parliament for controls.

• Departments cannot legally enter into commitment/spending without Treasury (the UK Ministry of Finance) approval. In practice, the Treasury has delegated this responsibility to departments and does not “micro-manage” approvals except for very large projects or unusual transactions.

• The Treasury sets government wide standards for systems of accounting, financial management and control, and internal audit.
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ministry itself. A second approach, found in European countries such as the Netherlands, and the UK (see Box 10.1), and the Scandinavian countries emphasises that responsibility for control issues has been decentralised to the head of line ministries and other budget entities, or sometimes to officials in the budget and finance departments of these organisations. However, the latter approach does not mean a relinquishment of centralised control since the ministry of finance remains responsible for the overall consistency and effectiveness of the government’s internal (management) control system. In some countries, a mixture of elements of the two approaches may be found.

The examples cited in this section have been limited to financial transactions, e.g. where expenditure for a service or a training course or the purchase of equipment is involved. They could equally well have referred to the receipt of revenue. But the scope of internal control goes wider and ultimately should incorporate the following control procedures (see also Box 10.2):

- Clear instructions and appropriate training to all staff on the objectives, policies and code of conduct of a ministry or agency.
- An unambiguous definition of the responsibilities of staff, in particular of delegated responsibilities.
- Clear separation of function between staff members involved in handling financial transactions or resource management operations, particularly contracts.
- Development of an “open” culture to encourage staff at all levels to draw attention to non-compliance or irregularity.
- Insistence that staff at all levels are aware of and apply all relevant instructions.

Box 10.2. FINANCIAL CONTROL CHECKLIST

SIGMA uses the following four basic questions when assessing the development of the financial control system in a country. These questions should of course be followed up in more detail:

1. Is there a coherent and comprehensive statutory base in place that defines the principles and procedures of financial control and internal audit?

2. Are there effective internal control systems and procedures in place? Do these scrutinise relevant areas of an organisation’s activities, namely: accounting systems, procurement, ex ante control of expenditure, revenue control, audit trail and reporting systems?

3. Is there a functionally independent internal audit/inspectorate mechanism in place, with relevant remit and scope?

4. Are there systems in place to prevent and take action against irregularities and to recover amounts lost as a result of irregularity or negligence?

As noted above, the term financial control usually refers to the financial aspects of internal control. Such controls may be either ex ante or ex post. The European Commission attaches a slightly different meaning to the term “financial control”. In this context, “financial control” covers both what the Commission terms “internal financial control” and “external financial control”. The former term is synonymous with what is usually referred to as financial control, while the latter describes what is usually referred to as external audit. As used by the European Commission, the key difference between the terms financial control and audit is that financial control includes both ex ante and ex post controls, whereas audit exclusively covers ex post controls. To further clarify the issue, the Commission is now using the term “Public Internal Financial Control Systems” or simply PIFCS when addressing the issue of financial control (see Box 10.3).

**Box 10.3. PUBLIC INTERNAL FINANCIAL CONTROL SYSTEMS**

Based on its experience in the candidate countries, the European Commission (DG Financial Control) frequently uses the term “public internal financial control systems” (PIFCS) in assessing the progress made by these countries in meeting the requirements for EU membership. PIFCS covers:

*Public*, covering all control activities in the public sector.

*Internal*, covering controls exercised by central and decentralised government agencies as opposed to external controls exercised by a body outside the government (e.g. the supreme audit institution).

*Financial*, to stress the financial (administrative, managerial or budgetary) character of the activities to be checked.

*Control*, meaning all activities to oversee the entire field of financial management, enabling the government to be “in control” of its finances (therefore comprising all control tools such as ex ante control and ex post audit); and

*Systems*, covering organisations, staff training, methodology, reporting, responsibilities, sanctions and penalties.

*Source*: European Commission, DG-Financial Control, April 2000.

### 2. Responsibility for internal control

In Member States employing the first of the two approaches described above, the ministry of finance not only plays a key role in preparing the budget and allocating funds to line ministers, but also in intervening directly with an ex ante control by its own staff in the line ministries. In Member States using the second approach, each line ministry takes full responsibility for spending its own budget and for ensuring appropriate checks and safeguards. It should however be noted that this in some cases is a responsibility originally delegated from the ministry of finance and over which that ministry retains powers of supervision and regulation to ensure that a consistent approach is applied in all spending units.
Following criticism by the European Parliament of financial management practices within the European Commission which led to the resignation of the entire Commission in March 1999, a Committee of Independent Experts concluded that “the existence of a procedure whereby all transactions must receive the explicit prior approval of a separate financial control service has been a major factor in relieving Commission managers of a sense of personal responsibility for the operations they authorise while doing little or nothing to prevent serious irregularities.” The committee recommended that a professional and independent Internal Audit Service should be set up reporting directly to the President of the Commission, that the existing centralised pre-audit function should be dispensed with, and that internal control — as an integrated part of line management — should be decentralised to the Directorates-General in the Commission. The Commission announced in January 2000 that it would accept this recommendation, and a reorganisation of the Commission services began later that year.

In general, the term management control or internal control describes the systems, processes and methods of managing activities rather than a specific unit in a ministry or government agency. It is interesting to note, however, that the Committee of Independent Experts referred to above recommended that a specialised internal control function should be established in each Directorate-General of the Commission. This function should be exercised under the responsibility of a senior official reporting to the Director General or Head of Service and an accounting function exercised under the responsibility of a delegated accounting officer.

**Box 10.4. KEY ELEMENTS OF EFFECTIVE SYSTEMS OF FINANCIAL CONTROL**

- Strong central ministry responsible for all financial matters.
- Central standards for accounting, financial reporting and internal audit and a system to enforce these standards.
- Clear and transparent lines of accountability for organisational units and government officials.
- Effective and coherent systems and procedures for ex-ante control (wherever situated).
- Clear, comprehensive and transparent procedures for financial and performance reporting of all public sector entities.
- Strong external oversight by parliament and an effective public sector external audit.

**3. Prerequisites for effective control**

Internal controls are the responsibility of the leadership of an organisation. Therefore, to establish and maintain effective internal controls, the top leadership of the organisation must, first of all, be committed to the effective management of the entity and demonstrate personal integrity and professionalism. Only if sufficient leadership and commitment are in place will it be possible to establish and maintain an effective system of controls. Other key elements of a financial control system are described in Box 10.4.
Internal (management) control requires a strong control environment as well as a coherent framework of control systems and procedures (see Box 10.5). The control environment includes management’s philosophy and operating style, the assignment of responsibility and the policing of internal (management) control systems and procedures. It therefore affects the way in which control systems and procedures operate in the organisations concerned.

### Box 10.5. FINANCIAL CONTROL ENVIRONMENT

The main risks in the financial control environment are:

- Inadequate management integrity and weak ethical values.
- Inadequate management commitment to professional competence among staff and inappropriate assignment of authority and responsibility.
- Inadequate management oversight.
- Inadequate management policies to prevent monitor and respond to illegal acts.

The consequences of a weak financial control environment include:

- Expenditure for purposes other than originally intended.
- Inappropriate or misleading reporting.
- Financial losses.
- Loss of public confidence.
- Increased risk of fraud and corruption.

The next requirement is a careful and thorough assessment of the risks facing the organisation and an identification of useful controls to manage those risks. In a complex organisation, this can be a difficult task and one for which the leadership of the entity may wish to seek expert assistance. Internal and external auditors are frequently the source of such assistance. Whatever assistance is obtained, however, it is essential that the leadership of the entity remain involved throughout the process and especially in the decisions about the control arrangements to be put in place. The controls that are implemented must be ones that the management will actually use, even when they create some inconvenience in day-to-day operations, and must be used throughout the entity. Few things weaken the credibility of the system more than the introduction of controls that are then left on the shelf.

The controls must therefore be cost-effective. They must not be so detailed and onerous as to paralyse the organisation. And the cost of the control systems must not be out of proportion to the risk they
are intended to avoid. This point is stated briefly, but is extremely important: “red tape” is an ever-present risk, and there can be a temptation to introduce new controls even when there is no need for them.

Because of the importance of management controls in assuring the effective control of public funds and the proper execution of the budget, the budget department of the ministry of finance in many governments plays an active role in strengthening the management controls of the operating units.

4. Types of internal (management) control

Because internal (management) controls must be designed for the individual circumstances of a particular entity there is no universally applicable list of controls. However, it is possible to describe categories of controls and the circumstances in which they might be appropriate.

- Financial accounting and reporting. The importance of these tasks is discussed at length in Chapters 11 and 12.

- Performance monitoring. This subject is examined thoroughly in Chapter 15.

- Effective communications. Managers should recognise that subordinates perform better if they have a clear understanding of the mission and goals of the organisation and the purpose being served by the activities they are asked to perform. Channels of communication are part of the management control system. For example, managers should communicate their performance expectations to subordinates, who should then define the expectations for their components of the organisation that are needed to accomplish the overall goals of the organisation. It is important that communications flow upward as well as downward. When management sets clear goals and expectations, workers can often suggest ways of achieving greater efficiency in the attainment of those goals. Management should pay careful attention to such suggestions, as front-line workers are often aware of procedural inefficiencies that escape the notice of senior managers.

In addition to ensuring that the goals of the organisation are achieved, however, managers are also responsible for ensuring that the resources available to the organisation are protected against improper use. A variety of devices might be used for this purpose:

- Physical controls. These would include, primarily, the security procedures intended to control access (e.g. to accounting records or to inventories of items — and to the items themselves — that have high value and might be easily stolen).

- Accounting controls. These include the procedures by which transactions are required to be recorded in the accounting system. For example, there might be a requirement that all cash receipts be deposited daily in a bank. The person who collects the cash might be required to provide a written receipt to the payer and to file a copy with the accounting clerk. The person who deposits the cash in the bank would be required to file a copy of the bank receipt with the accounting clerk. Accounting controls also include the internal procedures within the accounting systems that are intended to detect and report any anomalies. In this example, the accounting clerk might be required to reconcile the two reports — of cash collection and cash deposit — to report any discrepancies. Another typical accounting control would apply to expenditures, which would be compared with the budget or other authorisation. Expenditures that depart from the expected pattern would be reported while expenditures that exceed the maximum authorised amount would be blocked.
• **Process controls.** These are the procedures designed to ensure that actions are taken only with proper authorisation. For example, the issuance of a purchase order or the approval of a sizeable contract might require documentation from the requesting official, review by a purchasing clerk, and approval by a supervisor. Large purchases might require approval from a higher official. Payments to contractors might require documentation in the form of the original purchase order, a voucher from the contractor describing the goods and services provided, and a certification from the receiving official that the goods and services were received. Payments above a certain amount might require review and approval by a higher authority. In some countries, personnel standards are an important part of the management control system. Applicants for a post undergo rigorous examination and must receive a qualifying certificate before assuming the position.

• **Procurement controls.** These were discussed in Chapter 8.

• **Separation of duties.** This is both a control measure and an indispensable element of many control systems. The central feature is that, in any transaction, at least two people should be involved to minimise the risk of improper actions. In the previous example concerning the handling of cash receipts, one person collects the cash, another makes the bank deposits, and a third reconciles the cash receipt documents and enters the data in the accounting records. Separation of duties in this way is an essential element of almost every financial control system, but its use can be overdone. If carried to extremes, however, it can severely degrade the efficiency of an organisation and impair its ability to accomplish its mission efficiently.

• **Internal audit.** For a full discussion, see Section C below.

### 5. Limitations of internal control

No system of controls can be an absolute guarantee against the risk of wrongdoing or honest error. Any system that attempted to reach that goal, especially in a complex organisation, would impose costs far out of proportion to the risks and would create rigidities for the organisation. Thus, the proper goal of the control system should be to provide “reasonable assurance” that improprieties will not occur or that if they occur, they will be revealed and will be reported to the appropriate authorities. With this in mind, managers should be aware of certain risks involved in building and maintaining management control systems.

• **Design flaws.** It has been stressed that internal (management) control systems must be designed for the specific organisation, operations, and environment in which they will function, after careful consideration of the risk involved in that particular situation. Managers are sometimes tempted to shortcut the design process, for example by adopting the control systems designed for another organisation. This can be dangerous. A flawed design may leave the impression of safety but may overlook important risks in one part of an operation while creating unnecessary rigidities in another.

• **Poor implementation.** The best-designed system will achieve its goal only if it is implemented properly. Managers and supervisors at all levels must be vigilant to ensure that everyone complies with applicable control procedures. Even more importantly, the required procedures must be ones that employees will appreciate and accept, and which they will not be tempted to ignore when the procedures become inconvenient or in times of pressure and stress. Meeting this criterion is one of the key considerations in the design of effective control systems. Managers should also plan ahead for alternative arrangements that might need to be put in place in the event of an emergency requiring the regular procedures to be bypassed.
• **Poor response to reported anomalies.** Control systems are designed to call attention to events that depart from normal expectations. For the systems to remain effective, therefore, it is essential that supervisors and managers respond properly to alerts. The triggering event should be investigated promptly to determine if an irregularity was involved. If so, corrective action should be initiated. Failure to respond effectively to reports of anomalies will quickly undermine the effectiveness of the control system. This should also be a factor in the design of control systems. However, care should be taken to avoid making the systems so sensitive that they yield frequent “false alarms”. If this happens too frequently, valid alarms might be ignored.

• **Collusion.** Any system of controls can be defeated if a sufficient number of dishonest key individuals conspire to subvert them and are able to falsify the relevant documents. A sufficiently complex set of controls can make it difficult to assemble the needed number of conspirators, but at a potentially great cost in organisational inefficiency. Conspiracies of this sort usually come to light when they are observed (and reported) by someone who is not a party to the conspiracy, or when there is a falling out among conspirators. They may also be detected during a routine audit if substantial amounts of funds are involved or if the conspirators are not sufficiently careful in falsifying the documents.

• **Wrongdoing by top managers.** Internal (management) controls are designed to help control the organisation on behalf of its management, not to control the top managers themselves. There are many examples of dishonest top managers evading the control systems to commit various forms of fraud and abuse. In a large organisation, however, such activities are usually noticed by subordinates. Thus, the best protection against wrongdoing by top managers may be an environment of openness, in which workers are encouraged to report evidence of irregularities, confident that they will not be punished for being disloyal to their superiors. Such openness in an organisation becomes part of the control environment.

Internal (management) controls are an essential part of the structure and operations of any organisation. The larger and more complex the organisation and its activities, the more care must be given to the design of the control systems. To be fully effective, control systems need the active support of managers in installing and maintaining them.

### C. Internal Audit

1. **Introduction**

   The Institute of Internal Auditors defines internal audit as follows:

   “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 effectiveness of risk management, control, and governance processes.”

   Internal audit is a concept which flows logically from internal control.

   European models for specialised financial control organisations correspond to the two approaches — centralised and localised — referred to in Section B above. In Portugal, for example, a centrally placed Inspectorate General for Finance (IGF) reports directly to the Minister of Finance and is responsible
for ex post financial control of all public expenditure and revenue of the government administration. In addition to the IGF, line ministries have their own control organisations (Inspectorates General). By contrast, the Internal Audit Service of the UK’s Ministry of Finance is not responsible for financial control of public expenditure and revenue as such, but rather for ensuring that management/internal control systems in the line ministries, including the ministries’ own specialised financial control organisations (Internal Audit units), are properly enforced. Many central and eastern European countries have until now had no specialised financial control organisations as such, but have a “control office”, which inter alia investigates allegations of irregularities and fraud before turning the cases over to the courts. Most central and eastern European candidate countries are transforming such functions into genuine financial control organisations.

The European Commission introduced its own internal audit function in 1990 by creating a special service in the existing Directorate-General for Financial Control. The European Commission’s internal audit service was given the mandate to carry out a financial audit in each Directorate-General every three to five years. These audits examine the budgetary and financial systems and carry out substantive tests on a sample of transactions. They then draw conclusions as to the strengths and weaknesses of the systems and make recommendations for any necessary improvements. A follow-up audit is carried out 12 to 18 months later. In addition to financial audits, the internal audit service has been developing a performance audit capacity, and has increasingly been called upon to investigate problem areas as a result of which it has identified substantial amounts for recovery.

Many candidate countries have no systematic internal audit procedures as such, but some have a “government control office” or “control corps” based on the practice of the pre-independence regime, which investigates complaints against staff received from the public and may also investigate allegations of irregularity and fraud before turning the cases over to the criminal or fiscal police. Such units do not appear to audit financial management on any systematic basis.

2. The mandate of the internal auditor

The internal auditor carries out his functions, as defined above, by looking into how a selection of the transactions have been processed and also, indeed primarily, by assessing how well the systems and procedures of internal control function. In practice, the internal audit service should cover two main types of activity — financial audit and performance audit:

- **Financial audit**: Audit of budgetary and financial systems with compliance tests (“walk-through”) and substantive tests of actual transactions. Financial audits are generally carried out on the basis of an annual plan providing for each department within a ministry or agency to be covered at least once in the course of a multi-annual cycle. Financial audit may also involve a specific assessment of the effectiveness of accounting systems, including IT system safeguards and reporting facilities.

- **Performance audit**: Performance, or “value for money” audits, which should also be part of an annual plan, cover the extent to which established objectives and specific programmes of the ministry or agency have been achieved or implemented, taking into account the extent to which they have been achieved — or not achieved — at a cost commensurate with the risk, and in an accurate and timely fashion with minimal use of resources.

Internal audit may also cover a specific analysis of staff resources with a judgement on the extent to which they correspond to the objectives of the ministry or agency and the tasks it is required to carry out. See Box 10.6 for some examples of issues typically examined by an internal auditor.
3. The independence of the internal auditor

The internal auditor should be responsible to the minister or secretary-general of a ministry or agency, giving technical advice on the efficient management of resources without becoming involved in political questions. In EU Member States where internal audit is carried out by a centralised Inspectorate-General of Finance, the independence of this office is ensured by its reporting directly to the minister of finance. In other countries the internal auditor reports directly to the head (top official) of the ministry or agency. Practice varies in the candidate countries. The “control office” inherited from the pre-independence regimes tends to report directly to the minister or to the prime minister’s office in some cases.

It is important to be clear about the nature of the internal auditor’s independence. It should not be compared with the independence of the external auditor (e.g. the supreme audit institution) who reports directly to the parliament or budgetary authority and whose independence is normally reinforced by the tenure and security of his appointment and safeguards against unjustified dismissal. The internal auditor is responsible to the head of the ministry and is part of the staff of the ministry or agency. The Institute of Internal Auditors defines independence in the following terms:

“Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgements essential to the proper conduct of audits. It is achieved through organisational status and objectivity.”

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**Box 10.6. WHAT DOES THE INTERNAL AUDITOR LOOK FOR?**

The first concern of the internal auditor is that systems and procedures are in place to ensure that resources are used in accordance with the relevant rules and regulations. This will often involve, particularly in the EU context, a requirement that an adequate sample of transactions or products is checked by the national authorities.

In the case of agricultural expenditure, for example, the auditor will wish to have solid evidence that grants to aid livestock or crop production have been used for that purpose, and have gone to farmers eligible to receive them.

Similarly, grants for training the unemployed must be shown to have been used for the intended purpose and for real and eligible applicants.

In the EU context, a common problem found by the auditor is that funds are claimed for estimated expenditure rather than for expenditure which has actually been incurred and paid.

In the area of public procurement the internal auditor will seek assurance that there has been adequate publicity for calls for tender, that there are satisfactory procedures for receiving and evaluating tenders and that the justification for the award of contract is in accordance with national and/or EU requirements. A Commission study in the late 1980s suggested that the European taxpayer would have paid some 20 billion ecu less each year if public procurement throughout the Community had been in accordance with EC Directives.

Overall, the internal auditor will look for evidence that programmes and actions have achieved their objectives.
It goes without saying that, as the Institute of Internal Auditors stresses, “internal auditors should be independent of the activities they audit.” There can be no question of an official responsible for, say, allocating housing grants subsequently carrying out an internal audit of the systems and procedures used in the allocation of these grants.

Since the internal auditor is not independent of the ministry or agency in which he functions it is essential for the internal audit function to achieve an appropriate status and weight in the organisation. One of the means of reinforcing the status of internal audit is to have an audit committee with, preferably, the head of the ministry or agency in the chair. The committee should include representatives of the ministry’s senior management in addition to financial management and audit specialists. The private sector as well as the public sector has come to recognise the value of the audit committee in ensuring that all levels of staff take internal audit seriously and give their full co-operation to the auditors. The development of such attitudes on the part of the staff will help create the right conditions for effective management (internal) control. An important function of an audit committee is to identify the areas to be covered by the ministry’s future audit programme and the conclusions to be drawn from ongoing audits.

4. Relation of internal audit to internal (management) control and to external audit

The internal auditor should not be involved in the internal (management) control process which he is required to assess and judge. There is clearly no objection to — and a great deal to be said in favour of — the internal auditor being asked to give an opinion on, or carry out a “pre-audit” of, the systems and procedures being prepared for a new action or programme. Internal audit should not, however, become part of, or be associated on a permanent basis with, internal control. It is essential that internal audit keeps its distance, so that line management recognises its responsibility for internal control and its interest in demonstrating that it is maintaining efficient internal control through its own efforts.

The relationship between the internal and external auditor can be fraught if the external auditor is seen as the supervisor or assessor of internal audit. It should be possible to establish an intelligent relationship in which each side clearly appreciates the role and responsibilities of the other side. While the external auditor may find room for improvement in the work of the internal auditor or may even be called upon to audit his work, this need not prevent a sensible working relationship based on partnership. There can be fruitful exchanges of views, experience and information on methodology, and valuable time and resources can be saved if the two sides have confidence in each other’s work and plan their own work accordingly. This can be done without any blurring of the distinctive features and objectives of the two types of audit.

It is essential for both auditee and auditor that a clearly defined audit trail is available. It enables the auditee to keep constantly under review the timely and adequate flow of funds and the procedures for efficient accounting, and the reconciliation of expenditure reports with the funds received or claimed. Box 10.7 and Figure 10.1 illustrate the main requirements for an audit trail and a basic chart for the flow of funds and information, together with the corresponding control functions in the context of EU Structural Fund payments to Member States. An indicative description of information requirements for the audit trail is provided in Commission Regulation No. 2064/97 dealing with the financial control by Member States of operations co-financed by the Structural Funds.

5. Financial control of external aid

The general rule in dealing with external aid, whether incorporated into the national budget or not, is to use the national financial control mechanisms (internal control, internal audit, external audit) to ensure proper and efficient use of the aid.
It is for the beneficiary country to demonstrate that its financial control mechanisms are adequate to ensure sound financial management of the aid and that the aid can be channelled through existing systems. Where this is not the case solutions should be found, in consultation with the ministry of finance, through

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**Box 10.7. AUDIT TRAIL**

The auditor will almost always need an audit trail in one form or another.

In the context of national or subnational budgets, it will be necessary:

- To trace the budget provision that authorises payment.
- To check the transfer of funds authorised by the ministry of finance (or treasury) to the line ministry and/or to the regional or local office.
- To trace and evaluate the systems/procedures through which approval for payment to the contractor or beneficiary will be required to pass.
- To locate completed payment files with evidence that payment has — or has not — been made in accordance with rules and regulations.

In the EU context it will be necessary:

- To identify the EU budget provision authorising funding.
- To locate the flow of funds from the European Commission to the ministry of finance.
- To trace the flow of funds to the line ministry responsible for administering funding and identify procedures for registering arrival and onward movement of these funds.
- To trace the flow of funds through regional and local offices and check procedures for registering arrival of funds, and the availability of national co-financing where appropriate, and identifying programmes and projects for which they are intended.
- To ensure that EU and national funds are available for payment to the fund beneficiary on production of the appropriate proofs of expenditure and work or service completed.
- To trace in reverse the flow of eligible expenditure back through local and regional offices to the ministry responsible for administering funding.
- To reconcile the proof of eligible expenditure for one project, or a series of projects, with funds initially received and with the report back to the Commission.

Examination of the audit trail can be helpful to both the Commission and the Member State in identifying possible delays in the flow of funds and the implementation of projects and possible difficulties in identifying items of expenditure, and in reconciling the actual use of funds with the amounts initially transferred. It can also highlight weaknesses or gaps in the control procedures.
specially created programme management units or through a network of implementing agencies linked to line ministries, with funds being channelled through a mechanism located in or attached to the ministry of finance (e.g. the National Fund in the case of EU pre-accession funds — Phare, ISPA and SAPARD — see Section D below).

As in any internal (management) control situation, it is essential to base the controls on a realistic assessment of the risk in the country concerned, but the tendency of international organisations, for perfectly valid reasons, is to apply their “house rules” across the board. This is no doubt inevitable, but as a compensatory measure, an attempt should be made by the international organisations to harmonise as far as possible these rules in order to facilitate the task of beneficiary countries in managing funds and to make maximum use of their existing systems. For their part, beneficiary countries can facilitate fund management by making one ministry — normally the ministry of finance — the co-ordinating body for external aid.

**Figure 10.1. EXAMPLE OF AN AUDIT TRAIL FOR EU FUNDS**
D. Financial Management of EU Funds in Candidate Countries

1. Introduction

The (questionable) practice in most of the central and eastern European countries that have received grant-based assistance (also called non-refundable technical assistance) from the EU and a number of bilateral and multilateral donors has been not to include such assistance in either budget planning or the budget execution process.

The reasons are several:

• As it was seldom within the power of the governments to decide on priorities for the use of such funds, and planning often took place outside the normal budget process, it made little sense to try and include the funds in the budget. In the case of aid received from bilateral donors, the amounts received are often not known by the recipient government.

• Aid funds often bypass normal controls by the state treasury.

• The procurement of services, supplies and works using the funds made available is generally the responsibility of the donor and not the recipient.

Some of the multilateral donors have already begun introducing greater responsibility to the recipient countries for the use of funds provided through loans or grants. The EU, for example, introduced the Decentralised Implementation System (DIS) several years ago, which gradually has shifted more and more of the responsibility for managing funds to the recipient country. The National Fund system is a further decentralisation and the “Memorandum of Understanding on Establishment of the National Fund” signed by the Commission and candidate countries (at differing dates) defines the National Fund as “the central treasury entity within the ministry of finance through which the Community funds are channelled towards the recipient”. The recipient country is responsible for the overall financial management of EU funds received during the period leading up to full membership of the EU (i.e. the “pre-accession funds”) including procurement through the Commission’s DIS system.

As the National Fund system transfers more of the management and control functions to the national administrations the overall responsibility and accountability for managing the system will be placed with the national senior officials in charge. In the case of mismanagement or misuse of funds the European Commission can require that the funds be reimbursed.

As a result of the introduction of the National Fund system, candidate countries need to adapt and strengthen their procedures for managing and controlling public funds. In particular, internal control and internal audit functions have to be introduced or improved. Accounting and public procurement systems also need upgrading in order to comply with European Union standards. Strengthening public expenditure management systems is a pre-accession requirement and a pre-requisite for effective management of EU funds. (Annex II sets out the main issues that need to be considered in establishing a National Fund system and the surrounding budget and control mechanisms).

A glossary of terms relating to the establishment of the National Fund, and related procedures, is shown in Box 10.8.
**Box 10.8. NATIONAL FUND — DEFINITIONS**

- **Decentralised Implementation System (DIS)**
  Implementation system of the Phare Programme where part of the management responsibilities have been transferred to the recipient country whilst the Commission retains the final responsibility under the EC Treaties.

- **Central Finance and Contracts Unit (CFCU)**
  An implementing body within the national administration in charge of tendering, contracting and making payments for Phare-funded projects. A Senior Programme Officer is responsible for technical implementation of the programme of these projects.

- **Implementing Agency (IA)**
  An implementing body within the national administration in charge of tendering, contracting, making payments and technical implementation of projects.

- **Joint Monitoring Committee (JMC)**
  A committee, consisting of the NAO, NAC, the PAOs and European Commission representatives, in charge of the review of Phare programmes and pre-accession measures.

- **National Aid Co-ordinator (NAC)**
  An official of the national administration (in most cases a minister) with overall responsibility for planning and managing EU-funded programmes in recipient countries. The NAC also ensures a close link between the general accession process and the use of Community financial assistance, and is responsible for the monitoring and assessment of Phare programmes.

- **National Authorising Officer (NAO)**
  An official of the national administration heading the National Fund. The NAO is responsible for the financial management of pre-accession funds.

- **National Fund (NF)**
  The central cash-management entity, usually within the ministry of finance, through which EU funds are channelled to beneficiaries.

- **Perseus**
  The financial reporting system of the European Commission, linked to DIS.

- **Programme Authorising Officer (PAO)**
  An official of the national administration heading an Implementing Agency or the CFCU. The PAO is responsible for the operations of the IA/CFCU and for the sound financial management of the projects to be implemented.

- **Senior Programme Officer (SPO)**
  An official of the national administration (line ministry/agency) in charge of the technical implementation of projects in cases where the CFCU is responsible for the administrative and financial implementation of the projects.
2. Including EU funds in the national budget

In many of the candidate countries, the external grant based resources are not part of the annual national budgeting process. This tends to reduce the scope for priority setting and can lead to overlapping and non-optimal resource allocation. As a result, the total resources available for a given area or ministry are not known accurately and the process is not transparent and difficult to control and monitor.

In order for a country to include external resources in the national budget process it is necessary to have an estimate of the amount of funds likely to be made available. Until recently this has rarely been the case. With the guidelines for Community assistance issued in 1999, it is now possible to include priorities and target schedules within the multi-annual Accession Partnerships. It should thus become possible for each country to include both the assistance and the co-financing for particular activities in the budget either under a specific budget line or as an overall line for external grant-based resources. The former approach seems to be more desirable from a priority setting and transparency point of view. It is, however, of paramount importance that the amount of funds and priorities are agreed between the Government and the donor before the budget process is completed for the following year.

In many countries, this may mean that the budget law should include a provision for external grant-based resources (if this is not already the case) and that ministries of finance in their yearly budget instructions should include directions on how the assistance is to be included and presented in the budget documentation.

3. Choosing a model for the financial management of EU funds

With regard to budget execution, countries vary in terms of the system they have established and the degree of financial independence given to each ministry. Many candidate countries have established a treasury system through which all national budget funds are managed. Others have delegated this responsibility to line ministries and other state institutions. When it comes to the management of external resources, it is generally recommended to follow the existing system of the administration. There is no single “standard” solution for establishing a National Fund system; each country will have to develop its own system, which matches the administrative structure and culture of that country.

In some countries, the possibility of establishing a separate institution for the management of Community assistance has been discussed. So far as possible, countries should use existing structures of the administration and upgrade these structures, if necessary, to comply with the requirements of the National Fund system.

The main issue is to determine the division of responsibilities between the National Fund and the Implementing Agencies in particular with regard to payments. In general, the Memorandum of Understanding between a candidate country and the European Commission foresees a division of responsibility between the National Fund and the Implementing Agencies. Under this arrangement, the National Fund takes responsibility for the overall financial management of the Community assistance and the Implementing Agencies are responsible for financial and technical implementation of specific funds/grants. Payments may be executed in either of the two ways (a) or (b) described below.

a. Using the treasury

In countries with a developed treasury system responsible for managing the national budget, it is logical for the National Fund system to be placed inside the treasury. Under this approach, the treasury’s main
responsibility in relation to the National Fund would be the financial management and execution of payments for the contracts concluded by the Implementing Agencies (see below). The treasury/National Fund would also make requests for funds to the European Commission, run the accounting system and prepare financial reports. As most treasuries are not banks themselves, the treasury would need to open bank accounts with commercial banks or the central bank of the country concerned.

b. Using a separate National Fund organisation

For countries that do not have a state treasury but where the individual ministries are responsible for financial management and hold their own bank accounts, a separate National Fund organisation/agency should be established under the ministry of finance. The National Fund will then act as a treasury for managing Community assistance.

In designing the system, a decision is required about who is authorised to make payments on the relevant accounts (which according to the Memorandum have to be opened by the National Fund). The payments can either be made by the National Fund or the Implementing Agencies. Responsibility for ensuring that financial management procedures are carried out correctly should be with the National Fund.

Some countries with a treasury system, however, may choose to establish a separate organisation for implementing the National Fund system, i.e. a parallel treasury. Under this approach, the accounts may still be run through the treasury or it may also be decided to establish separate accounts for EU funds outside the treasury. The main disadvantage with this approach is that there may be a duplication of functions with the treasury.

From a financial control point of view, it should be determined whether the institution is under the authority of an existing internal audit unit (e.g. within the ministry of finance) or whether a new internal audit function needs to be established.

4. Implementing agencies

The administration, and the financial and technical management, of programmes and projects funded by EU pre-accession aid (ISPA and SAPARD) and the Phare programme is carried out by Implementing Agencies. The Implementing Agencies are responsible for the design of projects and the entire procurement process according to the Phare Decentralised Implementation System together with the supervision of projects. Payments on the relevant contracts are either made by the Implementing Agencies themselves or the National Fund depending on which model has been selected — see above. If payments are made by the National Fund, the Implementing Agencies verify that they have received the required supplies or services and request that payment be made.

The National Fund should in all of the above examples conclude an agreement with each of the Implementing Agencies. This agreement sets out the responsibilities of the Implementing Agencies. Additional secondary legislation may be needed depending on a country’s administrative system.

The Implementing Agencies can be either departments of ministries or dedicated procurement units. In some cases, Implementing Agencies have been created out of units that were involved with the implementation of Phare projects in previous years. Some experience with procurement under the decentralised implementation system is valuable. As described in Box 10.8, the Implementing Agencies operate under the supervision of a Programme Authorising Officer (the PAO).
5. Internal audit and control

The required internal audit functions should be carried out by the internal audit departments of the relevant line ministries. The internal audit department of the ministry of finance (or another body with overall responsibility for internal audit) may consider it necessary to participate in the internal audit of all Community assistance for a transitional period and, on a continuing basis, ensure that the standards and procedures for internal audit are implemented by the internal audit departments in the ministries concerned. This will be in addition to its overall and permanent responsibility for providing guidance and co-ordination to line ministries in relation to internal audit.

6. Monitoring

As required by Article 15 of the Memorandum of Understanding on the Establishment of the National Fund, a Joint Monitoring Committee should be established to review the progress of the Community assistance programmes. The National Aid Co-ordinator, National Authorising Officer, representative(s) of the European Commission and the PAOs of the Implementing Agencies, are the required representatives of this committee.

The Joint Monitoring Committee is assisted by Monitoring Subcommittees, which should be established on either a sectoral or a programme objective basis. The Monitoring Subcommittees will have the NAO, PAO and representatives of their Implementing Agency and of the European Commission as members. The Monitoring Subcommittees are established in order to review progress on the projects for which they are responsible on a regular basis.

7. Training of staff

A number of the officials involved in the National Fund system may already be familiar with the Phare Decentralised Implementation System e.g. through previous work in project implementing units. However, officials in the control and audit functions may have no prior knowledge of the Community procurement rules.

Training — both formal and on-the-job — of all officials involved in the National Fund system (treasury, National Fund, Implementing Agencies, internal audit departments and the supreme audit institution) should be arranged on the Community procurement rules. Exchanges of experience between Implementing Agencies can be helpful in improving the overall performance of the system, as can the experience of countries that are further ahead in this field.

8. Ensuring the operational effectiveness of the system

Considerable effort and planning will be necessary to establish the National Fund and the supporting control system. It may be necessary, as mentioned above, to implement specific secondary legislation that clearly sets out the role and responsibilities of the officials and institutions involved. It is also recommended to develop a set of instructions and guidelines, in operational manuals, which lays down the activities and responsibilities of these institutions.

The instructions and guidelines should cover:

• The internal procedures of the National Fund and/or treasury for managing EU funds.

• The procedures for managing transactions between the National Fund and the Implementing Agencies.
• Templates for standard documentation.

• The procedures for operating the bank accounts.

• The ex ante control and internal audit procedures.

• The monitoring procedures.

Preparing for the setting up of a National Fund system is a very time consuming exercise and should not be underestimated. All the institutions involved have to be part of the process of establishing the system, training the staff, and building the necessary working culture. In particular, ensuring that the necessary controls and control points are in place and that staff have been sufficiently trained seems to be a more complex task than most expect. Accounting, reporting and monitoring systems are often overlooked aspects, which require the right organisational structure, staffing and training before being implemented. For further discussion, see Annex II in this book.
NOTES

1. See also INTOSAI standards (1992), and SIGMA (1996c).


3. Definition approved by the Board of Directors of the Institute of Internal Auditors in June 1999.


5. The DIS Manual — September 1997 prepared by the European Commission is applicable to the implementation of decentralised Phare Programmes. The Manual defines the standard procedures which must be respected by all bodies implementing a Phare Programme unless other provisions have been formally agreed in writing with the Commission. The Manual is based on Phare and Financing Regulations — Framework Agreements concluded with each country — as well as on previous Phare Manuals.