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Governance in the Public Sector:
A Governing Body Perspective

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PREFACE

The Public Sector Committee (PSC) is a standing committee of the Council of the International Federation of Accountants (IFAC) formed to address, on a coordinated worldwide basis, the needs of those involved in public sector financial reporting, accounting and auditing. In this regard, the term “public sector” refers to national governments, regional governments (e.g., state, provincial, territorial), local governments (e.g., city, town) and related governmental entities (e.g., agencies, boards, commissions and enterprises).

The PSC has been given the authority, on behalf of the Council, to issue standards, guidelines, studies and occasional papers on financial reporting, accounting and auditing in the public sector.

International Public Sector Studies are intended to provide advice on financial reporting, accounting and auditing issues in the public sector. They are based on the study of the best practice and most effective methods for dealing with the issues being addressed.

Circumstances vary in different jurisdictions and factors affecting governance in a particular jurisdiction are often unique to that jurisdiction. However, the PSC believes that the guidance included in this Study may be useful for developing regional and national guidance on governance. The PSC encourages regional and national organizations to consider this Study in developing guidance appropriate to their own jurisdictions.

This Study focuses on governance arrangements in the public sector; specifically on the responsibilities of a governing body of a public sector controlled entity. The PSC believes that the publication of this Study will contribute to good governance and accountability in the public sector throughout the world.

This Study has, to a certain extent, been based on the publication of the Chartered Institute of Public Finance and Accountancy (CIPFA) in the United Kingdom, *Corporate Governance — A Framework for Public Service Bodies*. The IFAC PSC is grateful to CIPFA for granting permission to use that publication as a basis for this Study.

Governance in the Public Sector: A Governing Body Perspective

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CHAPTER 1: INTRODUCTION

.001 In recent years, many developed and developing countries have embarked on a thorough re-evaluation of the role of government in their societies. Flowing from this, a redefinition of the political-administrative relationship has evolved, designed to ensure greater accountability and a greater devolution of power to managers.

.002 Over the last decade or so, "corporate governance" has brought about much debate and change in the private sector. "Broadly speaking corporate governance generally refers to the processes by which organizations are directed, controlled, and held to account"[1], and is underpinned by the principles of openness, integrity, and accountability. Governance is concerned with structures and processes for decision-making, accountability, control and behavior at the top of organizations. In some jurisdictions "corporate" may be interpreted as a private sector term. To avoid any possible confusion regarding the application of this Study, the term "governance" is used to describe what is also commonly referred to in the private sector as "corporate governance". In other jurisdictions "government governance" is used to describe governance in the public sector.

.003 The authors of a 1999 World Bank working paper concluded that there "is new empirical evidence that governance matters, in the sense that there is a strong causal relationship from good governance to better development outcomes such as higher per capita incomes, lower infant mortality and higher literacy".[2]

.004 Comments such as these serve to highlight the importance of good governance. In virtually all jurisdictions the public sector plays a major role in society, and effective governance in the public sector can encourage the efficient use of resources, strengthen accountability for the stewardship of those resources, improve management and service delivery, and thereby contribute to improving peoples' lives. Effective governance is also essential for building confidence in public sector entities — which is in itself necessary if public sector entities are to be effective in meeting their objectives.

.005 The focus of governance in the private sector is on the board of directors. In the public sector context, boards are sometimes difficult to identify and define, as they operate in different statutory and managerial frameworks. It is not possible to develop one framework and one set of recommendations of governance that would be applicable to all public sector entities, but similar principles nevertheless apply, whether the controlling body is elected or appointed. In particular, public sector entities have to satisfy a complex range of political, economic and social objectives, which subject them to a different set of external constraints. They are also subject to forms of accountability to various stakeholders, which are different to those that a company in the private sector has to its shareholders, customers etc. The stakeholders in the public sector may include the Ministers, other government officials, the electorate (Parliament), customers and clients, and the general public, each with a legitimate interest in public sector entities, but not necessarily with any "ownership rights".

.006 As an example, the Public Accounts Committee in the United Kingdom noted in their *Report on the Proper Conduct of Public Business* that what was needed was "…a framework … (which) must include effective systems of control and accountability, and above all responsible attitudes on the part of those handling public money. It is important that the drive to provide improved services at reduced costs should be sustained and that this drive should not be stifled by unnecessary bureaucracy. At such time it is even more essential to maintain honesty in the spending of public money and to ensure that traditional public sector values are not neglected in the effort to maximize economy and efficiency."

.007 In some countries the public sector includes a large number of entities that have been separately established by government agencies to undertake new activities or activities previously performed by core government.

[1] ANAO, Discussion Paper, *Corporate Governance in Commonwealth Authorities and Companies*, 1999.
[2] Kaufman, D Kraay A and ZoidoLobaton, P, 1999, *Governance Matters*, Working Paper, The World Bank.

One reason for the establishment of separate entities may have been an expectation that greater efficiency would be achieved through a separate structure. Thus, while the governing bodies of such public sector entities require sufficient freedom to manage operations in a vigorous and enterprising manner, they need to exercise that freedom within a framework of effective governance and accountability. Governing bodies of public sector entities that are part of the whole-of-government may also need to consider the impact of their activities on other government entities; to align, as far as possible, their activities with the whole-of-government's objectives.

.008 As discussed in Chapter 2, many parties play a role in the governance of public sector entities. The purpose of this Study is to consider an appropriate framework from the perspective of the governing body to assist in ensuring an appropriate balance between freedom to manage, accountability and the legitimate interests of the different stakeholders. This Study defines common principles and recommendations concerning the governance of public sector entities with the objective of providing guidance to assist governing bodies of public sector entities to develop or review their governance practices in such a way to enable them to operate in a more effective, efficient and transparent manner.

.009 This Study outlines principles of governance and their application to public sector entities. Governance practices will need to be tailored according to the circumstances of individual public sector entities and the jurisdictions within which they operate. As entities develop and change over time, it will be necessary for the governing body, on an ongoing basis, to review and amend governance practices.

.010 While this Study does not prescribe governance practices, it may be appropriate to give legislative or other regulatory status to the principles outlined in this Study.

SCOPE OF THE STUDY — THE PUBLIC SECTOR CONTEXT

.011 The principles outlined in this Study apply to all public sector entities, including national governments, regional governments (e.g., state, provincial, territorial), local governments (e.g., city, town), related governmental entities (e.g., agencies, boards, commissions) and government business enterprises (GBEs). Specifically, the principles in this Study are applicable to all public sector entities that form part of an economic entity as defined in International Public Sector Accounting Standard 6 *Consolidated Financial Statements and Accounting for Controlled Entities* (IPSAS 6).

.012 In some jurisdictions, governments or other public sector entities may engage and fund entities in the private and not-for-profit sectors to carry out certain activities or provide certain services. While this Study does not specifically consider governance arrangements in these circumstances, the principles and recommendations outlined in this Study may be relevant to such entities.

.013 The public sector is complex, and public sector entities do not operate within a common legislative framework or have a standard organizational shape or size. It is important, therefore, to recognize the diversity of the public sector and the different models of governance that apply in different countries and in different sectors, each of which has unique features that require special attention and impose different sets of accountabilities.

.014 In private sector companies (profit-seeking) the board represents the link between the shareholders and the managers, and is the instrument through which managers are accountable to the shareholders and by which their performance is appraised. The "unitary" board model combines both a governing (that is monitoring and supervisory) function, represented by non-executive directors independent of line management; and a management function, represented by executive directors employed directly by the company, who are responsible for the day-to-day management of the operations.

.015 In some countries, Government Business Enterprises (public entities) are governed by a unitary board with similar characteristics to the board of a company in the private sector.

.016 In other parts of the public sector, the governing and management functions may be separated, with a non-executive supervisory board overseeing an executive management board, in what may be described as a "two-tier" board structure.

.017 In some local governments the governance arrangements are also characterized by a two-tier structure. However, the simple model is complicated by the fact that the top (supervisory) tier comprises democratically elected councilors, whose role, while broadly analogous to that a non-executive board, is significantly different in that it fulfills essentially a political advocacy and representational function.

.018 In general, the constitutional basis of central government departments/entities and their executive agencies is different again. In particular, the separation of powers between the non-executive Legislature (Parliament) and the Executive (Ministers and public servants) is reflected in the particular arrangements for governance in that sector. These could include scrutiny by parliamentary committees, specific operational responsibilities of Chief Executives (heads of departments, agencies or entities), and Ministerial political accountability to Parliament. Chapter 9 illustrates applications of governance to central governments.

.019 In the different parts of the public sector, the group that fulfills the role of the board of a company in the private sector will be described differently and, indeed, in some sectors it may not be immediately obvious what the equivalent group is. In whatever way it is configured, constituted or described, all bodies need to have at their head a group that is responsible for giving leadership and strategic direction, defining control mechanisms and supervising the overall management of the entity's activities, and reporting on stewardship and performance.

.020 For simplicity, this document refers to this governing or "top management" group as the "governing body". In doing so it is recognized that the term may be alien to the constitution and culture of different parts of the public sector in some countries.

.021 As it is difficult to apply the concept of "governing body" in all public sector organizational circumstances, the organizational circumstances to which this advice is considered directly applicable are defined as:

> *All arrangements where a government (whether central, regional or local) delivers a service or activity through a controlled entity (subsidiary), whether that subsidiary entity is or is not wholly controlled by the government or has a separate legal identity.*

.022 Where a Minister has direct responsibility for the delivery of a service or activity, in the interest of good governance the Minister needs to ensure that the recommendations of governance in this study are applied in the delegated management arrangements for those activities. In those circumstances where this advice is not directly applicable it is considered essential that the basic principles of governance, being openness, integrity and accountability, should be followed. Chapter 9 sets out how this could occur within central government departments.

.023 An overview of the general accountability arrangements in the public sector and the responsibilities of primary role-players in governance (such as external auditors) are addressed in Chapter 2.

.024 It is recognized that, while the principles of good governance, as it is defined, apply to all public sector entities, not all of the specific recommendations will necessarily be applicable in all sectors. In some cases, while a particular recommendation may be relevant, it may not be appropriate or practicable to apply it. Furthermore, the costs of implementing a recommendation of governance may outweigh the benefits to be derived.

.025 Individual entities in a particular part of the public sector and their representative bodies, thus need to determine both the identity of the "governing body" and other role-players in their own context, and to what extent, and how, the recommendations set out in this Study might best be applied and, if necessary, adapted to meet their own particular circumstances. In that way the framework can be used to develop sector-specific codes of practice which properly reflect the culture and terminology, and the specific legal, constitutional and operational environment of particular countries and sectors.

CHAPTER 2: AN OVERVIEW OF THE ACCOUNTABILITY ARRANGEMENTS IN THE PUBLIC SECTOR

.026 As set out in Chapter 1, the institutional or organizational arrangements of the public sector differ between jurisdictions and countries. However, the principles of governance are considered applicable to all administrative arrangements.

.027 In most countries there are distinct roles or functions in establishing and maintaining an effective overall governance framework. The purpose of this Chapter is to provide an overview of the main functions of role-players in relation to overall governance in the public sector. The remainder of this Study focuses mainly on the governance responsibilities of the governing body of entities under the control of government, while Chapter 9 applies the recommendations on governance set out in Chapters 3 to 8 to central government departments.

OVERALL RESPONSIBILITY TO DETERMINE THE GOVERNANCE FRAMEWORK

.028 National cultural norms and values, and rules and regulations usually dictate the structure of the regulatory framework and its key constituent bodies which, in turn, reflect the nature and level of financial accountability to civil society. In many countries the responsibility to determine the overall governance framework is usually the responsibility of the Legislature and/or Executive arms of government on behalf of the civil society.

.029 The roles of each of these parties in relation to the overall governance framework often overlap. For example, the Legislature may initiate or provide the authority for the establishment of regulatory or oversight bodies and may approve/comment on governance policies formulated by the Executive (Ministers as the political heads).

.030 To enable Parliament to effectively hold the government accountable for its performance in the use of resources and management of assets, clarity on the boundaries of the government reporting entity is essential. Accountability cannot be effective without the provision of complete and appropriate information.

.031 It is normally the responsibility of the Executive that controls other entities or agencies, to ensure that appropriate governance arrangements are applied in all such controlled entities. It is not adequate to only appoint a governing body of a controlled entity, without ensuring mechanisms are in place to secure adherence to recommendations of governance. Similarly, governing bodies of such controlled entities also have a responsibility to ensure governance of the entities under their control, while government is the ultimate controlling entity.

.032 Where financial support is given to an entity, this entity will not necessarily form part of the entities controlled by government, as it is a prerequisite that the definition of control be met to be included in the consolidated reporting entity. However, the Executive providing the financial assistance needs to be held accountable to ensure that government receives value for money for the financial assistance provided. The entity receiving financial assistance is usually required to report adequate and appropriate information to the Executive.

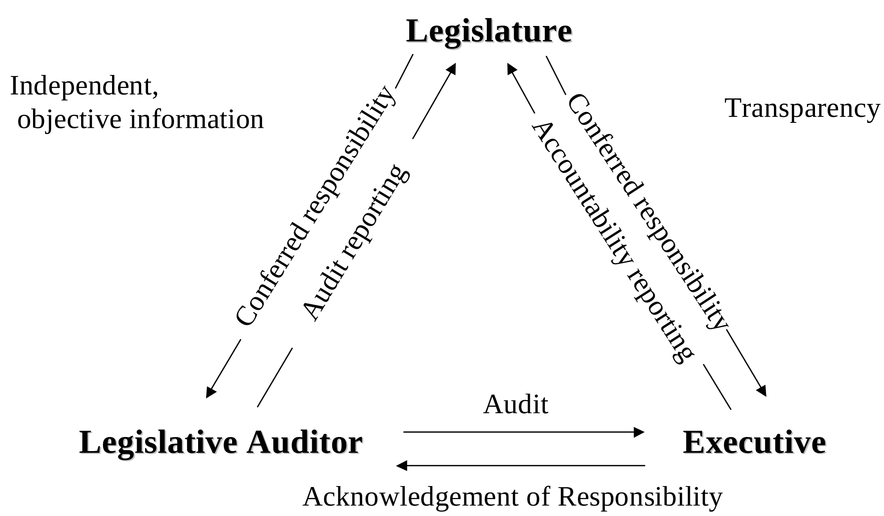
OVERSIGHT FUNCTION OF THE LEGISLATURE CONTRASTED WITH THE EXECUTIVE FUNCTION OF GOVERNMENT

.033 In most governments, there is a separation of executive and legislative functions. Legislatures (Parliament) provide authority for the acquisition and use of financial resources and are responsible for overseeing administration. Management of financial affairs and resources is usually the responsibility of the Executive (Ministers/Cabinet/Government Business Enterprises/executing agencies or entities).

.034 One example[3] of the overall accountability process in the public sector can schematically be set out as follows:

Figure 2.1

EXAMPLE OF OVERALL ACCOUNTABILITY PROCESS IN THE PUBLIC SECTOR



.035 The Legislature is usually responsible for sanctioning the overall public sector financial plan or budget and authorizing the Executive to make expenditures (within the overall level of expenditure), invest, borrow and administer programs in accordance with any laws that may affect them. The Executive is responsible for approving a budget or financial plan within the overall approved level of expenditure to provide authorization for the acquisition and use of financial resources, and for overseeing and monitoring the implementation of the approved budget or financial plan.

.036 The Executive is usually responsible for the planning, directing and controlling of day-to-day operations and for preparing reports that provide an account of their administration. Their responsibilities include directing operations with due regard to economy and efficiency, maintaining an adequate system of internal control, ensuring compliance with applicable authorities, selecting and applying appropriate accounting

[3] Office of the Auditor General of Canada training material.

policies, safeguarding assets, measuring the effectiveness of programs and reporting on their performance to those to whom they are accountable.

.037 Because it provides financial authority and powers, the Legislature has the right and responsibility to hold government and its entities accountable for the management of the financial affairs, the use of resources entrusted to them and the result achieved. In effect, accountability is the obligation to answer for a responsibility that has been conferred. It presumes the existence of at least two parties: one who allocates responsibility and one who accepts it with the undertaking to report upon the manner in which it has been discharged.[4] Therefore, the Legislature plays an important role in the overall framework of governance in the public sector.

.038 The Legislature needs to exercise control over the expenditure of public monies made available to the Executive authorities by way of budgets. It usually reviews the annual reports of public sector entities, evaluates the standard of their work and makes recommendations, based on the facts contained in the various audit reports by the legislative auditor (see paragraph .043) and the Executive in question. In the interest of transparency, such hearings need to be public hearings.

.039 This inner accountability cycle usually involves four steps — audit and reporting by the legislative auditor, hearing by the Legislature, recommendations of the Legislature to the Executive, and the response of the Executive. The efficiency of the cycle depends on the timeliness with which all four steps are completed.

.040 The Legislature also needs to review performance audit reports of the legislative auditor. The extent to which the Legislature utilizes a performance audit report depends on the efficiency of the accountability cycle, amongst other things. The legislative auditor needs to perform a follow up of the performance audit to review the earlier stance and the implementation of the recommendations of the Legislature.

.041 In most "Anglo Saxon" countries a Public Accounts Committee fulfills the responsibility of reviewing the audit reports of the legislative auditor. In other countries other structures may be responsible for this oversight responsibility, for example, in France the Commission des Finances in the House and in the Senate oversees public sector entities.

.042 The committee systems in most Legislatures are well suited to hold accountable those who exercise public power in society. Various committees in a Legislature usually have different areas of expertise to enable effective accountability. However, the traditional system of accountability through elected persons (Executive/Parliament), who are in turn held to account by the citizens in a democratic election, may also be weak and ineffectual. For example, in some jurisdictions the Legislature has limited powers of effective influence over government-owned entities. Therefore, it is important to ensure that centrally controlled and funded entities are able to respond to local needs and concerns, and good governance arrangements are in place that enable communication with stakeholders. The following chapters address recommendations of governance to be observed by the governing bodies of such entities.

INDEPENDENT ASSURANCE FUNCTION OF EXTERNAL AUDITORS

.043 In most countries, legislative auditing has a well established identity, usually in the form of a Supreme Audit Institution (Auditor-General, Comptroller General, an Audit Commission, or a Court of Accounts), but there are exceptions where private sector auditors conduct the audit of public sector entities. Many legislative auditors are members of the International Organization of Supreme Audit Institutions (INTOSAI).

.044 The Lima Declaration of INTOSAI is set out as Appendix 2 and contains a comprehensive list of goals and issues relating to government auditing.

[4] *Report of the Independent Committee for the Review of the Office of the Auditor General of Canada*, Ottawa: Information Canada, 1975.

.045 Relevant, reliable and audited financial statements are a key aspect of good governance and accountability. Public sector entities need to prepare their own financial statements. The legislative auditor or other external auditor, as an independent, objective auditor, provides assurance to the users through the expression of an "opinion" on the fair presentation of those statements (financial audit/attest audit).

.046 The external auditor needs to follow generally recognized auditing standards when conducting the external audit.

.047 The International Auditing Practices Committee of IFAC issues International Standards on Auditing (ISAs), which may contain a "Public Sector Perspective" (PSP). The ISAs set out basic principles and related practices and procedures that apply to audits of financial statements. The application of certain ISAs may need to be clarified or supplemented to accommodate public sector circumstances, particularly as they relate to the audit of public sector entities, and this is done with the inclusion of a PSP. Where no PSP is included, the basic principles and related practices may be applied in the public sector circumstances without further clarification or supplementation. In addition, the Auditing Standards Committee of INTOSAI has developed INTOSAI Auditing Standards. Although these standards do not have mandatory application, they reflect a "best practice" consensus amongst Supreme Audit Institutions (SAIs).

.048 The financial statements of public sector entities may include information that is different from, or in addition to, that contained in the financial statements of private sector entities, for example, comparison of expenditure in the period with limits established by legislation. In such circumstances, appropriate modifications may be required to the nature, timing and extent of audit procedures, and the auditor's report.

.049 Although the ISAs are intended to apply to all aspects of the audit of financial statements, they do not apply in respect of compliance and performance auditing, or in respect of other aspects such as reporting on internal control or other matters that may be in the public interest.

.050 The SAI may also be required to report on whether or not:

- expenditure has been applied for authorized purposes and conforms to the authority which governs it (regularity auditing/compliance auditing); and

- due regard is paid to securing economy, efficiency and effectiveness (performance auditing/value for money auditing).

SETTING ACCOUNTING STANDARDS AND MONITORING COMPLIANCE

.051 An important part of demonstrating accountability can be met by providing information on the activities of an entity to an oversight body (such as Parliament, Parliamentary committees, local government and its committees) or other external party, so that the activities are able to be scrutinized. For example, the efforts of the Executive to demonstrate accountability usually start with proper financial reporting. When improved accounting standards are adopted, and this information is then subjected to independent audit, improved quality information would be reported. Therefore, compliance with accounting standards enhances financial accountability as it contributes to the reliability, consistency and transparency of financial information.

.052 Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements. Accordingly, compliance with an authoritative and recognized set of accounting standards will normally be necessary for financial statements to give a fair presentation.

.053 The IFAC PSC establishes recommended accounting standards for public sector entities, referred to as International Public Sector Accounting Standards (IPSASs) to apply to the accrual basis of accounting. Public sector entities are encouraged to harmonize with these IPSASs. In addition, the PSC establishes the reporting requirements for entities using the cash basis of accounting.

.054 IPSASs are the public sector equivalent of the International Accounting Standards (IASs) issued by the International Accounting Standards Board (IASB) (formerly the International Accounting Standards Committee (IASC)), and draw, as far as is appropriate, on those standards. Copies of the IPSASs are available on the IFAC web site — www.ifac.org.

.055 In July 2000, the IFAC PSC issued Study 11 *Governmental Financial Reporting: Accounting Issues and Practices*. Study 11 aims to assist governments at all levels in the identification of issues associated with financial reporting. It contains a detailed description of both the accrual and cash bases of accounting and provides examples of financial statements prepared under each basis. Study 11 also explains common practice within each basis of accounting, and provides examples of the variations within those bases. Governments wishing to change their basis of accounting or modify their accounting policies will be able to use Study 11 as a source of information about a basis of accounting, including accounting policy issues associated with that basis and the format of financial statements prepared under that basis. This may assist governments in changing their basis of accounting and ultimately contribute to greater comparability within and between financial statements of governments. However, the Study is not an accounting standard, and does not prescribe particular accounting treatments.

Standard-Setting Arrangements

.056 Different standard-setting arrangements exist in different jurisdictions. Within each jurisdiction, regulations may govern the issue of general purpose financial statements of public sector entities. These regulations may be in the form of statutory requirements, financial reporting directives and instructions, and/or accounting standards promulgated by governments, regulatory bodies and/or professional accounting.

.057 When regulations governing financial reporting require that financial statements give a fair presentation and be prepared in accordance with generally accepted accounting practice, without a clear identification of the standards that constitute generally accepted accounting practice, flexibility may exist in the interpretation thereof. Unsound accounting practices may be followed as “generally accepted accounting practice” purely because they are adopted by several entities. This situation can prejudice users of financial statements if such accounting practices are adopted, because they may not reflect an objective view or fairly present the financial performance and position of an entity to users. Providing legal backing to accounting standards whereby the legislator requires compliance with an identified set of standards in a statute may address this concern.

.058 Standards would be perceived to be more credible when the standard-setting process is independent of any particular body (compared to when a government as preparer or controlling body sets the standards).

.059 Monitoring compliance with those standards may also enhance the integrity and transparency of the financial reporting process. The main objective may be the promotion of fair presentation being achieved in the financial statements through compliance with standards, rather than the punishment or penalizing of those who do not comply.

.060 The governing body or Chief Executive of a public sector entity is primarily responsible for the financial statements, and they are answerable for their stewardship to stakeholders. Not all public sector entities may have an annual general meeting of shareholders where the governing body or Chief Executive may be questioned about the entity’s compliance with accounting standards. Furthermore, there is a need for a mechanism to be provided in appropriate circumstances to smaller shareholders and other stakeholders to question compliance with accounting standards. In some jurisdictions in the private sector a Review Panel or similar body performs this monitoring function. Similar arrangements may be instituted in the public sector with good effect.

CHAPTER 3: PRINCIPLES OF GOVERNANCE

.061 *The Report of the Committee on the Financial Aspects of Corporate Governance*[5] (the Cadbury report) defined corporate governance as "the system by which organizations are directed and controlled". It identified the three fundamental principles of corporate governance as:

- **openness;**
- **integrity; and**
- **accountability.**

.062 These principles are relevant to public sector entities as they are to private sector entities. They apply equally to all public sector entities, irrespective of whether governing bodies are elected or appointed, and whether or not they comprise a group of people or an individual.

.063 The Cadbury report defined these three principles in the context of the private sector and, more specifically, of public companies. However, in the context of the public sector, the definitions of these principles need to be adapted to reflect the key characteristics of public sector entities, which distinguish them from the private sector. In particular, public sector entities have to satisfy a more complex range of political, economic and social objectives, which subject them to a different set of external constraints and influences; and are subject to forms of accountability to their various stakeholders which are different to those that a company in the private sector owes to its shareholders.

.064 Aspects of governance in the public sector have been addressed by the Committee on Standards in Public Life (the Nolan Committee (U.K.)), the first report of which was published in May 1995. The report (the Nolan report) identified and defined seven general principles of conduct that should underpin public life, and recommended that all public sector entities should draw up codes of conduct incorporating these principles. These "principles of public life" are:

- **selflessness;**
- **integrity;**
- **objectivity;**
- **accountability;**
- **openness;**
- **honesty; and**
- **leadership.**

.065 Each of these principles is defined in terms of the responsibilities of "holders of public office". For the purposes of this framework, which is concerned with governance and, as such, with the collective as well as individual responsibilities of members of governing bodies of public sector entities, the three principles identified in the Cadbury report — openness, integrity and accountability — have been built upon and

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[5] Cadbury Committee (U.K.). *Report of the Committee on the Financial Aspects of Corporate Governance*, December 1992.

redefined to reflect the public sector context, as shown in Figure 3.1. In redefining them in this way, cognizance has been taken of the seven principles of the Nolan report.

Figure 3.1

PRINCIPLES OF GOVERNANCE IN THE PUBLIC SECTOR CONTEXT

Openness	Openness is required to ensure that stakeholders[6] can have confidence in the decision-making processes and actions of public sector entities, in the management of their activities, and in the individuals within them. Being open through meaningful consultation with stakeholders and communication of full, accurate and clear information leads to effective and timely action and stands up to necessary scrutiny.
Integrity	Integrity comprises both straightforward dealing and completeness. It is based upon honesty and objectivity, and high standards of propriety and probity in the stewardship of public funds and resources, and management of an entity's affairs. It is dependent on the effectiveness of the control framework and on the personal standards and professionalism of the individuals within the entity. It is reflected both in the entity's decision-making procedures and in the quality of its financial and performance reporting.
Accountability	Accountability is the process whereby public sector entities, and the individuals within them, are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance, and submit themselves to appropriate external scrutiny. It is achieved by all parties having a clear understanding of those responsibilities, and having clearly defined roles through a robust structure. In effect, accountability is the obligation to answer for a responsibility conferred.

.066 These fundamental principles are reflected in each of the "dimensions" of the governance of public sector entities:

- standards of behavior — how the management of the organization exercises leadership in determining the values and standards of the organization, which define the culture of the organization and the behavior of everyone within it;

- organizational structures and processes — how the top management within organizations is appointed and organized, how its responsibilities are defined, and how it is held accountable;

- control — the network of various controls established by the top management of the organization to support it in achieving the entity's objectives, the effectiveness and efficiency of operations, the reliability of internal and external reporting, and compliance with applicable laws and regulations and internal policies; and

[6] Stakeholders will include the body or individual(s) electing or appointing the governing body and having responsibility for appraising performance, elected representatives (Parliament), providers of resources (taxpayers, lenders, bondholders, and creditors), service providers and partners (employees, contractors, joint venture partners and other government entities), users of services (individuals and businesses who benefit from the services that the entity provides), interest groups, analysts and other statistics gatherers (policy analysts, economists, financial analysts, rating agencies), media and the wider community.

- external reporting — how the top management of the organization demonstrates its financial accountability for the stewardship of public money and its performance in the use of resources.

.067 From the fundamental principles it is possible to derive a set of recommendations on governance.

.068 These recommendations are outlined in the next Chapter and illustrated in Figure 3.2. The focus is on the responsibilities of the governing body or its equivalent and on steps they can take to confirm effective governance within the entity. Chapters 5 to 8 set out some additional guidance on how these recommendations can be implemented in practice. Chapter 9 sets out how these recommendations could be applied within central government departments.

Figure 3.2

RECOMMENDTIONS ON GOVERNANCE IN THE PUBLIC SECTOR

<table>
<tr><th colspan="3">Standards of Behavior</th></tr>
<tr><td colspan="3">• Leadership

• Codes of Conduct
⇒ Probity and Propriety
⇒ Objectivity, Integrity and Honesty
⇒ Relationships</td></tr>
<tr><th>Organizational Structures and Processes</th><th>Control</th><th>External Reporting</th></tr>
<tr><td>• Statutory Accountability

• Accountability for Public Money

• Communication with Stakeholders

• Roles and Responsibilities
⇒ Balance of Power and Authority
⇒ The Governing Body
⇒ The Chairperson
⇒ Non-Executive Governing Body Members
⇒ Executive Management
⇒ Remuneration Policy</td><td>• Risk Management

• Internal Audit

• Audit Committees

• Internal Control

• Budgeting

• Financial Management

• Staff Training</td><td>• Annual Reporting

• Use of Appropriate Accounting Standards

• Performance Measures

• External Audit</td></tr>
</table>

CHAPTER 4: RECOMMENDATIONS ON GOVERNANCE

This Chapter outlines the recommendations illustrated in Figure 3.2. The focus is on the responsibilities of "the governing body" or its equivalent and on the steps it can take to confirm effective governance within the entity. Chapters 5 to 8 set out some additional guidance on how these recommendations can be implemented in practice. Chapter 9 explores the possibility of applying the recommendations on governance set out in Chapters 3 to 8 to central government departments.

STANDARDS OF BEHAVIOR

Leadership

.069 Members of governing bodies of public sector entities need to exercise leadership by conducting themselves in accordance with high standards of behavior, as a role model for others within the entity.

Codes of Conduct

.070 Governing bodies of public sector entities need to adopt a formal code of conduct defining the standards of behavior to which individual governing body members and all employees of the entity are required to subscribe.

Objectivity, Integrity and Honesty

.071 Governing bodies of public sector entities need to establish appropriate mechanisms to ensure that members of the governing body and employees of public sector entities are not influenced by prejudice, bias or conflicts of interest.

ORGANIZATIONAL STRUCTURES AND PROCESSES

Statutory Accountability

.072 Governing bodies of public sector entities need to establish effective arrangements to ensure compliance with all applicable statutes and regulations, and other relevant statements of best practice.

Accountability for Public Money

.073 Governing bodies of public sector entities need to establish appropriate arrangements to ensure that public funds and resources are properly safeguarded and are used economically, efficiently, effectively, with due propriety, and in accordance with the statutory or other authorities that govern their use.

Communication with Stakeholders

.074 Governing bodies of public sector entities need to establish:

- clear channels of communication with their stakeholders on the entity's mission, roles, objectives and performance; and
- appropriate procedures to ensure that such channels operate effectively in practice.

.075 Governing bodies of public sector entities need to make an explicit commitment to openness and transparency in all of the activities of the entity, subject only to the need to preserve confidentiality in those specific circumstances where it is proper and appropriate to do so.

.076 Governing bodies of public sector entities need to report publicly the processes for making appointments to the governing body, and need to make publicly available the names of all governing body members, together with their relevant other interests.

Roles and Responsibilities

Balance of Power and Authority

.077 There needs to be a clearly defined division of responsibilities at the head of public sector entities to ensure a balance of power and authority.

The Governing Body of a Public Sector Entity

.078 Every public sector entity needs to be headed by an effective governing body to lead and control the entity, and monitor the executive management.

.079 Members of the governing body need to receive appropriate induction training on the first occasion of appointment to the governing body, and subsequently as necessary.

.080 Governing bodies of public sector entities need to establish appropriate arrangements to ensure that they have access to all such relevant information, advice and resources as are necessary to enable them to carry out their role effectively.

.081 To ensure that the direction and control of the entity is firmly in their hands, governing bodies of public sector entities need to establish and maintain an up-to-date framework of delegated or reserved powers that includes a formal schedule of those matters specifically reserved for the collective decision of the governing body.

.082 To support them in carrying out their duties, governing bodies of public sector entities need to establish clearly documented and understood management processes for policy development, implementation and review; decision-making, monitoring, control and reporting; and formal procedural and financial regulations to govern the conduct of the governing body's operations.

.083 There needs to be a formal and transparent process to ensure that appointments to the governing body are made in accordance with specified criteria of competence and on the basis of merit and the individual's ability to carry out a defined role within the organization.

The Chairperson of the Governing Body

.084 The role of the Chairperson needs to be formally defined in writing, to include responsibility for providing effective strategic leadership to the governing body and to ensure the holder successfully discharges the overall responsibility for the activities of the entity as a whole.

Non-Executive Members of the Governing Body

.085 Non-executive members of public sector governing bodies need to provide an independent judgment on issues of strategy, performance, resources and standards of conduct. Apart from directors' fees they may receive, it is appropriate that they are independent of management and free from any other relationships that may materially interfere with their role. Their duties, terms of office, remuneration and the review thereof, need to be defined clearly.

Executive Management

.086 The Chief Executive needs to have line responsibility for all aspects of executive management, whether as a member of the governing body or not. He or she is accountable to the governing body for the ultimate performance of the entity and implementation of the governing body's policy.

.087 In addition, a senior executive, whether a member of the governing body or not, needs to be made responsible for ensuring that appropriate advice is given to the governing body on all financial matters, for keeping proper financial records and accounts, and for maintaining an effective system of internal financial control.

.088 A senior executive, whether a member of the governing body or not, needs to be made responsible to the governing body for ensuring that governing body procedures are followed, and that all applicable statutes and regulations and other relevant statements of best practice are complied with.

Remuneration Policy

.089 Levels of remuneration of members of the governing body need to be sufficient to attract and retain them to run the entity successfully.

.090 Public sector entities need to establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual members of the governing body. It is appropriate that no member is involved in deciding his or her own remuneration.

.091 The annual report of a public sector entity needs to contain a statement on the remuneration policy and details of the remuneration of members of the governing body. Such disclosure supports the governance principles of openness and integrity, particularly where members of the governing body have the ability to set their own remuneration.

CONTROL

Risk Management

.092 Governing bodies of public sector entities need to ensure that effective systems of risk management are established as part of the framework of control.

Internal Audit

.093 Governing bodies of public sector entities need to ensure that an effective internal audit function is established as part of the framework of control.

Audit Committees

.094 Governing bodies of public sector entities need to establish an audit committee, comprising non-executive members, with the responsibility for independent review of the framework of control and of the external audit process.

Internal Control

.095 Governing bodies of public sector entities need to ensure that a framework of internal control is established, operates in practice, and that a statement on its effectiveness is included in the entity's annual report.

Budgeting, Financial Management and Staff Training

.096 Governing bodies of public sector entities need to oversee, and need to ensure that procedures are in place that will result in, effective and efficient budgeting and financial management.

.097 Governing bodies of public sector entities need to ensure that training programs are in place so that staff are competent to perform the task at hand.

EXTERNAL REPORTING

Annual Reporting

.098 Governing bodies of public sector entities need to publish on a timely basis an annual report (including financial statements), presenting an objective, balanced and understandable account and assessment of the entity's activities and achievements, and of its financial position and performance and performance prospects.

.099 Governing bodies of public sector entities need to include in their annual report a statement explaining (at a minimum) that they have the responsibility for:

- approving the budget or financial plan to provide authorization for the acquisition and use of financial resources;
- the financial statements that fairly present the state of affairs of the entity as at the end of the financial year and the results of the operations for that year;
- maintaining an effective framework of control;
- ensuring the consistent use of appropriate accounting policies, supported by reasonable and prudent judgments and estimates; and
- ensuring adherence to applicable accounting standards.

.100 Governing bodies of public sector entities need to include in their annual report a statement on whether or not they have adopted standards or codes of governance. This statement should identify the standards or codes adopted, as well as confirm compliance therewith, or if not, in what respect there has not been compliance.

Use of Appropriate Accounting Standards

.101 Governing bodies of public sector entities need to ensure that the financial statements contained in the annual report are prepared in accordance with IPSASs, or another authoritative and recognized set of accounting standards, and applicable legislation.

Performance Measures

.102 Governing bodies of public sector entities need to establish and report relevant performance measures to ensure and demonstrate that all resources have been procured economically and are utilized efficiently and effectively.

External Audit

.103 Governing bodies of public sector entities need to ensure that an objective and professional relationship is maintained with the external auditors.

The next four chapters consider how these recommendations on governance can be implemented in practice. ***.*** *Each recommendation is reproduced in sequence in bold type and is followed by comment and, where appropriate, additional guidance on its application in practice.*

CHAPTER 5: STANDARDS OF BEHAVIOR

INTRODUCTION

.104 Clearly the openness, integrity and accountability of individuals within a public sector entity is the cornerstone of effective governance. The reputation of the entity depends on the standards of behavior of everyone within it, whether governing body members, employees or agents contracted to it.

.105 Therefore, effective procedures and safeguards need to be put in place to ensure that all staff:

- are committed to high standards of personal behavior; and

- maintain open and honest relationships with the public, with people from other organizations, and with other employees and members of the governing body.

.106 The IFAC Financial Management and Accounting Committee published Study 8 *Codifying Power and Control: Ethical Codes in Action* in May 1999. The study focuses on ethical codes as one way in which corporations make explicit their values, guide and direct decision-making, and define the ground rules of behavior. Three forms of ethical codes are defined: *codes of ethics*, that is, statements of the values and principles that define the purpose of the organization; *codes of practice*, which guide and direct decision-making; and *codes of conduct or behavior*, which prescribe or proscribe certain behaviors. In practice, codes are variously named and may include components of more than one of these forms.

.107 Study 8 notes that:

Corporate Codes (of Ethics, Practice, Conduct/Behavior) serve three purposes. First, they are vehicles through which the power of overarching forms of social morality is drawn on for use as corporate power. Second, they are vehicles for deploying corporate power over values, choices and behaviors — in ways designed to induce appropriate responses to contextual requirements. Third, they are vehicles for establishing control over the exercise of values, choices and behaviors — so that appropriate responses to contextual requirements are induced. [7]

LEADERSHIP

.108 **Members of governing bodies of public sector entities need to exercise leadership by conducting themselves in accordance with high standards of behavior, as a role model for others within the entity.**

.109 Governing bodies of public sector entities are usually responsible for determining those values and standards that will serve to define the culture of the entity and govern the behavior of everyone within it.

.110 High standards of behavior need to be demanded of all public servants. Governing body members have a special responsibility to exemplify the standards that they expect others within the organization to meet. This reinforces the need for appropriate human resource policies, including recruitment procedures, followed by induction and ongoing awareness training to ensure governing body members have a proper understanding of their responsibilities and the standards of behavior expected of them.

[7] Study 8 *Codifying Power and Control: Ethical Codes in Action* published by the IFAC Financial Management and Accounting Committee in May 1999. The Study seeks to demonstrate that Corporate Codes of Ethics are not ornamental expressions of good intent. Instead, they are practical instruments of management, designed to capture the power of social or community morality and put it to good corporate use. It addresses questions such as: How are Corporate Codes of Ethics used? Why are they used? When are they used differently? When is their use effective?

CODES OF CONDUCT

.111 **Governing bodies of public sector entities need to adopt a formal code of conduct defining the standards of behavior to which individual governing body members and all employees of the entity are required to subscribe.**

.112 A government-wide code of conduct may exist, which governing bodies may choose to adopt, or which could be used as the basis for a tailored code of conduct for the public sector entity.

.113 The code of conduct needs to:

- commit the entity to the highest standards of behavior;
- be developed in a consultative manner and involve all the entity's stakeholders to infuse the entity's culture;
- receive total commitment from the governing body and the Chief Executive of the entity — they need to set the example for other employees to follow; and
- be sufficiently detailed so as to give a clear guide to the expected behavior of all employees.

.114 Following appointment, all governing body members and staff need to undertake to uphold and abide by the relevant code. Intended compliance could be a condition of appointment, and continuing compliance a condition of continuation in the post.

.115 An entity's code of conduct needs to reflect the three fundamental principles of openness, integrity and accountability, and address:

- probity and propriety;
- objectivity, integrity and honesty; and
- relationships.

.116 In this context, good conduct can be defined as a person's responsibility to act fairly and in good faith, and in such a way as to meet the specified objectives of the entity to which he or she has been appointed or elected.

Probity and Propriety

.117 All public servants need to conduct themselves in accordance with high standards of behavior to the extent that this may reflect on their or the entity's reputation.

.118 In particular, public servants need to be trustworthy in the handling of public funds. They have to demonstrate:

- probity in handling assets and resources entrusted to them;
- care in safeguarding property, assets and confidential information to ensure they are not stolen, abused or damaged;

- proper observance of the entity's rules and procedures, particularly when accounting for finances;

- economy to avoid waste and extravagance; and

- personal honesty in claiming expenses and ensuring that official assets and resources are not used for private advantage.

Objectivity, Integrity and Honesty

.119 **Governing bodies of public sector entities need to establish appropriate mechanisms to ensure that members of the governing body and employees of public sector entities are not influenced by prejudice, bias or conflicts of interest.**

.120 Members of governing bodies and employees of public sector entities involved in the decision-making process need to be, and be seen to be, objective and putting the interests of the entity above other interests. This imposes an obligation to be fair, honest and free of conflicts of interest.

Conflicts of Interest

.121 Members of the governing body and employees of public sector entities are required to observe not only the statute law but also other relevant rules on disclosure of interest. In the treatment of disclosure of interest, complete openness needs to be observed. The appearance of a conflict of interest could be as damaging as the existence of a real conflict, and public office holders need to do their utmost to ensure that in all their activities, both professional and private, the appearance of a conflict of interest does not arise. In this context, avoiding conflicts of interest means that governing body members and employees of public sector entities do not use their position in the public sector entity to further their private gain in a social or business relationship outside the public entity. Examples may include:

- Any outside employment, directorship or material shareholding is not entered into if it is contrary to the objectives and interests of the entity. Where public servants have such outside interests, they are declared.

- Official decisions or official actions are not improperly influenced by any relationship (e.g., kin, marriage or partnership) or by any personal or financial consideration.

- Fees for performing services that form part of official duties (e.g., lecturing) are disclosed to the entity, which establishes procedures for their treatment.

.122 Members of governing bodies may be appointed on either a full-time or a part-time basis. Some members of a governing body may have their own consultancy businesses or may act as members on the boards of other entities. Concise and unambiguous guidelines and complete disclosure requirements need to be in place in such circumstances.

.123 Furthermore, a governing body may wish to engage a non-executive member of the governing body to provide remunerated consultancy services to the governing body. This may be justifiable, provided that guidelines and rules have been complied with (this may entail, for example, observing a transparent tendering process and complete disclosure).

.124 These rules could be underpinned by a "register of interests" to record all relevant personal and business interests, which, for members of the governing body and top managers, needs to be made publicly available. When a conflict is established, the person should play no part in the relevant discussion, decision or action.

Political Interests

.125 In this context, relevant interests will include any significant political activity, including office holding, elected positions, public appearances and candidature for election, undertaken in the last five years. Any such activity is disclosed in the register of interests and, where it may conflict, or appear to conflict, with public office, that person takes no part in the relevant discussion, decision or action.

Gifts, Hospitality and Entertainment

.126 Public servants should not offer or accept any payment, bribe, favor or inducement which might influence (or appear to influence) an official action.

.127 Gifts, hospitality and entertainment should only be offered or accepted if there is a genuine need to impart information or represent the entity. To resolve any doubts about the appropriateness of offering or accepting hospitality or a gift, whether or not it is intended (or might be thought to be intended) to influence a public servant's actions, the person needs to:

- consider whether the offering or acceptance of any such gifts or hospitality could be regarded as normal and reasonable. "Normal and reasonable" is defined for this purpose as no more than the entity would be prepared to offer in equivalent circumstances. Entities need to provide guidance as to what may be considered appropriate, and officers and members must not exceed such guidance without the specific and written authority of the entity. Where there is no guidance, the person needs to ensure that any hospitality or gift is not of a level or an amount which would lead any person to believe that the person might be influenced;

- ensure that a full record is kept of all hospitality or gifts offered, given or accepted above a minimum limit; and

- if there is doubt as to the propriety of making or accepting an offer, decline.

Relationships

The Public and People from Other Organizations

.128 Public servants need to uphold the reputation of the entity by treating the general public and people from other organizations:

- in a helpful and courteous manner;

- on a timely, reliable and, where appropriate, confidential basis; and

- in an open, fair and efficient way.

Employees

.129 All public servants should have a general duty to treat colleagues with respect, that is to:

- be open, honest and courteous;

- have due consideration for others' health, safety and personal welfare; and

- avoid harassment, discrimination or abuse of any kind.

.130 For their part, governing body members have a responsibility towards their staff. The governing body needs to seek to establish an open climate and culture in which staff can have confidence in the fairness and impartiality of procedures for registering and dealing with their interests and concerns. Similarly, it is the responsibility of governing body members and senior executive management to ensure equality of opportunity and to establish open and fair procedures for making appointments and for determining terms and conditions of service.

.131 It is recommended that governing bodies of public sector entities nominate a governing body member or senior executive who is responsible for investigating any concerns raised on a confidential basis by members of staff about standards of conduct. Members of staff will be able to raise such concerns without going through the normal management structure and could be guaranteed anonymity.

Suppliers

.132 All public servants need to take care to maintain the reputation of the entity for honoring contracts and other agreements to which it is a party. This implies building trust through fair, open and consistent dealing.

.133 Governing body members and employees involved with suppliers are usually expected to display high standards of competence and integrity.

.134 Individuals need to be aware of the risks involved in contracting and purchasing relationships. Suppliers should be selected on the basis of quality, suitability and value for money. Members and employees need to be fair, straightforward and honest in their dealings with suppliers. They should take care at all times to avoid becoming, or appearing to become, obliged to an individual supplier, e.g., by accepting gifts, hospitality, entertainment or other inducements.

.135 When dealing with suppliers, public servants need to:

- comply with the law and the entity's internal rules and procedures, e.g., public procurement legislation, tender board regulations and purchasing and technical standards;

- ensure quality standards are met and procedures followed, and be diligent in ensuring that suppliers comply with the standards specified; and

- pay for supplies within the time agreed.

CHAPTER 6: ORGANIZATIONAL STRUCTURES AND PROCESSES

INTRODUCTION

.136 Governing bodies of public sector entities need to establish effective organizational structures and processes to ensure:

- their **statutory accountability** is properly discharged to the individual(s) or entity responsible for electing or appointing the governing body and appraising its performance, and for providing the entity with assets and resources;
- proper **accountability for public money**;
- clear **communication with stakeholders**; and
- clarity about **roles and responsibilities** of top management, and in particular the relative roles and responsibilities of non-executive members of the governing body and executive management.

STATUTORY ACCOUNTABILITY

.137 **Governing bodies of public sector entities need to establish effective arrangements to ensure compliance with all applicable statutes and regulations, and other relevant statements of best practice.**

.138 Most public sector entities are established for specific purposes and have limited authority to incur expenditure (only for identified purposes). Many bodies also have statutory responsibilities to deliver, either directly or indirectly, services to citizens. The purpose, authority and responsibilities of many public sector entities is usually set out in enabling or other legislation. Public sector entities therefore, need to establish appropriate mechanisms to ensure that they do not exceed their powers or functions, and that they comply with any obligations imposed upon them, whether defined in statute or otherwise. In the public sector careful attention needs to be paid to social and environmental matters and other matters that impact upon issues of inter-generational equity.

.139 Accordingly, governing bodies of public sector entities need to give a senior executive specific responsibility for ensuring that appropriate advice is given to the governing body on compliance with applicable statutes and regulations, and other relevant statements of best practice (also see paragraphs .216 to .219).

.140 In addition, governing bodies of public sector entities need to set in place mechanisms to take anticipatory action as well as post-event action, to prevent the occurrence of possible breaches of the law.

ACCOUNTABILITY FOR PUBLIC MONEY

.141 **Governing bodies of public sector entities need to establish appropriate arrangements to ensure that public funds and resources are properly safeguarded and are used economically, efficiently, effectively, with due propriety, and in accordance with the statutory or other authorities that govern their use.**

.142 Accountability can be interpreted as a means of making public sector entities (politicians and officials) accountable to the "public". This needs to be distinguished from political accountability, whereby politicians are accountable directly to the public (e.g., through a referendum), and managerial accountability, whereby officials are accountable to their superiors through the hierarchy up to the political head.

.143 Public money is used to deliver goods and services and to further economic and social objectives. Individual citizens do not have the choice to "buy" or "sell" their interests in a public sector entity. Taxes are levied and expenditure incurred to implement policies that can affect the lives and welfare of citizens.

.144 Accountability to the public addresses:

- the stewardship of assets and resources entrusted;
- the financial performance, that is, the use of those assets and resources and the incurrence of liabilities in the delivery of services; and
- non-financial aspects of performance, including accountability for the entity's priorities and the quality of service.

.145 Accountability for public money will be secured by the establishment of an effective framework of internal control, and discharged by means of timely, objective, balanced and understandable reporting to stakeholders.

.146 Accordingly, governing bodies of public sector entities need to give a senior executive specific responsibility for ensuring that appropriate advice is given to the governing body on all financial matters, for keeping proper financial records and accounts, and for maintaining an effective system of internal financial control (also see paragraphs .214 and .215).

COMMUNICATION WITH STAKEHOLDERS

.147 **Governing bodies of public sector entities need to establish:**

- **clear channels of communication with their stakeholders on the entity's mission, roles, objectives and performance; and**
- **appropriate procedures to ensure that such channels operate effectively in practice.**

.148 Most public sector entities affect the lives of citizens in a wide range of social and economic activities, and therefore citizens have the right to know what government intends to achieve in a specified period of time, and what it actually accomplished at the end thereof. Therefore a public sector entity needs to account to its stakeholders on its intentions, objectives and strategies and the actual results achieved.

.149 Stakeholders of public sector entities may include:

- the entity or individual(s) electing or appointing the governing body and having responsibility for appraising performance;
- elected representatives (Parliament);
- providers of resources (taxpayers, lenders, bondholders and creditors);
- service providers and partners (employees, contractors, joint venture partners and other government entities);

- users of services (individuals and businesses who benefit from the services that the entity provides);
- interest groups;
- analysts and other statistics gatherers (policy analysts, economists, financial analysts, rating agencies);
- media; and
- the wider community.

.150 To ensure effective communication with stakeholders, public sector entities may:

- establish and publish formal predetermined standards and measures of performance, and report actual performance against them in reports that are public documents. These standards of performance usually relate to key financial and non-financial objectives (also see paragraphs .313 to .332);
- inform stakeholders of their rights to information and services, and how to seek redress should they need it;
- inform stakeholders of contracting and partnership arrangements and how to become involved;
- develop and publish formal procedures for both internal and external enquiries and complaints, and ensure that enquiries and complaints are dealt with promptly and effectively;
- where relevant, establish mechanisms to investigate external complaints, where routine complaints procedures have failed to deal with them to the satisfaction of the complainant; and
- set in place clear procedures for employees to voice concerns or complaints about maladministration, breaches of the law or ethical concerns, in an environment where they will be supported and protected from reprisals. These include a clear hierarchy for raising concerns with line management up to the Chief Executive and governing body members. Employees should be aware of the concerns that can be dealt with by those with specific roles within the organization, such as the chief internal auditor or the individual vested with the power or responsibility to ensure compliance with the law, and of any independent bodies to which they may take their concerns if they are not satisfied with the action taken internally, for example the external auditor, the ombudsman, the regulator or the police.

.151 **Governing bodies of public sector entities need to make an explicit commitment to openness and transparency in all of the activities of the entity, subject only to the need to preserve confidentiality in those specific circumstances where it is proper and appropriate to do so.**

.152 Openness is more than structures and processes. It is also an attitude and belief among key players, politicians, public servants and other stakeholders that information is to be shared and is not owned by any particular entity — it is a public resource.

.153 There is a presumption that as much information as possible about the activities, including policy decisions and actions, of public sector entities needs to be in the public domain, with information only being withheld when it falls within strictly defined criteria. Many jurisdictions have in place legislation designed to improve transparency and protect the public's right to information. Public sector entities need to ensure there are procedures in place to comply with any such legislation and to aim to provide positive and timely responses to any reasonable request for information. However, the confidentiality of personal information and commercial confidences needs to be respected at all times. In some jurisdictions the confidentiality of such information is backed up by data protection legislation.

.154 Public sector entities should develop their own codes of openness, and take steps to ensure that the public are aware of their provisions.

.155 The communication to stakeholders needs to be balanced, understandable, transparent and timely.

.156 The quality of the information needs to be based on the guidelines of openness and substance over form. Reporting usually addresses material matters of significant interest to stakeholders.

.157 Reports should present a balance between the positive and negative aspects of the entity.

.158 In any communication with the stakeholders, the governing body may ask themselves the following four questions:

- Is the communication open and transparent?
- Is it relevant and substantial or merely a communication of form?
- Is the communication prompt and clear?
- Does it fairly set out the position?

.159 **Governing bodies of public sector entities need to report publicly the processes for making appointments to the governing body, and need to make publicly available the names of all governing body members, together with their relevant other interests.**

.160 If public sector entities are to be accountable to their stakeholders it is important that the identity of the members of the governing body is publicized, together with information about both how and why they came to be appointed. This accountability may be discharged by full disclosure in the entity's annual report. In this context "relevant other interests" will include membership of other public sector entities and any significant office-holding and political activity, that is political public speaking and candidature for election, undertaken in the last five years. Such interests need to be disclosed in a publicly available "register of interests".

ROLES AND RESPONSIBILITIES

Balance of Power and Authority

.161 **There needs to be a clearly defined division of responsibilities at the head of public sector entities to ensure a balance of power and authority.**

.162 One way of achieving such a balance is for the governing body to include a balance of executive and non-executive members (including independent non-executives), so that no individual or small group of individuals can dominate the governing body's decision-making. The governing body needs to include non-executive members of sufficient caliber and number for their views to carry significant weight in the governing body's decisions.

.163 The majority of non-executive members of the governing body need to be independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgment. Non-executive members considered by the governing body to be independent in this sense should be identified in the annual report.

.164 Ideally the Chairperson is not the Chief Executive and is a non-executive member of the governing body. Where there is a two-tier governing body structure, a balance is essentially catered for by the separation of executives from non-executives. However, checks and balances are still required at both tiers.

.165 It is suggested that a decision to combine the posts of Chairperson and Chief Executive in one person be publicly justified. Whether the posts are held by different people or by the same person, there needs to be a strong and independent non-executive element on the governing body, with a recognized senior member other than the Chairperson to whom concerns can be conveyed. It is appropriate that the Chairperson, Chief Executive and any senior independent director are identified in the annual report.

.166 In particular, the roles and responsibilities of the governing body, the Chairperson, the non-executive members of the governing body and executive management need to be explicit.

.167 Good governance requires clear definitions of responsibility and a clear understanding of relationships between the organization's stakeholders and those entrusted to manage resources. It needs to be based on an acceptance by all involved in top management that the highest standards of integrity are expected of them, and it needs to be clearly visible in all their actions. Risks can be reduced by making participants in the governance process aware of their roles, responsibilities and accountabilities.

.168 The clarity of roles, responsibilities, and accountability needs to be balanced, so that a productive relationship exists between the governing body and the executive staff.

The Governing Body of a Public Sector Entity

.169 **Every public sector entity needs to be headed by an effective governing body to lead and control the entity, and monitor the executive management.**

.170 Ongoing self-reflection and reassessment of the functions and the effectiveness of the governing body as a whole may contribute to openness to change and innovation rather than only to sustain stability. Such assessments should include assessing the performance of the individual governing body members and that of the Chief Executive.

.171 Governing bodies of public sector entities need to meet regularly.

.172 All governing body members (whether elected or appointed, non-executives or executives) need to have collective responsibility for the stewardship of the entity, including:

- the adoption of a strategic planning process within the policy and resources framework laid down by Parliament, Ministers and/or the regulator; which includes:
  - defining and challenging the vision, mission, annual and longer term objectives and agreeing plans to achieve them;
  - overseeing the delivery of planned results by monitoring performance against agreed strategic objectives and targets, and ensuring corrective action is taken when necessary; and
  - maintaining a forward looking perspective;
- the appointment, development and succession of the senior management;
- the formal approval and adoption of the annual report of the entity, including the financial statements;

- the implementation of an effective communication policy;
- the establishment of an effective system of internal control and information; and
- the identification and monitoring of the principal risks and opportunities of the entity and ensuring appropriate systems are in place to manage these risks (this includes safeguarding the public reputation of the entity).

.173 The governing body needs to assume explicit responsibility for the activities as set out in paragraph .172. The governing body may do this by including their responsibilities for these areas in the annual report or other relevant public documents.

Training, Skills, Information and Advice

.174 **Members of the governing body need to receive appropriate induction training on the first occasion of appointment to the governing body, and subsequently as necessary.**

.175 It is particularly important that members of the governing body receive induction training to gain an understanding both of the public sector context in which the entity operates and of its specific operations and environment. On appointment, new governing body members should make a commitment to undertake induction training that includes awareness of public sector values, and standards of probity and accountability.

.176 Written information on the entity's aims and objectives, control environment and control activities, including key policies and procedures, organizational risks and risk management practices, key personnel, delegation arrangements, governing body and staff structure, as well as its budgeting, planning and performance arrangements, needs to be supplied to members of the governing body. Individual governing body members need to be made aware of their wider responsibilities as members of the governing body, particularly their duty to comply with the letter and spirit of rules relating to the use of public resources, and to act in good faith and in the best interests of the public entity.

.177 Members of the governing body should also receive ongoing awareness training to maintain and enhance skills. Collective or individual training could be considered. It may be appropriate to allocate specific responsibility to keep members of the governing body up to date.

.178 **Governing bodies of public sector entities need to establish appropriate arrangements to ensure that they have access to all such relevant information, advice and resources as are necessary to enable them to carry out their role effectively.**

.179 The governing body should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

.180 Management has an obligation to provide the governing body with appropriate and timely information, but information volunteered by management is unlikely to be enough in all circumstances and members need to make further enquiries where necessary.

.181 In some jurisdictions governing bodies obtain periodic independent reviews. These reviews may involve the contracting of external consultancy services to review the operations of the entity and, where appropriate, suggest changes for improvements or to identify risk, opportunity and focus areas.

.182 The Chairperson needs to ensure that all members are properly briefed on issues arising at governing body meetings. There should be an agreed procedure for members of the governing body in the furtherance of their duties to take independent professional advice, if necessary, at the entity's expense.

.183 The agreed procedure to take professional advice should be laid down formally, for example, in a governing body resolution, or in the letter of appointment/service contract.

.184 Before seeking such professional advice, however, the member concerned needs to discuss and clear the matter with the Chairperson or compliance officer (see paragraphs .216 to .219). If to approach either of them is inappropriate in the circumstances of the matter, the member needs to act with the best interests of the entity being their guideline.

.185 All members of the governing body also need to have access to the advice and services of the compliance officer.

Delegation and Reserved Powers

.186 **To ensure that the direction and control of the entity is firmly in their hands, governing bodies of public sector entities need to establish and maintain an up-to-date framework of delegated or reserved powers that includes a formal schedule of those matters specifically reserved for the collective decision of the governing body.**

.187 Clearly, governing bodies cannot do everything. Therefore, to the extent permitted by legislation and other provisions governing the entity, responsibility for day-to-day management matters is usually delegated to executive management below the governing body so far as is practicable. The framework whereby executive management is empowered to act needs to be explicit and written. The governing body also needs to agree on the procedures to be followed when, in exceptional circumstances, decisions are required between governing body meetings.

.188 The governing body may also decide to delegate, where it has power to do so, responsibility for specified matters to individual members or committees of the governing body. Where responsibilities have been delegated, there is a need to ensure that individual responsibility for decisions can be established, and that such responsibility is made properly accountable so far as the individual is concerned.

.189 However, there will be matters that the governing body specifically reserves for its collective decision, to ensure that the direction and control of the entity remains firmly in the governing body's hands and to safeguard against misjudgments and possible illegal practices. These are likely to include issues of strategy, key strategic objectives and targets, major decisions involving the use of financial and other resources, and personnel issues, including key appointments and standards of conduct. Again, the clarity of roles, responsibilities, and accountability needs to be balanced so that a productive relationship exists between the governing body and the executive staff. The governing body needs to let the managers manage, but should hold them accountable.

.190 The governing body formulates a definition of materiality on matters such as acquisition and disposal of assets, investments, capital projects, authority levels, and specification of delegation levels. The level or definition of materiality is a matter for each entity to decide.

Procedures

.191 **To support them in carrying out their duties, governing bodies of public sector entities need to establish clearly documented and understood management processes for policy development, implementation and review; decision-making, monitoring, control and reporting; and formal procedural and financial regulations to govern the conduct of the governing body's operations.**

.192 Such processes will normally be an integral part of an effective system of control. See Chapter 7: Control.

.193 Procedural regulations to govern the conduct of the governing body's operations normally include the procedures for:

- giving notice of meetings to members of the governing body, including procedures for non-executive members to call meetings;
- voting by members;
- recording of attendance; and
- recording of decisions of the governing body.

Appointments

.194 **There needs to be a formal and transparent process to ensure that appointments to the governing body are made in accordance with specified criteria of competence and on the basis of merit and the individual's ability to carry out a defined role within the organization.**

.195 The responsibility for ensuring the transparent appointment of members of the governing body will differ depending on the overall legislative framework that exists in a particular jurisdiction. In some jurisdictions the governing body may have responsibility for the appointment of members to the governing body. In other cases legislation may provide that a Minister has the legislative power to appoint members of the governing body. In such a case the governing body may have no power or limited influence to appoint members.

.196 In some jurisdictions there is a statutory limit on the length of time a person can serve in certain roles within a public sector entity.

.197 A number of levels of government may also have various responsibilities to ensure the good governance and accountability of public sector entities. In some countries it is often the responsible Minister who has the legislative power to appoint members of governing bodies of certain public sector entities. In some cases the local community elects the governing body. An example in New Zealand is where the School Board of Trustees is the governing body of a school, and members are elected by the parents of the students who attend that school. The Legislature formulated the powers and responsibilities of the School Board in relation to the operation of the school, as well as the accountability of the School Board, in the Education Act (1989) and the Public Finance Act (1989).

.198 Where a governing body has the responsibility for the appointment of its members, each time a vacancy occurs it is preferable that the governing body collectively considers the desired mix of background, experience and skills required in the new governing body member(s) and how they might best be obtained.

.199 If the governing body is large, a nomination committee could be established to make recommendations to the governing body on all new appointments. Usually, a majority of the members of this committee are non-executive members, and the Chairperson is either the Chairperson of the governing body or a non-executive director. The Chairperson and members of the nomination committee need to be identified in the annual report.

.200 Irrespective of whose responsibility it is to make appointments to the governing body, the key criterion for an appointment needs to always be what an individual can contribute to the governing body. The governing body as a whole needs the right balance and mix of individuals, representing a range of relevant backgrounds, experience and professional skills, subject only to the overriding principle that all appointments to public sector entities are made on merit. To operate effectively and efficiently it is important that the governing body has an appropriate mix of skills including operational and technical expertise, financial expertise, legal expertise, and expertise in government and regulatory requirements. The range of skills and background sought in the appointee needs to be clearly specified. The basis on which members are appointed and how they are expected to fulfill their role need to be explicit.

.201 Non-executive members need to be appointed for a specified term subject to re-election. Reappointment should not be automatic, but subject to a performance appraisal by the Chairperson. Letters of appointment need to be given to each non-executive governing body member to clearly set out their duties, responsibilities and fee, if applicable.

.202 It is preferable that executive members are appointed based on contracts subject to the approval of the governing body. Consideration could be given for such contracts to be for a fixed period, and where possible, to include relevant performance standards.

The Chairperson of the Governing Body

.203 **The role of the Chairperson needs to be formally defined in writing, to include responsibility for providing effective strategic leadership to the governing body and to ensure the governing body successfully discharges the overall responsibility for the activities of the entity as a whole.**

.204 The Chairperson may be appointed in different ways, for example, by election and/or government appointment.

.205 The role of Chairperson needs to be separate from that of the Chief Executive.

.206 The Chairperson is preferably an independent and non-executive director. However, if the Chairperson is an executive member, the non-executive members should have a particular responsibility to ensure that the Chairperson encourages proper deliberation of all matters requiring the governing body's attention, and obtains optimum input from all other members of the governing body.

.207 The Chairperson has a key role to play in ensuring that the governing body works effectively. Therefore, the demands on the time of a Chairperson may be quite heavy. He or she needs to not only be competent to fill the role but also have sufficient time to devote to the entity's affairs. The Chairperson's role is critical to the success of the entity.

.208 It is the Chairperson's role to:

- provide leadership to the governing body, ensuring the individual governing body members work together as cohesive team to enable it to carry out its responsibilities effectively;
- enable all governing body members to make a full contribution to the governing body's affairs and make sure the governing body acts as a team. This includes a role in ensuring that all governing body members, when taking up office, are fully briefed on the terms of their appointment and on their duties and responsibilities. It also includes a role in appraising governing body members' performance and the contribution they make to the operations of the entity;
- ensure that there is an effective process of review regarding the performance of the governing body as a whole;
- ensure all members of the governing body have access to all relevant information;
- ensure that key and appropriate issues are discussed by the governing body in a timely manner;

- ensure the governing body has adequate support and is provided efficiently with all the necessary information on which to base decisions;

- ensure that the governing body, in reaching decisions, takes proper account of statutory and other requirements. Management's recommendations are accepted only when the Chairperson is satisfied that the governing body has fully considered all the issues; and

- ensure the governing body meets at regular intervals and that minutes of meetings accurately record decisions taken and, where appropriate, the views of individual governing body members.

Non-Executive Members of the Governing Body

.209 **Non-executive members of public sector governing bodies need to provide an independent judgment on issues of strategy, performance, resources and standards of conduct. Apart from directors' fees they may receive, it is appropriate that they are independent of management and free from any other relationships which may materially interfere with their role. Their duties, terms of office, remuneration and the review thereof, need to be defined clearly.**

.210 In the public sector context, non-executive governing body members represent those governing body members, including the Chairperson, who are independent from management, free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment that is in the best interests of the entity. They are usually not paid for their services under a service or employment contract with the entity, apart from their fee which reflects the time that they commit to the governing body. Refer to paragraphs .123 and .124 for guidance where a governing body wishes to engage a non-executive member to provide remunerated consultancy services to the governing body.

Executive Management

.211 Certain executives, whether members of the governing body (unitary structure) or not (two-tier structure) have particular responsibilities for which they are accountable to the governing body. In this respect, the roles and responsibilities of the functions of Chief Executive, director of finance and compliance officer are particularly significant.

The Chief Executive

.212 **The Chief Executive needs to have line responsibility for all aspects of executive management, whether as a member of the governing body or not. He or she is accountable to the governing body for the ultimate performance of the entity and implementation of the governing body's policy.**

.213 In some parts of the public sector, certain senior executives may have specific statutory responsibility to members of the governing body, which requires them to have rights of direct access to the governing body, rather than through the Chief Executive. However, this does not undermine the Chief Executive's responsibility as head of paid services/personnel.

Financial Officer/Director of Finance

.214 **In addition, a senior executive, whether a member of the governing body or not, needs to be made responsible for ensuring that appropriate advice is given to the governing body on all financial matters, for keeping proper financial records and accounts, and for maintaining an effective system of internal financial control.**

.215 The responsible financial officer is normally a qualified accountant and a member of a recognized accountancy body. Membership of such a body will require compliance with professional (that is ethical and technical) standards over and above any requirements imposed by statute and regulations, and other relevant statements of best practice.

Compliance Officer

.216 **A senior executive, whether a member of the governing body or not, needs to be made responsible to the governing body for ensuring that governing body procedures are followed, and that all applicable statutes and regulations and other relevant statements of best practice are complied with.**

.217 The role envisaged here is analogous to that of the company secretary in the private sector. The Chairperson and the governing body members will look to the compliance officer for guidance on what their responsibilities are and how they should be discharged. The compliance officer will be a source of advice on the implementation of an effective system of governance.

.218 Any question of removal of the compliance officer needs to be considered by the governing body as a whole.

.219 The functions of Chief Executive, financial officer/director of finance and compliance officer need not be carried out by separate individuals. In some organizations all three responsibilities may be vested in the same person. For example, in central government agencies the role of Chief Executive may subsume all three responsibilities. The Nolan report recommends that the responsibilities of Chief Executives should be redefined to emphasize their responsibility for all aspects of propriety. However, where a split in roles is not maintained, the governing body must be satisfied that its management arrangements are consistent with good governance as there are clear risks in merging these roles. The risks relate particularly to the concentration of power in one post and the fact that the roles are clearly different. It is therefore suggested that the roles be clearly defined and split over several posts to ensure that they are discharged effectively.

Remuneration Policy

.220 **Levels of remuneration of members of the governing body need to be sufficient to attract and retain them to run the entity successfully.**

.221 As noted earlier, non-executive members are usually not paid for their services under a service or employment contract with the entity, apart from their fee which reflects their responsibility and the time that they commit to the governing body (also refer to paragraphs .122 to .123 and .230). Therefore, they are neither full-time nor part-time employees of the entity.

.222 The remuneration committee (see paragraph .227) needs to provide appropriate packages to attract, retain and motivate executive members of the quality required. A proportion of executive members' remuneration could be structured so as to link rewards to the entity's and the individual's performance.

.223 Remuneration committees need to judge where to position their entity relative to other entities. They need to be aware what comparable entities are paying and may take account of relative performance. But they should use such comparisons with caution, in view of the risk that they can result in an increase of remuneration levels with no corresponding improvement in performance.

.224 Remuneration committees need to be sensitive to the wider scene, including pay and employment conditions elsewhere in the public sector, especially when determining annual salary increases.

.225 The performance-related elements of remuneration may form a proportion of the total remuneration package of executive members and may be designed to align their interests with those of stakeholders and to give these members keen incentives to perform at the highest levels. It is suggested that the performance contracts address both short-term and medium-term performance measures. The parts of the remuneration of executive members that are performance based need to be consistent with targets set by the governing body.

.226 **Public sector entities need to establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual members of the governing body. It is appropriate that no member is involved in deciding his or her own remuneration.**

.227 To avoid potential conflicts of interest, governing bodies may set up remuneration committees of independent non-executive members to make recommendations to the governing body, within agreed terms of reference, on the entity's framework of executive remuneration and its cost; and to determine on their behalf specific remuneration packages for each of the executive members, including pension rights and any compensation payments. Where applicable, public service regulations need to be adhered to.

.228 It is preferable that remuneration committees consist exclusively of non-executive members who are independent of management and free from any business or other relationship that could materially interfere with the exercise of their independent judgment.

.229 The members of the remuneration committee need to be listed each year in the governing body's remuneration report to stakeholders.

.230 The governing body itself or the stakeholders may determine the fee of the non-executive members, including members of the remuneration committee.

.231 Remuneration committees need to consult the Chairperson and/or Chief Executive about their proposals relating to the remuneration of other executive members and have access to professional advice inside and outside the entity.

Disclosure

.232 **The annual report of a public sector entity needs to contain a statement on the remuneration policy and details of the remuneration of members of the governing body. Such disclosure supports the governance principles of openness and integrity, particularly where members of the governing body have the ability to set their own remuneration.**

.233 The governing body needs to report to the stakeholders each year on remuneration. The report may form part of, or be annexed to, the entity's annual report. It is the main vehicle through which the entity reports to stakeholders on remuneration of the members of the governing body.

.234 The report needs to set out the entity's policy on executive members' remuneration. It usually draws attention to factors specific to the entity.

.235 Separate and full disclosure of the total of the executive and non-executive members' earnings needs to be made in the annual report, and those of the Chairperson and highest paid director. Separate figures need to be shown for salary, fees, other benefits and other performance-related elements.

.236 The number of governing body members and top managers whose remuneration exceeds a defined sum, expressed in bands, may also be disclosed. In some jurisdictions such disclosures may be required by legislation or regulation.

.237 The basis on which performance is measured (for performance-related remuneration) needs to be explained.

CHAPTER 7: CONTROL

RISK MANAGEMENT

.238 **Governing bodies of public sector entities need to ensure that effective systems of risk management are established as part of the framework of control.**

.239 Risk can be defined as a measure of uncertainty, and comprises those factors that can facilitate or prevent the achievement of organizational objectives. Risk management can be viewed as a process of:

- understanding the organizational objectives;
- identifying the risks associated with achieving the objectives;
- assessing the risks, including the likelihood and potential impact of specific risks;
- developing and implementing programs/procedures to address identified risks; and
- monitoring and evaluating risks and the programs/procedures in place to address risks.

.240 The governing body needs to identify internal and external risks on an ongoing basis so it can react to (or initiate) changes in an appropriate and timely manner.

.241 Controls are not regarded as static. As the environment, the entity itself, its objectives and activities change, then so should the systems of control also change. The governing body needs to ensure that it establishes procedures to:

- identify and assess the internal risks (for example, loss of key staff or resources) and opportunities attached to the different activities and resources of the organization;
- identify and evaluate new risks (for example, non-recovery of user charges for a new service) and opportunities arising from new objectives or external factors (such as collaborative arrangements with other levels of government and organizations in the private sector to deliver programs and services — here risks could include partners not meeting commitments, insufficient transparency and inadequate accountability);
- quantify potential liabilities and opportunities;
- review past risks (for example Y2K); and
- attempt to anticipate future risks and changes by monitoring internal and external environments to obtain information that may signal a need to re-evaluate the entity's objectives or control.

.242 Once risks and opportunities have been identified and the likelihood and consequences of their occurring have been evaluated, appropriate policies and procedures can be established to manage them, proportionate to the risk or opportunity involved.

.243 There is a need for other staff to know what risks are acceptable to the governing body and the executive management. In turn, the governing body needs to understand what risks are acceptable to the entity's other stakeholders. Explicit recognition and communication of risks that have been accepted is essential.

INTERNAL AUDIT

.244 **Governing bodies of public sector entities need to ensure that an effective internal audit function is established as part of the framework of control.**

.245 Governing bodies of public sector entities need to ensure that an effective internal audit function is established as part of the system of control, unless the costs of such a function outweigh the benefits to be derived. This may be the case where the size, complexity, geographical distribution or materiality of the goods or services rendered do not justify the associated costs of the internal audit function. In such circumstances the governing body can ensure that the entity is managed to achieve its objectives, is complying with appropriate legislation, policies and procedures, and is performing efficiently and effectively.

.246 Acceptable standards should be applied by the internal audit function, in particular relating to independence, professional proficiency, scope of work and performance of work. The Institute of Internal Auditors *Standards for the Professional Practice of Internal Auditing* may be a useful reference in this respect.

.247 The internal audit function needs to have the respect and co-operation of the governing body, management and the audit committee (refer to paragraphs .252 to .259).

.248 Internal audit needs to be objective, and, as far as possible, operationally independent of the organization's management. It is the responsibility of the audit committee to ensure that conflicts of interests do not arise and that its objectivity and independence are not compromised. The chief internal auditor needs to be accountable and/or have access directly to the chair of the Audit Committee or other senior non-executive director.

.249 The governing body needs to determine the scope of internal audit. An effective internal audit function needs to cover the systematic review, appraisal and reporting of the adequacy of the systems of managerial, financial, operational and budgetary control and their effectiveness in practice, including, at a minimum:

- the relevance of established policies, plans and procedures, the extent of compliance with these, and their financial effect;
- the adequacy of guidance;
- the appropriateness of organizational, personnel and supervision arrangements;
- a review of the operations and programs to ascertain whether results are consistent with established objectives and goals, and whether the operations and programs are being carried out as planned;
- the extent to which assets and interests are accounted for and safeguarded from losses of all kinds arising from waste, extravagance, inefficient administration, poor value for money, fraud or other cause;
- the appropriateness, reliability and integrity of financial and other management information and the means used to identify, measure, classify, report and act upon that information;
- the economy and efficiency with which resources are employed;
- the integrity of computer systems, including systems under development; and

- the follow-up action taken to remedy previously identified weaknesses.

.250 The internal audit function needs to have relevant documented procedures (e.g., an audit charter and manuals) and other guidelines.

.251 Entities that do not have an internal audit function need to explicitly reveal their justification, and should review from time to time the need to establish one.

AUDIT COMMITTEES

.252 **Governing bodies of public sector entities need to establish an audit committee, comprising non-executive members, with the responsibility for independent review of the framework of control and of the external audit process.**

.253 The establishment of audit committees is essentially an "Anglo Saxon" phenomenon. However the reasons for the establishment of an audit committee (see paragraph .259) may also be applicable to other jurisdictions.

.254 To be fully effective, the audit committee is independent of the organization's executive management. To achieve this:

- it is established as a high level sub-committee of the main governing body, and members are given written terms of reference which deal adequately with their membership, authority and duties;

- membership is confined to non-executives[8], although committee members need not all be members of the governing body. Members of the audit committee are named in the annual report;

- the responsible finance officer or director of finance, the chief internal auditor and the external auditors normally attend meetings of the audit committee and have direct access to this committee at any time; other governing body members also have the right to attend;

- the chief internal auditor and the external auditors bring all significant findings arising from audit activities to the attention of the audit committee, and if necessary, the governing body;

- the audit committee schedules discussions with the auditors at least once a year, without the executive governing body members present, to ensure that there are no unresolved issues of concern; and

- the committee has explicit authority to investigate any matters within its terms of reference, the resources it needs to do so, and full access to information. The committee is able to obtain outside professional advice and if necessary, invite outsiders with relevant experience to attend meetings.

.255 It is important that the governing body establishes an audit committee, rather than aiming to carry out its functions themselves, as the existence of an audit committee will enable a more in-depth review to be undertaken. However, in doing so, the governing body does not absolve itself of its overall responsibility for the functions delegated to the audit committee.

.256 The effectiveness of the audit committee will depend on its having a strong Chairperson who has the confidence of the governing body and of the internal and external auditors, and on the quality of its non-executive members.

[8] Non-executive members of the governing body are those members of the governing body who are not also employed in other management roles within the entity.

.257 The Chairperson of the audit committee should not be the Chairperson of the governing body and should neither fulfill an executive role in the organization nor any other role that may conflict with his or her role as chair of the audit committee. However, he or she needs to be a member of the governing body. Other members of the audit committee may be independent of the governing body. The Chairperson of the governing body is normally not a member of the audit committee.

.258 Members of the audit committee need to be appropriately qualified, and receive appropriate information, advice and training to enable them to carry out their roles effectively.

.259 The terms of reference of the audit committee need to be written and confirmed by the governing body. The functions of the audit committee include:

- to provide an oversight function over management's responsibility for the effectiveness of the internal control system;

- to review with management the adequacy of policies and practices to ensure compliance with relevant statutes, directions, guidance and policies;

- to review with management their ability to monitor compliance with relevant standards or codes of governance;

- to review with management the adequacy of the financial information presented to the governing body;

- to ensure that the internal audit function is properly resourced and has appropriate standing within the entity;

- to recommend or approve the hiring or removal of the chief internal auditor and the external auditors. In many jurisdictions appointment of the external auditor may be made by the Legislature or a separate audit regulator and may not be within the remit of the audit committee of the entity;

- to review the activities of the internal audit function, including its annual work program, co-ordination with the external auditors, the reports of significant investigations and the responses of executive management to specific recommendations;

- where relevant, to review the scope and results of the audit and its cost effectiveness, and the independence and objectivity of the auditors. Where the auditors also supply a substantial volume of non-audit services to the company, the committee needs to keep the nature and extent of such services under review, seeking to balance the maintenance of objectivity and value for money; and

- to manage on behalf of the governing body all aspects of the entity's relationship with the external auditors. This includes a review of the audit report and other communication with management, as well as actions taken by management on recommendations included in previous communications, reviewing any non-audit work proposed to be carried out by the external auditors, and ensuring adequate safeguards are in place to prevent possible conflicts of interest and guard the external auditor's independence.

INTERNAL CONTROL

.260 **Governing bodies of public sector entities need to ensure that a framework of internal control is established, and operates in practice, and that a statement on its effectiveness is included in the entity's annual report.**

.261 "Internal control" has been broadly defined by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control – Integrated Framework*, as:

*… a **process**, effected by an entity's board of directors, management and other personnel (**people**), designed to provide **reasonable assurance** regarding the achievement of objectives in the following categories:*

- *effectiveness and efficiency of operations; (**basic operational objectives, performance goals and safeguarding of resources**)*
- *reliability of financial reporting; and*
- *compliance with applicable laws and regulations.*

.262 The Criteria of Control Board (COCO) of the Canadian Institute of Chartered Accountants defines control as[9]:

*… 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 internal and external reporting.*
- *Compliance with applicable laws and regulations and internal policies.*

.263 COCO includes within the scope of control some particular aspects of management that COSO excludes: objective setting, strategic planning and risk management, and corrective actions. COCO excludes from the scope of control only decision-making.

.264 While internal control is a process, its effectiveness is a state or condition of the process at one or more points in time. Internal control systems operate at different levels of effectiveness. Control is effective to the extent that it provides reasonable assurance that the entity will achieve its objectives reliably (COCO). Internal control can be judged effective in each of the three categories respectively, if the governing body of directors and management have reasonable assurance that:

- they understand the extent to which the entity's operational objectives are being achieved;
- published financial statements are being prepared reliably; and
- applicable laws and regulations are being complied with. (COSO)

.265 In reporting on the effectiveness of the entity's framework of internal control, governing bodies need to include in the annual report a statement to the effect that the framework of internal control they have established is both appropriate to the nature of the organization and effective in practice. The statement outlines the arrangements that they have established to enable them to make the required statement. These may take the form of a review of the various systems, risks and opportunities, as well as monitoring of the key control processes and procedures. The criteria against which the system is measured are thus identified, as well as the date on which the conclusion is made.

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[9] The Canadian Institute of Chartered Accountants (CICA), Appendix 1 *Guidance on Control* (1995).

.266 Care needs to be taken to provide staff with the skills required to implement and maintain an internal control system, and to ensure that staff responsible for securing major changes in the system are suitably experienced (also see paragraphs .288 to .296).

.267 Objectives change over time and therefore management needs to periodically assess the effectiveness of control in the entity and communicate the results to the governing body.

.268 Procedures and control activities need to be revised from time to time to ensure their continuing relevance and reliability, especially at times of major change.

.269 The effectiveness of internal control needs to be reviewed and tested regularly. The review covers all control activities, including those related to financial, operational, budgetary, compliance and risk management. The primary responsibility for this rests with management.

BUDGETING, FINANCIAL MANAGEMENT AND STAFF TRAINING

.270 **Governing bodies of public sector entities need to oversee, and need to ensure that procedures are in place that will result in, effective and efficient budgeting and financial management.**

Budgeting

.271 The Legislature is usually responsible for the sanctioning of the overall public sector budget and for authorizing the executive to incur expenditures within the overall level of expenditure (refer to paragraph .033). The governing body of a public sector entity usually approves a budget or financial plan within the overall approved level of expenditure to provide authorization for the acquisition and use of financial resources, and is responsible for overseeing and monitoring the implementation of the approved budget or financial plan.

.272 Budgeting is an essential element of the financial planning, control and evaluation processes of public sector entities. By its nature it is a means of allocating resources to achieving the objectives of a public sector entity, is a management tool for planning, and also a means of controlling funds to ensure that the stated objectives can be met.

.273 Annual budgeting is most successful if it is linked to a medium-term framework (a plan which usually covers a period of about three to five years) containing measurable statements of the objectives of the public sector entity, policies and priorities, strategies for achieving the objectives, and a resource framework to plan for the period (projections of revenues and ceilings). It is often impossible to achieve the objectives within one year, thus it is necessary to plan ahead to ensure the best use is made of resources.

.274 Differing financial circumstances, political organizations and cultures suggest that systems should be developed to meet the needs of individual countries and public sector entities. The most successful systems in practice are those that have been developed to meet the needs of specific public sector entities.

.275 Emphasis needs to be placed on identifying objectives, priorities and activities. The format of the budget documents should provide a clear explanation of the rationale for the proposed allocation of resources. Where possible, public feedback is taken into account in the formulation of the budget.

.276 To be effective, budgeting needs to be integrated with accounting. If a similar basis of accounting is adopted for budgeting purposes and financial reporting, it will provide a framework of accounting information to provide a more rational basis for planning and controlling expenditure and for decisions about its financing.

.277 Even where the accounting system is on an accrual basis of accounting, cash flow budgeting is nevertheless an essential element of effective cash management, and therefore a forecast of the timing of cash inflows and outflows will always be needed.

.278 Regular monitoring against the budget is vital. The revenues or expenditures reported against budgets need to be reliable and readily available for discussion and management action, and projections revised where necessary.

.279 The World Bank Publication, *Financial Accounting Reporting and Auditing Handbook* (FARAH), 1995, states that the budget problems in developing countries relate to:

(a) a lack of appropriate feedback systems;

(b) a failure to integrate budgeting with accounting and cash management functions;

(c) a lack of comprehensive coverage, i.e., certain programs/agencies may be excluded from the budget;

(d) a focus on one year rather than multi-year;

(e) classifications or budget categories not being fully useful for expenditure planning and control;

(f) a lack of focus on goals and programs;

(g) lack of clarity and accuracy in defining recurrent and development expenditures; and

(h) over-emphasis on sophisticated concepts beyond realistic capacity.

.280 Appendix 3 sets out some of the key factors that contribute to making the budgeting process effective in practice.

Financial Management

.281 The governing body of a public sector entity needs to be responsible for overseeing and monitoring effective and efficient financial management in the public sector entity.

.282 The objective of a financial management system in the public sector is to support management in their deployment of limited resources with the purpose of ensuring economy and efficiency in the delivery of outputs (i.e., services and/or goods produced by entities in terms of quantity, quality, cost and time), required to achieve desired outcomes (effectiveness) that will serve the needs of the community.

.283 Financial management embraces daily cash management as well as the formulation of medium and long-term financial objectives, policies and strategies, in support of the operational plan of the entity. It includes the planning and control of capital expenditure, working capital management, and funding and performance decisions. It supervises the supporting financial and management accounting functions, and the internal control environment, as well as supporting financial information systems.

.284 Financial management is of a higher standard when it has strong high-level support, complemented by a strategy of management for results instead of management for compliance. Some characteristics of this strategy are:

- term contracts, supported by performance agreements for Chief Executives and other key staff;

- clearly defined objectives and specified outputs;
- clearly defined responsibility for the Chief Executive and other role players for resources committed to outputs produced;
- strategic planning and operational plans;
- central regulations are reduced to the minimum and are replaced with guidelines;
- Chief Executives have:
  - flexibility in the use of resources;
  - discretion to determine cost allocations;
  - full responsibility to determine staffing requirements and remuneration;
- risk management principles are followed;
- accounting practices similar to those employed in the private sector are followed (accrual basis of accounting);
- incentives are created to ensure improved efficiency; and
- non-financial measures for outputs in terms of quantity, quality and timeliness are introduced and used together with financial measures in the evaluation of performance towards the achievement of predetermined goals.

.285 A sound financial management system needs to be supported by appropriate legislation, regulations, instructions and systems. Trained and competent staff are essential, informed by an efficient information system.

.286 There should be guidelines, manuals or instructions setting out the procedures and regulations to be complied with in public sector financial management and reporting. These documents need to be regularly reviewed for their relevance and updated accordingly.

.287 Management should have useful and reliable information in order to evaluate the operations of the entity. The information system and its operators need to ensure full and proper records are kept of the affairs of the public sector entity. Information systems need to be designed in such a way as to measure costs and the key performance indicators considered essential by management and the governing body in their assessment of the entity's success or failure. The accounting system that produces the financial statements needs to be integrated with other management systems (e.g., cash, budget, treasury and debt management).

Staff Training

.288 **Governing bodies of public sector entities need to ensure that training programs are in place so that staff are competent to perform the task at hand.**

.289 Sound recruitment policies, acceptable conditions of employment and appropriate training programs can contribute to a competent staff force. The quality of financial management in public sector entities is directly related to the ability to obtain and retain qualified financial managers, accountants and program managers.

.290 Salary levels in public sector entities need to be sufficient to attract and retain financial management staff of the right caliber.

.291 Financial managers in the public sector need to be competent and proficient in the following areas to discharge their responsibilities effectively:

• Strategic management	• Information systems
• Performance measurement	• Economy
• Management Accounting	• Presentation
• Financial Accounting	• Analysis
• Operational Planning and Design	• Negotiating
• Budgeting	• Writing
• Internal Control	• Counseling
• Audit	• Facilitation
• Governance	• Conflict management

.292 The critical areas for financial management performance are:

- strategic planning;
- formulation of output objectives, performance measures and operational plans;
- organization (people and structure, operational processes and technology);
- performance measurement, financial and performance reporting;
- management of funds, working capital and other assets;
- reliable and relevant accounting and information systems; and
- procurement and contracting for goods and services.

.293 An assessment of the performance of staff will ensure that individual performance is linked to the operational plan of the public sector entity. Incentives need to be given for good performance to ensure continued improved efficiency, and sanctions need to be instituted for non-performance or sub-standard performance.

.294 All staff of the public sector entity should have a financial management responsibility to a lesser or greater extent. Financial management training opportunities need to be provided to all staff in the public sector entity to ensure that staff are competent to perform the task at hand. Some staff have specialized responsibilities and would require appropriate training.

.295 Staff need to be appropriately supervised and their performance evaluated against an appropriate profile.

.296 Training should be tailored to fit the immediate requirements and career aspirations of staff. The training program needs to integrate formal training with on-the-job training.

CHAPTER 8: EXTERNAL REPORTING

ANNUAL REPORTING[10]

.297 **Governing bodies of public sector entities need to publish on a timely basis an annual report (including financial statements), presenting an objective, balanced and understandable account and assessment of the entity's activities and achievements, and of its financial position and performance and performance prospects.**

.298 To discharge their accountability for public resources, governing bodies need to ensure that they publish an annual report within a reasonable time of the end of the financial year, which includes:

- audited financial statements and auditor's report;
- a statement of the aims and objectives of the entity, the performance measures against which future years' performance will be judged and a comparison of the actual performance achieved in the year covered by the annual report with the performance measures as determined in the previous financial year;
- a statement about how the Chairperson and other governing body members are appointed and the terms of their appointment, together with disclosure of the remuneration policy (refer to paragraphs .194 to .202 and .220 to .231 above); and
- a statement which presents an objective, balanced and understandable commentary on the entity's financial performance and position, its non-financial performance, and on its future ability to meet liabilities and commitments.

.299 The usefulness of financial statements is impaired if they are not made available to users within a reasonable period after the reporting date. International Public Sector Accounting Standards 1 *Presentation of Financial Statements* (IPSAS 1) provides guidance that an entity should be in a position to issue its financial statements within six months of the reporting date. IPSAS 1 is applicable to public sector entities adopting the accrual basis of accounting. Entities adopting the cash basis of accounting (or other basis of accounting) should also be in a position to issue financial statements within six months of the reporting date. Ongoing factors such as the complexity of an entity's operations are not sufficient reasons for failing to report on a timely basis. More specific deadlines are dealt with by legislation and regulations in many jurisdictions. The IFAC PSC encourages the issue of financial statements within three months after the reporting period.

.300 The inclusion of both qualitative and quantitative information may assist with the ready comprehension of the report.

.301 The governing body's responsibility to present a balanced and understandable assessment extends to reports to regulators as well as to information required to be presented by statute.

.302 **Governing bodies of public sector entities need to include in their annual report a statement explaining (at a minimum) that they have the responsibility for:**

- **approving the budget or financial plan to provide authorization for the acquisition and use of financial resources;**

[10] Where an entity is required to, or chooses to, prepare interim financial statements, the guidance in this chapter may also be appropriate in relation to such interim financial statements.

- **the financial statements that fairly present the state of affairs of the entity as at the end of the financial year and the results of the operations for that year;**

- **maintaining an effective framework of control;**

- **ensuring the consistent use of appropriate accounting policies, supported by reasonable and prudent judgments and estimates; and**

- **ensuring adherence to applicable accounting standards.**

.303 Governing bodies of public sector entities are accountable for the stewardship and use of public resources. As such, the financial statements of the entity are those of the governing body. It is important, therefore, that the governing body formally approves and adopts the financial statements of the entity and that a statement of their responsibility for the financial statements is included in the annual report.

.304 Governing bodies of public sector entities need to include in their annual report a statement explaining the auditor's responsibility for reporting on the entity's financial statements.

.305 The annual report needs to be made publicly available.

.306 **Governing bodies of public sector entities need to include in their annual report a statement on whether or not they have adopted standards or codes of governance. This statement should identify the standards or codes adopted, as well as confirm compliance therewith, or if not, in what respect there has not been compliance.**

.307 To demonstrate their commitment to high standards of governance, governing bodies need to include in their annual report a statement that they have complied with relevant standards or codes of governance, identifying the standards or codes adopted and identifying those standards or parts of codes with which they have not complied, for what part of the period such non-compliance continued, and giving reasons for such non-compliance.

.308 The governing body needs to report that the entity is a going concern, with supporting assumptions or qualifications as necessary. Where an entity is reliant on a subsidy or other financial support, this fact needs to be explicitly stated. If there is any doubt about the ability of the entity to continue as a going concern, the reasons should be disclosed and explained. The auditor usually comments on this disclosure in the report of the governing body.

USE OF APPROPRIATE ACCOUNTING STANDARDS

.309 **Governing bodies of public sector entities need to ensure that the financial statements contained in the annual report are prepared in accordance with IPSASs, or another authoritative and recognized set of accounting standards, and applicable legislation.**

.310 Accounting standards are a prerequisite to financial accountability because compliance with accounting standards promotes the reliability, consistency and transparency of financial information.

.311 Accounting standards are authoritative statements of how particular types of transactions and other events should be reflected in the financial statements. Accordingly, compliance with accounting standards will normally be necessary for financial statements to give a fair presentation. Also refer to paragraphs .051 to .060.

.312 In some cases there may be a conflict between the reporting requirements set out in the accounting standards and certain legislative reporting requirements. While the legislative requirement may take precedence in this situation, it may mean that the entity will not be able to state that it complies with the accounting standards in question. For example, IPSAS 1 (paragraph 31) states that "Departures from the requirements of an International Public Sector Accounting Standard in order to comply with statutory/legislative financial reporting requirements in a particular jurisdiction do not constitute departures necessary to achieve fair presentation as outlined in paragraph 28. If such departures are material an entity cannot claim to be complying with International Public Sector Accounting Standards."

PERFORMANCE MEASURES

.313 **Governing bodies of public sector entities need to establish and report relevant performance measures to ensure and demonstrate that all resources have been procured economically and are utilized efficiently and effectively.**

.314 In some countries the management of government expenditures has traditionally focused on a system of expenditure control to ensure that budgetary authority granted by the Legislature is not exceeded. In striving to achieve "appropriation control", the government has traditionally applied the cash basis of accounting whereby expenditures are measured by the payments that are made by public sector entities during the fiscal year. The focus was on the "inputs" side only, with the main emphasis on the borrowing requirement. The cash basis of accounting does not measure the resources consumed during the period under review, thus the actual costs of government programs are not measured, controlled or reported. In the absence of accurate cost information, performance measures of efficiency and cost-effectiveness cannot be readily determined other than by performing relatively expensive ad-hoc studies. The information available cannot appropriately satisfy the need to evaluate or control the operations under review. Public sector entities are therefore encouraged to strive to adopt an accrual basis of accounting, as monitoring of performance against objectives will be easier, and will also provide the information needed to manage cash.

.315 However, financial statements prepared on the accrual basis of accounting are primarily limited to data that is both historical and financial. This information is often not responsive to all the decision-making needs of users, who also need forward-looking and non-financial information.

.316 The public sector is under intense pressure to improve its operations and deliver its products and services more efficiently and at the least cost to the taxpayer. Performance measurement is a useful tool in this regard, since it formalizes the process of tracking progress toward established goals and provides objective justifications for organizational and management decisions. Thus, performance measurement can help improve the quality and reduce cost of government activities.

.317 To improve performance, it is also necessary to measure performance in non-monetary terms. Without information about what is being delivered (outputs), what it is costing (inputs), and what is achieved (outcomes) it is impossible to make efficient resource allocations within the public sector. The objectives of performance measures include responding to accountability requirements, improving service delivery, and reducing costs while maximizing output and increasing productivity in the entity.

.318 Performance measures are therefore useful management and accountability tools. They are needed by both internal and external users. Internal users need information on the entity's effectiveness to make efficiency and quality improvements. Government entities may require performance information to decide how much to spend and where within the sector the spending should be allocated. In particular they will be interested to know what results may be achieved as a consequence of a particular level of funding, or to decide whether or not a service could be delivered more efficiently and effectively by the private sector.

.319 Public sector entities will be held accountable not only for the money entrusted to them, but also for the results achieved. External users will thus also need information on performance measures to assess whether the entity has achieved its objectives effectively and used available resources efficiently and economically, and whether or not further investment is needed.

.320 In the private sector, the inputs and outputs (i.e., purchases and sales) are automatically defined in monetary terms. Profit, essentially the difference between them, is to some extent a measure of the degree to which a business has achieved its objectives. For both private sector and public sector entities, inputs can usually be measured in monetary terms. However, a measurement difficulty may exist with regard to the outputs and outcomes of a public sector entity, due to multiple, non-financial objectives.

.321 Performance measures need to be quantified in terms of identified goals in a time constraint. Even though quality may be difficult to measure, performance measures should attempt to reflect both quality and quantity.

.322 There are different levels of performance measurement. At the lower level of the entity it is possible that these measures may be more specific and technical. However, emphasis is placed on "high-level" performance measures that focus on crucial strategic issues to measure the most important outcomes, rather than the "low-level" performance measures. Low-level measures are developed by reference to already developed high-level measures.

.323 To assess efficiency in an organizational unit it is important that outputs are measured on the same basis as the resources consumed (inputs) to produce them.

.324 A basis of comparison is needed for performance measures. The most usual bases of comparisons are:

- comparison with previous years;
- comparisons with similar entities; and
- comparison of actual with target.

.325 Where comparisons over time are made by a particular entity, then a consistent basis of measurement should be used.

.326 Performance measures should be relevant, understandable, reliable, complete, objective and neutral, timely, and comparable. A balance or trade-off between these qualitative characteristics may often be necessary. Judgment will be necessary in the selection of appropriate performance measures. Effective performance measures take time to design, implement, and perfect. A performance measurement system needs to be approached as an iterative project in which continuous improvement is a critical and constant objective**.**

.327 The credibility of performance information is enhanced if it is subject to external verification. A number of jurisdictions require performance information to be audited.

.328 Performance measures should be predetermined. Without some discipline and standardization regarding the choice of measures, measures may be chosen only to show the entity's performance in a favorable light, and not its actual performance over a broad spectrum of objectives.

.329 Performance measures usually measure:

- *economy* — refers to the acquisition of the appropriate quality and quantity of financial, human and physical resources at the appropriate time and place, and at the lowest possible cost;

- *efficiency* — refers to the use of resources so that output is maximized for any given set of resource inputs, or input is minimized for any given quantity and quality of output provided;

- *effectiveness* — refers to the extent of the achievement of set or predetermined outcomes, objectives or other intended effects of programs, operations, activities or processes; and

- *appropriateness* — whether the objectives or outcomes of programs, operations, activities or processes address the real needs of customers.

.330 A possible classification of performance measures for public sector entities is:

- process measures — measures of activity carried on by the entity ("means" orientated);

- results measures — measures related to the entity's objectives ("ends" orientated); and

- social indicators — broad measures of outcomes which significantly reflect the work and impact of the entity.

Benchmarking

.331 Benchmarking is the process of continuously comparing and measuring an entity against leaders anywhere in the world to gain information that will help the entity take action to improve its performance.

.332 Benchmarking performance can be used as a methodology for organizational improvement; developing performance measurement systems; validating operational position; and to maintain world-class performance. External benchmarking and competitive benchmarking (where comparisons are made with entities outside the organization) are primarily used, while internal benchmarkings and benchmarking consortiums are also used.

EXTERNAL AUDIT

.333 **Governing bodies of public sector entities need to ensure that an objective and professional relationship is maintained with the external auditors.**

.334 An audit committee, as a sub-committee of the governing body (see paragraphs .252 to .259), needs to be responsible for managing the relationship with the external auditors.

.335 In most countries, external auditors have a wider range of responsibilities for reporting on the activities of public sector entities than is the case in the private sector, covering not only the financial statements, but also compliance audits, value for money audits and public interest issues. Also refer to paragraphs .048 to .050.

.336 In managing the entity's relationship with the external auditors on behalf of the governing body, the audit committee's responsibilities include:

- considering, where relevant, the appointment of the external auditor, the audit fee, and any questions of resignation or dismissal;

- considering the objectives and scope of any non-financial audit or consultancy work proposed to be undertaken by the external auditors, and reviewing the remuneration for this work;

- discussing with the external auditor before the audit commences the scope of the audit and the extent of reliance on internal audit and other review agencies;

- discussing with the external auditors any significant issues from the review of the financial statements by either the non-executive management or the auditors (in the absence of executive management where necessary), and any other work undertaken or overseen by the audit committee;

- reviewing and considering the external auditor's communication with management and management's response thereto; and

- reviewing progress on accepted recommendations from the external auditors.

.337 Generally, external auditors are contracted to carry out non-audit work only where the audit committee is satisfied that there are no conflicts of interest and the auditor's independence will not be compromised.

CHAPTER 9: APPLICATION OF GOVERNANCE RECOMMENDATIONS TO CENTRAL GOVERNMENTS

The material in Chapters 3 to 8 applies to public sector entities that have governing bodies resembling boards of directors in the private sector. To apply the same recommendations to a central government, where power is exercised in a more hierarchical and less collegial fashion, may be more complex. In particular, central governments are usually governed by specific legislation and regulations and therefore the scope to apply recommendations of governance may be reduced. Nevertheless, these recommendations suggest possible actions and policies of value to central governments. This Chapter explores the application of the recommendations on governance set out in Chapters 3 to 8 to central government departments.

.338 The introduction to the Study noted that the organizational circumstances to which this guidance is directly applicable are:

> *All arrangements where a government (whether central, regional, or local) delivers a service or activity through a controlled entity (subsidiary), whether that subsidiary entity is or is not wholly controlled by the government or has a separate legal identity.* (paragraph .021)

.339 It was also noted that where a Minister, with senior policy officials, has a direct responsibility for the delivery of a service or activity, in the interest of good governance the Minister may need to ensure that the recommendations of governance in this study are applied in the delegated management arrangements for those activities.

.340 In those circumstances where advice set out in Chapters 3 to 8 is not directly applicable, the basic principles of governance, being openness, integrity and accountability, should still be followed.

.341 **Openness** is required to ensure that stakeholders[11] can have confidence in the decision-making processes and actions of public sector entities, in the management of their activities, and in the individuals within them. Being open through meaningful consultation with stakeholders and communication of full, accurate and clear information leads to effective and timely action and stands up to necessary scrutiny.

.342 **Integrity** comprises both straightforward dealing and completeness. It is based upon objectivity, honesty and high standards of propriety and probity in the stewardship of public funds and management of an entity's affairs. It is dependent on the effectiveness of the control framework and on the personal standards and professionalism of the individuals within the entity. It is reflected both in the entity's decision-making procedures and in the quality of its financial and performance reporting.

.343 **Accountability** is the process whereby public sector entities, and the individuals within them, are responsible for their decisions and actions, including their stewardship of public funds and all aspects of performance, and submit themselves to appropriate external scrutiny. It is achieved by all parties having a clear understanding of those responsibilities, and having clearly defined roles through a robust structure.

STANDARDS OF BEHAVIOR

.344 The Chief Executive has a leadership role — his or her actions need to set a high standard: formally by setting rules and regulations and communicating those standards, and informally through personal adherence to high standards of behavior and the setting of a good example. In a central government

[11] Stakeholders will include the body or individual(s) electing or appointing the governing body and having responsibility for appraising performance, elected representatives (Parliament), providers of resources (taxpayers, lenders, bondholders and creditors), service providers and partners (employees, contractors, joint venture partners and other government entities) users of services (individuals and businesses who benefit from the services that the entity provides), interest groups, analysts and other statistics gatherers (policy analysts, economists, financial analysts, rating agencies), media and the wider community.

environment, the Legislature, or a specific Chief Executive on behalf of all the Chief Executives, may set expected standards of behavior of all public officials. The recommendations of behavior defined in Chapter 5 are well suited to be applied to any governance arrangements in a central government.

ORGANIZATIONAL STRUCTURES AND PROCESSES

.345 In most countries, central government departments do not have a "Board" that serves as a governing body. As set out in Chapter 1, in most central governments there is a separation of executive and legislative functions. A Legislature (Parliament) is usually responsible to ensure that statutory accountability of the Executive is properly discharged, that there is clear accountability for public money and clarity about roles and responsibilities of the Executive and Legislature. To fulfill this responsibility it usually provides authority for the acquisition and use of financial resources and is responsible for overseeing their administration. Management of financial affairs and resources is usually the responsibility of the Executive.

.346 The Legislature is usually responsible for sanctioning the financial plan or budget and authorizing the Executive to make expenditures (within limits), invest, borrow and administer programs in accordance with any laws that may affect them.

.347 The entity's executive management is usually responsible for the planning, directing and controlling of day-to-day operations and for preparing reports that provide an account of their administration. Their responsibilities include directing operations with due regard to economy and efficiency, maintaining an adequate framework of internal control, ensuring compliance with applicable authorities, selecting and applying appropriate accounting policies, safeguarding assets, measuring the effectiveness of programs and reporting on their performance to those to whom they are accountable.

.348 Because it provides financial authority and powers, the Legislature has the right and responsibility to hold government and its entities accountable for the management of their financial affairs and use of resources entrusted to them.

Roles and Responsibilities

.349 In terms of political accountability, the Executive (Ministers/Cabinet of a government) usually carries a collective responsibility for its decisions. Individual ministers are usually **politically accountable** for the operation of their departments in terms of the powers vested in them.

.350 Heads of departments (Chief Executives/Accounting Officers) are usually **operationally accountable** for the discharge of the responsibilities and commensurate authorities delegated to them. In these terms Ministers may be considered responsible for the outcomes of the programs under their charge, while heads of departments/entities are responsible for the outputs achieved. Ministers need to establish clear channels of communication with their stakeholders on the entity's mission, roles, objectives and performance, and appropriate procedures to ensure that they operate effectively in practice.

.351 Distinguishing between political accountability and operational accountability is a helpful device to consider the different roles of Ministers and Chief Executives. However, in practice it may be difficult to separate political accountability from operational accountability. For example, a government may decide to introduce a policy to provide housing to low-income earners. The housing department is assigned responsibility for implementing this policy. A critical part to implementing this policy will be determining the criteria to decide who are low-income earners and therefore who will be eligible to apply for the low-income housing. The housing department may have the responsibility for developing the criteria (operationally accountable). However, because the eligibility criteria are central to the policy, the Cabinet or responsible Minister are also likely to be concerned with the criteria and be held politically accountable for the criteria developed.

.352 There are two reporting levels at which a government is normally held accountable. Firstly, at the level of individual departments/entities and secondly, at the level of the government as a whole. The former is usually the responsibility of the line Ministers and the head of the department/entity as discussed above. The latter is usually the responsibility of the Minister of Finance (and/or the Cabinet), being one of the measures of success in achieving the fiscal plan of the government.

.353 Ministers are thus politically accountable, and the head of the department is operationally accountable to the Legislature for the performance of their department in achieving the policy objectives established by cabinet. Areas of accountability need to be clearly defined. The information to satisfy this accountability may substantially be derived from legislation requiring annual reports that contain inter alia annual financial statements and performance information.

.354 As noted in Chapter 2, to enable parliament to effectively hold the government accountable for its use of resources and management of assets, clarity on the boundaries of the government reporting entity is essential. Accountability cannot be effective without the provision of complete and appropriate information.

.355 It is therefore the responsibility of the Executive with a control over other entities or agencies, to ensure that appropriate governance arrangements are applied in all such controlled entities. It is not adequate to only appoint a governing body of a controlled entity, without ensuring mechanisms are in place to secure adherence to recommendations of governance. Similarly, governing bodies of such controlled entities also have a responsibility to ensure governance of the entities under their control, while government is the ultimate controlling entity.

.356 Where financial support is given to an entity, this entity will not necessarily form part of the entities controlled by government, as it is a prerequisite that the definition of control be met to be included in the consolidated reporting entity. However, the Executive providing the financial assistance needs to be held accountable to ensure that government receives value for money for the financial assistance provided. The entity receiving financial assistance is usually required to report adequate and appropriate information to the Executive.

.357 Some central governments have recently entered into new governance arrangements such as government partnerships and/or contracts with other governments or the private sector to deliver its programs or services. Through these arrangements, traditional delivery of government services has shifted to outside organizations. The Executive should ensure that proper accountability, performance reporting, transparency and protection of public resources in such arrangements are adequate. The governance recommendations in this Study may be used as a guideline in evaluating such governance arrangements.

Chief Executives

.358 The Chief Executive is, in the first instance, accountable to the Minister who appointed the Chief Executive, but he or she is also accountable to the Legislature for the operational aspects of his or her public sector department/entity. A Chief Executive may thus be called to give evidence before the Public Accounts Committee (see paragraph .041*)* on the basis of reports by the legislative auditor (Auditor-General or its equivalent; see paragraphs .043 to .050 and Appendix 2).

.359 Appointment as a Chief Executive vests a responsibility for the overall organization, management and staffing of the body and for its procedures in financial and other matters. The essence of the Chief Executive's role is a personal responsibility for the functions entrusted.

.360 When the Chief Executive fulfills the role of the governing body, his or her responsibilities normally include appropriate arrangements to ensure that public funds and resources are properly safeguarded and are used economically, efficiently, effectively and in accordance with the statutory or other authorities that govern their use.

Accountability for Process

.361 The Chief Executive will be responsible for how results are achieved — taking cognizance of due process and observance of proper procedures. Thus, it is not good enough to deliver a specific set of outputs; they need to be delivered in an appropriate way.

.362 The Chief Executive needs to establish effective arrangements to ensure compliance with all applicable statutes and regulations, and other relevant statements of best practice.

Accountability for Public Resources

.363 The Chief Executive:

- is responsible for accounting for the financial performance, that is the use of the entity's assets and resources in the delivery of services;
- needs to ensure that the department/entity has and maintains an effective, efficient and transparent system of control, including risk management, budgeting and financial management;
- is responsible for the effective, efficient, economical and transparent use of financial and other resources of the entity concerned (value for money — financial implications);
- is responsible for the management, including safeguarding of assets, and the management of the liabilities of the entity; and
- needs to take effective and appropriate steps to:
  - collect all revenue due to the entity concerned; and
  - prevent wasteful expenditure, losses resulting from criminal conduct, and expenditure not complying with legislation ("regularity" of spending — to spend money only for purposes intended).

Accountability for Performance

.364 The Chief Executive is also responsible for the wider, non-financial aspects of performance:

- priorities (defining objectives and allocation of resources to defined objectives); and
- the quality of services rendered.

.365 It may be necessary for the Chief Executive to establish some mechanisms to ensure that he or she obtains independent advice to execute the above responsibilities. In some countries, for example in New Zealand, the Chief Executive Officer of certain government departments has established an Advisory Board. The Advisory Board usually comprises individuals with significant experience in management, and/or the issues facing the entity concerned. In such instances, the advice in this Study dealing with the non-executive members of a governing body could easily be applied.

Relationship between Executive and Staff

.366 The processes for appointing Chief Executives need to be made publicly available. Reference can be made to the guidance in paragraphs .159 to .160.

.367 To strengthen the accountability of the Chief Executive to the Executive (Minister or Cabinet), the Executive as political head could consider entering into a performance agreement with the Chief Executive. The agreement needs to identify the key accountabilities to which the Chief Executive will add value to meet the objectives of the entity. Ministers may be able to dismiss Chief Executives, but this would often be subject to review by another body or person, and the Chief Executive would typically have rights of appeal for unfair dismissal.

.368 Where responsibilities have been delegated by the Chief Executive, there is a need to ensure that individual responsibility for management decisions can be established, and that such responsibility is made properly accountable so far as the individual is concerned. Every employee needs to be accountable for his or her expected contribution towards the successful delivery of outputs.

.369 The Chief Executive could consider entering into performance contracts with senior executive officers. These contracts will be similar to performance agreements between the Minister and the Chief Executive, but will be more limited in scope, as they will only apply to that part of the entity's operations for which the senior executive officers are responsible. They need to be linked to the objectives of the entity set out in strategic and business plans. An assessment of performance of other staff will ensure that the individual performance is linked to the operational plan of the entity.

.370 If implementation of any directive by a Minister (or other executive authority) to the Chief Executive is likely to result in non-compliance with legislation (e.g., overspending) or could infringe the requirements of regularity or propriety, the Chief Executive will usually be responsible unless he or she has informed the Minister in writing of the likelihood of that non-compliance.

.371 Any decision of the Minister (or other executive authority) to proceed with the implementation of such a directive, needs to be in writing, and the Chief Executive needs to file a copy of this decision with the legislative auditor or equivalent body.

Communication with Stakeholders

.372 The advice in this Study set out in paragraphs .147 to .158 regarding communication with stakeholders on the entity's mission, roles, objectives and performance, can also be applied in a central government environment. The Chief Executive makes an explicit commitment to openness and transparency in all of the activities of the entity, subject only to the need to preserve confidentiality in those specific circumstances where it is proper and appropriate to do so.

.373 To ensure openness and transparency, the Chief Executive may also institute periodic external reviews of the entity and establish consultative groups with key stakeholders. The non-financial aspects of the activities of the public sector entity could be subject to external review by a sponsoring department, funding body or regulator, to ensure that the entity fulfills the obligations imposed on it in statute and or regulation, that the conduct of its affairs complies with appropriate standards of conduct and its delivery of services is satisfying predetermined levels of quality.

CONTROL AND EXTERNAL REPORTING

.374 The guidance in Chapter 7 on risk management, internal audit, audit committees, internal control, and budgeting, financial management and staff training, as well as the advice in Chapter 8 on annual reporting, the use of appropriate accounting standards, performance measures and external audit, is generally relevant in the central government environment.

CHAPTER 10: CONCLUSION

.375 The principles of governance — openness, integrity and accountability — are interlinked, and as such the recommendations of governance are mutually supportive and should be taken as a whole.

.376 In many countries, the public sector is undergoing wide-ranging structural and managerial changes and new governance arrangements are emerging. Examples of new governance arrangements include partnering arrangements with other governments or the private sector to deliver programs or services. Through these arrangements, traditional delivery of government services has shifted to outside organizations. This enhances the need for extra vigilance and care to ensure that sound systems of governance are set in place and work in practice.

.377 The recognition of the principles of good governance and the observance of recommendations reflecting those principles should ensure that any potential problems are discovered quickly and resolved. No system of governance can provide total protection against management failure or fraudulent behavior. However, risks can be reduced by making all participants in the governance process — members of governing bodies, employees, auditors and other stakeholders — aware of what is expected from them.

.378 Public expectations of behavior in the public sector are continually rising and this framework of principles and recommendations of governance is offered both as a practical response to these rising expectations and as a practical step forward towards improving the effectiveness of governance across the public sector in countries around the world.

APPENDIX 1: GOOD GOVERNANCE: A CHECKLIST FOR GOVERNING BODIES[12]

This checklist is intended to assist governing bodies to identify potential strengths and weaknesses in governance arrangements. Where the checklist uncovers weaknesses in the governance arrangements, the governing body will need to give further consideration to the specific areas identified.

No.	Question	YES	NO
	STANDARDS OF BEHAVIOR		
	LEADERSHIP		
1	Has the governing body taken steps to ensure that its members exercise leadership by conducting themselves in accordance with high standards of behavior?		
	CODE OF CONDUCT		
2	Has the governing body adopted a formal code of conduct defining the standards of behavior to which individual governing body members and all employees of the entity are required to subscribe?		
3	Does the governing body periodically review adherence to the code of conduct?		
	OBJECTIVITY, INTEGRITY, AND HONESTY		
4	Has the governing body established appropriate mechanisms to ensure that members of the governing body and employees of public sector entities are not influenced by prejudice, bias or conflicts of interest?		
	ORGANIZATIONAL STRUCTURES AND PROCESSES		
	STATUTORY ACCOUNTABILITY		
5	Has the governing body established effective arrangements to ensure compliance with all applicable statutes and regulations, and other relevant statements of best practice?		
	ACCOUNTABILITY FOR PUBLIC MONEY		
6	Has the governing body established appropriate arrangements to ensure that public funds and resources are:		
	• properly safeguarded?		
	• used economically, efficiently, effectively, appropriately, and with due propriety?		
	• used in accordance with the statutory or other authorities that govern their use?		
	COMMUNICATION WITH STAKEHOLDERS		
7	Has the governing body established:		
	• clear channels of communication with the stakeholders on the entity's mission, roles, objectives and performance?		
	• appropriate processes to ensure that such channels operate effectively in practice?		
8	Has the governing body made an explicit commitment to openness and transparency in all the activities of the entity?		

[12] Checklist adapted from *Corporate Governance — A Framework for Public Service Bodies*, CIPFA, July 1995.

		YES	NO
9	Does the governing body:		
	• report publicly the processes for making appointments to the governing body?		
	• make publicly available the names of all governing body members, together with their relevant other interests?		
	ROLES AND RESPONSIBILITIES		
10	Is there a clearly defined division of responsibilities at the head of the body to ensure a balance of power and responsibility?		
11	Does the governing body:		
	• meet regularly?		
	• effectively lead and exercise control over the entity?		
	• monitor the executive management?		
13	Do members of the governing body receive induction training on the first occasion of appointment to the governing body, and subsequently as necessary?		
14	Has the governing body established appropriate arrangements to ensure that it has access to all such relevant information, advice and resources as are necessary to enable it to carry out its role effectively?		
15	Has the governing body established a framework of strategic control (or scheme of delegated or reserved powers)?		
16	Does the governing body keep the framework of strategic control up-to-date?		
17	Does the framework of strategic control include a formal schedule of those matters specifically reserved for the collective decision of the governing body?		
18	Has the governing body established clearly documented and understood management processes for:		
	• policy development, implementation and review?		
	• decision-making, monitoring, control and reporting?		
19	Has the governing body established formal procedural and financial regulations to govern the conduct of its business?		
20	Where the body is responsible for making appointments to the governing body, has it established a formal process to ensure that such appointments are made:		
	• in accordance with specified criteria?		
	• on the basis of merit and the individual's ability to carry out a defined role within the organization?		
21	Where the body is responsible for making appointments to the governing body, are such appointments dealt with by the governing body as a whole?		
22	Is the role of the Chairperson formally defined in writing, and does it include responsibility for providing effective leadership to the governing body and for the activities of the entity as a whole?		

		YES	NO
23	Are non-executive governing body members: • independent of management? • free from any other relationships that may materially interfere with exercising an independent judgment on issues of strategy, performance, resources and standards of conduct?		
24	Where the governing body is responsible for making appointments of non-executives to the governing body, are the: • appointments for a fixed term? • reappointments subject to a formal appraisal process?		
25	Does the Chief Executive have line responsibility for all aspects of executive management?		
26	Is the Chief Executive accountable to the governing body for the ultimate performance of the entity and implementation of the governing body's policies?		
27	Are the duties, terms of office, remuneration and the review thereof, of non-executive governing body members defined clearly?		
28	Has the governing body made a senior executive responsible for ensuring that appropriate advice is given to it on all financial matters and for maintaining an effective system of internal and financial control?		
29	Has the governing body made a senior executive responsible for ensuring that governing body procedures are followed and that all applicable statutes and regulations, and other relevant statements of best practice are complied with?		
30	Has the governing body established a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual members of the governing body?		
31	Has the governing body established procedures to ensure that no member of the governing body is involved in determining his or her own remuneration?		
32	Does the annual report of the governing body contain a statement on the remuneration policy and details of the remuneration of the members of the governing body?		
	<u>CONTROL</u>		
	RISK MANAGEMENT		
33	Has the governing body taken steps to ensure that effective systems of risk management are established as part of the framework of internal control?		
	INTERNAL AUDIT		
34	Has the governing body taken steps to ensure that an effective internal audit function is established as part of the framework of internal control?		

		YES	NO
	AUDIT COMMITTEES		
35	Has the governing body established an audit committee, comprising non-executive members, with responsibility for the independent review of the framework of control and of the external audit process?		
	INTERNAL CONTROL		
36	Has the governing body taken steps to ensure that an effective framework of internal control:		
	• is established?		
	• operates in practice?		
37	Does the governing body include in its annual report a statement on the effectiveness of the body's framework of internal control?		
	BUDGETING AND FINANCIAL MANAGEMENT		
38	Has the governing body ensured procedures are in place to ensure effective and efficient budgeting and financial management?		
	STAFF TRAINING		
39	Has the governing body established training programs to ensure that staff are competent to perform the task at hand?		
	EXTERNAL REPORTING		
	ANNUAL REPORTING		
40	Does the governing body publish on a timely basis an objective, balanced and understandable annual report?		
41	Does the annual report contain a statement explaining the responsibilities of the governing body?		
42	Does the governing body include in its annual report a statement confirming that it has complied with relevant standards or codes of corporate governance?		
43	Does the governing body ensure that financial statements comply with a recognized set of accounting standards?		
	PERFORMANCE MEASURES		
44	Does the governing body institute and report relevant performance measures?		
	EXTERNAL AUDIT		
45	Has the governing body taken steps to ensure that an objective and professional relationship is maintained with the external auditors?		

APPENDIX 2: LEGISLATIVE AUDITING

The Lima Declaration of Guidelines on Auditing Precepts

Foreword

When the Lima Declaration on Auditing Precepts was adopted by an acclamation of the delegates more than two decades ago in October 1977 at the IXth INCOSAI in Lima (Peru) there were great hopes, but no certainty, that it would achieve world-wide success.

The experiences made with the Lima Declaration since that time have exceeded even the highest expectations and proven how decisively they influence the development of government auditing in the given context of each individual country. The Lima Declaration is equally significant for all Supreme Audit Institutions grouped in INTOSAI, no matter to what region they belong, what development they have undergone, how they are integrated into the system of government or how they are organized.

The success of the declaration is above all due to the fact that it contains a comprehensive list of all goals and issues relating to government auditing, while simultaneously remaining remarkably significant and concise, making it easy to use, with its clear language ensuring that focus does not wander away from the main elements.

The chief aim of the Lima declaration is to call for independent government auditing. A Supreme Audit Institution which cannot live up to this demand does not come up to standard. It is not surprising, therefore, that the issue of independence of Supreme Audit Institutions continues to be a theme repeatedly discussed within the INTOSAI community. However, the demands of the Lima Declaration are not satisfied by a SAI just achieving independence; this independence is also required to be anchored in legislation. For this, however, well-functioning institutions of legal security must exist, and these are only to be found in a democracy based on the rule of law.

Rule of law and democracy are, therefore, essential premises for really independent government auditing and are the pillars on which the Declaration of Lima is founded. The precepts contained in the Declaration are timeless and essential values which have maintained their topicality since the years they were first adopted. The fact that it has been decided to re-publish the Declaration more than 20 years later indeed witnesses the quality and farsighted spirit of their authors.

We extend our thanks to the International Journal of Government Auditing for their effort in publishing the new edition of the Lima Declaration, realizing the great importance of this fundamental paper which quite rightly is held to be the Magna Carta of government auditing. We now know that the Lima Declaration will continue to be disseminated in future. Living up to its high ideals remains an ongoing task for us all.

Vienna, in the fall of 1998.

Dr Franz Fiedler Secretary General of INTOSAI

Preamble

The IXth Congress of the International Organization of Supreme Audit Institutions (INTOSAI), meeting in Lima:

- Whereas the orderly and efficient use of public funds constitutes one of the essential prerequisites for the proper handling of public finances and the effectiveness of the decisions of the responsible authorities;
- whereas, to achieve this objective, it is indispensable that each country have a Supreme Audit Institution whose independence is guaranteed by law;

- whereas such institutions become even more necessary because the state has expanded its activities into the social and economic sectors and thus operates beyond the limits of the traditional financial framework;
- whereas the specific objectives of auditing, namely, the proper and effective use of public funds; the development of sound financial management; the proper execution of administrative activities; and the communication of information to public authorities and the general public through the publication of objective reports, are necessary for the stability and the development of states in keeping with the goals of the United Nations;
- whereas at previous INTOSAI congresses, plenary assemblies adopted resolutions whose distribution was approved by all member countries;

RESOLVES:
To publish and distribute the document entitled *The Lima Declaration of Guidelines on Auditing Precepts.*

I. General

Section 1. Purpose of audit
The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent – or at least render more difficult – such breaches.

Section 2. Pre-audit and post-audit
1. Pre-audit represents a before the fact type of review of administrative or financial activities; post-audit is audit after the fact.
2. Effective pre-audit is indispensable for the sound management of public funds entrusted to the state. It may be carried out by a Supreme Audit Institution or by other audit institutions.
3. Pre-audit by a Supreme Audit Institution has the advantage of being able to prevent damage before it occurs, but has the disadvantage of creating an excessive amount of work and of blurring responsibilities under public law. Post-audit by a Supreme Audit Institution highlights the responsibility of those accountable; it may lead to compensation for the damage caused and may prevent breaches from recurring.
4. The legal situation and the conditions and requirements of each country determine whether a Supreme Audit Institution carries out pre-audit. Post-audit is an indispensable task of every Supreme Audit Institution regardless of whether or not it also carries out pre-audits.

Section 3. Internal audit and external audit
1. Internal audit services are established within government departments and institutions, whereas external audit services are not part of the organisational structure of the institutions to be audited. Supreme Audit Institutions are external audit services.
2. Internal audit services necessarily are subordinate to the head of the department within which they have been established. Nevertheless, they shall be functionally and organisationally independent as far as possible within their respective constitutional framework.
3. As the external auditor, the Supreme Audit Institution has the task of examining the effectiveness of internal audit. If internal audit is judged to be effective, efforts shall be made, without prejudice to the right of the Supreme Audit Institution to carry out an overall audit, to achieve the most appropriate division or assignment of tasks and cooperation between the Supreme Audit Institution and internal audit.

Section 4. Legality audit, regularity audit and performance audit
1. The traditional task of Supreme Audit Institutions is to audit the legality and regularity of financial management and of accounting.

2. In addition to this type of audit, which retains its significance, there is another equally important type of audit - performance audit – which is oriented towards examining the performance, economy, efficiency and effectiveness of public administration. Performance audit covers not only specific financial operations, but the full range of government activity including both organisational and administrative systems.
3. The Supreme Audit Institution's audit objectives – legality, regularity, economy, efficiency and effectiveness of financial management – basically are of equal importance. However, it is for each Supreme Audit Institution to determine its priorities on a case-by-case basis.

II. Independence

Section 5. Independence of Supreme Audit Institutions

1. Supreme Audit Institutions can accomplish their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.
2. Although state institutions cannot be absolutely independent because they are part of the state as a whole, Supreme Audit Institutions shall have the functional and organisational independence required to accomplish their tasks.
3. The establishment of Supreme Audit Institutions and the necessary degree of their independence shall be laid down in the Constitution; details may be set out in legislation. In particular, adequate legal protection by a supreme court against any interference with a Supreme Audit Institution's independence and audit mandate shall be guaranteed.

Section 6. Independence of the members and officials of Supreme Audit Institutions

1. The independence of Supreme Audit Institutions is inseparably linked to the independence of its members. Members are defined as those persons who have to make the decisions for the Supreme Audit Institution and are answerable for these decisions to third parties, that is, the members of a decision making collegiate body or the head of a monocratically organised Supreme Audit Institution.
2. The independence of the members shall be guaranteed by the Constitution. In particular, the procedures for removal from office also shall be embodied in the Constitution and may not impair the independence of the members. The method of appointment and removal of members depends on the constitutional structure of each country.
3. In their professional careers, audit staff of Supreme Audit Institutions must not be influenced by the audited organisations and must not be dependent on such organisations.

Section 7. Financial independence of Supreme Audit Institutions

1. Supreme Audit Institutions shall be provided with the financial means to enable them to accomplish their tasks.
2. If required, Supreme Audit Institutions shall be entitled to apply directly for the necessary financial means to the public body deciding on the national budget.
3. Supreme Audit Institutions shall be entitled to use the funds allotted to them under a separate budget heading as they see fit.

III. Relationship to Parliament, government and the administration

Section 8. Relationship to Parliament

The independence of Supreme Audit Institutions provided under the Constitution and law also guarantees a very high degree of initiative and autonomy, even when they act as an agent of Parliament and perform audits on its instructions. The relationship between the Supreme Audit Institution and Parliament shall be laid down in the Constitution according to the conditions and requirements of each country.

Section 9. Relationship to government and the administration

Supreme Audit Institutions audit the activities of the government, its administrative authorities and other subordinate institutions. This does not mean, however, that the government is subordinate to the Supreme Audit Institution. In particular, the government is fully and solely responsible for its acts and omissions and cannot absolve itself by referring to the audit findings – unless such findings were delivered as legally valid and enforceable judgments – and on expert opinions of the Supreme Audit Institution.

IV. Powers of Supreme Audit Institutions

Section 10. Powers of Investigation

1. Supreme Audit Institutions shall have access to all records and documents relating to financial management and shall be empowered to request, orally or in writing, any information deemed necessary by the SAI.
2. For each audit, the Supreme Audit Institution shall decide whether it is more expedient to carry out the audit at the institution to be audited, or at the Supreme Audit Institution itself.
3. Either the law or the Supreme Audit Institution (for individual cases) shall set time limits for furnishing information or submitting documents and other records including the financial statements to the Supreme Audit Institution.

Section 11. Enforcement of Supreme Audit Institution findings

1. The audited organisations shall comment on the findings of the Supreme Audit Institution within a period of time established generally by law, or specifically by the Supreme Audit Institution, and shall indicate the measures taken as a result of the audit findings.
2. To the extent the findings of the Supreme Audit Institution are not delivered as legally valid and enforceable judgments, the Supreme Audit Institution shall be empowered to approach the authority which is responsible for taking the necessary measures and require the accountable party to accept responsibility.

Section 12. Expert opinions and rights of consultation

1. When necessary, Supreme Audit Institutions may provide Parliament and the administration with their professional knowledge in the form of expert opinions, including comments on draft laws and other financial regulations. The administrative authorities shall bear the sole responsibility for accepting or rejecting such expert opinions; moreover, this additional task must not anticipate the future audit findings of the Supreme Audit Institution and must not interfere with the effectiveness of its audit.
2. Regulations for appropriate and as uniform as possible accounting procedures shall be adopted only after agreement with the Supreme Audit Institution.

V. Audit methods, audit staff, international exchange of experiences

Section 13. Audit methods and procedures

1. Supreme Audit Institutions shall audit in accordance with a self-determined programme. The rights of certain public bodies to request a specific audit shall remain unaffected.
2. Since an audit can rarely be all-inclusive, Supreme Audit Institutions as a rule will find it necessary to use a sampling approach. The samples, however, shall be selected on the basis of a given model and shall be sufficiently numerous to make it possible to judge the quality and regularity of financial management.
3. Audit methods shall always be adapted to the progress of the sciences and techniques relating to financial management.
4. It is appropriate for the Supreme Audit Institution to prepare audit manuals as an aid for its auditors.

Section 14. Audit staff

1. The members and the audit staff of Supreme Audit Institutions shall have the qualifications and moral integrity required to completely carry out their tasks.
2. In recruiting staff for Supreme Audit Institutions, appropriate recognition shall be given to above-average knowledge and skills and adequate professional experience.
3. Special attention shall be given to improving the theoretical and practical professional development of all members and audit staff of SAIs, through internal, university and international programs. Such development shall be encouraged by all possible financial and organisational means. Professional development shall go

beyond the traditional framework of legal, economic and accounting knowledge, and include other business management techniques, such as electronic data processing.
4. To ensure auditing staff of excellent quality, salaries shall be commensurate with the special requirements of such employment.
5. If special skills are not available among the audit staff, the Supreme Audit Institution may call on external experts as necessary.

Section 15. International exchange of experiences
1. The international exchange of ideas and experiences within the International Organization of Supreme Audit Institutions is an effective means of helping Supreme Audit Institutions accomplish their tasks.
2. This purpose has so far been served by congresses, training seminars jointly organised with the United Nations and other institutions, by regional working groups and by the publication of a professional journal.
3. It is desirable to expand and intensify these efforts and activities. The development of a uniform terminology of government audit based on comparative law is of prime importance.

VI. Reporting

Section 16. Reporting to Parliament and to the general public
1. The Supreme Audit Institution shall be empowered and required by the Constitution to report its findings annually and independently to Parliament or any other responsible public body; this report shall be published. This will ensure extensive distribution and discussion, and enhance opportunities for enforcing the findings of the Supreme Audit Institution.
2. The Supreme Audit Institution shall also be empowered to report on particularly important and significant findings during the year.
3. Generally, the annual report shall cover all activities of the Supreme Audit Institution; only when interests worthy of protection or protected by law are involved shall the Supreme Audit Institution carefully weigh such interests against the benefits of disclosure.

Section 17. Method of reporting
1. The reports shall present the facts and their assessment in an objective, clear manner and be limited to essentials. The wording of the reports shall be precise and easy to understand.
2. The Supreme Audit Institution shall give due consideration to the points of view of the audited organisations on its findings.

VII. Audit powers of Supreme Audit Institutions

Section 18. Constitutional basis of audit powers; audit of public financial management
1. The basic audit powers of Supreme Audit Institutions shall be embodied in the Constitution; details may be laid down in legislation.
2. The actual terms of the Supreme Audit Institution's audit powers will depend on the conditions and requirements of each country.
3. All public financial operations, regardless of whether and how they are reflected in the national budget, shall be subject to audit by Supreme Audit Institutions. Excluding parts of financial management from the national budget shall not result in these parts being exempted from audit by the Supreme Audit Institution.
4. Supreme Audit Institutions should promote through their audits a clearly defined budget classification and accounting systems which are as simple and clear as possible.

Section 19. Audit of public authorities and other institutions abroad
As a general principle, public authorities and other institutions established abroad shall also be audited by the Supreme Audit Institution. When auditing these institutions, due consideration shall be given to the constraints laid down by international law; where justified these limitations shall be overcome as international law develops.

Section 20. Tax audits

1. Supreme Audit Institutions shall be empowered to audit the collection of taxes as extensively as possible and, in doing so, to examine individual tax files.
2. Tax audits are primarily legality and regularity audits; however, when auditing the application of tax laws, Supreme Audit Institutions shall also examine the system and efficiency of tax collection, the achievement of revenue targets and, if appropriate, shall propose improvements to the legislative body.

Section 21. Public contracts and public works

1. The considerable funds expended by public authorities on contracts and public works justify a particularly exhaustive audit of the funds used.
2. Public tendering is the most suitable procedure for obtaining the most favourable offer in terms of price and quality. Whenever public tenders are not invited, the Supreme Audit Institution shall determine the reasons.
3. When auditing public works, the Supreme Audit Institution shall promote the development of suitable standards for regulating the administration of such works.
4. Audits of public works shall cover not only the regularity of payments, but also the efficiency of construction management and the quality of construction work.

Section 22. Audit of electronic data processing facilities

The considerable funds spent on electronic data processing facilities also calls for appropriate auditing. Such audits shall be systems-based and cover aspects such as planning for requirements; economical use of data processing equipment; use of staff with appropriate expertise, preferably from within the administration of the audited organization; prevention of misuse; and the usefulness of the information produced.

Section 23. Commercial enterprises with public participation

1. The expansion of the economic activities of government frequently results in the establishment of enterprises under private law. These enterprises shall also be subject to audit by the Supreme Audit Institution if the government has a substantial participation in them — particularly where this is majority participation — or exercises a dominating influence.
2. It is appropriate for such audits to be carried out as post-audits; they shall address issues of economy, efficiency and effectiveness.
3. Reports to Parliament and the general public on such enterprises shall observe the restrictions required for the protection of industrial and trade secrets.

Section 24. Audit of subsidised institutions

1. Supreme Audit Institutions shall be empowered to audit the use of subsidies granted from public funds.
2. When the subsidy is particularly high, either by itself or in relation to the revenues and capital of the subsidised organization, the audit can, if required, be extended to include the entire financial management of the subsidised institution.
3. Misuse of subsidies shall lead to a requirement for repayment.

Section 25. Audit of international and supranational organisations

1. International and supranational organisations whose expenditures are covered by contributions from member countries shall be subject to external, independent audit like individual countries.
2. Although such audits shall take account of the level of resources used and the tasks of these organisations, they shall follow principles similar to those governing the audits carried out by Supreme Audit Institutions in member countries.
3. To ensure the independence of such audits, the members of the external audit body shall be appointed mainly from Supreme Audit Institutions.

APPENDIX 3: BUDGET PREPARATION PROCESS – KEY FACTORS

Some of the key factors which contribute to making the budgeting process effective in practice are outlined in this appendix.[13]

Transparency	• the budget documents provide a clear link between objectives and expenditures; • all participants in the budget process are clear about their roles and responsibilities; • simple, well-documented procedures; • well-defined basis of budgeting e.g., incremental, zero-based etc.; and • departmental/entity targets and resources are allocated, clearly indicated and explained.
Management	• effective budgeting involves more than simply preparing annual budgets; • the management and monitoring of the budget are equally important, with an emphasis on results achieved.
Decentralization	• all decision-making taking place at the center is potentially inefficient and may undermine the budget system .
Co-ordination and co-operation	• all those involved in the budget process are required to ensure links between recurrent and development budgets and the processes in the financial management system.
Integration	• of recurrent and development budgets: the recurrent costs arising from the development projects need to be built into recurrent expenditure planning and trade-offs between recurrent and development expenditure considered for sustainability.
Flexibility	• the system allows responses to changed circumstances: these responses are built into the system, so that implications of any changes are sufficiently analyzed and still fit within the public sector entity's overall objectives and priorities.
Discipline	• although the system provides flexibility, there is also effective control over expenditures; • any changes to the budget are carefully analyzed and justified; • only limited use of supplementary estimates; and • penalties for breach of rules and regulations.
Link to medium term framework (MTF)	• link between the resource framework of the MTF and the annual budget; and • link between the policies and priorities of the MTF and the budget allocations.

[13] Based on the The United Nations Development Program, *The Draft Country Assessment in Accountability & Transparency Report*, February 1997

Accountability and credibility	• governing body involvement: good links between the governing body and the Executive; • involvement of accountability of senior managers in all stages of the process; • if the Executive do not believe that they will be held to their ceilings, or if they can easily by-pass normal procedures, the whole process of budgeting can be undermined; and • budgets are reliably close to actual outcome.
Comprehensive	• the budget process and documents need to include all revenues and expenses, including aid funds; as well as information on previous year's and current year's expenses.
Performance measurement	• measuring the impact of the budget through output performance measurements for recurrent and development expenses.

APPENDIX 4: A GOVERNANCE INFORMATION CHECK-UP

The CCAF (a foundation formed by the legislative auditing community in Canada) published a self-diagnostic check-up to help members of governing bodies and their senior management to determine what performance issues are important in their organization, and what information governing bodies require about these issues to fulfill their decision-making and accountability responsibilities[14].

MANAGEMENT DIRECTION – *Does everyone understand what they are meant to be doing?*

- [ ] whether our organization's mission and priorities are clear, and are understood and shared throughout the organization
- [ ] whether there are shared values that bind our organization together and help the diversity of professional, administrative and cultural backgrounds work together
- [ ] whether staff have the authority and tools they need to make decisions and take action, consistent with the responsibilities assigned to them

RELEVANCE – *Do our activities continue to make sense in terms of the conditions, needs or problems to which they are intended to respond?*

- [ ] knowing the nature and extent of these conditions, needs or problems — now, and as they may have changed over time
- [ ] knowing what other organizations are doing in relation to these conditions, needs or problems
- [ ] understanding the added-value that our products or services are intended to provide in this context

APPROPRIATENESS – *Are levels of effort and selected methods of pursuing objectives sensible and sufficient?*

- [ ] the degree to which each product or service is necessary to the accomplishment of stated objectives
- [ ] whether our products or services are designed and delivered in a manner that best responds to the nature and extent of the conditions, needs or problems identified
- [ ] whether the overall level and distribution of effort represented by our products or services is proportional to stated objectives, identified needs, etc.

ACHIEVEMENT OF INTENDED RESULTS – *How challenging are our established goals, and have they been accomplished?*

- [ ] extent to which our achievements in key result areas meet expectations in terms of (as applicable): the conditions, needs or problems concerned; established performance targets; past organizational performance; the performance of comparable organizations or activities

[14] This appendix is extracted from the self-diagnostic check-up prepared by the CCAF – *A Governance Information Check-Up*.

☐ whether we are meeting our own prescribed standards of practice, i.e., we are doing the right things right

ACCEPTANCE – *Are clients and other key stakeholders satisfied with the organization and its products or services?*

☐ knowing the expectations of our clients and other key stakeholders and understanding the basis for these expectations

☐ the extent to which our clients and stakeholders indicate acceptance or satisfaction with the organization and its products or services

☐ whether the organization and its products or services are respected within its peer network

SECONDARY IMPACTS – *What are the unintended effects of our activities, be they positive or negative?*

☐ understanding the secondary impacts (e.g., social, economic, financial, environmental, etc.) that our activities, products or services could have on our clients, other key stakeholders, related organizations and programs, and/or the community at large

☐ being able to explain secondary impacts that significantly impede or work at cross-purposes to our stated objectives, or where such information might call into question the value attached to primary objectives

COST AND PRODUCTIVITY – *Are the relationships between costs, inputs and outputs favorable?*

☐ whether defined product and service standards are being met at least cost

☐ the extent to which there is an appropriate balance between capital investments and operating expenses, overhead and operations expenses, capacity-utilization of major resources, etc.

☐ how we compare to similar organizations with respect to the above matters

RESPONSIVENESS – *How well are we anticipating and responding to change?*

☐ whether the organization has effective networks and processes to identify and assess important events and trends in its environment

☐ the degree to which the organization has a history of being able to adapt or respond successfully to changing needs, circumstances, etc

☐ how the practices and track-record of the organization in this regard compare to similar organizations

FINANCIAL RESULTS – *How good are the financial results in terms of matching costs with revenues and appropriations, and financial assets with obligations?*

☐ whether our books of account, records and financial management control and information systems are in accordance with sound financial policies and procedures

☐ how our cost and revenue ratios compare to similar organizations

☐ the extent to which our organization's overall financial position is viable

WORKING ENVIRONMENT – *Is it a happy, healthy and constructive working environment where staff are motivated to work together, adapt to change, and develop?*

☐ the degree to which our staff have the ability and opportunity to provide services to clients in a way that is valued by clients

☐ whether our staff are performing to stated and agreed expectations, and are receiving appropriate recognition for their efforts

☐ whether our human resources management plan is integrated into the organization's culture and operating plans, thus enabling the recruitment, retention, development and replenishment of well-qualified people

PROTECTION OF ASSETS – *How well do we protect against surprise events or losses of key personnel, critical occupations, client information, facilities, equipment, inventories, processes or agreements?*

☐ whether we have strategies that adequately respond to the nature and level of risk of impairment or loss of our organization's key assets

☐ whether these strategies and the organization's performance comply with applicable regulations

☐ how these strategies and performance compare with the industry in general

MONITORING AND REPORTING – *Do management have the information they need to support their decision-making and their own accountability, and do they use it appropriately?*

☐ whether management receive complete, credible and fair information that satisfies their decision-making and accountability requirements

☐ whether accountability reporting by management is done in a transparent manner; the right things are reported to the governing body at the right time and in the appropriate level of detail or aggregation

☐ the extent to which monitoring and reporting systems and processes are cost-effective

APPENDIX 5: INDICATORS OF GOVERNMENT FINANCIAL CONDITION

The Canadian Institute of Chartered Accountants issued a research report that identified ten financial indicators that measure, report and track a government's overall financial condition. These indicators would help general users gain a better understanding of the financial health of a government. The indicators focus on the government's sustainability, flexibility and vulnerability. These indicators are listed below.

Sustainability
- Debt-to-Gross Domestic Product (GDP)
- Deficit-to-GDP

Flexibility
- Public Debt Charges-to-Revenues
- Changes in Physical Capital Expenditures-to-Capital Stock
- Own Source Revenues-to-GDP

Vulnerability
- Government to Government Transfers-to-Revenues
- Foreign Held Government Debt-to-Government Net Debt
- Foreign Currency Debt-to-Government Net Debt
- Current Account Balance-to-GDP
- Total External Debt-to-GDP

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